

## PUBLICATIONS

# Digital Assets a Focus Point for Regulators

September 20, 2018

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As investor interest in cryptocurrencies has picked up, government agencies and non-governmental organizations tasked with protecting investors are taking a harder look at these virtual investment products. While the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), Financial Industry Regulatory Authority (FINRA), and the National Futures Association (NFA), are all taking steps to reach out directly to investors to educate them to the possible dangers of the products, regulated entities are also facing more scrutiny over their trading in cryptocurrencies.

Most recently, FINRA sent out a regulatory notice to its members, asking “each firm to promptly notify FINRA if it, or its associated persons or affiliates, currently engages, or intends to engage, in any activities related to digital assets, such as cryptocurrencies and other virtual coins and tokens.”<sup>1</sup> The notice is meant to supplement efforts already undertaken by FINRA to understand the scope of firms’ activities with the products, which has included FINRA Regulatory Coordinators conducting a survey of firms and including questions about digital assets in FINRA’s 2018 Risk Control Assessment Survey.

Additionally, FINRA member firms should determine whether any of their proposed activities in the digital assets space rises to a “material change in business operations” as defined in NASD Rule 1011(k), necessitating the filing of a Continuing Membership Application with FINRA pursuant to NASD Rule 1017(a)(5), as administered by FINRA. FINRA member firms should consult *Notice to Members 00-73*<sup>2</sup> for additional guidance if necessary.

Similarly, the NFA is also taking stock of which of its member firms are dealing in virtual currencies and their derivatives. Earlier this

year, the NFA issued a reminder that commodity pool operators, commodity trading advisers, and introducing brokers were required, as of December 2017, to immediately notify the NFA if they executed transactions or accepted or solicited orders involving virtual currencies or their derivatives by updating their annual questionnaire.<sup>3</sup>

Such requests should not come as a surprise based on the increasing interest the financial agencies have shown in the products. The CFTC was the first to assert its jurisdiction over virtual currencies by finding such products to be commodities under the Commodity Exchange Act in 2015 and has continued to issue guidance regarding the products. Most recently, the Divisions of Market Oversight and Clearing and Risk issued an advisory to exchanges that list virtual currency derivatives, which discussed, among other things, enhanced market surveillance and coordination with CFTC staff.<sup>4</sup>

Both the SEC's Office of Compliance Inspections and Examinations (OCIE) and FINRA included virtual currencies as one of their 2018 exam priorities. In OCIE's exam priorities, it noted that for virtual currencies deemed securities, it would check firms for regulatory compliance, with areas of focus including "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."<sup>5</sup> As it has continued to become more evident that the SEC does, in fact, regard most cryptocurrencies offered pursuant to an ICO as securities,<sup>6</sup> firms that deal with them should be ready for the agencies' questions.

For a more in depth conversation on the SEC's recent focus on internal controls and disclosures under the Investment Advisers Act, we invite you to join [Dorsey & Whitney LLP's Private Funds Symposium on September 26, 2018](#) . For more information, please contact Genna Garver, Daniel Baich, and Kimberly Frumkin.

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<sup>1</sup> FINRA Regulatory Notice, "Digital Assets: FINRA Encourages Firms to Notify FINRA if They Engage in Activities Related to Digital Assets," (July 6, 2018) *available at* [https://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Regulatory-Notice-18-20.pdf](https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-20.pdf).

<sup>2</sup> NASD Notice to Members 00-73, "SEC Approves Amendments to NASD Membership Rules," (October 2000) *available at* <http://www.finra.org/industry/notices/00-73>.

<sup>3</sup> National Futures Association, "Notice 1-18-07: Reminder to update annual questionnaire regarding virtual currencies," (Mar. 27, 2018) *available at* <https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4999>.

<sup>4</sup> CFTC Staff Advisory No. 18-14, "Advisory with respect to Virtual Currency Derivative Product Listings," (May 21, 2018) *available at* [https://www.cftc.gov/sites/default/files/idc/groups/public/%40lrlettergeneral/documents/letter/2018-05/18-14\\_0.pdf](https://www.cftc.gov/sites/default/files/idc/groups/public/%40lrlettergeneral/documents/letter/2018-05/18-14_0.pdf).

<sup>5</sup> SEC's Office of Compliance Inspections and Examinations, "2018 National Exam Program Examination Priorities," (Feb. 7, 2018) *available at* <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf>.

<sup>6</sup> *See, e.g.*, speech by Director of Division of Corporate Finance at the SEC, William Hinman at Yahoo Finance All Markets Summit entitled "Digital Asset Transactions: When Howey Met Gary (Plastic)," June 14, 2018, *available at* <https://www.sec.gov/news/speech/speech-hinman-061418>.