

Regulatory brief

A publication of PwC's financial services regulatory practice

Carving up crypto: Regulators begin to find their footing

The emergence of cryptocurrencies¹ into the mainstream this past year came at a meteoric rate, attracting the attention of the investing public and financial institutions.² As with any emerging market, regulators in the US and abroad are now playing catch up, tasked with protecting the investing public and maintaining market stability while not going so far as to stifle innovation.

In the US, regulators have been carefully attempting to strike this balance while determining their respective authorities in regulating the cryptocurrency markets. The Securities and Exchange Commission (SEC) has been monitoring Initial Coin Offerings (ICOs)³ for fraud and other misconduct, while the Commodity Futures Trading Commission (CFTC) has exercised its authority over derivatives markets – and both agencies have issued numerous enforcement actions over the past year. Meanwhile, the Treasury Department's Financial Crimes Enforcement Network (FinCEN) has been filling in the gaps by classifying non-securities and non-commodities as “money transmitters” subject to anti-money laundering (AML) requirements, and state banking regulators have been overseeing cryptocurrency trading platforms for consumer protection.

Globally, regulators have taken a variety of approaches – China has called for an outright ban on cryptocurrency, Switzerland has had relatively lenient policies, while others such as Japan and the UK have been somewhere in between. One similarity between virtually all regulators is their support for monitoring the markets to prevent theft, fraud, market manipulation, and money laundering.

Going forward, we expect to see new guidance from the US regulators as well as a continued increase in enforcement actions. While it remains to be seen whether a new regulatory framework emerges within the US or abroad, ICO issuers, trading platforms, and other firms that deal with cryptocurrencies should begin enhancing their AML, anti-fraud, cybersecurity, and reporting programs as regulatory scrutiny in these areas will only increase.

This **Regulatory brief** outlines (a) the United States' regulatory approach toward cryptocurrency, (b) the approach taken by global regulators, and (c) the outlook for the rest of 2018.

The US and Cryptocurrency

US regulators have been gaining their footing in carving out which pieces of the cryptocurrency puzzle fall under their respective oversight. However, the piecemeal approach of having federal and state regulators claim respective portions of the regulatory responsibility has led to concerns from market participants over complying with the patchwork of regulation both within the US and abroad. One example is the confusion around whether a particular token or coin constitutes a security (subject to SEC regulation), a commodity (subject to CFTC regulation), or a payment (subject to money transmitter requirements under FinCEN and state regulation).

There is also growing concern from regulators that they will be unable to maintain adequate oversight of this emerging technology due to insufficient jurisdictional authority. Last month, SEC Chairman Jay Clayton and CFTC Chairman Christopher Giancarlo testified to the Senate Banking Committee that they could not state whether they have sufficient authority over the cryptocurrency markets and noted that they may return to Congress to ask for additional regulatory authority.

SEC and ICOs

The SEC has been ramping up its oversight of cryptocurrencies since last September when it created a new Cyber Unit to prevent and enforce misconduct related to ICOs and Blockchain technology. In the following months, the Cyber Unit issued over a dozen enforcement actions and cease-and-desist orders against ICO issuers for fraud and selling unregistered securities.

Many ICO issuers have claimed that their tokens are not “securities” subject to SEC oversight because the tokens have utility beyond investment purposes.⁴ However, Chairman Clayton issued a statement last December explaining that the vast majority of ICOs have characteristics similar to a traditional securities offering and, as a result, will be treated as securities.⁵ Despite the SEC’s warning, only one entity to date has taken steps to register its ICO with the SEC. As a result, issuers should consider structuring their ICOs in accordance with existing SEC rules to provide transparency to the regulators while also giving market participants a familiar framework with respect to registration and sales practices.

In addition to ICOs, the SEC has made it clear that it is exploring all potential avenues concerning its regulatory authority over cryptocurrency markets.⁶ Earlier this month, the agency issued a warning that cryptocurrency exchanges that offer trading of coins or tokens that are “securities” are subject to federal securities laws including registration requirements, cybersecurity requirements, and requirements to have policies around

preventing fraud and market manipulation. The SEC’s warning follows an action it took last month charging the owner of a cryptocurrency trading platform with operating an unregistered securities exchange, misappropriating funds, and failing to disclose a cyberattack. While no trading platforms are currently registered with the SEC, one major platform announced last month that it intends to become the “US’s first regulated exchange,” presumably indicating that it will register with the SEC and other applicable agencies.

Going forward, it remains to be seen whether the SEC will develop a new regulatory framework for ICOs and exchanges or seek additional regulatory authority from Congress. Regardless, the SEC is determined to use the extent of its power to prevent fraud and other abuse in the cryptocurrency markets.

CFTC and Derivatives

While the SEC has largely tailored its efforts towards ICOs, the CFTC has focused its attention on cryptocurrency derivative products and the underlying Blockchain technology.⁷ Recently, the CFTC allowed several cryptocurrency exchanges to self-certify cryptocurrency futures products on major exchanges. Taking a similar approach to the SEC, the CFTC has mainly issued enforcement actions to prevent fraud and other abuse such as misappropriation of funds in the derivative markets— and has issued over a dozen enforcement cases this year alone. To further its efforts in monitoring the markets for fraud, the CFTC last month issued a policy offering monetary rewards for information regarding pump-and-dump schemes.

Although the CFTC has made it clear that it intends to monitor the markets for fraud and market abuse, it has been vocally supportive of industry efforts to use cryptocurrency and Blockchain technology in financial technology (FinTech) innovation. Last May, the CFTC created LabCFTC to research emerging technology and engage with the industry on FinTech such as cryptocurrency. As part of this effort, the agency hosted a conference last month with the industry to discuss the growth of the technology and concerns around the uncertainty of future regulations. Additionally, LabCFTC signed an agreement with the UK’s Financial Conduct Authority to share information, harmonize regulatory best practices, and provide assistance to foreign FinTechs looking to enter each country’s markets.

Most recently, CFTC Commissioner Brian Quintenz has recommended the development of a self-regulatory organization (SRO) that would create a framework for industry standards, work with regulators to prevent misconduct, and police the industry. This month, Commissioner Quintenz issued a statement supporting

one SRO proposal while cautioning that it would need independence from its membership to be successful.

Irrespective of whether an SRO eventually emerges, exchanges and firms that offer cryptocurrency derivative products should at a minimum prepare themselves to adhere to marketplace conduct rules set out by other CFTC regulations. Furthermore, it would be wise for these firms to examine whether their existing reporting platforms have both the capacity and capability necessary to address cryptocurrency.

Other regulators

In addition to the SEC and CFTC overseeing their respective areas of the markets, FinCEN has been bringing enforcement actions for AML violations. In particular, it fined a coin issuer for failure to maintain an adequate program to protect its products from use in money laundering, and issued a \$110 million penalty against an exchange for failure to detect suspicious transactions and file suspicious activity reports. Earlier this month, FinCEN released a statement explaining that ICO issuers whose products are not registered as securities with the SEC are money transmitters and therefore subject to FinCEN registration requirements. As a result, these ICO issuers and exchanges will need to comply with FinCEN's AML, know-your-customer (KYC), and reporting requirements.⁸ This includes enhancing existing transaction monitoring programs to address the unique risks associated with cryptocurrency and incorporating cryptocurrency into ongoing customer due diligence.⁹

Meanwhile, state regulators are beginning to exercise their enforcement authority over trading platforms, which are mostly registered as money transmitters and therefore subject to direct oversight by the states rather than federal agencies. Most notably, the New York Department of Financial Services (DFS) requires that trading platforms operating in New York obtain a "BitLicense," which contains capital requirements and requires that trading platforms have programs in place to detect and prevent AML, cyber incidents, and fraud. Several other states have issued similar requirements, and California's state legislature is currently considering its own licensing requirement.

Furthermore, the Internal Revenue Service (IRS) has reminded the investing public that cryptocurrency assets are taxable like any other transaction involving property that require reporting of losses and profits on an annual basis.¹⁰ We expect scrutiny over taxation in cryptocurrency markets to increase, and firms opting to raise capital through ICOs will need to consider potential tax implications and structure their ICOs accordingly.

Cryptocurrency around the World

Outside of the US, Asian countries have had conflicting approaches to cryptocurrency regulation, with some countries aggressively prohibiting trading and others expressing support. On the other hand, EU countries have been relatively united in their cautious optimism toward cryptocurrency and Blockchain technology, seeking to promote the emerging market while preventing misconduct and informing potential investors of risks. Accordingly, the Financial Stability Board issued a letter this month stating that it does not see cryptocurrency as a threat to global stability, but calls for international cooperation on investor protection and AML efforts.

Asia

Asian countries have been leaders in the cryptocurrency space since the inception of Bitcoin in 2009. Japan has had relatively lenient cryptocurrency policies and recognizes Bitcoin as a form of currency, but has recently increased scrutiny over exchanges' cybersecurity, AML, and anti-fraud policies after a series of hacks.¹¹ Singapore and Hong Kong have also been relatively supportive of cryptocurrency – Singapore has ruled out any ban on trading and noted that it may issue its own cryptocurrency in the future, and Hong Kong has launched initiatives to educate the public about ICOs and cryptocurrencies.

In contrast, China – which at its peak was home to over 80% of Bitcoin miners¹² – has recently shifted gears, banning all ICOs and cracking down on trading platforms by not only banning national cryptocurrency exchanges, but also restricting access of its residents to overseas platforms. Similarly, South Korea has prohibited all domestic companies and startups from participating in ICOs. Unlike China, however, South Korea has focused its attention on scrutinizing AML and KYC aspects of cryptocurrency exchanges rather than banning trading on exchanges altogether.

India has been slower than its Asian peers in implementing cryptocurrency regulation or supervision, but it recently required that any person transacting in cryptocurrencies register their national IDs with exchanges. This registration requirement has implications for AML and KYC efforts as well as taxation consideration.

European Union and United Kingdom

Similar to US regulators, the EU and UK's financial regulators are approaching Blockchain technology and the growth of the cryptocurrency markets with cautious optimism to better cultivate the technologies before taking action. Switzerland published guidelines last month explaining that it will determine whether coins or tokens are assets (and therefore are subject to securities laws) or payments or utility tokens (and therefore not subject to securities laws).¹³ France also published a statement last month explaining that certain cryptocurrency products could be subject to existing derivatives laws and that new reporting and AML requirements for ICOs may come in the future. The Swiss guidance and French statement are both welcome news to the cryptocurrency industry as they seek small steps to prevent abuse in the market without creating any burdensome new requirements. Additionally, Spain announced that it is working on very favorable legislation that will encourage both ICOs and Blockchain companies to establish themselves in the country.

However, many EU regulators are also cautioning against cryptocurrency's potential for fraud and other misconduct. Last month, the European Securities and Market Authority issued a statement (a) warning investors to consider the risks associated with cryptocurrency, including price volatility and the potential for fraud, and (b) warning ICO issuers to consider whether they are violating any existing regulations. Additionally, Germany last month issued a statement warning that it is scrutinizing ICOs and that issuers should "reach out" prior to starting the process. This announcement from German regulators came just days before the UK launched an inquiry into the role of cryptocurrencies including any potential opportunities and risks to consumers.

What's next?

Going forward, we expect that US regulators – including the SEC, CFTC, FinCEN, IRS, and Federal Reserve – will issue guidance for different sectors of the cryptocurrency market including issuers and exchanges covering concerns such as cybersecurity, AML, registration, anti-fraud, and transaction reporting. The regulators will also likely begin conducting collective authority examinations to ensure that these areas are adequately addressed. Therefore, any firm dealing in cryptocurrency should prepare for heightened scrutiny and potential examinations by incorporating new risks into their risk assessments and developing mitigating controls for these new risks.

Additionally, we expect continued legal challenges to regulatory authority in the US. Particularly, it is only a matter of time until the SEC's view that ICOs are "securities offerings" will be challenged in court. Meanwhile, a district court agreed this month with the CFTC's definition of cryptocurrencies as "commodities," but we expect other courts to weigh in over the course of the next year.

Further, we expect some small steps toward international cooperation in regulating the cryptocurrency markets. Notably, a task force at the G20 summit earlier this month met to discuss how global authorities can cooperate to monitor cryptocurrency risks and combat the use of cryptocurrency in money laundering. The task force will consider proposed recommendations at its next meeting in July, and the members are likely to agree at the very least that additional steps need to be taken to prevent market manipulation, money laundering, and cyber attacks. However, the biggest changes to the regulatory landscape will continue to come from the national regulators, and firms' legal and compliance departments should be actively monitoring for regulatory changes and adjusting their programs accordingly.

While it remains unclear as to whether the US will continue with its piecemeal approach or whether Congress will act to establish a new regulatory framework, it is clear that interest in regulating this space is continuing to grow. If a new framework in the US emerges, other global regulators will likely follow with similar requirements. Going forward, a smart first step for issuers and exchanges – regardless of their location – is to establish sound sales and registration practices, responsible market conduct rules, robust cybersecurity programs, anti-fraud procedures, and cohesive AML programs as these areas will continue to be key areas of concern from regulators both domestic and abroad.

Endnotes

1. A cryptocurrency is a digital store of funds that utilizes a cryptography security technique to (1) control the creation of new units and (2) validate the transfer of the asset. It is important to not confuse crypto assets with Blockchain, which is the technology that enables crypto assets to act as a decentralized network where the ledger of data entries does not exist on any one server as a physical database but is instead distributed across and validated by the other users of the network.
2. Financial institutions are also beginning to take this emerging market seriously. For key considerations, see PwC's *Ten questions every board should ask about cryptocurrencies* (February 2018).
3. An ICO is a form of fundraising that is similar in structure to initial public offerings, but allocates virtual tokens instead of shares to investors. These tokens typically do not represent actual ownership in the company, but often provide access to an ecosystem and can be traded on an aftermarket. For additional information on ICOs, see PwC's *Understanding the ICO* (February 2018).
4. For example, tokens have uses beyond mere investment purposes such as to exchange dormant computing power, advertising space, and even dental industry purchases.
5. Specifically, the statement explained that most tokens are marketed and purchased with the expectation that they will increase in value, are traded on secondary markets, and are generally not purchased with the intent to act upon the token's purported utility.
6. Additionally, the SEC has warned that they are scrutinizing public companies that change their business model (or simply imply that they have changed their business model) to capitalize on the popularity of cryptocurrency or Blockchain technology, and has recently halted trading for several companies that have done so. The SEC has also warned that they are watching professionals such as lawyers and accountants that have been structuring ICOs in the same fashion as initial public offerings without complying with securities laws.
7. The CFTC has consistently affirmed that cryptocurrencies are commodities and therefore maintains authority over regulating the associated futures and options markets. Earlier this month, a federal court agreed with Giancarlo's view, ruling that the CFTC has jurisdiction over cryptocurrencies because cryptocurrencies are "commodities" subject to the Commodity Exchange Act.
8. For additional information on FinCEN's AML and KYC requirements, see PwC's Financial Crimes Observer, *AML: Who is your customer? FinCEN wants you to know* (May 2016). For more information on FinCEN's reporting requirements, see *A Meeting of the Minds: Emerging Regulation and the Convergence of Cyber and Fraud* (March 2017).
9. For our perspective on enhancing transaction monitoring programs, see PwC's *AML: Do you really know your customers?* (January 2016).
10. For related accounting considerations, see *PwC's Cryptocurrencies: Time to consider plan B* (March 2018).
11. Earlier this month, Japan suspended two cryptocurrency exchanges citing a lack of proper controls to prevent cyber attacks, fraud, and market manipulation.
12. The mining process utilizes the other transactions in the network (blocks) to computationally solve complex math problems (cryptography), so that the new transaction can be validated and confirmed resulting in the addition of a new block to the public distributed ledger (Blockchain).
13. ICOs where the token is intended to function as a means of payment and can be readily transferred remain subject to Swiss AML laws.

Additional information

For additional information on *Regulatory brief* series or PwC's Financial Services Regulatory Practice, please contact:

Dan Ryan

Banking and Capital Markets Leader
646 471 8488
daniel.ryan@pwc.com
@DanRyanWallSt

Julien Courbe

Financial Services Advisory Leader
646 471 4771
julien.courbe@pwc.com
@juliencourbe

Adam Gilbert

Financial Services Advisory Regulatory Leader
646 471 5806
adam.gilbert@pwc.com

Mike Alix

Financial Services Advisory Risk Leader
646 471 3724
michael.alix@pwc.com

Roberto Rodriguez

Director of Regulatory Strategy
646 471 2604
roberto.j.rodriguez@pwc.com

Grainne McNamara

Blockchain Leader
347 491 0509
grainne.mcnamara@pwc.com

Contributing authors: Matthew Blumenfeld, Michael Horn, Keaghan Ames, Nikhil Raina, Cesar Munoz, and Margaret Paulsen.

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