

**VIRTUAL CURRENCIES: THE OVERSIGHT ROLE OF
THE U.S. SECURITIES AND EXCHANGE COMMIS-
SION AND THE U.S. COMMODITY FUTURES
TRADING COMMISSION**

HEARING
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED FIFTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE GROWING WORLD OF VIRTUAL CURRENCIES AND THE
OVERSIGHT CONDUCTED BY THE U.S. SECURITIES AND EXCHANGE
COMMISSION AND THE U.S. COMMODITY FUTURES TRADING COMMIS-
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**VIRTUAL CURRENCIES: THE OVERSIGHT
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MODITY FUTURES TRADING COMMISSION**

TUESDAY, FEBRUARY 6, 2018

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:04 a.m., in room SD-538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. The Committee will come to order.

This morning we will receive testimony from SEC Chairman Jay Clayton and CFTC Chairman Chris Giancarlo on the growing world of virtual currencies and the oversight conducted by their two agencies. And welcome, gentlemen.

Virtual currencies are meant to act as a type of money that can be traded on online exchanges for conventional currencies, such as dollars, or used to purchase goods or services, predominantly online.

Additionally, developers, businesses, and individuals are selling virtual coins or tokens through initial coin offerings, also known as ICOs, to raise capital.

Over the last year, many Americans have become increasingly interested in virtual currencies, especially given the meteoric rise in valuation and recent fall of Bitcoin.

Just for perspective, on January 2 of last year, Bitcoin broke the \$1,000 barrier, then peaked in December of 2017 at almost \$20,000, and as of this morning is trading at roughly \$6,900.

Today the market capitalization of Bitcoin is roughly \$115 billion. This is an incredible rise given that in 2013, when this Committee had subcommittee hearings on the topic, the total value of Bitcoin in circulation was approximately \$5 billion.

As virtual currencies have become more widespread, financial regulators and heads of financial institutions have noticed and voiced their opinions.

Regulators and heads of industry have tried to educate investors so that they make informed decisions and ensure that the markets they oversee and participate in are working appropriately.

For its part, the SEC has put forth many statements and guideposts to help the markets and investors. Namely, the SEC has

issued investor bulletins on initial coin offerings; issued an investigative report on what characteristics make an ICO a security offering; issued several statements by Chairman Clayton on the issue; brought enforcement actions against fraudsters; and issued joint statements with the CFTC about enforcement of virtual currency-related products.

The CFTC has also been helping inform the markets by launching a dedicated website on virtual currencies to educate investors; bringing enforcement actions against individuals involved in cryptocurrency-related scams; issuing several statements by Chairman Giancarlo and other Commissioners on the issue; and scheduling hearings on the topic.

Much of the recent news about virtual currencies has been negative. Between the enforcement actions brought by your agencies, the hack of the international Coincheck exchange, and the concerns raised by various regulators and market participants, there is no shortage of examples that increase investor concerns.

It is also important to note that the technology, innovation, and ideas underlying these markets present significant positive potential.

These aspects underpinning virtual currencies have the ability to transform for investors the composition of, and the ability to access, the financial landscape, thus changing and modernizing capital formation and transfer of risk.

Technology is forward-looking, and we look to our regulators to continue carrying out their mandates, including investor protection, as markets evolve.

I look forward to hearing more and learning more about virtual currency oversight from our two witnesses today, including what their agencies are doing to ensure appropriate disclosures and safeguards for investors.

Senator Brown.

OPENING STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Chairman Crapo, and welcome to Chair Clayton and Chair Giancarlo. Good to have you both here.

Virtual currencies, and Bitcoin specifically, have captured the attention of investors and speculators and computer programmers and regulators all over the world. I do not know how many people imagined how quickly and broadly Bitcoin, and the technology it is based on, would spread. To most of us, it is nothing short of remarkable.

To be sure, it is critical for our regulators to understand innovation and technology so that markets can grow and evolve while investors and consumers are protected. Understanding the risks of emerging technologies is no easy task, but we are relying on you to maintain the integrity of these new markets and minimize the risks to Americans who want to participate in them.

The volatility of Bitcoin has also been remarkable, defying attempts to think of it as a traditional currency. Bitcoin's 1,000-percent rise last year and 60-percent decline last month makes yesterday's Dow Jones record point drop look almost like a rounding error.

But that growth has shown us the intersection of ingenuity and, too often, greed. Sometimes it appears that scam artists and hackers may understand more about the technology than most market participants. That should concern all of us.

I hope our witnesses today can help us understand the evolution of the markets related to virtual currencies, raise awareness of the many threats involved, and identify the regulatory gaps.

Each of you has made several public statements recently explaining the threats to investor protection and the potential for abuses in virtual currency markets.

I understand that neither the SEC nor the CFTC has sufficient authority to police all aspects of virtual currencies, but you must make the most of the authority you have.

As you both noted in the *Wall Street Journal*, Bitcoin mania has some analogies to the dot-com bubble of the late 1990s. I hope there are lessons from that era that you draw on to do your job to protect investors.

In addition to the investment risk, virtual currency may be used to fund illicit activity, especially outside the United States. I know the regulatory framework in many other countries is still in development. I am pleased that the U.S., and FinCEN in particular, has been a leader. But we can do more.

I hope the Chairman agrees with me that the Committee needs to look closely at the gaps in regulation in this area and to review your agencies' ability to get ahead of the curve.

As you begin to adapt to the unique enforcement and regulatory demands posed by virtual currencies, I call on both of you not to forget your day jobs—as Chair Clayton and I talked the other day—not to forget your day jobs: to pursue and punish misconduct, more traditional misconduct but very serious misconduct, wherever it might appear. That means Main Street; it also means Wall Street.

I am concerned that it is business as usual when it comes to violations by the big banks. Just last week the CFTC imposed penalties on three big banks for market manipulation—good—but then decided those firms deserved waivers from bad actor provisions under the securities laws. That might make sense if this were an isolated incident, but the banks in question have something like 68 violations over the last 10 years. So it is very, very serious.

Too often we see big banks pay fines and move right along, with little contrition and, frankly, no serious punishment. Recidivist violators will not stop breaking the law if your agencies serve as sanctuaries. I have raised the issue of waivers over the years. I am disappointed in your unwillingness to pursue every avenue available. It is clear that virtual currencies bring us into a new age, but that does not mean we overlook the basic principles of going after the bad guys and being tough when they are repeat offenders.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you. Senator Brown.

Now we will turn to the testimony of our witnesses, and first today we will receive testimony from the Honorable Jay Clayton, Chairman of the U.S. Securities and Exchange Commission.

Following him, we will then hear from the Honorable Chris Giancarlo, Chairman of the U.S. Commodity Futures Trading Commission.

Gentlemen, again, we welcome both of you here, appreciate you coming to share your knowledge and understanding on this issue with us. And, Chairman Clayton, you may proceed.

**STATEMENT OF JAY CLAYTON, CHAIRMAN, U.S. SECURITIES
AND EXCHANGE COMMISSION**

Mr. CLAYTON. Thank you. Chairman Crapo, Ranking Member Brown, distinguished Senators of the Committee, thank you for the opportunity to testify before you today on the important topic of cryptocurrencies, initial coin offerings, and related trading activities.

The total market capitalization of all cryptocurrencies was estimated at \$700 billion earlier this year. In 2017, ICOs—initial coin offerings—raised nearly \$4 billion. These markets are local, national, and international.

Today I will attempt to level-set where we stand from a market regulatory perspective. My remarks may be viewed by some as overly simplistic, but they reflect how I present these issues to Main Street investors.

For ease of analysis, I break this space into three categories:

First, a promising new technology referred to as distributed ledger technology or blockchain. Proponents of this technology assert that it will bring great efficiencies to our national and global economies, including our capital markets. I hope that it does. And the Commission looks forward to working with market participants who seek to bring efficiencies, including more effective oversight, to our markets.

The second and third categories are cryptocurrencies and ICOs, which are subsets of the products seeking to take advantage of the commercial opportunities presented by blockchain technology. One is promoted to be a replacement for dollars. The other is like a stock offering.

Cryptocurrencies: Some of the more widely known cryptocurrencies were introduced as substitutes for traditional currencies, such as the U.S. dollar or the euro. Those who promote these so-called virtual currencies have asserted that they will make it easier and cheaper to buy and sell goods, particularly across borders. They have asserted that transaction and verification fees and costs will be eliminated or reduced. To date, these assertions have proved elusive in many areas.

ICOs: From what I have seen, initial coin offerings are securities offerings. They are interests in companies, much like stocks and bonds, under a new label. Promoters use the term “coin” based on the fact that the security being offered is represented by a digital entry or “coin” on an electronic ledger, as compared with a stock certificate and a related entry in a company’s records. You can call it a coin, but if it functions as a security, it is a security.

Also, importantly, an ICO may have nothing to do with distributed ledger technology beyond the coin itself. Buying an ICO does not mean you are investing in blockchain-related ventures.

There are many problems with the way cryptocurrency and ICO markets are operating, but two are worth particular attention.

First, the markets for these products have substantially less oversight than our traditional securities markets. To be blunt, if you are trading cryptocurrencies on a platform that looks like a stock exchange, do not take any comfort from that look. Our stock exchanges have extensive rule sets, and they are required to conduct surveillance. Also, broker-dealers who facilitate securities trading have capital and conduct requirements. These requirements, and others, without a doubt are necessary to protect those markets and our investors.

Second, many ICOs are being conducted illegally. Their promoters and other participants are not following our securities laws. Some say this is because the law is not clear. I do not buy that for a moment. The analysis is simple. Are you offering a security? If so, you have a choice: follow our private placement rules or conduct a public offering registered with the SEC.

A note for professionals in these markets: Those who engage in semantic gymnastics or elaborate structuring exercises in an effort to avoid having a coin be a security are squarely within the crosshairs of our Enforcement Division.

So what are we doing about these problems? I look forward to discussing with you that question in more detail, but will start with a comment on jurisdiction and a comment on enforcement.

We—the SEC and the CFTC—do not have direct jurisdiction over the popular markets that trade true cryptocurrencies. This is not an oversight. It is the result of a new product and market. The traditional currency markets did not need direct regulation by market regulators such as the SEC or the CFTC. They are sovereign-backed and regulated with a long history.

Cryptocurrencies, on the other hand, have no sovereign backing or oversight and, again, to be blunt, are currently functioning as assets for trading and investment much more than as mediums for exchange.

Please do not view this description as a request for expanded SEC jurisdiction. If asked, we will work with other regulators to evaluate and address this issue, including our friends at the Fed, our friends at the CFTC, and the State regulators. They all have a keen interest in this market.

I will close. I know my time is short. To the extent that digital assets like ICOs are securities—and I believe every ICO I have seen is a security—we have jurisdiction and our Federal securities laws apply. We will enforce these laws. Many of these laws also include private rights of action. We are working with the DOJ and other regulators to enforce these laws.

Thank you for the opportunity to testify before you today. I stand ready to work with Congress on these issues and look forward to your questions.

Chairman CRAPO. Thank you, Chairman Clayton.
Chairman Giancarlo.

**STATEMENT OF J. CHRISTOPHER GIANCARLO, CHAIRMAN, U.S.
COMMODITY FUTURES TRADING COMMISSION**

Mr. GIANCARLO. Thank you, Chairman Crapo, Ranking Member Brown, and distinguished Members of the Committee. I have submitted a written statement for the record that details the CFTC's work and authority over virtual currencies, but with your permission, I would like to begin briefly with a slightly different perspective, and that is as a Dad.

I am the father of three college-age children: a senior, a junior, and a freshman. During their high school years, we tried to interest them in financial markets. My wife and I set up small brokerage accounts with a few hundred dollars that they could use to buy stocks. Yet other than my youngest son, who owns shares in a video game company, we have not been able to pique their interest in the stock market. I guess they are not much different than most kids their age.

Well, something changed in the last year. Suddenly they were all talking about Bitcoin. They were asking me what I thought and should they buy it. One of their older cousins, who owns Bitcoin, was telling them about it, and they got all excited. And I imagine that maybe Members of this Committee may have had some similar experiences in your own families of late.

It strikes me that we owe it to this new generation to respect their enthusiasm about virtual currencies with a thoughtful and balanced response, not a dismissive one. And yet we must crack down hard on those who try to abuse their enthusiasm with fraud and manipulation.

We must thoroughly educate ourselves and the public about this new innovation, and we must make good policy choices and put in place sound regulatory frameworks to reduce risks for consumers.

Putting my CFTC hat back on, I suggest that the right regulatory response to virtual currencies has at least several elements, and the first is to learn everything we can. At the CFTC we have launched a new initiative called "LabCFTC" to engage with these innovators and inform the agency about virtual currencies and other financial technology.

Next is to put things in perspective. As of 8 a.m. this morning, the total value of all outstanding Bitcoin is about \$113 billion. We have a slightly different figure than you have, Chairman, but close. But the point is that that is less than the market cap of one large publicly traded company—McDonald's.

The total value of all virtual currency in the world is around \$313 billion. In comparison, global money supply is around \$7.6 trillion. And because Bitcoin is sometimes compared to gold as an investment asset, the value of all the gold in the world is around \$8 trillion, which dwarfs the size of the virtual currency market.

The next task is to tell the public what we learn and educate consumers. There is a lot of noise around virtual currency, and regulators must help set the record straight. The CFTC has produced a large amount of consumer education materials on virtual currencies, including written statements, podcasts, webinars, and a dedicated Bitcoin website. We have even scheduled visits to libraries and briefings for seniors. We have never conducted this much outreach for any other financial product.

Another element is regulatory coordination. Because no one agency has direct authority over virtual currencies, we have to work together. That includes us, the SEC, the Fed, the IRS, the Treasury's FinCEN network, and even State banking officials.

And the next element is to exercise our legal authority over derivatives on virtual currencies while clarifying our statutory limitations. To be clear, the CFTC does not regulate the dozens of virtual currency trading platforms here and abroad. We cannot require them to meet requirements like trade reporting and market surveillance, standards for conduct, capital requirements, or even cyberprotections or platform safeguards. But these are all standard regulations in the futures markets we oversee. Yet through our authority over commodity derivative markets, we do have enforcement power over spot coin markets. And with newly launched Bitcoin futures, the CFTC can now obtain trading data and analyze it for fraud and manipulation in five underlying spot markets.

And that leads to the final element, and that is tough enforcement. Led by the CFTC's Virtual Currency Enforcement Task Force, we have launched several civil actions over the past few weeks cracking down on fraudsters and manipulators, and more will follow.

In closing, I want to quote something that Chairman Clayton and I wrote recently in the *Wall Street Journal*: "These markets are new, evolving, and international. They require us to be nimble and forward-looking, and coordinated with State, Federal, and international colleagues, and engaged with important stakeholders, including Congress."

I am glad to be with you today, and I hope my kids are listening. Thank you very much.

Chairman CRAPO. Thank you, Chairman Giancarlo.

I will begin the questioning. First I will say I have had those dinner conversations with my own children, and you are right, this is an incredibly interesting but growing new area of financial challenge, particularly among our—at least my children and yours.

Both of you have said in one way or another that neither of you, neither of your agencies have complete jurisdiction over cryptocurrencies. The question I have is whether you have sufficient jurisdiction, and I would like both of you to address that question. Should Congress address revising and refining our financial law so that one agency or a group of agencies have complete jurisdiction? Or if you look at the jurisdiction of all agencies today, do we have sufficient jurisdiction in place today? Chairman Clayton?

Mr. CLAYTON. Well, thank you, and in my position you are always cautious about speaking for other agencies, so I thank you—

Chairman CRAPO. Understood.

Mr. CLAYTON. —for saying that we should all come to—to be very direct, we should all come together, the Federal banking regulators, the CFTC, the SEC—there are States involved as well—and have a coordinated plan for dealing with the virtual currency trading market. I think our Main Street investors look at these virtual currency trading platforms and assume that they are regulated in

the same way that a stock exchange is regulated. And as I said, it is far from that. And I think we should address that issue.

Chairman CRAPO. So am I hearing you say that you do not think we need to have additional legislative authorities?

Mr. CLAYTON. I think we may. I think we may.

Chairman CRAPO. So first you should get together and tell us what you can and cannot do and then advise us.

Mr. CLAYTON. I think that is a very good way to put it, Senator. Chairman CRAPO. Chairman Giancarlo.

Mr. GIANCARLO. I think that is exactly right. I think the first step is to recognize where the gap is. So as we both said in different ways, what we call the spot market for Bitcoin is not a regulated marketplace.

For us at the CFTC, we are familiar with that because we generally do not have regulatory supervision over the spot markets for which derivatives apply. That is a longstanding basis. We regulated derivative markets. The underlying markets we surveil, and we will take enforcement action for fraud and manipulation. But we do not have the ability to set the standards on those markets, and that is what we have today in Bitcoin. And unless it is an ICO, then, as Chairman Clayton described, he also does not have the jurisdiction. So there is that gap, and I think the starting point for an informed conversation is there is that.

Now, there are other elements to it. There are other agencies that come to bear on this. So State regulators, there is a patchwork of State regulation across the Nation. Some States have been very assertive in this area, other States less so, and some States have nothing.

FinCEN, as you referenced, has also been active in the area in terms of anti-money laundering and Know Your Customer requirements. So there is a patchwork here, but there is not a comprehensive structure, and that is something that I think is a policy discussion and an important one to be had.

Chairman CRAPO. All right. Thank you. And you have led to my next question. Much of the activity in the virtual currency markets is cross-border and international, so that raises obviously the question of what challenges does that present and what is the appropriate role for FinCEN. I would like both of you to respond. I only have about a minute left so take about 30 seconds each, if you would.

Mr. CLAYTON. I will try to be quick. The international nature of this market is why a patchwork is probably not sufficient if it is going to continue to develop as a significant market and one that our Main Street investors access.

From FinCEN's perspective, there are reports that we all have heard that these cryptocurrencies are used for illicit activity. I think FinCEN has been stepping up in that regard, and I encourage them to continue to do so. And this challenge of global markets is a challenge that I think we face now in many regards. In the 21st century with the dawn of the Internet, markets have become truly global and not just in virtual currencies but so many things. And it does become a challenge as we think about regulation. We certainly have had that challenge working with overseas regulators in the area of derivatives regulation as a result of the Dodd-Frank

Act. The challenge of bringing these regulations together in a comprehensive whole is really a tremendous challenge for all of us. So in this area, it requires a lot of new thinking.

Chairman CRAPO. Well, thank you. I appreciate your remarks from both of you on these issues, and I would encourage you to form that work group, get together between yourselves, State regulators, other appropriate Federal regulators, and evaluate exactly what our regulatory structure should like in America to deal with this and let us know your thoughts, your further thoughts on that. I would appreciate that.

Mr. CLAYTON. Thank you.

Chairman CRAPO. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

Chair Clayton, again, nice to see you. Last year initial coin offerings raised about \$4 billion globally. You have testified that the SEC is focused on policing these transactions to protect investors. How much of that \$4 billion was raised in the U.S.?

Mr. CLAYTON. It is not clear. It is hard to get a number on that because this has been conducted on largely an unregulated basis, but I imagine, Senator, a significant enough portion where we should be paying attention.

Senator BROWN. And my understanding is that during the last few months the SEC has taken four enforcement actions targeting coin offers for serious violations of law. That speaks volumes about the work that—the challenges in front of you.

In response to the Chair's question, you both talked, leading with you, Chair Clayton, about agencies working together and the importance of that on this and other issues. Your testimony highlights cooperation between the SEC and CFTC, Chair Clayton, regulating Bitcoin and other virtual currencies. It does not mention any cooperation with the Consumer Financial Protection Bureau. Hundreds of consumers have filed complaints with the Bureau about virtual currencies. How have you been coordinating your work specifically on this but in other areas, too, with CFPB?

Mr. CLAYTON. On this area, largely through the FSOC. At the FSOC I believe I have made very clear my views in this area and that this is an area that we should all be on the lookout for, on the lookout from each of our perspectives. The CFPB is a member of FSOC, and they have heard my comments there.

From an enforcement perspective, we are in the securities area. We do not see the CFPB on the securities side of this. I am not aware of any direct coordination on a particular enforcement action, but I could check on that.

Senator BROWN. OK. In the past few months, Deutsche Bank, Credit Suisse, UBS, and HSBC have been fined over \$300 million by other regulators for various forms of market manipulation. But SEC has been quiet under your watch. One study by a Georgetown law professor found that SEC has "virtually stopped enforcement actions against large entities, often referred to as 'Wall Street firms'."

How do we have confidence, Mr. Chairman, that the SEC is willing to hold Wall Street accountable when the trend in penalties and actions is going the wrong way?

Mr. CLAYTON. I actually saw that report. That probably does not come as a surprise to you that someone sent it to me. I found it annoying, to be honest, because it did not reflect the fact that the gestation period for the cases we bring is roughly 22 to 24 months. So any type of statistics necessarily have a latency period to them.

Our Enforcement Division put out a report that talks about the numbers in a comprehensive way. I am happy with that report. I am also confident that the people who are in our Enforcement Division and leading it, many of them former Federal prosecutors, two of them former heads of the Securities Task Force in the Southern District of New York, are pursuing our securities laws vigorously. I have no doubt. They come to work every day and they have my full confidence.

Senator BROWN. I hear you say that, and I believe you when you say that. I remember the last SEC—and it was not you—the last SEC under a Republican President, how they were asleep at the switch. So as the Governor of the Richmond Federal Reserve used to tell me, “Watch us, and let us know you are watching us.”

But I am further troubled by a statement by one of the SEC’s enforcement codirectors last fall that SEC might lose 100 of its enforcement staff by not replacing those who leave. Compared to 2016 figures, this would reflect a 7-percent reduction in enforcement head count. So how are you going to stay on top of developments in virtual currencies and the other enforcement in all the other areas that we just talked about to be able to fight traditional misconduct? How are you going to do that when you are not replacing them, if, in fact, that is the case?

Mr. CLAYTON. Senator Brown, personnel is my biggest challenge at the moment. We have a hiring freeze as a result of natural increases in costs and people retiring or taking other jobs has reduced the size of the workforce at the SEC. I could use more people in Enforcement. I could use more people in Trading and Markets. Those are the two areas where I think the American people would get the greatest return for additional bodies.

Senator BROWN. So when you come in front of us—and I appreciate your candor. When you come in front of us and tell us that you are having trouble filling those jobs and—

Mr. CLAYTON. No trouble. I just cannot.

Senator BROWN. OK, I guess trouble that way, all right, because of the freeze. Isn’t that message to those who want to game the system and those who want to defraud the system, isn’t the message that the SEC is not the cop on the beat that even the new Chair wants it to be?

Mr. CLAYTON. Do I want more bodies to do more? Yes. Is the message that somehow we are asleep at the switch? Absolutely not.

Senator BROWN. And with your budget that is coming out, our understanding is the budget—I hope the freeze is lifted. I hope the budget is enough. And I hope that you will speak to us and ask particularly people on the other side of the aisle for the dollars you need and the flexibility you need to put those cops on the beat.

Mr. CLAYTON. I think I have been very straight about an incremental amount of money and where I think value can be added.

Senator BROWN. Thank you.

Chairman CRAPO. Senator Shelby.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Chairman Clayton, you and Chairman Giancarlo, you are Chairmen of two powerful regulatory bodies, but you have different jurisdictions. Anything that smacks of security comes somewhere in your range, does it not? Dealing with a commodity, something that could be deemed a commodity clearly comes in your range. The Federal Reserve is the biggest bank regulator we have and also the—and Treasury is involved in this. How are you going to put together a task force, can you do it on your own through the Administration, to deal with the cryptocurrencies—because you have got the Fed, you have got the Treasury, you have got the commodities, you have got the securities, perhaps some others that we have not thought about—before this gets out of control somewhere in the world?

Mr. CLAYTON. Let me start, and then Chris can—

Senator SHELBY. Yes, sir, go ahead.

Mr. CLAYTON. —by recognizing the Treasury Secretary. He has brought us together—

Senator SHELBY. That is good.

Mr. CLAYTON. —the CFTC, the SEC, and representatives of the Federal Reserve to talk about this because, Senator, you are exactly right. The funny thing about these cryptocurrencies is they only work for their purported purpose if they are integrated with the financial system. And so, therefore, it necessarily touches on all of our regulation.

Senator SHELBY. Chairman.

Mr. GIANCARLO. I would just reinforce that. The Treasury Secretary has been out front on this. He has formed a Virtual Currency Working Group of ourselves, the SEC, the Fed, and FinCEN. We have had a number of preliminary conversations and work streams developed. I have had a number of bilateral conversations with the Treasury Secretary on virtual currencies, and we are going to be coordinating our various responses.

It has begun with just some broad conversations establishing our different jurisdictions so that we are all clear as to what we are doing, but also what we are not doing, where the gaps are.

Senator SHELBY. Do you need additional legislation in this area, to both of you, or do you think you can work a task force together to get your arms around this without that?

Mr. CLAYTON. I cannot give you a definitive answer to that question because we should work together, but, Senator, we may be back with our friends from Treasury and the Fed to ask for additional legislation.

Senator SHELBY. You know, we live in a virtual world. We go to the doctor, and they give you a virtual examination, you know? We can go here and it is virtual, and this was not my world. I started out with pencil and paper in school, as you can imagine, in my day.

But at the same time, this currency, these cryptocurrencies, they lack intrinsic value, it seems to me. They lack liquidity. I am sure people have probably made a lot of money going up, and a lot of them made money or lost money going down. But I do not know where the bottom is, if the bottom was ever reached, as opposed to a sovereign-issued currency. Do you disagree?

Mr. GIANCARLO. No, Senator. I do not know where the natural equilibrium point is in this, but I will tell you there are some economists who posit that there is a relationship between Bitcoin value and the difficulty or the cost of mining, which is a process of electronically producing these, and that there are some charts I have seen that have plotted that correlation that seemed to be readily correlated until last summer when the price broke free of that correlation and that it came back into correlation late at the end of the year last year.

Now, I am not an economist. I find those things fascinating, but I am not an expert in it. But the point the economists are making is that there is some sort of floor, that the level set is not zero, that there is some floor there tied into the cost of mining of Bitcoin. And I am not endorsing that point of view. I am just sharing that with you.

Senator SHELBY. Chairman Clayton, do you have any comment?

Mr. CLAYTON. Look, there are a lot of smart people who think there is something to the value of the cryptocurrency in the international exchange, and I am not seeing those benefits manifesting themselves in the marketplace yet. And from the perspective of—look, I look at this as protecting Main Street investors. They should understand that.

Senator SHELBY. How do you put a value on cryptocurrencies? Does the market put a value on it, or does it go straight up, then straight down, or what?

Mr. CLAYTON. Well, that is what is something worth? It is worth what somebody is willing to pay you for it. But in our world, the securities world, you know, there are rules that dictate how much you have to tell somebody about what it is you are selling them.

Senator SHELBY. But part of your mandate, the Securities and Exchange Commission, is to protect the investor. Is that right?

Mr. CLAYTON. That is right.

Senator SHELBY. And the Chairman of the Commodity Futures Trading Commission, he has seen obviously commodities just go wild at times, and your mandate is to watch the commodities, right?

Mr. GIANCARLO. Market integrity is generally perceived to be our core mandate.

Senator SHELBY. You also mentioned personnel, you know, you need personnel. There is a hiring freeze on. We talked the other day about—this gets into the realm of appropriations and so forth. I am hoping that we will give you every tool you need to do your job and to hire the people that you need to execute that.

Mr. CLAYTON. Thank you very much. Thank you.

Senator BROWN [presiding]. Senator Reed.

Senator REED. Thank you very much. Thank you, gentlemen, for your testimony.

Following on the questions of Senator Brown and Senator Shelby, you do need more personnel, but very specifically, do you have the technologists, the computer experts that can begin to understand how these cryptocurrencies work, the cryptologists, and not just sort of on a day-to-day basis, you know, to give you the Thompson, but look ahead and say this is the direction it is going,

which could have very significant deleterious effects? Do you have anyone like that on the staff?

Mr. CLAYTON. The answer to your question is we formed a Distributed Ledger Technology Working Group, a cybergroup. They have done an exceptional job getting up to speed on this in a short amount of time and identifying some of the very issues you talk about.

You know, in an emerging area like this, could you use more horsepower? Always. But you make a very good point, Senator, on looking out across the international nature of this and trying to understand where it is going to land and do the things that people say add up. That is a very important—

Senator REED. Where are the technologists located? If you do not have them—and I presume you do not—is it—

Mr. CLAYTON. What we have, I would say it is a combination of economists and technologists. It is a question of, you know, here is what the technology is and does it make economic sense. We have those people in our Division of Economic and Risk Analysis, DERA, and we also have some of them in Enforcement, and they work together.

Senator REED. But you need more. I will take that as a yes.

Mr. Giancarlo, the same question. Do you have the technologists? Are you working together?

Mr. GIANCARLO. Thank you, Senator Reed. We have done a couple of things in 2017, as Senator Brown said, to get ahead of the curve. We hired the agency's first-ever Chief Innovation Officer, someone who comes with a deep background in a lot of these new financial technology innovations.

We also created something called "LabCFTC", which is our innovation hub, and you asked where is it located. It is actually located in New York City because so much of this innovation is taking place there and we wanted to be close to these innovators to learn from them.

But in terms of protecting consumers, we also formed a Virtual Currency Enforcement Task Force. It was actually that task force that recently brought three civil actions against Bitcoin fraudsters. And as I said in my testimony, there is more to come.

And as to the resource questions, we do need more resources. I used our bypass authority last year to put forward a budget request of 13 percent over our budget. We had been flat-funded for 3 years, and we do need additional resources. And built into those resources are additional resources for FinTech generally and cyber and cryptocurrencies specifically.

Senator REED. Let me just elaborate a bit. We continue to refer to Bitcoin. That is just one cryptocurrency. They seem to be proliferating, that every day there is a new variety of cryptocurrency, some of them out-and-out fraudulent, some of them based on the Bitcoin technology or processes. But just the sheer expansion of these cryptocurrencies is an issue, one.

And, two—because my time is short and I have one other slightly unrelated question to Chairman Clayton—are you tracking all these different daily emerging currencies, one? And, two—again, it goes back to my sort of step-back question—is someone looking long term at the systemic effects? You know, where are we going

to be? This is eerily reminiscent of the late 1990s in derivatives which were nominally small parts of the market that were esoteric, et cetera, and then, of course, 10 years later, exploded. So why don't you start, Mr. Giancarlo? And I will finish up with the Chairman.

Mr. GIANCARLO. Thank you very much. So you are absolutely right. Bitcoin is one of many. However, of the many, there is really a handful that have gotten significant traction.

Senator REED. Right.

Mr. GIANCARLO. And so that is important, though, for listeners to know because so many of these are fraudulent, as you said. We went after one—and I just mention it because I think it is interesting—called “My Big Coin”, which became known as “My Big Con” by people that were defrauded by it. It was people that really were taking—it was a Ponzi scheme. They were taking consumers' money and using it to buy houses and furniture and jewelry. And we went after them and went after them hard, and we will continue to do that.

In terms of systemic risk, right now this is still a relatively small market just by ratio. But as you say, we have to watch it and watch it carefully.

Senator REED. Mr. Chairman.

Mr. CLAYTON. So as I mentioned, the SEC does not have direct jurisdiction over pure cryptocurrencies, but we have had to watch them because, of course, they are integrated with the markets that we do oversee. And to your question of does 10 make sense or 15 or 20 make sense, I have a hard time getting my head around that because if it is an efficient medium of exchange, 15 of them fluctuating different places probably does not make a lot of sense to me. That is where I am at.

On systemic effects, I agree with Chairman Giancarlo, but if people are getting ripped off, that presents reputational risks that can have systemic effects.

Senator REED. We can go into a raft of questions, money laundering, evading, et cetera, but just changing gears one second, I will make a comment and then follow up with a written question. There is some consideration, I have heard, of the SEC allowing in public offering, initial public offering, borrowers to sue, i.e., forced arbitration. I think that would be a very bad idea, and I will make the argument and—

Mr. CLAYTON. I am happy to address the question.

Chairman CRAPO [presiding]. Well, we are out of time on that right now, so we will have to do it in writing.

Senator REED. We will talk.

Chairman CRAPO. Senator Rounds.

Senator ROUNDS. Thank you, Mr. Chairman.

Gentlemen, I am just curious. I go back to where I learned with a pen and pencil to begin with as well, and we did not have a quill at that time, but we did have No. 2 lead. And as I get into this and learn more about this thing, it is fascinating to see how quickly things are moving, and yet everything that we talk about seems to translate back into dollars and cents yet. That has not changed—until now, and suddenly we are talking about a new type of exchange, and it sounds almost like bartering to me. And it is

a bartering which could avoid the determination of a value in dollars and cents.

Which brings up the question of how do you tax it if you need to, how do you recognize income? But, also, in this particular case, I notice both of you identified that you have additional—or you have existing resources and regulatory oversight capabilities that you are utilizing today. And while I question whether or not there are seams that have to be filled, it would appear that there are some basics that maybe a lot of us do not quite understand that still have to be answered.

I just want to start out, because I think, Mr. Clayton, you started with this discussion, with regard to the issue of whether or not you had control over an ICO and the fact that if they were issuing in this particular case Bitcoin or the opportunity to market it, you had identified it as a stock or at least a value of something. What is in this particular case that thread that you utilize once again? And can you delve into that a little bit more about how your agency responds to the regulatory need in this particular case? What is the specific item that you look at as being an item which is subject to your review, a security in what?

Mr. CLAYTON. The definition of a security is broad, and it includes—I am not going to use the technical terms. There are Supreme Court cases and things like that. But it includes situations where if you are offering me a security—or offering me something, a coin, and I give you money, and the purpose of me giving you that money is to profit from your efforts going forward. So if I give you money, you give me a coin and you say, “I am going to take the money and I am going to grow a business, and that is going to increase the value of that coin. And, by the way, Chairman Clayton, you can trade it to somebody else. So you may be able to get value for it tomorrow. In fact, you probably will get value for it tomorrow. Buy now so you can get more value for it in a few days.” That is a security.

Senator ROUNDS. So commodity-wise, if we are looking at trading commodities, you would not have an interest in the subject of investigating or reviewing whether or not the trading of an ag. commodity was something, and yet when we talk about the CFTC, we are talking about a different story where commodities most certainly are an item of interest to you. Is Bitcoin or are these as currently being traded, are they a commodity or are they a security? Or are they both?

Mr. GIANCARLO. So what is so challenging about Bitcoin is it has characteristics of multiple different things. One of the phrases that is often used is that Bitcoin is a medium of exchange, a store of value, or a means of account. Well, those three things have different connotations to them. If it is a medium of exchange, then it is a currency-like instrument. And yet, as we have seen, a number of means of exchanges have been closed to Bitcoin. There was recently a Bitcoin conference that stopped accepting Bitcoin from registrants because they could not process the payments. But yet it is still spoken of as perhaps a means of account. And in that case, it has implications from the Fed and currency.

From our point of view, when it is used as a store of value, then it is very much like an asset, like a commodity. And, in fact, what

we hear a lot of is people buying and holding. If you go on to the Twitter universe, you will see a phrase, “HODL,” which means hold on for dear life. And the thinking is that they buy it and hold it. In fact, I mentioned in my opening remarks my 30-year-old niece, who bought Bitcoin years ago, and she is an HODL. She says, “I am going to own it. I do not know what is going to come of it, but I want to hang onto it.” And she is not a fraudster or a manipulator. She is just a kid and believes in it. You know, I was fascinated talking to her, and I think she represents a lot of folks that think there is something in this I want to hold onto it.

And so in that regard, from our point of view, it is a commodity. And if there is a derivative on that, we regulate it. The problem is in the cash market we do not have regulatory authority. It means we cannot set the standards. But what we will do and we are doing is looking for fraud and manipulation, and we intend to be very aggressive, if nothing else so that people like my niece can have some security that there are not fraudsters and manipulators out there, and there are far too many of them.

Senator ROUNDS. Thank you, Mr. Chairman. Your suggestion earlier that we bring them both back in at a later date after they have had an opportunity to look at the differences would be very appropriate. Thank you, gentlemen.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman.

Chairman Clayton, on January 26th, Bloomberg published an article entitled, “SEC Weighs a Big Gift to Companies: Blocking Investor Lawsuits”. Now, as you know, class action lawsuits are how investors can hold companies accountable when they defraud people, and the article says the SEC is thinking about letting companies sell shares in initial public offerings while at the same time allowing those companies to prohibit investors from bringing class action lawsuits against them.

Wow, I mean, forcing investors to give up class actions when they have been defrauded. The SEC has never allowed corporations to bar investors who get cheated from bringing class action lawsuits.

So I just want to get a straight yes-or-no answer from you on this. Do you support this enormous change in SEC policy?

Mr. CLAYTON. So I think you know that I cannot prejudge an issue that may come before the SEC, but I would be happy to talk to you about this, and let me get to the bottom line. I cannot dictate whether this issue comes before us or not because of the way it has come before the SEC in the past. But I am not anxious to see a change in this area.

Senator WARREN. OK. So I am reading tea leaves here.

Mr. CLAYTON. I am not—

Senator WARREN. I mean, you run this agency. The change cannot happen without your approval. I think it is fair for the—

Mr. CLAYTON. That is actually not right. If it came up before the agency, I am only one of five votes.

Senator WARREN. I am going to guess there are going to be at least two votes against that and that you at best will be the deciding vote.

Mr. CLAYTON. Senator, I do not want to prejudge the issue. If this issue—I want to be practical. If this issue were to come up before the agency, it would take a long time for it to be decided because it would be the subject of a great deal of debate. And like I said, in terms of where we can do better, this is not an area that is on my list for where we can do better.

Senator WARREN. OK. So I will tell you what. Chairman Clayton, I am going to let you get away with that, because what I am reading is real skepticism about a rule like this. The SEC's mission is to protect investors, not throw them under the bus. And I cannot think of anything that would do more harm to investors than saying they have to pre-waive their rights to sue a company in a class action when that company cheats them. So—

Mr. CLAYTON. Like I said, it is not a change that is on—

Senator WARREN. I hear you. So let me ask you about something else, and that is the fiduciary rule. Financial advisers who put the high fees, the commissions, the kickbacks, the prizes they can get for recommending a specific product ahead of the interests of their clients cost hardworking Americans trying to save for their retirements about \$17 billion every year. And that is why President Obama and the Department of Labor put the fiduciary rule in place to eliminate these conflicts of interest in retirement accounts like 401(k)s and IRAs.

Now, less than a month after you were sworn in as Chairman of the SEC, you issued a Request for Information asking for public comment on rulemaking related to the standards of conduct for investment advisers and broker-dealers. Can you state to this Committee that any rulemaking you do on this topic will not weaken the existing protections for retirement savers?

Mr. CLAYTON. Making an absolute statement like that—

Senator WARREN. Yeah, an absolute statement that you are not going to weaken rules for people who are trying to save for their retirement.

Mr. CLAYTON. From what baseline—let me—

Senator WARREN. Well, we have a rule from the Department of Labor. Now you could strengthen the rule, you could pass the same rule, or you could weaken the rule. I want to know that you are not going to weaken the rule. That is all I am asking you.

Mr. CLAYTON. Here is what I am trying to do. Let me tell you what I am trying to do. The relationship between an investment adviser or a broker-dealer and their client in a very simple area—they have a 401(k), they have an annuity, and they have a few stocks—is regulated—throw out the banking regulators. It is regulated by no less than five people. And they all have different standards. My main objective is to bring clarity to that without jeopardizing investor protections. That is how I am—

Senator WARREN. Well, but that is the question I am asking you, about whether or not you are jeopardizing the protection that people are trying to save for their retirement get. I get that you could bring clarity. Clarity could be do whatever you want. Clarity is

what right now has cost American investors saving for their retirement \$17 billion a year.

Mr. CLAYTON. I think it is a combination of an insufficient standard in some places, which we are looking to increase——

Senator WARREN. Glad to hear that.

Mr. CLAYTON. —a lack of clarity and also the standard is only as good as the remedy available. And one of the things that I am also looking at, believe me, I spend a lot of time in this space trying to get it right. One of the things we are looking at is what dollars do you actually collect when somebody has done you harm, because you could have a really strong standard, but if there are no dollars there, that is a problem.

Senator WARREN. So I agree with you, Mr. Chairman, if you want to strengthen enforcement of this rule or strengthen the rule itself, count me in. But that is what the American people look to the SEC for. Thank you.

Mr. CLAYTON. I do.

Senator WARREN. Thank you.

Thank you, Mr. Chairman.

Chairman CRAPO. Senator Perdue.

Senator PERDUE. I want to go change the subject a little bit back to Bitcoin here or to cryptocurrencies. You know, we see in IPOs and tax jurisdictional arbitrage. Do you guys see that today in this developing cryptocurrency and also in ICOs? Chairman Clayton, do you want to start with that?

Mr. CLAYTON. Well, yeah——

Senator PERDUE. And, by the way, who pays for frivolous class action lawsuits? Who pays for that?

Mr. CLAYTON. Shareholders.

Senator PERDUE. Yeah, and investors, I would argue customers, employees, all of the above, right?

Mr. CLAYTON. Yes.

Senator PERDUE. Would you answer the other question for me, please?

Mr. CLAYTON. So regulatory arbitrage is one of many issues that I see in this market. To be frank, tax loss and things like that are there. Of course they are because it is recordkeeping, it is difficult to trace.

Senator PERDUE. South Korea and China are the ones that predominantly play in this world. You said before most of the current investment comes from the U.S. I am not sure—I do not know if we all know enough yet to know that, right? South Korea and China are really heavily invested. In fact, South Korea has a new rule that says you have to use real name bank accounts in order to trade in this. Those are the kinds of things I am asking for. Is the arbitrage really going on around the world here?

Mr. CLAYTON. There is certainly regulatory arbitrage, but you are making a great point because this was a largely unregulated space across the world. And now what you are seeing is each country taking a perspective, a view, action, et cetera, which also goes to how functional is this asset class and how would we regulate it and how does it work. There is a lot happening that is beyond the kind of understanding of your average investor. How would you know how——

Senator PERDUE. So how can we and two agencies here—I understand there is interaction between all of our regulatory agencies, but there is also another axis here that you have to coordinate, and that is the other country regulators as well.

Mr. CLAYTON. Correct.

Senator PERDUE. So I am asking both of you, what are you seeing and what are you anticipating we need to do, either legislatively or rulemaking, to combat that?

Mr. CLAYTON. Chris, do you want to—

Mr. GIANCARLO. Sure, let me jump in. I will just identify two areas of arbitrage we are seeing. One is regulatory, which I want to come to, but actually we are also seeing price arbitrage as well. There is something known as the “kimchi premium” for Bitcoin traded in South Korea because there is so much interest there that it drives the price up there slightly higher, so price arbitrage.

But, you know, in the early days of many markets, every American city had a cotton exchange and the prices were different there before you developed a national market. So here we have different regional and international markets and perhaps as this market matures, if it matures, a single price may develop.

In terms of regulation, unfortunately I think that some time ago, perhaps the middle of last year, there was this perception that Bitcoin was off the regulatory grid. And one of the things that Chairman Clayton and I have been working so hard to do is to disabuse that notion. Now, we are limited in our regulatory authority to set regulatory standards on these underlying platforms. But when it comes to enforcement, when it comes to ICOs, we are using our full authority to drive the message, and other countries are doing that as well, and we have had frequent conversations. I spoke recently or had communication recently with the head of the Japan financial service agency about some things that were going on there. Jay Clayton spoke very eloquently at the FSB meeting recently in Basel, Switzerland. We are beginning our communication with other regulators. And I think the message is getting through that this is not off the grid, and I think part of that is now you are seeing it in the Bitcoin price. As the word is getting out that we will go after misconduct, I think you are starting to see that reflect in the price, and I think that is an important step.

Senator PERDUE. Well, with what little time we have left, I would like both of you to respond to the pump-and-dump efforts that are underway right now. You see this beginning to develop. I know you are both involved in this. Can you both address what your agencies are doing to combat that?

Mr. CLAYTON. Senator Perdue, this is one of the things that I am worried that investors do not understand, which is when you have—

Senator PERDUE. Me, too.

Mr. CLAYTON. When you have an unregulated exchange, the ability to manipulate prices increases significantly. And, you know, just a few coordinated sales can change a price.

Senator PERDUE. Or an email, a fraudulent email.

Mr. CLAYTON. Correct.

Mr. GIANCARLO. I have mentioned we formed this Virtual Currency Enforcement Task Force. We have got some really good peo-

ple on this, and we have brought three actions in the last few weeks. I said there are more to come. There are more to come. We are digging deep and learning a lot and seeing a lot. And I do not want to get ahead of that other than to say that we are working the beat hard right now.

Senator PERDUE. And you have a jurisdictional right to do that, right?

Mr. GIANCARLO. We have enforcement jurisdiction. Yes, we do.

Senator PERDUE. Great. Thank you, Mr. Chairman.

Chairman CRAPO. Senator Donnelly.

Senator DONNELLY. Thank you, Mr. Chairman. Thanks to both the witnesses.

This would be to both of you. Now that the SEC and the CFTC have asserted jurisdiction and warned the public of the risks posed by virtual currency operators, what other ways can your agencies prevent retail investors from falling victim to fraud and manipulation?

Mr. GIANCARLO. I am happy to take this question, Senator. Earlier Ranking Member Brown mentioned what do we do with the CFPB. We have actually formed a partnership with the CFPB to consumer education in the area of Bitcoin. One of the things I have learned recently is that America's libraries are a place where a lot of people go and research Bitcoin. In fact, they use the library computers. One of the most frequently searched items from a library computer is Bitcoin. And so we are teaming up with CFPB to go out to America's libraries, to educate librarians who often get some of the questions asked, to be able to direct library patrons to use our resources, our Bitcoin website and our other resources.

So we are really getting very creative in the area of consumer education. I had mentioned we have got several podcasts on this subject with thousands of downloads. We are working as hard as we ever were. We have never done as much work on consumer education as we have done with virtual currency.

Mr. CLAYTON. We also have an Office of Investor Education and Advocacy that has been engaged with a number of groups on this, and I think they have done a terrific job getting the word out.

In terms of getting the word out, though, there are financial intermediaries and other actors that we are counting on to act responsibly in this area.

Senator DONNELLY. OK. Well, let me ask you a follow-up, and it goes to the point you just made about the libraries and others. Are you concerned that retail investors will remain vulnerable to fraudulent and manipulative online solicitations that are sometimes more difficult for you guys to pick up?

Mr. GIANCARLO. Senator, in the broad range of marketplaces, seniors seem to be the prey of choice for fraudsters and manipulators. Whether it is in precious metals, whether it is in foreign exchange, whether it is in a whole range of products, we see and we prosecute continuously fraudsters who seek to prey on either the less sophisticated seniors who maybe do not quite have the retirement nest egg that they believe they need and fall prey to get-rich-quick schemes or schemes that say we will guarantee 100 percent returns and all kinds of nonsense like that. And it is a big part of our enforcement effort at the agency.

Senator DONNELLY. Let me ask you this, and this goes to perspective and to hopes and dreams. But what warnings would you give? There was an article in the *Washington Post* yesterday, and it was about good, hardworking Americans, people who have worked really hard and want to have a pension. It was about a group of our friends and neighbors from Kentucky, and the title of the article was, "Bitcoin Is My Potential Pension". What would you say to them to help protect them from winding up in a situation a few years from now where it did not quite work out the way they were hoping?

Mr. GIANCARLO. It is such a troubling development, Senator, unquestionably, which is why we are putting out so much materials. But what I would say to them is—it is the same advice I would give my children. If it sounds too good to be true, it is. If they are promising ridiculous returns, they are ridiculous. If you are going to give them money, you had better be prepared to lose it.

Mr. CLAYTON. I agree with everything that Chairman Giancarlo said. I also would say this to them, which is there are things like disruptive technologies that come along, but they should not disrupt the way you look at markets or the way you look at investing. Pumping all of your money into a disruptive technology has a very high likelihood of not working out for you as an individual. When we see disruptive technologies come along, you know, there will be winners, but there will be many losers.

Senator DONNELLY. OK.

Mr. CLAYTON. That is the way it works.

Senator DONNELLY. Let me ask you one other question. How can both of you best assist law enforcement and Federal authorities to ensure these virtual currencies are not used by terrorist groups or Nations like North Korea to evade sanctions?

Mr. GIANCARLO. So we work very closely with law enforcement. We recently commenced a program with the FBI where we actually had FBI agents on secondment with our agency in order to look at this. At the end of the day, the use of these cash markets for that, it is going to require cooperation amongst multiple agencies, especially with FinCEN, who often because of their anti-money-laundering operation may see some of these issues before we can, and then bring our expertise to bear and coordinate with our law enforcement agencies.

Mr. CLAYTON. Same here. I would supplement that with we also have a Dark Web Working Group that tries to monitor what is going on in that space in order to identify these types of issues.

Senator DONNELLY. Thank you, Mr. Chairman.

Senator BROWN [presiding]. Senator Kennedy.

Senator KENNEDY. Thank you, Mr. Chairman. Welcome, gentlemen. I think you are both doing a terrific job.

Chairman Giancarlo, when is the last time you bought a stock exchange-traded fund, mutual fund, or a bond?

Mr. GIANCARLO. So I hold generally traded funds—

Senator KENNEDY. Yes, but when is the last time you bought one?

Mr. GIANCARLO. Well, probably before I—I pretty much put my investing—

Senator KENNEDY. A year ago?

Mr. GIANCARLO. Well, probably before I started at the Commission.

Senator KENNEDY. Two years ago?

Mr. GIANCARLO. Yes.

Senator KENNEDY. OK. When you bought it, what did you buy? Equity or bond?

Mr. GIANCARLO. Index funds mostly.

Senator KENNEDY. Index funds, OK. When you bought it, did you sit down and read the prospectus for the index fund?

Mr. GIANCARLO. Well, you know, I am not supposed to say this—

Senator KENNEDY. Cover to cover?

Mr. GIANCARLO. As a lawyer, I am not supposed to say that I probably did not read it cover to cover.

[Laughter.]

Mr. GIANCARLO. But I will confess that I did not read it cover to cover.

Senator KENNEDY. How many investors do you think do that, do not read it?

Mr. GIANCARLO. I think most.

Senator KENNEDY. OK. So what is the point? I mean, we are talking about all the dangers and the risks of cryptocurrencies like Bitcoin. I am putting aside the shyster fraud issue. I mean, what is the point of all this over disclosure if nobody is reading it?

Mr. GIANCARLO. Well, I—

Senator KENNEDY. And why do we want to do the same thing with Bitcoin?

Mr. GIANCARLO. I will say historically it has been one of the foundational principles of our securities laws that adequacy of disclosure, full disclosure, is one of the building blocks.

I will tell you, having been in business, that most business people will tell you they study the prospectus only to see what they can sue on if they need to sue on something if something goes wrong.

Senator KENNEDY. I think you see where I am going. I am going to ask you both a philosophical question in a second about how far you think we ought to go to protect people from themselves. But I do not think the disclosure we have right now works. I think it is good for the lawyers, and it is good for the financial advisers. But I think we overdisclose, and I think you can—I will bet you each have a smart lawyer on your staff. You could go to them and say, “Write me a good disclosure for Bitcoin.” And you would get it back and look at it and then pick 50 names from the Washington, DC, phone book and ask them to come in and say, “Read this and tell me if it makes sense to you.” I mean, what is the point?

How far do you think we ought to go here in terms of a cryptocurrency—I am separating this from the blockchain technology. China outlawed it. I think South Korea has, too. What are you suggesting, that we just go after the shysters and fully disclose? I mean, is that what you think we ought to do? Chairman Clayton.

Mr. CLAYTON. Well, I think that is exactly the question we are here to pose and take forward, which is, you know, what is the

right way to deal with this new thing? As just a person watching it, I am not satisfied when I see people thinking that these trading platforms of cryptocurrencies have the same kind of protections that a stock exchange would. And I am very unhappy that people are conducting ICOs like public offerings of stock when they should know that they should be following the private placement rules unless they are registering with us. Those two things make me unhappy. To figure out how to deal with them is why we are here.

I agree with you that we should be careful not to go too far. But just to be clear, for me in this ICO space, it is pretty clear that our securities laws work pretty well. Disclosure can be improved. It can really be improved.

Senator KENNEDY. Well, let me make this suggestion, because I do not want to go over. The last time I asked questions, I got a little carried away. I think I went over 3 minutes, and our Ranking Member put me on double secret probation.

[Laughter.]

Senator KENNEDY. So I am not going to do that today.

Senator BROWN. Like I have the power to do that.

[Laughter.]

Senator KENNEDY. He does.

The disclosure, I mean, you can extend the disclosure we have now to Bitcoin, and you have not done anything. I am not suggesting we should not have disclosure, but you have got to have disclosure that makes sense and helps people other than the lawyers.

Mr. CLAYTON. I agree, Senator.

Senator BROWN. Senator Warner.

Senator WARNER. I usually agree with my friend from Louisiana. I think we may be on top of something that is transformational, and I do not think you can separate the underlying distributed ledger or blockchain from some of these crypto assets. And if we had the same rate of increase the next 2 years that we have had the last couple years—we are talking now a couple hundred billion—we would be north of \$20 trillion caught up in this area by 2020. And I think you—I remember back, I was lucky enough to get in the cell phone business back in the early 1980s, and everybody thought it was going to be a small business, and they were wrong and I got rich. I think we are looking at the same kind of transformation about to take place, and we are going to have to wrap our arms around it.

We have talked about some of the consumer protection issues, but we have got money-laundering issues, we have got cybersecurity issues. A third of the Bitcoin exchanges have been cyberhacked between 2009 and 2015.

I am not exactly sure what the right regime ought to be, but I would argue that—while I commend the Treasury Secretary for putting a working group together, I would argue this is the reason we created FSOC in the first place, that this rises potentially to the level of a systemically relevant event, and I would just be curious whether you believe—and I commend what both of you are trying to do, but whether this ought to elevate to an FSOC-level analysis.

Mr. CLAYTON. So, Senator, I had the same question you had, which is: There is a big rise here; if it does keep going is this a

systemic issue? Which is one of the reasons we brought it up at FSOC, talked about it at FSOC. Again, I commend the Treasury Secretary for forming the working group.

I want to go back to separating ICOs and cryptocurrencies. ICOs that are securities offerings, we should regulate them like we regulate securities offerings. End of story.

Senator WARNER. I have a couple more points I want to make.

Mr. GIANCARLO. Thank you, Senator. Just real quickly, on the issue of disclosure, sometimes what we are seeing is not a problem of absence of disclosure. It is false disclosure. False disclosure is often fraud, and I think we need to step in there. But just in terms of discussion, as Chairman Clayton mentioned, we have begun discussions at FSOC. In addition, there have also been discussions led by Chairman Clayton at the Financial Stability Board and also at IOSCO, which is the International Organization of Securities Commissions. So these discussions are taking place at the right levels of debate, but there is so much more to be done.

Senator WARNER. Again, to my friend from Louisiana, we have got this—we are focusing a lot on Bitcoin and crypto assets, cryptocurrencies, and I think there are even definitional issues here. But you have got a whole new platform called “Ethereum” where they are creating, you know, file sharing or extra computer time. I am not sure what kind of assets those fall into? Are they potentially regulated within your realm or if there is a trading exchange, a tokenization exchange between excess computer time? I am not sure where that fits at this point.

Mr. CLAYTON. The definition of a security I believe—the people who wrote the 1934 Act and the 1933 Act, they were smart. They did it on a principled basis. They basically said if you are giving people money in exchange for a future development of a business with the hope of a return—and whether that return comes in the form of server time or your ability to sell server time—it is a security.

Senator WARNER. I concur with the approach you have taken in terms of the ICOs, and I think there has been some very bad behavior. Yet certain ICOs the SEC has not stopped; others they have stopped. Are you going to go back and re-review the ones that have gone forward?

Mr. CLAYTON. Let me say another thing about the 1933 and 1934 Acts. When they were written, there was a great recognition that there was a tremendous amount of securities activity in this country, and that we were going to rely on gatekeepers to help us enforce those rules and they would be liable if they did not help us enforce those rules—accountants, lawyers, underwriters, sellers, and the like. I am counting on those people to do their job, and I have made that clear.

Senator WARNER. Let me ask, Chairman Giancarlo, what we did—and one of the things I am concerned about was that I think we may have moved too fast on allowing, for example, futures trading on Bitcoin. And I just wonder. You know, you have allowed future trading contracts on Bitcoin, yet the SEC has not allowed ETFs. I am just worried that we need a much more coordinated effort, because I think the potential, writ large, amongst crypto assets and the underlying blockchain could be as transformational as

wireless was years ago, and I think we are going to need a much more coordinated effort.

I know my time has expired, but if you could both quickly comment on that, I would appreciate it.

Mr. GIANCARLO. Well, so I believe it is critically important that we coordinate on this. I believe that we are all both individually and collectively understanding our authorities, understanding this new technology, working around it. There was communication among myself, Chairman Clayton, the Treasury Secretary, and others in connection with Bitcoin futures. And, you know, Bitcoin future are quite different than the Bitcoin market. Bitcoin is an anonymous area. Bitcoin futures is fully transparent to the regulator. Bitcoin, retail. Bitcoin futures, mostly institutional and high net worth. Bitcoin futures, regulated. Bitcoin futures, regulated. Bitcoin, unregulated. And with Bitcoin futures we are now having visibility into underlying spot markets and data from those markets we would not otherwise have.

Mr. CLAYTON. I completely agree on coordination. Like I said, I break it down into three areas. There is this great technology that I agree with you has promise. There are these pure cryptocurrencies, which we need to take a look at across FinCEN, Treasury, CFTC, the Fed. And then there are securities offerings that are called ICOs that should be undertaken as securities offerings consistent with our regulatory regime.

Chairman CRAPO [presiding]. Senator Cotton.

Senator COTTON. Thank you, and thank you, gentlemen, for your appearance today.

I want to continue on the line of questioning that Senator Warner began. Putting aside Bitcoin or other kinds of cryptocurrencies that are based on blockchain or distributed ledger technology, what are your thoughts on the potential value of that underlying technology, of blockchain and distributed ledger technology, both to enterprises and consumers and perhaps to Government agencies?

Mr. GIANCARLO. It is important to remember that if there were no Bitcoin, there would be no distributed ledger technology. It grew out of that technology initiative. And the potential applications—and, by the way, I am no pie-in-the-sky dreamer. I just report what I read. But the applications range from enormous potential in the financial services industry, in the banking industry, but right down to the way charity dollars are spent, the way perhaps refugees are accounted for across the globe.

There was an article just this morning about use of distributed ledger technology for 2.5 billion people around the world who do not have access to banking services.

One of the areas that—in our own area of agriculture futures, 66 million tons of American soybeans were just handled through a blockchain transaction by the Dreyfus Company for sale to China. So Bitcoin is now being used—it is used in our American transportation logistics system, and, most importantly, the potential of distributed ledger technology for regulators to be able to do really close market surveillance, and if it had been available in 2008, if we had been able to see the counterparty credit exposure of one bank to another bank in real time with precision, that would have enabled much more precise policy choices that had to be made in

a rush without good data. So I think distributed ledger technology has got enormous potential.

Now, how it will be realized, when it will be realized, what are the other challenges in it, those we cannot say. But the potential seems extraordinary.

Senator COTTON. Thank you.

Mr. Clayton.

Mr. CLAYTON. I agree that the potential seems very significant, and just look around anywhere in our economy where verification and recordkeeping has cost that is potentially reduced, that is an opportunity for this technology. That is just one of them, and I hope people pursue it vigorously.

Senator COTTON. Thank you. Let us turn our attention now to cryptocurrency and to Bitcoin, since it is the most prominent. Yesterday, the Dow Jones had its single largest decline in a point scale, 4.6 percent as a percent, which is high—not the highest ever. That obviously generated a lot of news coverage. The dollar has faced 2-percent inflation or less now for many years. Bitcoin, however, has seen a 32,000-percent increase in its value over the last 5 years. It has declined by some 60 percent, I think, in just the last 30 days.

What are the factors driving that kind of extreme price volatility in Bitcoin relative to securities in publicly traded companies or the U.S. dollar?

Mr. GIANCARLO. Well, just recently the volatility you see in Bitcoin was not as large as volatility we have seen in some other assets classes, such as the VIX product, which is known as the fear index or volatility gauge. And so we have seen extraordinary volatility in Bitcoin, but, you know, in our world, in commodity derivatives, we are used to volatility in asset classes, and that is one of the things the emergence of a futures product is meant to do, is to provide those who are exposed to that volatility means of hedging and mitigating the risk to that volatility.

Senator COTTON. Mr. Clayton.

Mr. CLAYTON. I do not really know what is driving the volatility in Bitcoin and cryptocurrencies. They are not correlated with sovereign currencies, so it must be something different from what would drive the dollar. But that is one of the issues before us, there does appear to be a lot of volatility compared to the medium they are supposed to be a substitute for.

Senator COTTON. So what does that kind of volatility portend for a cryptocurrency's future as a potential alternative to legal tender of Nation States or, in the EU's case, a transnational organization?

Mr. CLAYTON. You raise a great point. Now, maybe that volatility tamps down to a stable currency—but an asset that is highly volatile is not a very effective means of exchange because you do not know how much you are getting by the time you receive it or how much you are paying at the time you have to pay it. If you agree to a price on day one but have to source it on day ten, you expose yourself to significant risk.

Senator COTTON. Thank you. My time has expired. I do want to associate myself with the remarks of Senator Donnelly at the end of his remarks about the risks that cryptocurrencies are currently posing as a way for rogue Nations, terrorist organizations, criminal

organizations to evade sanctions, not just in trading but in hacking as well, as we have seen in media reports on North Korea. So I am glad to hear that you are working closely with our law enforcement and intelligence agencies, and I hope that continues.

Thank you.

Chairman CRAPO. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you to both of you. It is good to welcome a fellow New Jerseyan in your role, Mr. Chairman.

I have been actively following both Venezuela's and Russia's interest in developing virtual currencies for the purposes of evading U.S. sanctions. Last month I sent a letter to Secretary Mnuchin on this subject, and I asked Under Secretary Mandelker about this a few weeks ago when she was here before the Committee.

Under what circumstances would the SEC and the CFTC have a role in engaging or regulating the proposed new petro or crypto ruble currencies? More broadly, does the SEC and CFTC have a role to play in preventing the use of digital currencies by foreign Governments to evade U.S. sanctions?

Mr. GIANCARLO. Our jurisdiction would be very limited in that area, Senator. As I have spoken about before, we do have enforcement authority for fraud and manipulation, and so if we thought that that instrument was being used for fraudulent purposes, manipulation purposes, we would not hesitate to take authority. But you are probably touching on an area where the jurisdictional lapse is probably greatest for the two agencies sitting before you today.

Senator MENENDEZ. And so let me ask you, manipulation, what if you are manipulating to avoid U.S. sanctions?

Mr. GIANCARLO. You know, I would have to speak to our enforcement counsel to see how that fits in, but we would certainly look at it, and if—

Senator MENENDEZ. I would like to have you do so, and I would love to hear back through the Committee.

Mr. GIANCARLO. Thank you.

Senator MENENDEZ. Are you interacting with FinCEN to the extent that you may have limited jurisdiction? Are you adequately integrated into the financial regulatory network that watches for illicit activities? Or are there gaps that could create vulnerabilities?

Mr. GIANCARLO. So as we mentioned before, Senator, Chairman Clayton and I are part of a Virtual Currency Task Force that has been put together by the Treasury Secretary that includes the Fed and FinCEN, and we have already had our first meeting, a beginning meeting to set up some work streams. We will have more to come.

It just so happens that I am actually meeting with FinCEN's virtual currency team this week on a previously scheduled meeting to get some introductory discussions started of cooperation between our agencies, and so I look forward to actually asking them this question as well.

Senator MENENDEZ. OK. And I would just say to both of you, to the extent that you have a role to play and you lack the present authorities to do so, I would love to know about that if you determine that is necessary, because my sense of cryptocurrency is largely driven to evade U.S. sanctions and to undermine sovereign

currencies. Both of them are a challenge to the national interest of the United States.

Let me ask you this: We have seen a dramatic increase in the number of initial coin offerings where private companies are using digital tokens to raise money instead of going through the capital markets. The *Wall Street Journal* reported that initial coin offerings grew from about 96 million in 2016 to over 4 billion in 2017. Many of these ICOs are relying on celebrity promoters to gin up the sales. For example, last year Floyd Mayweather, the boxer, used Instagram to promote the purchase of Centra tokens.

Now, I have done extensive work on consumer protections in the prepaid card space where we have seen celebrities like the Kardashians use their status to sell products that come at a steep cost to consumers, and this feels eerily similar to that, just the next avenue of exploitation. And I worry about unsuspecting investors that do not have the resources to understand the true risks.

What can the SEC do to better protect investors who may be persuaded by celebrity promoters to purchase tokens offered in initial coin offerings without fully understanding the risks?

Mr. CLAYTON. Senator, I am not going to comment on a specific instance, but—

Senator MENENDEZ. I am talking about broadly.

Mr. CLAYTON. Some time ago we put out an alert that said if you are promoting securities, you are taking on securities law liability. I believe that that has tamped down some of this endorsement activity.

I will say it again right here: If you are promoting securities, you are potentially taking on securities law liability.

Senator MENENDEZ. Well, let me ask you—I appreciate that, and I hope that you will think about doing more to protect consumers. Can you walk us through why the SEC at this point is not comfortable with approving ETFs with significant investments in cryptocurrencies?

Mr. CLAYTON. Our ETF product space is largely a retail product space, and we have made it clear to the marketplace that there are a couple of issues with having an ETF that is based on a cryptocurrency. They go to price discovery, custody, and, you know, some other issues around volatility. We have let the industry know that those are issues that are of concern to us and that we do not want to approve an ETF product with a cryptocurrency underlier until we can get comfortable with those issues.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Moran.

Senator MORAN. Mr. Chairman, thank you very much. I am sorry you both have to crane your necks to the left so hard to have a conversation with me. But I am delighted to be back on the Committee, Mr. Chairman. Thank you very much.

Let me first start by suggesting to you that if you have suggestions, I will probably not have the chance to see you in the Financial Services Appropriations Subcommittee before we take a look at fiscal year 2019. Assuming that we are successful in the next few days on fiscal year 2018 and budget caps, we will have an opportunity to reconsider spending levels for fiscal year 2018. You have

made your request through the budgetary process and an appearance before our subcommittee, but if there are priorities in which as we go back to potentially increase funding and any levels of jurisdiction within FSGG, I would welcome your input as to what is the highest priority.

I heard the commentary earlier in regard to one of the questions, I think, of Senator Reed that the hiring freeze has created challenges. I do not know that we can overcome that. But if it is personnel in a particular way or other things, it would be useful for me to know.

Mr. CLAYTON. Thank you very much. And I did not want to get ahead of the process. Our fiscal year 2019 request reflects the sentiment I have expressed today.

Senator MORAN. I do not know that we will see the fiscal year 2019 request before we are taking a look at the potential increase in funding for fiscal year 2018, depending on when the President's budget is released. But I would offer that—it does not need to be today—if there are any suggestions you would like to convey to me.

You may have answered this question just now with Senator Menendez, Chairman Clayton, but doesn't—you indicated why you were reluctant or unwilling at the moment to approve an ETF proposal. But doesn't ETF, just as options do on its exchange, reduce the—mitigate the concerns, reduce the volatility and increase price discovery and reduce risk? So additional products—my question really is: Don't additional products help alleviate some of the challenges that we face? Or is Bitcoin or cryptocurrency so unique that it is different than other items that are traded on exchanges?

Mr. CLAYTON. Yes, I think that the CFTC product has that effect. It is largely an institutional product, and you can take both sides of the market and, you know, it gives people a chance. As for ETFs, you can take both sides of an ETF, but predominantly they are offered for a long investor, someone who wants exposure to the rise and fall of Bitcoin or other currencies, and that is a different dynamic than a futures product. And we have long taken an investor protection view of approving those types of products, which is embodied in our liquidity, custody, and pricing rules. If we get comfortable with those rules, then we can move forward.

Senator MORAN. Very good. Let me raise a different topic than cryptocurrency. One of the things that I have tried to pay attention to and often in cooperation with the Senator from New Mexico, Senator Udall, is trying to modernize our IT system, particularly within the Federal Government. And you indicated, Chairman Clayton, about the \$500 million loss in a Japanese cryptocurrency in your written testimony. We have now passed as part of the national defense authorization bill what has been labeled as "MGT Act". It is the Modernizing Government Technology Act, and what it does is create a fund for Federal agencies to rid themselves of their legacy technologies and have access to dollars to replace that legacy. It encourages moving to the cloud, again, with the opportunities for us to have better technologies and safer technology systems to reduce our vulnerabilities.

I just would encourage you, you have a lot at risk in the safety and security of the data that you hold, and I would welcome your reassurances that—I am sure you will tell me that you are spend-

ing many millions of dollars and working diligently and you have the right personnel in place. But I would guess if we ask agencies of the Federal Government who have been hacked themselves and whose data has been released, they would have told us the same thing prior to that occurring to them. I would be, first of all, delighted to be reassured that we will not be reading in tomorrow's paper or next month's papers that there has been a hack at CFTC or SEC.

Then, second, I just would offer you the opportunity to take a look at that legislation and see how it might be of benefit to your agencies and to suggest any ideas that you would have for what Congress can do to further strengthen cybersecurity within your worlds.

Mr. CLAYTON. Thank you.

Senator MORAN. You are welcome.

Mr. CLAYTON. Thank you very much.

Senator MORAN. Mr. Chairman, thank you.

Chairman CRAPO. Thank you.

Senator Cortez Masto.

Senator CORTEZ MASTO. Thank you. Gentlemen, thank you. I apologize. I have had another Committee hearing going on at the same time, but I appreciate your written comments and the conversation today. It is so important. And as somebody who was Attorney General of the State of Nevada and worked on consumer protection issues, obviously weeding out any type of fraud is important in this space as well.

Let me start with a couple of questions that I have. I understand that companies that originated outside the cryptocurrency space like Kodak and Burger King have recently jumped into the cryptocurrency space. However, some critics have warned that companies are using blockchain as an opportunistic venture to pump up stock prices without having a clear business plan. One company, Long Island Iced Tea, I understand changed its name to Long Blockchain and watched its stock soar.

So are you concerned that companies may be utilizing blockchain as a scheme to pump up their stock prices? I am going to just open it up to both of you.

Mr. CLAYTON. The short answer is yes. The longer answer is I have put out a warning in this space, and I have put out a warning to securities lawyers as well, which is nobody should think it is OK to change your name to something that involves blockchain when you have no real underlying blockchain business plan and try to sell securities based on the hype around blockchain.

Senator CORTEZ MASTO. And when you say you put out a warning, what does that mean specifically?

Mr. CLAYTON. I made a speech regarding this, which is published on the SEC website. But this is an area of concern to us. Anytime there is something new that people seek to raise the value of their securities without the underlying goods being there is problematic.

Senator CORTEZ MASTO. Right.

Mr. GIANCARLO. Thank you, Senator. So as you know, the jurisdiction of the CFTC and the SEC is slightly different in this regard, and so Chairman Clayton is rightfully concerned with initial coin offerings that are misrepresenting the affiliation, whether it be

with Kodak or otherwise. We focus on fraud and manipulation broadly in instruments where there is wild claims for them, and I mentioned earlier a case we recently brought on a Long Island firm called “My Big Coin”, which turned out to be My Big Con. There was nothing there. They were taking people’s money and not investing in anything other than their own jewelry and houses and fancy cars and this kind of thing.

We have been very aggressive in using our enforcement authority. We have recently brought three cases just last month alone. I have said there will be more, and we are looking into this and monitoring markets very carefully. We believe that our big task is bringing enforcement cases and letting people see that, as well as consumer education, which I have also—

Senator CORTEZ MASTO. Yeah, because it has a deterrent effect. You hope it does, right?

Mr. CLAYTON. Yes.

Senator CORTEZ MASTO. OK. Thank you.

It has also been reported that more than 3 million Bitcoins have been stolen. That is about 14 percent of the Bitcoins or one in seven Bitcoins stolen. And on January 26th, Coincheck, a Japanese currency exchange, was hacked. In minutes, \$430 million was lost to hackers. This follows another theft of more than \$500 million from another exchange, Mt. Gox. If people put money into a stock or bond and it was stolen, they would have help. For example, the Federal Government is still trying to help investors recover the money stolen by Bernie Madoff. When virtual currencies are stolen by hackers, what can buyers do to get their money back, if anything?

Mr. CLAYTON. This is a very good point, and it is one that we have emphasized in our investor alerts, that when you engage in investing online with an offshore entity, the chances that we can do anything practical to get your money back are very, very low.

Mr. GIANCARLO. In our futures market, for example, we have what we call “system safeguards,” requirements that futures exchanges have cyberprotections in place and they adopt best practices. For these underlying spot markets, which we do not regulate, we do not have the authority to require them to have cybersafeguards in place.

Senator CORTEZ MASTO. Right.

Mr. GIANCARLO. And, you know, a lot of these companies are young, they are startups. They are focused on putting what resources they have into developing their technology. And in the case of some of the cases you mentioned, what I understand was the cyberprotections just were not there.

Now, I know that the JFSA has been aggressive on this. We have had some conversations with them. We have asked questions. What are they doing about it? But, unfortunately, the theft has already happened.

Senator CORTEZ MASTO. Right.

Mr. GIANCARLO. And so this is a problem, that these underlying stages, while we do have enforcement authority, we do not have the same regulatory authority that we have in the markets that we oversee. That is our day job, as one of your colleagues mentioned earlier, and so, therefore, this is a gap.

Mr. CLAYTON. Or the same kind of protection rules like custody.
 Senator CORTEZ MASTO. Right.

Mr. CLAYTON. It was gone.

Senator CORTEZ MASTO. Yeah, so it is the old axiom, “Buyer beware.” So around this space, a lot of education is important, I would imagine, from all the Federal agencies to buyers so they know until something else can be done, which I think we are still trying to figure that out

I notice my time is up. Thank you very much. Thank you.

Chairman CRAPO. Thank you, Senator.

I had not planned on having a second round, but I have agreed to allow Senator Shelby and Senator Warren to each have one brief question. Senator Shelby.

Senator SHELBY. I want to get in the area of what is on a lot of people’s minds today, and I know you do not control the stock market. You know, what goes up comes down, as we all know, and we do not know when and so forth. Is this perhaps more than an ordinary correction, or do you have a judgment on that at all? Chairman Clayton.

Mr. CLAYTON. So your question is exactly the question I asked my staff and some of my colleagues across the Federal Government.

Senator SHELBY. OK.

Mr. CLAYTON. Because we should be asking those questions. By this morning, there was nothing to indicate that any of our systems did not function as they were expected to function yesterday. This was the largest volume since November 2016. There was a significant price change. We have two types of limits. We have single stock limits, and then we have market limits, the circuit breakers. Neither one of those were hit in any great detail. The single stock was nine; the circuit breakers did not get hit.

So as I sit here today, there is nothing that came out of this that concerns me from a functioning standpoint. But days like yesterday, our job is to look at them.

Senator SHELBY. From a regulatory standpoint, are you saying that you do not see anything amiss?

Mr. CLAYTON. Yes.

Senator SHELBY. From a regulatory standpoint.

Mr. CLAYTON. Yes.

Senator SHELBY. You cannot control what goes up and what goes down. But what spooked the markets? Is it profit taking perhaps? Is it a whiff of maybe inflation out there? Because people that watch the markets and participate in the markets see that the Fed is beginning to raise interest rates, dealing with price stability as they see it. And the Fed has information perhaps we do not have. The economy is hot, unemployment is low, and so forth. Is it a combination of all, or can we really say?

Mr. CLAYTON. Well, I cannot really say because I—you know, there are a lot of opinions on those things. Our job is to look at the functioning—

Senator SHELBY. Absolutely.

Mr. CLAYTON. —and look at the systemic risks.

Senator SHELBY. That is right.

Mr. CLAYTON. And I am asking myself, is there anything that happened yesterday that gives me a different view of systemic risk than I had the day before? And so far, no. But that is a question I ask myself almost every day.

Senator SHELBY. Of course, we all know that when the market is going up, people are elated. That is natural. When it is going down, some people profit, but not a lot of people are elated. Is that fair?

Mr. CLAYTON. That is fair.

Senator SHELBY. Do you have any comment, Mr. Chairman?

Mr. GIANCARLO. Well, I am just smiling because of just a recollection of a saying that a mentor of mine who actually was my introduction in to the financial markets used to say. When I would ask him—and he was an old hand in the markets—what drove the market up yesterday, or down, he would say, “Oh, it was up? More people bought than sold. Oh, it was down? More people sold than bought.” And we laugh, but what he said to me, he said, you know, “When you listen to the pundits and they say, ‘Well, the market was up yesterday because of this,’ that may have been why or it may not have been why.” But the reporters or the pundit needed a reason, so they pick something out and that becomes the reason for the day.

I do not mean to be facetious, but markets are very, very complex. Very, very complex.

Senator SHELBY. Very much.

Mr. GIANCARLO. And sometimes it is oversimplifying, and you hear it on the news, you hear it by people that are stock pickers, and they say, “Well, it was because of this.” Well, I do not know how anybody really knows.

Now, if there are fundamental moves, fundamental changes, that is where we have to do—and I share Chairman Clayton’s view. Our job is to look at the structural underpinnings and see whether there is anything that is not functioning.

Senator SHELBY. See if the fundamentals are sound.

Mr. GIANCARLO. See if the fundamentals are sound. So you will not be surprised to know that we had a late night last night and an early morning this morning, checking in with our exchanges to make sure that things are in order, making sure that the margin levels held, to make sure there was no significant margin breaches. And I can say that the system held. The system worked as it was designed to do. The margin levels worked as they were designed to work. And so the right systems and the right policies are in place. But the markets are always evolving, always organic, and that is why we need to stay very close to them.

Senator SHELBY. The market always corrects. The question is: Is this an ordinary—maybe not an ordinary correction, but is it a correction, the market will correct itself, and we go from there? Is that fair?

Mr. GIANCARLO. Yes.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman CRAPO. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman.

So I want to go back to virtual currency, and I want to ask about initial coin offerings, ICOs. Some ICOs raise money for legitimate

companies, but others we know are just Ponzi schemes. And many of the investors in ICOs are just everyday Americans lured by aggressive marketing promising very high returns. In fact, it is now so bad that Facebook recently banned all ads for virtual currency-related products and ICOs because there were so many “deceptive and misleading” advertising that targeted regular consumers. So I just want to ask a little question around how we make ICOs safer.

Chairman Clayton, the SEC evidently recognized the risk, so it announced last summer that it would consider certain coins to be securities under the Securities Act, meaning that they have to be registered with the Commission and comply with disclosure requirements. In 2017, companies raised more than \$4 billion in ICOs. How many of those companies registered their ICO with the SEC?

Mr. CLAYTON. Not one.

Senator WARREN. Not one. And as of today, how many companies have registered for upcoming ICOs?

Mr. CLAYTON. Not one.

Senator WARREN. Not one, so we are still at zero. Can you just say a word about why that is so?

Mr. CLAYTON. Yes. I do not think the gatekeepers that we rely on to assist us in making sure our securities laws are followed have done their job. We have made it clear what the law is. As I have said many times, there are thousands and thousands of private placements that go on every year in the U.S. We want them to go on. We want people to raise capital. But we want them to do it right.

Senator WARREN. Right.

Mr. CLAYTON. What ICOs do is they take the disclosure-like benefits of a private placement and then add to it the public general solicitation and retail investor promise of a secondary market without registering with us. And folks somehow got comfortable that this was new and it was OK and it was not a security, it was just some other way to raise money. Well, I disagree with them.

Senator WARREN. So it is not new, it is—or it is new, but it is not OK and it is not another way to raise money.

Mr. CLAYTON. Correct.

Senator WARREN. I am understanding you to say it is a violation of the law.

Mr. CLAYTON. Yes.

Senator WARREN. Registration really matters. When companies do not register their tokens as securities, they can hide information, and the SEC does not have the information it needs to monitor this market.

Mr. CLAYTON. I am perfectly happy for these people to do private placements, but do them right. Do not try and do it as a private placement but get all the benefits of a public—

Senator WARREN. And then lever over into a public—

Mr. CLAYTON. Yeah, and do all the other shenanigans that are—

Senator WARREN. Well, good. So should I take today as you are sounding a warning bell for people, maybe they better pay a little closer attention to the law or the SEC is going to pay closer attention to them?

Mr. CLAYTON. Yes, and it is not the first time. But I really appreciate the opportunity to do it today.

Senator WARREN. Thank you.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator. And thank you to our witnesses. We appreciate not only your testimony today but the work that you are doing in this critical area.

I would ask you to get back to me on recommendations as you refine your evaluation of our current financial legislative system and whether we need to provide further clarification from Congress.

With that, this hearing is adjourned.

[Whereupon, at 11:54 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN MIKE CRAPO

This morning, we will receive testimony from SEC Chairman Jay Clayton and CFTC Chairman Chris Giancarlo on the growing world of virtual currencies and the oversight conducted by their two agencies.

Virtual currencies are meant to act as a type of money that can be traded on online exchanges for conventional currencies, such as dollars, or used to purchase goods or services, predominantly online.

Additionally, developers, businesses and individuals are selling virtual coins or tokens through initial coin offerings, also known as ICOs, to raise capital.

Over the last year, many Americans have become increasingly interested in virtual currencies, especially given the meteoric rise in valuation and recent fall of Bitcoin.

Just for perspective, on January 2 of last year, Bitcoin broke the \$1,000 barrier, then peaked in December of 2017 at almost \$20,000 and as of this morning is trading at roughly \$6,900.

Today, the market capitalization of Bitcoin is roughly \$115 billion.

This is an incredible rise given that in 2013, when this Committee had subcommittee hearings on the topic, the total value of Bitcoin in circulation was approximately \$5 billion.

As virtual currencies have become more widespread, financial regulators and heads of financial institutions have noticed and voiced their opinions.

Regulators and heads of industry have tried to educate investors so that they make informed decisions, and ensure that the markets they oversee and participate in are appropriately working.

For its part, the SEC has put forth many statements and guideposts to help the markets and investors. Namely, the SEC has: issued investor bulletins on initial coin offerings; issued an investigative report on what characteristics make an ICO a security offering; issued several statements by Chairman Clayton on the issue; brought enforcement actions against fraudsters; and issued joint statements with the CFTC about enforcement of virtual currency related products.

The CFTC has also been helping inform the markets by: launching a dedicated website on virtual currencies to educate investors; bringing enforcement actions against individuals involved in cryptocurrency related scams; issuing several statements by Chairman Giancarlo and other Commissioners on the issue; and scheduling hearings on the topics.

Much of the recent news about virtual currencies has been negative; between the enforcement actions brought by your agencies, the hack of the international Coincheck exchange, and the concerns raised by various regulators and market participants, there is no shortage of examples that increase investor concerns.

It is also important to note that the technology, innovation, and ideas underlying these markets present significant positive potential.

These aspects underpinning virtual currencies have the ability to transform for investors the composition of, and ability to access, the financial landscape, thus changing and modernizing capital formation and transfer of risk.

Technology is forward looking, and we look to our regulators to continue carrying out their mandates, including investor protection, as the markets evolve.

I look forward to learning more about virtual currency oversight from the two witnesses, including what their agencies are doing to ensure appropriate disclosures and safeguards for investors.

PREPARED STATEMENT OF JAY CLAYTON

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

FEBRUARY 6, 2018

Chairman Crapo, Ranking Member Brown, and distinguished senators of the Committee, thank you for the opportunity to testify before you today.¹ I am pleased that the Committee is holding this hearing to bring greater focus to the important issues that cryptocurrencies, initial coin offerings (ICOs) and related products and activities present for American investors and our markets.

I am also pleased to join my counterpart, Commodity Futures Trading Commission (CFTC) Chairman Christopher Giancarlo, for our second time testifying together before Congress. Since I joined the Commission in May, Chairman Giancarlo

¹The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the President, the full Commission, or any Commissioner.

and I have built a strong relationship. Cryptocurrencies, ICOs and related subjects are the latest in a host of market issues on which we and our staffs have been closely collaborating to strengthen our capital markets for investors and market participants.²

The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets and facilitate capital formation. We do so through our enforcement of the Federal securities laws and our oversight of the securities markets and their participants including (1) approximately \$75 trillion in securities trading annually on U.S. equity markets; (2) the disclosures of approximately 4,100 exchange-listed public companies with an approximate aggregate market capitalization of \$31 trillion; and (3) the activities of over 26,000 registered entities and self-regulatory organizations, including investment advisers, broker-dealers, transfer agents, securities exchanges, clearing agencies, mutual funds, exchange-traded funds (ETFs), the Financial Industry Regulatory Authority (FINRA), and the Municipal Securities Rulemaking Board (MSRB), among others.

For those who seek to raise capital to fund an enterprise, as many in the ICO space have sought to do, a primary entry into the SEC's jurisdiction is the offer and sale of securities, as set forth in the Securities Act of 1933.³ As I will explain in greater detail below, determining what falls within the ambit of a securities offer and sale is a facts-and-circumstances analysis, utilizing a principles-based framework that has served American companies and American investors well through periods of innovation and change for over 80 years.

The cryptocurrency and ICO markets, while new, have grown rapidly, gained greater prominence in the public conscience and attracted significant capital from retail investors. We have seen historical instances where such a rush into certain investments has benefited our economy and those investors who backed the right ventures. But when our laws are not followed, the risks to all investors are high and numerous—including risks caused by or related to poor, incorrect or nonexistent disclosure, volatility, manipulation, fraud, and theft.

To be clear, I am very optimistic that developments in financial technology will help facilitate capital formation, providing promising investment opportunities for institutional and Main Street investors alike. From a financial regulatory perspective, these developments may enable us to better monitor transactions, holdings and obligations (including credit exposures) and other activities and characteristics of our markets, thereby facilitating our regulatory mission, including, importantly, investor protection.

At the same time, regardless of the promise of this technology, those who invest their hard-earned money in opportunities that fall within the scope of the Federal securities laws deserve the full protections afforded under those laws. This ever-present need comes into focus when enthusiasm for obtaining a profitable piece of a new technology “before it's too late” is strong and broad. Fraudsters and other bad actors prey on this enthusiasm.

The SEC and the CFTC, as Federal market regulators, are charged with establishing a regulatory environment for investors and market participants that fosters innovation, market integrity and ultimately confidence. To that end, a number of steps the SEC has taken relating to cryptocurrencies, ICOs and related assets are discussed below.

Message for Main Street Investors

Before discussing regulation in more detail, I would like to reiterate my message to Main Street investors from a statement I issued in December.⁴ Cryptocurrencies, ICOs and related products and technologies have captured the popular imagination—and billions of hard-earned dollars—of American investors from all walks of life. In dealing with these issues, my key consideration—as it is for all issues that

² See Jay Clayton and J. Christopher Giancarlo, “Regulators Are Looking at Cryptocurrency”, *Wall St. J.* (Jan. 24, 2018), available at <https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363?mod=searchresults&page=1&pos=2>.

³ Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes, among other items, “an investment contract.” See 15 U.S.C. §§77b-77c. An investment contract is 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. See *SEC v. Edwards*, 540 U.S. 389, 393 (2004); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946); see also *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852-53 (1975).

⁴ In December, I issued a statement that provided my general views on the cryptocurrency and ICO markets. The statement was directed principally at two groups: (1) Main Street investors and (2) market professionals—including, for example, broker-dealers, investment advisers, exchanges, lawyers, and accountants—whose actions impact Main Street investors. See “Statement on Cryptocurrencies and Initial Coin Offerings” (Dec. 11, 2017), available at <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

come before the Commission—is to serve the long term interests of our Main Street investors. My efforts—and the tireless efforts of the SEC staff—have been driven by various factors, but most significantly by the concern that too many Main Street investors do not understand all the material facts and risks involved. Unfortunately, it is clear that some have taken advantage of this lack of understanding and have sought to prey on investors’ excitement about the quick rise in cryptocurrency and ICO prices.⁵

There should be no misunderstanding about the law. When investors are offered and sold securities—which to date ICOs have largely been—they are entitled to the benefits of State and Federal securities laws and sellers and other market participants must follow these laws.

Yes, we do ask our investors to use common sense, and we recognize that many investment decisions will prove to be incorrect in hindsight. However, we do not ask investors to use their common sense in a vacuum, but rather, with the benefit of information and other requirements where judgments can reasonably be made.

This is a core principle of our Federal securities laws and is embodied in the SEC’s registration requirements. Investors should understand that to date no ICOs have been registered with the SEC, and the SEC also has not approved for listing and trading any exchange-traded products (such as ETFs) holding cryptocurrencies or other assets related to cryptocurrencies. If any person today says otherwise, investors should be especially wary.

Investors who are considering investing in these products should also recognize that these markets span national borders and that significant trading may occur on systems and platforms outside the U.S. Investors’ funds may quickly travel overseas without their knowledge. As a result, risks can be amplified, including the risk that U.S. market regulators, such as the SEC and State securities regulators, may not be able to effectively pursue bad actors or recover funds.

Further, there are significant security risks that can arise by transacting in these markets, including the loss of investment and personal information due to hacks of online trading platforms and individual digital asset “wallets.” A recent study estimated that more than 10 percent of proceeds generated by ICOs—or almost \$400 million—has been lost to such attacks.⁶ And less than 2 weeks ago, a Japanese cryptocurrency market lost over \$500 million in an apparent hack of its systems.⁷

In order to arm investors with additional information, the SEC staff has issued investor alerts, bulletins and statements on ICOs and cryptocurrency-related investments, including with respect to the marketing of certain offerings and investments by celebrities and others.⁸ If investors choose to invest in these products, they should ask questions and demand clear answers. I would strongly urge investors—especially retail investors—to review the sample questions and investor alerts issued by the SEC’s Office of Investor Education and Advocacy.⁹

These warnings are not an effort to undermine the fostering of innovation through our capital markets—America was built on the ingenuity, vision, and spirit of entre-

⁵In one instance, the SEC brought an enforcement action against a purported Bitcoin mining company that claimed to have a product “so easy to use that it is ‘Grandma approved.’” In this case, in less than 6 months, the company allegedly raised more than \$19 million from more than 10,000 investors. The SEC charged that company with operating a Ponzi scheme. See Press Release 2015-271, “SEC Charges Bitcoin Mining Companies” (Dec. 1, 2015), available at <https://www.sec.gov/news/pressrelease/2015-271.html>; “SEC Obtains Final Judgment Against Founder of Bitcoin Mining Companies Used To Defraud Investors” (Oct. 4, 2017), available at <https://www.sec.gov/litigation/litreleases/2017/lr23960.htm>.

⁶See “EY Research: Initial Coin Offerings (ICOs)” (Dec. 2017), available at <http://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/%24File/ey-research-initial-coin-offerings-icos.pdf>.

⁷See Reuters, “Japan Raps Coincheck, Orders Broader Checks After \$530 Million Cryptocurrency Theft”, Jan. 28, 2018, available at <https://www.reuters.com/article/us-japan-cryptocurrency/japan-raps-coincheck-orders-broader-checks-after-530-million-cryptocurrency-theft-idUSKBN1FI06S>.

⁸“Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others” (Nov. 1, 2017), available at <https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos>; “Investor Alert: Public Companies Making ICO-Related Claims” (Aug. 28, 2017), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_ico-related-claims; “Investor Bulletin: Initial Coin Offerings” (July 25, 2017), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings; “Investor Alert: Bitcoin and Other Virtual Currency-Related Investments” (May 7, 2014), available at <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-bitcoin-other-virtual-currency>; “Investor Alert: Ponzi Schemes Using Virtual Currencies” (July 23, 2013), available at https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf.

⁹See “Sample Questions for Investors Considering a Cryptocurrency or ICO Investment Opportunity” (Dec. 2017), available at https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11#_ftnref8.

preneurs who tackled old and new problems in new, innovative ways. Rather, they are meant to educate Main Street investors that many promoters of ICOs and cryptocurrencies are not complying with our securities laws and, as a result, the risks are significant.

With my remaining testimony, I would like to provide the Committee an overview of the Commission's ongoing work on cryptocurrencies and ICOs.

Cryptocurrencies and Related Products and Trading

Speaking broadly, cryptocurrencies purport to be items of inherent value (similar, for instance, to cash or gold) that are designed to enable purchases, sales, and other financial transactions. Many are promoted as providing the same functions as long-established currencies such as the U.S. dollar but without the backing of a Government or other body. While cryptocurrencies currently being marketed vary in different respects, proponents of cryptocurrencies often tout their novelty and other potential beneficial features, including the ability to make transfers without an intermediary and without geographic limitation and lower transaction costs compared to other forms of payment. Critics of cryptocurrencies note that the purported benefits highlighted by proponents are unproven and other touted benefits, such as the personal anonymity of the purchasers and sellers and the absence of Government regulation or oversight, could also facilitate illicit trading and financial transactions, as well as fraud.

The recent proliferation and subsequent popularity of cryptocurrency markets creates a question for market regulators as to whether our historic approach to the regulation of sovereign currency transactions is appropriate for these new markets. These markets may look like our regulated securities markets, with quoted prices and other information. Many trading platforms are even referred to as "exchanges." I am concerned that this appearance is deceiving. In reality, investors transacting on these trading platforms do not receive many of the market protections that they would when transacting through broker-dealers on registered exchanges or alternative trading systems (ATSs), such as best execution, prohibitions on front running, short sale restrictions, and custody and capital requirements. I am concerned that Main Street investors do not appreciate these differences and the resulting substantially heightened risk profile.

It appears that many of the U.S.-based cryptocurrency trading platforms have elected to be regulated as money-transmission services. Traditionally, from an oversight perspective, these predominantly State-regulated payment services have not been subject to direct oversight by the SEC or the CFTC. Traditionally, from a function perspective, these money transfer services have not quoted prices or offered other services akin to securities, commodities and currency exchanges. In short, the currently applicable regulatory framework for cryptocurrency trading was not designed with trading of the type we are witnessing in mind. As Chairman Giancarlo and I stated recently, we are open to exploring with Congress, as well as with our Federal and State colleagues, whether increased Federal regulation of cryptocurrency trading platforms is necessary or appropriate. We also are supportive of regulatory and policy efforts to bring clarity and fairness to this space.

The SEC regulates securities transactions and certain individuals and firms who participate in our securities markets. The SEC does not have direct oversight of transactions in currencies or commodities, including currency trading platforms.

While there are cryptocurrencies that, at least as currently designed, promoted, and used, do not appear to be securities, simply calling something a "currency" or a currency-based product does not mean that it is not a security. To this point I would note that many products labeled as cryptocurrencies or related assets are increasingly being promoted as investment opportunities that rely on the efforts of others, with their utility as an efficient medium for commercial exchange being a distinct secondary characteristic. As discussed in more detail below, if a cryptocurrency, or a product with its value tied to one or more cryptocurrencies, is a security, its promoters cannot make offers or sales unless they comply with the registration and other requirements under our Federal securities laws.¹⁰

In this regard, the SEC is monitoring the cryptocurrency-related activities of the market participants it regulates, including brokers, dealers, investment advisers, and trading platforms. Brokers, dealers and other market participants that allow for payments in cryptocurrencies, allow customers to purchase cryptocurrencies (includ-

¹⁰It is possible to conduct an offer and sales of securities, including an ICO, without triggering the SEC's registration requirements. For example, just as with a Regulation D exempt offering to raise capital for the manufacturing of a physical product, an ICO that is a security can be structured so that it qualifies for an applicable exemption from the registration requirements.

ing on margin) or otherwise use cryptocurrencies to facilitate securities transactions should exercise particular caution, including ensuring that their cryptocurrency activities are not undermining their anti-money-laundering and know-your-customer obligations.¹¹ As I have stated previously, these market participants should treat payments and other transactions made in cryptocurrency as if cash were being handed from one party to the other.

Finally, financial products that are linked to underlying digital assets, including cryptocurrencies, may be structured as securities products subject to the Federal securities laws even if the underlying cryptocurrencies are not themselves securities. Market participants have requested Commission approval for new products and services of this type that are focused on retail investors, including cryptocurrency-linked ETFs. While we appreciate the importance of continuing innovation in our retail fund space, there are a number of issues that need to be examined and resolved before we permit ETFs and other retail investor-oriented funds to invest in cryptocurrencies in a manner consistent with their obligations under the Federal securities laws. These include issues around liquidity, valuation, and custody of the funds' holdings, as well as creation, redemption, and arbitrage in the ETF space.

Last month, after working with several sponsors who ultimately decided to withdraw their registration statements, the Director of our Division of Investment Management issued a letter to provide an overview of certain substantive issues and related questions associated with registration requirements and to encourage others who may be considering a fund registered pursuant to the Investment Company Act of 1940 to engage in a robust discussion with the staff concerning the above-mentioned issues.¹² Until such time as those questions have been sufficiently addressed, I am concerned about whether it is appropriate for fund sponsors that invest substantially in cryptocurrencies and related products to register. We will continue engaging in a dialogue with all interested parties to seek a path forward consistent with the SEC's tripartite mission.

ICOs and Related Trading

Coinciding with the substantial growth in cryptocurrencies, companies and individuals increasingly have been using so-called ICOs to raise capital for businesses and projects. Typically, these offerings involve the opportunity for individual investors to exchange currency, such as U.S. dollars or cryptocurrencies, in return for a digital asset labeled as a coin or token. The size of the ICO market has grown exponentially in the last year, and it is estimated that almost \$4 billion was raised through ICOs in 2017. Note that this number may understate the size of the ICO market (and the potential for loss) as many ICOs "trade up" after they are issued.

These offerings can take different forms, and the rights and interests a coin is purported to provide the holder can vary widely. A key question all ICO market participants—promoters, sellers, lawyers, officers, and directors and accountants, as well as investors—should ask: "Is the coin or token a security?" As securities law practitioners know well, the answer depends on the facts. But by and large, the structures of ICOs that I have seen involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our Federal securities laws. As noted above, the foundation of our Federal securities laws is to provide investors with the procedural protections and information they need to make informed judgments about what they are investing in and the relevant risks involved. In addition, our Federal securities laws provide a wide array of remedies, including criminal and civil actions brought by the DOJ and the SEC, as well as private rights of action.

The Commission previously urged market professionals, including securities lawyers, accountants, and consultants, to read closely an investigative report it released. On July 25, 2017, the Commission issued a Report of Investigation pursuant to Section 21(a) of the Securities Exchange Act of 1934¹³ regarding an ICO of DAO

¹¹I am particularly concerned about market participants who extend to customers credit in U.S. dollars—a relatively stable asset—to enable the purchase of cryptocurrencies, which, in recent experience, have proven to be a more volatile asset.

¹²See "Staff Letter: Engaging on Fund Innovation and Cryptocurrency-Related Holdings" (Jan. 18, 2018), available at <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm>.

¹³Section 21(a) of the Exchange Act authorizes the Commission to investigate violations of the Federal securities laws and, in its discretion, to "publish information concerning any such violations." The Report does not constitute an adjudication of any fact or issue addressed therein, nor does it make any findings of violations by any individual or entity.

Tokens.¹⁴ In the Report, the Commission considered the particular facts and circumstances presented by the offer and sale of DAO Tokens and concluded that DAO Tokens were securities based on longstanding legal principles, and therefore that offers and sales of the DAO Tokens were subject to the Federal securities laws. The Report also explained that issuers of distributed ledger or blockchain technology-based securities must register offers and sales of such securities unless a valid exemption from registration applies, and that platforms that provide for trading in such securities must register with the SEC as national securities exchanges or operate pursuant to an exemption from such registration.

The Commission’s message to issuers and market professionals in this space was clear: those who would use distributed ledger technology to raise capital or engage in securities transactions must take appropriate steps to ensure compliance with the Federal securities laws. The Report and subsequent statements also explain that the use of such technology does not mean that an offering is necessarily problematic under those laws. The registration process itself, or exemptions from registration, are available for offerings employing these novel methods.

The statement I issued in December that was directed to Main Street investors and market professionals provided additional insight into how practitioners should view ICOs in the context of our Federal securities laws. Certain market professionals have attempted to highlight the utility or voucher-like characteristics of their proposed ICOs in an effort to claim that their proposed tokens or coins are not securities. Many of these assertions that the Federal securities laws do not apply to a particular ICO appear to elevate form over substance. The rise of these form-based arguments is a disturbing trend that deprives investors of mandatory protections that clearly are required as a result of the structure of the transaction. Merely calling a token a “utility” token or structuring it to provide some utility does not prevent the token from being a security.¹⁵ Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens, i.e., the ability to sell them on an exchange at a profit. In short, prospective purchasers are being sold on the potential for tokens to increase in value—with the ability to lock in those increases by reselling the tokens on a secondary market—or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering.

On this and other points where the application of expertise and judgment is expected, I believe that gatekeepers and others, including securities lawyers, accountants and consultants, need to focus on their responsibilities. I have urged these professionals to be guided by the principal motivation for our registration, offering process and disclosure requirements: investor protection and, in particular, the protection of our Main Street investors.¹⁶

I also have cautioned market participants against promoting or touting the offer and sale of coins without first determining whether the securities laws apply to those actions. Engaging in the business of selling securities generally requires a license, and experience shows that excessive touting in thinly traded and volatile markets can be an indicator of “scalping,” “pump and dump,” and other manipulations and frauds. Similarly, my colleagues and I have cautioned those who operate systems and platforms that effect or facilitate transactions in these products that they may be operating unregistered exchanges or broker-dealers that are in violation of the Securities Exchange Act of 1934.

I do want to recognize that recently social media platforms have restricted the ability of users to promote ICOs and cryptocurrencies on their platforms. I appreciate the responsible step.

¹⁴Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

¹⁵See *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) (“[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as ‘investment contracts,’ or as any interest or instrument commonly known as a ‘security.’”); see also *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990) (“Congress’ purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.”).

¹⁶See “Opening Remarks at the Securities Regulation Institute” (Jan. 22, 2018), available at <https://www.sec.gov/news/speech/speech-clayton-012218>.

Enforcement

A number of concerns have been raised regarding the cryptocurrency and ICO markets, including that, as they are currently operating, there is substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation. The ability of bad actors to commit age-old frauds with new technologies coupled with the significant amount of capital—particularly from retail investors—that has poured into cryptocurrencies and ICOs in recent months and the offshore footprint of many of these activities have only heightened these concerns.

In September 2017, the Division of Enforcement established a new Cyber Unit focused on misconduct involving distributed ledger technology and ICOs, the spread of false information through electronic and social media, brokerage account takeovers, hacking to obtain nonpublic information and threats to trading platforms.¹⁷ The Cyber Unit works closely with our cross-divisional Distributed Ledger Technology Working Group, which was created in November 2013. We believe this approach has enabled us to leverage our enforcement resources effectively and coordinate well within the Commission, as well as with other Federal and State regulators.

To date, we have brought a number of enforcement actions concerning ICOs for alleged violations of the Federal securities laws. In September 2017, we brought charges against an individual for defrauding investors in a pair of ICOs purportedly backed by investments in real estate and diamonds.¹⁸ According to the SEC’s complaint, investors provided approximately \$300,000 in funding and were told they could expect sizeable returns despite neither company having real operations. In December 2017, we obtained an emergency asset freeze to halt an alleged ICO fraud that purportedly raised up to \$15 million from thousands of individual investors beginning in August 2017.¹⁹ According to the complaint, the scam was operated by a recidivist securities law violator and promised investors a more than 1,300 percent profit in under 29 days. As another example, after being contacted by the SEC last December, a company halted its ICO to raise capital for a blockchain-based food review service, and then settled proceedings in which we determined that the ICO was an unregistered offering and sale of securities in violation of the Federal securities laws.²⁰ Before tokens were delivered to investors, the company refunded investor proceeds after the SEC intervened.

And most recently, we halted an allegedly fraudulent ICO that targeted retail investors promoting what it portrayed as the world’s first decentralized bank.²¹ We were able to freeze some of the allegedly ill-gotten cryptocurrency assets and obtained a receiver to try to marshal these assets back to harmed investors.

I also have been increasingly concerned with recent instances of public companies, with no meaningful track record in pursuing distributed ledger or blockchain technology, changing their business models and names to reflect a focus on distributed ledger technology without adequate disclosure to investors about their business model changes and the risks involved. A number of these instances raise serious investor protection concerns about the adequacy of disclosure especially where an offer and sale of securities is involved. The SEC is looking closely at the disclosures of public companies that shift their business models to capitalize on the perceived promise of distributed ledger technology and whether the disclosures comply with the Federal securities laws, particularly in the context of a securities offering.

With the support of my fellow Commissioners, I have asked the SEC’s Division of Enforcement to continue to police these markets vigorously and recommend enforcement actions against those who conduct ICOs or engage in other actions relating to cryptocurrencies in violation of the Federal securities laws. In doing so, the SEC and CFTC are collaborating on our approaches to policing these markets for

¹⁷ See Press Release 2017-176, “SEC Announces Enforcement Initiatives To Combat Cyber-Based Threats and Protect Retail Investors” (Sept. 25, 2017), available at <https://www.sec.gov/news/press-release/2017-176>.

¹⁸ Press Release 2017-185, “SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds” (Sept. 29, 2017), available at <https://www.sec.gov/news/press-release/2017-185-0>.

¹⁹ Press Release 2017-219, “SEC Emergency Action Halts ICO Scam” (Dec. 4, 2017), available at <https://www.sec.gov/news/press-release/2017-219>.

²⁰ Press Release 2017-227, “Company Halts ICO After SEC Raises Registration Concerns” (Dec. 11, 2017), available at <https://www.sec.gov/news/press-release/2017-227>.

²¹ Press Release 2018-8, “SEC Halts Alleged Initial Coin Offering Scam” (Jan. 30, 2018), available at <https://www.sec.gov/news/press-release/2018-8>.

fraud and abuse.²² We also will continue to work closely with our Federal and State counterparts, including the Department of Treasury, Department of Justice, and State attorneys general and securities regulators.

Conclusion

Through the years, technological innovations have improved our markets, including through increased competition, lower barriers to entry and decreased costs for market participants. Distributed ledger and other emerging technologies have the potential to further influence and improve the capital markets and the financial services industry. Businesses, especially smaller businesses without efficient access to traditional capital markets, can be aided by financial technology in raising capital to establish and finance their operations, thereby allowing them to be more competitive both domestically and globally. And these technological innovations can provide investors with new opportunities to offer support and capital to novel concepts and ideas.

History, both in the United States and abroad, has proven time and again that these opportunities flourish best when pursued in harmony with our Federal securities laws. These laws reflect our tripartite mission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. Being faithful to each part of our mission not in isolation, but collectively, has served us well. Said simply, we should embrace the pursuit of technological advancement, as well as new and innovative techniques for capital raising, but not at the expense of the principles undermining our well-founded and proven approach to protecting investors and markets.

Thank you for the opportunity to testify before you today and for your support of the Commission and its workforce. I stand ready to work with Congress on these issues and look forward to answering your questions.

²² See Joint Statement by SEC and CFTC Enforcement Directors Regarding Virtual Currency Enforcement Actions (Jan. 19, 2018), available at <https://www.sec.gov/news/public-statement/joint-statement-sec-and-cftc-enforcement-directors>.

APPENDIX

[Press Release: SEC Halts Alleged Initial Coin Offering Scam \(Jan. 30, 2018\)](#)

[Statement by SEC Chairman Jay Clayton and CFTC Chairman J. Christopher Giancarlo: Regulators Are Looking at Cryptocurrency \(Jan. 25, 2018\)](#)

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[Press Release: SEC Emergency Action Halts ICO Scam \(Dec. 4, 2017\)](#)

[Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others \(Nov. 1, 2017\)](#)

[Investor Alert: Celebrity Endorsements \(Nov. 1, 2017\)](#)

[Press Release: SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds \(Sept. 29, 2017\)](#)

[Investor Alert: Public Companies Making ICO-Related Claims \(Aug. 28, 2017\)](#)

[Statement by the Divisions of Corporation Finance and Enforcement on the Report of Investigation on The DAO \(July 25, 2017\)](#)

[Report of Investigation Pursuant to Section 21\(a\) of the Securities Exchange Act of 1934: The DAO \(July 25, 2017\)](#)

[Investor Bulletin: Initial Coin Offerings \(July 25, 2017\)](#)

[Investor Alert: Bitcoin and Other Virtual Currency-Related Investments \(May 7, 2014\)](#)

[Investor Alert: Ponzi Schemes Using Virtual Currencies \(July 23, 2013\)](#)

Press Release

SEC Halts Alleged Initial Coin Offering Scam

FOR IMMEDIATE RELEASE
2018-8

Washington D.C., Jan. 30, 2018 — The Securities and Exchange Commission obtained a court order halting an allegedly fraudulent initial coin offering (ICO) that targeted retail investors to fund what it claimed to be the world's first "decentralized bank."

According to the SEC's complaint, filed in federal district court in Dallas on Jan. 25 and unsealed late yesterday, Dallas-based AriseBank used social media, a celebrity endorsement, and other wide dissemination tactics to raise what it claims to be \$600 million of its \$1 billion goal in just two months.

AriseBank and its co-founders Jared Rice Sr. and Stanley Ford allegedly offered and sold unregistered investments in their purported "AriseCoin" cryptocurrency by depicting AriseBank as a first-of-its-kind decentralized bank offering a variety of consumer-facing banking products and services using more than 700 different virtual currencies. AriseBank's sales pitch claimed that it developed an algorithmic trading application that automatically trades in various cryptocurrencies.

The SEC alleges that AriseBank falsely stated that it purchased an FDIC-insured bank which enabled it to offer customers FDIC-insured accounts and that it also offered customers the ability to obtain an AriseBank-branded VISA card to spend any of the 700-plus cryptocurrencies. AriseBank also allegedly omitted to disclose the criminal background of key executives.

"We allege that AriseBank and its principals sought to raise hundreds of millions from investors by misrepresenting the company as a first-of-its-kind decentralized bank offering its own cryptocurrency to be used for a broad range of customer products and services. We sought emergency relief to prevent investors from being victimized by what we allege to be an outright scam," said Stephanie Avakian, Co-Director of the SEC's Enforcement Division.

"This is the first time the Commission has sought the appointment of a receiver in connection with an ICO fraud. We will use all of our tools and remedies to protect investors from those who engage in fraudulent conduct in the emerging digital securities marketplace," said Steven Peikin, Co-Director of the SEC's Enforcement Division.

Shamail T. Shipchandler, Director of the SEC's Fort Worth Regional Office, said, "Attempting to conceal what we allege to be fraudulent securities offerings under the veneer of technological terms like 'ICO' or 'cryptocurrency' will not escape the Commission's oversight or its efforts to protect investors."

The court approved an emergency asset freeze over AriseBank, Rice, and Ford and appointed a receiver over AriseBank, including over its digital assets. The SEC intervened to protect the digital assets before they could be dissipated, enabling the receiver to immediately secure various cryptocurrencies held by AriseBank including Bitcoin, Litecoin, Bitshares, Dogecoin, and BitUSD. AriseCoin's public sale began around Dec. 26, 2017, and was originally scheduled to conclude on Jan. 27, 2018, with distribution to investors on Feb. 10, 2018. The SEC seeks preliminary and permanent injunctions, disgorgement of ill-gotten gains plus interest and penalties, and bars against Rice and Ford to prohibit them from serving as officers or directors of a public company or offering digital securities again in the future.

The SEC's investigation was conducted by David Hirsch and supervised by Jessica Magee and Eric Werner in the Fort Worth Regional Office in coordination with the Enforcement Division's Cyber Unit. The litigation is being conducted by Timothy Evans, Christopher Davis, and Mr. Hirsch, and supervised by B. David Fraser. The SEC appreciates the assistance of the Federal Bureau of Investigation, U.S. Attorney's Office for the Northern District of Texas, Federal Deposit Insurance Corporation, U.S. Patent and Trademark Office, and Texas Department of Banking.

Investors in the AriseBank ICO who believe they may be a victim are asked to [report it to the SEC](#) as a tip or complaint.

The SEC's Office of Investor Education and Advocacy issued an [Investor Alert](#) in August 2017 warning investors about scams of companies claiming to be engaging in initial coin offerings.

###

More About This Topic

- [Investor Alert: Public Companies Making ICO-Related Claims](#)

Related Materials

- [SEC Complaint](#)

Public Statement

Statement by SEC Chairman Jay Clayton and CFTC Chairman J. Christopher Giancarlo: Regulators are Looking at Cryptocurrency

SEC Chairman Jay Clayton

CFTC Chairman J. Christopher Giancarlo

Jan. 25, 2018

Excerpts from joint op-ed published in Wall Street Journal, Jan. 25, 2018.

Distributed ledger technology, or DLT, is the advancement that underpins an array of new financial products, including cryptocurrencies and digital payment services. Many have identified DLT as the next great driver of economic efficiency. Some have even compared it to productivity-driving innovations such as the steam engine and personal computer.

Our task, as market regulators, is to set and enforce rules that foster innovation while promoting market integrity and confidence. In recent months, we have seen a wide range of market participants, including retail investors, seeking to invest in DLT initiatives, including through cryptocurrencies and so-called ICOs—initial coin offerings. Experience tells us that while some market participants may make fortunes, the risks to all investors are high. Caution is merited.

A key issue before market regulators is whether our historic approach to the regulation of currency transactions is appropriate for the cryptocurrency markets. Check-cashing and money-transmission services that operate in the U.S. are primarily state-regulated. Many of the internet-based cryptocurrency trading platforms have registered as payment services and are not subject to direct oversight by the SEC or the CFTC. We would support policy efforts to revisit these frameworks and ensure they are effective and efficient for the digital era.

The CFTC and SEC, along with other federal and state regulators and criminal authorities, will continue to work together to bring transparency and integrity to these markets and, importantly, to deter and prosecute fraud and abuse. These markets are new, evolving and international. As such they require us to be nimble and forward-looking; coordinated with our state, federal and international colleagues; and engaged with important stakeholders, including Congress.

[Click here to read the entire op-ed.](#)

Public Statement

Joint Statement by SEC and CFTC Enforcement Directors Regarding Virtual Currency Enforcement Actions

SEC Co-Enforcement Directors Stephanie Avakian and Steven Peikin and
CFTC Enforcement Director James McDonald

Jan. 19, 2018

"When market participants engage in fraud under the guise of offering digital instruments – whether characterized as virtual currencies, coins, tokens, or the like – the SEC and the CFTC will look beyond form, examine the substance of the activity and prosecute violations of the federal securities and commodities laws. The Divisions of Enforcement for the SEC and CFTC will continue to address violations and bring actions to stop and prevent fraud in the offer and sale of digital instruments."

Public Statement

Statement of Chairman Jay Clayton and Commissioners Kara M. Stein and Michael S. Piwowar on "NASAA Reminds Investors to Approach Cryptocurrencies, Initial Coin Offerings and Other Cryptocurrency-Related Investment Products with Caution" by NASAA

Chairman Jay Clayton
Commissioner Kara M. Stein
Commissioner Michael S. Piwowar

Jan. 4, 2018

We commend the North American Securities Administrators Association (NASAA) on their [release](#) highlighting important issues and concerns related to cryptocurrencies, initial coin offerings (ICOs) and other cryptocurrency-related investment products.

NASAA's release is a timely and thoughtful reminder to Main Street investors to exercise caution. The release recognizes that cryptocurrencies, while touted as replacements for traditional currencies, lack many important characteristics of traditional currencies, including sovereign backing and responsibility, and now are being promoted more as investment opportunities than efficient mediums for exchange.

The NASAA release also reminds investors that when they are offered and sold securities they are entitled to the benefits of state and federal securities laws, and that sellers and other market participants must follow these laws. Unfortunately, it is clear that many promoters of ICOs and others participating in the cryptocurrency-related investment markets are not following these laws. The SEC and state securities regulators are pursuing violations, but we again caution you that, if you lose money, there is a substantial risk that our efforts will not result in a recovery of your investment.

We encourage investors to read NASAA's release and particularly to keep in mind the common red flags of investment fraud that the release reiterates. We also encourage investors to review the SEC investor bulletins, alerts, reports, and statements linked below.

- [SEC Chairman Jay Clayton Statement on Cryptocurrencies and Initial Coin Offerings \(Dec. 11, 2017\)](#)
- [SEC Division of Enforcement and SEC Office of Compliance Inspections and Examinations Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others \(Nov. 1, 2017\)](#)
- [Investor Alert: Public Companies Making ICO-Related Claims \(Aug. 28, 2017\)](#)

2/1/2018 SEC.gov | Statement of Chairman Jay Clayton and Commissioners Kara M. Stein and Michael S. Piowar on "NASAA Reminds Investors to App...

- [Report of Investigation Pursuant to Section 21\(a\) of the Securities Exchange Act of 1934: The DAO \(July 25, 2017\)](#)
- [Investor Bulletin: Initial Coin Offerings \(July 25, 2017\)](#)
- [Investor Alert: Bitcoin and Other Virtual Currency-Related Investments \(May 7, 2014\)](#)
- [Investor Alert: Ponzi Schemes Using Virtual Currencies \(July 23, 2013\)](#)

Related Materials

- [NASAA Statement](#)

Public Statement

Statement on Cryptocurrencies and Initial Coin Offerings

SEC Chairman Jay Clayton

Dec. 11, 2017

The world's social media platforms and financial markets are abuzz about cryptocurrencies and "initial coin offerings" (ICOs). There are tales of fortunes made and dreamed to be made. We are hearing the familiar refrain, "this time is different."

The cryptocurrency and ICO markets have grown rapidly. These markets are local, national and international and include an ever-broadening range of products and participants. They also present investors and other market participants with many questions, some new and some old (but in a new form), including, to list just a few:

- Is the product legal? Is it subject to regulation, including rules designed to protect investors? Does the product comply with those rules?
- Is the offering legal? Are those offering the product licensed to do so?
- Are the trading markets fair? Can prices on those markets be manipulated? Can I sell when I want to?
- Are there substantial risks of theft or loss, including from hacking?

The answers to these and other important questions often require an in-depth analysis, and the answers will differ depending on many factors. This statement provides my general views on the cryptocurrency and ICO markets^[1] and is directed principally to two groups:

- "Main Street" investors, and
- Market professionals – including, for example, broker-dealers, investment advisers, exchanges, lawyers and accountants – whose actions impact Main Street investors.

Considerations for Main Street Investors

A number of concerns have been raised regarding the cryptocurrency and ICO markets, including that, as they are currently operating, there is substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation.

Investors should understand that to date no initial coin offerings have been registered with the SEC. The SEC also has not to date approved for listing and trading any exchange-traded products (such as ETFs) holding cryptocurrencies or other assets related to cryptocurrencies.^[2] **If any person today tells you otherwise, be especially wary.**

We have issued investor alerts, bulletins and statements on initial coin offerings and cryptocurrency-related investments, including with respect to the marketing of certain offerings and investments by celebrities and others.^[3] Please take a moment to read them. **If you choose to invest in these products, please ask questions and demand clear answers.** A list of sample questions that may be helpful is attached.

2/1/2018

SEC.gov | Statement on Cryptocurrencies and Initial Coin Offerings

As with any other type of potential investment, if a promoter guarantees returns, if an opportunity sounds too good to be true, or if you are pressured to act quickly, please exercise extreme caution and be aware of the risk that your investment may be lost.

Please also recognize that these markets span national borders and that significant trading may occur on systems and platforms outside the United States. Your invested funds may quickly travel overseas without your knowledge. As a result, risks can be amplified, including the risk that market regulators, such as the SEC, may not be able to effectively pursue bad actors or recover funds.

To learn more about these markets and their regulation, please read the "Additional Discussion of Cryptocurrencies, ICOs and Securities Regulation" section below.

Considerations for Market Professionals

I believe that initial coin offerings – whether they represent offerings of securities or not – can be effective ways for entrepreneurs and others to raise funding, including for innovative projects. However, any such activity that involves an offering of securities must be accompanied by the important disclosures, processes and other investor protections that our securities laws require. A change in the structure of a securities offering does not change the fundamental point that when a security is being offered, our securities laws must be followed.^[4] Said another way, replacing a traditional corporate interest recorded in a central ledger with an enterprise interest recorded through a blockchain entry on a distributed ledger may change the form of the transaction, but it does not change the substance.

I urge market professionals, including securities lawyers, accountants and consultants, to read closely the investigative report we released earlier this year (the "21(a) Report")^[5] and review our subsequent enforcement actions.^[6] In the 21(a) Report, the Commission applied longstanding securities law principles to demonstrate that a particular token constituted an investment contract and therefore was a security under our federal securities laws. Specifically, we concluded that the token offering represented 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.

Following the issuance of the 21(a) Report, certain market professionals have attempted to highlight utility characteristics of their proposed initial coin offerings in an effort to claim that their proposed tokens or coins are not securities. Many of these assertions appear to elevate form over substance. Merely calling a token a "utility" token or structuring it to provide some utility does not prevent the token from being a security. Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law. **On this and other points where the application of expertise and judgment is expected, I believe that gatekeepers and others, including securities lawyers, accountants and consultants, need to focus on their responsibilities.** I urge you to be guided by the principal motivation for our registration, offering process and disclosure requirements: investor protection and, in particular, the protection of our Main Street investors.

I also caution market participants against promoting or touting the offer and sale of coins without first determining whether the securities laws apply to those actions. **Selling securities generally requires a license, and experience shows that excessive touting in thinly traded and volatile markets can be an indicator of "scalping," "pump and dump" and other manipulations and frauds.** Similarly, I also caution those who operate systems and platforms that effect or facilitate transactions in these products that they may be operating unregistered exchanges or broker-dealers that are in violation of the Securities Exchange Act of 1934.

On cryptocurrencies, I want to emphasize two points. First, while there are cryptocurrencies that do not appear to be securities, simply calling something a "currency" or a currency-based product does not mean that it is not a security. Before launching a cryptocurrency or a product with its value tied to one or more cryptocurrencies, its promoters must either (1) be able to demonstrate that the currency or product is not a security or (2) comply with applicable registration and other requirements under our securities laws. Second, brokers, dealers and other market participants that allow for payments in cryptocurrencies, allow customers to purchase cryptocurrencies on

margin, or otherwise use cryptocurrencies to facilitate securities transactions should exercise particular caution, including ensuring that their cryptocurrency activities are not undermining their anti-money laundering and know-your-customer obligations.^[7] **As I have stated previously, these market participants should treat payments and other transactions made in cryptocurrency as if cash were being handed from one party to the other.**

Additional Discussion of Cryptocurrencies, ICOs and Securities Regulation

Cryptocurrencies. Speaking broadly, cryptocurrencies purport to be items of inherent value (similar, for instance, to cash or gold) that are designed to enable purchases, sales and other financial transactions. They are intended to provide many of the same functions as long-established currencies such as the U.S. dollar, euro or Japanese yen but do not have the backing of a government or other body. Although the design and maintenance of cryptocurrencies differ, proponents of cryptocurrencies highlight various potential benefits and features of them, including (1) the ability to make transfers without an intermediary and without geographic limitation, (2) finality of settlement, (3) lower transaction costs compared to other forms of payment and (4) the ability to publicly verify transactions. Other often-touted features of cryptocurrencies include personal anonymity and the absence of government regulation or oversight. Critics of cryptocurrencies note that these features may facilitate illicit trading and financial transactions, and that some of the purported beneficial features may not prove to be available in practice.

It has been asserted that cryptocurrencies are not securities and that the offer and sale of cryptocurrencies are beyond the SEC's jurisdiction. Whether that assertion proves correct with respect to any digital asset that is labeled as a cryptocurrency will depend on the characteristics and use of that particular asset. In any event, it is clear that, just as the SEC has a sharp focus on how U.S. dollar, euro and Japanese yen transactions affect our securities markets, we have the same interests and responsibilities with respect to cryptocurrencies. This extends, for example, to securities firms and other market participants that allow payments to be made in cryptocurrencies, set up structures to invest in or hold cryptocurrencies, or extend credit to customers to purchase or hold cryptocurrencies.

Initial Coin Offerings. Coinciding with the substantial growth in cryptocurrencies, companies and individuals increasingly have been using initial coin offerings to raise capital for their businesses and projects. Typically these offerings involve the opportunity for individual investors to exchange currency such as U.S. dollars or cryptocurrencies in return for a digital asset labeled as a coin or token.

These offerings can take many different forms, and the rights and interests a coin is purported to provide the holder can vary widely. A key question for all ICO market participants: "Is the coin or token a security?" As securities law practitioners know well, the answer depends on the facts. For example, a token that represents a participation interest in a book-of-the-month club may not implicate our securities laws, and may well be an efficient way for the club's operators to fund the future acquisition of books and facilitate the distribution of those books to token holders. In contrast, many token offerings appear to have gone beyond this construct and are more analogous to interests in a yet-to-be-built publishing house with the authors, books and distribution networks all to come. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens. Prospective purchasers are being sold on the potential for tokens to increase in value – with the ability to lock in those increases by reselling the tokens on a secondary market – or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering.

By and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws. Generally speaking, these laws provide that investors deserve to know what they are investing in and the relevant risks involved.

I have asked the SEC's Division of Enforcement to continue to police this area vigorously and recommend enforcement actions against those that conduct initial coin offerings in violation of the federal securities laws.

Conclusion

2/1/2018

SEC.gov | Statement on Cryptocurrencies and Initial Coin Offerings

We at the SEC are committed to promoting capital formation. The technology on which cryptocurrencies and ICOs are based may prove to be disruptive, transformative and efficiency enhancing. I am confident that developments in fintech will help facilitate capital formation and provide promising investment opportunities for institutional and Main Street investors alike.

I encourage Main Street investors to be open to these opportunities, but to ask good questions, demand clear answers and apply good common sense when doing so. When advising clients, designing products and engaging in transactions, market participants and their advisers should thoughtfully consider our laws, regulations and guidance, as well as our principles-based securities law framework, which has served us well in the face of new developments for more than 80 years. I also encourage market participants and their advisers to engage with the SEC staff to aid in their analysis under the securities laws. Staff providing assistance on these matters remain available at FinTech@sec.gov.

**Sample Questions for Investors Considering a Cryptocurrency or ICO
Investment Opportunity^[8]**

- Who exactly am I contracting with?
 - Who is issuing and sponsoring the product, what are their backgrounds, and have they provided a full and complete description of the product? Do they have a clear written business plan that I understand?
 - Who is promoting or marketing the product, what are their backgrounds, and are they licensed to sell the product? Have they been paid to promote the product?
 - Where is the enterprise located?
- Where is my money going and what will it be used for? Is my money going to be used to "cash out" others?
- What specific rights come with my investment?
- Are there financial statements? If so, are they audited, and by whom?
- Is there trading data? If so, is there some way to verify it?
- How, when, and at what cost can I sell my investment? For example, do I have a right to give the token or coin back to the company or to receive a refund? Can I resell the coin or token, and if so, are there any limitations on my ability to resell?
- If a digital wallet is involved, what happens if I lose the key? Will I still have access to my investment?
- If a blockchain is used, is the blockchain open and public? Has the code been published, and has there been an independent cybersecurity audit?
- Has the offering been structured to comply with the securities laws and, if not, what implications will that have for the stability of the enterprise and the value of my investment?
- What legal protections may or may not be available in the event of fraud, a hack, malware, or a downturn in business prospects? Who will be responsible for refunding my investment if something goes wrong?
- If I do have legal rights, can I effectively enforce them and will there be adequate funds to compensate me if my rights are violated?

[1] This statement is my own and does not reflect the views of any other Commissioner or the Commission. This statement is not, and should not be taken as, a definitive discussion of applicable law, all the relevant risks with respect to these products, or a statement of my position on any particular product. Additionally, this statement is not a comment on any particular submission, in the form of a proposed rule change or otherwise, pending before the Commission.

2/1/2018

SEC.gov | Statement on Cryptocurrencies and Initial Coin Offerings

[2] The CFTC has designated bitcoin as a commodity. Fraud and manipulation involving bitcoin traded in interstate commerce are appropriately within the purview of the CFTC, as is the regulation of commodity futures tied directly to bitcoin. That said, products linked to the value of underlying digital assets, including bitcoin and other cryptocurrencies, may be structured as securities products subject to registration under the Securities Act of 1933 or the Investment Company Act of 1940.

[3] Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others (Nov. 1, 2017), available at <https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos>; Investor Alert: Public Companies Making ICO-Related Claims (Aug. 28, 2017), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_ico-related-claims; Investor Bulletin: Initial Coin Offerings (July 25, 2017), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings; Investor Alert: Bitcoin and Other Virtual Currency-Related Investments (May 7, 2014), available at <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-bitcoin-other-virtual-currency>; Investor Alert: Ponzi Schemes Using Virtual Currencies (July 23, 2013), available at https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf.

[4] It is possible to conduct an ICO without triggering the SEC's registration requirements. For example, just as with a Regulation D exempt offering to raise capital for the manufacturing of a physical product, an initial coin offering that is a security can be structured so that it qualifies for an applicable exemption from the registration requirements.

[5] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

[6] Press Release, Company Halts ICO After SEC Raises Registration Concerns (Dec. 11, 2017), available at <https://www.sec.gov/news/press-release/2017-227>; Press Release, SEC Emergency Action Halts ICO Scam (Dec. 4, 2017), available at <https://www.sec.gov/news/press-release/2017-219>; Press Release, SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds (Sept. 29, 2017), available at <https://www.sec.gov/news/press-release/2017-185-0>.

[7] I am particularly concerned about market participants who extend to customers credit in U.S. dollars – a relatively stable asset – to enable the purchase of cryptocurrencies, which, in recent experience, have proven to be a more volatile asset.

[8] This is not intended to represent an exhaustive list. Please also see the SEC investor bulletins, alerts and statements referenced in note 3 of this statement.

Press Release

Company Halts ICO After SEC Raises Registration Concerns

FOR IMMEDIATE RELEASE

2017-227

Washington D.C., Dec. 11, 2017 — A California-based company selling digital tokens to investors to raise capital for its blockchain-based food review service halted its initial coin offering (ICO) after being contacted by the Securities and Exchange Commission, and agreed to an order in which the Commission found that its conduct constituted unregistered securities offers and sales.

According to the SEC's order, before any tokens were delivered to investors, Munchee Inc. refunded investor proceeds after the SEC intervened. Munchee was seeking \$15 million in capital to improve an existing iPhone app centered on restaurant meal reviews and create an "ecosystem" in which Munchee and others would buy and sell goods and services using the tokens. The company communicated through its website, a white paper, and other means that it would use the proceeds to create the ecosystem, including eventually paying users in tokens for writing food reviews and selling both advertising to restaurants and "in-app" purchases to app users in exchange for tokens.

According to the order, in the course of the offering, the company and other promoters emphasized that investors could expect that efforts by the company and others would lead to an increase in value of the tokens. The company also emphasized it would take steps to create and support a secondary market for the tokens. Because of these and other company activities, investors would have had a reasonable belief that their investment in tokens could generate a return on their investment. As the SEC has said in the *DAO Report of Investigation*, a token can be a security based on the long-standing facts and circumstances test that includes assessing whether investors' profits are to be derived from the managerial and entrepreneurial efforts of others.

"We will continue to scrutinize the market vigilantly for improper offerings that seek to sell securities to the general public without the required registration or exemption," said Stephanie Avakian, Co-Director of the SEC's Enforcement Division. "In deciding not to impose a penalty, the Commission recognized that the company stopped the ICO quickly, immediately returned the proceeds before issuing tokens, and cooperated with the investigation."

"Our primary focus remains investor protection and making sure that investors are being offered investment opportunities with all the information and disclosures required under the federal securities laws," said Steven Peikin, Co-Director of the SEC's Enforcement Division.

Munchee consented to the SEC's cease-and-desist order without admitting or denying the findings.

The SEC's new Cyber Unit is focused on misconduct involving distributed ledger technology and initial coin offerings, the spread of false information through electronic and social media, brokerage account takeovers, hacking to obtain nonpublic information, and threats to trading platforms. The SEC also has a Distributed Ledger Technology Working Group that focuses on various emerging applications of distributed ledger technology in the financial industry.

The SEC's investigation was conducted by the Enforcement Division's Cyber Unit and Complex Financial Instruments Unit, including Jeff Leasure, Brent Mitchell and James Murtha. The case was supervised by Robert Cohen, Reid Muoio, and Valerie Szczepanik.

The SEC's Office of Investor Education and Advocacy issued an [Investor Bulletin](#) in July 2017 to make investors aware of the potential risks of participating in initial coin offerings.

###

Related Materials

- [SEC Order](#)

Press Release

SEC Emergency Action Halts ICO Scam

FOR IMMEDIATE RELEASE**2017-219**

Washington D.C., Dec. 4, 2017 — The Securities and Exchange Commission today announced it obtained an emergency asset freeze to halt a fast-moving Initial Coin Offering (ICO) fraud that raised up to \$15 million from thousands of investors since August by falsely promising a 13-fold profit in less than a month.

The SEC filed charges against a recidivist Quebec securities law violator, Dominic Lacroix, and his company, PlexCorps. The Commission's complaint, filed in federal court in Brooklyn, New York, alleges that Lacroix and PlexCorps marketed and sold securities called PlexCoin on the internet to investors in the U.S. and elsewhere, claiming that investments in PlexCoin would yield a 1,354 percent profit in less than 29 days. The SEC also charged Lacroix's partner, Sabrina Paradis-Royer, in connection with the scheme.

Today's charges are the first filed by the SEC's new Cyber Unit. The unit was created in September to focus the Enforcement Division's cyber-related expertise on misconduct involving distributed ledger technology and initial coin offerings, the spread of false information through electronic and social media, hacking and threats to trading platforms.

"This first Cyber Unit case hits all of the characteristics of a full-fledged cyber scam and is exactly the kind of misconduct the unit will be pursuing," said Robert Cohen, Chief of the Cyber Unit. "We acted quickly to protect retail investors from this initial coin offering's false promises."

Based on its filing, the SEC obtained an emergency court order to freeze the assets of PlexCorps, Lacroix, and Paradis-Royer.

The SEC's complaint charges Lacroix, Paradis-Royer and PlexCorps with violating the anti-fraud provisions, and Lacroix and PlexCorps with violating the registration provision, of the U.S. federal securities laws. The complaint seeks permanent injunctions, disgorgement plus interest and penalties. For Lacroix, the SEC also seeks an officer-and-director bar and a bar from offering digital securities against Lacroix and Paradis-Royer.

The Commission's investigation was conducted by Daphna A. Waxman, David H. Tutor, and Jorge G. Tenreiro of the New York Regional Office and the Cyber Unit, with assistance from the agency's Office of International Affairs. The case is being supervised by Valerie A. Szczepanik and Mr. Cohen. The Commission appreciates the assistance of Quebec's Autorité Des Marchés Financiers.

The SEC's Office of Investor Education and Advocacy issued an Investor Alert in August 2017 warning investors about scams of companies claiming to be engaging in initial coin

offerings; <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-public-companies-making-ico-related>.

###

Related Materials

- [SEC Complaint](#)

Public Statement

Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others

SEC Division of Enforcement and
SEC Office of Compliance Inspections and Examinations

Nov. 1, 2017

Celebrities and others are using social media networks to encourage the public to purchase stocks and other investments. These endorsements may be unlawful if they do not disclose the nature, source, and amount of any compensation paid, directly or indirectly, by the company in exchange for the endorsement. The SEC's Enforcement Division and Office of Compliance Inspections and Examinations encourage investors to be wary of investment opportunities that sound too good to be true. We encourage investors to research potential investments rather than rely on paid endorsements from artists, sports figures, or other icons.

Celebrities and others have recently promoted investments in Initial Coin Offerings (ICOs). In the SEC's Report of Investigation concerning The DAO, the Commission warned that virtual tokens or coins sold in ICOs may be securities, and those who offer and sell securities in the United States must comply with the federal securities laws. Any celebrity or other individual who promotes a virtual token or coin that is a security must disclose the nature, scope, and amount of compensation received in exchange for the promotion. A failure to disclose this information is a violation of the anti-touting provisions of the federal securities laws. Persons making these endorsements may also be liable for potential violations of the anti-fraud provisions of the federal securities laws, for participating in an unregistered offer and sale of securities, and for acting as unregistered brokers. The SEC will continue to focus on these types of promotions to protect investors and to ensure compliance with the securities laws.

Investors should note that celebrity endorsements may appear unbiased, but instead may be part of a paid promotion. Investment decisions should not be based solely on an endorsement by a promoter or other individual. Celebrities who endorse an investment often do not have sufficient expertise to ensure that the investment is appropriate and in compliance with federal securities laws. Conduct research before making investments, including in ICOs. If you are relying on a particular endorsement or recommendation, learn more regarding the relationship between the promoter and the company and consider whether the recommendation is truly independent or a paid promotion. For more information, see an [Investor Alert](#) that the SEC's Office of Investor Education and Advocacy issued today regarding celebrity endorsements.

Additional Resources

[Investor Bulletin: Initial Coin Offerings](#)

[Investor Alert: Public Companies Making ICO-Related Claims](#)

[Investor Alert: Social Media and Investing – Avoiding Fraud](#)



INVESTOR ALERT: CELEBRITY ENDORSEMENTS

11/01/2017

The SEC's Office of Investor Education and Advocacy (OIEA) is warning investors not to make investment decisions based solely on celebrity endorsements.

Celebrities, from movie stars to professional athletes, can be found on TV, radio, and social media endorsing a wide variety of products and services – sometimes even including investment opportunities. But a celebrity endorsement does not mean that an investment is legitimate or that it is appropriate for all investors. **It is never a good idea to make an investment decision just because someone famous says a product or service is a good investment.**

Celebrities, like anyone else, can be lured into participating (even unknowingly) in a fraudulent scheme. Also, celebrities are sometimes linked to products or services without their consent so the celebrity may not even have endorsed the investment.

Even if the celebrity endorsement and the investment opportunity are genuine, the investment may not be a good one for you. Before investing, always do your research, including these three steps:

- ▶ Check out the background, including registration or license status, of anyone recommending or selling an investment, using the search tool on [Investor.gov](https://www.investor.gov/) (<https://www.investor.gov/>);
- ▶ Learn about the company's finances, organization, and business prospects by carefully reading any prospectus and the company's latest financial reports, which may be available through the SEC's [EDGAR](http://www.sec.gov/edgar/quickedgar.htm) (<http://www.sec.gov/edgar/quickedgar.htm>) database; and
- ▶ Consider the investment's potential costs and fees, risks, and benefits in light of your own investment goals, risk tolerance, investment horizon, net worth, existing investments and assets, debt, and tax considerations.

Never make an investment decision based solely on a celebrity endorsement, or other information you receive through social media, investment newsletters, online advertisements, email, investment research websites, internet chat rooms, direct mail, newspapers, magazines, television, or radio.

Additional Resources

[Investor Alert: Beware of False or Exaggerated Credentials](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-beware-false-or-exaggerated) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-beware-false-or-exaggerated>)

[Investor Alert: Beware of Stock Recommendations on Investment Research Websites](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-beware-stock-recommendations) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-beware-stock-recommendations>)

2/1/2018

Investor Alert: Celebrity Endorsements | Investor.gov

[Investor Alert: Public Companies Making ICO-Related Claims](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-public-companies-making-ico-related) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-public-companies-making-ico-related>)

Report [possible securities fraud](https://www.sec.gov/complaint/tioscomplaint.shtml) (<https://www.sec.gov/complaint/tioscomplaint.shtml>) to the SEC. [Ask a question or report a problem](https://www.sec.gov/complaint/question.shtml) (<https://www.sec.gov/complaint/question.shtml>) concerning your investments, your investment account or a financial professional.

Visit [Investor.gov](http://www.investor.gov/) (<http://www.investor.gov/>), the SEC's website for individual investors.

Receive Investor Alerts and Bulletins from the Office of Investor Education and Advocacy ("OIEA") by [email](mailto:investor.ed@sec.gov) (http://www.sec.gov/news/press/subscribe_updates.htm) or [RSS feed](http://www.sec.gov/rss/investor/alertsandbulletins.xml) (<http://www.sec.gov/rss/investor/alertsandbulletins.xml>). Follow OIEA on [Twitter](https://twitter.com/SEC_Investor_Ed) (https://twitter.com/SEC_Investor_Ed) @SEC_Investor_Ed. Like OIEA on [Facebook](https://www.facebook.com/secinvestoreducation) (<https://www.facebook.com/secinvestoreducation>) at [facebook.com/secinvestoreducation](https://www.facebook.com/secinvestoreducation).

The Office of Investor Education and Advocacy has provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.

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Press Release

SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds

FOR IMMEDIATE RELEASE

2017-185

Washington D.C., Sept. 29, 2017 — The Securities and Exchange Commission today charged a businessman and two companies with defrauding investors in a pair of so-called initial coin offerings (ICOs) purportedly backed by investments in real estate and diamonds.

The SEC alleges that Maksim Zaslavskiy and his companies have been selling unregistered securities, and the digital tokens or coins being peddled don't really exist. According to the SEC's complaint, investors in REcoin Group Foundation and DRC World (also known as Diamond Reserve Club) have been told they can expect sizeable returns from the companies' operations when neither has any real operations.

Zaslavskiy allegedly touted REcoin as "The First Ever Cryptocurrency Backed by Real Estate." Alleged misstatements to REcoin investors included that the company had a "team of lawyers, professionals, brokers, and accountants" that would invest REcoin's ICO proceeds into real estate when in fact none had been hired or even consulted. Zaslavskiy and REcoin allegedly misrepresented they had raised between \$2 million and \$4 million from investors when the actual amount is approximately \$300,000.

According to the SEC's complaint, Zaslavskiy carried his scheme over to Diamond Reserve Club, which purportedly invests in diamonds and obtains discounts with product retailers for individuals who purchase "memberships" in the company. Despite their representations to investors, the SEC alleges that Zaslavskiy and Diamond have not purchased any diamonds nor engaged in any business operations. Yet they allegedly continue to solicit investors and raise funds as though they have.

The SEC obtained an emergency court order to freeze the assets of Zaslavskiy and his companies.

The SEC's Office of Investor Education and Advocacy recently issued an investor alert warning about the risks of ICOs.

"Investors should be wary of companies touting ICOs as a way to generate outsized returns," said Andrew M. Calamari, Director of the SEC's New York Regional Office. "As alleged in our complaint, Zaslavskiy lured investors with false promises of sizeable returns from novel technology."

The SEC's complaint, filed in federal district court in Brooklyn, N.Y., charges Zaslavskiy, REcoin, and Diamond with violations of the anti-fraud and registration provisions of the federal securities laws. The

complaint seeks permanent injunctions and disgorgement plus interest and penalties. For Zaslavskiy, the SEC also seeks an officer-and-director bar and a bar from participating in any offering of digital securities.

The SEC's investigation, which is continuing, has been conducted by Jorge Tenreiro, Pamela Sawhney and Valerie A. Szczepanik. The case is being supervised by Lara S. Mehraban. The SEC encourages victims of the alleged fraud to contact Ms. Szczepanik at (212) 336-1100.

###

Related Materials

- [SEC complaint](#)



INVESTOR ALERT: PUBLIC COMPANIES MAKING ICO-RELATED CLAIMS

08/28/2017

The SEC's Office of Investor Education and Advocacy is warning investors about potential scams involving stock of companies claiming to be related to, or asserting they are engaging in, Initial Coin Offerings (or ICOs). Fraudsters often try to use the lure of new and emerging technologies to convince potential victims to invest their money in scams. These frauds include "pump-and-dump" and market manipulation schemes involving publicly traded companies that claim to provide exposure to these new technologies.

Recent Trading Suspensions

Developers, businesses, and individuals increasingly are using ICOs - also called coin or token launches or sales - to raise capital. There has been media attention regarding this form of capital raising. While these activities may provide fair and lawful investment opportunities, there may be situations in which companies are publicly announcing ICO or coin/token related events to affect the price of the company's common stock.

The SEC may suspend trading in a stock when the SEC is of the opinion that a suspension is required to protect investors and the public interest. Circumstances that might lead to a trading suspension include:

- ▶ A lack of current, accurate, or adequate information about the company - for example, when a company has not filed any periodic reports for an extended period;
- ▶ Questions about the accuracy of publicly available information, including in company press releases and reports, about the company's current operational status and financial condition; or
- ▶ Questions about trading in the stock, including trading by insiders, potential market manipulation, and the ability to clear and settle transactions in the stock.

The SEC recently issued several trading suspensions on the common stock of certain issuers who made claims regarding their investments in ICOs or touted coin/token related news. The companies affected by trading suspensions include [First Bitcoin Capital Corp.](https://www.sec.gov/litigation/suspensions/2017/34-81474.pdf) (<https://www.sec.gov/litigation/suspensions/2017/34-81474.pdf>), [CIAO Group](https://www.sec.gov/litigation/suspensions/2017/34-81367-o.pdf) (<https://www.sec.gov/litigation/suspensions/2017/34-81367-o.pdf>), [Strategic Global](https://www.sec.gov/litigation/suspensions/2017/34-81314-o.pdf) (<https://www.sec.gov/litigation/suspensions/2017/34-81314-o.pdf>), and [Sunshine Capital](https://www.sec.gov/litigation/suspensions/2017/34-80435-o.pdf) (<https://www.sec.gov/litigation/suspensions/2017/34-80435-o.pdf>).

Investors should be very cautious in considering an investment in a stock following a trading suspension. A trading suspension is one warning sign of possible [microcap fraud](https://investor.gov/investing-basics/avoiding-fraud/types-fraud/microcap-fraud/) (<https://investor.gov/investing-basics/avoiding-fraud/types-fraud/microcap-fraud/>) ([microcap stocks](https://investor.gov/additional-resources/general-resources/glossary/microcap-stocks/) (<https://investor.gov/additional-resources/general-resources/glossary/microcap-stocks/>), some of which are [penny stocks](http://www.sec.gov/answers/penny.htm) (<http://www.sec.gov/answers/penny.htm>) and/or nanocap stocks, tend to be low priced and trade in low volumes). If current, reliable information about a company and its stock is not available, investors should consider seriously the risk of making an investment in the company's stock. For

more on trading suspensions, see our [Investor Bulletin: Trading in Stock after an SEC Trading Suspension - Be Aware of the Risks](https://investor.gov/news-alerts/investor-bulletins/trading-stock-after-sec-trading-suspension-be-aware-risks) (<https://investor.gov/news-alerts/investor-bulletins/trading-stock-after-sec-trading-suspension-be-aware-risks>).

Pump-and-Dump and Market Manipulations

One way fraudsters seek to profit is by engaging in [market manipulation](https://www.sec.gov/fast-answers/answerstomanipul.htm) (<https://www.sec.gov/fast-answers/answerstomanipul.htm>), such as by spreading false and misleading information about a company (typically microcap stocks) to affect the stock's share price. They may spread stock rumors in different ways, including on company websites, press releases, email spam, and posts on social media, online bulletin boards, and chat rooms. The false or misleading rumors may be positive or negative.

For example, "[pump-and-dump](https://investor.gov/additional-resources/general-resources/glossary/pump-dump)" (<https://investor.gov/additional-resources/general-resources/glossary/pump-dump>) schemes involve the effort to manipulate a stock's share price or trading volume by touting the company's stock through false and misleading statements to the marketplace. Pump-and-dump schemes often occur on the Internet where it is common to see messages posted that urge readers to buy a stock quickly or to sell before the price goes down, or a promoter will call using the same sort of pitch. In reality, the author of the messages may be a company insider or paid promoter who stands to gain by selling their shares after the stock price is "pumped" up by the buying frenzy they create. Once these fraudsters "dump" their shares for a profit and stop hyping the stock, the price typically falls, and investors lose their money. *Learn more about these schemes in our [Updated Investor Alert: Fraudulent Stock Promotions](https://investor.gov/news-alerts/investor-alerts/investor-alert-fraudulent-stock-promotions)* (<https://investor.gov/news-alerts/investor-alerts/investor-alert-fraudulent-stock-promotions>).

Tips for Investors

- ▶ Always research a company before buying its stock, especially following a trading suspension. Consider the company's finances, organization, and business prospects. This type of information often is included in filings that a company makes with the SEC, which are available for free and can be found in the Commission's [EDGAR filing system](https://www.sec.gov/edgar.shtml) (<https://www.sec.gov/edgar.shtml>).
- ▶ Some companies are not required to file reports with the SEC. These are known as "non-reporting" companies. Investors should be aware of the risks of trading the stock of such companies, as there may not be current and accurate information that would allow investors to make an informed investment decision.
- ▶ Investors should also do their own research and be aware that information from online blogs, social networking sites, and even a company's own website may be inaccurate and potentially intentionally misleading.
- ▶ Be especially cautious regarding stock promotions, including related to new technologies such as ICOs. Look out for these warning signs of possible ICO-related fraud:
 - Company that has common stock trading claims that its ICO is "SEC-compliant" without explaining how the offering is in compliance with the securities laws; or
 - Company that has common stock trading also purports to raise capital through an ICO or take on ICO-related business described in vague or nonsensical terms or using undefined technical or legal jargon.
- ▶ Look out for these warning signs of possible microcap fraud:
 - SEC suspended public trading of the security or other securities promoted by the same promoter;
 - Increase in stock price or trading volume happening at the same time as the promotional activity;
 - Press releases or promotional activity announcing events that ultimately do not happen (e.g., multiple announcements of preliminary deals or agreements; announcements of deals with unnamed partners; announcements using hyperbolic language);
 - Company has no real business operations (few assets, or minimal gross revenues);

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Investor Alert: Public Companies Making ICO-Related Claims | Investor.gov

- Company issues a lot of shares without a corresponding increase in the company's assets; and
- Frequent changes in company name, management, or type of business.

Additional Resources

[Investor Bulletin: Initial Coin Offerings](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-initial-coin-offerings>)

[Updated Investor Alert: Social Media and Investing – Stock Rumors](https://investor.gov/news-alerts/investor-alerts/updated-investor-alert-social-media-investing-stock-rumors) (<https://investor.gov/news-alerts/investor-alerts/updated-investor-alert-social-media-investing-stock-rumors>)

[Investor Alert: Be Aware of Stock Recommendations On Investment Research Websites](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-beware-stock-recommendations) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-beware-stock-recommendations>)

[Report possible securities fraud to the SEC](https://www.sec.gov/complaint/tloscomplaint.shtml) (<https://www.sec.gov/complaint/tloscomplaint.shtml>). [Report a problem or ask the SEC a question](https://www.sec.gov/complaint/question.shtml) (<https://www.sec.gov/complaint/question.shtml>). Visit [Investor.gov](https://www.investor.gov/) (<https://www.investor.gov/>), the SEC's website for individual investors.

The Office of Investor Education and Advocacy has provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.

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Public Statement

Statement by the Divisions of Corporation Finance and Enforcement on the Report of Investigation on The DAO

Divisions of Corporation Finance and Enforcement

July 25, 2017

Emerging Technologies and the Federal Securities Laws

Distributed ledger and other emerging technologies have the potential to influence and improve the capital markets and the financial services industry. Interest in and funding for these technologies appears to be growing at a rapid pace. We welcome and encourage the appropriate use of technology to facilitate capital formation and provide investors with new investment opportunities. We are particularly hopeful that innovation in this area will facilitate fair and efficient capital raisings for small businesses. We are also mindful of our obligation to protect investors and recognize that new technologies can offer opportunities for misconduct and abuse.

A fundamental tenet of our regulatory framework is that an offer or sale of securities in the United States must comply with the federal securities laws. This approach has been critical to maintaining market integrity and fostering investor protection for over 80 years, including through various changes in technology. In this regard, the issue of whether a particular investment opportunity involves the offer or sale of a security — regardless of the terminology or technology used in the transaction — depends on the facts and circumstances, including the economic realities and structure of the enterprise.

Report of Investigation — DAO Tokens are Securities

Today, the Commission issued a Report of Investigation ("Report") relating to an offering by The DAO — a decentralized autonomous organization that used distributed ledger or blockchain technology to operate as a "virtual" entity. The DAO sold tokens representing interests in its enterprise to investors in exchange for payment with virtual currency. Investors could hold these tokens as an investment with certain voting and ownership rights or could sell them on web-based secondary market platforms. Based on the facts and circumstances of this offering, the Commission, as explained in the Report, determined that the DAO tokens are securities.

Sponsors involved in an exchange of something of value for an interest in a digital or other novel form for storing value should carefully consider whether they are creating an investment arrangement that constitutes a security. The definition of a security under the federal securities laws is broad, covering traditional notions of a security, such as a stock or bond, as well as novel products or instruments where value may be represented and transferred in digital form. A hallmark of a security is an investment of money or value in a business or operation where the investor has a reasonable expectation of profits based on the efforts of others.

A market participant engaged in offering an investment opportunity that constitutes a security must either register the offer and sale of the security with the Commission or structure it so that it qualifies for an exemption from registration. Market participants in this area must also consider other aspects of the securities laws, such as

2/1/2018 SEC.gov | Statement by the Divisions of Corporation Finance and Enforcement on the Report of Investigation on The DAO

whether a platform facilitating transactions in its securities is operating as an exchange, whether the entity offering and selling the security could be an investment company, and whether anyone providing advice about an investment in the security could be an investment adviser. Structuring an offering so that it involves digital instruments of value or operates using a distributed ledger or blockchain does not remove that activity from the requirements of the federal securities laws.

Consultation with Securities Counsel and the Staff

Although some of the detailed aspects of the federal securities laws and regulations embody more traditional forms of offerings or corporate organizations, these laws have a principles-based framework that can readily adapt to new types of technologies for creating and distributing securities. We encourage market participants who are employing new technologies to form investment vehicles or distribute investment opportunities to consult with securities counsel to aid in their analysis of these issues and to contact our staff, as needed, for assistance in analyzing the application of the federal securities laws.

In particular, staff providing assistance on these matters can be reached at FinTech@sec.gov.

Investors Should Be Mindful of Risks Associated with New Technologies, Including Risks of Fraud

Finally, we recognize that new technologies also present new opportunities for bad actors to engage in fraudulent schemes, including old schemes under new names and using new terminology. We urge the investing public to be mindful of traditional “red flags” when making any investment decision, including: deals that sound too good to be true; promises of high returns with little or no risk; high-pressure sales tactics; and working with unregistered or unlicensed sellers. In that regard, the SEC’s website for individual investors, Investor.gov, has a number of relevant resources — including an Investor Bulletin that the SEC’s Office of Investor Education and Advocacy issued today regarding Initial Coin Offerings.

SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 81207 / July 25, 2017

**Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934:
The DAO**

I. Introduction and Summary

The United States Securities and Exchange Commission's ("Commission") Division of Enforcement ("Division") has investigated whether The DAO, an unincorporated organization; Slock.it UG ("Slock.it"), a German corporation; Slock.it's co-founders; and intermediaries may have violated the federal securities laws. The Commission has determined not to pursue an enforcement action in this matter based on the conduct and activities known to the Commission at this time.

As described more fully below, The DAO is one example of a Decentralized Autonomous Organization, which is a term used to describe a "virtual" organization embodied in computer code and executed on a distributed ledger or blockchain. The DAO was created by Slock.it and Slock.it's co-founders, with the objective of operating as a for-profit entity that would create and hold a corpus of assets through the sale of DAO Tokens to investors, which assets would then be used to fund "projects." The holders of DAO Tokens stood to share in the anticipated earnings from these projects as a return on their investment in DAO Tokens. In addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms ("Platforms") that supported secondary trading in the DAO Tokens.

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 whereby DAO Token holders could opt to have their investment returned to them, as described in more detail below.

The investigation raised questions regarding the application of the U.S. federal securities laws to the offer and sale of DAO Tokens, including the threshold question whether DAO Tokens are securities. Based on the investigation, and under the facts presented, the Commission has determined that DAO Tokens are securities under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").¹ The Commission deems it appropriate and in the public interest to issue this report of investigation ("Report") pursuant to

¹ This Report does not analyze the question whether The DAO was an "investment company," as defined under Section 3(a) of the Investment Company Act of 1940 ("Investment Company Act"), in part, because The DAO never commenced its business operations funding projects. Those who would use virtual organizations should consider their obligations under the Investment Company Act.

Section 21(a) of the Exchange Act² to advise those who would use a Decentralized Autonomous Organization (“DAO Entity”), or other distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws. All securities offered and sold in the United States must be registered with the Commission or must qualify for an exemption from the registration requirements. In addition, any entity or person engaging in the activities of an exchange must register as a national securities exchange or operate pursuant to an exemption from such registration.

This Report reiterates these fundamental principles of the U.S. federal securities laws and describes their applicability to a new paradigm—virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and/or investment and the related offer and sale of securities. The automation of certain functions through this technology, “smart contracts,”³ or computer code, does not remove conduct from the purview of the U.S. federal securities laws.⁴ This Report also serves to stress the obligation to comply with the registration provisions of the federal securities laws with respect to products and platforms involving emerging technologies and new investor interfaces.

II. Facts

A. Background

From April 30, 2016 through May 28, 2016, The DAO offered and sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million Ether (“ETH”), a

² Section 21(a) of the Exchange Act authorizes the Commission to investigate violations of the federal securities laws and, in its discretion, to “publish information concerning any such violations.” This Report does not constitute an adjudication of any fact or issue addressed herein, nor does it make any findings of violations by any individual or entity. The facts discussed in Section II, *infra*, are matters of public record or based on documentary records. We are publishing this Report on the Commission’s website to ensure that all market participants have concurrent and equal access to the information contained herein.

³ Computer scientist Nick Szabo described a “smart contract” as:

a computerized transaction protocol that executes terms of a contract. The general objectives of smart contract design are to satisfy common contractual conditions (such as payment terms, liens, confidentiality, and even enforcement), minimize exceptions both malicious and accidental, and minimize the need for trusted intermediaries. Related economic goals include lowering fraud loss, arbitrations and enforcement costs, and other transaction costs.

See Nick Szabo, *Smart Contracts*, 1994, <http://www.virtualschool.edu/mon/Economics/SmartContracts.html>.

⁴ See *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) (“[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as ‘investment contracts,’ or as ‘any interest or instrument commonly known as a ‘security’.”); see also *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990) (“Congress’ purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.”).

virtual currency⁵ used on the Ethereum Blockchain.⁶ As of the time the offering closed, the total ETH raised by The DAO was valued in U.S. Dollars (“USD”) at approximately \$150 million.

The concept of a DAO Entity is memorialized in a document (the “White Paper”), authored by Christoph Jentzsch, the Chief Technology Officer of Slock.it, a “Blockchain and IoT [(internet-of-things)] solution company,” incorporated in Germany and co-founded by Christoph Jentzsch, Simon Jentzsch (Christoph Jentzsch’s brother), and Stephan Tual (“Tual”).⁷ The White Paper purports to describe “the first implementation of a [DAO Entity] code to automate organizational governance and decision making.”⁸ The White Paper posits that a DAO Entity “can be used by individuals working together collaboratively outside of a traditional corporate form. It can also be used by a registered corporate entity to automate formal governance rules contained in corporate bylaws or imposed by law.” The White Paper proposes an entity—a DAO Entity—that would use smart contracts to attempt to solve governance issues it described as inherent in traditional corporations.⁹ As described, a DAO Entity purportedly would supplant traditional mechanisms of corporate governance and management with a blockchain such that contractual terms are “formalized, automated and enforced using software.”¹⁰

⁵ The Financial Action Task Force defines “virtual currency” as:

a digital representation of value that can be digitally traded and functions as: (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued or guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinguished from fiat currency (a.k.a. “real currency,” “real money,” or “national currency”), which is the coin and paper money of a country that is designated as its legal tender, circulates; and is customarily used and accepted as a medium of exchange in the issuing country. It is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency.

FATF Report, Virtual Currencies, Key Definitions and Potential AML/CFT Risks, FINANCIAL ACTION TASK FORCE (June 2014), <http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf>.

⁶ Ethereum, developed by the Ethereum Foundation, a Swiss nonprofit organization, is a decentralized platform that runs smart contracts on a blockchain known as the Ethereum Blockchain.

⁷ Christoph Jentzsch released the final draft of the White Paper on or around March 23, 2016. He introduced his concept of a DAO Entity as early as November 2015 at an Ethereum Developer Conference in London, as a medium to raise funds for Slock.it, a German start-up he co-founded in September 2015. Slock.it purports to create technology that embeds smart contracts that run on the Ethereum Blockchain into real-world devices and, as a result, for example, permits anyone to rent, sell or share physical objects in a decentralized way. See SLOCK.IT, <https://slock.it/>.

⁸ Christoph Jentzsch, *Decentralized Autonomous Organization to Automate Governance Final Draft – Under Review*, <https://download.slock.it/public/DAO/WhitePaper.pdf>.

⁹ *Id.*

¹⁰ *Id.* The White Paper contained the following statement:

A word of caution, at the outset: the legal status of [DAO Entities] remains the subject of active and vigorous debate and discussion. Not everyone shares the same definition. Some have said that [DAO Entities] are autonomous code and can operate independently of legal systems; others

B. The DAO

“The DAO” is the “first generation” implementation of the White Paper concept of a DAO Entity, and it began as an effort to create a “crowdfunding contract” to raise “funds to grow [a] company in the crypto space.”¹¹ In November 2015, at an Ethereum Developer Conference in London, Christoph Jentzsch described his proposal for The DAO as a “for-profit DAO [Entity],” where participants would send ETH (a virtual currency) to The DAO to purchase DAO Tokens, which would permit the participant to vote and entitle the participant to “rewards.”¹² Christoph Jentzsch likened this to “buying shares in a company and getting ... dividends.”¹³ The DAO was to be “decentralized” in that it would allow for voting by investors holding DAO Tokens.¹⁴ All funds raised were to be held at an Ethereum Blockchain “address” associated with The DAO and DAO Token holders were to vote on contract proposals, including proposals to The DAO to fund projects and distribute The DAO’s anticipated earnings from the projects it funded.¹⁵ The DAO was intended to be “autonomous” in that project proposals were in the form of smart contracts that exist on the Ethereum Blockchain and the votes were administered by the code of The DAO.¹⁶

have said that [DAO Entities] must be owned or operate[d] by humans or human created entities. There will be many use cases, and the DAO [Entity] code will develop over time. Ultimately, how a DAO [Entity] functions and its legal status will depend on many factors, including how DAO [Entity] code is used, where it is used, and who uses it. This paper does not speculate about the legal status of [DAO Entities] worldwide. This paper is not intended to offer legal advice or conclusions. Anyone who uses DAO [Entity] code will do so at their own risk.

Id.

¹¹ Christoph Jentzsch, *The History of the DAO and Lessons Learned*, SLOCK.IT BLOG (Aug. 24, 2016), <https://blog.slock.it/the-history-of-the-dao-and-lessons-learned-d06740f8cfa5#5062zo8uv>. Although The DAO has been described as a “crowdfunding contract,” The DAO would not have met the requirements of Regulation Crowdfunding, adopted under Title III of the Jumpstart Our Business Startups (JOBS) Act of 2012 (providing an exemption from registration for certain crowdfunding), because, among other things, it was not a broker-dealer or a funding portal registered with the SEC and the Financial Industry Regulatory Authority (“FINRA”). See *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, SEC (Apr. 5, 2017), <https://www.sec.gov/info/smallbus/sec/rccomplianceguide-051316.htm>; *Updated Investor Bulletin: Crowdfunding for Investors*, SEC (May 10, 2017), https://www.sec.gov/oia/investor-alerts-bulletins/ib_crowdfunding-.html.

¹² See Slockit, *Slock.it DAO demo at Devcon: IoT + Blockchain*, YOUTUBE (Nov. 13, 2015), <https://www.youtube.com/watch?v=49wHQoJxYPo>.

¹³ *Id.*

¹⁴ See Jentzsch, *supra* note 8.

¹⁵ *Id.* In theory, there was no limitation on the type of project that could be proposed. For example, proposed “projects” could include, among other things, projects that would culminate in the creation of products or services that DAO Token holders could use or charge others for using.

¹⁶ *Id.*

On or about April 29, 2016, Slock.it deployed The DAO code on the Ethereum Blockchain, as a set of pre-programmed instructions.¹⁷ This code was to govern how The DAO was to operate.

To promote The DAO, Slock.it's co-founders launched a website ("The DAO Website"). The DAO Website included a description of The DAO's intended purpose: "To blaze a new path in business for the betterment of its members, existing simultaneously nowhere and everywhere and operating solely with the steadfast iron will of unstoppable code."¹⁸ The DAO Website also described how The DAO operated, and included a link through which DAO Tokens could be purchased. The DAO Website also included a link to the White Paper, which provided detailed information about a DAO Entity's structure and its source code and, together with The DAO Website, served as the primary source of promotional materials for The DAO. On The DAO Website and elsewhere, Slock.it represented that The DAO's source code had been reviewed by "one of the world's leading security audit companies" and "no stone was left unturned during those five whole days of security analysis."¹⁹

Slock.it's co-founders also promoted The DAO by soliciting media attention and by posting almost daily updates on The DAO's status on The DAO and Slock.it websites and numerous online forums relating to blockchain technology. Slock.it's co-founders used these posts to communicate to the public information about how to participate in The DAO, including: how to create and acquire DAO Tokens; the framework for submitting proposals for projects; and how to vote on proposals. Slock.it also created an online forum on The DAO Website, as well as administered "The DAO Slack" channel, an online messaging platform in which over 5,000 invited "team members" could discuss and exchange ideas about The DAO in real time.

1. DAO Tokens

In exchange for ETH, The DAO created DAO Tokens (proportional to the amount of ETH paid) that were then assigned to the Ethereum Blockchain address of the person or entity remitting the ETH. A DAO Token granted the DAO Token holder certain voting and ownership rights. According to promotional materials, The DAO would earn profits by funding projects

¹⁷ According to the White Paper, a DAO Entity is "activated by deployment on the Ethereum [B]lockchain. Once deployed, a [DAO Entity's] code requires 'ether' [ETH] to engage in transactions on Ethereum. Ether is the digital fuel that powers the Ethereum Network." The only way to update or alter The DAO's code is to submit a new proposal for voting and achieve a majority consensus on that proposal. See Jentsch, *supra* note 8. According to Slock.it's website, Slock.it gave The DAO code to the Ethereum community, noting that:

The DAO framework is [a] side project of Slock.it UG and a gift to the Ethereum community. It consisted of a definitive whitepaper, smart contract code audited by one of the best security companies in the world and soon, a complete frontend interface. All free and open source for anyone to re-use, it is our way to say 'thank you' to the community.

SLOCK.IT, <https://slock.it>. The DAO code is publicly-available on GitHub, a host of source code. See *The Standard DAO Framework, Inc., Whitepaper*, GitHub, <https://github.com/slockit/DAO>.

¹⁸ The DAO Website was available at <https://daohub.org>.

¹⁹ Stephen Tual, *Deja Vu DAO Smart Contracts Audit Results*, SLOCK.IT BLOG (Apr. 5, 2016), <https://blog.slock.it/deja-vu-dai-smart-contracts-audit-results-d26bc088e32e>.

that would provide DAO Token holders a return on investment. The various promotional materials disseminated by Slock.it's co-founders touted that DAO Token holders would receive "rewards," which the White Paper defined as, "any [ETH] 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 ETH to DAO Token holders.

From April 30, 2016 through May 28, 2016 (the "Offering Period"), The DAO offered and sold DAO Tokens. Investments in The DAO were made "pseudonymously" (i.e., an individual's or entity's pseudonym was their Ethereum Blockchain address). To purchase a DAO Token offered for sale by The DAO, an individual or entity sent ETH from their Ethereum Blockchain address to an Ethereum Blockchain address associated with The DAO. All of the ETH raised in the offering as well as any future profits earned by The DAO were to be pooled and held in The DAO's Ethereum Blockchain address. The token price fluctuated in a range of approximately 1 to 1.5 ETH per 100 DAO Tokens, depending on when the tokens were purchased during the Offering Period. Anyone was eligible to purchase DAO Tokens (as long as they paid ETH). There were no limitations placed on the number of DAO Tokens offered for sale, the number of purchasers of DAO Tokens, or the level of sophistication of such purchasers.

DAO Token holders were not restricted from re-selling DAO Tokens acquired in the offering, and DAO Token holders could sell their DAO Tokens in a variety of ways in the secondary market and thereby monetize their investment as discussed below. Prior to the Offering Period, Slock.it solicited at least one U.S. web-based platform to trade DAO Tokens on its system and, at the time of the offering, The DAO Website and other promotional materials disseminated by Slock.it included representations that DAO Tokens would be available for secondary market trading after the Offering Period via several platforms. During the Offering Period and afterwards, the Platforms posted notices on their own websites and on social media that each planned to support secondary market trading of DAO Tokens.²⁰

In addition to secondary market trading on the Platforms, after the Offering Period, DAO Tokens were to be freely transferable on the Ethereum Blockchain. DAO Token holders would also be permitted to redeem their DAO Tokens for ETH through a complicated, multi-week (approximately 46-day) process referred to as a DAO Entity "split."²¹

2. *Participants in The DAO*

According to the White Paper, in order for a project to be considered for funding with "a DAO [Entity]'s [ETH]," a "Contractor" first must submit a proposal to the DAO Entity. Specifically, DAO Token holders expected Contractors to submit proposals for projects that could provide DAO Token holders returns on their investments. Submitting a proposal to The DAO involved: (1) writing a smart contract, and then deploying and publishing it on the

²⁰ The Platforms are registered with FinCEN as "Money Services Businesses" and provide systems whereby customers may exchange virtual currencies for other virtual currencies or fiat currencies.

²¹ According to the White Paper, the primary purpose of a split is to protect minority shareholders and prevent what is commonly referred to as a "51% Attack," whereby an attacker holding 51% of a DAO Entity's Tokens could create a proposal to send all of the DAO Entity's funds to himself or herself.

Ethereum Blockchain; and (2) posting details about the proposal on The DAO Website, including the Ethereum Blockchain address of the deployed contract and a link to its source code. Proposals could be viewed on The DAO Website as well as other publicly-accessible websites. Per the White Paper, there were two prerequisites for submitting a proposal. An individual or entity must: (1) own at least one DAO Token; and (2) pay a deposit in the form of ETH that would be forfeited to the DAO Entity if the proposal was put up for a vote and failed to achieve a quorum of DAO Token holders. It was publicized that Slock.it would be the first to submit a proposal for funding.²²

ETH raised by The DAO was to be distributed to a Contractor to fund a proposal only on a majority vote of DAO Token holders.²³ DAO Token holders were to cast votes, which would be weighted by the number of tokens they controlled, for or against the funding of a specific proposal. The voting process, however, was publicly criticized in that it could incentivize distorted voting behavior and, as a result, would not accurately reflect the consensus of the majority of DAO Token holders. Specifically, as noted in a May 27, 2016 blog post by a group of computer security researchers, The DAO's structure included a "strong positive bias to vote YES on proposals and to suppress NO votes as a side effect of the way in which it restricts users' range of options following the casting of a vote."²⁴

Before any proposal was put to a vote by DAO Token holders, it was required to be reviewed by one or more of The DAO's "Curators." At the time of the formation of The DAO, the Curators were a group of individuals chosen by Slock.it.²⁵ According to the White Paper, the Curators of a DAO Entity had "considerable power." The Curators performed crucial security functions and maintained ultimate control over which proposals could be submitted to, voted on, and funded by The DAO. As stated on The DAO Website during the Offering Period, The DAO relied on its Curators for "failsafe protection" and for protecting The DAO from "malicious [sic] actors." Specifically, per The DAO Website, a Curator was responsible for: (1) confirming that any proposal for funding originated from an identifiable person or organization; and (2)

²² It was stated on The DAO Website and elsewhere that Slock.it anticipated that it would be the first to submit a proposal for funding. In fact, a draft of Slock.it's proposal for funding for an "Ethereum Computer and Universal Sharing Network" was publicly-available online during the Offering Period.

²³ DAO Token holders could vote on proposals, either by direct interaction with the Ethereum Blockchain or by using an application that interfaces with the Ethereum Blockchain. It was generally acknowledged that DAO Token holders needed some technical knowledge in order to submit a vote, and The DAO Website included a link to a step-by-step tutorial describing how to vote on proposals.

²⁴ By voting on a proposal, DAO Token holders would "tie up" their tokens until the end of the voting cycle. See Jentsch, *supra* note 8 at 8 ("The tokens used to vote will be blocked, meaning they can not [sic] be transferred until the proposal is closed."). If, however, a DAO Token holder abstained from voting, the DAO Token holder could avoid these restrictions; any DAO Tokens not submitted for a vote could be withdrawn or transferred at any time. As a result, DAO Token holders were incentivized either to vote yes or to abstain from voting. See Dino Mark et al., *A Call for a Temporary Moratorium on The DAO*, HACKING, DISTRIBUTED (May 27, 2016, 1:35 PM), <http://hackingdistributed.com/2016/05/27/dao-call-for-moratorium/>.

²⁵ At the time of The DAO's launch, The DAO Website identified eleven "high profile" individuals as holders of The DAO's Curator "Multisig" (or "private key"). These individuals all appear to live outside of the United States. Many of them were associated with the Ethereum Foundation, and The DAO Website touted the qualifications and trustworthiness of these individuals.

confirming that smart contracts associated with any such proposal properly reflected the code the Contractor claims to have deployed on the Ethereum Blockchain. If a Curator determined that the proposal met these criteria, the Curator could add the proposal to the “whitelist,” which was a list of Ethereum Blockchain addresses that could receive ETH from The DAO if the majority of DAO Token holders voted for the proposal.

Curators of The DAO had ultimate discretion as to whether or not to submit a proposal for voting by DAO Token holders. Curators also determined the order and frequency of proposals, and could impose subjective criteria for whether the proposal should be whitelisted. One member of the group chosen by Slock.it to serve collectively as the Curator stated publicly that the Curator had “complete control over the whitelist ... the order in which things get whitelisted, the duration for which [proposals] get whitelisted, when things get unwhitelisted ... [and] clear ability to control the order and frequency of proposals,” noting that “curators have tremendous power.”²⁶ Another Curator publicly announced his subjective criteria for determining whether to whitelist a proposal, which included his personal ethics.²⁷ Per the White Paper, a Curator also had the power to reduce the voting quorum requirement by 50% every other week. Absent action by a Curator, the quorum could be reduced by 50% only if no proposal had reached the required quorum for 52 weeks.

3. *Secondary Market Trading on the Platforms*

During the period from May 28, 2016 through early September 2016, the Platforms became the preferred vehicle for DAO Token holders to buy and sell DAO Tokens in the secondary market using virtual or fiat currencies. Specifically, the Platforms used electronic systems that allowed their respective customers to post orders for DAO Tokens on an anonymous basis. For example, customers of each Platform could buy or sell DAO Tokens by entering a market order on the Platform’s system, which would then match with orders from other customers residing on the system. Each Platform’s system would automatically execute these orders based on pre-programmed order interaction protocols established by the Platform.

None of the Platforms received orders for DAO Tokens from non-Platform customers or routed its respective customers’ orders to any other trading destinations. The Platforms publicly displayed all their quotes, trades, and daily trading volume in DAO Tokens on their respective websites. During the period from May 28, 2016 through September 6, 2016, one such Platform executed more than 557,378 buy and sell transactions in DAO Tokens by more than 15,000 of its U.S. and foreign customers. During the period from May 28, 2016 through August 1, 2016, another such Platform executed more than 22,207 buy and sell transactions in DAO Tokens by more than 700 of its U.S. customers.

²⁶ Epicenter, *EB134 – Emin Gün Sirer And Vlad Zamfir: On A Rocky DAO*, YOUTUBE (June 6, 2016), <https://www.youtube.com/watch?v=ONS5GhIQdFUS>.

²⁷ Andrew Quentson, *Are the DAO Curators Masters or Janitors?*, THE COIN TELEGRAPH (June 12, 2016), <https://cointelegraph.com/news/are-the-dao-curators-masters-or-janitors>.

4. Security Concerns, The “Attack” on The DAO, and The Hard Fork

In late May 2016, just prior to the expiration of the Offering Period, concerns about the safety and security of The DAO’s funds began to surface due to vulnerabilities in The DAO’s code. On May 26, 2016, in response to these concerns, Slock.it submitted a “DAO Security Proposal” that called for the development of certain updates to The DAO’s code and the appointment of a security expert.²⁸ Further, on June 3, 2016, Christoph Jentzsch, on behalf of Slock.it, proposed a moratorium on all proposals until alterations to The DAO’s code to fix vulnerabilities in The DAO’s code had been implemented.²⁹

On June 17, 2016, an unknown individual or group (the “Attacker”) began rapidly diverting ETH from The DAO, causing approximately 3.6 million ETH—1/3 of the total ETH raised by The DAO offering—to move from The DAO’s Ethereum Blockchain address to an Ethereum Blockchain address controlled by the Attacker (the “Attack”).³⁰ Although the diverted ETH was then held in an address controlled by the Attacker, the Attacker was prevented by The DAO’s code from moving the ETH from that address for 27 days.³¹

In order to secure the diverted ETH and return it to DAO Token holders, Slock.it’s co-founders and others endorsed a “Hard Fork” to the Ethereum Blockchain. The “Hard Fork,” called for a change in the Ethereum protocol on a going forward basis that would restore the DAO Token holders’ investments as if the Attack had not occurred. On July 20, 2016, after a majority of the Ethereum network adopted the necessary software updates, the new, forked Ethereum Blockchain became active.³² The Hard Fork had the effect of transferring all of the funds raised (including those held by the Attacker) from The DAO to a recovery address, where DAO Token holders could exchange their DAO Tokens for ETH.³³ All DAO Token holders

²⁸ See Stephan Tual, *Proposal #1-DAO Security, Redux*, SLOCK.IT BLOG (May 26, 2016), <https://blog.slock.it/both-our-proposals-are-now-out-voting-starts-saturday-morning-ba322d6d3aea>. The unnamed security expert would “act as the first point of contact for security disclosures, and continually monitor, pre-empt and avert any potential attack vectors The DAO may face, including social, technical and economic attacks.” *Id.* Slock.it initially proposed a much broader security proposal that included the formation of a “DAO Security” group, the establishment of a “Bug Bounty Program,” and routine external audits of The DAO’s code. However, the cost of the proposal (125,000 ETH), which would be paid from The DAO’s funds, was immediately criticized as too high and Slock.it decided instead to submit the revised proposal described above. See Stephan Tual, *DAO Security, a Proposal to guarantee the integrity of The DAO*, SLOCK.IT BLOG (May 25, 2016), <https://blog.slock.it/dao-security-a-proposal-to-guarantee-the-integrity-of-the-dao-3473899ace9d>.

²⁹ See *The DAO Proposal ID 5*, ETHERSCAN, <https://etherscan.io/token/thedao-proposal/5>.

³⁰ See Stephan Tual, *DAO Security Advisory: live updates*, SLOCK.IT BLOG (June 17, 2016), <https://blog.slock.it/dao-security-advisory-live-updates-2a0a42a2d07b>.

³¹ *Id.*

³² A minority group, however, elected not to adopt the new Ethereum Blockchain created by the Hard Fork because to do so would run counter to the concept that a blockchain is immutable. Instead they continued to use the former version of the blockchain, which is now known as “Ethereum Classic.”

³³ See Christoph Jentzsch, *What the ‘Fork’ Really Means*, SLOCK.IT BLOG (July 18, 2016), <https://blog.slock.it/what-the-fork-really-means-6fe573ac31dd>.

who adopted the Hard Fork could exchange their DAO Tokens for ETH, and avoid any loss of the ETH they had invested.³⁴

III. Discussion

The Commission is aware that virtual organizations and associated individuals and entities increasingly are using distributed ledger technology to offer and sell instruments such as DAO Tokens to raise capital. These offers and sales have been referred to, among other things, as “Initial Coin Offerings” or “Token Sales.” Accordingly, the Commission deems it appropriate and in the public interest to issue this Report in order to stress that the U.S. federal securities law may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular offer or sale. In this Report, the Commission considers the particular facts and circumstances of the offer and sale of DAO Tokens to demonstrate the application of existing U.S. federal securities laws to this new paradigm.

A. Section 5 of the Securities Act

The registration provisions of the Securities Act contemplate that the offer or sale of securities to the public must be accompanied by the “full and fair disclosure” afforded by registration with the Commission and delivery of a statutory prospectus containing information necessary to enable prospective purchasers to make an informed investment decision. Registration entails disclosure of detailed “information about the issuer’s financial condition, the identity and background of management, and the price and amount of securities to be offered ...” *SEC v. Cavanagh*, 1 F. Supp. 2d 337, 360 (S.D.N.Y. 1998), *aff’d*, 155 F.3d 129 (2d Cir. 1998). “The registration statement is designed to assure public access to material facts bearing on the value of publicly traded securities and is central to the Act’s comprehensive scheme for protecting public investors.” *SEC v. Aaron*, 605 F.2d 612, 618 (2d Cir. 1979) (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953)), *vacated on other grounds*, 446 U.S. 680 (1980). Section 5(a) of the Securities Act provides that, unless a registration statement is in effect as to a security, it is unlawful for any person, directly or indirectly, to engage in the offer or sale of securities in interstate commerce. Section 5(c) of the Securities Act provides a similar prohibition against offers to sell, or offers to buy, unless a registration statement has been filed. Thus, both Sections 5(a) and 5(c) of the Securities Act prohibit the unregistered offer or sale of securities in interstate commerce. 15 U.S.C. § 77e(a) and (c). Violations of Section 5 do not require scienter. *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044, 1047 (2d Cir. 1976).

³⁴ *Id.*

B. DAO Tokens Are Securities

1. *Foundational Principles of the Securities Laws Apply to Virtual Organizations or Capital Raising Entities Making Use of Distributed Ledger Technology*

Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes “an investment contract.” See 15 U.S.C. §§ 77b-77c. An investment contract is 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. See *SEC v. Edwards*, 540 U.S. 389, 393 (2004); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946); see also *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852-53 (1975) (The “touchstone” of an investment contract “is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”). This definition embodies a “flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.” *Howey*, 328 U.S. at 299 (emphasis added). The test “permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of ‘the many types of instruments that in our commercial world fall within the ordinary concept of a security.’” *Id.* In analyzing whether something is a security, “form should be disregarded for substance.” *Tcherepin v. Knight*, 389 U.S. 332, 336 (1967), “and the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto.” *United Housing Found.*, 421 U.S. at 849.

2. *Investors in The DAO Invested Money*

In determining whether an investment contract exists, the investment of “money” need not take the form of cash. See, e.g., *Uselton v. Comm. Lovelace Motor Freight, Inc.*, 940 F.2d 564, 574 (10th Cir. 1991) (“[I]n spite of *Howey*’s reference to an ‘investment of money,’ it is well established that cash is not the only form of contribution or investment that will create an investment contract.”).

Investors in The DAO used ETH to make their investments, and DAO Tokens were received in exchange for ETH. Such investment is the type of contribution of value that can create an investment contract under *Howey*. See *SEC v. Shavers*, No. 4:13-CV-416, 2014 WL 4652121, at *1 (E.D. Tex. Sept. 18, 2014) (holding that an investment of Bitcoin, a virtual currency, meets the first prong of *Howey*); *Uselton*, 940 F.2d at 574 (“[T]he ‘investment’ may take the form of ‘goods and services,’ or some other ‘exchange of value.’”) (citations omitted).

3. *With a Reasonable Expectation of Profits*

Investors who purchased DAO Tokens were investing in a common enterprise and reasonably expected to earn profits through that enterprise when they sent ETH to The DAO’s Ethereum Blockchain address in exchange for DAO Tokens. “[P]rofits” include “dividends, other periodic payments, or the increased value of the investment.” *Edwards*, 540 U.S. at 394. As described above, the various promotional materials disseminated by Slock.it and its co-founders informed investors that The DAO was a for-profit entity whose objective was to fund

projects in exchange for a return on investment.³⁵ The ETH was pooled and available to The DAO to fund projects. The projects (or “contracts”) would be proposed by Contractors. If the proposed contracts were whitelisted by Curators, DAO Token holders could vote on whether The DAO should fund the proposed contracts. Depending on the terms of each particular contract, DAO Token holders stood to share in potential profits from the contracts. Thus, a reasonable investor would have been motivated, at least in part, by the prospect of profits on their investment of ETH in The DAO.

4. *Derived from the Managerial Efforts of Others*

a. The Efforts of Slock.it, Slock.it’s Co-Founders, and The DAO’s Curators Were Essential to the Enterprise

Investors’ profits were to be derived from the managerial efforts of others—specifically, Slock.it and its co-founders, and The DAO’s Curators. 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.” *SEC v. Glem W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973). The DAO’s investors relied on the managerial and entrepreneurial efforts of Slock.it and its co-founders, and The DAO’s Curators, to manage The DAO and put forth project proposals that could generate profits for The DAO’s investors.

Investors’ expectations were primed by the marketing of The DAO and active engagement between Slock.it and its co-founders with The DAO and DAO Token holders. To market The DAO and DAO Tokens, Slock.it created The DAO Website on which it published the White Paper explaining how a DAO Entity would work and describing their vision for a DAO Entity. Slock.it also created and maintained other online forums that it used to provide information to DAO Token holders about how to vote and perform other tasks related to their investment. Slock.it appears to have closely monitored these forums, answering questions from DAO Token holders about a variety of topics, including the future of The DAO, security concerns, ground rules for how The DAO would work, and the anticipated role of DAO Token holders. The creators of The DAO held themselves out to investors as experts in Ethereum, the blockchain protocol on which The DAO operated, and told investors that they had selected persons to serve as Curators based on their expertise and credentials. Additionally, Slock.it told investors that it expected to put forth the first substantive profit-making contract proposal—a blockchain venture in its area of expertise. Through their conduct and marketing materials, Slock.it and its co-founders led investors to believe that they could be relied on to provide the significant managerial efforts required to make The DAO a success.

Investors in The DAO reasonably expected Slock.it and its co-founders, and The DAO’s Curators, to provide significant managerial efforts after The DAO’s launch. The expertise of The DAO’s creators and Curators was critical in monitoring the operation of The DAO, safeguarding investor funds, and determining whether proposed contracts should be put for a

³⁵ That the “projects” could encompass services and the creation of goods for use by DAO Token holders does not change the core analysis that investors purchased DAO Tokens with the expectation of earning profits from the efforts of others.

vote. Investors had little choice but to rely on their expertise. At the time of the offering, The DAO's protocols had already been pre-determined by Slock.it and its co-founders, including the control that could be exercised by the Curators. Slock.it and its co-founders chose the Curators, whose function it was to: (1) vet Contractors; (2) determine whether and when to submit proposals for votes; (3) determine the order and frequency of proposals that were submitted for a vote; and (4) determine whether to halve the default quorum necessary for a successful vote on certain proposals. Thus, the Curators exercised significant control over the order and frequency of proposals, and could impose their own subjective criteria for whether the proposal should be whitelisted for a vote by DAO Token holders. DAO Token holders' votes were limited to proposals whitelisted by the Curators, and, although any DAO Token holder could put forth a proposal, each proposal would follow the same protocol, which included vetting and control by the current Curators. While DAO Token holders could put forth proposals to replace a Curator, such proposals were subject to control by the current Curators, including whitelisting and approval of the new address to which the tokens would be directed for such a proposal. In essence, Curators had the power to determine whether a proposal to remove a Curator was put to a vote.³⁶

And, Slock.it and its co-founders did, in fact, actively oversee The DAO. They monitored The DAO closely and addressed issues as they arose, proposing a moratorium on all proposals until vulnerabilities in The DAO's code had been addressed and a security expert to monitor potential attacks on The DAO had been appointed. When the Attacker exploited a weakness in the code and removed investor funds, Slock.it and its co-founders stepped in to help resolve the situation.

b. DAO Token Holders' Voting Rights Were Limited

Although DAO Token holders were afforded voting rights, these voting rights were limited. DAO Token holders were substantially reliant on the managerial efforts of Slock.it, its co-founders, and the Curators.³⁷ Even if an investor's efforts help to make an enterprise profitable, those efforts do not necessarily equate with a promoter's significant managerial efforts or control over the enterprise. See, e.g., *Glem W. Turner*, 474 F.2d at 482 (finding that a multi-level marketing scheme was an investment contract and that investors relied on the promoter's managerial efforts, despite the fact that investors put forth the majority of the labor that made the enterprise profitable, because the promoter dictated the terms and controlled the scheme itself); *Long v. Shultz*, 881 F.2d 129, 137 (5th Cir. 1989) ("An investor may authorize the assumption of particular risks that would create the possibility of greater profits or losses but still depend on a third party for all of the essential managerial efforts without which the risk could not

³⁶ DAO Token holders could put forth a proposal to split from The DAO, which would result in the creation of a new DAO Entity with a new Curator. Other DAO Token holders would be allowed to join the new DAO Entity as long as they voted yes to the original "split" proposal. Unlike all other contract proposals, a proposal to split did not require a deposit or a quorum, and it required a seven-day debating period instead of the minimum two-week debating period required for other proposals.

³⁷ Because, as described above, DAO Token holders were incentivized either to vote yes or to abstain from voting, the results of DAO Token holder voting would not necessarily reflect the actual view of a majority of DAO Token holders.

pay off.”). See also generally *SEC v. Merchant Capital, LLC*, 483 F.3d 747 (11th Cir. 2007) (finding an investment contract even where voting rights were provided to purported general partners, noting that the voting process provided limited information for investors to make informed decisions, and the purported general partners lacked control over the information in the ballots).

The voting rights afforded DAO Token holders did not provide them with meaningful control over the enterprise, because (1) DAO Token holders’ ability to vote for contracts was a largely perfunctory one; and (2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.

First, as discussed above, DAO Token holders could only vote on proposals that had been cleared by the Curators.³⁸ And that clearance process did not include any mechanism to provide DAO Token holders with sufficient information to permit them to make informed voting decisions. Indeed, based on the particular facts concerning The DAO and the few draft proposals discussed in online forums, there are indications that contract proposals would not have necessarily provide enough information for investors to make an informed voting decision, affording them less meaningful control. For example, the sample contract proposal attached to the White Paper included little information concerning the terms of the contract. Also, the Slock.it co-founders put forth a draft of their own contract proposal and, in response to questions and requests to negotiate the terms of the proposal (posted to a DAO forum), a Slock.it founder explained that the proposal was intentionally vague and that it was, in essence, a take it or leave it proposition not subject to negotiation or feedback. See, e.g., *SEC v. Shields*, 744 F.3d 633, 643-45 (10th Cir. 2014) (in assessing whether agreements were investment contracts, court looked to whether “the investors actually had the type of control reserved under the agreements to obtain access to information necessary to protect, manage, and control their investments at the time they purchased their interests.”).

Second, the pseudonymity and dispersion of the DAO Token holders made it difficult for them to join together to effect change or to exercise meaningful control. Investments in The DAO were made pseudonymously (such that the real-world identities of investors are not apparent), and there was great dispersion among those individuals and/or entities who were invested in The DAO and thousands of individuals and/or entities that traded DAO Tokens in the secondary market—an arrangement that bears little resemblance to that of a genuine general partnership. Cf. *Williamson v. Tucker*, 645 F.2d 404, 422-24 (5th Cir. 1981) (“[O]ne would not expect partnership interests sold to large numbers of the general public to provide any real partnership control; at some point there would be so many [limited] partners that a partnership vote would be more like a corporate vote, each partner’s role having been diluted to the level of a single shareholder in a corporation.”).³⁹ Slock.it did create and maintain online forums on which

³⁸ Because, in part, The DAO never commenced its business operations funding projects, this Report does not analyze the question whether anyone associated with The DAO was an “[i]nvestment adviser” under Section 202(a)(11) of the Investment Advisers Act of 1940 (“Advisers Act”). See 15 U.S.C. § 80b-2(a)(11). Those who would use virtual organizations should consider their obligations under the Advisers Act.

³⁹ The Fifth Circuit in *Williamson* stated that:

investors could submit posts regarding contract proposals, which were not limited to use by DAO Token holders (anyone was permitted to post). However, DAO Token holders were pseudonymous, as were their posts to the forums. Those facts, combined with the sheer number of DAO Token holders, potentially made the forums of limited use if investors hoped to consolidate their votes into blocs powerful enough to assert actual control. This was later demonstrated through the fact that DAO Token holders were unable to effectively address the Attack without the assistance of Slock.it and others. The DAO Token holders' pseudonymity and dispersion diluted their control over The DAO. See *Merchant Capital*, 483 F.3d at 758 (finding geographic dispersion of investors weighing against investor control).

These facts diminished the ability of DAO Token holders to exercise meaningful control over the enterprise through the voting process, rendering the voting rights of DAO Token holders akin to those of a corporate shareholder. *Steinhardt Group, Inc. v. Citicorp.*, 126 F.3d 144, 152 (3d Cir. 1997) ("It must be emphasized that the assignment of nominal or limited responsibilities to the participant does not negate the existence of an investment contract; where the duties assigned are so narrowly circumscribed as to involve little real choice of action . . . a security may be found to exist . . . [The] emphasis must be placed on economic reality.") (citing *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 n. 14 (5th Cir. 1974)).

By contract and in reality, DAO Token holders relied on the significant managerial efforts provided by Slock.it and its co-founders, and The DAO's Curators, as described above. Their efforts, not those of DAO Token holders, were the "undeniably significant" ones, essential to the overall success and profitability of any investment into The DAO. See *Glem W. Turner*, 474 F.2d at 482.

C. Issuers Must Register Offers and Sales of Securities Unless a Valid Exemption Applies

The definition of "issuer" is broadly defined to include "every person who issues or proposes to issue any security" and "person" includes "any unincorporated organization." 15 U.S.C. § 77b(a)(4). The term "issuer" is flexibly construed in the Section 5 context "as issuers devise new ways to issue their securities and the definition of a security itself expands." *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 909 (5th Cir. 1977); accord *SEC v. Murphy*, 626 F.2d 633, 644 (9th Cir. 1980) ("[W]hen a person [or entity] organizes or sponsors the organization of

A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venture that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.

Williamson, 645 F.2d at 424 & n.15 (court also noting that, "this is not to say that other factors could not also give rise to such a dependence on the promoter or manager that the exercise of partnership powers would be effectively precluded.").

limited partnerships and is primarily responsible for the success or failure of the venture for which the partnership is formed, he will be considered an issuer ...”).

The DAO, an unincorporated organization, was an issuer of securities, and information about The DAO was “crucial” to the DAO Token holders’ investment decision. *See Murphy*, 626 F.2d at 643 (“Here there is no company issuing stock, but instead, a group of individuals investing funds in an enterprise for profit, and receiving in return an entitlement to a percentage of the proceeds of the enterprise.”) (citation omitted). The DAO was “responsible for the success or failure of the enterprise,” and accordingly was the entity about which the investors needed information material to their investment decision. *Id.* at 643-44.

During the Offering Period, The DAO offered and sold DAO Tokens in exchange for ETH through The DAO Website, which was publicly-accessible, including to individuals in the United States. During the Offering Period, The DAO sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million ETH, which was valued in USD, at the time, at approximately \$150 million. Because DAO Tokens were securities, The DAO was required to register the offer and sale of DAO Tokens, unless a valid exemption from such registration applied.

Moreover, those who participate in an unregistered offer and sale of securities not subject to a valid exemption are liable for violating Section 5. *See, e.g., Murphy*, 626 F.2d at 650-51 (“[T]hose who ha[ve] a necessary role in the transaction are held liable as participants.”) (citing *SEC v. North Am. Research & Dev. Corp.*, 424 F.2d 63, 81 (2d Cir. 1970); *SEC v. Culpepper*, 270 F.2d 241, 247 (2d Cir. 1959); *SEC v. International Chem. Dev. Corp.*, 469 F.2d 20, 28 (10th Cir. 1972); *Pemahuna & Co. v. SEC*, 410 F.2d 861, 864 n.1, 868 (9th Cir. 1969)); *SEC v. Softpoint, Inc.*, 958 F. Supp 846, 859-60 (S.D.N.Y. 1997) (“The prohibitions of Section 5 ... sweep[] broadly to encompass ‘any person’ who participates in the offer or sale of an unregistered, non-exempt security.”); *SEC v. Chinese Consol. Benevolent Ass’n*, 120 F.2d 738, 740-41 (2d Cir. 1941) (defendant violated Section 5(a) “because it engaged in selling unregistered securities” issued by a third party “when it solicited offers to buy the securities ‘for value’”).

D. A System that Meets the Definition of an Exchange Must Register as a National Securities Exchange or Operate Pursuant to an Exemption from Such Registration

Section 5 of the Exchange Act makes it unlawful for any broker, dealer, or exchange, directly or indirectly, to effect any transaction in a security, or to report any such transaction, in interstate commerce, unless the exchange is registered as a national securities exchange under Section 6 of the Exchange Act, or is exempted from such registration. *See* 15 U.S.C. §78e. Section 3(a)(1) of the Exchange Act defines an “exchange” as “any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood ...” 15 U.S.C. § 78c(a)(1).

Exchange Act Rule 3b-16(a) provides a functional test to assess whether a trading system meets the definition of exchange under Section 3(a)(1). Under Exchange Act Rule 3b-16(a), an

organization, association, or group of persons shall be considered to constitute, maintain, or provide "a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange," if such organization, association, or group of persons: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.⁴⁰

A system that meets the criteria of Rule 3b-16(a), and is not excluded under Rule 3b-16(b), must register as a national securities exchange pursuant to Sections 5 and 6 of the Exchange Act⁴¹ or operate pursuant to an appropriate exemption. One frequently used exemption is for alternative trading systems ("ATS").⁴² Rule 3a1-1(a)(2) exempts from the definition of "exchange" under Section 3(a)(1) an ATS that complies with Regulation ATS,⁴³ which includes, among other things, the requirement to register as a broker-dealer and file a Form ATS with the Commission to provide notice of the ATS's operations. Therefore, an ATS that operates pursuant to the Rule 3a1-1(a)(2) exemption and complies with Regulation ATS would not be subject to the registration requirement of Section 5 of the Exchange Act.

The Platforms that traded DAO Tokens appear to have satisfied the criteria of Rule 3b-16(a) and do not appear to have been excluded from Rule 3b-16(b). As described above, the Platforms provided users with an electronic system that matched orders from multiple parties to buy and sell DAO Tokens for execution based on non-discretionary methods.

IV. Conclusion and References for Additional Guidance

Whether or not a particular transaction involves the offer and sale of a security—regardless of the terminology used—will depend on the facts and circumstances, including the

⁴⁰ See 17 C.F.R. § 240.3b-16(a). The Commission adopted Rule 3b-16(b) to exclude explicitly certain systems that the Commission believed did not meet the exchange definition. These systems include systems that merely route orders to other execution facilities and systems that allow persons to enter orders for execution against the bids and offers of a single dealer system. See Securities Exchange Act Rel. No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998) (Regulation of Exchanges and Alternative Trading Systems) ("Regulation ATS"), 70852.

⁴¹ 15 U.S.C. § 78e. A "national securities exchange" is an exchange registered as such under Section 6 of the Exchange Act. 15 U.S.C. § 78f.

⁴² Rule 300(a) of Regulation ATS promulgated under the Exchange Act provides that an ATS is:
any organization, association, person, group of persons, or system: (1) [t]hat constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of [Exchange Act Rule 3b-16]; and (2) [t]hat does not: (i) [s]et rules governing the conduct of subscribers other than the conduct of subscribers' trading on such [ATS]; or (ii) [d]iscipline subscribers other than by exclusion from trading.

Regulation ATS, *supra* note 40, Rule 300(a).

⁴³ See 17 C.F.R. § 240.3a1-1(a)(2). Rule 3a1-1 also provides two other exemptions from the definition of "exchange" for any ATS operated by a national securities association, and any ATS not required to comply with Regulation ATS pursuant to Rule 301(a) of Regulation ATS. See 17 C.F.R. §§ 240.3a1-1(a)(1) and (3).

economic realities of the transaction. Those who offer and sell securities in the United States must comply with the federal securities laws, including the requirement to register with the Commission or to qualify for an exemption from the registration requirements of the federal securities laws. The registration requirements are designed to provide investors with procedural protections and material information necessary to make informed investment decisions. These requirements apply to those who offer and sell securities in the United States, 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. In addition, any entity or person engaging in the activities of an exchange, such as bringing together the orders for securities of multiple buyers and sellers using established non-discretionary methods under which such orders interact with each other and buyers and sellers entering such orders agree upon the terms of the trade, must register as a national securities exchange or operate pursuant to an exemption from such registration.

To learn more about registration requirements under the Securities Act, please visit the Commission's website [here](#). To learn more about the Commission's registration requirements for investment companies, please visit the Commission's website [here](#). To learn more about the Commission's registration requirements for national securities exchanges, please visit the Commission's website [here](#). To learn more about alternative trading systems, please see the Regulation ATS adopting release [here](#).

For additional guidance, please see the following Commission enforcement actions involving virtual currencies:

- *SEC v. Tredon T. Shavers and Bitcoin Savings and Trust*, Civil Action No. 4:13-CV-416 (E.D. Tex., complaint filed July 23, 2013)
- *In re Erik T. Voorhees*, Rel. No. 33-9592 (June 3, 2014)
- *In re BTC Trading, Corp. and Ethan Burnside*, Rel. No. 33-9685 (Dec. 8, 2014)
- *SEC v. Homero Joshua Garza, Gaw Miners, LLC, and ZenMiner, LLC (d/b/a Zen Cloud)*, Civil Action No. 3:15-CV-01760 (D. Conn., complaint filed Dec. 1, 2015)
- *In re Bitcoin Investment Trust and SecondMarket, Inc.*, Rel. No. 34-78282 (July 11, 2016)
- *In re Sunshine Capital, Inc.*, File No. 500-1 (Apr. 11, 2017)

And please see the following investor alerts:

- *Bitcoin and Other Virtual Currency-Related Investments* (May 7, 2014)
- *Ponzi Schemes Using Virtual Currencies* (July 2013)

By the Commission.



INVESTOR BULLETIN: INITIAL COIN OFFERINGS

07/25/2017

Developers, businesses, and individuals increasingly are using initial coin offerings, also called ICOs or token sales, to raise capital. These activities may provide fair and lawful investment opportunities. However, new technologies and financial products, such as those associated with ICOs, can be used improperly to entice investors with the promise of high returns in a new investment space. The SEC's Office of Investor Education and Advocacy is issuing this Investor Bulletin to make investors aware of potential risks of participating in ICOs.

Background - Initial Coin Offerings

Virtual coins or tokens are created and disseminated using distributed ledger or blockchain technology. Recently promoters have been selling virtual coins or tokens in ICOs. Purchasers may use fiat currency (e.g., U.S. dollars) or virtual currencies to buy these virtual coins or tokens. Promoters may tell purchasers that the capital raised from the sales will be used to fund development of a digital platform, software, or other projects and that the virtual tokens or coins may be used to access the platform, use the software, or otherwise participate in the project. Some promoters and initial sellers may lead buyers of the virtual coins or tokens to expect a return on their investment or to participate in a share of the returns provided by the project. After they are issued, the virtual coins or tokens may be resold to others in a secondary market on virtual currency exchanges or other platforms.

Depending on the facts and circumstances of each individual ICO, the virtual coins or tokens that are offered or sold may be securities. If they are securities, the offer and sale of these virtual coins or tokens in an ICO are subject to the federal securities laws.

On July 25, 2017, the SEC issued a [Report of Investigation under Section 21\(a\)](https://www.sec.gov/litigation/investreport/34-81207.pdf) of the Securities Exchange Act of 1934 describing an SEC investigation of The DAO, a virtual organization, and its use of distributed ledger or blockchain technology to facilitate the offer and sale of DAO Tokens to raise capital. The Commission applied existing U.S. federal securities laws to this new paradigm, determining that DAO Tokens were securities. The Commission stressed that those who offer and sell securities in the U.S. are required to comply with federal securities laws, regardless of whether those securities are purchased with virtual currencies or distributed with blockchain technology.

To facilitate understanding of this new and complex area, here are some basic concepts that you should understand before investing in virtual coins or tokens:

What is a blockchain?

A blockchain is 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.

What is a virtual currency or virtual token or coin?

A virtual currency is a digital representation of value that can be digitally traded and functions as a medium of exchange, unit of account, or store of value. Virtual tokens or coins may represent other rights as well. Accordingly, in certain cases, the tokens or coins will be securities and may not be lawfully sold without registration with the SEC or pursuant to an exemption from registration.

What is a virtual currency exchange?

A virtual currency exchange is a person or entity that exchanges virtual currency for fiat currency, funds, or other forms of virtual currency. Virtual currency exchanges typically charge fees for these services. Secondary market trading of virtual tokens or coins may also occur on an exchange. These exchanges may not be registered securities exchanges or alternative trading systems regulated under the federal securities laws. Accordingly, in purchasing and selling virtual coins and tokens, you may not have the same protections that would apply in the case of stocks listed on an exchange.

Who issues virtual tokens or coins?

Virtual tokens or coins may be issued by a virtual organization or other capital raising entity. A virtual organization is an organization embodied in computer code and executed on a distributed ledger or blockchain. The code, often called a "smart contract," serves to automate certain functions of the organization, which may include the issuance of certain virtual coins or tokens. The DAO, which was a decentralized autonomous organization, is an example of a virtual organization.

Some Key Points to Consider When Determining Whether to Participate in an ICO

If you are thinking about participating in an ICO, here are some things you should consider.

► 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. A few things to keep in mind about registration:

- If an offering is registered, you can find information (such as a registration statement or "Form S-1") on [SEC.gov](https://www.sec.gov/) through [EDGAR](https://investor.gov/research-before-you-invest/research/researching-investments/using-edgar-researching-public-companies).
- If a promoter states that an offering is exempt from registration, and you are not an [accredited investor](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-accredited-investors), you should be very careful - most exemptions have net worth or income requirements.
- Although ICOs are sometimes described as [crowdfunding](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-crowdfunding-investors) contracts, it is possible that they are not being offered and sold in compliance with the requirements of Regulation Crowdfunding or with the federal securities laws generally.

► Ask what your money will be used for and what rights the virtual coin or token provides to you. The promoter should have a clear business plan that you can read and that you understand. The rights the token or coin entitles you to should be clearly laid out, often in a white paper or development roadmap. You should specifically ask about how and when you can get your money back in the event you wish to do so. For example, do you have a right to give the token or coin back to the company or to receive a refund? Or can you resell the coin or token? Are there any limitations on your ability to resell the coin or token?

- ▶ 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. You can visit [Investor.gov](https://www.investor.gov/) (<https://www.investor.gov/>) to check the registration status and background of these investment professionals.
- ▶ Ask whether the blockchain is open and public, whether the code has been published, and whether there has been an independent cybersecurity audit.
- ▶ Fraudsters often use innovations and new technologies to perpetrate fraudulent investment schemes. Fraudsters may entice investors by touting an ICO investment “opportunity” as a way to get into this cutting-edge space, promising or guaranteeing high investment returns. Investors should always be suspicious of jargon-laden pitches, hard sells, and promises of outsized returns. Also, it is relatively easy for anyone to use blockchain technology to create an ICO that looks impressive, even though it might actually be a scam.
- ▶ Virtual currency exchanges and other entities holding virtual currencies, virtual tokens or coins may be susceptible to fraud, technical glitches, hacks, or malware. Virtual tokens or virtual currency may be stolen by hackers.

Investing in an ICO may limit your recovery in the event of fraud or theft. While you may have rights under the federal securities laws, your ability to recover may be significantly limited.

If fraud or theft results in you or the organization that issued the virtual tokens or coins losing virtual tokens, virtual currency, or fiat currency, you may have limited recovery options. Third-party wallet services, payment processors, and virtual currency exchanges that play important roles in the use of virtual currencies may be located overseas or be operating unlawfully.

Law enforcement officials may face particular challenges when investigating ICOs and, as a result, investor remedies may be limited. These challenges include:

- ▶ Tracing money. Traditional financial institutions (such as banks) often are not involved with ICOs or virtual currency transactions, making it more difficult to follow the flow of money.
- ▶ International scope. ICOs and virtual currency transactions and users span the globe. Although the SEC regularly obtains information from abroad (such as through cross-border agreements), there may be restrictions on how the SEC can use the information and it may take more time to get the information. In some cases, the SEC may be unable to obtain information from persons or entities located overseas.
- ▶ No central authority. As there is no central authority that collects virtual currency user information, the SEC generally must rely on other sources for this type of information.
- ▶ Freezing or securing virtual currency. Law enforcement officials may have difficulty freezing or securing investor funds that are held in a virtual currency. Virtual currency wallets are encrypted and unlike money held in a bank or brokerage account, virtual currencies may not be held by a third-party custodian.

Be careful if you spot any of these potential warning signs of investment fraud.

- ▶ “Guaranteed” high investment returns. There is no such thing as guaranteed high investment returns. Be wary of anyone who promises that you will receive a high rate of return on your investment, with little or no risk.
- ▶ Unsolicited offers. An unsolicited sales pitch may be part of a fraudulent investment scheme. Exercise extreme caution if you receive an unsolicited communication—meaning you didn’t ask for it and don’t know the sender—about an investment opportunity.
- ▶ Sounds too good to be true. If the investment sounds too good to be true, it probably is. Remember that investments providing higher returns typically involve more risk.

- ▶ **Pressure to buy RIGHT NOW.** Fraudsters may try to create a false sense of urgency to get in on the investment. Take your time researching an investment opportunity before handing over your money.
- ▶ **Unlicensed sellers.** Many fraudulent investment schemes involve unlicensed individuals or unregistered firms. Check license and registration status on [Investor.gov](https://investor.gov/) (<https://investor.gov/>).
- ▶ **No net worth or income requirements.** The federal securities laws require securities offerings to be registered with the SEC unless an exemption from registration applies. Many registration exemptions require that investors are [accredited investors](http://www.sec.gov/answers/accred.htm) (<http://www.sec.gov/answers/accred.htm>); some others have investment limits. Be highly suspicious of private (*i.e.*, unregistered) investment opportunities that do not ask about your net worth or income or whether investment limits apply.

Before making any investment, carefully read any materials you are given and verify the truth of every statement you are told about the investment. For more information about how to research an investment, read our publication [Ask Questions](http://www.sec.gov/investor/eubs/sec-questions-investors-should-ask.pdf) (<http://www.sec.gov/investor/eubs/sec-questions-investors-should-ask.pdf>). Investigate the individuals and firms offering the investment, and check out their backgrounds on [Investor.gov](https://investor.gov/) (<https://investor.gov/>) and by contacting your [state securities regulator](http://www.nasaa.org/about-us/contact-us/contact-your-regulator/) (<http://www.nasaa.org/about-us/contact-us/contact-your-regulator/>). Many fraudulent investment schemes involve unlicensed individuals or unregistered firms.

Additional Resources

[SEC Investor Alert: Bitcoin and Other Virtual Currency-Related Investments](https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-bitcoin-other-virtual-currency) (<https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-bitcoin-other-virtual-currency>)

[SEC Investor Alert: Ponzi Schemes Using Virtual Currencies](http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf) (http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf)

[SEC Investor Alert: Social Media and Investing - Avoiding Fraud](http://www.sec.gov/investor/alerts/socialmediaandfraud.pdf) (<http://www.sec.gov/investor/alerts/socialmediaandfraud.pdf>)

The Office of Investor Education and Advocacy has provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.

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INVESTOR ALERT: BITCOIN AND OTHER VIRTUAL CURRENCY-RELATED INVESTMENTS

05/07/2014

The SEC's Office of Investor Education and Advocacy is issuing this Investor Alert to make investors aware about the potential risks of investments involving Bitcoin and other forms of virtual currency.

The rise of Bitcoin and other virtual and digital currencies creates new concerns for investors. *A new product, technology, or innovation – such as Bitcoin – has the potential to give rise both to frauds and high-risk investment opportunities.* Potential investors can be easily enticed with the promise of high returns in a new investment space and also may be less skeptical when assessing something novel, new and cutting-edge.

We previously issued an [Investor Alert](http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf) about the use of Bitcoin in the context of a Ponzi scheme. The Financial Industry Regulatory Authority (FINRA) also recently issued an [Investor Alert](http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P456458) cautioning investors about the risks of buying and using digital currency such as Bitcoin. In addition, the North American Securities Administrators Association (NASAA) included digital currency on its [list](http://www.nasaa.org/3752/top-investor-threats/) of the top 10 threats to investors for 2013.

What is Bitcoin?

Bitcoin has been described as a decentralized, peer-to-peer virtual currency that is used like money – it can be exchanged for traditional currencies such as the U.S. dollar, or used to purchase goods or services, usually online. *Unlike traditional currencies, Bitcoin operates without central authority or banks and is not backed by any government.*

IRS treats Bitcoin as property. The IRS recently issued [guidance](http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance) stating that it will treat virtual currencies, such as Bitcoin, as property for federal tax purposes. As a result, general tax principles that apply to property transactions apply to transactions using virtual currency

If you are thinking about investing in a Bitcoin-related opportunity, here are some things you should consider.

Investments involving Bitcoin may have a heightened risk of fraud.

Innovations and new technologies are often used by fraudsters to perpetrate fraudulent investment schemes. *Fraudsters may entice investors by touting a Bitcoin investment “opportunity” as a way to get into this cutting-edge space, promising or guaranteeing high investment returns.* Investors may find these investment pitches hard to resist.

2/1/2018

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Bitcoin Ponzi scheme. In July 2013, the SEC charged an individual for an alleged Bitcoin-related Ponzi scheme in [SEC v. Shavers](#) (http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539730583#_Ue6vZODmp-Jk). The defendant advertised a Bitcoin “investment opportunity” in an online Bitcoin forum, promising investors up to 7% interest per week and that the invested funds would be used for Bitcoin activities. Instead, the defendant allegedly used bitcoins from new investors to pay existing investors and to pay his personal expenses.

As with any investment, be careful if you spot any of these potential warning signs of investment fraud:

- ▶ **“Guaranteed” high investment returns.** There is no such thing as guaranteed high investment returns. Be wary of anyone who promises that you will receive a high rate of return on your investment, with little or no risk.
- ▶ **Unsolicited offers.** An unsolicited sales pitch may be part of a fraudulent investment scheme. Exercise extreme caution if you receive an unsolicited communication – meaning you didn’t ask for it and don’t know the sender – about an investment opportunity.
- ▶ **Unlicensed sellers.** Federal and state securities laws require investment professionals and their firms who offer and sell investments to be licensed or registered. Many fraudulent investment schemes involve unlicensed individuals or unregistered firms. Check license and registration status by searching the SEC’s [Investment Adviser Public Disclosure \(IAPD\)](#) (http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/Iapd_SiteMap.aspx) website or FINRA’s [BrokerCheck](#) (<http://brokercheck.finra.org/Search/Search.aspx>) website.
- ▶ **No net worth or income requirements.** The federal securities laws require securities offerings to be registered with the SEC unless an exemption from registration applies. Most registration exemptions require that investors are [accredited investors](#) (<http://www.sec.gov/answers/accred.htm>). Be highly suspicious of private (*i.e.*, unregistered) investment opportunities that do not ask about your net worth or income.
- ▶ **Sounds too good to be true.** If the investment sounds too good to be true, it probably is. Remember that investments providing higher returns typically involve more risk.
- ▶ **Pressure to buy RIGHT NOW.** Fraudsters may try to create a false sense of urgency to get in on the investment. Take your time researching an investment opportunity before handing over your money.

Bitcoin users may be targets for fraudulent or high-risk investment schemes.

Both fraudsters and promoters of high-risk investment schemes may target Bitcoin users. The exchange rate of U.S. dollars to bitcoins has fluctuated dramatically since the first bitcoins were created. As the exchange rate of Bitcoin is significantly higher today, many early adopters of Bitcoin may have experienced an unexpected increase in wealth, making them attractive targets for fraudsters as well as promoters of high-risk investment opportunities.

Fraudsters target any group they think they can convince to trust them. Scam artists may take advantage of Bitcoin users’ vested interest in the success of Bitcoin to lure these users into Bitcoin-related investment schemes. The fraudsters may be (or pretend to be) Bitcoin users themselves. Similarly, promoters may find Bitcoin users to be a receptive audience for legitimate but high-risk investment opportunities. Fraudsters and promoters may solicit investors through forums and online sites frequented by members of the Bitcoin community.

Bitcoins for oil and gas. The Texas Securities Commissioner [recently](#) (http://www.ssb.state.tx.us/News/Press_Release/03-11-14_press.php) entered an emergency cease and desist order against a Texas oil and gas exploration company, which

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claims it is the first company in the industry to accept bitcoins from investors, for intentionally failing to disclose material facts to investors including “the nature of the risks associated with the use of Bitcoin to purchase working interests” in wells. The company advertised working interests in wells in West Texas, both at a recent Bitcoin conference and through social media and a web page, according to the emergency order.

Bitcoin trading suspension. In February 2014, the SEC [suspended](https://www.sec.gov/litigation/suspensions/2014/34-71568.pdf) trading in the securities of Imogo Mobile Technologies because of questions about the accuracy and adequacy of publicly disseminated information about the company’s business, revenue and assets. Shortly before the suspension, the company announced that it was developing a mobile Bitcoin platform, which resulted in significant movement in the trading price of the company’s securities.

Using Bitcoin may limit your recovery in the event of fraud or theft.

If fraud or theft results in you or your investment losing bitcoins, you may have limited recovery options. Third-party wallet services, payment processors and Bitcoin exchanges that play important roles in the use of bitcoins may be unregulated or operating unlawfully.

Law enforcement officials may face particular [challenges](http://www.hssec.senate.gov/download/?id=ac50a1af-cc38-4b04-b013-a7522ea7a70d) when investigating the illicit use of virtual currency. Such challenges may impact SEC investigations involving Bitcoin:

- ▶ **Tracing money.** Traditional financial institutions (such as banks) often are not involved with Bitcoin transactions, making it more difficult to follow the flow of money.
- ▶ **International scope.** Bitcoin transactions and users span the globe. Although the SEC regularly obtains information from abroad (such as through cross-border agreements), there may be restrictions on how the SEC can use the information and it may take more time to get the information. In some cases, the SEC may be unable to obtain information located overseas.
- ▶ **No central authority.** As there is no central authority that collects Bitcoin user information, the SEC generally must rely on other sources, such as Bitcoin exchanges or users, for this type of information.
- ▶ **Seizing or freezing bitcoins.** Law enforcement officials may have difficulty seizing or freezing illicit proceeds held in bitcoins. Bitcoin wallets are encrypted and unlike money held in a bank or brokerage account, bitcoins may not be held by a third-party custodian.

Investments involving Bitcoin present unique risks.

Consider these risks when evaluating investments involving Bitcoin:

- ▶ **Not insured.** While securities accounts at U.S. brokerage firms are often insured by the [Securities Investor Protection Corporation](http://www.sec.gov/answers/sipc.htm) (SIPC) and bank accounts at U.S. banks are often insured by the Federal Deposit Insurance Corporation (FDIC), bitcoins held in a digital wallet or Bitcoin exchange currently do not have similar protections.

- ▶ **History of volatility.** The exchange rate of Bitcoin historically has been very volatile and the exchange rate of Bitcoin could drastically decline. For example, the exchange rate of Bitcoin has dropped more than 50% in a single day. Bitcoin-related investments may be affected by such volatility.
- ▶ **Government regulation.** Bitcoins are not legal tender. Federal, state or foreign governments may restrict the use and exchange of Bitcoin.
- ▶ **Security concerns.** Bitcoin exchanges may stop operating or permanently shut down due to fraud, technical glitches, hackers or malware. Bitcoins also may be stolen by hackers.
- ▶ **New and developing.** As a recent invention, Bitcoin does not have an established track record of credibility and trust. Bitcoin and other virtual currencies are evolving.

Recent Bitcoin exchange failure. A Bitcoin exchange in Japan called Mt. Gox recently failed after hackers apparently stole bitcoins worth hundreds of millions of dollars from the exchange. Mt. Gox subsequently filed for bankruptcy. Many Bitcoin users participating on the exchange are left with little recourse.

Before making any investment, carefully read any materials you are given and verify the truth of every statement you are told about the investment. For more information about how to research an investment, read our publication [Ask Questions](http://www.sec.gov/investor/oibs/sec-questions-investors-should-ask.pdf) (<http://www.sec.gov/investor/oibs/sec-questions-investors-should-ask.pdf>). Investigate the individuals and firms offering the investment, and check out their backgrounds by searching the SEC's [IAPD](http://www.adviserinfo.sec.gov/IAPD/Content/loadMain/iaod_SiteMap.aspx) (http://www.adviserinfo.sec.gov/IAPD/Content/loadMain/iaod_SiteMap.aspx) website or FINRA's [BrokerCheck](http://brokercheck.finra.org/Search/Search.aspx) (<http://brokercheck.finra.org/Search/Search.aspx>) website and by contacting your [state securities regulator](http://www.nasaa.org/about-us/contact-us/contact-your-regulator/) (<http://www.nasaa.org/about-us/contact-us/contact-your-regulator/>).

Additional Resources

[SEC Investor Alert: Ponzi Schemes Using Virtual Currencies](http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf) (http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf)
[SEC Investor Alert: Social Media and Investing – Avoiding Fraud](http://www.sec.gov/investor/alerts/socialmediaandfraud.pdf) (<http://www.sec.gov/investor/alerts/socialmediaandfraud.pdf>)
[SEC Investor Alert: Private Oil and Gas Offerings](http://www.sec.gov/investor/alerts/ia_oilgas.pdf) (http://www.sec.gov/investor/alerts/ia_oilgas.pdf)
[SEC Investor Bulletin: Affinity Fraud](http://www.sec.gov/investor/alerts/affinityfraud.pdf) (<http://www.sec.gov/investor/alerts/affinityfraud.pdf>)
[FINRA Investor Alert: Bitcoin: More Than a Bit Risky](http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P456458) (<http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P456458>)
[NASAA Top Investor Threats](http://www.nasaa.org/3752/top-investor-threats/) (<http://www.nasaa.org/3752/top-investor-threats/>)
[IRS Virtual Currency Guidance](http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance) (<http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance>)
[European Banking Authority Warning to Consumers on Virtual Currencies](http://www.eba.europa.eu/documents/10180/588344/EBA+Warning+on+Virtual+Currencies.pdf) (<http://www.eba.europa.eu/documents/10180/588344/EBA+Warning+on+Virtual+Currencies.pdf>)

Contact the SEC

[Submit a question](https://www.sec.gov/oiaa/QuestionsAndComments.html) (<https://www.sec.gov/oiaa/QuestionsAndComments.html>) to the SEC or call the SEC's toll-free investor assistance line at (800) 732-0330 (dial 1-202-551-6551 if calling from outside of the United States).

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- ▶ Visit [Investor.gov](http://www.investor.gov) (<http://www.investor.gov>), the SEC's website for individual investors

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INVESTOR ALERT: PONZI SCHEMES USING VIRTUAL CURRENCIES

07/23/2013

The SEC's Office of Investor Education and Advocacy is issuing this investor alert to warn individual investors about fraudulent investment schemes that may involve Bitcoin and other virtual currencies.

Ponzi Schemes Generally

A [Ponzi scheme](http://www.sec.gov/answers/ponzi.html) (<http://www.sec.gov/answers/ponzi.html>) is an investment scam that involves the payment of purported returns to existing investors from funds contributed by new investors.

Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, rather than engaging in any legitimate investment activity, the fraudulent actors focus on attracting new money to make promised payments to earlier investors as well as to divert some of these "invested" funds for personal use. The SEC investigates and [prosecutes](http://www.sec.gov/spotlight/enf-actions-ponzi.shtml) (<http://www.sec.gov/spotlight/enf-actions-ponzi.shtml>) many Ponzi scheme cases each year to prevent new victims from being harmed and to maximize recovery of assets to investors.

As with many frauds, Ponzi scheme organizers often use the latest innovation, technology, product or growth industry to entice investors and give their scheme the promise of high returns. Potential investors are often less skeptical of an investment opportunity when assessing something novel, new or "cutting-edge."

Look Out For Potential Scams Using Virtual Currency

Virtual currencies, such as Bitcoin, have recently become popular and are intended to serve as a type of money. They may be traded on online exchanges for conventional currencies, including the U.S. dollar, or used to purchase goods or services, usually online.

We are concerned that the rising use of virtual currencies in the global marketplace may entice fraudsters to lure investors into Ponzi and other schemes in which these currencies are used to facilitate fraudulent, or simply fabricated, investments or transactions. The fraud may also involve an unregistered offering or trading platform. These schemes often promise high returns for getting in on the ground floor of a growing Internet phenomenon.

Fraudsters may also be attracted to using virtual currencies to perpetrate their frauds because transactions in virtual currencies supposedly have greater privacy benefits and less regulatory oversight than transactions in

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of the SEC regardless of whether the investment is made in U.S. dollars or a virtual currency. ***In particular, individuals selling investments are typically subject to federal or state licensing requirements.***

Bitcoin Ponzi Scheme. In a recent case, [SEC v. Shavers](#) (<http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539730583>), the organizer of an alleged Ponzi scheme advertised a Bitcoin “investment opportunity” in an online Bitcoin forum. Investors were allegedly promised up to 7% interest per week and that the invested funds would be used for Bitcoin arbitrage activities in order to generate the returns. Instead, invested Bitcoins were allegedly used to pay existing investors and exchanged into U.S. dollars to pay the organizer’s personal expenses.

Common Red Flags Of Fraud

Many Ponzi schemes share common characteristics. Following are some red flags:

- ▶ **High investment returns with little or no risk.** Every investment carries some degree of risk, and investments yielding higher returns typically involve more risk. “Guaranteed” investment returns or promises of high returns for little risk should be viewed skeptically.
- ▶ **Overly consistent returns.** Investments tend to go up and down over time, especially those seeking high returns. Be suspect of an investment that generates consistent returns regardless of overall market conditions.
- ▶ **Unregistered investments.** Ponzi schemes typically involve investments that have not been registered with the SEC or with state securities regulators.
- ▶ **Unlicensed sellers.** Federal and state securities laws require certain investment professionals and their firms to be licensed or registered. Many Ponzi schemes involve unlicensed individuals or unregistered firms.
- ▶ **Secretive and/or complex strategies and fee structures.** It is a good rule of thumb to avoid investments you don’t understand or for which you can’t get complete information.
- ▶ **No minimum investor qualifications.** Most legitimate private investment opportunities require you to be an [accredited investor](#) (<http://www.sec.gov/answers/accred.htm>). You should be highly skeptical of investment opportunities that do not ask about your salary or net worth.
- ▶ **Issues with paperwork.** Be skeptical of excuses regarding why you can’t review information about the investment in writing. Always read and carefully consider an investment’s prospectus or disclosure statement before investing. Be on the lookout for errors in account statements which may be a sign of fraudulent activity.
- ▶ **Difficulty receiving payments.** Be suspicious if you don’t receive a payment or have difficulty cashing out your investment. Ponzi scheme organizers sometimes encourage participants to “roll over” promised payments by offering higher investment returns.
- ▶ **It comes through someone with a shared affinity.** Fraudsters often exploit the trust derived from being members of a group that shares an affinity, such as a national, ethnic or religious affiliation. Sometimes, respected leaders or prominent members may be enlisted, knowingly or unknowingly, to spread the word about the “investment.”

If you have a question or concern about an investment, or you think you have encountered fraud, please contact the SEC, FINRA or your state securities regulator to report the fraud and to get assistance.

[U.S. Securities and Exchange Commission \(http://www.sec.gov/\)](http://www.sec.gov/)

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Additional Information

For more information about [Ponzi schemes \(http://www.sec.gov/answers/ponzi.htm\)](http://www.sec.gov/answers/ponzi.htm), visit [sec.gov/answers/ponzi.htm \(http://www.sec.gov/answers/ponzi.htm\)](http://www.sec.gov/answers/ponzi.htm).

For a [list \(http://www.sec.gov/spotlight/enf-actions-ponzi.shtml\)](http://www.sec.gov/spotlight/enf-actions-ponzi.shtml) of SEC enforcement actions against Ponzi schemes, visit [sec.gov/spotlight/enf-actions-ponzi.shtml \(http://www.sec.gov/spotlight/enf-actions-ponzi.shtml\)](http://www.sec.gov/spotlight/enf-actions-ponzi.shtml).

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For additional investor educational information, see the SEC's website for individual investors, [investor.gov \(http://www.investor.gov/\)](http://www.investor.gov/).

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PREPARED STATEMENT OF J. CHRISTOPHER GIANCARLO

CHAIRMAN, U.S. COMMODITY FUTURES TRADING COMMISSION

FEBRUARY 6, 2018

Introduction: Virtual Currency

Thank you, Chairman Crapo, for the invitation to testify before the Committee. Thank you, Ranking Member Brown, and all the Members of the Committee for this opportunity to discuss virtual currencies.

At the outset, I would like to note that this hearing is timely, even fortuitous. Emerging financial technologies broadly are taking us into a new chapter of economic history. They are impacting trading, markets and the entire financial landscape with far ranging implications for capital formation and risk transfer. They include machine learning and artificial intelligence, algorithm-based trading, data analytics, “smart” contracts valuing themselves and calculating payments in real-time, and distributed ledger technologies, which over time may come to challenge traditional market infrastructure. They are transforming the world around us, and it is no surprise that these technologies are having an equally transformative impact on U.S. capital and derivatives markets.

The more specific topic for today’s hearing, however, is virtual currency. Broadly speaking, virtual currencies are a digital representation of value that may function as a medium of exchange, a unit of account, and/or a store of value. Virtual currencies generally run on a decentralized peer-to-peer network of computers, which rely on certain network participants to validate and log transactions on a permanent, public distributed ledger, commonly known as the blockchain.

Supporters of virtual currencies see a technological solution to the age-old “double spend” problem—that has always driven the need for a trusted, central authority to ensure that an entity is capable of, and does, engage in a valid transaction. Traditionally, there has been a need for a trusted intermediary—for example a bank or other financial institution—to serve as a gatekeeper for transactions and many economic activities. Virtual currencies seek to replace the need for a central authority or intermediary with a decentralized, rules-based and open consensus mechanism.¹ An array of thoughtful business, technology, academic, and policy leaders have extrapolated some of the possible impacts that derive from such an innovation, including how market participants conduct transactions, transfer ownership, and power peer-to-peer applications and economic systems.²

Others, however, argue that this is all hype or technological alchemy and that the current interest in virtual currencies is overblown and resembles wishful thinking, a fever, even a mania. They have declared the 2017 heightened valuation of Bitcoin to be a bubble similar to the famous “Tulip Bubble” of the 17th century. They say that virtual currencies perform no socially useful function and, worse, can be used to evade laws or support illicit activity.³ Indeed, history has demonstrated to us time-and-again that bad actors will try to invoke the concept of innovation in order to perpetrate age-old fraudulent schemes on the public. Accordingly, some assert that virtual currencies should be banned, as some Nations have done.⁴

There is clearly no shortage of opinions on virtual currencies such as Bitcoin. In fact, virtual currencies may be all things to all people: for some, potential riches, the next big thing, a technological revolution, and an exorable value proposition; for

¹ See generally, *CFTC Talks*, Episode 24, Dec. 29, 2017, Interview with Coincenter.org Director of Research, Peter Van Valkenburgh, at <http://www.cftc.gov/Media/Podcast/index.htm>.

² See Marc Andreessen, “Why Bitcoin Matters”, *New York Times DealBook* (Jan. 21, 2014), <https://dealbook.nytimes.com/2014/01/21/why-bitcoin-matters/>; Jerry Brito and Andrea O’Sullivan, “Bitcoin: A Primer for Policymakers”, George Mason University Mercatus Center (May 3, 2016), <https://www.mercatus.org/publication/bitcoin-primer-policymakers>; Christian Catalini and Joshua S. Gans, “Some Simple Economics of the Blockchain”, Rotman School of Management Working Paper No. 2874598, MIT Sloan Research Paper No. 5191-16 (last updated Sept. 21, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2874598; Arjun Kharpal, “People Are ‘Underestimating’ the ‘Great Potential’ of Bitcoin, Billionaire Peter Thiel Says”, CNBC (Oct. 26, 2017), <https://www.cnbc.com/2017/10/26/bitcoin-underestimated-peter-thiel-says.html>; Hugh Son, “Bitcoin ‘More Than Just a Fad,’ Morgan Stanley CEO Says”, Bloomberg (Sept. 27, 2017), <https://www.bloomberg.com/news/articles/2017-09-27/bitcoin-more-than-just-a-fad-morgan-stanley-ceo-gorman-says>; Chris Brummer and Daniel Gorfine, “FinTech: Building a 21st-Century Regulator’s Toolkit”, Milken Institute (Oct. 21, 2014), available at <http://www.milkeninstitute.org/publications/view/665>.

³ Virtual currencies are not unique in their utility in illicit activity. National currencies, like the U.S. Dollar, and commodities, like gold and diamonds, have long been used to support criminal enterprises.

⁴ Countries that have banned Bitcoin include Bangladesh, Bolivia, Ecuador, Kyrgyzstan, Morocco, Nepal, and Vietnam. China has banned Bitcoin for banking institutions.

others, a fraud, a new form of temptation and allure, and a way to separate the unsuspecting from their money.

Perspective is critically important. As of the morning of February 5, the total value of all outstanding Bitcoin was about \$130 billion based on a Bitcoin price of \$7,700. The Bitcoin “market capitalization” is less than the stock market capitalization of a single “large cap” business, such as McDonalds (around \$130 billion). The total value of all outstanding virtual currencies was about \$365 billion. Because virtual currencies like Bitcoin are sometimes considered to be comparable to gold as an investment vehicle, it is important to recognize that the total value of all the gold in the world is estimated by the World Gold Council to be about \$8 trillion which continues to dwarf the virtual currency market size. Clearly, the column inches of press attention to virtual currency far surpass its size and magnitude in today’s global economy.

Yet, despite being a relatively small asset class, virtual currency presents novel challenges for regulators. SEC Chairman Clayton and I recently wrote:

The CFTC and SEC, along with other Federal and State regulators and criminal authorities, will continue to work together to bring transparency and integrity to these markets and, importantly, to deter and prosecute fraud and abuse. These markets are new, evolving, and international. As such they require us to be nimble and forward-looking; coordinated with our State, Federal, and international colleagues; and engaged with important stakeholders, including Congress.⁵

It is this perspective that has guided our work at the CFTC on virtual currencies.

Introduction: The Mission of the CFTC

The mission of the CFTC is to foster open, transparent, competitive, and financially sound derivatives markets.⁶ By working to avoid systemic risk, the Commission aims to protect market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices related to derivatives and other products that are subject to the Commodity Exchange Act (CEA).

The CFTC was established as an independent agency in 1974, assuming responsibilities that had previously belonged to the Department of Agriculture since the 1920s. The Commission historically has been charged by the CEA with regulatory authority over the commodity futures markets. These markets have existed since the 1860s, beginning with agricultural commodities such as wheat, corn, and cotton.

Over time, these organized commodity futures markets, known as designated contract markets (DCMs) regulated by the CFTC, have grown to include those for energy and metals commodities, collectively including crude oil, heating oil, gasoline, copper, gold, and silver. The agency now also oversees these commodity futures markets for financial products such as interest rates, stock indexes, and foreign currency. The definition of “commodity” in the CEA is broad. It can mean a physical commodity, such as an agricultural product (e.g., wheat, cotton) or natural resource (e.g., gold, oil). It can mean a currency or interest rate. The CEA definition of “commodity” also includes “all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.”

In the aftermath of the 2008 financial crisis, President Obama and Congress enhanced the CFTC’s regulatory authority. With passage of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act), the agency now also oversees most of the U.S. swaps market in addition to exchange traded futures markets.

Futures, swaps and other derivatives markets are essential means for commercial and financial risk mitigation and transfer. These markets allow the risks of variable production costs, such as the price of raw materials, energy, foreign currency, and interest rates, to be transferred from those who cannot afford them to those who can. They are the reason why American consumers enjoy stable prices in the grocery store, whatever the conditions out on the farm.

But derivatives markets are not just useful for agricultural producers. They impact the price and availability of heating in American homes, the energy used in factories, the interest rates borrowers pay on home mortgages, and the returns workers earn on their retirement savings. More than 90 percent of Fortune 500 companies use derivatives to manage commercial or market risk in their worldwide business operations. In short, derivatives serve the needs of society to help moderate

⁵ Jay Clayton and J. Christopher Giancarlo, “Regulators Are Looking at Cryptocurrency: At the SEC and CFTC We Take Our Responsibility Seriously”, *Wall Street Journal*, Jan. 24, 2018, <https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363>.

⁶ See CFTC, “Mission and Responsibilities”, <http://www.cftc.gov/About/MissionResponsibilities/index.htm>.

price, supply and other commercial risks to free up capital for economic growth, job creation, and prosperity.

To ensure the integrity of U.S. derivatives markets, the CFTC regulates derivatives market participants and activities. The agency oversees a variety of individuals and organizations. These include swap execution facilities, derivatives clearing organizations, designated contract markets, swap data repositories, swap dealers, futures commission merchants, commodity pool operators, and other entities. The CFTC also prosecutes derivative market fraud and manipulation, including misconduct in underlying spot markets for commodities.

I. CFTC Authority and Oversight Over Virtual Currencies

In 2015, the CFTC determined that virtual currencies, such as Bitcoin, met the definition of “commodity” under the CEA. Nevertheless, the CFTC does NOT have regulatory jurisdiction under the CEA over markets or platforms conducting cash or “spot” transactions in virtual currencies or other commodities or over participants on such platforms. More specifically, the CFTC does not have authority to conduct regulatory oversight over spot virtual currency platforms or other cash commodities, including imposing registration requirements, surveillance and monitoring, transaction reporting, compliance with personnel conduct standards, customer education, capital adequacy, trading system safeguards, cybersecurity examinations, or other requirements. In fact, current law does not provide any U.S. Federal regulator with such regulatory oversight authority over spot virtual currency platforms operating in the United States or abroad. However, the CFTC DOES have enforcement jurisdiction to investigate through subpoena and other investigative powers and, as appropriate, conduct civil enforcement action against fraud and manipulation in virtual currency derivatives markets and in underlying virtual currency spot markets.

In contrast to the spot markets, the CFTC does have both regulatory and enforcement jurisdiction under the CEA over derivatives on virtual currencies traded in the United States. This means that for derivatives on virtual currencies traded in U.S. markets, the CFTC conducts comprehensive regulatory oversight, including imposing registration requirements and compliance with a full range of requirements for trade practice and market surveillance, reporting and monitoring and standards for conduct, capital requirements, and platform and system safeguards.

II. Assertion of CFTC Authority

The CFTC has been straightforward in asserting its area of statutory jurisdiction concerning virtual currencies derivatives. As early as 2014, former CFTC Chairman Timothy Massad discussed virtual currencies and potential CFTC oversight under the Commodity Exchange Act (CEA).⁷ And as noted above, in 2015, the CFTC found virtual currencies to be a commodity.⁸ In that year, the agency took enforcement action to prohibit wash trading and prearranged trades on a virtual currency derivatives platform.⁹ In 2016, the CFTC took action against a Bitcoin futures exchange operating in the U.S. that failed to register with the agency.¹⁰ Last year, the CFTC issued proposed guidance on what is a derivative market and what is a spot market in the virtual currency context.¹¹ The agency also issued warnings about valuations and volatility in spot virtual currency markets¹² and launched an unprecedented consumer education effort (detailed in Section IV herein).

a. Enforcement

The CFTC Division of Enforcement is a premier Federal civil enforcement agency dedicated to deterring and preventing price manipulation and other disruptions of market integrity, ensuring the financial integrity of all transactions subject to the CEA, and protecting market participants from fraudulent or other abusive sales practices and misuse of customer assets. Appendix A hereto summarizes recent CFTC enforcement activities.

⁷ Testimony of CFTC Chairman Timothy Massad before the U.S. Senate Committee on Agriculture, Nutrition, and Forestry (Dec. 10, 2014), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6>.

⁸ In re Coinflip, Inc., Dkt. No. 15-29 (CFTC Sept. 17, 2015), <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>.

⁹ In re TeraExchange LLC, Dkt. No. 15-33 (CFTC Sept. 24, 2015), <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfteraexchangeorder92415.pdf>.

¹⁰ In re BFXNA Inc. d/b/a Bitfinex, Dkt. No. 16-19 (CFTC June 2, 2016), <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfbfxnaorder060216.pdf>.

¹¹ CFTC, Retail Commodity Transactions Involving Virtual Currency, 82 FR 60335 (Dec. 20, 2017), www.gpo.gov/fdsys/pkg/FR-2017-12-20/pdf/2017-27421.pdf.

¹² CFTC, A CFTC Primer on Virtual Currencies (Oct. 17, 2017), http://www.cftc.gov/idc/groups/public/documents/file/labcfte_primercurrencies100417.pdf.

The CFTC has been particularly assertive of its enforcement jurisdiction over virtual currencies. It has formed an internal virtual currency enforcement task force to garner and deploy relevant expertise in this evolving asset class. The task force shares information and works cooperatively with counterparts at the SEC with similar virtual currency expertise.

In September 2017, the CFTC took enforcement action against a virtual currency Ponzi scheme.¹³ Over the past few weeks, the CFTC filed a series of civil enforcement actions against perpetrators of fraud, market manipulation and disruptive trading involving virtual currency. These include:

- i. My Big Coin Pay Inc., which charged the defendants with commodity fraud and misappropriation related to the ongoing solicitation of customers for a virtual currency known as My Big Coin;
- ii. The Entrepreneurs Headquarters Limited, which charged the defendants with a fraudulent scheme to solicit Bitcoin from members of the public, misrepresenting that customers' funds would be pooled and invested in products including binary options, and instead misappropriated the funds and failed to register as a Commodity Pool Operator; and
- iii. Coin Drop Markets, which charged the defendants with fraud and misappropriation in connection with purchases and trading of Bitcoin and Litecoin.

These recent enforcement actions confirm that the CFTC, working closely with the SEC and other fellow financial enforcement agencies, will aggressively prosecute bad actors that engage in fraud and manipulation regarding virtual currencies.

b. Bitcoin Futures

It is important to put the new Bitcoin futures market in perspective. It is quite small with open interest at the CME of 6,695 bitcoin¹⁴ and at Cboe Futures Exchange (Cboe) of 6,695 bitcoin (as of Feb. 2, 2018). At a price of approximately \$7,700 per Bitcoin,¹⁵ this represents a notional amount of about \$94 million. In comparison, the notional amount of the open interest in CME's WTI crude oil futures was more than one thousand times greater, about \$170 billion (2,600,000 contracts) as of Feb 2, 2018, and the notional amount represented by the open interest of Comex gold futures was about \$74 billion (549,000 contracts).

Prior to the launch of Bitcoin futures, the CFTC closely observed the evolution of virtual currencies over the past several years. One exchange, CME Group, launched a Bitcoin Reference Rate in November 2016. And, another exchange, CBOE Futures Exchange (Cboe), first approached the CFTC in July 2017. The CFTC anticipated receiving proposals for the launch of Bitcoin futures products in late 2017.

Under CEA and Commission regulations and related guidance, futures exchanges may self-certify new products on 24-hour notice prior to trading. In the past decade and a half, over 12,000 new futures products have been self-certified.¹⁶ It is clear that Congress and prior Commissions deliberately designed the product self-certification framework to give futures exchanges, in their role as self-regulatory organizations, the ability to quickly bring new products to the marketplace. The CFTC's current product self-certification framework has long been considered to function well and be consistent with public policy that encourages market-driven innovation that has made America's listed futures markets the envy of the world.

Practically, both CME and Cboe had numerous discussions and exchanged numerous draft product terms and conditions with CFTC staff over a course of months prior to their certifying and launching Bitcoin futures in December 2017. This type of lengthy engagement is not unusual during the self-certification process for products that may raise certain issues. The CFTC staff undertook its review of CME's and Cboe's Bitcoin futures products with considered attention. Given the emerging nature and heightened attention of these products, staff conducted a "heightened review" of CME's and Cboe's responsibilities under the CEA and Commission regula-

¹³ On September 21, 2017, the CFTC filed a complaint in Federal court in the Southern District of New York against Nicholas Gelfman and Gelfman Blueprint, Inc., see <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enf/gelfmancomplaint09212017.pdf>.

¹⁴ Each CME contract represents 5 bitcoin.

¹⁵ The price changes day to day.

¹⁶ Prior to the changes made in the Commodity Futures Modernization Act of 2000 (CFMA) and the Commission's subsequent addition of Part 40, exchanges submitted products to the CFTC for approval. From 1922 until the CFMA was signed into law, less than 800 products were approved. Since then, exchanges have certified over 12,000 products. For financial instrument products specifically, the numbers are 494 products approved and 1,938 self-certified. See <http://www.cftc.gov/IndustryOversight/ContractsProducts/index.htm>.

tions to ensure that their Bitcoin futures products and their cash-settlement processes were not readily susceptible to manipulation,¹⁷ and the risk management of the associated Derivatives Clearing Organizations (DCOs) to ensure that the products were sufficiently margined.¹⁸

Staff obtained the voluntary cooperation of CME and Cboe with a set of enhanced monitoring and risk management steps.

1. Designated contract markets (DCMs) setting exchange large trader reporting thresholds at five bitcoins or less;
2. DCMs entering direct or indirect information sharing agreements with spot market platforms to allow access to trade and trader data making up the underlying index that the futures contracts settle to;
3. DCMs agreeing to engage in monitoring of underlying index data from cash markets and identifying anomalies and disproportionate moves;
4. DCMs agreeing to conduct inquiries, as appropriate, including at the trade settlement and trader level when anomalies or disproportionate moves are identified;
5. DCMs agreeing to regular communication with CFTC surveillance staff on trade activities, including providing trade settlement and trader data upon request;
6. DCMs agreeing to coordinate product launches to enable the CFTC's market surveillance branch to monitor developments; and
7. DCOs setting substantially high initial¹⁹ and maintenance margin for cash-settled instruments.

The first six of these elements were used to ensure that the new product offerings complied with the DCM's obligations under the CEA core principles and CFTC regulations and related guidance. The seventh element, setting high initial and maintenance margins, was designed to ensure adequate collateral coverage in reaction to the underlying volatility of Bitcoin.

In crafting its process of "heightened review" for compliance, CFTC staff prioritized visibility, data, and monitoring of markets for Bitcoin derivatives and underlying settlement reference rates. CFTC staff felt that in gaining such visibility, the CFTC could best look out for Bitcoin market participants and consumers, as well as the public interest in Federal surveillance and enforcement. This visibility greatly enhances the agency's ability to prosecute fraud and manipulation in both the new Bitcoin futures markets and in its related underlying cash markets.

As for the interests of clearing members, the CFTC recognized that large global banks and brokerages that are DCO clearing members are able to look after their own commercial interests by choosing not to trade Bitcoin futures, as some have done, requiring substantially higher initial margins from their customers, as many have done, and through their active participation in DCO risk committees.

After the launch of Bitcoin futures, some criticism was directed at the self-certification process from a few market participants. Some questioned why the Commission did not hold public hearings prior to launch. However, it is the function of the futures exchanges and futures clearinghouses—and not CFTC staff²⁰—to solicit and address stakeholder concerns in new product self-certifications. The CFTC staff's focus was on how the futures contracts and cash settlement indices are designed to bar manipulation and the appropriate level of contract margining to meet CEA and Commission regulations.

Interested parties, especially clearing members, should indeed have an opportunity to raise appropriate concerns for consideration by regulated platforms proposing virtual currency derivatives and DCOs considering clearing new virtual currency products. That is why CFTC staff has added an additional element to the Review and Compliance Checklist for virtual currency product self-certifications. That

¹⁷ See CEA Section 5(d)(3), 7 U.S.C. 7(d)(3); Section 5(d)(4), 7 U.S.C. 7(d)(4); 17 CFR 38.253 and 38.254(a), and Appendices B and C to Part 38 of the CFTC's regulations.

¹⁸ CEA Section 5b(c)(2)(D)(iv), 7 U.S.C. 7a-1(c)(2)(D)(iv) ("The margin from each member and participant of a derivatives clearing organization shall be sufficient to cover potential exposures in normal market conditions.")

¹⁹ In the case of CME and Cboe Bitcoin futures, the initial and maintenance margins were ultimately set at 47 percent and 44 percent by the respective DCOs. By way of comparison that is more than 10 times the margin required for CME corn futures products.

²⁰ Unlike provisions in the CEA and Commission regulations that provide for public comment on rule self-certifications, there is no provision in statute or regulation for public input into CFTC staff review of product self-certifications. It is hard to believe that Congress was not deliberate in making that distinction.

is, requesting DCMs and SEFs to disclose to CFTC staff what steps they have taken in their capacity as self-regulatory organizations to gather and accommodate appropriate input from concerned parties, including trading firms and FCMs. Further, CFTC staff will take a close look at DCO governance around the clearing of new virtual currency products and formulate recommendations for possible further action.

The CFTC's response to the self-certification of Bitcoin futures has been a balanced one. It has resulted in the world's first federally regulated Bitcoin futures market. Had it even been possible, blocking self-certification would not have stopped the rise of Bitcoin or other virtual currencies. Instead, it would have ensured that virtual currency spot markets continue to operate without effective and data-enabled Federal regulatory surveillance for fraud and manipulation. It would have prevented the development of a regulated derivatives market that allowed participants to take "short" positions that challenged the 2017 rise of Bitcoin prices.

III. Adequacy of CFTC Authority

The CFTC has sufficient authority under the CEA to protect investors in virtual currency derivatives over which the CFTC has regulatory jurisdiction under the CEA. As noted above, the CFTC does NOT have regulatory jurisdiction over markets or platforms conducting cash or "spot" transactions in virtual currencies or over participants on those platforms. For such virtual currency spot markets, CFTC only has enforcement jurisdiction to investigate and, as appropriate, conduct civil enforcement action against fraud and manipulation.

Any extension of the CFTC's regulatory authority to virtual currency spot markets would require statutory amendment of the CEA.²¹ The CFTC is an experienced regulator of derivatives markets that mostly serve professional and eligible contract participants. Such extension of regulatory authority would be a dramatic expansion of the CFTC's regulatory mission, which currently does not give the CFTC regulatory authority (distinct from enforcement authority) over cash commodity markets.

IV. Educating Investors and Market Participants

The CFTC believes that the responsible regulatory response to virtual currencies must start with consumer education. Amidst the wild assertions, bold headlines, and shocking hyperbole about virtual currencies, there is a need for much greater understanding and clarity.

Over the past 6 months, the CFTC has produced an unprecedented amount of consumer information concerning virtual currencies (listed in Appendix B hereto). These consumer materials include an information "primer" on virtual currencies (Appendix C hereto), consumer and market advisories on investing in Bitcoin and other virtual currencies (Appendix D hereto), a dedicated CFTC "Bitcoin" webpage, several podcasts (available on the Commission's website and from various streaming services) concerning virtual currencies and underlying technology, weekly publication of Bitcoin futures "Commitment of Traders" data and an analysis of Bitcoin spot market data.

In addition, the CFTC's Office of Consumer Education and Outreach (OCEO) is actively engaging with responsible outside partners to better educate consumers on Bitcoin and other virtual currencies. The OCEO is currently partnering with:

- The Consumer Finance Protection Bureau (CFPB) to train U.S. public library staff to identify and report consumer in virtual currencies;
- the American Association of Retired Persons (AARP) to distribute a virtual currency "Watchdog Alert" to 120,000 AARP members;
- North American Securities Administrators Association (NASAA) Investor Educators, who are responsible for conducting outreach to the public on avoiding investment fraud, including in virtual currencies;
- the National Attorneys General Training and Research Institute (NAGTRI), which is the research and training arm of the National Association of Attorneys General (NAAG), to inform State AGs about the availability of CFTC's virtual currency resources; and

²¹ The CFTC has jurisdiction over retail foreign currency markets and retail commodity transactions that use leverage, margin, or financing with some exceptions. Congress responded to concerns in the regulation of leveraged retail FX by providing the CFTC oversight responsibilities for Retail Foreign Exchange Dealers (RFEDs). The CFTC Re-authorization Act of 2008 amended the CEA to create a new registration category for RFEDs that include disclosure requirements and leverage limitations to customers.

- The Federal Reserve Bank of Chicago to help consumers manage their finances better, OCEO will again coordinate with NFA, FINRA, and SEC to hold a webinar on fraud prevention in virtual currencies.

V. Interagency Coordination

As noted, the CFTC's enforcement jurisdiction over virtual currencies is not exclusive. As a result, the U.S. approach to oversight of virtual currencies has evolved into a multifaceted, multi-regulatory approach that includes:

- The Securities and Exchange Commission (SEC) taking increasingly strong action against unregistered securities offerings, whether they are called a virtual currency or initial coin offering in name.
- State Banking regulators overseeing certain U.S. and foreign virtual currency spot exchanges largely through State money transfer laws.
- The Internal Revenue Service (IRS) treating virtual currencies as property subject to capital gains tax.
- The Treasury's Financial Crimes Enforcement Network (FinCEN) monitoring Bitcoin and other virtual currency transfers for anti-money-laundering purposes.

The CFTC actively communicates its approach to virtual currencies with other Federal regulators, including the Federal Bureau of Investigation (FBI) and the Justice Department and through the Financial Stability Oversight Council (FSOC), chaired by the Treasury Department. The CFTC has been in close communication with the SEC with respect to policy and jurisdictional considerations, especially in connection with recent virtual currency enforcement cases. In addition, we have been in communication with overseas regulatory counterparts through bilateral discussions and in meetings of the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO).

VI. Potential Benefits

I have spoken publicly about the potential benefits of the technology underlying Bitcoin, namely Blockchain or distributed ledger technology (DLT).²² Distributed ledgers—in various open system or private network applications—have the potential to enhance economic efficiency, mitigate centralized systemic risk, defend against fraudulent activity and improve data quality and governance.²³

DLT is likely to have a broad and lasting impact on global financial markets in payments, banking, securities settlement, title recording, cybersecurity, and trade reporting and analysis.²⁴ When tied to virtual currencies, this technology aims to serve as a new store of value, facilitate secure payments, enable asset transfers, and power new applications.

Additionally, DLT will likely develop hand-in-hand with new “smart” contracts that can value themselves in real-time, report themselves to data repositories, automatically calculate and perform margin payments and even terminate themselves in the event of counterparty default.²⁵

DLT may enable financial market participants to manage the significant operational, transactional, and capital complexities brought about by the many mandates, regulations, and capital requirements promulgated by regulators here and abroad in the wake of the financial crisis.²⁶ In fact, one study estimates that DLT could eventually allow financial institutions to save as much as \$20 billion in infra-

²²J. Christopher Giancarlo, Keynote Address of Commissioner J. Christopher Giancarlo before the Market Group, 2016 Annual Customer Conference, New York, May 10, 2016, <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-15>.

²³Id.

²⁴See, e.g., Larry Greenemeier, “Can't Touch This: New Encryption Scheme Targets Transaction Tampering”, *Scientific American*, May 22, 2015, <http://www.scientificamerican.com/article/can-t-touch-this-new-encryption-scheme-targets-transaction-tampering/>.

²⁵See Massimo Morini and Robert Sams, “Smart Derivatives Can Cure XVA Headaches”, *Risk Magazine*, Aug. 27, 2015, <http://www.risk.net/risk-magazine/opinion/2422606/smart-derivatives-can-cure-xva-headaches>; see also Jeffrey Maxim, “UBS Bank Is Experimenting with ‘Smart-Bonds’ Using the Bitcoin Blockchain”, *Bitcoin Magazine*, June 12, 2015, <https://bitcoinmagazine.com/articles/ubs-bank-experimenting-smart-bonds-using-bitcoin-blockchain-1434140571>; see also Pete Harris, “UBS Exploring Smart Bonds on Block Chain”, *Block Chain Inside Out*, June 15, 2015, http://harris-on.typepad.com/block_chain_io/2015/06/ubs-exploring-smart-bonds-on-block-chain.html; See, generally, Galen Stops, “Blockchain: Getting Beyond the Buzz”, *Profit & Loss*, Aug.–Sept. 2015, at 20, <http://www.profit-loss.com/articles/analysis/technology-analysis/blockchain-getting-beyond-the-buzz>.

²⁶See, e.g., “Oversight of Dodd–Frank Act Implementation”, U.S. House Financial Services Committee, <http://financialservices.house.gov/Dodd-Frank/> (last visited Mar. 2, 2016).

structure and operational costs each year.²⁷ Another study reportedly estimates that blockchain could cut trading settlement costs by a third, or \$16 billion a year, and cut capital requirements by \$120 billion.²⁸ Moving from systems-of-record at the level of a firm to an authoritative system-of-record at the level of a market is an enormous opportunity to improve existing market infrastructure.²⁹

Outside of the financial services industry, many use cases for DLT are being posited from international trade to charitable endeavors and social services. International agricultural commodities merchant, Louis Dreyfus, and a group of financing banks have just completed the first agricultural deal using distributed ledger technology for the sale of 60,000 tons of U.S. soybeans to China.³⁰ Other DLT use cases include: legal records management, inventory control and logistics, charitable donation tracking and confirmation; voting security and human refugee identification and relocation.³¹

Yet, while DLT promises enormous benefits to commercial firms and charities, it also promises assistance to financial market regulators in meeting their mission to oversee healthy markets and mitigate financial risk. What a difference it would have made on the eve of the financial crisis in 2008 if regulators had access to the real-time trading ledgers of large Wall Street banks, rather than trying to assemble piecemeal data to recreate complex, individual trading portfolios. I have previously speculated³² that, if regulators in 2008 could have viewed a real-time distributed ledger (or a series of aggregated ledgers across asset classes) and, perhaps, been able to utilize modern cognitive computing capabilities, they may have been able to recognize anomalies in marketwide trading activity and diverging counterparty exposures indicating heightened risk of bank failure. Such transparency may not, by itself, have saved Lehman Brothers from bankruptcy, but it certainly would have allowed for far prompter, better-informed, and more calibrated regulatory intervention instead of the disorganized response that unfortunately ensued.

VII. Policy Considerations

Two decades ago, as the Internet was entering a phase of rapid growth and expansion, a Republican Congress and the Clinton administration established a set of enlightened foundational principles: the Internet was to progress through human social interaction; voluntary contractual relations and free markets; and Governments and regulators were to act in a thoughtful manner not to harm the Internet's continuing evolution.³³

This simple approach is well-recognized as the enlightened regulatory underpinning of the Internet that brought about such profound changes to human society. During the almost 20 years of "do no harm" regulation, a massive amount of investment was made in the Internet's infrastructure. It yielded a rapid expansion in access that supported swift deployment and mass adoption of Internet-based technologies. Internet-based innovations have revolutionized nearly every aspect of American life, from telecommunications to commerce, transportation and research and development. This robust Internet economy has created jobs, increased productivity and fostered innovation and consumer choice.

"Do no harm" was unquestionably the right approach to development of the Internet. Similarly, I believe that "do no harm" is the right overarching approach for distributed ledger technology.

²⁷ Santander InnoVentures, Oliver Wyman, and Anthemis Group, "The FinTech Paper 2.0: Rebooting Financial Services" 15 (2015), <http://santanderinnoventures.com/wp-content/uploads/2015/06/The-Fintech-2-0-Paper.pdf>.

²⁸ Telis Demos, "Bitcoin's Blockchain Technology Proves Itself in Wall Street Test", Apr. 7, 2016, *Wall Street Journal*, <http://www.wsj.com/articles/bitcoins-blockchain-technology-proves-itself-in-wall-street-test-1460021421>.

²⁹ Based on conversations with R3 CEV, <http://r3cev.com/>.

³⁰ Emiko Terazono, "Commodities Trader Louis Dreyfus Turns to Blockchainhttps", *Financial Times*, Jan. 22, 2018, www.ft.com/content/22b2ac1e-fd1a-11e7-a492-2c9be7f3120a.

³¹ Frisco d'Anconia, "IOTA Blockchain To Help Trace Families of Refugees During and After Conflicts", *Cointelegraph.com*, Aug. 8, 2017, <https://cointelegraph.com/news/iota-blockchain-to-help-trace-families-of-refugees-during-and-after-conflicts>.

³² See supra n. 22.

³³ The Telecommunications Act of 1996 (See Telecommunications Act of 1996 (Pub. L. No. 104-104, 110 Stat. 56 (1996))) and the ensuing Clinton administration "Framework for Global Electronic Commerce" (See Clinton administration, Framework for Global Electronic Commerce, <http://clinton4.nara.gov/WH/New/Commerce/>) established a simple and sensible framework: (a) the private sector should play the leading role in innovation, development, and financing; and (b) Governments and regulators should "do no harm" by avoiding undue restrictions, supporting a predictable, consistent, and simple legal environment and respecting the "bottom-up" nature of the technology and its deployment in a global marketplace.

Virtual currencies, however, likely require more attentive regulatory oversight in key areas, especially to the extent that retail investors are attracted to this space. SEC Chairman Clayton and I recently stated in a joint op-ed, that:

Our task, as market regulators, is to set and enforce rules that foster innovation while promoting market integrity and confidence. In recent months, we have seen a wide range of market participants, including retail investors, seeking to invest in DLT initiatives, including through cryptocurrencies and so-called ICOs . . . initial coin offerings. Experience tells us that while some market participants may make fortunes, the risks to all investors are high. Caution is merited.

A key issue before market regulators is whether our historic approach to the regulation of currency transactions is appropriate for the cryptocurrency markets. Check-cashing and money-transmission services that operate in the U.S. are primarily State-regulated. Many of the internet-based cryptocurrency trading platforms have registered as payment services and are not subject to direct oversight by the SEC or the CFTC. We would support policy efforts to revisit these frameworks and ensure they are effective and efficient for the digital era.³⁴

As the Senate Banking Committee, the Senate Agriculture Committee and other Congressional policymakers consider the current state of regulatory oversight of cash or “spot” transactions in virtual currencies and trading platforms, consideration should be given to shortcomings of the current approach of State-by-State money transmitter licensure that leaves gaps in protection for virtual currency traders and investors. Any proposed Federal regulation of virtual currency platforms should be carefully tailored to the risks posed by relevant trading activity and enhancing efforts to prosecute fraud and manipulation. Appropriate Federal oversight may include: data reporting, capital requirements, cybersecurity standards, measures to prevent fraud and price manipulation and anti-money laundering and “know your customer” protections. Overall, a rationalized Federal framework may be more effective and efficient in ensuring the integrity of the underlying market.

Conclusion

We are entering a new digital era in world financial markets. As we saw with the development of the Internet, we cannot put the technology genie back in the bottle. Virtual currencies mark a paradigm shift in how we think about payments, traditional financial processes, and engaging in economic activity. Ignoring these developments will not make them go away, nor is it a responsible regulatory response. The evolution of these assets, their volatility, and the interest they attract from a rising global millennial population demand serious examination.

With the proper balance of sound policy, regulatory oversight, and private sector innovation, new technologies will allow American markets to evolve in responsible ways and continue to grow our economy and increase prosperity. This hearing is an important part of finding that balance.

Thank you for inviting me to participate.

³⁴See *supra* n. 5.

Appendix A**CFTC Enforcement Activities: Fiscal Year (FY) 2017 Year Through the Present**Overview of FY 2017

In the fiscal year that ended September 30, 2017, the CFTC brought 49 enforcement-related actions, which included significant actions to root out manipulation and spoofing and to protect retail investors from fraud. The CFTC also pursued significant and complex litigation, including cases charging manipulation, spoofing, and unlawful use of customer funds. The CFTC obtained orders totaling \$412,726,307 in restitution, disgorgement and penalties. Specifically, in the fiscal year, the CFTC obtained \$333,830,145 in civil monetary penalties and \$78,896,162 million in restitution and disgorgement orders. Of the civil monetary penalties imposed, the CFTC collected and deposited at the U.S. Treasury more than \$265 million.

Retail Fraud

The CFTC brought a significant number of retail fraud actions in FY 2017 (20 out of the 49). For example, in February 2017, the CFTC filed and settled charges against Forex Capital Markets LLC for \$7 million for defrauding retail foreign exchange customers over a five year time period by concealing its relationship with its most important market maker and misrepresenting that its platform had no conflicts of interests with its customers. That month the CFTC also brought an action charging Carlos Javier Ramirez, Gold Chasers, Inc., and Royal Leisure International, Inc. with misappropriating millions in customer funds and engaging in fraudulent sales solicitations in connection with a Ponzi scheme involving the purported purchase of physical gold.

In May 2017, the CFTC filed charges against an individual and his company with defrauding 40 investors out of at least \$13 million in connection with a commodity pool they operated; investors included family members and members of his church. In June 2017, the CFTC filed charges against two individuals and their company with fraudulently soliciting customers, including at a church gathering, and defrauding them out of more than \$11 million. The pair was also arrested by the Federal Bureau of Investigation (FBI) on related criminal charges.

In September 2017, the CFTC filed one of the largest precious metals fraud cases in the history of the Commission. As alleged, the Defendants defrauded thousands of retail customers—many of whom are elderly—out of hundreds of millions of dollars as part of a multi-year scheme in connection with illegal, off-exchange leveraged precious metal transactions.

Market Manipulation

In February 2017, the CFTC settled with RBS for \$85 million for attempted manipulation of ISDAFIX, a leading global benchmark for interest rate swaps and related derivatives. The CFTC

also brought actions against The Royal Bank of Scotland plc and Goldman Sachs Group, Inc. and Goldman, Sachs & Co. for attempted manipulation of the ISDAFIX, resulting in \$85 million and \$120 million in penalties, respectively. In February 2018, the CFTC settled with Deutsche Bank Securities Inc. for \$70 million for attempted manipulation of ISDAFIX.

Since 2012, the CFTC has imposed over \$5 billion in penalties against banks and brokers with respect to benchmark manipulation settlements.

Disruptive Trading

In November 2016, the CFTC entered into a consent order with Navinder Singh Sarao and Nav Sarao Futures Limited PLC to settle allegations related to the 2010 flash crash for \$25.7 million in monetary sanctions, \$12.9 million in disgorgement, and a permanent trading and registration ban. In December 2016, the CFTC settled with trading company 3Red and trader Igor Oystacher imposing a \$2.5 million penalty, a monitor for three years, and requiring the use of certain trading compliance tools for intentionally and repeatedly engaging in a manipulative and deceptive spoofing scheme while placing orders for and trading futures contracts on multiple registered entities.

In January 2017, the CFTC fined Citigroup \$25 million for failing to diligently supervise the activities of its employees and agents in conjunction with spoofing orders in the U.S. Treasury futures markets. Later that year, in July 2017, the CFTC entered into its first non-prosecution agreements (NPA) with three former Citigroup traders who admitted to spoofing in the U.S. Treasury futures markets in 2011 and 2012. The NPAs emphasize the traders' timely and substantial cooperation, immediate willingness to accept responsibility for their misconduct, material assistance provided to the CFTC's investigation of Citigroup, and the absence of a history of prior misconduct.

In January 2018, in conjunction with the Department of Justice (DOJ) and FBI, the CFTC announced criminal and civil enforcement actions against three banks and six individuals involved in commodities fraud and spoofing schemes. The banks were fined \$45.6 million in penalties.

Virtual Currency

In September 2017, as part of its work to identify and root out bad actors in the virtual currency markets, the CFTC brought its first virtual currency anti-fraud enforcement action in Gelfman Blueprint, Inc., which charged an individual and his corporation with fraud, misappropriation, and issuing false account statements in connection with operating a Bitcoin Ponzi scheme.

In January 2018, the CFTC brought three virtual currency enforcement actions: (i) My Big Coin Pay Inc., which charged the defendants with commodity fraud and misappropriation related to

the ongoing solicitation of customers for a virtual currency known as My Big Coin; (ii) The Entrepreneurs Headquarters Limited, which charged the defendants with a fraudulent scheme to solicit Bitcoin from members of the public, misrepresenting that customers' funds would be pooled and invested in products including binary options, making Ponzi-style payments to commodity pool participants from other participants' funds, misappropriating pool participants' funds, and failing to register as a Commodity Pool Operator; and (iii) CabbageTech, Corp., which charged the defendants with fraud and misappropriation in connection with purchases and trading of Bitcoin and Litecoin.

APPENDIX B

Virtual Currency Educational Materials and Outreach Activities

CFTC's Bitcoin web page Resources

Launched on December 15, 2017, the CFTC now has a dedicated web page, www.cftc.gov/bitcoin, where the public can access educational materials on the CFTC's regulatory oversight authority of virtual currencies and ways to avoid fraud in the virtual currency space.

Current resources available on www.cftc.gov/bitcoin :

- "CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets"
- LabCFTC's Virtual Currency Primer
- *CFTC Talks* Virtual Currency Podcast, "Roundtable with CFTC leaders on Bitcoin";
- Self-Certification Fact Sheet
- Customer Advisories on "Understand the Risks of Virtual Currency Trading" and "Beware 'IRS Approved' Virtual Currency IRAs"

Forthcoming resources to be featured on www.cftc.gov/bitcoin:

- Customer Advisories (under development; issuance expected in February 2018)
 - Bitcoin pump-and-dump schemes
 - Avoiding fraud in Bitcoin-to-gold trades
- Brochures (available digitally and printed in mid-February 2018):
 - "Virtual Currency"
 - 6-paneled brochure on the definition of virtual currencies, the risks associated with them, and ways to avoid fraud
 - "Bitcoin Basics"
 - 2-sided Bitcoin brochure that speaks about the currency's distinct traits, that fact that it is a commodity, and recommendations for spotting fraud

Virtual Currency Outreach Activities by Audience

- Reaching retail investors and industry professionals via in-person presentations at industry events, conferences and trade shows
- Targeting seniors, vulnerable populations and those who serve them:
 - Connecting national non-profits who serve seniors and vulnerable populations to relevant CFTC virtual currency materials to use for their constituent outreach and communications
 - Distribution of both digital and print virtual currency materials to state regulators for their fraud prevention outreach
 - Participation in trainings for intermediaries, such as library staff, to educate them on the CFTC's fraud prevention resources to protect and assist their constituencies

- Outreach to key virtual currency demographics, such as Millennials, through digital communications designed to engage these demographics through channels and in forums they are predisposed to engage
- Engaging the general public through institutional partnerships and direct communication:
 - Working with other federal financial regulators and self-regulatory organizations to hold joint outreach activities, such as webinars, educational campaigns and community-level outreach, to build public awareness of the CFTC's virtual currency resources
 - Utilizing print and radio features to reach the public through media placements

Appendix C

October 17, 2017



A CFTC Primer on
Virtual Currencies



CFTC

Please note that LabCFTC cannot and will not provide legal advice. If you have specific questions regarding your activities and whether they conform to legal or regulatory requirements, you should consult with a qualified lawyer or appropriate expert. LabCFTC has no independent authority or decision-making power, and cannot independently provide, or create an expectation for, legal or regulatory relief. Communications from LabCFTC shall not create estoppel against CFTC or other enforcement actions. Any formal requests for relief must be addressed by relevant CFTC staff or, as necessary, by the Commission. LabCFTC will work with entities on such requests with the appropriate offices through established processes.

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Contents

This primer format is intended to be an educational tool regarding emerging FinTech innovations. It is not intended to describe the official policy or position of the CFTC, or to limit the CFTC's current or future positions or actions. The CFTC does not endorse the use or effectiveness of any of the financial products in this presentation. It is organized as follows:

- **Overview**
 - What is a Virtual Currency?
 - Bitcoin and Related Technologies
 - Potential Uses of Virtual Currencies and Blockchain Technologies
- **The Role of the CFTC**
 - The CFTC's Mission
 - Sample Permitted and Prohibited Activities
 - ICOs, Virtual Tokens, and CFTC Oversight
- **Risks of Virtual Currencies**
 - Operational Risks
 - Speculative Risks
 - Cybersecurity Risks
 - Fraud and Manipulation Risks

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OVERVIEW OF VIRTUAL CURRENCIES



What is a Virtual Currency?

- Although precise definitions offered by others are varied, an IRS definition provides us with a general idea:
 - "Virtual currency is a digital representation of value that functions as a **medium of exchange, a unit of account, and/or a store of value.**
 - In some environments, it operates like 'real' currency . . . but it **does not have legal tender status** [in the U.S.].
 - Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as 'convertible' virtual currency. **Bitcoin is one example of a convertible virtual currency.**
 - Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies.¹

¹IRS Notice 2014-21, available at <https://www.irs.gov/businesses/small-businesses-self-employed/virtual-currencies> (emphasis added). Please note that this definition is not a statement of the Commission's view, and is instead offered as an aid to enhance public understanding of virtual currencies. We further note that one prominent type of virtual currency is cryptocurrency. Cryptocurrency has been described as "an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party." Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (Oct. 31, 2008), available at <https://bitcoin.org/bitcoin.pdf>.



What is Bitcoin?

- Bitcoin is currently the largest convertible virtual currency by market capitalization (close to \$72 billion in August 2017)[†]
- Bitcoin was created in 2008 by a person or group that used the name "Satoshi Nakamoto," with the belief that:

"[w]hat is needed is an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party."
- Bitcoin:
 - Is "pseudonymous" (or partially anonymous) in that an individual is identified by an alpha-numeric public key/address;
 - Relies on cryptography (and unique digital signatures) for security based on public and private keys and complex mathematical algorithms;
 - Runs on a decentralized peer-to-peer network of computers and "miners" that operate on open-source software and do "work" to validate and irrevocably log transactions on a permanent public distributed ledger visible to the entire network;
 - Solves the lack of trust between participants who may be strangers to each other on a public ledger through the transaction validation work noted in the sub-bullet above; and
 - Enables the transfer of ownership without the need for a trusted, central intermediary.

[†] Paul Vigna, Bitcoin, Valued Like a Cool Blue Chip, Trading Like a Hot Small Cap, Wall Street Journal (Aug. 29, 2017), available at <https://blogs.wsj.com/moneybeat/2017/08/29/bitcoin-valued-like-a-blue-chip-trading-like-a-small-cap/>. It is important to note that there are many other virtual currencies with sizeable market capitalizations that are built upon various Blockchain technologies, but may have different characteristics or functionalities than Bitcoin, including Ethereum (or Ether), Litecoin, and Ripple.



What is the Difference between Public and Private Ledger Systems?

- Certain virtual currencies operate on public distributed ledger systems that capture "blocks" of transactions – there is no inherent trust in this decentralized system.
 - Virtual currencies create an economic incentive for dispersed, independent, computers, or groups of computers, around the world to confirm transactions and perform verifiable "work" (that creates consensus) to publish a new block of transactions on the public ledger in exchange for a payment of the applicable virtual currency.
- Private / permissioned distributed ledger networks typically have some degree of trust between participants.
 - Private ledger systems allow a network of known participants to share transaction information between themselves more efficiently.
 - While cryptography and consensus may still be involved in private ledger systems, these systems do not necessarily involve a virtual currency that may serve as the economic incentive for miner or validator participation in public networks.



Sample Potential Use Cases of Virtual Currencies

- **Store of Value**
 - Like precious metals, many virtual currencies are a “non-yielding” asset (meaning they do not pay dividends or interest), but they may be more fungible, divisible, and portable
 - Limited or finite supply of virtual currencies may contrast with “real” (fiat) currencies
- **Trading**
 - Trading in virtual currencies may result in capital gains or losses
 - Note that trading in virtual currencies may involve significant speculation and volatility risk (see Virtual Currency Risks section below)
- **Payments and Transactions**
 - Some merchants and online stores are accepting virtual currencies in exchange for physical and digital goods (i.e., payments)
 - Some public Blockchain systems rely on the payment of fees in virtual currency form in order to power the network and underlying transactions
- **Transfer / Move Money**
 - Domestic and international money transfer (e.g., remittances) in order to increase efficiencies and potentially reduce related fees

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Sample Potential Use Cases of Blockchain/DLT Technology

Blockchain, or distributed ledger technology,* underpins many virtual currencies, but can also be used within private, permissioned ledger systems – versions of public and private systems may be used by:

- **Financial Institutions**
 - Trading & Payment Platforms / Clearing and Settlement
 - Regulatory Reporting, Compliance & Audit
 - Know Your Customer (KYC) / Anti-Money Laundering (AML)
 - Repurchase Agreement Transactions ("Repos," i.e., short-term borrowing of securities)
- **Governments**
 - General Records Management
 - Title & Ownership Records Management (e.g., real property deeds and title transfer)
 - Regulatory Reporting and Oversight
- **Cross-Industry**
 - Smart Contracts (i.e., self executing agreements)
 - Resource / Asset Sharing Agreements (e.g., allowing rental of a personal car left behind during a vacation or allowing rental of excess computer or data storage)
 - Digital Identity (e.g., proof of identity when entering into a contract)

* See generally Marco Iansiti and Karim R. Lakhani, *The Truth About Blockchain*, Harvard Business Review (Jan-Feb 2017), available at <https://hbr.org/2017/01/the-truth-about-blockchain> (for a general overview of how a public Blockchain works).



THE ROLE OF THE CFTC



The CFTC's Mission

- The mission of the CFTC is to foster open, transparent, competitive, and financially sound markets. By working to avoid systemic risk, the Commission aims to protect market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices related to derivatives and other products that are subject to the Commodity Exchange Act (CEA).
 - To foster the public interest and fulfill its mission, the CFTC will act:
 - To deter and prevent price manipulation or any other disruptions to market integrity;
 - To ensure the financial integrity of all transactions subject to the CEA and the avoidance of systemic risk;
 - To protect all market participants from fraudulent or other abusive sales practices and misuse of customer assets; and
 - To promote responsible innovation and fair competition among boards of trade, other markets, and market participants.
 - Responsible innovation is market-enhancing.
-



Virtual Currencies are Commodities

- The definition of “commodity” in the CEA is broad.
 - It can mean a physical commodity, such as an agricultural product (e.g., wheat, cotton) or natural resource (e.g., gold, oil).
 - It can mean a currency or interest rate.
 - The CEA definition of “commodity” also includes “all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.”
- The CFTC first found that Bitcoin and other virtual currencies are properly defined as commodities in 2015.[‡]
- The CFTC has oversight over futures, options, and derivatives contracts.
- The CFTC’s jurisdiction is implicated when a virtual currency is used in a derivatives contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce.
 - Beyond instances of fraud or manipulation, the CFTC generally does not oversee “spot” or cash market exchanges and transactions involving virtual currencies that do not utilize margin, leverage, or financing.

[‡] See, In the Matter of: Coinflip, Inc., d/b/a Dentrabit, and Francisco Riordan, CFTC Docket No. 15-29, available at <http://www.cftc.gov/foia/groups/public/@enforcementactions/documents/legal/leading/enf/coinfliporder09172015.pdf>.



Examples of Permitted Activities

- TeraExchange, LLC, a Swap Execution Facility ("SEF") registered with the CFTC, entered in to the virtual currency market in 2014 by listing a Bitcoin swap for trading. Trading on a SEF platform is limited to "eligible contract participants," a type of sophisticated trader, which includes various financial institutions and persons, with assets above specified statutory minimums.
 - North American Derivatives Exchange Inc. ("NADEX"), a designated contract market ("DCM"), listed binary options based on the Tera Bitcoin Price Index from November 2014 to December 2016. Retail customers may trade on NADEX.
 - LedgerX, LLC ("LedgerX") registered with the CFTC as a SEF and Derivative Clearing Organization ("DCO") in July 2017. It plans to list digital currency options.
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Examples of Prohibited Activities[‡]

- Price manipulation of a virtual currency traded in interstate commerce.
- Pre-arranged or wash trading in an exchange-traded virtual currency swap or futures contract.
- A virtual currency futures or option contract or swap traded on a domestic platform or facility that has not registered with the CFTC as a SEF or DCM.
- Certain schemes involving virtual currency marketed to retail customers, such as off-exchange financed commodity transactions with persons who fail to register with the CFTC.

[‡]Please note that this is not an exhaustive list of prohibited activities.

 **ICOs, Virtual Tokens, and CFTC Oversight**

- The Securities and Exchange Commission (“SEC”) recently released a report about an Initial Coin Offering or “ICO” (the “DAO Report”).[‡]
- The DAO Report explains that “The DAO” is an example of a “Decentralized Autonomous Organization,” which is a “virtual” organization embodied in computer code and executed on a distributed ledger or blockchain.
- Investors exchanged Ether, a virtual currency, for virtual DAO “Tokens” to fund projects in which the investors would share in anticipated earnings. DAO Tokens could be resold on web-based platforms.
- Based on the facts and circumstances, the SEC determined that DAO Tokens are “securities” under the federal securities laws.
- There is no inconsistency between the SEC’s analysis and the CFTC’s determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances.
 - The CFTC looks beyond form and considers the actual substance and purpose of an activity when applying the federal commodities laws and CFTC regulations

[‡] See Release No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934. The DAO, available at <https://www.sec.gov/litigation/investreport/04-81207.pdf>.



RISKS OF VIRTUAL CURRENCIES



Virtual Currencies Have Risks

- While virtual currencies have potential benefits, this emerging space also involves various risks, including:
 - Operational Risks
 - Cybersecurity Risks
 - Speculative Risks
 - Fraud and Manipulation Risks
- Virtual currencies are relatively unproven and may not perform as expected (for example, some have questioned whether public distributed ledgers are in fact immutable).
- Investors and users of virtual currencies should educate themselves about these and other risks before getting involved.



Virtual Currency: Operational Risk

- *Conduct extensive research before giving any money or personal information to a virtual currency platform.*
 - The virtual currency marketplace is comprised of many different platforms where you can convert one type of virtual currency into another or into real currency, if offered.
 - Many of these platforms are not subject to the supervision which applies to regulated exchanges. For example, if they engage in only certain spot or cash market transactions and do not utilize margin, leverage, or financing, they may be subject to federal and state money transmission and anti-money laundering laws, but they do not have to follow all the rules that regulated exchanges operate under.
 - Some virtual currency platforms may be missing critical system safeguards and customer protection related systems; without adequate safeguards, customers may lose some or all of their virtual assets.
-

 **Virtual Currency: Cybersecurity Risk**

- *Keep your property in safe accounts and carefully verify digital wallet addresses.*
 - Some platforms may “commingle” (mix) customer assets in shared accounts (at a bank for real currency or a digital wallet for virtual currency). This may affect whether or how you can withdraw your currency.
 - Depending on the structure and security of the digital wallet, some may be vulnerable to hacks, resulting in the theft of virtual currency or loss of customer assets.
 - If a bad actor gains access to your private key, it can take your virtual currency with limited or no recourse
 - When transferring virtual currency, be sure to confirm the destination wallet address, even when using “copy and paste.” It is possible for hackers to change digital wallet addresses on your computer.
-



Virtual Currency: Speculative Risk

- *Only invest what you are willing and able to lose.*
- The virtual currency marketplace has been subject to substantial volatility and price swings.
- An individual or coordinated group trading a large amount of virtual currency at once could affect the price, depending on the overall amount of trading in the marketplace.
- Periods of high volatility with inadequate trade volume may create adverse market conditions, leading to harmful effects such as customer orders being filled at undesirable prices.
- Some advertisements promise guaranteed returns – this can be a common tactic with fraudulent schemes.



Virtual Currency: Fraud & Manipulation Risk

- *Carefully research the platform you want to use, and pay close attention to the fee structure and systems safeguards.*
 - Unregistered virtual currency platforms may not be able to adequately protect against market abuses by other traders.
 - For example, recent news articles discuss potential "spoofing" activity and other manipulative behavior that can negatively affect prices
 - Some virtual currency platforms may be selling you virtual currency directly from their own account – these types of transactions may give the platform unfair advantages and sometimes resemble fraudulent "bucket shop" schemes.
 - There is also a risk of Ponzi schemers and fraudsters seeking to capitalize on the current attention focused on virtual currencies.
-

Appendix D

Consumer and Market Advisories on Investing in Bitcoin and other virtual Currencies



Customer Advisory: Understand the Risks of Virtual Currency Trading

The U.S. Commodity Futures Trading Commission (CFTC) is issuing this customer advisory to inform the public of possible risks associated with investing or speculating in virtual currencies or recently launched Bitcoin futures and options.

Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, or a store of value, but it does not have legal tender status. Virtual currencies are sometimes exchanged for U.S. dollars or other currencies around the world, but they are not currently backed nor supported by any government or central bank. Their value is completely derived by market forces of supply and demand, and they are more volatile than traditional fiat currencies. Profits and losses related to this volatility are amplified in margined futures contracts.

For hedgers – those who own Bitcoin or other virtual currencies and who are looking to protect themselves against potential losses or looking to buy virtual currencies at some point in the future – futures contracts and options are intended to provide protection against this volatility. However, like all futures products, speculating in these markets should be considered a high-risk transaction.

Bitcoin is a Commodity

Bitcoin and other virtual currencies have been classified as commodities under the Commodity Exchange Act (CEA). The CFTC primarily regulates commodity derivatives contracts that are based on underlying commodities. While its regulatory oversight authority over commodity anti-fraud and manipulation enforcement authority over virtual currency cash markets as a commodity.

What makes virtual currency risky?

Purchasing virtual currencies on the cash market – spending dollars to purchase Bitcoin for your

personal wallet, for example – comes with a number of risks, including:

- most cash markets are not regulated or supervised by a government agency;
- platforms in the cash market may lack critical system safeguards, including customer protections;
- volatile cash market price swings or flash crashes;
- cash market manipulation;
- cyber risks, such as hacking customer wallets; and/or
- platforms selling from their own accounts and putting customers at an unfair disadvantage.

It's also important to note that market changes that affect the cash market price of a virtual currency may ultimately affect the price of virtual currency futures and options.

When customers purchase a virtual currency-based futures contract, they may not be entitled to receive the actual virtual currency, depending on the particular contract. Under most futures contracts currently being offered, customers are buying the right to receive or pay the amount of an underlying commodity value in dollars at some point in the future. Such futures contracts are said to be "cash settled." Customers will pay or receive (depending on which side of the contract they have taken –

long or short) the dollar equivalent of the virtual currency based on an index or auction price specified in the contract. Thus, customers should inform themselves as to how the index or auction prices used to settle the contract are determined.

Entering into futures contracts through leveraged accounts can amplify the risks of trading the product. Typically, participants only fund futures contracts at a fraction of the underlying commodity price when using a margin account. This creates "leverage," and leverage amplifies the underlying risk, making a change in the cash price even more significant. When prices move in the customers' favor, leverage provides them with more profit for a relatively small investment. But, when markets go against customers' positions, they will be forced to refill their margin accounts or close out their positions, and in the end may lose more than their initial investments.

Beware of related fraud

Virtual currencies are commonly targeted by hackers and criminals who commit fraud. There is no assurance of recourse if your virtual currency is stolen. Be careful how and where you store your virtual currency. The CFTC has received complaints about virtual currency exchange scams, as well as Ponzi and "pyramid" schemes.

If you decide to buy virtual currencies or derivatives based on them, remember these tips:

- If someone tries to sell you an investment in options or futures on virtual currencies, including Bitcoin, verify they are registered with the CFTC. Visit [SmartCheck.gov](https://www.smartcheck.gov) to check registrations or learn more about common investment frauds.
- Remember—much of the virtual currency cash market operates through Internet-based trading platforms that may be unregulated and unsupervised.
- Do not invest in products or strategies you do not understand.
- Be sure you understand the risks and how the product can lose money, as well as the likelihood of loss. Only speculate with money you can afford to lose.
- There is no such thing as a guaranteed investment or trading strategy. If someone tells you there is no risk of losing money, do not invest.

- Investors should conduct extensive research into the legitimacy of virtual currency platforms and digital wallets before providing credit card information, wiring money, or offering sensitive personal information.
- The SEC has also warned that some token sales or initial coin offerings (ICOs) can be used to improperly entice investors with promises of high returns.¹

If you believe you may have been the victim of fraud, or to report suspicious activity, contact us at 866.366.2382 or visit [CFTC.gov/TipOrComplaint](https://www.cftc.gov/TipOrComplaint).

¹ See https://www.sec.gov/ocie/investor-alerts-and-bulletins/ib_coinofferings.

The CFTC has provided this information as a service to investors. It is neither a legal interpretation nor a statement of CFTC policy. If you have questions concerning the meaning or application of a particular law or rule, consult an attorney.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN
FROM JAY CLAYTON**

Q.1. When I asked you how much of the \$4 billion raised by initial coin offerings (ICOs) last year was raised in the United States, you said that it was unclear and hard to estimate “because this has been conducted largely on an unregulated basis,” but there is enough to make it worth paying attention. Later, when asked why no ICOs were registered with the SEC, you stated that you do not think gatekeepers “have done their job,” even though you have made the law clear. You also explained that you want private placements to happen, but you “want them to do it right,” and ICOs have taken “the disclosure-like benefits of a private placement” but used general solicitation and the promise of secondary trading among retail investors without registering with the SEC.

Based on these responses, you seem to share my concern that ICOs are evading the registration requirements of the securities laws and failing to satisfy private-placement requirements. Accordingly, I have several follow-up questions and requests about the SEC’s efforts to police ICOs:

Please describe the strategy, policies, and procedures that the SEC is using to track and monitor ICOs and secondary trading of “tokens” issued in ICOs.

A.1. I do share your concern that a number of initial coin offering (ICO) participants are evading the registration requirements of the Securities Act of 1933 by failing to either register the token offering or to qualify for an exemption from the registration requirements. With the support of my fellow Commissioners, I have asked the SEC’s Enforcement staff to continue to police these markets vigorously and recommend enforcement actions against those who conduct or facilitate ICOs or engage in other actions relating to digital assets in violation of the Federal securities laws.

Last year, the SEC announced two initiatives to build on the Enforcement Division’s ongoing efforts to address cyber-based threats and protect retail investors. One such effort was to create a Cyber Unit to focus on targeting cyber-related misconduct, including in the insider trading and ICO spaces. The other was to establish a Retail Strategy Task Force to implement initiatives that directly affect retail investors. The Cyber Unit and Retail Strategy Task Force are helping to build upon and leverage the expertise already developed by the cross-divisional Distributed Ledger Technology Working Group, formed in 2013, to address violations of the Federal securities laws.

I want to emphasize that our efforts are not limited to the offerings of coins or tokens. The number of broker-dealers and investment advisers engaged in this space has grown, and we are reviewing their activities as well. The SEC’s National Examination Program announced in its public priorities that it will continue to monitor the sales of ICOs and cryptocurrencies, and where the products are securities, will conduct examinations of investment advisers and broker-dealers to assess regulatory compliance. Areas of focus include, among other things, whether financial professionals maintain adequate controls and safeguards to protect these assets from theft or misappropriation, and whether financial professionals are providing investors with disclosure about the risks

associated with these investments, including the risk of investment losses, liquidity risks, price volatility, and potential fraud.

Through these various functions, the SEC staff surveils publicly available data sources; receives and reviews tips, complaints and referrals, which can be submitted to the SEC via <https://www.sec.gov/whistleblower/submit-a-tip>; and liaises with domestic and international regulatory and law enforcement partners and with members of the public to gather information. The staff also established a dedicated email address at FinTech@sec.gov to centralize communications from the public on FinTech issues to engage with issuers and other market participants about these issues. I have made cross-border awareness of and attention to these issues a priority, including in connection with our participation in the Financial Stability Board (FSB) and International Organization of Securities Commissions (IOSCO).

With respect to secondary trading of tokens, because token trading platforms by and large are not registered as national securities exchanges or operating pursuant to the Regulation ATS exemption, and certain of them appear to operate overseas, the SEC's direct knowledge of the nature and full extent of trading by those platforms has been limited. The SEC's Divisions of Enforcement and Trading and Markets recently issued a joint statement on potentially unlawful online platforms for trading digital assets. The statement emphasizes that investors should use a platform or entity registered with the SEC to get the protections offered by the Federal securities laws and SEC oversight.¹ Notwithstanding the fact that these platforms largely have not registered with us or operated pursuant to an exemption, the SEC staff has continued to monitor publicly available sources; review tips, complaints and referrals, and work with regulatory partners, members of the public, and members of the industry to obtain information on secondary trading as described above. The Commission has brought enforcement actions against online platforms for operating as unregistered national securities exchanges and will continue to do so where appropriate.

Q.2. Please provide statistics on ICOs tracked by the SEC and/or any third-party data obtained and used by the SEC to follow ICOs.

Please provide: the total number of offerings and monetary value, and the exemptions used and/or purported to be used for those ICOs, by number of offerings and monetary value.

A.2. Although a number of public data sources purport to track ICOs, we do not have definitive data on their number or value. In this regard, it is noteworthy that many of the platforms that facilitate trading in digital assets are not regulated and do not provide information that is subject to regulatory review. In addition, much of the information found in public data sources is unaudited.

In addition, while the SEC possesses offering data with respect to registered offerings, data with respect to ICOs purporting to

¹ If those tokens are securities and the platforms on which they trade register as national securities exchanges or operate as alternative trading systems (ATSs), those exchanges and ATSs are required to report information about their operations and trading to the SEC. For example, ATSs file quarterly reports on Form ATS-R to disclose to the SEC their trade volume, the securities traded, and trading participants, which augments the SEC's oversight to monitor the activities of these markets.

qualify for an exemption from registration is more spotty (e.g., with respect to offerings conducted under Regulation D, which requires the provision of only limited data to the Commission and does not require the issuer to designate whether the offering is an ICO), or non-existent (e.g., with respect to offerings relying on statutory exemptions rather than Commission rules).

In connection with the efforts described above, the SEC staff reviews third-party data sources to examine market data for ICOs. Publicly reported numbers from third-party data sources indicate on a worldwide basis more than \$6.2 billion has been raised in 2018; \$3.9 billion in 2017; and \$95 million in 2016.

Q.3. I am concerned that the anonymity afforded by blockchain technology may allow issuers to evade the geographic and accredited-investor restrictions that they claim to impose on ICOs. How is the SEC ensuring that ICOs do not evade these requirements? In answering this question, please address: o How is the SEC ensuring that issuers in ICOs that are restricted to non-U.S. investors do not sell securities to U.S. investors through blockchain or other technology?

How is the SEC ensuring that issuers in ICOs that are restricted to accredited investors do not sell securities to nonaccredited investors through blockchain or other technology?

How is the SEC ensuring that securities issued in unregistered ICOs are not sold to U.S. investors in secondary trading in violation of the securities laws through blockchain or other technology?

A.3. The Federal securities laws provide that all offers and sales of securities to persons within the United States must be registered or qualify for an exemption. These laws apply to protect United States investors regardless where the issuer is located. Just as with any other offer and sale of securities, the SEC will bring enforcement actions where appropriate for violations of the registration provisions of the Federal securities laws.

The Federal securities laws provide certain exemptions from registration for both primary offerings of securities and resales of securities, notably concerning accredited investors. Failure to comply with the conditions for such exemptions can result in violations of the registration provisions of the Federal securities laws. To the extent offering participants are able to qualify for an exemption from registration, our efforts will examine whether the procedures they are following are designed to ensure compliance with an appropriate exemption, and we are aware of issues raised by anonymity and other aspects of ICOs that make compliance with private placement exemptions more difficult on a relative basis. The SEC will continue to review information related to individual ICOs, ask for additional information from issuers and trading platforms, and bring enforcement actions where appropriate for violations of the registration provisions of the Federal securities laws.

The SEC already has brought enforcement actions alleging violations of the registration and anti-fraud provisions of the Federal securities laws. See *SEC v. REcoin Group Foundation, LLC et al.* (E.D.N.Y.) (Sep. 29, 2017); *SEC v. PlexCorps et al.*, 17-cv-7007 (E.D.N.Y.) (Dec. 1, 2017); *SEC v. AriseBank et al.*, 3:28-cv-0186 (N.D. Tex.) (Jan. 25, 2017); see also *In re Munchee, Inc., Admin.*

File No. 3-18304 (Dec. 11, 2017) (settled administrative action alleging registration violations). Additionally, the SEC has brought enforcement actions against virtual currency-denominated platforms operating as unregistered securities exchanges. See SEC v. Jon E. Montroll and Bitfunder, 18-cv-1582 (S.D.N.Y.) (Feb. 21, 2018); *In re BTC Trading, Corp. and Ethan Burnside*, Admin. File No. 3-16307 (Dec. 8, 2014).

This is the same approach—clarifying the application of long-standing law, then prosecuting violations—that the SEC has taken for any offers and sales of securities for many years. The SEC will continue to police these markets vigorously—including through the use of our investigatory tools, such as issuing document requests and administrative subpoenas, conducting witness interviews, and taking sworn testimony—and staff will recommend enforcement actions against those who conduct ICOs or engage in other actions relating to digital assets in violation of the Federal securities laws.

Q.4. What is the SEC doing to ensure that gatekeepers are doing their jobs?

Without commenting on any specific ongoing investigations, has the SEC considered taking enforcement actions against any accountants, securities lawyers, consultants, or other gatekeepers in connection with ICOs?

A.4. Our securities laws are based in substantial part on, and in many ways require, market professionals holding themselves to high standards. In December, I issued a public statement on cryptocurrencies and ICOs directed in part to market professionals. I have since made other public statements that these professionals, especially gatekeepers, need to act responsibly and hold themselves to high standards. I have made it clear that gatekeepers need to focus on their responsibilities, keeping in mind the principal motivation for our registration, offering process and disclosure requirements—to protect retail investors. I’m counting on them to do their jobs.

We have encouraged market professionals to contact our staff for assistance and have set up a dedicated email address, FinTech@sec.gov, for this very purpose. Within the SEC, a group of staff across the agency has been tasked with focusing on these issues and are exploring the best ways to message our expectations to professionals.

SEC staff is examining approaches to ICOs that may be contrary to our securities laws and the professional obligations of the securities bar. In this regard, staff is focusing on professional advisers and other gatekeepers, and, as with other areas of the securities laws, the SEC will consider bringing enforcement actions where appropriate.

Q.5. Do you believe a virtual currency exchange or platform utilized in an ICO could have liability under the securities laws for an illegal unregistered ICO?

A.5. The SEC’s Report of Investigation Pursuant to Section 21(a) of the Securities Act of 1934: The DAO (The DAO Report), issued on July 25, 2017, reminded entities that engage in exchange activity, including with respect to the trading of tokens that meet the definition of “security,” regarding their obligation to register as a

national securities exchange or operate pursuant to an exemption from such registration. More recently, the Divisions of Enforcement and Trading and Markets issued a statement with information for investors and market participants about the applicability of the Federal securities laws to online trading platforms that operate as an “exchange” for securities trading.

As The DAO Report and the statement make clear, a platform can be found to have violated Section 5 of the Exchange Act by effecting trades in a token that is a security without registering as a national securities exchange or operating pursuant to an exemption from such registration. In addition, as The DAO Report addresses, those who participate in an unregistered offer and sale of securities not subject to a valid exemption can be liable for violating the registration provisions of the Federal securities laws. Accordingly, such a platform could also be found to have violated Section 5 of the Exchange Act to the extent it participated in the offer or sale of the token in the ICO itself, including (for example) by soliciting offers to buy the securities for value. The SEC will bring enforcement action against unregistered securities token exchanges as the facts and circumstances warrant.

Q.6. In response to my questions about how the SEC is handling a reported reduction in its enforcement staff headcount by 100, you stated that “personnel” is your “biggest challenge at the moment,” with “a hiring freeze” and attrition having reduced SEC staff headcount. You then said you “could use more people” in the Divisions of Enforcement and Trading and Markets, adding that “[t]hose are the two areas where I think the American people would get the greatest return for additional bodies.”

Please explain the hiring freeze, i.e., how and when it was authorized, when it was implemented, staffing levels at the time of implementation, and when or under what conditions you expect it to be lifted.

A.6. In late Fiscal Year (FY) 2016, the SEC implemented a general freeze on external hiring, with limited exceptions. As a result, the filling of 365 total positions was suspended. Limited backfills of vacancies have been allowed for specific needs. Recently, I submitted the SEC’s budget request for FY 2019 seeking \$1.658 billion in support of 4,628 positions. The funds will allow us to restore 100 positions, approximately one-quarter of the total reduction resulting from the hiring freeze, to address critical priority areas and enhance the agency’s expertise in key areas. These key areas include cybersecurity and risk management, protecting Main Street investors, facilitating capital formation, and effective oversight of our capital markets. I expect that a significant number of these positions would be in or related to our Trading and Markets and Enforcement Divisions.

Q.7. As noted in Question 2, you stated the SEC is under a “hiring freeze”. The day following the hearing, The Wall Street Journal reported that former Representative Scott Garrett plans to take a position as your advisor at the SEC. Is this report accurate? Assuming it is:

What is, or will be, Mr. Garrett’s role at the SEC? Please explain if this is a new role. Specifically, please state (i) his title; (ii) the

division where he works or will work; (iii) his responsibilities; (iv) who he reports to (and, if applicable, who that individual reports to), and (v) who, or how many staff, he supervises or will supervise, if any.

Has Mr. Garrett started work at the SEC yet? If not, when will Mr. Garrett start work at the SEC?

Why does the hiring freeze not appear to apply to Mr. Garrett?

Did you consider any other individuals for Mr. Garrett's role? If so, what were these other individuals' backgrounds and qualifications?

A.7. Mr. Garrett began working at the SEC on March 5, 2018, as a senior advisor to the General Counsel in the Office of the General Counsel. He is not acting as my advisor. Mr. Garrett has an important, specialized, and narrowly tailored role. He will be working primarily on projects involving other Federal financial regulators that oversee our capital markets (e.g., the CFTC, Federal Reserve, and the Treasury Department). Information sharing, and in particular, sharing information regarding market operations, is important to the SEC. Mr. Garrett will focus on matters where we need to seek greater information sharing and regulatory cooperation. As a former member of Congress with many years of experience interacting with and overseeing Federal financial regulatory agencies, Mr. Garrett is well positioned to help ensure that appropriate protocols are in place to foster information sharing and regulatory coordination that improve our ability to oversee the capital markets and its participants.

Our current plan for FY2018 allows for limited external hiring, including the position Mr. Garrett occupies. This hiring action is consistent with our prioritization of hiring professionals to assist the agency in fulfilling its mission generally and the specific needs discussed above. The agency hired Mr. Garrett as an attorney, an "excepted-service" position, which means that the position was excepted from competitive hiring procedures.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SASSE
FROM JAY CLAYTON**

Q.1. We've heard a lot about the potential for fraud with ICOs.

What are the potential benefits of ICOs? For example, do ICOs have the potential to expand access to capital for small businesses?

A.1. If done in conformance with our securities laws, ICOs may allow small businesses to raise capital in an efficient and cost-effective manner. At the same time, these ICOs could provide investors with additional investment opportunities. Importantly, though, when offering these investment opportunities to investors in the form of an ICO, issuers must be sure to comply with our securities laws, including with respect to providing adequate disclosures to investors about the risks of the investment and how the money raised will be used. We should embrace the pursuit of technological advancement, as well as new and innovative techniques for capital raising, but not at the expense of the principles undermining our well-founded and proven approach to protecting investors and markets.

Q.2. According to your testimony, ICOs raised nearly \$4 billion in 2017. While the SEC has filed enforcement actions that argue that certain ICOs should have been registered with the SEC, your testimony states that no ICOs have yet to be registered with the SEC.

Why have no ICOs been registered with the SEC?

Is one possible explanation for the lack of ICO registrations that the registration requirements are too stringent and not adapted to the unique nature of an ICO?

A.2. I am not aware of unique features of ICOs that would prevent and further complicate compliance, as opposed to other types of securities offerings, with the Federal securities laws. The SEC has assisted numerous issuers in registering novel and unusual products over the years, utilizing a principles-based framework that has served American companies and American investors well through periods of innovation and change.

While I will not speculate as to why no issuer to date has chosen to conduct an ICO as a registered offering, we have received inquiries about registering ICOs with the SEC and will continue to work with parties that seek to do so. The staff has held itself out as ready and willing to engage with would-be issuers and other market participants who would like to conduct offerings in compliance with the Federal securities laws but may need compliance assistance or exemptive, no-action, or other forms of regulatory relief in order to comply with our rules and regulations that may have been written with a more traditional offering in mind. Unfortunately, too few have sought to take us up on that offer.

Q.3. What guidance has the SEC provided to companies as to whether their ICO should be registered with the SEC?

Does the SEC intend to provide more guidance as to when ICOs should be registered with the SEC? For example, beyond enforcement actions, the SEC could issue no action letters, put out a concept release or proposed rule, or otherwise provide further written guidance as to what constitutes a security.

How—if at all—has the SEC tried to work with companies that want to register their ICOs with the SEC?

A.3. The SEC and its staff have issued a number of statements, investor alerts and bulletins, and press releases.² The Commission also issued The DAO 21Report and has brought a number of enforcement actions consistent with the requirements of the Federal securities laws. We have made clear that, for decades, we have applied a flexible, principles-based analysis to determine whether an instrument is a security. This analysis has served our markets and our investors well for many years as investment opportunities and market structures have changed. In short, where purchasers make an investment of money with an expectation of profits derived from the entrepreneurial and managerial efforts of others, there is an investment contract and therefore a security. The focus is not on form, but on the economic realities of the transaction and relationship.

Again, we have been clear on this issue. We have applied our securities law framework to a number of different ICOs and shown

²See testimony appendix

each time that the ICO was a security. I worry that many have sought to make this analysis more complicated than it really is, in the hopes of coming to a conclusion that the securities laws should not apply and, as a result, they are free to seek investments from the general public without regard to disclosure and procedural rules that have served our markets so well.

That said, to the extent additional guidance in this area would be appropriate or helpful, we will continue to be open to providing it. We also stand ready to engage with issuers seeking to register ICOs or to discuss potential ICO structures. We have established a FinTech@sec.gov email address dedicated to FinTech-specific inquiries. I have encouraged market participants, including issuers and their advisers, to engage with the SEC staff to aid in their analysis under the Federal securities laws. Through the FinTech@sec.gov email address, and in-person meetings, the SEC staff regularly communicates with dozens of individuals and practitioners regarding the Federal securities laws and regulations thereunder, and to date, the staff has had numerous potential issuers seeking guidance on how to register or qualify an ICO.

Q.4. Does the SEC intend to evaluate whether all of the registration requirements for a securities offering should also apply to registering an ICO?

A.4. The SEC staff has substantial experience in assisting issuers in registering novel and unusual products, making appropriate accommodations to adapt to particular circumstances of each offering. While I am not aware of unique features of ICOs that would prevent and further complicate compliance with the Federal securities laws, SEC staff stand ready to engage with interested issuers and market participants on issues related to securities offerings involving ICOs and other cryptocurrency-related products.

Q.5. Are you concerned about the potential for bitcoin and other cryptocurrencies to facilitate money laundering by criminals such as human traffickers, gangs like MS-13, or terrorists like Hezbollah?

What—if any—role does your agency have in addressing this problem, including through cooperation with other agencies?

A.5. Several characteristics of cryptocurrencies can facilitate efforts to evade our money-laundering laws and regulations and, as a result, facilitate criminal and other illicit activity. For example:

- *Anonymity/Tracing money.* Many of the cryptocurrencies are specifically designed to be pseudonymous or truly anonymous. Attribution of a specific private key to an individual or entity could be difficult or impossible, especially where tools such as digital tumblers and mixers are used to make tracing and attribution difficult. Traditional financial institutions (such as banks) often are not involved with cryptocurrency transactions, again making it more difficult to follow the flow of money.
- *International scope.* Cryptocurrency transactions and users span the globe. Although the SEC has methods for obtaining information from abroad (including through cross-border agreements), there may be restrictions on how the SEC can use the information, and it may take more time to get the information

than in the case of domestic activity. In many cases, the SEC may be unable to obtain relevant information located overseas.

- *No central authority.* As there is no central authority that collects cryptocurrency user information, the SEC generally must rely on other sources, such as cryptocurrency exchanges or users, for this type of information.
- *Seizing or freezing cryptocurrency.* Law enforcement officials may have difficulty seizing or freezing illicit proceeds held in cryptocurrencies. Cryptocurrency wallets may be encrypted and, unlike money held in a bank or brokerage account, cryptocurrencies may not be held by a third-party custodian.
- *New technologies.* Cryptocurrencies involve new and developing technologies, ever evolving.

The SEC staff collaborates regularly with other agencies (Federal, State, and international) on matters of mutual interest and has frequent communications with other financial regulators. In particular, the SEC's Division of Enforcement has long-standing and on-going cooperation efforts with a number of Federal law enforcement and regulatory partners, such as the DOJ, FBI, IRS, and CFTC, to name a few, in addition to State and international regulators. In matters of mutual interest, SEC Enforcement staff will collaborate as appropriate with these partners through, among other ways, information sharing arrangements, access grants, and memoranda of understanding. In addition, SEC staff participates in forums organized within the law enforcement and regulatory communities.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED
FROM JAY CLAYTON**

Q.1. On January 26th, Bloomberg reported that the SEC is considering breaking with its prior position, and permitting issuers to slip forced arbitration clauses into initial public offerings, which would bar investors from suing issuers for wrongdoing, such as fraud. During your testimony, you said that you “cannot prejudge an issue that may come before the SEC,” but added that you are “not anxious to see a change in this area.”

Isn't it the case that the SEC has previously opposed barring investors in initial public offerings from pursuing legal remedies against issuers for offenses like fraud? If so, what—if anything—has changed?

Does your comment during your testimony that you are “not anxious to see a change” in this area reflect your belief that investors should not be barred from suing issuers for fraud and other securities violations?

A.1. This matter is complex. It involves our securities laws, matters of other Federal and State law, an array of market participants and activities, as well as matters of U.S. jurisdiction. It also involves many public policy considerations. Further, this issue has come before the Commission in a variety of ways and contexts and may do so in the future. Views of market participants on this issue, particularly in the case of an initial public offering (IPO) of a U.S. company, are deeply held and, in many cases, divergent. In re-

sponse to the recent heightened interest from Congress and others relating to the inclusion of mandatory arbitration provisions in the charters or bylaws of U.S. companies contemplating an IPO, I have (1) made several statements¹ and (2) more recently, asked the Division of Corporation Finance (the Division) to review how this issue has arisen in the past, and may arise in the future, in connection with filings made by companies with the Division.

A summary provided by the Division of its prior approach to this issue, as well as how the Division would expect to proceed if the issue were presented in the context of an IPO of a U.S. company, is below. The summary reflects the Division's view that should a U.S. company pursue a registered IPO with a mandatory arbitration clause in its governing documents, the decision about whether to declare the filing effective should be made by the Commission, not the Division by delegated authority. I agree with the Division's view on process and, in particular, that this would be a decision for the Commission. Although I have made several prior statements on this issue, for reasons of clarity and completeness, I summarize my perspective on the issue below.

As a threshold matter, and recognizing the complexity and importance of this issue, I reiterate my personal view that any analysis of this issue or decision making by the Commission in the context of a registered IPO by a U.S. public company should be conducted in a measured and deliberative manner.

The Federal securities laws provide a basis for private rights of action by investors in the event of material misstatements as part of securities offerings. There is a long history of claims of this type being brought against U.S. publicly traded companies in our Federal and State courts, including as class actions. The Division's summary notes that, in the case of foreign private issuers that have conducted registered offerings in the United States and U.S. companies that are not listed, direct and indirect limitations on such actions have been prevalent for many years. In addition, and beginning several years prior to my arrival at the Commission, certain U.S. companies conducting exempt Regulation A offerings have included mandatory arbitration clauses in their governing documents or subscription agreements. The Division's summary discusses these and other matters in more detail.

It is my view that if we are presented with this issue in the context of a registered IPO of a U.S. company, I would expect that any decision would involve Commission action (and not be made through delegated authority) and that the Commission would give the issue full consideration in a measured and deliberative manner. Such a review would take into account various considerations, including developments in applicable law and any other relevant considerations. Since this hearing, I have reiterated these views and sought to appropriately frame this issue and my preference for such a process in my public statements.

These statements have not only addressed my perspective on the appropriate procedure for analyzing this matter but also its relative priority. With respect to priority, generally speaking, my view

¹See, e.g., Remarks before the SEC Investor Advisory Committee (March 8, 2018), available at <https://www.sec.gov/news/public-statement/statement-clayton-2018-3-8>.

is that the Commission should allocate its limited rulemaking and other related resources to a portfolio of matters that (1) present currently pressing and significant issues for investors and our markets, (2) are central to our mission, (3) are ripe for consideration, and/or (4) are addressable through a reasonable share of Commission and staff time. To me, such matters currently include, among others and in no particular order, (1) standards of conduct for investment professionals, (2) Congressionally-mandated rulemaking, (3) the regulation of investment products, including ETFs, (4) the impact of distributed ledger technology (including cryptocurrencies and ICOs), (5) FinTech developments, (6) the elimination of burdensome regulations that do not enhance investor protection or market integrity with an eye toward facilitating capital formation, (7) an examination of equity and fixed income market structure, and (8) of course, inevitable issues that we have not yet identified but will emerge as pressing.

These statements have made it clear that I have not formed a definitive view on whether or not mandatory arbitration for shareholder disputes is appropriate in the context of an IPO for a U.S. company. I believe any decision would be facts and circumstances dependent and could inevitably divert a disproportionate share of the Commission's resources from the priorities I noted above. In short, this issue is not a priority for me. Although the issue is not a priority for me, it does not mean that it is not worthwhile to analyze, and I have encouraged those with strong views to support their position with robust, legal and data driven analysis. If this matter does come before the Commission, such analysis will assist the Commission in its deliberative process.

Summary Provided by the Division of Corporation of Finance

The Division of Corporation Finance (the Division) oversees periodic filings by reporting companies and filings of issuers seeking to raise money in the capital markets through, for example, initial public offerings. The Federal securities laws generally focus on requiring companies to provide full and fair disclosure of material information to investors and the Division's oversight of filings is intended to facilitate compliance with those laws.

State laws generally provide the parameters for companies to establish their corporate governance through their organizational documents, such as their charter or bylaws. The Commission does not have rules permitting or prohibiting companies from using arbitration provisions.

The Commission's processes with respect to arbitration provisions have been and may in the future be implicated through the Division's role in overseeing and processing filings by companies. The most often identified channel for this issue to arise is if a U.S. company sought to include a mandatory arbitration provision in its governing documents when it filed an initial registration statement to offer and sell securities publicly. Following is an overview of circumstances in which mandatory arbitration provisions have been and could be present in the governance documents of companies that make filings with the Commission.

Registered Offerings by U.S. Companies

A company may not sell securities in the United States unless (1) it has an effective registration statement on file with the SEC or (2) an exemption from registration is available. Section 8(a) of the Securities Act of 1933 (Securities Act) provides that a registration statement will become effective 20 days after it is filed and authorizes the Commission to accelerate the effective date of a registration statement after taking into account the adequacy of the disclosure and certain other considerations.² This authority to accelerate the effective date has been delegated to the Division by the Commission. By statute, registration statements become effective with the passage of time. As a matter of practice, a company will nearly always include in any pre-effective registration statement a legend, referred to as a “delaying amendment,” in order to prevent the registration statement from becoming effective automatically following the passage of time and to better control the timing of its offering. During this time, the Division staff may review the filing. In the course of a filing review, Division staff will evaluate the company’s disclosure and may issue comments to elicit better compliance with disclosure requirements, and the company will amend its registration statement to address the comments as appropriate. Following this review and comment process, the company submits a request to accelerate the effective date of the registration statement.

When this issue last arose in the context of an initial public offering (IPO) of a U.S. company in 2012, the Division took the position, based on a consideration of relevant Federal laws and case law, that it would not use its delegated authority to accelerate the effective date of a U.S. company’s registration statement when the company’s governing documents contained a mandatory arbitration provision covering disputes arising under Federal securities laws. In that context, the Division was unable to conclude that such provisions are consistent with “the public interest and protection of investors” as required by Securities Act Section 8(a) in light of, among other things, the anti-waiver provision in Section 14 of that Act.³ More specifically, at that time, the Division advised a company that it did not anticipate exercising its delegated authority to accelerate the effective date of the registration statement if such a provision was included in the company’s governing documents and that the Commission would need to make any decision on a request for acceleration. In that situation, the company decided not to include the mandatory arbitration provisions in its governing documents in connection with its IPO.

If this issue were to come before the Division in a U.S. company’s registration statement for an IPO today, as discussed in more detail below, the Division would not use its delegated authority to ac-

²In its entirety, Section 8(a) states that “The effective date of a registration statement shall be the twentieth day after the filing thereof or such earlier date as the Commission may determine, having due regard to the adequacy of the information respecting the issuer theretofore available to the public, to the facility with which the nature of the securities to be registered, their relationship to the capital structure of the issuer and the rights of holders thereof can be understood, and to the public interest and the protection of investors [emphasis added].”

³Section 14 states that “Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations of the Commission shall be void.”

celerate the effective date of the registration statement. Instead, the Division would refer a request for acceleration to the full Commission.

The historical treatment of this issue in other circumstances, such as in the qualification of Regulation A offerings and in the processing of registration statements filed by foreign private issuers, is described below.

Other Circumstances

For many years, U.S. and non-U.S. companies have made other types of filings with the Commission that have included mandatory arbitration provisions for shareholder disputes in their governing or offering documents. These circumstances and the relevant considerations are described further below. In these circumstances, the relevant statutes and rules generally require appropriate disclosure regarding material risks to the issuer or of the offering, which would include risks relating to mandatory arbitration provisions and any impact on holders of the offered securities.

Regulation A: Some companies utilizing the exemption from registration available under Regulation A have included mandatory arbitration clauses in their governing documents or subscription agreements. Under Regulation A, a company may not sell its securities until the Division has qualified its offering statement. In these exempt offerings, neither the Federal securities laws nor the Commission's rules require the Division to make the same public interest determination as is required when accelerating the effective date of a registration statement in the context of an IPO.

In 2015, after reviewing the relevant law and regulations, the Commission staff concluded that there would not be grounds to withhold qualification of a Regulation A offering on the basis that the issuer had included a mandatory arbitration provision in its governing documents. Since then, in light of the Commission staff's 2015 determination, certain offerings that have included a mandatory arbitration clause have been qualified under Regulation A, provided that the material risks of such a dispute resolution approach had been disclosed and the issuer otherwise qualified for the exemption.

Foreign Private Issuers: For many years, a number of foreign companies with securities listed or traded in the United States have included mandatory arbitration and other analogous provisions in their filings. Registration statements of foreign private issuers offering and selling securities in the United States also generally include disclosures regarding limitations investors may face as a result of the issuer's foreign status and home country laws and regulations. These disclosures have typically included a risk factor informing investors that due to jurisdictional issues it may be difficult for them to obtain or enforce judgments or bring original actions, including actions styled as class actions, against the company. In these instances and in situations where mandatory arbitration has been required, either due to local law requirements or otherwise, the Division staff has focused on the disclosure of the material risks related to these limitations and has declared these filings effective.

Exchange Act Reporting Companies: There are several other ways a company could be in the Securities Exchange Act of 1934 (Exchange Act) reporting regime and have a mandatory arbitration provision in its governing documents. For example, a registration statement for a class of securities pursuant to Exchange Act Section 12(g) becomes effective automatically 60 days after filing. As another example, a public reporting company could amend its by-laws or seek shareholder approval of a charter amendment or to include an arbitration provision (assuming that the applicable State law allows for the enforceability of such a provision).⁴ In any of these situations, the Commission's rules would require appropriate disclosures to investors.

Considerations

Mandatory arbitration clauses involve complexities beyond the Commission and its rules. For example, they raise issues under the State corporate laws under which the issuers are organized. In addition, Federal case law regarding mandatory arbitration continues to evolve. Since 2012, when this issue was last presented to the Division in the context of an IPO of a U.S. company, the Supreme Court has affirmed the strong Federal interest in promoting the arbitration of claims under Federal laws.⁵ Over the last several years, commentators have observed that there is uncertainty as to whether the Commission would have a basis to deny an acceleration request in these circumstances.⁶ If a U.S. company were to file for an IPO with governing documents that included a mandatory arbitration provision, the Commission would need to evaluate the specific facts and circumstances in the context of not just the Federal securities laws but also State corporate and other Federal law. This is a complex legal and policy issue that requires careful consideration. As such, and as discussed above, if the issue were presented to the Division in the context of an IPO for a U.S. company, the Division would decline to exercise its delegated authority to accelerate the effective date of a registration statement and instead refer the matter to the Commission for its consideration.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SCHATZ FROM JAY CLAYTON

Q.1. During your testimony you mentioned that initial coin offerings (ICO) seem to be security offerings, which would bring under the jurisdiction of your agency to regulate. One major concern that members of the committee, financial experts, and investors all share is that ICOs may actually be Ponzi schemes.

How can investors discern between legitimate ICOs with legitimate value and those that are fraudulent schemes?

⁴See Claudia H. Allen, "Bylaws Mandating Arbitration of Stockholder Disputes", 39 *Del. J. of Corp. Law* 751, 779-782 (2015) (discusses circumstances where arbitration clauses included in public issuers' filings) (Allen).

⁵See, e.g., *American Express Co. v. Italian Colors Restaurant*, 133 S. Ct. 2304 (2013) (holding that, under the Federal Arbitration Act (FAA), courts must "rigorously enforce" arbitration agreements according to their terms unless the FAA's mandate has been "overridden by a contrary congressional command").

⁶See, e.g., Allen at 778 (fn 141).

A.1. Your question goes to the heart of the Federal securities laws—ensuring that investors, especially retail investors, have adequate information to make informed investment decisions. I believe that it is difficult for investors to make determinations whether an investment opportunity is at risk of being a Ponzi scheme or another scheme in the absence of disclosures of material information by ICO issuers. While many ICOs issue a “White Paper” in conjunction with the offering, many of these White Papers are, in essence, outlines of an idea, and none that I have seen provide the scope and depth of information one would find in a statutory prospectus. Many provide nothing comparable in the way of disclosure. In the absence of this critical information, I do not know how an average investor would be able to discern with a reasonable degree of confidence whether the ICO is “legitimate” or whether there is significant risk that it is a fraudulent scheme. As part of my December statement on cryptocurrencies and ICOs, I cautioned investors to ask clear questions and demand answers from ICO issuers and promoters.

In addition to publicized enforcement actions, the SEC and its staff have issued a number of statements, investor alerts, and bulletins targeted to retail investors. Investors can access much of this information by visiting the www.investor.gov website “Spotlight on Initial Coin Offerings and Digital Assets.”

Q.2. Do you need new statutory authority to regulate ICOs (and other areas of cryptocurrencies) or do you believe already-existing authorities sufficiently address this new area?

If new statutory authority is required, what should the authority aim to achieve?

A.2. The registration and disclosure requirements of the Federal securities laws provide flexibility in describing the terms of the securities, as well as the particular businesses that may be issuing these securities. Over the past 84 years, the SEC and its staff have worked with companies issuing novel types of securities and have used a principles-based approach to assure appropriate disclosure is made to investors, and this approach has worked well. In addition, the Federal securities laws have anti-fraud and other remedial provisions that are principles-based, broad, and flexible and that are aimed at protecting investors from fraud, including fraud arising from securities offerings, actions of intermediaries, and market manipulation. These provisions provide the SEC with important tools that can be applied to securities activities involving novel technologies—regardless of how those technologies are used. I believe offerings of digital assets that are securities should be treated and evaluated no differently. Nevertheless, the staff will continue monitoring developments in this area and consider the need for additional authorities.

As Chairman Giancarlo and I testified, we are open to exploring with Congress, as well as with our Federal and State colleagues, whether increased Federal regulation of cryptocurrency trading platforms—or spot markets—is necessary or appropriate. We also are supportive of regulatory and policy efforts to bring clarity and fairness to this space and are conferring with our colleagues at the U.S. Department of the Treasury and the Federal Reserve Board

with respect to any potential legislative suggestions. To the extent that new issues arise in our markets that the SEC is unable to address, we will alert Congress to gaps in authority and request additional authority where necessary.

Q.3. In *SEC v. W.J. Howey Co.*, the Supreme Court created the “Howey Test” which has since been the test for determining whether a financial transaction is a security or not. However, cryptocurrencies are not squarely compatible with the test that was designed to address more traditional instruments and contracts.

Does Howey apply to cryptocurrencies?

More specifically, is the “efforts of others” requirement met?

Who should arbitrate whether a particular cryptocurrency should be considered an investment contract, commodity, or some other financial instrument?

Do you believe that responsibility should belong to a specific Federal agency or should it be made in an interagency forum, such as the Financial Stability Oversight Council?

A.3. Determining whether a transaction involves a security does not turn on labelling—such as the characterization of something as a “cryptocurrency.” Whether a token or a digital asset called a cryptocurrency is a security is determined by applying long-established law to the facts and circumstances of the particular instrument being sold. As you noted, under Supreme Court case law in *SEC v. W.J. Howey* and its progeny, where purchasers make an investment of money with an expectation of profits derived from the entrepreneurial and managerial efforts of others, there is a security. Determining whether the Howey test results in an investment being a security requires an assessment of the facts and circumstances of each case, including the economic realities underlying a transaction. Such analysis looks to the substance of the transaction, not merely its form or other naming conventions.

As is the case with any “investment contract” analysis, securities counsel assisting its client may exercise judgment in making an initial determination. The SEC staff may confer with counsel to express different views and explain its basis. If these differences remain unresolved and the company offers the instrument, the SEC may authorize an enforcement action on the basis that the instrument is a security. If litigated, a court would make the ultimate determination.

As is the case with any instrument being offered or sold, the SEC is the agency appropriately charged with determining whether a particular instrument is an “investment contract,” and, thus, a security. This principles-based framework has served American companies and investors well throughout periods of innovation and change for 84 years. Such determinations have been made without recourse to an interagency forum. The SEC staff does confer, and will continue to confer, with other agencies as appropriate to discuss particular products that may raise issues under different regulatory regimes.

With respect to the “managerial efforts of others” prong of the Howey test, the DAO Report noted that the central issue turned on “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.”¹ In the case of The DAO, its investors “relied on the managerial and entrepreneurial efforts of Slock.it and its co-founders, and The DAO’s Curators, to manage The DAO and put forth project proposals that could generate profits for The DAO’s investors.” The DAO Report further noted that The DAO’s investors’ expectations of future profits were primed by market efforts of The DAO and its co-founders. Whether any other particular token or cryptocurrency met this test would be a facts-and-circumstances analysis, utilizing the principles-based framework.

With respect to a “true” cryptocurrency, it may well be that the Howey test leads to the conclusion that the cryptocurrency is not a security and the cryptocurrency is a commodity. Again, however, such a determination would need to be made on an individual basis based on the facts and circumstances, without regard to what the product is named.

Q.4. The concept of banks is familiar to the average American. Banks comply with extensive regulations to ensure safety and protect consumer confidence and are insured by the Federal Deposit Insurance Corporation (FDIC). Cryptocurrency investments are quite different. But many retail investors do not seem to appreciate how different cryptocurrencies are from real currencies. For example, there is no FDIC-like protection for investments in cryptocurrency.

Should cryptocurrency wallets and exchanges be subject to similar rules aimed at protecting consumer funds under their control?

A.4. I agree with the premise in your question that banks are subject to regulations designed to ensure their safety and soundness and bank cash deposits are insured by the FDIC. In the securities industry, customers receive protection for cash and securities held at broker-dealers under the SEC’s customer protection rule, which requires broker-dealers to hold customer fully paid and excess margin securities in possession or control and free of lien and to segregate the net amount of cash owed to customers. These provisions, along with the SEC’s net capital rule applicable to broker-dealers, are designed to facilitate the prompt return of securities and cash to customers if the broker-dealer fails financially.

Moreover, if the failed broker-dealer cannot promptly return these assets, there is a special bankruptcy regime to protect customers. Specifically, the Securities Investor Protection Act (SIPA) gives the customers a priority claim over other creditors to customer securities and cash held by the failed broker-dealer. In addition, if the amount of customer securities and cash held by the failed firm is insufficient to make each customer whole, SIPA provides up to \$500,000 per customer (of which \$250,000 can be used for cash claims) to make up any shortfalls.

In a recent statement from the Divisions of Enforcement and Trading and Markets, SEC staff noted that there may be online trading platforms—such as digital wallet services—that, while not exchanges, directly or indirectly offer trading or other services to investors in ICOs and cryptocurrencies. To the extent these services involve securities, this would trigger certain requirements

¹SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973).

under the Federal securities laws, including registration as a broker-dealer, transfer agent, or clearing agency, among others, and the customer protections that go along with that registration.

With respect to cryptocurrencies that are not securities, the question of whether wallets and exchanges should be subject to a regime that provides for consumer insurance and supervisory oversight is part of the broader questions of whether a separate regulatory regime is necessary or appropriate for those cryptocurrencies. We are discussing this question with our fellow regulators and expect to consult with the Committee on any recommendations.

With these matters as context, I generally agree with your assessment that investors in cryptocurrencies and ICOs are not receiving the protections that are comparable to bank deposits and brokerage accounts.

Q.5. Do you think consumers fully understand the level of inherent risk associated with investing in cryptocurrencies?

A.5. I have significant concerns that Main Street investors have not been given clear disclosures that would provide a basis for understanding the material facts and risks involved when it comes to ICOs and cryptocurrencies. Worse, I have seen examples where it appears promoters are intentionally confusing ICOs with SEC-registered IPOs. Unfortunately, I believe it is clear that some have taken advantage of this lack of understanding. In response, I have urged investors, particularly retail investors, to ask questions and demand clear answers from issuers and promoters of cryptocurrencies and ICOs. The SEC staff also has taken a number of steps to alert investors to this very point and arm investors with information on these assets. For example, the SEC staff has issued a number of investor alerts, statements, and warnings. So, too, have SROs, State securities regulators, and other Federal, State, local, and international regulators. The www.investor.gov website “Spotlight on Initial Coin Offerings and Digital Assets,” lists a series of statements, investor alerts and bulletins, announcements of enforcement actions, and further provides contact information. It is important for investors to be informed about critical questions related to these products and for them to understand the risks involved.

Q.6. Currently, States play a major role in regulating cryptocurrencies. The result has been a wide range of approaches with a patchwork of regulatory schemes that can prove difficult to navigate. Should a formal interagency committee be created to aid financial regulatory agencies create coordinated regulation and oversight of new financial products, services, and platforms associated with cryptocurrencies?

What role should States play in regulating cryptocurrencies?

A.6. Federal and State regulators play an important role in protecting Main Street investors against fraudulent and illegal activities. Coordination among Federal and State regulators concerning the introduction of new types of financial products occurs through a number of long-established channels. The SEC staff has worked with a number of agencies over the years to discuss products that may raise issues under different regulatory regimes, and currently

we are participating in the FSOC subcommittee formed at the direction of the Secretary of the Treasury to coordinate the regulatory approach to issues regarding cryptocurrencies, ICOs, and other digital assets.

To the extent a digital asset operates as a “true” currency, trading in such instruments does not fall under the SEC’s jurisdiction. Currency trading—such as trading in euros, dollars, or yen—implicates regulation by FinCEN and State laws regarding money transfers, among others. Traditional money-transmission services that operate in the United States are primarily State-regulated and many of the internet-based cryptocurrency trading platforms have registered as payment services that are not subject to direct oversight by the SEC or the CFTC. To the extent these financial instruments take on other characteristics or are used in particular markets, they may be subject to regulation by the SEC and/or CFTC. The SEC has been collaborating with the CFTC on our approaches to policing these markets for fraud and abuse and will continue to work closely with our Federal and State counterparts, including the Department of Treasury, Department of Justice, and State attorneys general and securities regulators to ensure appropriate oversight consistent with our respective statutory missions.

Should additional legislative, regulatory, or other policy efforts be necessary to address these issues, I stand ready to work with Congress and our regulatory counterparts.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN
FROM J. CHRISTOPHER GIANCARLO**

Q.1. On January 18, 2018, the Director of the SEC’s Division of Investment Management wrote a letter to industry raising concerns about potential “fraud and manipulation” that could impact prices in both cryptocurrency markets and the derivatives markets linked to them. As a result of these and other concerns, the Director wrote: “Until the questions identified above can be addressed satisfactorily, we do not believe that it is appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products.”

This letter follows the SEC’s previous denial of an application to list Bitcoin exchange-traded funds in March 2017 and reports that the SEC told other exchanges to withdraw their applications. One former SEC lawyer characterized the SEC’s first application denial as “essentially saying that until significant Bitcoin markets are regulated, the listing exchange really can’t address concerns about the potential for manipulative trading,” leading some observers to believe that the SEC would change its position after the launch of the CME and Cboe Bitcoin futures exchanges. However, between the Investment Management letter and the SEC’s requests for certain exchange applicants to withdraw their applications, it appears that there are still serious concerns at the SEC about the potential for fraud and manipulation in cryptocurrency and related futures markets, even after the launch of the CME and Cboe exchanges.

I have several questions related to these developments:

Do you believe that the SEC’s concerns about the risks of fraud and manipulation in the cryptocurrencies and related futures mar-

kets are accurate? Do you believe that the SEC is being too conservative waiting until its concerns are resolved before approving new products?

A.1. There are different statutory provisions and regulatory standards for how products under the SEC's or CFTC's jurisdiction are listed to trade. With respect to the SEC, commodity-trust exchange traded products, (ETP) (e.g., the Winklevoss Bitcoin ETP submitted in 2017) are exchange rule changes. The SEC must determine whether the proposed rule change is consistent with the statutory provisions, and the rules and regulations that apply to national securities exchanges. The SEC must approve the filing if it finds that the proposed rule change is consistent with these legal requirements and it must disapprove the filing if it does not make such a finding. The proposed rule change is published in the *Federal Register* and subject to notice and comment. Under the Commodity Exchange Act (CEA) and Commission regulations, futures exchanges can self-certify new futures contracts on 24-hour notice prior to trading. There are limited grounds for the CFTC to "stay" self-certification such as filing a false statement in the certification. It is clear that Congress and prior Commissions deliberately designed the CFTC's product self-certification framework to give futures exchanges the ability to quickly bring new products to the marketplace.

Q.2. If you believe that the SEC is being too conservative, or its markets and products are sufficiently different from the CFTC's, please explain how the risks in your markets are different from the risks that led the SEC to identity fraud and manipulation concerns in the cryptocurrencies and related derivatives markets.

A.2. The functional role of futures and securities are also fundamentally different. Futures are risk management instruments, typically very short term in nature (hence weekly and quarterly expirations) and designed to help firms manage risk exposures, while ETPs are investment products, held by retail investors for long periods—for example, an ETP can be held as part of a retail investor's retirement investment in an IRA account. The regulatory approach to these two sets of instruments reflects these economic and functional differences.

Q.3. Additionally, are there specific risks or events that would cause you to reconsider the markets underlying the Bitcoin futures and other derivatives?

A.3. The CFTC's approach to Bitcoin futures was a balanced approach that took into account promoting responsible innovation and development that is consistent with its statutory mission.

The information access and risk management protocols established for the Bitcoin futures contracts reflects an appropriate and thoughtful balance of flexibility provided in the statute to the exchanges to self-certify new futures contracts, and for CFTC to monitor that these contracts continue to be in compliance with the CEA's core principles.

Q.4. Your written testimony mentioned that CME's and Cboe's Bitcoin futures exchanges have information-sharing agreements with the Bitcoin exchanges they rely on.

Could you please submit a model or sample information-sharing agreement for the record? This would help the Committee and others in Congress understand the unique risks in these markets, how oversight is being conducted, and whether additional legislation related to virtual currencies is necessary.

A.4. One purpose of the Commodity Exchange Act is to serve the public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information. The CEA sets forth a series of Core Principles applicable to a board of trade designated by the Commission as a contract market. Those core principles, also adopted by the Commission in Part 38 of its Regulations, contain requirements that (core principle 3) the board of trade list contracts that are not readily susceptible to manipulation and that (core principle 4) the board of trade “shall have the capacity and responsibility to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process through market surveillance, . . . including (A) methods for conducting real-time monitoring of trading.”

Designated contract markets that list futures contracts that are cash settled must also have, in accordance with Commission Regulation 38.253, “rules or agreements that allow the designated contract market access to information on the activities of its traders in the reference market.” The Commission has also published guidance and acceptable practices for contract markets to comply with these referenced core principles on an ongoing basis. In particular, the Commission’s guidance for cash settled contracts provides that “at a minimum, an acceptable program of monitoring cash-settled contracts must include access, either directly or through an information-sharing agreement, to traders’ positions and transactions in the reference market for traders of a significant size in the designated contract market near the settlement of the contract.” See Part 38, Appendix B, Core Principle 4, Section (b)(3) (Cash-settled contracts).

The Cboe Futures Exchange (CFE) has entered into an information sharing agreement with the Gemini auction platform concerning the Cboe’s listed Bitcoin contracts. The information sharing agreement is described starting in the last paragraph of page 5 of the CFE certification filing, continuing on to page 6, which is linked here: <http://www.cftc.gov/filings/ptc/ptc120117/cfedcm001.pdf>.

Specifically, the certification states that “the Amendment modifies [CFE] Rule 216 to make clear that CFE may enter into information sharing agreements with trading venues like the Gemini Exchange. In particular, CFE is amending Rule 216 to clarify that CFE may have information sharing agreements with trading venues other than domestic or foreign self-regulatory organizations, associations, boards of trade, and swap execution facilities. CFE is also amending Rule 216 to make clear that CFE may be a direct party to any information sharing agreements under Rule 216 or be a party as a third party beneficiary to information sharing agreements entered into by CFE affiliates. In this regard, Cboe Options has entered into an information sharing agreement with Gemini that provides CFE with the ability to access Gemini Exchange trade data for regulatory purposes, including in connection with the

surveillance and regulation of trading in XBT futures on CFE's market. Pursuant to this information sharing agreement, CFE Regulation (CFER) will receive on a regular basis from Gemini, order and trade detail information from the Gemini Exchange market for Bitcoin in U.S. dollars, which CFER will utilize to conduct cross market surveillance of the Gemini Exchange Bitcoin auction and the CFE XBT futures settlements. This information sharing agreement also permits CFE to share that data with the Commission. One way in which this information sharing will occur is that CFE plans to share Gemini Exchange market data with the Commission."

The Chicago Mercantile Exchange (CME) also self-certified its Bitcoin futures contract which can be reviewed here: <http://www.cftc.gov/filings/ptc/ptc120117cmedcm001.pdf>. The Bitcoin contract utilizes an index, referred to as the Bitcoin Reference Rate or BRR, for settlement. According to the CME's certification filing, the BRR is calculated by Crypto Facilities, a financial services firm, and the BRR is also governed by an oversight committee. In order for a trading venue to be considered a constituent exchange by the BRR, CME's certification further states at pages 4–5, that certain criteria must be met including that "the venue cooperates with inquiries and investigations of regulators and the Calculation Agent upon request."

In addition, the Commission is closely coordinating with other regulators who have access to cash platform data, in particular the Financial Crimes Enforcement Network (FinCEN) within the Department of Treasury.

Q.5. On January 19, 2018, you said in a speech that you had directed CFTC staff to develop a "heightened review" process for virtual currencies derivatives, including a checklist for new products, and that you had asked the CFTC's General Counsel to discuss the statutory support for codifying these principles through rule-making.

Could you please provide an update on the process and status of these discussions?

A.5. The elements of the "heightened review" process are publicly available on the CFTC's website in its January 4, 2018, "Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets."

Q.6. Is the CFTC staff developing a proposed rule for notice and comment?

A.6. CFTC staff is currently preparing staff-level guidance on the heightened review process that will be publicly available on the CFTC's website.

Q.7. Will the full Commission vote on the rule?

A.7. If a rule was proposed, it would go through the notice-and-comment process under the Administrative Procedure Act (APA) and require a Commission vote to implement.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SASSE
FROM J. CHRISTOPHER GIANCARLO**

Q.1. The CFTC’s backgrounder on its oversight and approach to virtual currency futures markets states that virtual currency “self-certification under heightened review means that the CFTC not only has clear legal authority, but now also will have the means to police certain underlying spot markets for fraud and manipulation.”

How will the CFTC exercise this authority in light of your testimony that “the CFTC does NOT have regulatory jurisdiction under the CEA over markets or platforms conducting cash or ‘spot’ transactions in virtual currencies or other commodities or over participants on such platforms.”

A.1. In 2015, the CFTC determined that virtual currencies, such as Bitcoin, met the definition of “commodity” under the CEA. Nevertheless, to be clear, the CFTC does not have regulatory jurisdiction over markets or platforms conducting cash or “spot” transactions in virtual currencies or other commodities or over participants on such platforms. More specifically, the CFTC does not have authority to conduct regulatory oversight over spot virtual currency platforms or other cash commodities, including imposing registration requirements, surveillance and monitoring, transaction reporting, compliance with personnel conduct standards, customer education, capital adequacy, trading system safeguards, cybersecurity examinations, or other requirements. In fact, current law does not provide any U.S. Federal regulator with such regulatory oversight authority over spot virtual currency platforms operating in the United States or abroad. However, the CFTC does have enforcement jurisdiction to investigate through subpoena and other investigative powers and, as appropriate, conduct civil enforcement action against fraud and manipulation in virtual currency derivatives markets, and in underlying virtual currency spot markets just like other commodities.

In contrast to its lack of regulatory authority over virtual currency spot markets, the CFTC does have both regulatory and enforcement jurisdiction under the CEA over derivatives on virtual currencies traded in the United States. This means that for derivatives on virtual currencies traded in U.S. markets, the CFTC conducts comprehensive regulatory oversight, including imposing registration requirements and compliance with a full range of requirements for trade practice and market surveillance, reporting and monitoring and standards for conduct, capital requirements, and platform and system safeguards.

Q.2. Are you concerned about the potential for Bitcoin and other cryptocurrencies to facilitate money laundering by criminals such as human traffickers, gangs like MS-13, or terrorists like Hezbollah?

A.2. I am very concerned about the potential for the use of cryptocurrency for illicit activity. The CFTC does not have the regulatory authority to prevent or stop the use of it for those purposes, which has to be done by law enforcement agencies, with whom we actively cooperate on cryptocurrency and other matters. We are

committed to referring any illicit activity to our law enforcement partner agencies.

Q.3. What—if any—role does your agency have in addressing this problem, including through cooperation with other agencies?

A.3. I met recently with the new head of FinCEN, and the financial crimes unit, and they assured me that their anti-money-laundering procedures are in place for all domestic virtual currency trading platforms, which we do not regulate at the CFTC, but about which we are concerned. We are broadly concerned about the use of virtual currencies for illicit activities, and yet no Federal regulator has direct authority over these markets. I think policymakers in Congress, as well as the regulatory agencies, should focus first and foremost on developing a plan for where we go next.

And, I think the industry itself has something to do in this area as well. A number of virtual currency platforms in the U.K. are banding together to develop a self-regulatory organization to clean up the industry of these problems. I think advocates for virtual currencies need to know that they have a responsibility for cleaning up this industry if they really want it to be something that bears respect and becomes part of not only our future but their future as well.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR SCHATZ
FROM J. CHRISTOPHER GIANCARLO**

Q.1. Currently, States play a major role in regulating cryptocurrencies. The result has been a wide range of approaches with a patchwork of regulatory schemes that can prove difficult to navigate.

Should a formal interagency committee be created to aid financial regulatory agencies create coordinated regulation and oversight of new financial products, services, and platforms associated with cryptocurrencies?

A.1. The creation of a formal interagency committee to aid financial regulatory agencies to coordinate and oversee new financial products, services, and platforms associated with cryptocurrencies is an interesting idea that would have potential benefits. Currently, the CFTC actively communicates its approach to virtual currencies with other Federal regulators, including the Federal Bureau of Investigation (FBI) and the Justice Department and through the Financial Stability Oversight Council (FSOC), chaired by the Treasury Department.

Q.2. What role should States play in regulating cryptocurrencies?

A.2. With respect to the role of States, I believe that the States have an important role to play, at least, if not beyond, the point that a Federal regulator is designated to have regulatory jurisdiction over virtual currency platforms.

Q.3. The CFTC has authorized Bitcoin options on the Chicago Mercantile Exchange and Cboe Options Exchange.

What procedures and regulations are in place to ensure the volatility of Bitcoin does not spread such that it risks the stability of the more traditional financial sectors trading the future?

A.3. The seventh element of the “heightened review” process for virtual currency product certifications provides that derivatives clearing organizations (DCOs) set substantially high initial margin and maintenance margin for cash-settled Bitcoin futures. This element was designed to ensure adequate collateral coverage in reaction to the underlying volatility of Bitcoin.

Futures exchanges also have risk controls and tools to manage periods of volatility as well as unexpected spikes in volatility. CFTC regulations require futures exchanges to conduct real-time market monitoring of trading activity and market conditions, and to establish and maintain risk control mechanisms to prevent and reduce the potential risk of price distortions and market disruptions, including restrictions that pause or halt trading. See 17 CFR 38.157, 38.251, and 38.255. CFE and CME also have position limits on their Bitcoin futures, which limits the number of Bitcoin futures contracts a market participant may own.