Manifest Destiny: Risk, Opportunity & Reward Around Digital Currencies

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Rip Tide: Visibility & Volatility Around Global Regulation

Moderator:

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Hypothetical Client Inquiry

A Swiss blockchain gaming company, SMAXXI, with its own crypto token (SMX), is doing very well. It seeks to expand by setting up offices in Shanghai and New York to attract more engineering talent and offer services to US customers.

SMAXXI's founder and visionary contacts you. The only guidance given is (1) help us be compliant with all laws and regulations in the relevant jurisdictions -- we especially don't want to get into trouble with the SEC and (2) we want this to happen as quickly as possible. They are also contemplating taking in additional investors who will put in fiat in exchange for purchase of SMX at a discount. They will also need to do large money transfers from their Swiss banks to US banks to fund domestic operating expenses (and presumably need to do the same for the China operations once up and running).

Legal spend is not the issue. Rather, they are having difficulty identifying attorneys with the necessary understanding around blockchain and crypto to advise them. They have heard about the Thompson Reuters Manifest Destiny 2-day seminar, and are eager to get connected with lawyers who attended.

“The Crypto Universe” and "Web 3.0"

Q: Cryptocurrency vs Digital Assets: What is the distinction?

A: Cryptocurrency is a type of digital asset.

Big picture of Web 3.0 and digital assets - terminology:

- Digital assets, Virtual assets, Cryptoassets
- Cryptocurrency, Virtual currency, Digital currency
- Digital coins
- Utility and Digital tokens, Smart contracts
- Stablecoins vs. cryptos
- Central bank digital currency (CBDC)
- Non-fungible tokens (NFTs)

Regulatory Challenges

Regulation of Cryptocurrency and Digital Assets in the US: Overview

Q: How are cryptocurrency and digital assets regulated in the US?

A: Depends on type of entity and activity.

Cryptocurrency and digital assets are currently subject to a patchwork of regulation in the US

- Startups/Issuers
- Banks and financial institutions
- Funds and investment vehicles
- Exchanges and digital asset platforms (trading, DeFi, etc.)
- Custodians and other service providers
- Broker-dealers, CPOs, CTAs, swap dealers, retail brokers
- Individual traders and miners
- Other parties

KEY PARTICIPANTS IN CRYPTO REGULATION

The regulatory bodies and their potential roles in developing a crypto regulatory framework in the U.S.:

- **Presidents Working Group (PWG)** oversight and coordination
- **Financial Stability Oversight Council (FSOC)** oversight and coordination
- **Congress and the Internal Revenue Service (IRS)**
  filling in regulatory gaps and tax policy and collection
- **Securities and Exchange Commission (SEC)**
  investor protection, oversight of the trading platforms or exchanges
- **Commodity Futures Trading Commission (CFTC)** oversight of the trading platforms or exchanges
- **Consumer Financial Protection Bureau (CFPB)** investor protection and fraud
- **Office of the Comptroller of the Currency (OCC)** bank-related activities such as custody
- **Financial Crimes Enforcement Network (FinCEN)** payments, AML CTF and international aspects
- **Federal Reserve Board (FED)** systemic risks, and central bank digital currency efforts
- **Federal Deposit Insurance Corporation (FDIC)** stablecoins and banking





Financial Crime and AML Risks/Concerns

- There are over 300 exchanges operating around the world with differing levels of AML/CTF controls
  - There is also different risks associated with your customers interacting with different exchanges
- There are currently over 35,000 cash-to-cryptocurrency locations in the United States
- All fraudulent typologies that once utilized alternative methods (WU, MG, gift cards, etc.) have shifted to using cryptocurrency
- New typologies such as "rug pulls", NFT wash trading, ransomware payments, and dark marketplaces have developed as a result of cryptocurrency adoption
- **Cryptocurrency should be considered a red flag for suspicious activity, within a bigger typology, and not inherently suspicious on its own!**

Regulation of Cryptocurrency and Digital Assets in the US: Overview

- **Also subject to regulation by**:
  - **Self-regulatory organizations (SROs)** – FINRA (broker-dealers), NFA (swap dealers, CPOs, CTAs)
  - **Global standard-setting bodies** – BCBS, BIS, FSB, FATF
- **Applicable state statutes and regulations:**
  - **State virtual currency business statutes** - including New York State BitLicense framework
  - **State money services business (MSB) statutes** and related licensing requirements
  - **State money transmitter laws** and related licensing requirements
  - **State securities laws** – BlockFi action (NJ, AL. TX, VT. KY)
  - **State DAO statues** (Wyoming)
  - **State crypto banking regulations** (Texas)
  - **State money-laundering statutes** (FL)

Structures for selling crypto

- Virtually all sales of crypto assets are currently conducted pursuant to state money transmitter licenses.

Direct

- Sell directly to customers
- Licensed by states as money transmitter
- NY Bitlicense is key element
- Examples – Virtual all crypto exchanges (Coinbase, Binance, Kraken)
- Robinhood, Paypal

Partnership

- Institution partners with licensed Crypto entity
- Customer contracts with Crypto entity
- Likely path for most banks and Broker-Dealers
- Examples – NYDIG, BAKKT, Apex Crypto

Bank License

- Faciliting crypto transactions for customers (back-end partner) and acting as custodian
- National Trust Charter
- Examples - Anchorage, Protego, and Paxos

New York Bitlicense

- Most crypto businesses servicing New York customers (retail or institutional) or operating in NY will require a Bitlicense from the NY Department of Financial Services (DFS)
  - Challenges are sufficiently high that some companies do not do business in NY (Kraken and Bittrex)
  - Others are awaiting license approval

- DFS' consideration of applications has been slow
  - No approvals from March 2021 to February 2022
  - Adrienne Harris was confirmed as Superintendent of DFS in January 2022 which has resulted in some movement on bitlicense applications
    - BitOada and Apex approved March 29, 2022

- Recently passed budget provides DFS with the authority to collect supervisory costs through assessments from bitlicense entitities

New York Bitlicense – Application Requirements

- Extensive application requirements.*

  - **Background information**
    - Information about participants, including personal financial statements
    - Business plan
    - Qualified Chief Compliance Officer (3 years comparable experience)

  - **Capital Requirements**

  - **Anti-Money Laundering**
    - Policy, procedures, and related risk assessment
    - Most recent independent review
    - Qualified AML officer (3 years comparable experience)

  - **Cybersecurity**
    - Policy, procedures, and related risk assessment
    - Most recent independent review
    - Qualified CISO
    - NY Cybersecurity rules have prescriptive requirements and potentially apply to affiliates (annual penetration testing)

*https://mortgage.nationwidelicensingsystem.org/slr/PublishedStateDocuments/NY_Virtual_Currency_New_Application_Checklist.pdf

New York Bitlicense – Application Requirements Continued

- **Third-Party Service Provider Management and Onboarding**
  - Policy and procedure
  - List of all third party service providers, description of services and due diligence
- **Business Continuity and Disaster Recovery**
  - Policy, procedures, and related risk assessment
- **Consumer Protection**
  - Policy and Procedures, and related sample documents
- **Anti-Fraud**
  - Policy, procedures, and related risk assessment
- **Complaints**
  - Policy and procedures

Banks and Crypto

- Current ability of banks to engage in crypto activities is somewhat murky and regulators have promised to clarify during 2022
- Bank regulators seem to have concluded that it's legally permissible for banks to partner with Crypto providers to allow Crypto providers to provide Crypto services directly to bank customers
  - NYDIG and Bakkt
- OCC has approved a variety of crypto activities
  - Cryptocustodial activities (IL 1170 2020)
  - Holding stablecoin reserves (IL 1172 2020)
  - Acting as nodes on an independent node verification networks and engaging in related stablecoin activities. Also noted that Banks could use new technologies to conduct bank-permissible functions (IL 1174 2021)
- Prior notification/approval of crypto activities
  - FDIC requires prior notification (FIL-16-2022)
  - OCC requires that a bank "demonstrate, to the satisfaction of its supervisory office, that it has controls in place to conduct the activity in a safe and sound manner" and receive written non-objection from its regulator (IL 1179 2021)
  - Fed has not addressed this issue for state-member banks

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Crypto and the Bank Holding Company Act

- **Background –** Companies that own an FDIC-insured bank may only engage in activities that are authorized under the Bank Holding Company Act
  - Commercial activities are not permitted
  - Applies to US activities of foreign banks that own US banks
- Federal Reserve has not formally opined on what crypto activities are permissible under the Bank Holding Company Act.

*https://mortgage.nationwidelicensingsystem.org/slr/PublishedStateDocuments/NY_Virtual_Currency_New_Application_Checklist.pdf

SEC Chair Gary Gensler: *SEC Regulation Is Tech-Neutral, Digital Assets That Are Securities Will Be Regulated Like Securities*

The SEC's remit is overseeing the capital markets and our three-part mission: protecting investors, facilitating capital formation, and maintaining fair, orderly, and efficient markets. Within the policy perimeter, regulators also care about guarding against illicit activity, a role that is so important to us and our partners at the Department of the Treasury and the Department of Justice; and about financial stability, which is important to all financial regulators.

There's no reason to treat the crypto market differently just because different technology is used. We should be technology-neutral.

Prepared Remarks of Gary Gensler On Crypto Markets
Penn Law Capital Markets Association Annual Conference
April 4, 2022

The SEC's Regulatory Breakdown Of The Crypto Markets

Platforms

- **Crypto platforms trading or lending tokens that are securities**
- **Current SEC initiatives**
  - Register crypto platforms that trade securities as exchanges
  - Work with the Commodity Futures Trading Commission to develop a regulatory scheme for platforms that trade a mix of commodity and security crypto assets
  - Evaluate custody issues
  - Evaluate market-making issues

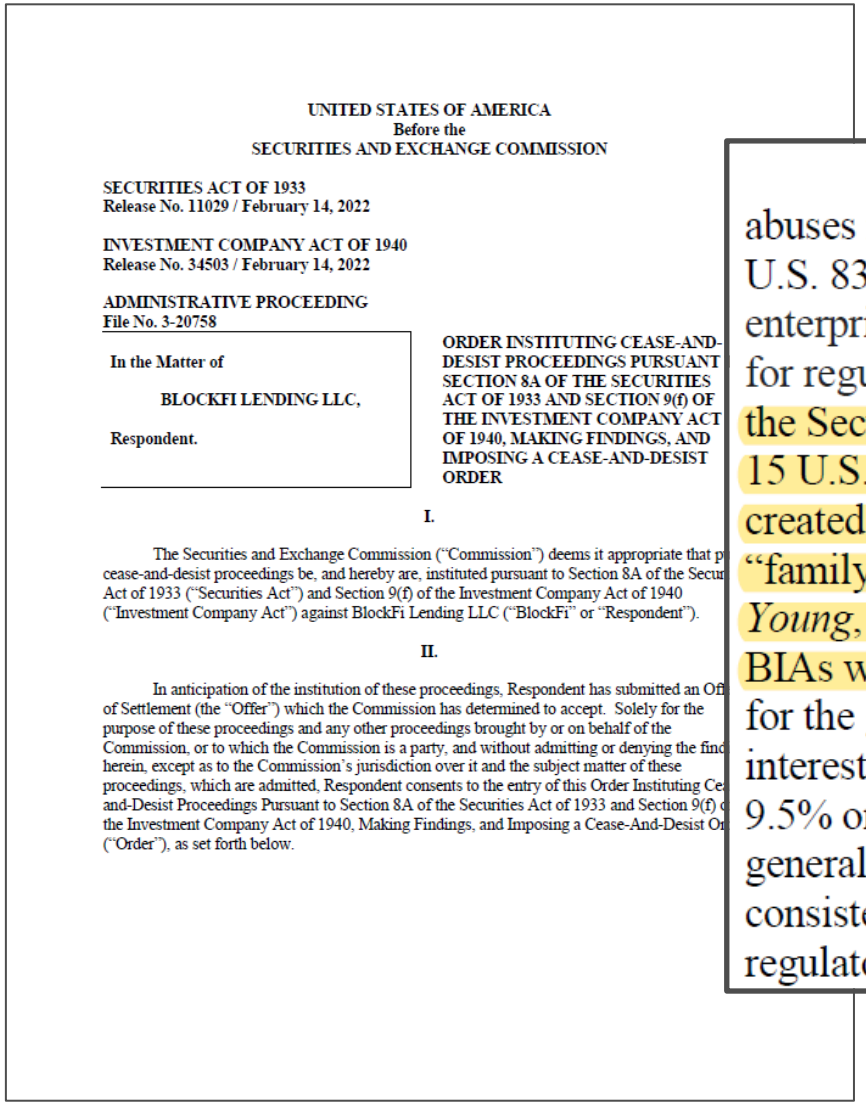
Stablecoins

- **Because asset-backed, implicate financial stability**
  - Similar to money market accounts, SEC concerned with loss of a peg or inability to redeem
- **Also, can move without intersecting with fiat currency and the traditional banking system**
  - SEC concerned with illicit activity
- **Implicate investor protection concerns because investors typically do not own stablecoins**
  - SEC concerned with market integrity, redemption rights, and potential conflicts of interest

Tokens

- **Most crypto tokens are securities—a few may be commodities or currencies**
- **Whether a crypto token is a security depends on the token's particular facts and circumstances**
- **Current SEC initiatives**
  - Force crypto tokens that are securities to register with the SEC and satisfy ongoing disclosure requirements, if not eligible for a registration exemption
  - Force issuers to register their new offers and sales of crypto tokens that are securities

SEC Director of Enforcement Gurbir Grewal: *To Understand SEC's Enforcement Stance On Crypto, Read BlockFi Order*



UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 11029 / February 14, 2022

INVESTMENT COMPANY ACT OF 1940
Release No. 34503 / February 14, 2022

ADMINISTRATIVE PROCEEDING
File No. 3-20758

In the Matter of

BLOCKFI LENDING LLC,

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 9(f) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

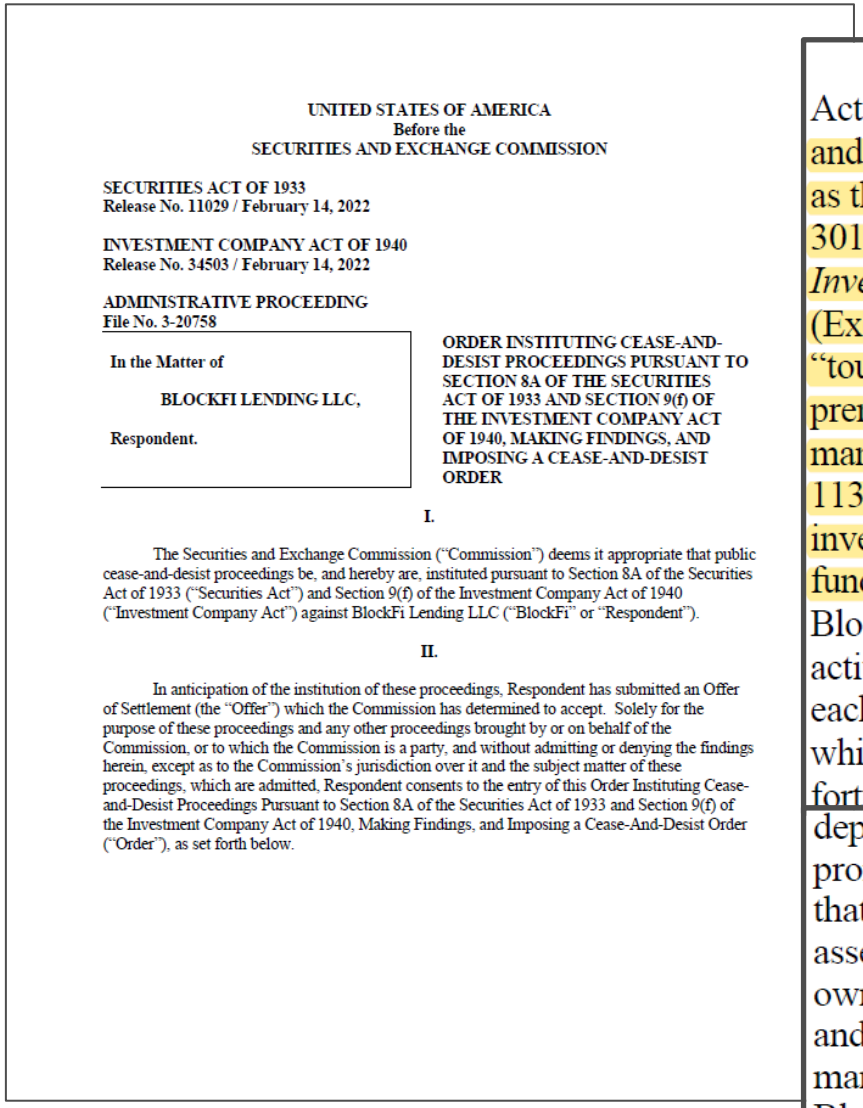
The Securities and Exchange Commission ("Commission") deems it appropriate that p
cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Secur
Act of 1933 ("Securities Act") and Section 9(f) of the Investment Company Act of 1940
("Investment Company Act") against BlockFi Lending LLC ("BlockFi" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Off
of Settlement (the "Offer") which the Commission has determined to accept. Solely for the
purpose of these proceedings and any other proceedings brought by or on behalf of the
Commission, or to which the Commission is a party, and without admitting or denying the find
herein, except as to the Commission's jurisdiction over it and the subject matter of these
proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Ce
and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 9(f) o
the Investment Company Act of 1940, Making Findings, and Imposing a Cease-And-Desist Or
("Order"), as set forth below.

30. The Securities Act and the Exchange Act were designed to "eliminate serious abuses in a largely unregulated securities market." *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975). They are focused, among other things, "on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes . . . and the need for regulation to prevent fraud and to protect the interest of investors. *Id.* Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes any "note." *See* 15 U.S.C. §§ 77b & 78c. A note is presumed to be a security unless it falls into certain judicially-created categories of financial instruments that are not securities, or if the note in question bears a "family resemblance" to notes in those categories based on a four-part test. *See Reves v. Ernst & Young*, 494 U.S. 56, 64–66 (1990), and its progeny. Applying the *Reves* four-part analysis, the BIAs were notes and thus securities. First, BlockFi offered and sold BIAs to obtain crypto assets for the general use of its business, namely to run its lending and investment activities to pay interest to BIA investors, and purchasers bought BIAs to receive interest ranging from 0.1% to 9.5% on the loaned crypto assets. Second, BIAs were offered and sold to a broad segment of the general public. Third, BlockFi promoted BIAs as an investment, specifically as a way to earn a consistent return on crypto assets and for investors to "build their wealth." Fourth, no alternative regulatory scheme or other risk reducing factors exist with respect to BIAs.

SEC Director of Enforcement Gurbir Grewal: *To Understand SEC's Enforcement Stance On Crypto, Read BlockFi Order*



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I.

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II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 9(f) of the Investment Company Act of 1940, Making Findings, and Imposing a Cease-And-Desist Order ("Order"), as set forth below.

31. Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes "an investment contract." *See* 15 U.S.C. §§ 77b, 78c. Based on the facts and circumstances set forth above, the BIAs were also offered and sold as "investment contracts," as they meet the elements for an investment contract under *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946), and its progeny, including the cases discussed by the Commission in its *Report of Investigation Pursuant To Section 21(a) Of The Securities Exchange Act of 1934: The DAO* (Exchange Act Rel. No. 81207) (July 25, 2017), citing *Forman*, 421 U.S. at 852-53 (The "touchstone" of an investment contract "is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."); *see also SEC v. R.G. Reynolds Enterprises, Inc.*, 952 F.2d 1125 1130-31 (9th Cir. 1991) (finding managed account product was an investment contract where investors provided funds in exchange for interest rate earned through the issuer's investment of the funds). BlockFi sold BIAs in exchange for the investment of money in the form of crypto assets. BlockFi pooled the BIA investors' crypto assets, and used those assets for lending and investment activity that would generate returns for both BlockFi and BIA investors. The returns earned by each BIA investor were a function of the pooling of the loaned crypto assets, and the ways in which BlockFi deployed those loaned assets. In this way, each investor's fortune was tied to the fortunes of the other investors. In addition, because BlockFi earned revenue for itself through its deployment of the loaned assets, the BIA investors' fortunes were also linked to those of the promoter, i.e., BlockFi. Through its public statements, BlockFi created a reasonable expectation that BIA investors would earn profits derived from BlockFi's efforts to manage the loaned crypto assets profitably enough to pay the stated interest rates to the investors. BlockFi had complete ownership and control over the borrowed crypto assets, and determined how much to hold, lend, and invest. BlockFi's lending activities were at its own discretion, and BlockFi advertised that it managed the risks involved. Similarly, its investment activities were at its own discretion, and BlockFi could decide whether and how to invest the BIA assets in equities or futures.

Engaging With The SEC: Self-Reporting And Coming Into Compliance

- The SEC is encouraging crypto entities to engage with the SEC to come into compliance with the federal securities laws
- Self-reporting always raises thorny issues for regulated entities
- But those issues are exacerbated in the crypto context
  - The SEC has made clear that self-reporting is to bring about future compliance with the federal securities laws
  - Self-reporting entities will not receive amnesty for past violations, although self-reporting may result in past violations being viewed more favorably from a remedies standpoint
- BlockFi Lending, LLC, for example, received cooperation credit and favorable consideration for remedial efforts
- Notwithstanding, BlockFi Lending still paid a $50 million penalty for past violations, was forced to stop offering its crypto lending product, and whether it can come into compliance with the federal securities laws remains uncertain