

Payment Sys Gd 100:900

Payment Systems and Electronic Fund Transfers Guide | This article was reviewed by author(s), and the law is current as of February 04, 2019.

Blockchain Technology and Virtual Currencies
Obiamaka P. Madubuko and Margaret Ukwu

Fintech in Focus: Anti-Money Laundering Regulatory Developments for Virtual Currencies and Initial Coin Offerings

Virtual currencies like Bitcoin and Ether are new entrants into the global financial services industry. ICOs (initial coin offerings) are opening new ways for businesses to access capital using blockchain technology. These new technologies pose real concerns regarding anti-money laundering (hereinafter “AML”), fraud and security risks. This article will explore AML regulatory developments and enforcement trends for virtual currencies and ICOs in the United States and offers insights for what fintech companies can do to minimize their AML, fraud and security risks.

Dec. 2018 Update: While there was no U.S. federal law specifically addressing ICOs or virtual currencies passed in 2018, enforcement efforts by federal and state regulators against ICOs and cryptocurrency administrators and exchangers are on the rise, indicating that a “regulation-through-litigation” trend is likely to continue in 2019.

Virtual Currencies and Blockchain Technology

Virtual or cryptocurrencies are digital assets created and managed using blockchain technology. These online currencies can have real value for investors who have the appetite for their high volatility. For example, Bitcoin, the world's first and most popular cryptocurrency was created in 2009, and has had huge swings in value in the past year. At the end of Dec. 2018, Bitcoin (BTC) was trading around \$4100 per coin, a nearly 80% drop in value after reaching a record high of \$19,000 per coin in Dec. 2017. *See* <https://www.tradingview.com/symbols/BTCUSD/> (last visited Dec. 21, 2018).

Blockchain technology is a digital ledger system used to verify, process and store records/transactions (called blocks) that are linked by a group of connected computers (called nodes) and secured using cryptography (a form of encryption). A core feature of blockchain is that it is decentralized. All participants to a transaction have access to the blockchain, which is intended to serve as an immutable record of the transaction. Blockchains may be public (open-sourced) or private/permissioned (accessible only to certain authorized users). Given that blockchain users do not need to know one another to engage in transactions and may be identified on the blockchain only by their public key, some have called blockchain networks “trustless” systems whereas blockchain enthusiasts argue that such networks provide “more trust” because these transactions are fully transparent and accessible by all transaction participants in real time.

Virtual currencies are not only a form of blockchain technology, they are also a method of payment (or access) that enable parties to use a blockchain network. Investors have begun to buy and hold these cryptocurrencies betting that their value will increase as blockchain technology gains greater acceptance and adoption by consumers and businesses.

Initial Coin Offerings (ICOs)

ICOs, now more commonly referred to as STOs (security token offerings), are the latest blockchain phenomenon to disrupt the financial services industry. An ICO or STO, generically called a token offering, is typically structured as an

online capital-raising campaign that offers and sells cryptocurrency (called tokens or coins), which are used to finance new projects or to provide access to a company's platform or services. Coin offerings often take the form of a "pre-sale" offering, using a derivative or other instrument that converts into the tokens at the initial generation event. Pre-sales facilitate access to capital and enable business start-ups and online projects to raise funds in a short time period, generally without having to give away equity in the underlying entity. Most pre-sales and ICOs are limited to accredited investors to qualify for exemptions from federal and state securities laws in the United States. For example, in Aug. 2017, Filecoin, a blockchain-based storage network startup, raised almost \$188 million in just 60 minutes. According to a Dec. 18, 2017 New York Times article, ICOs raised over \$4 billion in 2017, a 3,000% increase over ICO funds raised in 2016. See John Patrick Mullin, *ICOs In 2017: From Two Geeks and a Whitepaper To Professional Fundraising Machines*, Forbes.com (Dec. 18, 2017, 11:29 PM), <http://www.forbes.com/sites/outofasia/2017/12/18/ficos-in-2017-from-two-geeks-and-a-whitepaper-to-professional-fundraising-machines/#17ab8978139e> (last visited Mar. 15, 2018).

July 2018 Update: The market for virtual currencies and ICOs continues to skyrocket in 2018. As reported by Thomson Reuters, virtual currencies grew \$590 billion in 2017 in terms of market value as compared to an \$11 billion increase in 2016, with 30% of crypto holders located in the United States. See Chavez-Dreyfuss, Gertrude, *U.S. tax liabilities for crypto currencies in 2017 seen at \$25 billion, to pressure bitcoin: Fundstrat*, Thomson Reuters (Apr. 5, 2018, 01:08 PM), <https://www.reuters.com/article/us-crypto-currencies-taxes/u-s-tax-liabilities-for-crypto-currencies-in-2017-seen-at-25-billion-to-pressure-bitcoin-fundstrat-idUSKCN1HC29Y> (last visited July 10, 2018). According to CoinDesk, ICOs raised \$6.3 billion in the first quarter of 2018, which exceeds the total amount raised by ICOs in 2017. See Peter Ryan, *\$6.3 Billion: 2018 ICO Funding Has Passed 2017's Total*, (Apr. 19, 2018, 01:00 PM), <https://www.coindesk.com/6-3-billion-2018-ico-funding-already-outpaced-2017/> (last visited July 10, 2018). With such large sums of investor money involved, the risk of fraud and loss remains high as does the need for further regulation.

Sept. 2018 Update: So far in 2018, ICOs have raised over \$11.6 billion, with \$8.4 billion raised in the second quarter and North America accounting for 65% of global ICO funding this year. See Jeffrey Tucker, *Despite What You Hear, The ICO Is Not Over*, Forbes.com (Aug. 18, 2018, 01:42 PM), <https://www.forbes.com/sites/jeffreytucker/2018/08/18/despite-what-you-hear-the-ico-is-not-rip/#1d9f73563192> (last visited Sept. 12, 2018).

Dec. 2018 Update: Bloomberg reports that \$22 billion has been raised in ICOs as of Nov. 2018, however, it also noted that this amount could be far less depending on who you ask. See Justina Lee, *How Much Have ICOs Raised in 2018? Depends on Who You Ask*, Bloomberg.com (Nov. 4, 2018, 07:00PM), <https://www.bloomberg.com/news/articles/2018-11-05/how-much-have-token-sales-raised-in-2018-depends-on-who-you-ask> (last visited Dec. 21, 2018). Despite the large sums invested, the risk of losing one's money remains high. According to Ernst & Young, 86% of leading ICOs listed on a crypto exchange in 2017 are trading below their initial listing price and 30% of 2017 ICOs have lost "substantially all their value." See *86% of 2017 ICOs are now in the red Ernst & Young Study Finds*, MarketWatch, (Oct. 22, 2018, 7:33AM ET), <https://www.marketwatch.com/story/86-of-2017-icos-are-now-in-the-red-ernst-young-study-finds-2018-10-20> (last visited Dec. 21, 2018).

AML Risks for Virtual Currencies and ICOs

A chief concern for virtual currencies and ICOs is AML risk. Given that ICOs involve the online offer and sale of tokens (i.e., virtual currencies) conducted with limited (if any) central oversight, these potentially global investment platforms represent unique challenges for U.S. regulators.

The AML and fraud risks associated with virtual currencies and ICOs are multi-fold.

First, fraud and token theft remain looming concerns for any ICO offering or virtual currency owner. For example, Veritaseum, the issuer of a cryptocurrency called VERI, fell victim to a July 2017 hack in which \$8 million worth of VERI were stolen. Coindash, an Israeli startup, planned to raise capital by selling its tokens in exchange for ether (another

digital currency). However, just 13 minutes into the ICO, hackers stole \$7 million worth of ether by hacking Coindash's website and changing the address for investments to a fake one.

Second, customer identification and transaction verification present unique challenges, particularly given that token holders can be pseudonymous (identified by something other than their real name) making AML compliance difficult. The speed of such transactions, including the advent of smart contracts (computer code driven set of rules for self-executing and self-enforcing contracts), creates added challenges for regulators. Without the ability to accurately identify and track users and authenticate and authorize blockchain transactions, there is a heightened risk that virtual currencies and ICOs could be used to finance criminal activities or sponsor terrorism. Think of Bitcoin's sorted past with Silk Road, a notorious online drug marketplace, before it was shut down in 2013. In addition to the national and global security interests in ensuring virtual currencies and ICOs are AML compliant, these transactions also pose additional legal issues relating to taxation, cybersecurity, data privacy and data transfer. Criminals prefer to use virtual currencies because they are not tied to a single jurisdiction or set of laws, exchanges can be handled quickly and pseudonymously, and there is no need to rely on intermediaries and, in many cases, there is no central authority to monitor these exchanges.

Third, the international scope of virtual currencies and ICOs, particularly those organized offshore, represents a further regulatory challenge. The difficulty in tracing, freezing or securing cryptocurrency assets makes it hard for regulators to act to hold those who violate the law accountable. Add to this the lack of a central authority in many blockchain transactions, a lack of investor protection, and extreme volatility in cryptocurrency value, and the AML challenges multiply. It is no surprise that many regulators around the world have issued cautionary guidance for ICO investments and certain jurisdictions like China have banned them outright.

2018 Regulatory Landscape

A. Federal Regulations

Currently, there is no comprehensive U.S. federal regulation specifically governing virtual currencies and ICOs. However, several federal agencies have provided guidance and some have brought enforcement actions based on existing regulations. For example, the Internal Revenue Service (IRS) has stated that virtual currencies should be treated as property and the Commodity Futures Trading Commission (CFTC) has found that some virtual currencies fall within the definition of a commodity and, thus, are subject to CFTC enforcement actions. In Jan. 2017, the Financial Industry Regulatory Authority (FINRA) issued a report on the potential implications of blockchain technology for the securities industry. In July 2017, the Securities and Exchange Commission (SEC) issued an investigation report in the DAO case determining that the DAO tokens offered in an ICO qualified as securities and laying out a roadmap for future offerings to follow consistent with existing securities laws. *See* U.S. Securities and Exchange Commission, [Report of Investigation Pursuant to Section 21\(a\) of the Securities Exchange Act of 1934: The DAO \(Release No. 81207\) \(July 25, 2017\)](https://www.sec.gov/litigation/investreport/34-81207.pdf) <https://www.sec.gov/litigation/investreport/34-81207.pdf> (last visited Mar. 15, 2018). In 2018, the SEC initiated enforcement action against several ICO related companies, and SEC Chairman Jay Clayton publicly commented that, “*I have yet to see an ICO that doesn't have a sufficient number of hallmarks of a security,*” thus making it clear that enforcement of non-compliant ICO related activity will be a key SEC enforcement priority. However, on June 14, 2018 at the Yahoo Finance summit, the director of the division of corporation finance at the SEC, William Hinman declared that “the Ethereum network and its decentralized structure, current offers and sales of ether are not securities transactions.” *See* Shannon Liao, *The SEC says Ethereum tokens are not securities*, (June 14, 2018, 3:37 PM), <https://www.theverge.com/2018/6/14/17464692/sec-ethereum-tokens-securities-ether-yahoo-finance-summit> (last visited July 3, 2018). Given the SEC has not issued any specific regulations governing ICOs or virtual currencies, the regulatory landscape remains unclear.

In terms of AML regulatory oversight, the Financial Crimes Enforcement Network (FinCEN), which is under the U.S. Treasury Department, is the chief U.S. regulator for AML law enforcement. The Bank Secrecy Act (BSA) is the primary

U.S. anti-money laundering law, which requires all money service businesses (MSBs) to register with the U.S. Treasury Department, implement AML compliance programs and adhere to certain record-keeping and reporting requirements such as the filing of suspicious activity reports (SARs) and currency transaction reports (CTRs) for transactions over certain dollar amounts. Banks and other financial institutions are also required to have customer identification programs in place and to undertake customer due diligence commonly known as KYC (Know Your Customer) obligations, as mandated by the U.S. PATRIOT Act.

In 2013, FinCEN issued guidance on virtual currencies finding that virtual currency administrators and exchangers (as opposed to simply users/owners of cryptocurrencies) are considered MSBs and thus subject to BSA registration and reporting requirements. FinCEN regulations also extend to all ICOs and any transaction where a virtual currency is being exchanged for another cryptocurrency or fiat currency.

On Feb. 13, 2018, FinCEN's assistant secretary for legislative affairs, Drew Maloney, wrote a letter to U.S. Senator Rob Wyden (D-OR), clarifying FinCEN's position that virtual currency developers and cryptocurrency exchanges are subject to its AML regulations. See <https://coincenter.org/files/2018-03/fincen-ico-letter-march-2018-coin-center.pdf> (last visited June 8, 2018). FinCEN asserted that developers that sell a convertible virtual currency and cryptocurrency exchanges that sell tokens or exchange them for fiat or virtual currencies will generally be considered money services businesses (MSBs) subject to FinCEN regulation. This letter raises concerns that ICOs involving U.S. residents that fail to register with FinCEN and adhere to its AML/Know Your Customer regulations could be criminally investigated and prosecuted.

Coordinating the multiple federal agencies with overlapping oversight over the financial industry is another challenge facing cryptocurrencies and ICOs. In Jan. 2018, Treasury Secretary Steven Mnuchin announced the formation of a new working group of regulators under the Financial Stability Oversight Council to review the impact of cryptocurrencies on the U.S. financial system. As more regulators weigh in, there is a need to ensure any new laws or regulations are properly harmonized to minimize the regulatory burden for fintech transactions while maximizing investor protections.

July 2018 Update: In May 2018, the SEC unveiled a mock ICO website with fake cryptocurrency called HoweyCoins (named after the Howey test used to determine what constitutes a security) to bring greater awareness of the potential risk to ICO investors. The site claimed to offer a legitimate investment opportunity, but once investors clicked on the "BuyCoinsNow" button at the bottom of the site, they were taken to the SEC's site warning them they could have been scammed. See Dunstan Prial, *SEC Handling Each ICO Based on 'Facts and Circumstances'*, (May 16, 2018, 4:48 PM), <https://www.law360.com/articles/1044353> (last visited May 20, 2018).

On July 17, 2018, U.S. Congressmen Ed Perlmutter and Steve Pearce jointly filed a new Congressional bill, H.R. 6411, that would encourage FinCEN to actively focus on cryptocurrencies. It remains to be seen how new FinCEN's crypto enforcement mandate will be carried out. See <https://www.congress.gov/bill/115th-congress/house-bill/6411/text/1426> (last visited Sept 7, 2018).

On July 31, 2018, the U.S. Department of the Treasury's Office of the Comptroller of the Currency ("OCC") endorsed a national fintech charter where crypto-exchanges and other fintech firms that opt for the charter could soon be regulated more like banks and bypass state-by-state licensing laws. The OCC released a policy statement describing the chartering standards and supervisory expectations. See *Policy Statement on Financial Technology Companies' Eligibility to Apply for National Bank Charters*, (July 31, 2018), <https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-other-occ-policy-statement-fintech.pdf> (last visited Sept 6, 2018). The OCC also released a proposed licensing manual as part of the policy statement. This move by the OCC will potentially allow online lenders, payments firms, and cryptocurrency ventures to operate without having to get individual state licenses or rely on a bank. The OCC fintech license is not a full bank license so fintech companies will not be able to accept deposits but they will be supervised like national banks. However, applicants must publish their applications and make them available for a 30-day public comment period. The OCC will approve or reject a charter application within 120 days after receipt.

See *Comptroller's Licensing Manual Supplement*, (July 2018), <https://www.occ.gov/publications/publications-by-type/licensing-manuals/file-pub-lm-considering-charter-applications-fintech.pdf> (last visited Sept 13, 2018).

Sept. 2018 Update: Certain state regulators, including the California Department of Business Oversight and the New York State Department of Financial Services (“NYS DFS”) have resisted the OCC’s fintech charter, claiming that it represents an impermissible overreach by the federal government and will serve to weaken state enforcement of consumer protection laws. On Dec. 12, 2017, a New York federal court dismissed the NYS DFS claims, finding the court lacked jurisdiction as the OCC had not yet taken any final action. The NYS DFS lawsuit was revived in Sept. 2018 and remains pending.

On Sept. 19, 2018, the U.S. House’s Committee on Ways and Means wrote an open letter to the IRS arguing that cryptocurrency tax codes are too vague and requested the IRS update its guidance on tax obligations pertaining to virtual currencies by providing clarity to taxpayers. See https://waysandmeansforms.house.gov/uploadedfiles/letter_irs_virtual_currencies.pdf (last visited Dec. 21, 2018).

On Sept. 21, 2018, Congressman Tom Emmer (R-MN) announced that he would introduce legislation meant to support virtual currencies. See Schaffer, Spangler and Wu, *Blockchain and Digital Currencies Supported by Congressman, SEC Commissioner*, (Oct. 16, 2018), <https://www.lexology.com/library/detail.aspx?g=50da9ce0-299e-4021-aa16-3487f2502176&l=859YHJG> (last visited Dec. 9, 2018). The legislation includes the Blockchain Regulatory Certainty Act to prevent blockchain-related entities from registering under state laws as money transmitters under certain rules, the Safe Harbor for Taxpayers with Forked Assets Act that restricts penalties on taxpayers who profit from cryptocurrencies splitting in two blockchains/coins, and lastly, a resolution that supports blockchain and cryptocurrencies.

Dec. 2018 Update: In Oct. 2018, the Conference of State Bank Supervisors filed suit challenging the OCC’s authority to offer a national fintech charter. This lawsuit is in addition to the NYS DFS suit refiled in Sept. 2018 and the pending Ninth Circuit appeal (*Lusnak v. Bank of America*) to the U.S. Supreme Court, which also challenges OCC’s jurisdiction to offer a national fintech charter.

Following the U.S. Department of the Treasury’s Office of Foreign Assets Control (OFAC) announcement in March 2018 that it may add virtual currency identifiers associated with blocked persons to its Specially Designated Nationals (SDN) listing, on Nov. 28, 2018, OFAC added certain virtual currency addresses associated with blocked persons to its SDN listing. See Maxwell T.S. Thompson, *Crypto Addresses As OFAC Identifiers*, (Dec. 4, 2018, 06:05 PM), https://www.law360.com/cybersecurity-privacy/articles/1108104/crypto-addresses-as-ofac-identifiers?nl_pk=945e91dd-5d43-4e31-838b-f7574f18eceb&utm_source=newsletter&utm_medium=email&utm_campaign=cybersecurity-privacy&read_more=1(last visited Dec. 9, 2018).

On Dec. 6, 2018, Congressmen Darren Soto (D-FL) and Ted Budd (R-NC) announced two bipartisan bills aimed at preventing crypto price manipulation and boosting acceptance of virtual currencies. See Yogita Khatri, *US Congressmen Introduce Two Bills to Prevent Crypto Price Manipulation*, (Dec. 7, 2018, 11:03 AM), <https://www.coindesk.com/us-congressmen-introduce-two-bills-to-prevent-crypto-price-manipulation> (last visited Dec. 9, 2018). The bills, The Virtual Currency Consumer Protection Act of 2018 and U.S. Virtual Currency Market and Regulatory Competitiveness Act of 2018, request U.S. financial regulators, like the CFTC, to better regulate cryptocurrencies. These two bills come approximately two months after a bipartisan bill was introduced in the U.S. House of Representatives to create a definition for ‘blockchain.’ See Nikhilesh De, *US Lawmakers Push for ‘Blockchain’ Definition in New Congressional Bill*, (Oct. 3, 2018, 01:03 PM), <https://www.coindesk.com/us-lawmakers-introduce-bill-to-define-blockchain> (last visited Dec. 9, 2018). This bill, The Blockchain Promotion Act of 2018, would create a working group to understand the technology

and come to a consensus throughout government about the technology. *See Press Releases*, (Oct. 1, 2018), <https://matsui.house.gov/news/documentsingle.aspx?DocumentID=1819> (last visited Dec 9, 2018).

There is also a growing trend towards ICOs voluntarily complying with SEC and state securities laws prior to a launch to avoid potential compliance or regulatory hurdles. These offerings, called a security token offering or “STO”, are ICOs that comply with U.S. securities laws. The STO trend is expected to continue in 2019.

B. State Regulations

In addition to U.S. federal regulations, virtual currencies and ICOs must also comply with applicable U.S. state securities and MSB laws. Currently, each state regulates MSBs under their own laws. Some states like New York require companies that offer or sell virtual currencies to New York residents or wish to conduct an ICO to apply for a special BitLicense.

Other states (like California) are following New York's lead and have proposed legislation along the same lines. Florida recently passed House Bill 1379 clarifying the definition of virtual currency and Alabama and Washington recently updated their laws to include digital currency in the definition of money transmission. Illinois has issued digital currency guidance and Hawaii has shut down a virtual currency exchange, for failing to adhere to state law on cash reserves needed.

In 2015, the Conference of State Bank Supervisors (CSBS) drafted a model regulatory framework to address certain virtual currency activities, which includes among other things, a requirement that states require verification of an entity's service user, not only account holders as part of the customer identification process.

July 2018 Update: In contrast to the dearth of federal legislation specifically for ICOs and cryptocurrency, state lawmakers have been active in proposing new laws to address cryptocurrencies and ICOs in their respective jurisdictions. At least six U.S. states have proposed new cryptocurrency and ICO related legislation in 2018. Below are a few examples of recently enacted or proposed cryptocurrency and ICO related laws in various states.

Alaska

On March 14, 2017, Alaska House Bill 180 was introduced. The Act set out to define virtual currencies. If enacted, it could potentially make cryptocurrency firms be considered a money transmitter or currency exchange requiring a license. It has been referred to the Judiciary. *See* <https://legiscan.com/AK/bill/HB180/2017> (last visited Sept 7, 2018).

Colorado

On May 8, 2018, Colorado state senate voted and approved HB 1426, which offered guidelines to distinguish between tokens and securities and would have exempted virtual currency from state money transmitter laws, but then state lawmakers took another vote on May 9, 2018, and rejected it. *See* <http://leg.colorado.gov/bills/hb18-1426> (last visited Sept 7, 2018). On Jan. 4, 2019, the Colorado legislature introduced bill SB19-023 entitled the Colorado Digital Token Act, which seeks to exempt virtual currencies from the state's securities laws. *See* <http://leg.colorado.gov/bills/sb19-023> (last visited Jan. 8, 2019). This action is at odds with recent efforts by the Colorado Division of Securities, whose ICO Task Force has brought enforcement actions against 20 ICOs it claims are operating illegally in the state. *See* <https://www.colorado.gov/pacific/dora/colorado-ico-cases-filed> (last visited Dec. 21, 2018).

Connecticut

In March 2018, Connecticut introduced HB 5496, a bill to regulate virtual currency businesses. The bill remains pending. See https://www.cga.ct.gov/asp/cgabillstatus/cgabillstatus.asp?selBillType=Bill&bill_num=HB05496&which_year=2018 (last visited Sept 7, 2018).

Florida

Seminole County in Florida became the first county to accept Bitcoin as payment for taxes. See *Joel Greenberg Accepts Bitcoin and Bitcoin Cash for Payments through BitPay*, (May 14, 2018), <http://www.seminolecounty.tax/forms/bitcoin-announcement.pdf> (last visited Nov. 27, 2018).

Hawaii

In Jan. 2018, Hawaii introduced SB 2129, a bill to regulate virtual currency. The bill remains pending. See https://www.capitol.hawaii.gov/measure_indiv.aspx?billtype=SB&billnumber=2129&year=2018 (last visited Sept 7, 2018).

Illinois

The Illinois Department of Financial and Professional Regulation issued guidance regarding digital currencies on June 13, 2017. They stated that “a person or entity engaged in the transmission of solely digital currencies, as defined, would not be required to obtain a TOMA [Transmitters of Money Act] license.” See <https://www.idfpr.com/Forms/DFI/CCD/IDFPR%20-%20Digital%20Currency%20Regulatory%20Guidance.pdf> (last visited Sept 7, 2018).

Nebraska

In Jan. 2018, Nebraska introduced LB 987, a bill to regulate virtual currency businesses, but on April 18, 2018, it voted to indefinitely postpone further action on this bill. See https://nebraskalegislature.gov/bills/view_bill.php?DocumentID=34121 (last visited Sept 7, 2018).

New York

In Nov. 2017, four legislative proposals to study the impact of cryptocurrencies on the New York financial market and the use of blockchain technology in state record-keeping functions were introduced. All four bills remain pending, however, the fourth has made the most progress. See *Nikhilesh De, 4 Blockchain Bills Introduced in New York Legislature*, (Dec 4, 2017, 6:17 PM), <https://www.coindesk.com/4-blockchain-bills-introduced-new-york-legislature/> (last visited July 10, 2018).

On Sept. 18, 2018, OAG published its Virtual Markets Integrity Initiative Report on cryptocurrency trading platforms and the vulnerability many have to market manipulation. See https://ag.ny.gov/sites/default/files/vmii_report.pdf?mod=article_inline (last visited Dec. 9, 2018). The report described issues with certain practices put in place by the exchanges, including methods for monitoring and preventing market manipulation. The report stated that serious market surveillance measures had not been taken by the industry to detect and punish suspicious trading activity and noted the industry could not take proper action to protect customers if it was not even aware of the practices in the first place. However, the report noted that most exchanges use KYC procedures already.

On Nov. 1, 2018, the NYS DFS approved a virtual currency license for Coinsource, a company that operates Bitcoin ATMs, making it the first Bitcoin ATM operator to obtain a license in New York. See *Rafal Pytel, Bitcoin ATM Virtual Currency License Approved by NY Dept. of Financial Services*, (Nov. 1, 2018, 04:34 PM), <https://www.law.com/corpcounsel/2018/11/01/virtual-currency-license-approved-by-ny-dept-of-financial-services->

for-bitcoin-atm/?slreturn=20181110193710 (last visited Dec. 7, 2018). Companies must take many steps to be granted approval such as maintaining strict AML procedures. To date, NYS DFS has issued 14 BitLicenses. *See* NYS DFS Press Release, *DFS Grants Virtual Currency and Money Transmitter License to NYDIG Execution, LLC*, available at <https://www.dfs.ny.gov/about/press/pr1811141.htm> (last visited on Dec. 17, 2018).

Ohio

On Nov. 26, 2018, the Ohio State Treasurer announced that Ohio would accept Bitcoin as payment for taxes. *See* Melanie Kramer, *Ohio 'Plants a flag' for Bitcoin adoption, accepting BTC for taxes*, (Nov. 26, 2018, 2:00 PM), <https://bitcoinist.com/bitcoin-ohio-accept-tax/> (last visited Nov. 27, 2018). Ohio is the first state and second taxing authority (after Seminole County in Florida) to accept virtual currency payments. These payments will be converted to U.S. dollars for the Ohio government.

Texas

On March 2, 2017, HJR 89, which proposed an amendment to Texas Constitution regarding the right to own, hold, and use any mutually agreed upon medium of exchange, was introduced but died in committee. *See* <https://legiscan.com/TX/bill/HJR89/2017> (last visited Sept 7, 2018). However, Texas became the first state where an entire real estate transaction took place with Bitcoin. *See* Jon Buck, *First Bitcoin-Only Real Estate Transaction Completed in Texas*, (Sept 19, 2017), <https://cointelegraph.com/news/first-bitcoin-only-real-estate-transaction-completed-in-texas> (last visited Sept 7, 2018).

Vermont

In Jan. 2018, Vermont introduced a blockchain bill (S.269, at §4173(c)) that, among other things, exempts cryptocurrency companies from certain state taxes. This bill was signed into law on May 30, 2018, and went into effect on July 1, 2018. *See* <https://legislature.vermont.gov/bill/status/2018/S.269> (last visited July 10, 2018).

Wyoming

In March 2018, Wyoming Governor Matt Mead signed four blockchain-friendly bills into law. One exempts certain types of blockchain tokens from the state securities laws and two others exempt cryptocurrencies from state property taxes and facilitate cryptocurrency trading. The fourth bill allows businesses incorporated in Wyoming to use blockchain for record-keeping, making Wyoming a blockchain-friendly jurisdiction. *See* The Associated Press, *Wyoming courts tech behind cryptocurrency to entice business*, (May 23, 2018, 2:06 PM), <http://accesswdun.com/article/2018/5/673878> (last visited July 10, 2018).

2018 Enforcement Trends

A. Federal Enforcement Trends

In 2015, FinCEN brought its first civil enforcement action against a virtual currency exchanger, Ripple Labs Inc. Despite no allegation of any actual fraud or theft, Ripple Labs was fined \$700 million for selling its virtual currency, known as XRP, without registering with FinCEN and without implementing an effective AML program. Ripple Labs also forfeited \$450 million to resolve possible criminal violations. In 2017, BTC-e, a foreign based Bitcoin exchange, was criminally and civilly prosecuted for money laundering and assessed a \$110 million by FinCEN. BTC-e executives are currently facing criminal charges relating to their actions regarding the exchange. *See* Steve Hudak, *FinCEN Press Release* (July 27, 2017), <https://www.fincen.gov/news/news-releases/fincen-fines-btc-e-virtual-currency-exchange-110-million-facilitating-ransomware> (last visited Dec. 21, 2018).

July 2018 Update: SEC enforcement co-directors Stephanie Avakian and Steven Peikin have stated that fraudulent ICOs are among the greatest risks currently facing investors. See Stephanie Avakian and Steven Peikin, *Oversight of the SEC's Division of Enforcement*, (May 16, 2018), <https://www.sec.gov/news/testimony/testimony-oversight-secs-division-enforcement> (last visited June 8, 2018). In Sept. 2017, the SEC created a special cyber unit within its Division of Enforcement. The SEC's cyber unit's first enforcement action came in Dec. 2017 when it obtained an emergency asset freeze to shut down a \$15 million fraudulent ICO. In Jan. 2018, the SEC's cyber unit again successfully obtained an emergency asset freeze against AriseBank, a Texas-based ICO that claimed to have raised \$600 million. In April 2018, it froze \$27 million in trading proceeds of Longfin, a Nasdaq-listed blockchain company, in a case alleging Longfin trades violated existing securities laws.

Whether digital tokens and coins are securities or commodities subject to regulation by the SEC and CFTC remains an unresolved issue and continues to be litigated through the courts. A New York federal district court recently dismissed SEC fraud charges against a businessman for alleged misstatements he made to attract ICO investors. The court found the digital tokens at issue were not securities. See Dunstan Prial, *Ruling on What Isn't a Security Needed For ICO Clarity*, (May 9, 2018, 7:31 PM), <https://www.law360.com/articles/1042159?scroll=1> (last visited May 19, 2018).

The CFTC has also been active in its enforcement efforts. In March 2018, the United States District Court in the Eastern District of New York held that virtual currencies can be regulated by CFTC as a commodity. The court noted, however, that the CFTC's jurisdictional authority did not preclude other agencies from exercising their regulatory power when virtual currencies function differently than derivative commodities. See No. 1:18-cv-00361-JBW-RLM, Dkt. No. 29 (E.D.N.Y. Mar. 6, 2018). In May 2018, the CFTC and the U.S. Department of Justice launched a criminal investigation into potential cryptocurrency market manipulation.

In addition to policing U.S.-based ICOs and cryptocurrency related activity, the U.S. has also taken recent action regarding foreign cryptocurrencies. For example, on March 19, 2018, President Trump issued an Executive Order prohibiting transactions with any digital currency, coin or token issued by, for or on behalf of the Venezuelan government, including the *petro*. See Stinebower, *New Executive Order Adds New Sanctions Against Venezuela's Petro Cryptocurrency*, (March 27, 2018), <https://www.cmtradelaw.com/2018/03/new-executive-order-adds-new-sanctions-against-venezuelas-petro-cryptocurrency/> (last visited May 21, 2018). In March 2018, the U.S. Treasury issued guidance stating that any foreign virtual currency transaction must comply with OFAC (Office of Foreign Assets Control) sanctions rules. See OFAC FAQs: Questions on Virtual Currency, https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_compliance.aspx#vc_faqs (last visited on Dec. 17, 2018).

The IRS has also entered the enforcement arena. New tax implications are arising for token users and purchasers. After Jan. 1, 2018, exchanging or trading one cryptocurrency for another became a taxable event. In March 2018, the IRS issued a bulletin mentioning that the failure to report the income tax of virtual currency transactions could result in penalties or, in more extreme situations, a prison term and a fine. In 2017, the IRS brought an enforcement action against a cryptocurrency exchange that led to a federal court ordering the turnover of certain customer information to the government, signaling that the IRS may be looking to identify potential tax evaders through their cryptocurrency profits.

Sept. 2018 Update: The SEC's challenge to the issuance of certain digital tokens continues. On Aug. 22, 2018, SEC staff blocked nine bitcoin based exchange-traded funds from coming to market. See Trevor Hunnicut and Michelle Price, *SEC to review decision rejecting bitcoin ETFs*, (Aug 23, 2018, 6:11 PM), <https://www.reuters.com/article/us-bitcoin-etf/sec-to-review-decision-rejecting-bitcoin-etfs-idUSKCN1L82LB> (last visited Sept 6, 2018). The SEC rejected the applications claiming that the products did not comply with the requirements of Section 6(b)(5) of the Exchange Act. Then, on Aug. 23, 2018, the SEC released letters stating that its commissioners would review the decision but no deadline has been set for the completion of this review.

In Aug. 2018, the SEC settled an enforcement action against an ICO issuer who widely distributed tokens to third parties using an “air drop” distribution model, meaning the tokens are provided at no cost or in exchange for performing menial tasks. In this case, the free tokens were offered under a “bounty program” in exchange for online marketing materials that directed potential investors to the company’s offering materials. See Scott H. Kimpel and Beth F. Donohue, *SEC Brings Enforcement Case Involving “Airdrop” of Securities*, (Aug 21, 2018), <https://www.lexology.com/r.ashx?l=82Q6L5X> (last visited Sept 13, 2018). The SEC determined that the issuance of tokens under the bounty program constituted an offer and sale of securities because even though the tokens were provided to investors for free, the company received valuable economic benefits including online marketing, increased traffic to their websites and the creation of a public trading market for its securities. The lesson taken from this enforcement action is that “free” tokens does not always equate to a finding that a sale or offering of securities has not occurred for SEC enforcement purposes.

In Sept. 2018, FINRA filed its first disciplinary action involving the alleged unlawful distribution of an unregistered cryptocurrency security. They claimed that the company’s owner, Timothy Tilton Ayre, bought the rights to a cryptocurrency, HempCoin, repackaged it as a security backed by his company’s stock, then defrauded investors by making materially false statements and omissions regarding his business, HempCoin, and the state of the company’s financials. See *FINRA Charges Broker with Fraud and Unlawful Distribution of Unregistered Cryptocurrency Securities*, (Sept 11, 2018), <http://www.finra.org/newsroom/2018/finra-charges-broker-fraud-and-unlawful-distribution-unregistered-cryptocurrency> (last visited Sept 12, 2018). This case remains pending.

Dec. 2018 Update: On Nov. 8, 2018, the SEC settled its first enforcement action against an unregistered cryptocurrency exchange. See Rachel Graf, *SEC Puts Crypto Exchanges on Notice With First Settlement*, (Nov. 8, 2018, 6:35 PM), <https://www.reuters.com/article/us-bitcoin-etf/sec-to-review-decision-rejecting-bitcoin-etfs-idUSKCN1L82LB> (last visited Dec. 9, 2018). The cryptocurrency exchange EtherDelta was found to be violating federal securities laws by trading assets that were considered securities without registering with the SEC first. EtherDelta’s founder agreed to pay a \$75,000 fine and \$313,000 in disgorgement and interest but did not admit to any wrongdoing. This action by the SEC made clear that if digital tokens are considered actions during their initial sale, they may remain securities during subsequent trades.

B. State Enforcement Trends

July 2018 Update: On May 21, 2018, the North American Securities Administrators Association (NASAA) launched “Operation Cryptosweep,” the largest coordinated series of securities enforcement actions by U.S. and Canadian state regulators ever brought. To date, it has resulted in at least 70 inquiries and investigations and 35 pending or completed enforcement actions related to ICOs or cryptocurrencies since the beginning of May. See *Regulators Crack Down on Crypto Scams Via ‘Operation Crypto-Sweep’*, Fortune.com (May 21, 2018), <http://fortune.com/2018/05/21/regulators-cryptocurrency-ico-scams/> (last visited May 30, 2018). The probe targets unregistered securities offerings promising lucrative returns without adequately advising investors of the risks, including suspicious cryptocurrency transactions and ICOs. The NASAA has also agreed to share information with the CFTC, which could serve as a basis for the federal authorities to bring their own enforcement actions.

As cryptocurrency and ICO regulations lag behind the growing popularity of this emerging technology, state regulators are stepping up their enforcement efforts. For example, on March 27, 2018, Massachusetts stopped five unregistered ICOs, even though there was no allegation of fraud. Texas has emerged as an early leader in “Operation Cryptosweep” and has cracked down on bitcoin mining farms who are operating in violation of state securities laws. New York has also stepped up its efforts to protect NY residents investing in cryptocurrencies and ICOs. On Feb. 7, 2018, the New York Department of Financial Services (NYS DFS) issued new guidance to virtual currency business entities to ensure they have comprehensive policies on preventing and reporting fraud. On Apr. 17, 2018, the New York Attorney General launched the “Virtual Markets Integrity Initiative,” which requested a wide range of information from thirteen major virtual currency exchanges. Three of the four exchanges who declined to participate were referred to NYS DFS for further

investigation. See <https://virtualmarkets.ag.ny.gov/#key-findings> (last visited Dec. 21, 2018). This heightened scrutiny is intended to inform enforcement agencies, investors, and consumers on virtual currency practices and is sending a strong message to unlicensed ICOs and cryptocurrency exchanges seeking to enter the New York market that they must comply with state licensing requirements.

Sept. 2018 Update: NASAA has expanded Operation Cryptosweep from 70 active investigations to 200. See Kate Rooney, *State regulators expand ‘Operation Cryptosweep’ to 200 initial coin offerings*, CNBC.com (Aug. 28, 2018), <https://www.cnbc.com/2018/08/28/state-regulators-expand-operation-crypto-sweep-to-200-initial-coin-offeringinvestigations.html> (last visited Sept. 10, 2018). The NASAA President and Alabama Securities Commission Direct Joseph P. Borg noted that there should be a strong culture of compliance in place before, not after, these products are marketed to investors. See *NASAA Updates Coordinated Crypto Crackdown*, NASAA.com (Aug. 28, 2018), <http://www.nasaa.org/45901/nasaa-updates-coordinated-crypto-crackdown/> (last visited Sept. 13, 2018).

Dec. 2018 Update: A recent decision from the Eastern District of New York addresses whether cryptocurrency is subject to federal securities laws. See *United States v. Zaslavskiy*, 1-17-cr-00647. The government claimed that Brooklyn resident Zaslavskiy defrauded investors from July 2017 to Oct. 2017 by fraudulently raising at least \$300,000 through digital ‘tokens’ or ‘coins’ during ICO processes. Zaslavskiy claimed the virtual currencies were not securities and the federal securities laws were unconstitutionally vague and therefore the indictment should be dismissed. The Court held that the ICOs qualified as investment contracts and Zaslavskiy’s conduct constituted securities fraud because the ICO’s fit within the definition of an investment contract. The Judge’s ruling stands to have an impact on the SEC and DOJ’s oversight of ICO’s.

Future Regulatory Trends

So what to expect in the future? It is safe to say, as more regulators continue to weigh in on ICOs and virtual currencies, more regulation is expected. In 2016, a bi-partisan group of U.S. Congress members established a blockchain caucus understanding the potential for blockchain and the need for new laws to support this new technology.

At the state level, the Uniform Law Commission has proposed a Virtual Currency Businesses Act (VCBA) to promote uniform state laws for cryptocurrency related businesses. The VCBA drafting committee will consider licensing requirements, reciprocity, consumer protection, cybersecurity, AML/KYC, and supervision of licensees.

Sept. 2018 Update: Given the active enforcement of cryptocurrencies by federal and state regulators and newly defined enforcement priorities by FinCEN and FINRA, continued regulatory scrutiny of this emerging technology is expected.

Conclusion

In this new era of ICOs, virtual currencies and blockchain transactions, managing AML, fraud and security risks will remain top-of-mind for fintech companies seeking to gain investor confidence and will also remain an active area for government regulators for the foreseeable future.

Fintech companies would be wise to incorporate “security by design” features into their proposed projects, to consider security from inception through launch, and to voluntarily adopt AML/KYC processes that meet U.S. federal regulations while continuing to improve processes for verifying and storing user/customer identification and data. Government regulators and legislators, in turn, should enact smart regulations that are not overly burdensome or hamper innovation but are designed to keep consumers safe and create accountability for wrongdoers. This space will likely continue to generate a lot of interest and activity by regulators, consumers and fintech companies in the years to come.

About the Authors



Obiamaka P. Madubuko is a Litigation and Compliance Shareholder at Greenberg Traurig and is based in the firm's New York office. Obi focuses her practice on anti-corruption and fraud matters and advises U.S.-based companies doing business in international markets. She advises companies on a host of compliance and transactional due diligence issues arising under the Bank Secrecy Act (BSA), Foreign Corrupt Practices Act (FCPA), the Dodd-Frank Act, Office of Foreign Asset Control (OFAC) and other global trade regulations, including cybersecurity defense, data privacy and data breach response. She also assists clients with internal investigations, risk assessments and independent audits, as well as drafting, evaluating and updating corporate policies to ensure compliance. Obi is a member of the firm's Blockchain and Fintech Taskforce and the Financial Regulatory & Compliance Group.

In addition to her significant corporate advisory practice, Obi is an experienced trial lawyer who has defended individuals and corporations in complex civil litigation and white collar criminal cases. She has represented clients before state and federal courts and agencies, including the United States Congress, the United States Department of Justice, the U.S. Securities and Exchange Commission, the Equal Employment Opportunity Commission, the Federal Election Commission, and other federal and state authorities.



Margaret Ukwu is an Intellectual Property Litigation Associate at Greenberg Traurig and is based in the firm's New York office. Margaret focuses her practice on complex patent litigation and prosecution involving medical devices, pharmaceuticals, consumer products, electronics and a broad range of technologies pertaining to mechanical systems and devices, complex integrated circuits, semiconductors, signals processing, computer architecture, software and user interfaces. She has also assisted in writing and implementing new law in Uganda and Rwanda.

In addition to her legal work, Margaret is an experienced control systems engineer. She has worked on projects involving liquefied natural gas plants, vitrification plants and chemical agent destruction and demilitarization plants.

© 2019, Obiamaka P. Madubuko and Margaret Ukwu

End of Document

© 2019 Thomson Reuters. No claim to original U.S. Government Works.