CLIENT ALERT

Virtual Currency Update: FINRA Encourages Firms to Disclose Activities Relating to Digital Assets; CFTC Alerts Customers to Exercise Caution Before Making Purchases

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The Financial Industry Regulatory Authority and the Commodity Futures Trading Commission have each issued new guidance relating to digital assets. FINRA Regulatory Notice 18-20 encourages firms to notify FINRA if they engage in activities related to digital assets, and CFTC Customer Advisory 7756-18 alerts customers to use caution and research before purchasing virtual coins or tokens.

FINRA Regulatory Notice on Digital Assets

As part of its ongoing efforts to monitor developments in the digital asset marketplace and ascertain the extent of member involvement related to digital assets, FINRA issued new guidance on July 6, 2018, encouraging member firms to voluntarily and promptly disclose to FINRA if and to the extent they, or associated persons or affiliates, engage in, or intend to engage in, activities relating to digital assets.[1] FINRA further requested firms to keep their regulatory coordinator updated with any related developments or changes until July 31, 2019.

[1] The National Futures Association separately requires that NFA members notify the NFA if they are engaging, or begin to engage, in activities involving virtual currencies or virtual currency derivatives.

The request does not require duplicate notification by firms that have previously disclosed the applicable information in connection with direct requests, the 2018 Risk Control Assessment Survey or a continuing membership application unless there have been changes since such prior disclosures. Disclosure, however, is broadly requested for activities relating to digital assets, including cryptocurrencies and other virtual coins and tokens, whether or not such digital assets classify as securities.

The types of activities that FINRA is interested in include, but are not limited to:

- purchases, sales or executions of transactions in digital assets;
- purchases, sales or executions of transactions in a pooled fund investing in digital assets;
- creation, management or provision of advisory services for a pooled fund related to digital assets;
- purchases, sales or executions in derivatives, including futures and options, tied to digital assets;
- participation in initial or secondary offerings of digital assets, including initial coin offerings (“ICOs”) and pre-ICOs;
- creation or management of a platform for the secondary trading of digital assets;
- custody or similar arrangements of digital assets;
- acceptance of cryptocurrencies, including bitcoin, from customers;
- mining of cryptocurrencies;
- recommendations, solicitations or acceptances of orders in cryptocurrencies and other virtual coins and tokens;
- provision or facilitation of clearance and settlement services for cryptocurrencies and other virtual coins and tokens; or
- recording of cryptocurrencies and other virtual coins and tokens using distributed ledger technology or any other use of blockchain technology.

Firms are to notify their regulatory coordinator in writing (including email) of involvement in such activities by member firms and their associated persons or affiliates. This new request is in addition to any existing regulatory obligations under FINRA rules that may apply to a firm regarding its involvement in activities relating to digital assets.

CFTC Customer Advisory on Virtual Coins and Tokens

The CFTC issued its fourth advisory with respect to virtual currencies on July 16, 2018. Customer Advisory 7756-18 warns customers to exercise caution and do extensive research before purchasing virtual coins or tokens. The Advisory is part of the CFTC's education and outreach efforts on new financial products and services.

The Customer Advisory recommends that customers understand what rights are attached to digital coins or tokens and what underlying factors could affect current or longer-term value. It urges customers to weigh factors including:

- the potential for forks in open-source applications that could split away market participants, increase the number of digital coins or make coins obsolete;
- decreasing mining or validation costs (if price is tied to those factors);
- the acceptance of other currencies, coins or tokens for offered goods and services;
- the link between the value of a digital coin or token and the offered product or service;
- the adoption of the digital coin or token as a broad medium of exchange or store of value;
- future competitors or technological changes that could disrupt the underlying business;
- future demand or uses for an application, network, product or services;
- liquidity in the market for a specific digital coin or token;
- changes to the underlying technology that could devalue digital coins or tokens; and
- risk of theft from hacking.

The CFTC warns customers to be wary of promises or guarantees of future value and urges customers to take appropriate steps to avoid fraud and consider risk, including:

- conducting extensive due diligence on any individuals and entities listed as affiliates of a digital coin or token offering;
- considering whether the digital coins or tokens are securities and whether their offering is registered with the Securities and Exchange Commission; and

- finding out how money will be used, whether it can be recovered and the rights provided by the digital coin or token, and keeping copies of any such information provided.

The Customer Advisory notes that many ICOs have been identified as frauds. The CFTC maintains general anti-fraud and manipulation enforcement authority over virtual currency cash markets.

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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