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Client Alert

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SEC Staff Issues Statement on Platforms for Trading Digital Assets

On March 7, 2018, staff of the Securities and Exchange Commission (SEC) in the Division of Enforcement and Division of Trading and Markets issued a joint statement regarding "Potentially Unlawful Online Platforms for Trading Digital Assets" (the Statement). The Statement is the latest effort by the SEC and its staff to address potentially fraudulent or manipulative behavior in the burgeoning market for initial coin offerings (ICOs). The Statement is intended to serve as both an informational document for investors using online trading platforms and a warning to operators of those platforms that the SEC is scrutinizing their activities.

Overview of the Statement

As we have previously discussed, the SEC has concluded that many digital assets, including coins or tokens offered and sold in ICOs, are securities for purposes of the federal securities laws. It is becoming increasingly common for such securities to begin trading in secondary markets.

The Statement begins by noting that many online trading platforms claim to give investors the ability to buy and sell digital assets quickly. Many of these platforms bring buyers and sellers together in one place and offer investors access to automated systems that, according to the SEC staff, display priced orders, execute trades and provide transaction data.

The Statement then reminds market participants that any trading platform that meets the definition of an "exchange" under the federal securities laws must register with the SEC as an exchange or find an exemption from such registration. The Securities Exchange Act of 1934 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, and includes the market place and market facilities maintained by such exchange.

The federal regulatory framework governing registered national securities exchanges and exempt markets is intended to protect investors and prevent against fraudulent and manipulative trading.

SEC Staff Concerns

The Statement expresses the staff's concern that many online trading platforms appear to investors as SEC-registered and -regulated marketplaces, when in fact they are not. Although they are not registered with the SEC as exchanges, according to the staff many trading platforms call themselves "exchanges" or use similar terminology to create the impression that they are regulated or meet the regulatory standards of a national securities exchange. The staff cautions that the SEC does not review the trading protocols used by these platforms, which determine how orders interact and execute, and access to a platform's trading services may not be the same for all users.

The Statement also warns investors that they should not assume the trading protocols meet the standards of an SEC-registered national securities exchange. Further, according to the staff, many of these platforms give the impression that they perform exchange-like functions by offering order books with updated bid and ask pricing and data about executions on the system, but the staff has reason to question whether such information has the same integrity as that provided by registered securities exchanges. The Statement concludes with a series of due diligence questions that the staff recommends investors pose to a platform before they decide to trade digital assets there.

BitFunder Enforcement Action

As part of its larger ongoing enforcement sweep against ICO promoters, on February 21, 2018, the SEC charged BitFunder and its founder, Jon E. Montroll (Montroll), for operating an unregistered securities exchange on which users were able to create, offer, buy and sell virtual shares of cryptocurrency companies.

Montroll operated BitFunder from December 2012 through November 2013 during a time period when online "stock" exchanges for cryptocurrency companies were more common. Users deposited bitcoins into a virtual currency wallet controlled by Montroll called WeExchange. In addition, in July of 2013 Montroll offered and sold shares of his own digital security, Ukyo Notes, telling purchasers that the funds raised would be invested and would generate interest daily. In reality, Montroll used some of the funds for personal and business expenses and to replenish bitcoins Montroll had misappropriated from BitFunder prior to the offering. Subsequently, in August of 2013 hackers launched a cyberattack on BitFunder resulting in the theft of over 6,000 bitcoin, then valued at approximately $775,075. Montroll did not disclose the theft to any BitFunder users and instead used bitcoin deposits from new users to fund withdrawal requests after the cyberattack.

In its complaint, the SEC charged Montroll as a controlling person in BitFunder's violation of Section 5 of the Securities Exchange Act of 1934, as amended (the Exchange Act), for operating an unregistered securities exchange. Montroll and BitFunder were jointly charged with securities fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder and Montroll is charged individually for securities fraud under Section 17(a) of the Securities Act of 1933, as amended (the Securities Act). Additionally, the SEC charged Montroll with the unregistered offer and sale of securities for his sale of Ukyo Notes under Section 5(a) and Section 5(c) of the Securities Act.

Concurrently with these charges from the SEC, the US Justice Department arrested Montroll on February, 21, 2018, for giving false sworn testimony and false documentation to the staff of the SEC during the course of its investigation. In a statement to the public, US Attorney Geoffrey S. Berman said, "These charges signify that we will use the full force of the federal criminal law to protect the integrity of the SEC's investigative process."

Final Thoughts

We are not aware of any SEC-registered securities exchanges that currently accept digital coins or tokens for trading. However, a number of start-up and established trading platforms are at various stages of registering with the SEC as an alternative trading system for these instruments, which is a valid exemption from the SEC's requirement that all exchanges register. Relatedly, the Commodity Futures Trading Commission has separately brought enforcement actions against cryptocurrency exchanges that were not appropriately registered with the CFTC. As the SEC and other regulators continue to focus on digital assets and the related ICO market, issuers of tokens and the platforms that seek to develop secondary markets for them should continue to observe SEC and other relevant regulatory requirements.

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