

Financial Services

FinTech Alert: Six Weeks of CFTC and SEC Action in the Digital Currency Space

Action Item: Over the last six weeks, the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission (“SEC”) have taken rigorous action in the digital currency space, demonstrating that they will act swiftly against fraud when necessary to protect investors. The CFTC recently launched its Virtual Currency Primer (“CFTC Primer”) and targeted a corporate Bitcoin Ponzi scheme; the SEC has warned investors to be wary of celebrity endorsements of initial coin offerings (“ICOs”) and subsequently commenced a series of enforcement actions relating to digital currencies. Those in the digital currency space should be cognizant of these recent regulatory developments.

CFTC Guidance and Actions

On October 17, 2017, the CFTC released the CFTC Primer explaining its regulatory role in regards to financial technology, also known as FinTech. The CFTC has oversight of futures, options, and derivatives contracts, and first determined that Bitcoin and other digital currencies were commodities in 2015. The CFTC has fostered the development of the digital currency market in the United States by permitting the registration of (1) a swap execution facility for listing Bitcoin swaps (TeraExchange, LLC, in 2014), (2) an exchange listing binary options based on the Tera Bitcoin Price Index (the North American Derivatives Exchange, Inc. (“NADEX”)), and (3)

Ledger X, LLC, a swap execution facility and derivative clearing organization, which will list digital currency options.

At the same time, the CFTC has commenced an enforcement action when it sees fraud or manipulation involving a digital currency traded in interstate commerce. For example, it recently brought an enforcement action against Gelfman Blueprint Inc., a hedge fund invested in Bitcoin, and Nicholas Gelfman, its CEO and head trader, in the Southern District of New York, alleging that the company and Gelfman perpetrated a Ponzi scheme against investors who were eager to enter into the growing digital currency market. While claiming between seven and nine percent in monthly returns, Gelfman, in fact, rarely traded Bitcoin for investors and instead misappropriated investments for his and the company’s own use. By commencing this action, the CFTC has sent a clear message that it will use its enforcement capabilities not just in futures, options, and derivatives-based trading of digital currencies, but to regulate fraudulent digital currency activity in general.

SEC Guidance and Actions

On November 1, 2017, the SEC released a statement regarding celebrity endorsements of ICOs, warning investors to be “wary” of ICOs, and advising that any celebrity or other individual who promotes a virtual token or coin that is a security must disclose

the nature, scope, and amount of compensation received in exchange for the promotion. This advisory was undoubtedly prompted, at least in part, by *The New York Times'* October 27, 2017 article, "How Floyd Mayweather Helped Two Young Guys From Miami Get Rich." *The Times'* article explores how Mayweather, one of the greatest boxers of his generation, DJ Khaled, a record producer and radio personality, Jamie Foxx, Paris Hilton, and soccer player Luis Suarez have used social media to promote the ICOs of certain digital currencies, one of which raised over \$30 million. The SEC is cautioning investors to research potential investments, rather than rely on celebrity endorsements.

The SEC's statement on celebrity-endorsed ICOs comes on the heels of its [Report of Investigation concerning The DAO](#), in which the SEC warned that digital currencies sold in ICOs may be securities, and those who offer and sell securities in the United States must comply with the federal securities laws.

In addition, the SEC has aggressively pursued bad actors in the digital currency space over the last few weeks. On September 29, 2017, the SEC brought charges against two companies offering ICOs that were purportedly backed by investments in real estate and diamonds, alleging that the companies engaged in fraud and the sale of unregistered securities by falsely representing to investors the state of the companies' business operations and the use of the investment funds. (*SEC v. REcoin Group Foundation, LLC, et al.*, No. 17-cv-05725, E.D.N.Y.) On October 4, 2017, the SEC obtained a final judgment against an individual charged with conducting a fraudulent offering of unregistered securities and operating a Ponzi scheme in connection with the offering of shares in a Bitcoin mining operation. (*SEC v. Garza*, No. 15-cv-1760 D. Conn.) On October 30, 2017, the SEC filed a complaint against a day trader for allegedly committing fraud and market manipulation during which the trader utilized a digital currency exchange in a supposed attempt to cover his tracks. (*SEC v. Joseph P. Willner*, No. 1:17-cv-06305 E.D.N.Y.)

At the same time, the SEC is educating itself on blockchain, including the impact of the technology on the market, benefits, risks, and the potential for regulators to use the technology in order to have real-time insight into market activity. On October 12, 2017, the SEC Investor Advisory Committee held a meeting where it took testimony from Michael Bodson, President and CEO of DTCC; Fredrik Voss, VP of Blockchain Innovation at Nasdaq; Jeff Bandman of Bandman Advisors; Nancy Liao of Yale University; and Adam Ludwin, CEO of Chain Inc. Of note, Committee members questioned whether digital currencies should be categorized as securities and whether participation in a distributed ledger to engage in digital currency transactions constituted an investment contract with the other ledger participants.

Conclusion

The CFTC's and SEC's enforcement arms are keeping pace with the growing digital currency market. Both agencies are committed to using their authority wherever possible to eradicate investor fraud. Interestingly, CFTC Commissioner Brian Quintenz recently said at the event hosted by Georgetown Law School that digital currencies "may actually transform at some point from something that starts off as a security and transforms into a commodity." No matter how the assets are classified, the SEC and CFTC are working together closely on digital currencies, with little posturing over jurisdiction. Legitimate digital currency operations appear to be welcomed under the both CFTC and SEC regulatory paradigms so long as such operations comply with applicable laws.

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