

For Blockchain, a Coming Wave of Change?

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First published in *The National Law Journal*, October 1, 2017.

Virtual currencies present a host of new opportunities for businesses of all kinds, from entrepreneurs seeking to raise capital from unusual quarters, to traders looking for the next structured derivative market.

As with any new product, however, legal and regulatory pitfalls may arise. To say that the regulatory landscape for virtual currencies is not yet set is an understatement.

Regulators will need to decide whether to create new rules designed for these novel concepts, or whether the old rules can be similarly applied. Recent activity by the U.S. Securities and Exchange Commission and U.S. Commodity Futures Trading Commission signals that regulation in these areas will evolve in fits and starts and will likely lead to compliance and enforcement issues for the unwary. Where new financial instruments exist in shades of gray, businesses must exercise caution.

Initial Coin Offerings

Through initial coin offerings, companies raise money by creating and selling digital "coins," a form of virtual currency, which investors can trade across a digital network (i.e., the blockchain). ICOs are rising in popularity, as companies quickly raise capital in a previously unregulated space. In July alone, 34 ICO projects raised \$665 million.

The burgeoning number of ICOs has drawn the attention of the SEC. In July, the agency issued guidance that in certain cases, ICO tokens were securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. More broadly, any coin that an investor buys with the expectation that it will appreciate based on the efforts of its creators may constitute an "investment contract," subject to federal registration and disclosure provisions.

The SEC's guidance is welcome, and entrepreneurs and investors must be mindful of its consequences. Companies looking to ICOs should consider transforming ICO white papers into formal private placement memoranda seen in private securities offerings.

Likewise, if the coins are securities (as under the SEC's recent guidance), the SEC's registration requirements apply, unless the ICO fits an exception (such as for offerings to accredited investors or offshore investors).

How the SEC will proceed against companies offering ICOs that it views as unregistered, nonexempt securities offerings is unknown.

Virtual Currency Derivatives

Like the SEC's assertions of jurisdiction over ICOs, the CFTC has taken steps to assert jurisdiction over virtual currency derivatives. Bookending the CFTC's growth in this space are its September 2015 settlement with Coinflip Inc., the operator of an online trading platform for VC derivatives, and its July order granting LedgerX registration as the first VC-related derivatives clearing organization under the Commodity Exchange Act.

The CFTC's activity in the VC derivatives space triggers important compliance and registration consequences for market participants. For instance, VC derivatives — such as options, futures and/or swaps for which a unit of virtual currency is the underlying interest — will be treated as commodity interests under CEA and CFTC rules.

This treatment raises questions about the regulation of collective investment vehicles investing in VC derivatives; registration requirements for individuals or firms that provide advice on VC derivatives; and clearing, reporting and record keeping requirements.

The CFTC's decision to treat VCs as a commodity will mostly have direct effects on VC derivatives. Nevertheless, even VC spot traders should be aware that the CFTC has authority to investigate, bring action and impose penalties for manipulations in VC spot markets that impact derivatives prices.

As the market for VC derivatives grows, there will be an increase in CFTC investigations focused on VC and VC derivatives trading activity.

Moving Forward

The growth of VC financial instruments, combined with regulators' foray into these markets, raises a host of unanswered regulatory questions.

First, how much rulemaking will regulators undertake and where will they go? What transfer restrictions apply to ICO tokens? Will the CFTC promulgate regulations on position limits, clearing requirements or other regulations similar to those for foreign exchange or interest rate derivatives?

Second, how closely will the enforcers keep watch? Will the SEC take certain ICOs to task as unregistered, nonexempt securities offerings? Will the CFTC take action against abusers of VC derivatives as it does for other products within its jurisdiction? Will they pursue only the worst behavior?

Third is the issue of actual security. In the decentralized cryptocurrency market, who ensures that tokens or VC derivatives are protected from data thieves? If companies can't protect digital

currency and derivatives, will they be subject to regulatory enforcement for failure to maintain secure systems?

The law tends to evolve more slowly than technology. Whatever enforcement approaches are laid out over the next year — which promises to be an active time in VC market innovation — may move in unexpected directions in the years to come. Businesses in these areas should maintain a healthy balance of innovative energy and legal caution.

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