

[Securities Regulation Daily Wrap Up, STRATEGIC PERSPECTIVES— BakerHostetler's Van Cleef discusses FinTech, virtual currencies, \(Apr. 4, 2017\)](#)

Securities Regulation Daily Wrap Up

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By [Mark S. Nelson, J.D.](#)

[BakerHostetler](#) partner [Carol Van Cleef](#) recently talked to *Securities Regulation Daily* about the firm's review of key developments in FinTech and what may be ahead for financial innovators in 2017. Although best practices may be an evolving concept for lawyers who advise clients on financial innovations, Van Cleef cautioned that innovators often adhere to the mistaken belief that because something is new, no laws apply.

Likewise, Van Cleef noted that "innovation offers new opportunities for lawyers, but they must have sufficient expertise not only to recognize whether and to what existing laws may apply and be ready to help their clients navigate not just around those laws but through them."

"When examining innovative ideas, there is still a need for subject matter expertise in different practice areas," said Van Cleef. She emphasized that "innovators are not working in a vacuum, and their lawyers must be appropriately experienced to recognize and address the issues that may arise." She added "this does not mean the lawyer can't be innovative in working with those laws."

A bitcoin enforcement matter brought by the CFTC and the SEC's recent disapproval of two proposed exchange rules that would have allowed the listing and trading of shares in bitcoin trusts exemplify the need for FinTech innovators to seek experienced legal counsel to help them navigate existing laws that may still apply to their products and services even if those laws do not directly address the latest technological innovations in the financial services space.

Looking ahead to 2017, in addition to the prospects of issuing bank charters for fintech innovation, the BakerHostetler report indicated that regulators and law enforcement will need to grapple with many issues, including increasing anonymity in newer versions of virtual currencies. Blockchain and distributed ledger technologies are expected to take even firmer root at financial firms, and states may look to a model virtual currency code expected soon to help deal with certain regulatory issues.

To view the full BakerHostetler report, which is reprinted with the firm's permission, please click [here](#).

CFTC's Bitfinex enforcement order. According to the Baker-Hostetler report, the CFTC's action regarding an online platform where cryptocurrencies could be exchanged may have been the top enforcement action in the blockchain community in 2016. In the CFTC's administrative case against BFXNA Inc. d/b/a Bitfinex, Bitfinex entered into a [consent order](#) with the agency, without admitting or denying the agency's findings, that required Bitfinex to pay a \$75,000 civil monetary penalty for engaging in off-exchange commodity transactions without registering as a futures commission merchant.

Specifically, Bitfinex ran afoul of a Commodity Exchange Act revision made by the Dodd-Frank Act that bars any contract in any commodity with a non-eligible contract participant or non-eligible commercial entity in leveraged, margined, or financed retail commodity transactions, subject to an exception for actual delivery made within 28 days.

The CFTC's order explained that Bitfinex's margin trading feature let "margin funding providers" (lenders) make offers on the Bitfinex platform to "financing recipients" (traders) who sought to borrow bitcoins for purposes of using leverage. According to the CFTC, bitcoins are commodities and Bitfinex never made actual delivery

because it retained control over wallets, including control over the related private keys, such that Bitfinex controlled the release of bitcoins pending the further release of liens.

Van Cleef said the Bitfinex case was significant, in part, because it involved an enforcement action by a U.S. regulator against a foreign company. She also noted that the CFTC has been more proactive than other regulators on bitcoin and blockchain issues. Van Cleef further noted the case raises issues central to current methods of transferring or "delivering" bitcoin, although those issues haven't been fully resolved. The CFTC also noted the cooperation of Bitfinex and its voluntary efforts to come into compliance with the statutes and rules administered by the CFTC.

Still, the CFTC has established that its CEA authorities broadly apply to virtual currencies. The Bitfinex matter involved the CFTC's jurisdiction over retail commodity transactions while its prior enforcement efforts regarding virtual currencies ([Coinflip, Inc.](#); [TeraExchange LLC](#)) involved the agency's jurisdiction over derivatives. In the TeraExchange matter, Commissioner Sharon Bowen issued a brief [dissent](#) regarding the lack of any penalty. Following the Bitfinex order, the only one of the three CFTC matters to impose a civil monetary penalty, a law firm has drafted a rulemaking petition asking the CFTC to clarify "actual delivery" in the context of virtual currencies.

SEC denial of Bats/Winklevoss proposal. The SEC's Division of Trading and Markets, under its delegated authority, also has taken some first steps into the virtual currency world, most recently by [disapproving](#) a Bats BZX Exchange, Inc. proposed rule change to list and trade shares issued by the Winklevoss Bitcoin Trust. The SEC staff noted that the applicable Exchange Act standards for the listing and trading of shares of commodity-trust exchange-traded products (ETPs) include, among other things, the requirement that the markets for the underlying commodity or derivatives on that commodity be regulated, and that the exchange enter into surveillance sharing agreements with significant markets. The SEC's order said Bats could not achieve either of these requirements because the significant spot markets for bitcoin are unregulated.

According to Van Cleef, the SEC's order implicitly raises the question of how does a market become regulated enough. But the SEC held out some hope for future exchange proposals, saying that it could reconsider whether a bitcoin ETP meets the Exchange Act standards if fledgling bitcoin markets develop further over time.

A large portion of the SEC's order reviewed the nearly 60 comment letters received on the proposed rule change, many of which emphasized that bitcoin markets are often located overseas, can be illiquid, and may involve questionable practices, such as front-running, wash sales, and conflicts of interest regarding bitcoin mining.

The Winklevoss Bitcoin Trust's investment goal was to track the price of bitcoins on Gemini Trust Company's Gemini Exchange. With respect to regulatory oversight, the SEC said that, despite Bats's recitation of the CFTC's enforcement actions against Coinflip, TeraExchange, and Bitfinex, the CFTC registers spot markets only in limited instances, and the CFTC would not oversee Gemini Exchange. As for Gemini Exchange, the SEC noted that while public comments were unclear about how much bitcoin volume the exchange handled, it appeared to the SEC that Gemini Exchange's volume was a small part of the overall bitcoin market.

The SEC also found fault with a white paper submitted in support of another rule proposal because it failed to account for many aspects of bitcoin technology, such as a "hard fork" that could divide the underlying network into multiple blockchains. A footnote in the SEC's order noted that the Winklevoss Bitcoin Trust's [registration statement](#) had explained that the trust's custodian and sponsor would decide which of two resulting blockchains to use.

According to the Winklevoss Bitcoin Trust's registration statement, that choice would be made based on the "greatest cumulative computational difficulty"—*i.e.*, "the total threshold number of hash attempts required to mine all existing blocks in the respective Blockchain, accounting for potential differences in relative hash difficulty"—within the 48 hours after a hard fork. This computation would serve as a basis for transacting and valuing bitcoins, although creation and redemption baskets would be halted for 24 hours before, and 48 hours after, a hard fork.

Bats has since asked the Commission to review the order disapproving of the exchange's proposal. Bats said in its [petition for review](#) that the order applied a new, "prescriptive" standard not required by the Exchange Act and argued that the potential for manipulation of bitcoin is not as great as the SEC staff suggested. Bats also urged the Commission to review the order because of bitcoin's novelty and the first-ever nature of the exchange's proposal.

Moreover, the SEC has disapproved a similar rule change proposal by NYSE Arca, Inc. to list and trade shares of the SolidX Bitcoin Trust. The disapproval focused primarily on the same reasons cited for disapproving the Bats proposal: bitcoin markets are unregulated and the exchange could not enter into the needed surveillance sharing agreements. Additional information about the SolidX Bitcoin Trust can be found in its [Form S-1](#). The NYSE Arca and Bats proposals share many features (See [comparison chart](#)), although they differ in some respects.

It remains to be seen what action the Commission will take regarding the Bats petition for review and whether NYSE Arca will likewise seek Commission review of the disapproval of its proposal. The Commission also has been asked by another trading venue to engage in [rulemaking](#) to more generally clarify the legal status of digital assets like bitcoin.

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Companies: Investors Exchange LLC; BFXNA Inc. d/b/a Bitfinex; Coinflip, Inc.; TeraExchange LLC; Bats BZX Exchange, Inc.; Gemini Trust Company; Gemini Exchange; Winklevoss Bitcoin Trust

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