Regulatory Focus: Cryptocurrency

(March 2018)

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Overview

Following building coverage by the media and attention from seasoned investment professionals (as well as an influx of novice investors), it should not come as a surprise that cryptocurrency was noted as an examination priority for both the SEC and FINRA this year. According to the 2018 Exam Priorities Report released in February, OCIE plans to monitor the sale of products in the cryptocurrency and initial coin offering markets and examine for regulatory compliance in instances where products are determined to be securities. Per a brief IA Watch interview with OCIE Director Peter Driscoll, the Commission is considering an initiative that would focus on companies that operate in the cryptocurrency space. In addition to determining whether offerings should be considered securities, OCIE will focus primarily on whether sufficient precautions are maintained to protect these assets from theft or misappropriation, and whether financial professionals are adequately disclosing the risks associated with these products.

More recently, however, the SEC released a "Statement on Potentially Unlawful Online Platforms for Trading Digital Assets," that expands their existing focus, which primarily scrutinizes digital currencies and their developers, to include any companies involved in the trading of digital assets, as well as "digital wallet services" that hold digital assets. They made their point abundantly clear in the statement, noting that, "if a platform offers trading of digital assets that are securities and operates as an "exchange," as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration." Additionally, the statement noted that digital wallet services "and other services offered by platforms may trigger other registration requirements under the federal securities laws, including broker-dealer, transfer agent, or clearing agency."

The release did not specifically mention any of the major cryptocurrencies, such as Bitcoin (BTC/XBT) and Ethereum (ETH). This may be due to the fact that the release was, in some capacity, intended as a warning for newer digital coins that may attempt to circumvent or blatantly ignore securities laws. Such companies have been participating in fundraisers- known as token sales or initial coin offerings, and heavily promoting too-good-to-be-true rates of return, an approach which has garnered billions of dollars world-wide- all while remaining unregistered and flying under the regulatory radar.

All of this information seems to point to the fact that the SEC, and likely FINRA, are aiming to treat cryptocurrencies as securities in the near future, which would mean that appropriate registration of all parties involved in managing, trading, holding, or transferring them is the key to avoiding regulatory trouble and enforcement actions. Additionally, the buzz surrounding this market is not lost on investors; Bitcoin's value tumbled after the release of the SEC's statement. It is safe to venture that investors of

varying levels of sophistication looking to enter the crypto space will likely place more trust – and therefore funds- in a company that is conscious of regulatory implications and relevant securities laws. Companies vehemently denying that coins and tokens are securities, avoiding registration, or disregarding securities laws or private placement rules are beginning to raise more red flags than dollar signs in the eyes of potential investors.

Interestingly, Google will be prohibiting the publication of ads relating to Bitcoin and other cryptocurrencies starting in June 2018. The ban was announced in Google's annual “bad ads” report, which reviews deceptive or malicious ads that the company ultimately decided to remove. "We don't have a crystal ball to know where the future is going to go with cryptocurrencies, but we've seen enough consumer harm or potential for consumer harm that it's an area that we want to approach with extreme caution," Google's Director of Sustainable Ads, Scott Spencer, told CNBC. The announcement mirrors a move by Facebook, which banned cryptocurrency-related ads from its platform in January following criticism from users for displaying ads promoting get-rich-quick schemes and potential fraudulent ventures. Twitter is following suit as well, and will be removing all crypto ads over the next two weeks and banning future posts of that nature, citing concerns over distributing deceptive ads to users.

The SEC seems to be applying the Howey Test when determining whether a coin offering should be considered a security. We recommend that financial professionals wishing to avoid any negative scrutiny from regulatory bodies do the same. Below, we will walk through the Howey test and how it applies to a coin offering, using DAO as an example.

The Howey Test

Designed as the result of a ruling by the Supreme Court as a means of determining whether certain transactions qualify as “investment contracts,” this test will determine whether an investment is subject to regulatory oversight. Under the Howey Test, a transaction is an investment contract if:

1. It is an investment of money
2. There is an expectation of profits from the investment
3. The investment of money is in a common enterprise
4. Any profit comes from the efforts of a promoter or third party

It is important to note that the SEC has been very clear on the fact that if something is “virtual,” this does not categorically exempt it from being considered a security.

Let's break it down by each criterion, as applicable to the example (the purchase of DAO tokens). Per an investigative report released by the SEC in July 2017:

1. **Investment of Money** - The SEC determined that Ether ("ETH"), the Ethereum cryptocurrency used by investors to purchase DAO Tokens, was an "investment of money," noting that "such investment is the type of contribution of value that can create an investment contract under *Howey*."

2. **Common Enterprise** - The SEC also determined that purchasers of DAO Tokens were investing in a common enterprise, focusing on The DAO's promotional materials, which "informed investors that The DAO was a for-profit entity whose objective was to fund projects in exchange for a return on investment" by pooling the ETH raised from the sale of DAO Tokens.

3. **Reasonable Expectation of Profits** - The SEC also looked to The DAO's promotional materials to conclude that "[i]nvestors who purchased DAO Tokens were investing in a common enterprise and reasonably expected to earn profits through that enterprise," and that because DAO Tokens entitled investors to a share in potential profits, a "reasonable investor would have been motivated, at least in part, by the prospect of profits on their investment of ETH in The DAO."

4. **Derived from the Managerial Efforts of Others** - The SEC concluded that the investors relied on the "managerial and entrepreneurial efforts" of The DAO's creators and others selected by the creators to assist them to generate profits for investors. The SEC focused in part on the active involvement of The DAO's creators, who held themselves out as experts in Ethereum and provided active oversight of the DAO.

In this instance, investing money- cryptocurrencies included- in a token with an expectation of profit (to be derived from the managerial efforts of a third party) lead the SEC to the conclusion that cryptocurrencies are securities and are therefore required to be regulated as such.

Best Practices

Cause for Concern

The DAO raised US$150 million worth of ether from over 11,000 investors. Despite assertions that the DAO's code had been analyzed by "one of the world's leading security audit companies" and that "no stone was left unturned during those five whole days of security analysis," DAO was hacked. $50 million

USD of ether was stolen from investors and intensified a growing trend of mistrust and skepticism surrounding the cryptocurrency market. Coincheck, a cryptocurrency exchange in Japan, is under government scrutiny after hackers stole an estimated $530 million from users in January. This is the largest theft of this nature on record, overshadowing the estimated $450 million in Bitcoin stolen in 2014.

Safeguarding Assets from Theft & Misappropriation

As previous hacks and stolen assets cause alarm amongst investors, when selecting a financial professional to facilitate cryptocurrency investment, experts have recently recommended that investors should perform rigorous due diligence and seek out financial institutions that have safeguards in place to protect customer data and funds. They also recommend that investors ask whether financial institutions utilize a platform that employs a two-step authentication during login, such as a password and additional security questions or codes. In addition, insiders indicate that any reputable system will offer protections against money laundering, Know Your Customer (KYC) procedures, an easily accessible application for trading and price tracking, and a fast and way to move cash between an outside bank account and the cryptocurrency "wallet." Investors equate liquidity with security and legitimacy.

Firms should consider implementing procedures of this nature to satisfy regulators, protect client assets and information, and give potential investors peace of mind that is not offered by many companies when investing in cryptocurrency.

Additional Best Practices

The growing trend of investors performing rigorous due diligence prompts a lot of additional questions that financial institutions operating in the cryptocurrency space should be prepared to address, from having stringent policies in place, to being able to speak on issues and provide documentation to potential clients and investors. Industry experts have suggested the following (not-exhaustive) list of questions that investors should consider before investing in digital currency, whether directly or through an adviser or broker-dealer:

- How long has the company been operating?
- Are they insured?
- Do they have any affiliations?
- Are they registered with a regulatory body?
- What is their reputation in the market?
- What is the fee structure?

- Who can you contact to discuss investments, address questions, etc.?
- Is the company up front about providing fees prior to investment and/or trading?
- Where are they located? (Many insiders warn against using exchanges based in areas of the world where consumer protections are weak, preferring those operating from the United States and Europe, where there are at least some regulation and consumer protection.)

Based on the above questions at the front of investors' (and regulators') minds, a clear picture is emerging of what it means to be a trustworthy, legitimate business operating in this space, principally: liquidity of investments, visible efforts to protect client assets and data, and transparent and accessible communication with clients. Regulators want to see that you are putting the needs of your clients ahead of your own; investors want to know that you are not just another digital currency scam.

Disclosure of Risk

In a developing market such as this, appropriate disclosure with respect to the risk of investment is just as important as appropriate registration and policies and procedures. Firms handling digital currencies should consider drafting disclosures that address the volatility of the market, the uncertainty of the investment, and the unique nature of a market that is currently unregulated, and should consider including language that is reflective of these issues in promotional materials and contracts. In addition, firms should pay particular attention to disclosures when handling digital currency investments with respect to retail clients and, as a rule, should avoid investing retirement funds.

The U.S. Commodity Futures Trading Commission has issued a cautionary statement, noting that "virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, or a store of value, but it does not have legal tender status. Virtual currencies are sometimes exchanged for U.S. dollars or other currencies around the world, but they are not currently backed nor supported by any government or central bank. Their value is completely derived by market forces of supply and demand, and they are more volatile than traditional fiat currencies." Unlike money held at banks that are backed by various safety nets such as the Federal Deposit Insurance Corporation, digital currencies and coin offerings lack a similar option. Those who choose to invest in the market should only invest an amount that they can afford to lose and should not utilize retirement funds to buy cryptocurrencies.

With all of the stories touted by coin offering advertisements (and those reported in the media) that depict "Average Joe" types with no investment experience who made millions in the digital currency market, it is important to ground investors and remind them that cryptocurrency can be volatile, returns are not guaranteed, and investments are not insured.

Conclusion

In a developing and volatile cryptocurrency market full of unknowns, it is better to be safe than sorry. Showing good faith with regulators by ensuring compliance with securities laws and adopting appropriate policies and procedures surrounding cryptocurrencies holds the potential to pay off in the end – with regulators and investors alike. There is a growing trend of investors of varying levels of sophistication performing keen due diligence when attempting to enter the cryptocurrency market. As such, being able to prove that your policies and procedures address their concerns can help you attract clients in this space. In addition, a strong compliance program and a proactive approach to operating in the cryptocurrency market will help facilitate compliance with regulatory guidance which is clearly on the horizon and will help to avoid regulatory issues caused by failing to register or operate appropriately.

If you are looking to get into the cryptocurrency space and don't know where to start, or if you are currently engaging in the market and want to distinguish yourself as a compliant, legitimate financial professional, contact us for a ***CryptoConsult*** to evaluate potential risks and map out areas where we can provide support, including (but not limited to): appropriate registration, policies and procedures, and disclosures.

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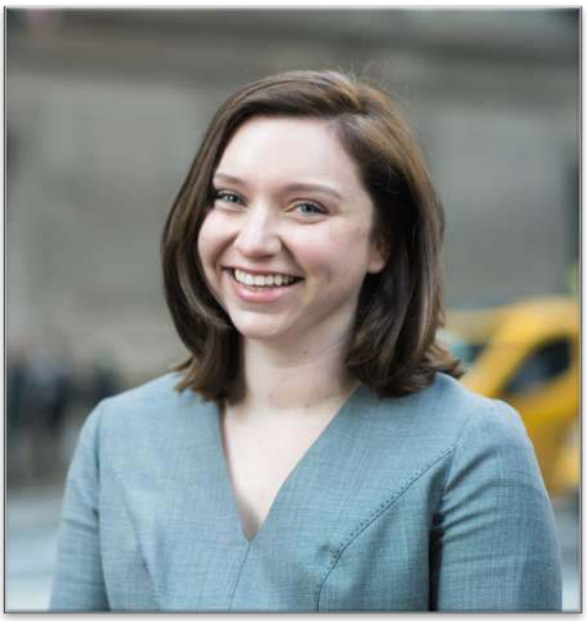

Kaitlyn Gibbs joined CRC in 2017. She is a regulatory compliance professional with 7 years of experience in the financial services industry. Kaitlyn has extensive knowledge of the rules of the Investment Company Act of 1940 and the Investment Advisers Act of 1940. She previously managed compliance processes and performed forensic testing in her role as Compliance Analyst at Welch & Forbes LLC.

She has experience performing annual reviews and risk analyses, regulatory research, as well as Code of Ethics administration. Her primary focus areas include, process implementation and enhancement, cybersecurity, marketing materials review, private equity investment compliance, and investment portfolio compliance.

Most recently at CRC, Kaitlyn has performed regulatory research, evaluated compliance programs, and performed annual reviews and risk assessments for investment advisors.

Kaitlyn holds a Bachelor's Degree in English from Boston University.

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