

CLIENT ALERT

# CFTC and SEC Continue to Be Active with Respect to the Virtual Currency Market

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## AUTHORS

**Conrad G. Bahlke** | **Barry P. Barbash** | **Rita M. Molesworth** | **P. Georgia Bullitt**  
**Paul J. Pantano, Jr.** | **Elizabeth P. Gray** | **Neal E. Kumar** | **Artyom Rogov**

In the past week, the CFTC and SEC have released statements emphasizing their continued focus on virtual currency. As part of this effort, the CFTC and SEC continue to bring enforcement actions, with a significant number involving alleged fraud under the guise of offering virtual currency.<sup>1</sup> At the state level, Massachusetts has brought an enforcement action against a company engaging in an initial coin offering (“ICO”) for an alleged unregistered state securities offering.<sup>2</sup>

<sup>1</sup> See CFTC Charges Illinois Traders Richard D. Carter and Mark R. Slobodnik and their Company, Blue Guru Trading, LLC, with Fraud, Release pr7672-18, available [here](#) (Jan. 12, 2018) (alleged ongoing commodity pool fraud that took in at least \$750,000); CFTC Charges Colorado Resident Dillon Michael Dean and His Company, The Entrepreneurs Headquarters Limited, with Engaging in a Bitcoin and Binary Options Fraud Scheme, Release pr7674-18, available [here](#) (Jan. 19, 2018) (alleged Ponzi scheme soliciting Bitcoin for investment in binary options); CFTC Charges Patrick K. McDonnell and His Company, CabbageTech Corp., d/b/a Coin Drop Markets, with Engaging in Fraudulent Virtual Currency Scheme, Release pr7675-18, available [here](#) (Jan. 19, 2018) (alleged solicitation of Bitcoin and Litecoin in exchange for investment advice, but advice never provided in return); CFTC Charges Randall Crater, Mark Gillespie, and My Big Coin Pay, Inc. with Fraud and Misappropriation in Ongoing Virtual Currency Scam, Release pr7678-18, available [here](#) (Jan. 24, 2018) (defendants allegedly solicited more than \$6 million for investments in a fraudulent virtual currency, My Big Coin, and instead spent the money on personal expenditures).

<sup>2</sup> In the Matter of Caviar and Kirill Bensonoff, Mass. Admin. Compliant E-2017-0120, available [here](#) (Jan. 17, 2018) (alleged violation of state law by the company Caviar by selling unregistered securities that are not exempt from registration since Massachusetts investors were able to invest in the Caviar ICO).

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On January 19, CFTC Enforcement Director James McDonald and SEC Enforcement Co-Directors Stephanie Avakian and Steven Peikin issued a joint statement regarding virtual currency enforcement actions.<sup>3</sup> The CFTC and SEC Directors emphasized that the CFTC and SEC will remain vigilant in prosecuting securities and commodities law violations by those “engag[ing] in fraud under the guise of offering digital instruments – whether characterized as virtual currencies, coins, tokens, or the like.” The CFTC and SEC also stated that they will not look at merely the form that digital instrument offerings take, which may be an attempt to avoid regulation or securities and commodities laws, but instead will “examine the substance of the activity and prosecute violations.”

On the same day, CFTC Chairman Giancarlo delivered a speech at the American Bar Association’s Derivatives and Futures Section Conference in which he discussed developments in the virtual currency market and the role of the CFTC as a regulator of virtual currency.<sup>4</sup> Chairman Giancarlo noted the considerable risks of virtual currency, which include “*operational risks* of unregulated and unsupervised trading platforms; *cybersecurity risks* of hackable trading platforms and virtual currency wallets; *speculative risks* of extremely volatile price moves; and *fraud and manipulation risks* through traditional market abuses of pump and dump schemes, insider trading, false disclosure, Ponzi schemes and other forms of investor fraud and market manipulation.” Chairman Giancarlo stated that despite these risks, the role of the CFTC is to allow for a virtual currency market and to ensure that the market price is “reflective of investors making informed decisions, free of fraud and manipulation.”

As part of the effort to allow for a virtual currency market, the CFTC will continue to allow self-certification of virtual currency futures products under a heightened review process. The CFTC is also seeking to codify its heightened review for self-certification of virtual currency products. The heightened review process includes seven elements: “(1) Designated contract markets (“DCMs”) setting exchange large trader reporting thresholds at five Bitcoins or less; (2) DCMs entering direct or indirect information sharing agreements with spot market platforms to allow access to trade and trader data; (3) DCMs agreeing to engage in monitoring of price settlement data from cash markets and identifying anomalies and disproportionate moves; (4) DCMs agreeing to conduct inquiries, including at the trade settlement and trader level when anomalies or disproportionate moves are identified; (5) DCMs agreeing to regular communication with CFTC surveillance staff on trade activities, including providing trade settlement and trader data upon request; (6) DCMs agreeing to coordinate product launches to enable the CFTC’s market surveillance branch to monitor minute-by-minute developments; and (7) Derivatives Clearing Organizations setting substantially high initial and maintenance margin for cash-settled instruments.” Furthermore, the CFTC is seeking to add an eighth element to allow market participant input by requiring DCMs and swap execution facilities to disclose to the CFTC the steps they have taken to “gather and accommodate appropriate input from concerned parties, including trading firms and [futures commission merchants].”

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<sup>3</sup> A copy of the January 19, 2018 statement by the CFTC is available [here](#). A copy of the January 19, 2018 statement by the SEC is available [here](#).

<sup>4</sup> A copy of the January 19, 2018 speech by CFTC Chairman Giancarlo is available [here](#).

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SEC Chairman Clayton also commented on the virtual currency market in a speech at the Securities Regulation Institute.<sup>5</sup> Chairman Clayton expressed particular concern about ICOs and urged market professionals “to act responsibly and hold themselves to high standards.” He emphasized that many ICOs are “offerings of products that have many of the key features of a securities offering,” but the promoters claim that the “products are not securities, and the promoters proceed without compliance with the securities laws, which deprives investors of the substantive and procedural investor protection requirements of our securities laws.” In response, Chairman Clayton stated that SEC staff will be on “high alert for approaches to ICOs that may be contrary to the spirit of our securities laws.” In addition, he noted that “the SEC is looking closely at the disclosures of public companies that shift their business models to capitalize on the perceived promise of distributed ledger technology and whether the disclosures comply with the securities laws, particularly in the case of an offering.”

In a January 18 SEC staff letter, Dalia Blass, Director of the Division of Investment Management, raised a series of questions that must be resolved before the SEC will permit virtual currency ETFs.<sup>6</sup> Director Blass stated that “we have, at this time, significant outstanding questions concerning how funds holding substantial amounts of cryptocurrencies and related products would satisfy the requirements of the 1940 Act.” The questions that she noted as needing to be addressed are: (i) how to value virtual currencies to strike a daily NAV; (ii) how to ensure sufficient liquid assets to meet daily redemption requests; (iii) how to provide custodial services for virtual currencies and address the existing lack of custodians; and (iv) how to effectively and quickly verify ownership. She also noted two concerns to be addressed: the fragmentation of the market that might result in different values for the same virtual currency, which might result in ETFs being used for arbitrage; and the greater opportunities for fraud and manipulation due to the unique market for virtual currencies. Director Blass stated that until these questions and concerns are satisfactorily addressed, the SEC does “not believe that it is appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products, and we have asked sponsors that have registration statements filed for such products to withdraw them. In addition, we do not believe that such funds should utilize rule 485(a) under the Securities Act, which allows post-effective amendments to previously effective registration statements for registration of a new series to go effective automatically.”

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<sup>5</sup> A copy of the January 22, 2018 speech by SEC Chairman Clayton is available [here](#).

<sup>6</sup> A copy of the January 18, 2018 SEC Staff Letter is available [here](#).

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## CFTC and SEC Continue to Be Active with Respect to the Virtual Currency Market

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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**Conrad G. Bahlke**

212 728 8233

cbahlke@willkie.com

**Barry P. Barbash**

202 303 1201

bbarbash@willkie.com

**Rita M. Molesworth**

212 728 8727

rmolesworth@willkie.com

**P. Georgia Bullitt**

212 728 8250

gbullitt@willkie.com

**Paul J. Pantano, Jr.**

202 303 1211

ppantano@willkie.com

**Elizabeth P. Gray**

202 303 1207

egray@willkie.com

**Neal E. Kumar**

202 303 1143

nkumar@willkie.com

**Artyom Rogov**

212 728 8477

arogov@willkie.com

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