

New York Regulators Focus on Fraud and Market Manipulation for Virtual Currency Businesses

March 28, 2018 | **CLIENT ALERTS**

On February 7, 2018, the New York State Department of Financial Services (“DFS”) issued guidance for entities with a Bit License or those handling virtual currency that are chartered as limited purpose trust companies under New York’s Banking Law. The guidance focuses on fraud detection and prevention of market manipulation of virtual currency pricing and essentially amplifies monitoring requirements already set forth in the Bit License regulations and other state and federal laws.

Market manipulation can occur when the price of virtual currency is inflated by hype around the token, coin, or currency on social media or elsewhere. In some instances, the currency is misrepresented as being approved by a federal agency. When the hype is created by holders of the virtual currency, they take advantage of the increased activity, and sell their holdings for a profit. Because there is no real basis for the increased price, the sales create volatility, and the price plummets. The creation of market hype as described above is an illegal fraudulent practice that plagued the market well before the advent of virtual currencies. Fraud can also take the form of fraudulent coin offering where the currency, product, or promised return on an investment is never delivered to the customer. The Commodities Futures Trading Commission (“CFTC”) has general anti-fraud and manipulation enforcement authority over virtual currency cash markets and can take enforcement action against perpetrators. Moreover, the CFTC can halt sales of the virtual currency to prevent unsophisticated consumers from suffering further losses.

DFS’ guidance simply reiterates the requirement for fraud detection policies and procedures and requires entities to report fraud or market manipulation upon discovery. DFS requires that the report be updated as the internal investigation continues and requires that the entities explain what steps they are taking to prevent a repeat occurrence. DFS’ approach with respect to fraud and market manipulation mirrors its requirements for reporting of cybersecurity attacks and follows the same framework as New York General Business Law 899-aa, NY’s breach notification statute.

DFS is asserting itself in an industry that has seen an increasing number of investigations and enforcement action by the CFTC and the Securities and Exchange Commission (“SEC”). While the guidance may clarify reporting obligations, it is also important to note that unlike the relevant federal laws, neither DFS’ Bit License regulations nor the subsequent guidance contain any specific adverse consequence, fine, or civil penalty. Without specific authority for civil penalties, the price for noncompliance is likely loss of the Bit License and/or an injunction enjoining the entity from operating in New York State. DFS’ guidance is going to continue to encourage entities to avoid New York. Many in the industry are already doing just that in the hopes that the federal government will step in and pre-empt states from regulating the industry given the significant implications for interstate and international commerce.

On the federal level, much like the CFTC, the SEC already has a dedicated market watch unit and recently set up a dedicated cybercrime/cyber fraud unit that monitors digital currencies for suspicious behavior. In fact, in December of 2017, the SEC took action against two companies that it believed to be peddling a fraudulent virtual currency. In contrast, DFS does not appear to have any structures in place to detect criminal conduct and the State has not taken any enforcement actions. Instead, in February a number of bills were introduced in the State Senate and Assembly to allow the State to study the impact of cryptocurrencies, the benefit of issuing a state-backed cryptocurrency, and whether the State should start accepting cryptocurrency as payment. While the market undoubtedly appreciates the absence of enforcement activity, one is left to wonder whether New York's regulations server any purpose or offer any real protections to consumers. If the answer to that question is a negative, it seems that New York should withdraw the Bit License regulations and allow the federal government to regulate virtual currency as an instrumentality of interstate commerce.