

May 16, 2018

---

**CONTACT**

Douglas Landy  
Partner  
+1-212-530-5234  
DLandy@milbank.com

Jonathan Edwards  
Associate  
+1-212-530-5476  
JEdwards2@milbank.com

James Kong  
Associate  
+1-212-530-5244  
JKong@milbank.com

---

## Financial Institutions Regulation Group Client Alert:

### Bitcoin and the Volcker Rule: Are Banks Banned from Cashing in on the Crypto Craze?

Over the past year, bitcoin and other virtual currencies (often referred to as “cryptocurrencies”) have skyrocketed in price<sup>1</sup> and greatly increased their place in the public consciousness.<sup>2</sup> While prices have since – to some extent – fallen back to earth,<sup>3</sup> there is no question that recent months have seen a number of developments that have taken cryptocurrencies further into the financial mainstream. Futures contracts based on the price of bitcoin are now traded on a number of prominent exchanges,<sup>4</sup> new virtual currency funds are established by the day,<sup>5</sup> and recently, Goldman Sachs was reported to be on the cusp of “using its own money to trade with clients in a variety of contracts linked to the price of Bitcoin”<sup>6</sup> while Barclays was rumored to be “gauging clients’ interest” in the bank starting a cryptocurrency trading desk.<sup>7</sup> But the involvement of regulated financial institutions in the virtual currency markets implicates myriad banking, securities and commodities laws. One question in

---

<sup>1</sup> See, e.g., <https://www.coindesk.com/price/>.

<sup>2</sup> See, e.g., <https://trends.google.com/trends/explore?geo=NG&q=bitcoin>.

<sup>3</sup> A recent research letter published by the Federal Reserve Bank of San Francisco observed that the price decline was correlated with the introduction of bitcoin futures trading in December 2017, “consistent with trading behavior that typically accompanies the introduction of futures markets for an asset.” <https://www.frbsf.org/economic-research/publications/economic-letter/2018/may/how-futures-trading-changed-bitcoin-prices/>.

<sup>4</sup> See, e.g., <http://www.cmegroup.com/trading/equity-index/us-index/bitcoin.html>.

<sup>5</sup> See <https://www.cnn.com/2017/10/27/there-are-now-more-than-120-hedge-funds-focused-solely-on-bitcoin.html>.

<sup>6</sup> See <https://www.nytimes.com/2018/05/02/technology/bitcoin-goldman-sachs.html>.

<sup>7</sup> See <https://www.bloomberg.com/news/articles/2018-04-16/barclays-is-said-to-be-sounding-out-clients-about-trading-crypto>. More recently, the CEO of Barclays clarified that the bank has no immediate plans to launch a dedicated cryptocurrency trading desk. See <https://www.fnlondon.com/articles/barclays-ceo-rules-out-move-into-crypto-trading-20180501>.

particular is especially relevant for banks and their affiliates: does the Volcker Rule<sup>8</sup> allow banking entities to invest in or trade cryptocurrencies?

The question of whether such regulated institutions may become involved in cryptocurrency trading is a critical one: despite the tremendous increase of popular interest in cryptocurrencies, optimists will argue that there is still plenty of room to grow, particularly as the market capitalization of all cryptocurrencies remains relatively small compared to traditional financial markets.<sup>9</sup> By a number of estimations, the large run-up in the prices of virtual currencies near the end of 2017 was driven primarily by retail market participants, with little involvement by institutional investors.<sup>10</sup> Spot trading of virtual currencies remains dispersed amongst a large number of exchanges worldwide,<sup>11</sup> many of which are subject to scant (if any) regulatory oversight and which are not subject to the same custody, order execution, and other standards applicable to registered exchanges in traditional markets.<sup>12</sup> Now, amidst rumors that institutions such as NASDAQ<sup>13</sup> and the parent company of the New York Stock Exchange<sup>14</sup> are looking into establishing their own cryptocurrency exchanges, speculation abounds that banks – those very institutions (along with government fiat currencies) that bitcoin and other cryptocurrencies were originally designed to circumvent<sup>15</sup> – may finally begin using their own balance sheets to purchase and sell virtual currencies.<sup>16</sup>

---

<sup>8</sup> 12 U.S.C. § 1851 and the final regulations issued thereunder.

<sup>9</sup> See <https://coinmarketcap.com/>. See also <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo34> (“Whatever one’s opinion, an objective perspective helps...The Bitcoin “market capitalization” is comparable to the stock market capitalization of a single ‘large cap’ business, such as Intel or Citigroup...Because virtual currencies like Bitcoin are sometimes considered to be comparable to gold as an investment vehicle, it is important to recognize that the total value of all the gold in the world is estimated by the World Gold Council to be about \$8 trillion which continues to dwarf the virtual currency market size.”).

<sup>10</sup> See, e.g., <https://www.wsj.com/articles/the-force-behind-bitcoins-meteoric-rise-millions-of-asian-investors-1513074750> (“Retail investors, mostly in Asia, are pushing the price of bitcoin to new heights”).

<sup>11</sup> See <https://coinmarketcap.com/exchanges/volume/24-hour/>.

<sup>12</sup> See <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading>.

<sup>13</sup> See <https://www.cnbc.com/2018/04/25/nasdaq-is-open-to-becoming-cryptocurrency-exchange-ceo-says.html>.

<sup>14</sup> See <https://www.nytimes.com/2018/05/07/technology/bitcoin-new-york-stock-exchange.html>.

<sup>15</sup> See, e.g., <https://www.bloomberg.com/news/articles/2017-10-05/bitcoin-s-rise-happened-in-shadows-of-finance-now-banks-want-in> (“At first, bitcoin was a way to make payments without banks. Now, with more than \$100 billion stashed in digital currencies, banks are debating whether and how to get in on the action.”).

<sup>16</sup> See, e.g., <https://www.cnbc.com/2018/04/17/blockchain-cryptocurrency-wallet-hires-top-goldman-sachs-exec.html> (“Analysts have said that 2018 could be the year that institutions begin

To be sure, the notion that banks will become involved in trading *virtual* currencies is not entirely without precedent. Banks have historically been key drivers of “traditional” currency markets worldwide, and continue to make up an outsize share of worldwide foreign exchange trading.<sup>17</sup> Should banks enter cryptocurrency markets, their involvement will bring liquidity, stability and likely a semblance of legal certainty to an emerging asset class. However, underlying the question of whether banks *will* participate in the virtual currency markets is the question of whether they *can*. Banks themselves are entities of limited powers, and even affiliates of banks are subject to comprehensive regulation and oversight of their activities by virtue of their affiliation. U.S. prudential bank regulators have broad supervisory and enforcement powers that allow them to police activities that they deem unsafe or unsound. To date, no major bank has been publicly reported to have engaged with the spot virtual currency markets, and even Goldman Sachs – reportedly the first Wall Street bank to establish a bitcoin-linked trading operation of any kind – “will not initially be buying and selling actual Bitcoins.”<sup>18</sup> Instead, “a team at the bank is looking at going in that direction if it can get regulatory approval and figure out how to deal with the additional risks associated with holding the virtual currency.”<sup>19</sup>

So what are the regulatory barriers to bank involvement in trading virtual currencies? The answer to this question will likely hinge in significant part on the Volcker Rule, the strictures of which were first expressed in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) and subsequently implemented through the lengthy and complex final regulations issued thereunder (the “Final Regulations”).<sup>20</sup> Below, we provide a brief overview of the Volcker Rule’s purpose and its relevant provisions. We then examine whether trading activities in bitcoin or other cryptocurrencies would be covered by the Volcker Rule, and if so, whether such trading would be permissible under the rule’s exceptions. We also

---

to get involved in the space.”); <https://www.nytimes.com/2018/05/07/technology/bitcoin-new-york-stock-exchange.html> (quoting Paul Chou, a former Goldman Sachs trader and founder of bitcoin exchange LedgerX, as saying that the “industry is seeing unprecedented institutional interest for the first time in Bitcoin’s history.”).

<sup>17</sup> See <https://www.euromoney.com/article/b1348tjhnv7h99/euromoney-fx-survey-2017-results-released>.

<sup>18</sup> See *supra* note 6.

<sup>19</sup> *Id.*

<sup>20</sup> Section 619 of the Dodd-Frank Act added a new Section 13 to the Bank Holding Company Act of 1956, as amended (the “BHC Act”). 12 U.S.C. § 1851. The Final Regulations were issued jointly by five federal agencies. *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5536 (Jan. 31, 2014).

explore a scenario in which a banking entity's investment in a company that holds its own virtual currency might implicate the Volcker Rule's covered fund provisions.

## **BACKGROUND**

### *What is the Volcker Rule?*

The Volcker Rule is one of the most significant reforms borne out of the 2008 financial crisis. As described recently by Federal Reserve Vice Chairman for Supervision Randal K. Quarles, “[the] fundamental premise of the Volcker Rule is simple: banks with access to the federal safety net – Federal Deposit Insurance Corporation insurance and the Federal Reserve discount window – should not engage in risky, speculative trading for their own account.”<sup>21</sup> The Volcker Rule consists of two primary components: a ban on “proprietary trading” for a bank’s own account, and a ban on investing in, or having certain relationships with, “covered funds.” Each ban is subject to a number of exemptions and exclusions, including those available for market-making activities, hedging activities, and activities conducted outside of the United States.<sup>22</sup>

The Final Regulations extend the scope of the Volcker Rule’s coverage to any “banking entity,” defined to include not only a U.S. insured depository institution, but also its holding company, any foreign banking organization regulated as if it were a U.S. bank holding company, and any affiliates or subsidiaries of the foregoing, subject to certain exceptions.<sup>23</sup> With respect to the question of whether a banking entity may trade virtual currencies for its own account, the most relevant component is whether such a banking entity would be considered to be engaging in “proprietary trading” within the meaning of the Volcker Rule.

---

<sup>21</sup> <https://www.federalreserve.gov/newsevents/speech/quarles20180305a.htm>. (Mar. 5, 2018). See also <https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm> (“During the debates on what became the Dodd-Frank Act, former Chairman Paul Volcker offered a fairly straightforward proposal: no insured depository institution or affiliate thereof should be permitted to engage in proprietary trading. It seemed then, and seems now, like an idea that could contribute to the safety and soundness of large financial firms.”) (April 4, 2017).

<sup>22</sup> 12 C.F.R. § 248.3-6.

<sup>23</sup> 12 C.F.R. § 248.2(c).

### *Definition of Proprietary Trading and “Financial Instrument”*

The Volcker Rule defines proprietary trading as engaging as principal, for the trading account of the banking entity, in any purchase or sale of one or more *financial instruments*. While nearly all of the foregoing terms are themselves further defined in the Volcker Rule, for our purposes, it is notable that the Final Regulations limit the proprietary trading ban to certain classes of assets – *i.e.*, those that fall within the definition of a “financial instrument.” Therefore, one threshold question is whether bitcoin or any particular cryptocurrency is considered a “financial instrument.” The Volcker Rule’s definition of financial instruments includes:

- A security, including an option on a security;
- A derivative, including an option on a derivative; or
- A contract of sale of a commodity for future delivery, or an option on such a contract.

In contrast, the following products or transactions are *not* considered “financial instruments”:

- Loans;
- A commodity that is not:
  - An excluded commodity (*i.e.*, financial commodities such as securities), other than foreign exchange or currency;
  - a derivative;
  - a futures contract; or
  - an option on a futures contract; or
- Foreign exchange or currency.

Given the above, the question of whether the Volcker Rule applies at all to trading in virtual currencies largely rests on whether such instruments are treated as securities, derivatives, or futures on the one hand, or as transactions in currencies or commodities, on the other hand.<sup>24</sup> The Preamble that accompanied the issuance of the

---

<sup>24</sup> The Volcker Rule does not anticipate or provide regulatory guidance on its application to new technology or novel instruments. Paul Volcker himself is famously skeptical to financial technology, stating in 2009 that “[t]he most important financial innovation that I have seen the past 20 years is the [ATM]...” See <https://www.wsj.com/articles/SB10001424052748704825504574586330960597134>.

Final Regulations (the “Preamble”) reinforces this distinction,<sup>25</sup> stating that the “exclusion of [foreign exchange or currency] is intended to eliminate potential confusion by making clear that the purchase or sale of ... foreign exchange or currency – none of which are referred to in Section 13(h)(4) of the BHC Act – are outside the scope of transactions to which the proprietary trading restrictions apply.”<sup>26</sup>

#### **HOW ARE VIRTUAL CURRENCIES CLASSIFIED UNDER THE VOLCKER RULE?**

*Are virtual currencies “currencies”?*

Which brings us to the question: are virtual currencies considered “currencies”? Bitcoin certainly appears to have been originally designed to serve the function of a currency: the bitcoin white paper, published in 2008 by the pseudonymous Satoshi Nakamoto, characterized bitcoin as a “peer-to-peer version of electronic cash.”<sup>27</sup> While current popular interest in bitcoin as a speculative asset almost certainly eclipses interest in its utility as a currency, this does not change the fact that bitcoin still functions in accordance with its original intentions. And while one popular objection to bitcoin is that it has no intrinsic value, neither does fiat money: rather than being backed by gold or any other commodity, “[fiat money’s] value comes from its general acceptance as money.”<sup>28</sup>

Traditional notions of what constitutes money provide that it must serve three functions: as a medium of exchange (something that people can use to buy and sell from one another), as a store of value (meaning people can save it and use it later), and a unit of account (meaning it provides a common base for prices).<sup>29</sup> Although bitcoin’s historic price volatility may undercut the argument that it has, to date, served as a store of value or unit of account, bitcoin nevertheless “has characteristics that allow it to function as money and make it a useful payment method.”<sup>30</sup> And we note that volatility alone does not disqualify a currency from being considered as such: even fiat

<sup>25</sup> See Preamble at 79 F.R. 5551, noting “commenters strongly supported exclusion of ... foreign currency transactions as consistent with the statute, arguing that these instruments are part of the traditional business of banking and do not represent the types of instruments that Congress designed section 13 to address.”

<sup>26</sup> See Preamble at 79 F.R. 5552.

<sup>27</sup> See <https://bitcoin.org/bitcoin.pdf>.

<sup>28</sup> See [https://files.stlouisfed.org/files/htdocs/publications/page1-econ/2018/03/01/bitcoin-money-or-financial-investment\\_SE.pdf](https://files.stlouisfed.org/files/htdocs/publications/page1-econ/2018/03/01/bitcoin-money-or-financial-investment_SE.pdf).

<sup>29</sup> See <http://www.imf.org/external/pubs/ft/fandd/2012/09/basics.htm>.

<sup>30</sup> See *supra* note 28.

currencies, such as in the case of the Venezuelan bolívar, can be tremendously volatile, but nevertheless remain currencies.<sup>31</sup>

The fact that bitcoin and other virtual currencies have characteristics of money, however doesn't necessarily mean that they meet the legal definition of a currency. Traditional legal notions of what constitutes a currency provide that it is "produced by a nation's government,"<sup>32</sup> and while neither the Volcker Rule nor the BHC Act defines "currency," clues found elsewhere in federal law reinforce that notion. One definition of currency is found in the regulations implementing the U.S. Bank Secrecy Act, as issued by the Financial Crimes Enforcement Network ("FinCEN").<sup>33</sup> Those regulations define currency as "[the] coin and paper money of the United States or of any other country that is designated as legal tender and that circulates and is customarily used and accepted as a medium of exchange in the country of issuance."<sup>34</sup> Further federal guidance reinforces the application of this definition against virtual currencies: a 2014 IRS publication, concluding that virtual currency should be treated as "property" for U.S. federal tax purposes, noted that "[in] some environments, virtual currency operates like 'real' currency - i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance - but it does not have legal tender status in any jurisdiction."<sup>35</sup>

The implication of the foregoing, of course, is that while virtual currencies may operate as "real" currencies in some respects, they are not themselves real currency, because they are not issued by any country or designated as legal tender.<sup>36</sup> The U.S. statutory

---

<sup>31</sup> See e.g., <https://www.reuters.com/article/us-venezuela-economy-forex/venezuela-exchange-rate-fluctuation-sparks-price-surge-idUSKBN1AP2LM>.

<sup>32</sup> See *supra* note 28.

<sup>33</sup> 31 C.F.R. § 1010.100(m).

<sup>34</sup> *Id.*

<sup>35</sup> See <https://www.irs.gov/newsroom/irs-virtual-currency-guidance>.

<sup>36</sup> In a recent speech, Federal Reserve Governor Lael Brainard reinforced this distinction between cryptocurrencies and traditional currencies, noting that "the unit of the cryptocurrency itself...is distinct from any traditional form of money used in routine transactions, such as U.S. currency...There is no trusted institution standing behind it...in stark contrast to U.S. currency...[and] while a typical cryptocurrency may be used in payments, it is not legal tender, in contrast to U.S. currency." See <https://www.federalreserve.gov/newsevents/speech/brainard20180515a.htm>. James Bullard, President of the Federal Reserve Bank of St. Louis, provided an economic argument for government backing in a recent speech. He acknowledged that "privately issued" cryptocurrencies can coexist alongside government-issued "public currencies," but that the large number of privately issued cryptocurrencies - and the ability of any person to issue their own private cryptocurrency - appear to be creating an undesirable drift toward a non-uniform currency "in which many types of currency trade simultaneously at a variety of prices in a local market." He argued that such fragmentation, and the resulting volatility in currency prices, undermines the reliability of currencies and "is probably why government backing has been

definition of “legal tender” similarly refers to “United States coins and currency [including Federal Reserve notes and circulating notes of Federal Reserve banks and national banks].”<sup>37</sup> Additionally, the Federal Reserve’s calculation of the U.S money supply – including the “monetary base,” defined as the sum of currency in circulation and reserve balances – likewise fails to take assets such as bitcoin and other virtual currencies into account.<sup>38</sup>

This is not to say that the potential widespread use and adoption of virtual currencies in the future might not one day change this analysis, or spur changes to the law. However, as of present, bitcoin and virtual currencies do not appear to meet any applicable legal definition of “currency” for purposes of the Volcker Rule.

*Are virtual currencies “commodities,” are they “securities,” or are they both?*

Provided that virtual currencies are not currencies for purposes of the Volcker Rule, there is another avenue under which they might fall outside the Volcker Rule’s definition of “financial instrument”: if they were certain types of “commodities.” The definition of “commodity” under the Commodity Exchange Act (“CEA”) is broad, and includes “all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.”<sup>39</sup> Here, there is at least a little certainty: the Commodity Futures Trading Commission (“CFTC”) has asserted, and at least one federal court has agreed,<sup>40</sup> that “[bitcoin] and other virtual currencies are encompassed in the definition and properly defined as commodities.”<sup>41</sup>

The fact that virtual currencies are considered by the CFTC to be commodities, however, does not end the analysis: the Volcker Rule’s carve-outs from the definition of “financial instrument” are not available for commodities that are otherwise considered

.....  
important historically, combined with a stable monetary policy that promotes stability of the currency.” See [https://www.stlouisfed.org/~media/Files/PDFs/Bullard/remarks/2018/Bullard\\_Consensus\\_New\\_York\\_14\\_May\\_2018.pdf?la=en](https://www.stlouisfed.org/~media/Files/PDFs/Bullard/remarks/2018/Bullard_Consensus_New_York_14_May_2018.pdf?la=en).

<sup>37</sup> 31 U.S.C. § 5103.

<sup>38</sup> The monetary base consists of “M1” and “M2.” M1 is defined as the sum of currency held by the public and transaction deposits at depository institutions. M2 is defined as M1 plus savings deposits, small-denomination time deposits (those issued in amounts of less than \$100,000), and retail money market mutual fund shares. See [https://www.federalreserve.gov/faqs/money\\_12845.htm](https://www.federalreserve.gov/faqs/money_12845.htm).

<sup>39</sup> 7 U.S.C. § 1a(9).

<sup>40</sup> See [https://www.cftc.gov/sites/default/files/idc/groups/public/@Irenforcementactions/documents/legal\\_pleading/enfcoindroporder030618.pdf](https://www.cftc.gov/sites/default/files/idc/groups/public/@Irenforcementactions/documents/legal_pleading/enfcoindroporder030618.pdf).

<sup>41</sup> See [https://www.cftc.gov/sites/default/files/idc/groups/public/@Irenforcementactions/documents/legal\\_pleading/enfcoinfliporder09172015.pdf](https://www.cftc.gov/sites/default/files/idc/groups/public/@Irenforcementactions/documents/legal_pleading/enfcoinfliporder09172015.pdf).



derivatives or “excluded commodities” (which include financial commodities such as securities). Additionally, a futures position in a commodity (i.e., a contract of sale of a commodity for future delivery) also falls explicitly within the definition of financial instrument.<sup>42</sup> As a result, in order for a virtual currency that is a commodity to be properly excluded from being considered a financial instrument, (i) it must not otherwise be considered a security or derivative, *and* (ii) the banking entity must be transacting on a spot basis.<sup>43</sup> By the same token (pun intended), a commodity that is otherwise a security, a derivative, or a futures contract would be considered a financial instrument subject to the Volcker Rule.

Muddying the waters further are a number of SEC pronouncements that a wide swath of virtual currencies that are currently traded on unregistered exchanges – and in particular, “tokens” that have been issued by companies in numerous recent “initial coin offerings” (“ICOs”), are *likely* securities that were issued pursuant to unregistered offerings in contravention of federal securities laws.<sup>44</sup> While bitcoin’s characteristics generally allow it to fall outside the definition of security,<sup>45</sup> Ether, the second largest cryptocurrency by market capitalization, may be considered a security: Ether was issued pursuant to a public ICO in 2014, and the sale was neither registered with the

---

<sup>42</sup> As noted in the introduction, the parent company of the New York Stock Exchange (the Intercontinental Exchange, or “ICE”) was recently reported to be exploring the establishment of an online trading platform that would allow large investors to buy and hold bitcoin. Interestingly, the report noted that rather than allowing for the spot trading dollars for bitcoin, the prospective operation would allow banks to buy a swap that would end with the customer owning bitcoin the next day. Delivering bitcoin pursuant to such a contract “allows the trading to come under the regulation of the [CFTC] and to operate clearly under existing laws.” It would also, for the reasons explained in this Client Alert, cause banking entities that transact on the exchange to have such activities be subject to the Volcker Rule. See <https://www.nytimes.com/2018/05/07/technology/bitcoin-new-york-stock-exchange.html>.

<sup>43</sup> See Preamble, at 79 F.R. 5552 (“As under the proposal, loans, commodities, and foreign exchange or currency are not included within the scope of instruments subject to section 13. The exclusion of these types of instruments is intended to eliminate potential confusion by making clear that the purchase and sale of loans, commodities, and foreign exchange or currency...are outside the scope of transactions to which the proprietary trading restrictions apply. For example, the spot purchase of a commodity would meet the terms of the exclusion, but the acquisition of a futures position in the same commodity would not qualify for the exclusion.”) (emphasis added).

<sup>44</sup> See <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

<sup>45</sup> While no court or government agency has yet opined on whether bitcoin is a security, it is unlikely that it would meet the criteria established by the Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (“*Howey*”). Under the test established in *Howey*, an investment contract (a type of security) exists if there is (1) an investment of money (2) in a common enterprise (3) with an expectation of profits predominantly from the efforts of others. Because of bitcoin’s foundational characteristics – among other factors, it was not sold pursuant to an initial offering, there is arguably no “common enterprise,” and new bitcoins are produced pursuant to a “mining” process rather than by a central issuer – it has largely escaped discussion of whether it should be characterized as a security.

SEC nor determined to be subject to an exemption from registration.<sup>46</sup> Regulators have reportedly focused on a number of factors, including the extent to which demand for Ether stems from people who use it to run applications on the Ethereum platform and whether Ether's price depends on the actions of a central actor, such as the Switzerland-based Ethereum Foundation.<sup>47</sup> A number of other parties, including the prominent Silicon Valley firm Andreessen Horowitz, have pushed back, arguing that Ether "has become so decentralized it should not be deemed a security."<sup>48</sup> While the SEC has yet to issue any formal determination on the issue, some regulators reportedly think Ether is currently in a "gray zone," but that its 2014 ICO was probably an illegal securities sale.<sup>49</sup>

Meanwhile, Ripple Labs, the company behind the third largest cryptocurrency by market capitalization, currently faces a lawsuit that its XRP tokens are unregistered securities that have been sold by the company pursuant to a "never-ending ICO."<sup>50</sup> The complaint alleges that XRP tokens are investment contracts under the *Howey* test because (1) purchasers of XRP made an investment of money in a common enterprise (i.e., Ripple Labs, which "sells XRP to fund its operations and promote the network"); (2) XRP investors had a reasonable expectation of profits, in part based on various statements made by Ripple's CEO touting the long-term value of XRP; and (3) the success of XRP requires efforts of Ripple Labs and others, as Ripple Labs exercises near complete control over the XRP ledger.<sup>51</sup>

The stakes are high: any determination by the SEC that a particular cryptocurrency is a "security" would subject both the issuer, and the exchanges that allow trading of that cryptocurrency, to federal securities laws and potential SEC enforcement actions.<sup>52</sup> The CFTC has acknowledged the SEC's jurisdiction over such virtual currencies, noting that "[there] is no inconsistency between the SEC's analysis and the CFTC's determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and

---

<sup>46</sup> See <https://www.wsj.com/articles/worlds-second-most-valuable-cryptocurrency-under-regulatory-scrutiny-1525167000>.

<sup>47</sup> *Id.*

<sup>48</sup> See <https://www.wsj.com/articles/worlds-second-most-valuable-cryptocurrency-under-regulatory-scrutiny-1525167000>.

<sup>49</sup> *Id.*

<sup>50</sup> See <https://www.bloomberg.com/news/articles/2018-05-04/ripple-hit-with-class-action-suit-over-never-ending-ico>. The complaint is available at <https://static1.squarespace.com/static/5938711a9de4bb74f63b4059/t/5aebc4112b6a28e0ef4a0381/1525400594617/Coffey+v+Ripple+Labs+Complaint.pdf>.

<sup>51</sup> *Id.*

<sup>52</sup> See <https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission>.

circumstances.”<sup>53</sup> While a complete discussion of the regulatory characterization of cryptocurrencies is outside the scope of this Client Alert (and, to date, an issue that remains very much unsettled), it suffices to say that (i) as a general matter, virtual currencies are commodities, but that (ii) many virtual currencies, and especially tokens that have been issued pursuant to ICOs, may be securities (and therefore excluded commodities) that would be considered financial instruments under the Volcker Rule. Aside from a number of discrete enforcement actions in which the SEC has found that a token constituted a security, however, the characterization of many cryptocurrencies (including a number that are freely traded on unregistered U.S. exchanges)<sup>54</sup> remains in a state of regulatory limbo.

*Some cryptocurrencies may be financial instruments, and some may not. What does that mean under the Volcker Rule?*

Given the foregoing, the universe of virtual currencies may essentially be divided into those that are (or almost certainly are) “financial instruments” under the Volcker Rule, and those that are not. Proprietary trading in assets that are not financial instruments falls outside of the Volcker Rule, but may be subject to general prudential concerns regarding safety and soundness, as described further below. Proprietary trading in assets that *are* financial instruments subjects a banking entity to the Volcker Rule and its myriad restrictions, exclusions, and exemptions.

While a full discussion of the Volcker Rule’s exclusions and exemptions is also outside the scope of this Client Alert, one route that a banking entity could take to trade cryptocurrencies is by doing so in response to customer demand, under the Volcker Rule’s exemption for market making-related activities (the “market-making exemption”). This exemption allows banking entities to provide intermediation and liquidity services to individual customers or to a given marketplace notwithstanding the general prohibition against proprietary trading. The market-making exemption is designed, at least in theory, to account for market making “across markets and asset classes,”<sup>55</sup> and therefore contains language allowing for certain requirements to be tailored to the liquidity, maturity and depth of the market of the relevant financial instruments.

---

<sup>53</sup> See [https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcfctc\\_primercryptocurrencies100417.pdf](https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcfctc_primercryptocurrencies100417.pdf).

<sup>54</sup> See, e.g., <https://bittrex.com/>.

<sup>55</sup> Preamble, at 79 F.R. 5589.

The market-making exemption applies largely at the level of each “trading desk” that engages in market making-related activities for one or more financial instruments.<sup>56</sup> In order to claim the market-making exemption, a trading desk must meet a host of requirements and conditions, including that it “routinely stands ready” to buy and sell the financial instrument(s) in which it makes a market and that it ensures that the instruments it carries in inventory at any time must be designed not to exceed the reasonably expected near term demand of its customers.<sup>57</sup> The market-making exemption also requires that, among others, the banking entity maintains an appropriate compliance program and that compensation arrangements for market-making personnel do not reward or incentivize prohibited proprietary trading.

While the purpose of the market making exemption is straightforward, compliance with its conditions has proved to be anything but: Federal Reserve Vice Chairman for Supervision Randal K. Quarles recently acknowledged that “the statute and implementing regulation’s approach to defining ‘market making-related activities’ rests on a number of complex requirements that are difficult or impossible to verify objectively in real time,” and as a result, “banks spend far too much time and energy contemplating whether particular transactions or positions are consistent with” the Volcker Rule.<sup>58</sup> Such difficulties are likely to be amplified when applied to a novel and emerging asset class such as virtual currencies, and may present a dilemma for banking entities looking to enter the virtual currency markets: on the one hand, banking entities may prefer to test the waters by limiting themselves to trading in regulated financial instruments (such as futures contracts that don’t require the banking entity to buy or sell the underlying asset) or on CFTC-regulated exchanges (such as an exchange that only lists swaps for bitcoin that are delivered on a delayed basis), thereby subjecting themselves to the Volcker Rule’s restrictions, compliance burdens, and prohibitions against trading for the purpose of realizing short-term profits. On the other hand, banking entities that would prefer to avoid incurring additional Volcker Rule compliance burdens, or that even seek explicitly to profit from the short-term trading of virtual currencies, are generally limited to trading on a spot basis in virtual currencies that fall outside the Volcker Rule’s definition of financial instrument.

<sup>56</sup> A trading desk is the “smallest discrete unit of organization” that banking entities use to trade for their own account. A trading desk may span multiple affiliated legal entities; additionally, a trading desk may include employees working on behalf of multiple affiliated entities or booking trades in multiple affiliated entities, provided that the trading desk keeps proper records of such trades and can provide those records to regulators upon request. 12 C.F.R. § 248.3(e)(13).

<sup>57</sup> 12 C.F.R. § 248.4.

<sup>58</sup> See <https://www.federalreserve.gov/newsevents/speech/quarles20180305a.htm>. We note that the Federal Reserve and the other four agencies that promulgated the Volcker Rule have publicly announced that they collectively are reviewing certain areas of the rule for potential re-proposal, including the restrictions on market-making.

### *What about the Covered Fund prohibitions of the Volcker Rule?*

Up to this point, this Client Alert has focused on the proprietary trading component of the Volcker Rule. While the Volcker Rule's other component – its prohibition on investing in, or maintaining certain relationships with, “covered funds” – is less immediately relevant to entities buying and selling virtual currencies, there are other avenues under which the covered fund provisions may be implicated. One novel concern, because cryptocurrency or blockchain-focused companies may have significant holdings of assets that are (or potentially could be deemed) “securities,” is whether such companies may be “covered funds” within the meaning of the Volcker Rule.<sup>59</sup> Banking entities are generally prohibited from acquiring “ownership interests” in covered funds, subject to a number of exclusions and exemptions that carry heavy compliance burdens.

The Volcker Rule defines a covered fund to include, with certain exceptions, an issuer that would be an “investment company” under the Investment Company Act of 1940 (“1940 Act”), *but for* Section 3(c)(1) or 3(c)(7) of the that Act.<sup>60</sup> This definition, originally used in the Volcker Rule statute as a means of identifying a hedge fund or private equity fund, has notably captured a wide range of additional entities that bear little resemblance to a “real” hedge fund or private equity fund. The 1940 Act's definition of “investment company” is broad, and if an unregistered entity falls within that definition without qualifying for an exception other than under Section 3(c)(1) or 3(c)(7), it will be a *prima facie* covered fund for purposes of the Volcker Rule.

The definition of investment company encompasses, among others, any issuer which “is engaged...in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 [percent] of the value of such issuer's total assets...on an unconsolidated basis.”<sup>61</sup> One can readily imagine how certain companies in the cryptocurrency space might fall within this broad bucket: for example, Ripple Labs (in which a number of banking entities have acquired an ownership interest),<sup>62</sup> has sold approximately 40 billion XRP tokens, and retains the remaining approximately 60 billion XRP tokens

<sup>59</sup> A full analysis of the complicated potential issues under the Volcker Rule's covered funds provisions is beyond the scope of this Client Alert. While we briefly introduce and analyze the issues here, we intend to explore this subject more fully in a future alert.

<sup>60</sup> 12 C.F.R. § 248.10. Section 3(c)(1) of the 1940 Act exempts from the definition of “investment company” funds whose securities are sold privately to less than 100 purchasers. Section 3(c)(7) exempts from the definition of “investment company” funds whose securities are sold privately only to “qualified purchasers.” 15 U.S.C. § 80a-3.

<sup>61</sup> 15 U.S.C. § 80a-3(a)(1)(C).

<sup>62</sup> See [https://www.crunchbase.com/organization/ripple-labs/investors/investors\\_list](https://www.crunchbase.com/organization/ripple-labs/investors/investors_list).

currently in existence.<sup>63</sup> That gives Ripple Labs approximately \$45 billion worth of XRP tokens (at a value, at the time of this writing, of 75 cents per XRP token).<sup>64</sup> While Ripple Labs is a privately held company and its financial statements are not publicly available, its large cache of XRP tokens means that any determination that those tokens are “securities” would likely raise the specter that Ripple Labs might be deemed a *prima facie* investment company under the 1940 Act’s definition.

The result above wouldn’t necessarily raise insurmountable issues under either the Volcker Rule or the 1940 Act; a *prima facie* investment company that qualifies for an exclusion or exemption other than Section 3(c)(1) or 3(c)(7) would be neither an investment company nor a covered fund. Section 3(b)(1) of the 1940 Act, for example, provides an exclusion from the investment company definition for certain issuers that are primarily engaged “in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.”<sup>65</sup> Although this provision is narrowly construed and highly fact-specific, a company such as Ripple – which develops and maintains a number of platforms and software solutions in addition to issuing and holding XRP – would likely argue that its primary business is something other than holding or selling XRP.<sup>66</sup> Nevertheless, as organizations that have spent the past several years conducting 1940 Act analyses on every nook and cranny of their worldwide holdings can attest, *prima facie* investment company status would at the very least place an unwelcome compliance burden on banking entities that hold ownership interests in Ripple and other similar companies.

#### **PRUDENTIAL CONCERNS**

*Just because you can, does that mean you (actually) can?*

Assuming a banking entity has determined that its virtual currency trading activities are permitted – either because the relevant asset is not a financial instrument under the Volcker Rule, or because the banking entity’s trading activities qualify for an exemption from the Volcker Rule – the analysis may *still* not be over. Any activities

<sup>63</sup> Ripple Labs currently holds the majority of its XRP in a series of escrows implemented on the XRP ledger itself. See <https://ripple.com/dev-blog/explanation-ripples-xrp-escrow/>.

<sup>64</sup> See <https://coinmarketcap.com/currencies/ripple/>.

<sup>65</sup> 15 U.S.C. § 80a-3(b)(1).

<sup>66</sup> The determination may be less clear with respect to many other companies that have sold tokens pursuant to ICOs and that continue to retain a significant portion of their tokens. As discussed elsewhere in this client alert, the SEC has placed many such companies within its crosshairs, both because it suspects that many tokens issued pursuant to ICOs are unregistered securities, and because many such companies may essentially be scams that have no legitimate business activities at all, let alone a primary business other than owning or holding securities. See, e.g., <https://www.wsj.com/articles/sec-launches-cryptocurrency-probe-1519856266>.

subject to the Volcker Rule are ultimately subject to its “prudential backstops,” which prohibit banking entities from engaging in, among others, any transactions or activities that would result in a material exposure by the banking entity to a “high-risk asset” or “high-risk trading strategy.” These prudential backstops apply even if such activity were otherwise permitted under the terms of one of the Volcker Rule’s exemptions (such as the market-making exemption).<sup>67</sup> The Volcker Rule defines a “high-risk asset” as “an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States”; a “high-risk trading strategy” means “a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.”<sup>68</sup>

Even in the event that a banking entity limits its virtual currency trading activities to non-financial instruments that fall outside of the scope of the Volcker Rule, the BHC Act provides the Federal Reserve with broad powers to order the termination of activities conducted by a bank holding company or nonbank subsidiary of such bank holding company that “[constitute] a serious risk to the financial safety, soundness, or stability” of a subsidiary depository institution.<sup>69</sup> While regulators have never (to our knowledge) invoked the Volcker Rule’s prudential backstops or declared virtual currencies a threat to safety and soundness, and we can only speculate as to whether regulators would consider virtual currencies a “high-risk asset” or banking entities trading virtual currencies to be engaging in a “high-risk trading strategy,” we note that the possibility exists. Prices of many virtual currencies are notoriously volatile, and a number of central banks and regulators around the world have taken skeptical stances toward bitcoin and other virtual currencies.<sup>70</sup> Randal Quarles argued in a speech last November that “if the central asset in a payment system cannot be predictably redeemed for the U.S. dollar at a stable exchange rate in times of adversity, the resulting price risk and potential liquidity and credit risk pose a large challenge for the

---

<sup>67</sup> 12 C.F.R. § 248.7.

<sup>68</sup> *Id.*

<sup>69</sup> 12 U.S.C. § 1844(e).

<sup>70</sup> For example, in April 2018, the Reserve Bank of India (“RBI”) issued a statement barring RBI-regulated entities from dealing with, or providing services to, any individual or businesses dealing with or settling virtual currencies. See <https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR264270719E5CB28249D7BCE07C5B3196C904.PDF>. More recently, a European Central Bank board member called for banks engaging in virtual currency trading to segregate such activities from other trading and investment activities, and to ensure that such activities are “backed by adequate levels of capital.” See <https://www.reuters.com/article/us-ecb-policy-bitcoin/ecb-wants-banks-to-segregate-any-virtual-currency-business-idUSKCN1IF168>.

system,” adding that “more serious financial stability issues may result if [digital currencies] achieve wide-scale usage.”<sup>71</sup> The ability of an institution to safeguard its digital assets will likely also receive regulatory scrutiny, as the history of virtual currencies is littered with a number of widely-publicized hacks of exchanges and other entities holding virtual currencies.<sup>72</sup>

Needless to say, a banking entity seeking to enter the virtual currency markets likely must consult its primary regulator and attempt to proactively address any of the foregoing concerns in advance of commencing any new activities, even if regulatory approval is not otherwise required under applicable law.

### **CONCLUSION**

The banking industry and the world of virtual currencies currently operate in parallel, but separate universes. There are significant reasons to push these worlds together: virtual currencies need the stability, liquidity, operational capacity and reputational boost that would come from banks beginning to treat them in a manner similar to other financial products. Banks will benefit from the introduction of new products and new customers in an increasingly competitive world. However, there is resistance to a marriage on each side. Many users of virtual currencies use them in order to avoid the banking system, and the regulatory issues and oversight it brings. And, as discussed above, the laws that govern the financial system do not easily contemplate products developed by new technology. Ultimately, some combination of Congress, the regulatory agencies and the courts will need to provide guidance on these issues.

We will be back soon with a Client Alert discussing cryptocurrencies and covered funds under the Volcker Rule.

---

<sup>71</sup> See <https://www.federalreserve.gov/newsevents/speech/quarles20171130a.htm>. See also a recent speech by Federal Reserve Governor Lael Brainard, noting that “the still relatively small scale of cryptocurrencies in relation to our broader financial system and relatively limited connections to our banking sector suggest that they do not currently pose a threat to financial stability,” but that “if cryptocurrencies were to achieve wide-scale use, or their impact were greatly magnified through leverage, the effects could be broader.” <https://www.federalreserve.gov/newsevents/speech/brainard20180515a.htm>.

<sup>72</sup> See, e.g., <https://arstechnica.com/tech-policy/2017/12/a-brief-history-of-bitcoin-hacks-and-frauds/>. See also the concerns recently articulated by Governor Brainard (“The lack of strong governance and questions about the applicable legal framework for some cryptocurrencies may make consumers vulnerable to mistakes, thefts, and security breaches without much, or any, recourse.”) <https://www.federalreserve.gov/newsevents/speech/brainard20180515a.htm>.



**FINANCIAL INSTITUTIONS  
REGULATION GROUP**

Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the members of our Financial Institutions Regulation Group.

This Client Alert is a source of general information for clients and friends of Milbank, Tweed, Hadley & McCloy LLP. Its content should not be construed as legal advice, and readers should not act upon the information in this Client Alert without consulting counsel.

© 2018 Milbank, Tweed, Hadley & McCloy LLP.

All rights reserved.

**NEW YORK**

28 Liberty Street, New York, NY 10005

---

Wayne Aaron	waaron@milbank.com	+1-212-530-5284
Joel Harrison	jharrison@milbank.com	+44-20-7615-3051
Douglas Landy	dlandy@milbank.com	+1-212-530-5234
Catherine Leef Martin	cmartin@milbank.com	+1-212-530-5189
Nicholas Smith	nsmith@milbank.com	+1-202-835-7522
John Williams	jwilliams@milbank.com	+1-212-530-5537
Melissa Ferraro	mferraro@milbank.com	+1-212-530-5332
James Kong	jkong@milbank.com	+1-212-530-5244