SULLIVAN & CROMWELL LLP

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Regulators Increase Focus on Virtual Currency and Digital Tokens, Including ICOs

Recent SEC, FinCEN and CFTC Actions Demonstrate Continued Focus of U.S. Regulators on Virtual Currency and Digital Token Businesses

SUMMARY

During the last full week in July, three U.S. regulators took actions that could have a significant effect on the development of virtual currencies and digital tokens.

- The SEC determined that some digital "tokens," including those issued and/or created in the context of some initial coin offerings ("ICOs"), may be securities for purposes of federal securities regulations, depending on the facts and circumstances surrounding the tokens and the offering.
- FinCEN assessed a $110 million civil money penalty against BTC-e, a virtual currency exchange, for its lack of anti-money laundering ("AML") efforts and alleged complicity in bitcoin-related criminal enterprises. FinCEN also worked in conjunction with other U.S. law enforcement agencies and international partners to arrest Alexander Vinnik, the alleged operator of BTC-e. Vinnik and BTC-e are both the subject of an indictment.
- The CFTC issued an order granting approval for LedgerX's registration as a derivatives clearing organization ("DCO"), which follows an earlier CFTC order granting LedgerX registration as a swap execution facility ("SEF"). The two CFTC approvals clear the way for LedgerX to proceed with its plans to offer customers the ability to trade and clear fully collateralized swaps and options on virtual currency, including bitcoin.

These developments represent a further maturation in the regulatory status and treatment of digital currencies and related businesses in the U.S., a rapidly growing segment of the FinTech industry.

THE SEC'S DAO INVESTIGATIVE REPORT; ICO INVESTOR BULLETIN

On July 25, 2017, the SEC's Division of Enforcement released an investigative report (the "DAO Report") concluding that the digital tokens offered and sold in April and May of 2016 by a virtual organization known as "The DAO" ("DAO" stands for "decentralized autonomous organization") were securities under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").[1] The SEC's Office of Investor Education and Advocacy also issued an investor bulletin (the "Bulletin"), as part of its investor education and investor protection mission, addressing the topic of ICOs more generally.[2] The Bulletin observed that, depending on the facts and circumstances of an individual ICO, the virtual coins or tokens that are offered or sold may be securities, and that if they are securities, the offer and sale of these virtual coins or tokens in an ICO are subject to the federal securities laws. The SEC's Divisions of Corporation Finance and Enforcement released a joint statement supporting the DAO Report and the Bulletin.[3] The implication of the DAO Report is that the analysis used by the SEC is not new; it is a straightforward application of longstanding securities law, leading to the conclusion that the form or embodiment of an instrument does not determine whether it is or is not a security.

What Is The DAO and What Are the DAO Tokens?

As described by the SEC, The DAO was an example of a decentralized autonomous organization, which is a term used to describe a "virtual" organization that is embodied in computer code and for which various management and governance processes are executed on a distributed ledger or blockchain.[4] The DAO was created by Slock.it UG ("Slock.it"), a German corporation, and Slock.it's co-founders, with the objective of operating for profit. The DAO would raise assets by selling digital tokens (the "DAO Tokens") to investors, and using the assets to fund "projects" intended to generate profits.

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1 SEC, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Exchange Act Release No. 81207 (July 25, 2017), *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf (the "*DAO Report*"). The report expressly did not analyze the status of The DAO under the Investment Company Act of 1940, but cautioned "[t]hose who would use virtual organizations" to "consider their obligations under the Investment Company Act." Please refer to the discussion of investment company issues below.

2 SEC, *Investor Bulletin: Initial Coin Offerings* (July 25, 2017), *available at* https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings.

3 SEC, *Statement by the Divisions of Corporation Finance and Enforcement on the Report of Investigation on The DAO* (July 25, 2017), *available at* https://www.sec.gov/news/public-statement/corpfin-enforcement-statement-report-investigation-dao.

4 As the Bulletin notes, "[a] blockchain as an electronic distributed ledger or list of entries – much like a stock ledger – that is maintained by various participants in a network of computers. Blockchains use cryptography to process and verify transactions on the ledger, providing comfort to users and potential users of the blockchain that entries are secure. Some examples of blockchain are the Bitcoin and Ethereum blockchains, which are used to create and track transactions in bitcoin and ether, respectively."

Investor participants in The DAO contributed original versions of ethereum tokens, now known as ethereum classic ("ETC"),[5] and received DAO Tokens, which granted the DAO Token holder certain voting and ownership rights. According to the SEC, promotional materials for The DAO stated that The DAO would earn profits by using the contributed assets to fund projects that would provide DAO Token holders a return on investment. The projects would be proposed by the holders of the DAO Tokens, vetted by "curators" (initially identified by Slock.it), and voted upon by the holders of the DAO Tokens. The SEC emphasized that the various promotional materials disseminated by Slock.it's co-founders touted that DAO Token holders would receive "rewards," which the promotional materials and accompanying White Paper[6] defined as, "any [ETC] received by a DAO [Entity] generated from projects the DAO [Entity] funded." DAO Token holders would then vote to either use the rewards to fund new projects or to distribute the ETC to DAO Token holders. In addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms that supported secondary trading in the DAO Tokens.[7]

SEC Analysis of the DAO Tokens Under the *Howey* Test

In the DAO Report, the SEC applied the *Howey* test[8] to its analysis of the DAO Tokens and determined that the DAO Tokens constituted an investment contract and thus a security. However, in light of the facts and circumstances attending The DAO,[9] the SEC determined not to pursue an enforcement action against either The DAO or Slock.it. Instead, the DAO Report concluded by cautioning and reminding the

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5 Ethereum classic is a type of digital currency issued on the Ethereum blockchain and is analogous to bitcoin. It is exchangeable or tradeable on multiple digital currency exchanges for bitcoin, USD, and other digital tokens and currencies. As discussed in footnote 9 below, The DAO was attacked by a hacker that stole more than one-third of the DAO Tokens issued, and the response resulted in a fork (or split) of the Ethereum blockchain and the creation of a new digital currency also called ethereum. After the fork and the creation of the new ethereum, the original ethereum became known as ethereum classic.

6 The White Paper was a document authored by Slock.it's Chief Technology Officer and issued prior to the offer and sale of the DAO Tokens. The White Paper described the concept of The DAO, including, among other things, the process for identifying potential projects and the voting rights of DAO Token holders.

7 The DAO Report contains a useful summary of the history of the creation and design, offer and sale of the DAO Tokens. *See* the *DAO Report*, at pp. 2–9.

8 The *Howey* test is set forth in *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 301 (1946), which is one of the foundational Supreme Court cases referenced when assessing whether any instrument is a security for purposes of the U.S. securities laws.

9 The SEC observed that after DAO Tokens were sold, but before The DAO was able to commence funding projects, an attacker used a flaw in The DAO's code to steal approximately one-third of The DAO's assets. Slock.it's co-founders and others responded by creating a work-around and a fork, or split, of the Ethereum blockchain whereby DAO Token holders could opt to have their initial ETC investment in The DAO returned to them as new ethereum. While the original DAO Tokens do technically still exist on the original Ethereum blockchain, The DAO no longer holds any ETC and no projects are or ever were funded.

industry and market participants that the federal securities laws "apply to those who offer and sell securities in the U.S., regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies and regardless whether they are distributed in certificated form or through distributed ledger technology."[10] The SEC did not take the position that bitcoin, ethereum or other virtual currencies, or interests in such currencies, are themselves securities.

The SEC began its analysis by observing that under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, an investment contract is a security. In *Howey*, the Supreme Court defined an investment contract as an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. The SEC then used the four factors of the *Howey* test to assess the regulatory status of the DAO Tokens:

- ***Investors in the DAO Invested Money:*** The first prong of the *Howey* test involves whether investors invested "money." The SEC observed that the investment of "money" need not take the form of cash, but must be a "contribution of value." Investors in the DAO Tokens used ETC to make their investments. The SEC found that an investment of ETC is the type of contribution of value that can create an investment contract under the *Howey* test.[11]
- ***The DAO Was a Common Enterprise:*** The DAO Report did not specifically analyze the second prong of the *Howey* test, which requires that the venture be a "common enterprise." However, the SEC asserted that "[i]nvestors who purchased DAO Tokens were investing in a common enterprise,"[12] presumably based on the fact that The DAO raised ETC from multiple investors who had a common interest in the success of The DAO.
- ***With a Reasonable Expectation of Profits:*** The third prong of the *Howey* test looks to whether investors who purchased an instrument reasonably expected to earn profits from that enterprise. The SEC found that the promotional materials publicized by The DAO creators informed investors that The DAO was a for-profit entity whose objective was to finance projects in exchange for a return on investment. The DAO was intended to make profits, via investments in contractor projects proposed by the token holders, to share with its token holders, once the projects had been approved by The DAO curators and voted upon by the token holders. Because the functional value of a DAO Token was to provide token holders with the prospect of profits, the SEC reasoned that The DAO's investors would have been motived by a reasonable expectation of profits.[13] The SEC statements make it clear that the "expectation of profits" is not necessarily limited to distributions of cash or appreciation of equity interests, and it can include the types of rewards that The DAO intended to provide.
- ***Derived from the Managerial Efforts of Others:*** The fourth prong of the *Howey* test examines whether or not the profits of an instrument are derived from the managerial efforts of others. One of the purposes of a decentralized autonomous organization is to provide direct involvement by the investors in the organization over the management of the organization,[14] limiting the extent to which

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10 *DAO Report* at 18.

11 *Id*. at 11.

12 *Id*.

13 *Id*. at 11-12.

14 As indicated in a paper by Christoph Jentzsch, founder of Slock.it and often identified as the creator of The DAO concept, "This paper illustrates a method that for the first time allows the creation of organizations in which (1) participants maintain direct real-time control of contributed funds and

(continued . . .)

management of the organization is delegated to others.[15] However, the SEC determined that (1) because the efforts of the DAO organizers and curators were required for the success of The DAO enterprise, and (2) because the DAO Token holders' voting rights were limited, The DAO's investors were reliant on the managerial efforts of others. Specifically, without the efforts of The DAO organizers and curators, the SEC observed, The DAO would not have been able to succeed, because of the following:

- First, through their conduct and marketing, the organizers of The DAO led investors to believe that they could be relied on to provide significant managerial efforts and the Ethereum blockchain expertise required to make The DAO a success.
- Second, the contractor project approval program placed substantial discretion in the hands of The DAO organizers and curators, and the limited nature of the DAO Token holders' voting rights meant that they were substantially reliant on the efforts of The DAO organizers and curators.
- Third, when The DAO was attacked by hackers, the organizers intervened and took crucial steps to resolve the situation, demonstrating the organizers' active oversight of The DAO.[16]

In the SEC's view, the DAO Token holders' voting rights did not provide meaningful control over the enterprise because (1) DAO Token holders' ability to vote for contracts was mostly perfunctory, and (2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.[17]

SEC Conclusion – The DAO Tokens Were Securities

As noted above, because the DAO Tokens satisfied the prongs of the *Howey* test, the SEC concluded that the tokens were investment contracts and thus securities subject to the federal securities laws. Absent a valid exemption, the registration, disclosure, reporting and other aspects of the securities laws applied to the offer, sale and subsequent trading of such tokens. Similarly, a system for trading in tokens may be subject to the SEC's rules relating to the regulation of securities exchanges, if it satisfies the definition of "exchange" and is not exempt.[18] The SEC emphasized that it is not seeking to ban or prohibit the issuance, offer and sale of digital currencies and digital tokens or the establishment of systems to trade in them, but to make the protections of the securities laws available to those who invest in tokens. The SEC has made clear that it is interested in engaging with parties seeking to conduct ICOs and,

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(. . . continued)
(2) governance rules are formalized, automated and enforced using software." *See* Christoph Jentzsch, *Decentralized Autonomous Organization To Automate Governance Final Draft - Under Review*, at 1, *available at* https://download.slock.it/public/DAO/WhitePaper.pdf.

[15] As the DAO Report notes, "The central issue is 'whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.'" *DAO Report* at 12 (citing *SEC* v. *Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973)).

[16] *Id*. at 12-13.

[17] *Id*. at 14. The DAO Report also indicates that the manner in which the voting rights were designed discouraged voting by those that opposed a project while encouraging voting by those who supported it. *Id.* at 13, n.37.

[18] *Id*. at 16-17.

according to SEC Chairman Jay Clayton, "[t]he SEC is studying the effects of distributed ledger and other innovative technologies and encourages market participants to engage with us. We seek to foster innovative and beneficial ways to raise capital, while ensuring – first and foremost – that investors and our markets are protected."[19]

ICO Investor Bulletin from the SEC Office of Investor Education and Advocacy

The SEC supplemented the DAO Report with an ICO Investor Bulletin issued by its Office of Investor Education and Advocacy on July 25, 2017. Among other things, the Bulletin provides investors with "Some Key Points to Consider When Determining Whether to Participate in an ICO," which included the following observations regarding the regulatory requirements applicable when the tokens offered in an ICO are securities:

- "Depending on the facts and circumstances, the offering may involve the offer and sale of securities. If that is the case, the offer and sale of virtual coins or tokens must itself be registered with the SEC, or be performed pursuant to an exemption from registration. Before investing in an ICO, ask whether the virtual tokens or coins are securities and whether the persons selling them registered the offering with the SEC."
- "If the virtual token or coin is a security, federal and state securities laws require investment professionals and their firms who offer, transact in, or advise on investments to be licensed or registered."

OBSERVATIONS FOLLOWING THE DAO REPORT

The DAO Report raises, both explicitly and implicitly, a number of issues and questions regarding how the SEC will view ICOs with facts and circumstances both similar to and different from those of The DAO. Below we identify some of the significant issues that remain unaddressed following the publication of the DAO Report:

- The DAO Report limited its analysis to the DAO Tokens. While the DAO Report establishes that some tokens will be securities, it does not lead to the conclusion that all tokens are securities. Therefore, each issuer, founder or promoter that seeks to undertake an ICO with a nexus to the U.S. will be compelled to consider whether its tokens, in the context of the facts and circumstances surrounding those tokens and their offering, will be considered securities under the *Howey* test and the analysis set forth in the DAO Report.
- As noted above, to the extent that tokens traded on a digital asset trading platform are securities, the platform may be required to register as a national securities exchange under Section 3(a)(1) of the Exchange Act. The DAO Report mentions that digital asset trading platforms may want to avail themselves of the exemption to this requirement set forth in Rule 3a1-1(a)(2) for "alternative trading systems" ("ATS").[20] Doing so requires that an ATS comply with Regulation ATS, which includes, among other things, requirements that the ATS register as a broker-dealer or be operated by a registered broker-dealer and that it file a Form ATS with the SEC to provide notice of the ATS's

[19] SEC, *Press Release: SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities* (July 25, 2017), *available at* https://www.sec.gov/news/press-release/2017-131.

[20] *DAO Report* at 17.

operations. Given that existing digital asset trading platforms may already be facilitating the exchange of tokens that the SEC could view as securities, U.S.-based digital asset trading platforms will wish to consider whether compliance with Regulation ATS is needed for their business model.

- The first footnote in the DAO Report indicates that the report did not analyze whether The DAO was an "investment company" as defined under Section 3(a) of the Investment Company Act of 1940 ("Investment Company Act"). The DAO Report cautioned, however, that "those who would use virtual organizations should consider their obligations under the Investment Company Act."[21] The Investment Company Act requires an investment company to register with the SEC unless it qualifies for one of several exclusions. Generally, an investment company is an issuer that engages in or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire "investment securities" that have a value exceeding 40 percent of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis. For purposes of the Investment Company Act, "securities" and "investment securities" are broadly defined and in some cases include instruments that may not be securities under the Securities Act; and an "issuer" may include an organized group of persons that is not a legal entity, such as The DAO. Even if an issuer successfully structures its ICO so that the tokens issued are not securities for the purposes of the Securities Act, the issuer will still need to figure out whether it is an investment company under the Investment Company Act and, if so, whether it is exempt from the requirements of that act.

FINCEN ASSESSES $110 MILLION PENALTY AGAINST BTC-E, COORDINATES WITH THE DEPARTMENT OF JUSTICE ON THE ARREST OF ALEXANDER VINNIK

On July 26, 2017, FinCEN, working in coordination with the U.S. Attorney's Office for the Northern District of California, assessed a $110,003,314 civil money penalty against the virtual currency exchange BTC-e (also known as Canton Business Corporation ("BTC-e")) for willfully violating U.S. AML laws.[22] This is the first instance of a FinCEN action against a foreign-located money services business, and it is FinCEN's second action against a virtual currency exchange.[23] One of BTC-e's operators, Alexander Vinnik, a 37-year-old Russian national, was arrested in Greece on July 25, 2017 and assessed a $12 million penalty in connection with his role at the exchange.[24] The Department of Justice's indictment (the "Indictment"), filed against BTC-e and Vinnik, alleges that BTC-e, Vinnik and an as yet unnamed co-conspirator X facilitated transactions involving ransomware, computer hacking, identity theft, tax refund

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21 *Id.* at 1, n.1.

22 FinCEN, *FinCEN Fines BTC-e Virtual Currency Exchange $110 Million for Facilitating Ransomware, Dark Net Drug Sales* (July 26, 2017), at 1, *available at* https://www.fincen.gov/news/news-releases/fincen-fines-btc-e-virtual-currency-exchange-110-million-facilitating-ransomware.

23 FinCEN's first action against a virtual currency exchange came in 2015, when it assessed a $700,000 civil money penalty against Ripple for violating requirements of the Bank Secrecy Act and for failing to implement an adequate AML program. *See* FinCEN, *FinCEN Fines Ripple Labs Inc. in First Civil Enforcement Action Against a Virtual Currency Exchanger* (May 5, 2015), at 1, *available at* https://www.fincen.gov/sites/default/files/2016-08/20150505.pdf.

24 Department of Justice: U.S. Attorney's Office for the Northern District of California, *Russian National and Bitcoin Exchange Charged in 21-count Indictment for Operating Alleged International Money Laundering Scheme and Allegedly Laundering Funds from Hack of Mt. Gox* (July 26, 2017), *available at* https://www.justice.gov/usao-ndca/pr/russian-national-and-bitcoin-exchange-charged-21-count-indictment-operating-alleged.

fraud schemes, public corruption and drug trafficking. Jamal El-Hindi, Acting Director for FinCEN, commented that, "[t]his action should be a strong deterrent to anyone who thinks that they can facilitate ransomware, dark net drug sales, or conduct other illicit activity using encrypted virtual currency. Treasury's FinCEN team and our law enforcement partners will work with foreign counterparts across the globe to appropriately oversee virtual currency exchangers and administrators who attempt to subvert U.S. law and avoid complying with U.S. AML safeguards."[25]

Background and the Indictment

According to the Indictment, BTC-e was founded in 2011 and operated as one of the world's largest and most frequently used virtual currency exchanges; the Indictment asserts that BTC-e "became one of the primary ways by which cybercriminals around the world transferred, laundered, and stored the criminal proceeds of their illegal activities."[26] Over the course of its operations, BTC-e processed more than $9 billion worth of bitcoin (using July 2017 USD-to-bitcoin exchange rates), and additional quantities of other virtual and fiat currencies.[27] The Indictment alleges that BTC-e "lacked basic anti-money laundering controls" and allowed its users to trade in bitcoin with high levels of anonymity that, as a result, attracted criminal users, because transacting through BTC-e made it difficult for law enforcement to trace the proceeds of criminal activities. The Indictment further alleges that the lax identity standards facilitated the obscuring and anonymizing of transactions and funding sources, and that after the seizure of the Liberty Reserve virtual currency exchange in 2013 and the 2014 reports of the hack of the Mt. Gox bitcoin exchange (discussed below), BTC-e grew substantially in prominence.[28]

According to the Indictment, BTC-e is located in Bulgaria, but is organized or otherwise subject to the laws of Cyprus. BTC-e allegedly operates in the Seychelles Islands as Canton Business Corporation and the web domains it uses are registered to shell companies organized in Singapore, the British Virgin Islands, France and New Zealand. Although based in the Seychelles, Canton Business Corporation had a Russian telephone number attached to it. BTC-e operated servers in the U.S. and relied on third-party companies based in Northern California to remain operational for U.S.-based users.[29] Even though BTC-e did substantial business in the U.S., it was not a registered money services business with the Department of the Treasury.

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[25] FinCEN, *FinCEN Fines BTC-e Virtual Currency Exchange $110 Million for Facilitating Ransomware, Dark Net Drug Sales* (July 26, 2017), at 1, *available at* https://www.fincen.gov/news/news-releases/fincen-fines-btc-e-virtual-currency-exchange-110-million-facilitating-ransomware.

[26] Department of Justice: U.S. Attorney's Office for the Northern District of California, *Superseding Indictment: United States of America* v. *BTC-e, a/k/a Canton Business Corporation and Alexander Vinnik* (January 17, 2017), at 5, *available at* https://www.justice.gov/usao-ndca/press-release/file/984661/download (the "*Indictment*").

[27] *Id*. at 5-6.

[28] *Id*. at 7.

[29] *Id.* at 3.

Users could fund BTC-e accounts by sending a wire transfer from a U.S. financial institution to another U.S. bank account maintained by one of BTC-e's shell or affiliated companies. To make deposits or withdrawals, users were required to use third-party "exchangers," a practice which enabled BTC-e to avoid collecting any information about its users through banking transactions or other activity that would leave some sort of centralized financial paper trail.[30] Besides the ability to fund a BTC-e account directly with bitcoin or other currencies, users could also fund BTC-e accounts by purchasing "BTC-e code" that could be sent and exchanged with other BTC-e users. The BTC-e code allowed users to withdraw funds from their BTC-e account and transfer them to other BTC-e users anonymously.[31]

Mt. Gox Connection; Ransomware Transactions

The Indictment also indicates that Vinnik was the owner and operator of multiple BTC-e accounts, including administrator accounts, and was also the primary beneficial owner of BTC-e's managing shell company, Canton Business Corporation. Withdrawals from the BTC-e administrator accounts went directly to Vinnik's personal bank accounts, and certain proceeds from the Mt. Gox bitcoin theft[32] were deposited into a BTC-e administrator account associated with Vinnik.[33] The Indictment alleges that over 300,000 bitcoin, stolen between 2011 and 2014 from the Mt. Gox bitcoin exchange, were deposited in three separate BTC-e accounts all associated with Vinnik. FinCEN's investigation also identified at least $3 million of facilitated transactions tied to ransomware attacks such as "Cryptolocker" and "Locky." FinCEN coordinated with the Internal Revenue Service Criminal Investigation Division, the Federal Bureau of Investigation, the Federal Deposit Insurance Corporation's Office of Inspector General, the Secret Service and Homeland Security investigations to conduct a seizure of the BTC-e domain and arrest Vinnik.[34]

The Indictment charges BTC-e and Vinnik with one count of operation of an unlicensed money service business, in violation of 18 U.S.C. § 1960, and one count of conspiracy to commit money laundering, in violation of 18 U.S.C. § 1956(h). Additionally, Vinnik was charged with 17 counts of money laundering in

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30 *Id*. at 10.

31 *Id.* at 9-10.

32 Mt. Gox was a Japan-based competitor bitcoin exchange to BTC-e that filed for bankruptcy in 2014 following a cyberattack that siphoned off much of its bitcoin.

33 *Indictment* at 8. One of these accounts was entitled "Vamnedam," which means "I will not give it to you" in Russian.

34 FinCEN, *FinCEN Fines BTC-e Virtual Currency Exchange $110 Million for Facilitating Ransomware, Dark Net Drug Sales* (July 26, 2017), at 2, *available at* https://www.fincen.gov/news/news-releases/fincen-fines-btc-e-virtual-currency-exchange-110-million-facilitating-ransomware.

violation of 18 U.S.C. § 1957. If convicted of the crimes, the maximum penalties Vinnik could face range from 5 to 20 years' imprisonment per count.[35]

Observations

The FinCEN and Department of Justice coordination to seize the BTC-e domain and arrest Vinnik reinforces the view that regulators are becoming increasingly sophisticated at using the Bitcoin network to prosecute criminal enterprises. Most notably, the agencies were able to analyze the underlying blockchain of the Bitcoin protocol to trace transactions and, in connection with other evidence, link transactions on the Bitcoin blockchain to real world identities.

CFTC REGISTERS LEDGERX AS A SWAP EXECUTION FACILITY AND DERIVATIVES CLEARING ORGANIZATION

On July 24, 2017, the CFTC unanimously voted to approve an order to grant LedgerX LLC's registration as a derivatives clearing organization ("DCO") under the Commodity Exchange Act.[36] Under the order, LedgerX will be authorized to provide clearing services for fully collateralized virtual currency swaps, including options. LedgerX will not be trading virtual currencies as part of its operations. LedgerX was previously granted registration as a swap execution facility ("SEF") on July 6, 2017. The SEF and DCO registrations together provide LedgerX the regulatory approvals needed to provide a CFTC regulated trading and clearing venue for virtual currency swaps and options. In response to a request from LedgerX, the CFTC's Division of Clearing and Risk also issued a letter that exempts LedgerX from complying with certain CFTC regulations because of LedgerX's fully collateralized clearing model, under which LedgerX will at all times require any market participant to fully fund any potential liability or loss related to a transaction entered into and cleared on LedgerX. Therefore, as a registered SEF and DCO, LedgerX will be able to trade and clear options on bitcoin for its institutional trading and clearing platform.

With the CFTC's approval, LedgerX is now the first U.S. platform licensed to act as a bitcoin swap exchange and a clearinghouse under regulatory oversight. However, in its press release, the CFTC noted that LedgerX's approval "does not constitute or imply a Commission endorsement of the use of digital currency generally, or bitcoin specifically."[37]

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[35] Department of Justice: U.S. Attorney's Office for the Northern District of California, *Russian National and Bitcoin Exchange Charged in 21-count Indictment for Operating Alleged International Money Laundering Scheme and Allegedly Laundering Funds from Hack of Mt. Gox* (July 26, 2017), *available at* https://www.justice.gov/usao-ndca/pr/russian-national-and-bitcoin-exchange-charged-21-count-indictment-operating-alleged.

[36] CFTC, *CFTC Grants DCO Registration to LedgerX LLC* (July 24, 2017), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr7592-17#PrRoWMBL.

[37] *Id*.

By late September or early October of 2017, LedgerX plans to offer one- to six-month bitcoin-to-dollars options contracts on its SEF. Contracts for other widely used virtual currencies are expected to be rolled out as well. Its business plan mentions that it may seek to become a global platform, given the CFTC's agreement with international regulators for an "equivalence arrangement," which fast tracks existing federally regulated institutions to acquire equivalent licenses in other countries.[38]

Observations

When considering the bitcoin ecosystem, LedgerX's SEF and DCO approvals can be seen as a step towards wider regulatory acceptance of bitcoin and other digital currencies as a new asset class. On March 10, 2017, the SEC used the absence of a regulated market for trading bitcoin derivatives as a reason to reject two bitcoin ETF applications. In rejecting the ETF applications, the SEC suggested that regulation in the derivatives market may be a prerequisite to approving a bitcoin ETF, stating that it "does not accept the premise, suggested by some commenters, that regulation of trading in the [ETF shares] is a sufficient and acceptable substitute for regulation in the spot or derivatives market related to the underlying asset."[39] The SEC is currently undertaking a review of its disapproval order in at least one of the bitcoin ETF disapprovals,[40] and it remains to be seen whether LedgerX's SEF and DCO approvals will factor into the SEC's review. Specifically, because the SEC bitcoin ETF disapprovals were based in part on the SEC's express observation that "the significant markets for bitcoin are unregulated," it is possible that the emergence of CFTC approved and regulated markets for bitcoin derivatives could provide a new basis for the SEC to reconsider these decisions.

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[38] Paul Cho, *Introducing LedgerX* (July 24, 2017), *available at* https://ledgerx.com/introducing-ledgerx/.

[39] *See, e.g.*, SEC, *Order Disapproving a Proposed Rule Change, As Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, to List and Trade Shares Issued by the Winklevoss Bitcoin Trust* (March 10, 2017), at 26, *available at* https://www.sec.gov/rules/sro/batsbzx/2017/34-80206.pdf.

[40] SEC, *Order Granting Petition for Review and Scheduling Filing of Statements: In the Matter of Bats BZX Exchange Inc., Regarding an Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, to List and Trade Shares Issued by the Winklevoss Bitcoin Trust* (April 24, 2017), *available at* https://www.sec.gov/rules/sro/batsbzx/2017/34-80511.pdf.

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