

# The New York AG Weighs In On Virtual Currency Exchanges

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The regulation and operations of virtual currency exchanges are again in the spotlight, due to the new report issued by the Office of the New York Attorney General (**OAG**). The [report](#), which follows the April launch by the OAG of its Virtual Markets Integrity Initiative (**VMII**), describes in detail the results of the OAG's "fact-finding inquiry into the policies and practices of platforms used by consumers" (discussed in an earlier [Blockchain Bulletin](#)).

The report is based upon responses provided voluntarily to the OAG by nine of the thirteen cryptocurrency exchanges to which the OAG sent a [questionnaire](#) when launching the VMII.<sup>[1]</sup> The remaining four exchanges declined to respond, some in no uncertain terms,<sup>[2]</sup> on the basis that they do not allow trading from New York.

The report pointedly criticizes many aspects of the operations of virtual currency exchanges, from transparency for participants on the markets, to security, to the robustness of internal controls and procedures. The report also applies several hotly debated securities market structure concepts, such as automated and high-speed trading and maker-taker pricing, to virtual currency markets and, in doing so, concludes that some trading practices and policies of the surveyed exchanges may advantage institutional market participants over retail ones. And, while the report is silent on whether the New York AG may be considering further investigation or action against these exchanges, it states that the OAG has referred three of the four exchanges that did not respond to its questionnaire to the New York Department of Financial Services for further review.

## Susceptibility to Manipulation and Transparency

The report focuses heavily on OAG's concerns about the susceptibility of virtual currency exchanges to manipulative trading activity and about fairness for retail investors trading on these exchanges. The report observes, for example, that while all of the surveyed exchanges prohibited market manipulation in their terms of service, "only a few reported having a formal policy in place, defining the types of conduct the platform believes to be manipulative or abusive." While acknowledging that the virtual currency markets are not regulated in the same manner as securities exchanges, the report states that "the industry has yet to implement serious market surveillance capacities" like those required for and deployed by securities trading venues.

Sources of conflicts of interest, and the thoroughness of disclosure of those conflicts of interest, are another area of concern for the OAG. For example, the report describes apparent differences in approaches taken by different exchanges in determining which virtual currencies to offer for trading, including whether exchanges are compensated for agreeing to do so. Employee trading, and restrictions on employee trading, are also highlighted as areas in which virtual currency exchange policies and practices both vary widely and "stand[] in contrast to traditional securities markets."

## Diving into Securities Market Structure Debates

Throughout the report, the OAG uses traditional securities market structure concepts as guideposts against which to measure the performance of virtual currency exchanges. Clearly, the OAG believes that those should be applied directly to virtual currency markets as they develop. However, the benefits and detriments to securities market participants from many of the practices highlighted in the report, from automated and high-speed trading, to co-location, to maker-taker fees, are far from settled.

For example, the report faults several exchanges for developing products and services that "appeal to, and advantage, sophisticated professional electronic traders, increasing risks for retail traders." As an example, the OAG states that

“some platforms offer high-speed direct market data feeds to professional traders, and permit traders to “co-locate’ or ‘cross-connect’ their trading computers to the platform’s servers.” However, co-location and direct data feeds are commonplace in securities markets and it is not clear that those practices harm retail investors, whose investment and trading strategies are different from those of institutional market participants. Similarly, the report describes how some of the responding exchanges employ maker-taker fee structures. The report concludes that these fee structures “favor professional traders over retail customers and may create incentives that distort the market.” Maker-taker pricing has been a security market feature for decades, intended to incentivize market makers to provide liquidity. As we’ve blogged [previously](#), in March 2018 the SEC proposed to establish a transaction fee pilot program to study the effects of such fee structures on order routing behavior, execution quality and market quality, as well as whether such fee structures create conflicts of interest for broker-dealers. While we agree that disclosure of these practices is appropriate, any conclusions in the report that they are fundamentally harmful to investors in virtual currency markets is premature.

### **What Next?**

The report was received cautiously, but optimistically, by the newly formed Blockchain Association, which was quoted by [POLITICO](#) as welcoming “all efforts to ensure consumer protection, market integrity, and ethical standards within this rapidly evolving industry.” We believe that virtual currency exchanges and other market participants should assume that this will not be the last word from the OAG or other regulators on these issues. It is an opportune time to improve market surveillance abilities and conflicts policies, and to review other policies, procedures, and practices that are highlighted in the report. While this may not necessarily mean always hewing to the methods and tools employed by regulated securities exchanges, there are areas in which policies, procedures, and practices can be enhanced.

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[1] Exchanges to receive questionnaires were Coinbase, Inc. (GDAX); Gemini Trust Company; bitFlyer USA, Inc.; iFinex Inc. (Bitfinex); Bitstamp USA Inc.; Payward, Inc. (Kraken); Bittrex, Inc.; Circle Internet Financial Limited (Poloniex LLC); Binance Limited; Elite Way Developments LLP (Tidex.com); Gate Technology Incorporated (Gate.io); itBit Trust Company; and Huobi Global Limited (Huobi.Pro).

[2] In a [blog post](#) published shortly after the OAG launched the questionnaire, Kraken stated that it “has no NY clients” and for that reason (as well as others) it would not be offering a response to the OAG’s “ill-prepared ... overly broad fishing expedition.”

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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