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U.S. Federal Regulators Turn Up the Heat on Cryptocurrency Trading Platforms

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With new types of digital assets and related business on the rise, federal authorities have been busy investigating. Recently, the SEC, FinCEN and the CFTC have imposed some notable settlements involving cryptocurrency trading platforms for allegedly operating without appropriate approvals from financial regulatory authorities. This may be the start of the next wave of government enforcement activities.

BitMex

In FinCEN's first enforcement action against a futures commission merchant, a high profile cryptocurrency derivatives trading platform known as BitMEX was found to have violated the Bank Secrecy Act and FinCEN's implementing regulations. BitMEX's platform allowed customers to conduct derivative trading but failed to implement reasonable due diligence, policies, and procedures to screen customers such as verifying their identity. Moreover, FinCEN alleged that BitMEX did not implement or maintain a compliant anti-money laundering program or report suspicious activity for at least 588 specific suspicious transactions, and further failed to verify the location of its customers. Although BitMEX publicly represented that it was not conducting business with U.S. persons, some customers' information had been altered to conceal the fact that they were indeed located in the U.S.

The FinCEN settlement was part of a broader resolution of claims that the CFTC previously filed against BitMEX in October 2020 for operating an unregistered cryptocurrency derivatives platform in violation of the Commodity Exchange Act and CFTC regulations. The CFTC and BitMEX parties collectively resolved their claims in a settlement requiring BitMEX to pay a civil penalty of $100 million to both FinCEN and the CFTC. BitMEX has also agreed to engage an independent consultant to analyze its data and determine whether BitMEX must file additional Suspicious Activity Reports, and also to ensure that it implements proper policies, procedures, and controls to verify the location of its customers.

DeFi Money Market

SEC Chairman Gary Gensler recently asserted that many decentralized finance projects bore enough resemblance to securities that they could and should be subject to regulation by the SEC. In the SEC's first action involving "decentralized finance" (DeFi) technology, two men and their company agreed to settle charges that they improperly offered a decentralized money market product known as DeFi Money Market ("DMM"), through which they sold over $30 million in unregistered securities. The Respondents used smart contracts to offer and sell two types of digital tokens to investors, the proceeds of which would then be used to purchase "real world" assets (e.g., car loans) and generate income for the investors. In addition to registration violations, the SEC alleged that they also misrepresented the operation and ownership of DMM's assets. For example, DMM represented through social media that its digital tokens were "overcollateralized" and backed by $8.9 million in car loans, when in reality the car loans were not owned by DMM but by another company controlled by Respondents.

The SEC found that Respondents had made unregistered offers and sales of securities. DMM offered two types of tokens: one providing for a consistent return of 6.25%, and the other a "governance token" that would trade on a secondary market entitling holders to excess profits. Both types of tokens offered by DMM qualified as securities because they were offered and sold as investment contracts under the *Howey* test. Moreover, the SEC found Respondents violated the antifraud provisions of the federal securities laws by deceiving investors about the operation and ownership of the assets underlying its tokens. Respondents agreed to a cease-and-desist order including disgorgement of $12.8 million in profits and $125,000 in penalties. They also were ordered to fund the smart contracts so investors could receive all principal and interest they were owed. For a more detailed summary of this matter, see our post here.

Poloniex

Similarly, a web-based trading platform known as Poloniex reached a $10 million settlement with the SEC for operating an unregistered digital asset "exchange" in violation of the Securities Exchange Act. The Poloniex platform allowed users to buy and sell cryptocurrencies and other digital assets. Although it did take steps to limit trades in digital assets that it determined were at risk of being considered "securities," the SEC alleged that certain digital investment contracts Poloniex approved satisfied the definition of "securities." The SEC order noted that even after the SEC issued the DAO Report in July 2017 (providing public guidance on digital assets as securities), Poloniex continued to be "aggressive" in approving new digital assets for trading on its platform.

Because the Poloniex platform qualified as an exchange by facilitating transactions of digital asset securities, but failed to register with the SEC, the SEC found Poloniex in violation of Section 5 of the Exchange Act. Poloniex agreed to a cease-and-desist order, disgorgement of $8,484,313, prejudgment interest of $404,995, and a civil penalty of $1.5 million, all of which was placed into a Fair Fund for the benefit of the investors affected.

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