

Katten

PRESENTATION TO

Latest Developments in Cryptoassets

Dan Davis, Co-Chair and Partner, Financial
Markets Regulatory, Washington D.C.

Regulation and Enforcement

Overview of U.S. Regulation and Recent Legislative/Regulatory Proposals

- According to the Commodity Futures Trading Commission (CFTC) and multiple court decisions, a virtual currency is a commodity.¹
- According to the Internal Revenue Service (IRS), it is taxable property.²
- According to one federal court (DC), it is money, but not a fiat currency.³
- According to the Securities and Exchange Commission (SEC), most virtual currencies are securities and therefore are subject to all relevant securities laws such as registration with the SEC.⁴
- Recently the Chair of the SEC implied⁵ and the New York Attorney General⁶ alleged that ETH was a security. The Chair of the CFTC,⁷ the National Futures Association⁸ and the New York Department of Financial Services⁹ continue to claim ETH is a commodity and not a security.
- In the *In re Voyager Digital Holdings, Inc., et al.*, the Hon. Michael E. Wiles wrote in an Opinion dated March 11, noted the current regulatory dysfunction that is prevalent in the oversight of cryptoassets: “If the current regulatory environment can be characterized as uncertain, the future regulatory environment can only be characterized, in my mind, as virtually unknowable. There have been differing proposals in Congress to adopt different types of regulatory regimes for cryptocurrency trading . Meanwhile, the SEC has filed some actions against particular firms with regard to particular cryptocurrencies, and those actions suggest that a wider regulatory assault may be forthcoming. The CFTC seems to have taken some positions that are at odds with the SEC’s views. Just how this will all sort itself out, how the pending actions relating to cryptocurrencies will be decided, and just what issues might be raised in future regulatory actions, and how they will affect individual firms or the industry as a whole, is unknown.”¹⁰

Overview of U.S. Regulation and Recent Legislative/Regulatory Proposals (cont.)

- 2022 saw a flurry of legislative activity attempting to address some of the industry's possible regulatory gaps. Some bills, such as the Digital Commodity Exchange Act¹¹, the Responsible Financial Innovation Act (Lummis-Gillibrand Bill)¹² and the Digital Commodities Consumer Protection Act¹³, would have given the CFTC primary authority over most types of digital assets and digital asset activities, including transactions involving spot virtual currencies, except to the extent such assets involved securities. Others such as the Stablecoin Transparency of Reserves and Uniform Safe Transactions Act¹⁴ would have established a federal framework to regulate payment stablecoins. As “crypto winter” enters its second year, it is uncertain what the pace of legislative developments in 2023 might be, although there are reports that there will be a revised version of the Lummis-Gillibrand Bill released in the next few months.
- On December 14, 2022, the SEC proposed rules that would establish SEC best execution requirements. While broker-dealers are already subject to best execution rules as members of FINRA, the SEC requirements are broader and would “apply to any digital asset that is a security, including, but not limited to so called virtual currencies, coins and tokens.”¹⁵

NYS Regulation and Enforcement

- New York's Department of Financial Services (NYDFS) has been very active in regulating virtual currency. In 2015, New York introduced a BitLicense regulatory regime that requires businesses that conduct "virtual currency business activity" involving New York (NY) or a NY resident to obtain a BitLicense and comply with various enumerated requirements.¹⁶ On April 28, 2022, NYDFS released guidance for all virtual currency entities that have a BitLicense or are registered as Limited Purpose Trust Companies, emphasizing the importance of using "blockchain analytics" when monitoring transactions. On the one hand, the nature of virtual currencies allows for the transfer of assets peer-to-peer without the oversight of a regulated intermediary. This can create issues for registrants fulfilling their know your customer (KYC) obligations. However, the blockchain ledger allows a historical view of virtual currency transactions on an immutable record between wallets which provides even greater potential visibility than exists for traditional fiat transfers. Much of the information that is on the blockchain is not helpful as the wallet addresses are pseudonymous and cannot be tracked to the owner. However, entities registered with NYDFS can use third party providers' or internally developed blockchain analytics to analyze the information and make it "usable" to satisfy KYC obligations, as well as conducting transaction monitoring of on-chain activity.¹⁷
- Illinois¹⁸ and New Jersey¹⁹ are expected to enact equivalent laws creating their own Bitlicense regimes.
- On January 23, 2023, NYDFS released "Guidance on Custodial Structures for Customer Protection in the Event of Insolvency" for BitLicense holders and Limited Purpose Trust Companies (i.e., virtual currency entities acting as custodians, termed VCE Custodians). NYDFS requires VCE Custodians to hold virtual currency in a manner that protects customer assets. This is done by depositing the virtual currency with a VCE Custodian. However, in order to custody the virtual currency properly, a VCE Custodian must segregate customers' virtual currency from its own assets and the assets of its affiliated entities on-chain and on the VCE Custodian's internal ledger accounts. Furthermore, a VCE Custodian cannot establish a debtor-creditor relationship with a customer.²⁰
- A VCE Custodian (after appropriate due diligence) may safe keep a customer's virtual currency through a sub custody arrangement.

NYS Regulation and Enforcement (cont.)

- Lastly, a VCE Custodian must disclose to each customer the terms and conditions associated with its products, including making clear the parties' intentions to enter into a custodial relationship, as opposed to a debtor-creditor relationship.²¹
- On January 4, 2023, NYDFS announced that Coinbase agreed to pay \$50 million to New York State for significant failures in its compliance program which allegedly violated NYDFS virtual currency, money transmitter, transaction monitoring, and cybersecurity regulations. In addition to the penalty, Coinbase agreed to invest an additional \$50 million to enhance its compliance program.²²
- On March 9, 2023, New York Attorney General Letitia James filed a lawsuit against KuCoin for failing to register as a securities and commodities broker-dealer and falsely representing itself as an exchange. The Office of the Attorney General created an account using a computer with a NY based IP address and was able to buy and sell cryptocurrencies.²³
- As stated previously, this lawsuit is especially noteworthy because it alleges that Ether is a security as it is a speculative asset that relies on the efforts of third parties in order to provide profit to Ether holders.
- Attorney General James, seeks a court order that prevents KuCoin from misrepresenting that it is an exchange, prevents the company from operating in NY and would require that KuCoin implement geo-blocking based on IP addresses and GPS location to prevent access to KuCoin's platforms in NY.²⁴

Recent Enforcement Actions

- At the end of 2022, the SEC, CFTC and Department of Justice (DOJ) announced charges of fraud and other matters in parallel legal actions against FTX founder Sam Bankman-Fried (SBF) relating to the collapse of FTX. These charges principally related to certain transactions between FTX and Alameda Research LLC (Alameda), the privately held crypto hedge fund of SBF. The SEC and CFTC's complaints alleged that there was an undisclosed diversion of FTX customers' funds to Alameda; undisclosed special treatment to Alameda including providing Alameda with an unlimited line of credit; and undisclosed risk due to FTX's exposure to Alameda's holdings of overvalued assets such as FTX affiliated tokens. The CFTC subsequently amended its complaint to include, and the SEC filed an additional separate complaint against, Caroline Ellison, Alameda's CEO, and Gary Wang, Alameda's and FTX's Co-Founder. Ellison and Wang have entered guilty pleas in a separate legal action brought against them by the DOJ.²⁵
- On February 23, 2023, the DOJ issued a superseding indictment against SBF. The indictment expanded factual allegations in its earlier indictment, including expanding upon SBF's alleged involvement and/or knowledge in purportedly (1) allowing FTX customer funds to be forwarded to/sent from accounts in the name of Alameda and another related entity, North Dimension; (2) misleading a bank regarding the purpose for North Dimension to establish an account with it (i.e., to facilitate fiat transactions for FTX customers; not to support proprietary trading); (3) establishing accounts in the names of two FTX executives to disguise the ultimate source (i.e., FTX customers and/or Alameda) of donations to both Democratic and Republican politicians and political action committees as directed by SBF and co-conspirators; and (4) misleading potential FTX investors as FTX experienced liquidity issues beginning in early November 2022.²⁶
- On February 28, the CFTC²⁷ and SEC²⁸ filed civil complaints against Nishad Singh related to his role in FTX, while Mr. Singh also pleaded guilty to separate counts of wire fraud, conspiracy to commit money laundering and conspiracy to defraud the United States by violating campaign finance laws, and three counts of conspiracy to commit fraud.²⁹
- On January 12, 2023, the SEC charged Gemini and Genesis for the alleged unregistered offer and sale of securities through the Gemini Earn crypto asset lending program. According to the complaint, Genesis entered into an agreement with Gemini to offer Gemini customers the ability to loan their crypto assets to Genesis in exchange for Genesis' promise to pay interest.³⁰ On January 19, 2023, the SEC charged Nexo Capital Inc. with purportedly failing to register its retail crypto asset lending product, the Earn Interest Product (EIP). To settle the charges, Nexo agreed to pay a \$22.5 million fine and cease its sale of the EIP, as well as an additional \$22.5 million to settle similar charges with state regulators.³¹

Recent Enforcement Actions

- On January 20, 2023, the SEC charged Avraham Eisenberg with orchestrating an attack on a decentralized crypto asset trading platform (DEX), Mango Markets, by increasing the price of the illiquid MNGO token through large purchases of MNGO on three separate trading platforms in order to increase the value of perpetual MGO – USDC futures positions he had previously established on the DEX.³²
- According to the complaint, because of the increased value of his perpetual futures positions, Eisenberg was able to borrow approximately \$116 million of collateral from the DEX which he never intended to return when the value of his perpetual futures subsequently declined. The CFTC and DOJ have both filed similar actions against Eisenberg as well.³³ However, The SEC claimed that the Mango governance token was a security, the CFTC claimed that USDC was a commodity, and both agencies referenced the perpetual futures contract Mr. Eisenberg traded on the DEX as a “swap” and not a “mixed swap.” This is legally incorrect.
- On February 9, 2023, the SEC charged Payward Ventures, Inc. and Payward Trading Ltd., together known as Kraken, with failing to register their crypto staking as a service program with the SEC. The SEC claimed staking as a service as offered by Kraken was a security. To settle the charges, Kraken agreed to cease selling its staking as a service program without registration and pay \$30 million in penalties.³⁴
- Coinbase argued on March 20, 2023, that staking as a service was not an investment contract and criticized the SEC’s enforcement action against Kraken for expressing “a new policy position and legal determination about a widespread industry practice through a single enforcement action, rather than through any formal guidance...” Coinbase articulated this view in a comment letter filed with the SEC in response to its own July 21, 2022 petition for rulemaking on digital asset securities regulation. Coinbase requested that the SEC clarify its view regarding staking as a service, including seeking input from the public.³⁵
- On February 16, 2023, the SEC charged Terraform Labs, the company behind the failed TerraUSD stablecoin and the Luna digital asset for selling unregistered securities, selling unregistered security based swaps and related claims.³⁶

Recent Enforcement Actions

- On February 7, 2023, Ishan Wahi, a former employee at Coinbase pled guilty to conspiring to commit wire fraud in connection with an insider trading scheme by using confidential information regarding which crypto assets were scheduled to be listed on Coinbase's exchange.³⁷ On July 21, 2022, the SEC filed a complaint against Mr. Wahi alleging insider trading in violation of securities laws. Notably, the SEC alleged that at least nine of the 25 crypto assets traded were "crypto asset securities."³⁸ The SEC did not disclose why it failed to label 16 crypto assets as securities at this time.
- On September 22, 2022, the CFTC charged bZeroX, LLC and its two founders, Tom Bean and Kyle Kistner, for illegally offering leveraged and margined retail commodity transactions in digital assets, engaging in activities only licensed futures commission merchants ("FCMs") can perform without registering as such, and failing to adopt a customer identification program as part of a Bank Secrecy Act compliance program. The CFTC claimed that bZeroX and its founders engaged in the above activities in connection with a DEX they had created, the bZx Protocol. The defendants agreed to a civil monetary penalty of \$250,000.³⁹
- That same day, the CFTC filed a complaint in the U.S. District Court for the Northern District of California against the successor to bZeroX, Ooki DAO. Ooki DAO is a decentralized autonomous organization ("DAO"), which is a term used to describe a virtual organization embodied in computer code and executed on a distributed ledger or blockchain. The complaint charged Ooki DAO for similar violations related to its alleged control over the bZeroX protocol (renamed the Ooki Protocol). The district court granted the CFTC's motion for alternative service, allowing the CFTC to serve Ooki DAO by posting summons documents in the DAO's online discussion forum and in its help chat box. The district court reaffirmed its decision on December 20, 2022. The case is pending.⁴⁰
- According to many news outlets, the SEC has told crypto firm Paxos that it plans on potentially suing it for violating investor protection laws because the firm issues and maintains Binance USD (BUSD), a stablecoin. The SEC alleges that BUSD is an unregistered security.⁴¹ NYDFS has separately instructed Paxos to stop minting BUSD.⁴²

Recent Enforcement Actions

- Binance's Chief Strategy Officer Patrick Hillman said in an interview that the firm expects to pay monetary penalties to settle existing US regulatory and law enforcement investigations. Hillman added that the outcome of the investigations will likely be fines but could be more stating "that is for regulators to decide."⁴³ In the past Binance has been subject to a DOJ investigation into potential violations of anti-money-laundering laws as well as a probe by the CFTC whether the company offered crypto derivatives without first registering with the agency.⁴⁴
- On February 22, 2023, a US Federal court in NY declined to grant a motion to dismiss in a lawsuit against Dapper Labs, Inc. and Roham Gharegozlou, Dapper's CEO. In their Complaint, Plaintiffs alleged that defendants offered and sold certain non-fungible tokens (NFTs) -- "NBA Top Shot Moments" -- to the public, without registering such NFTs as securities with the SEC. In response, Defendants argued that NFTs were not investment contracts and thus were not securities. The judge ruled that plaintiff's had pleaded sufficient allegations that could ultimately, if proven, demonstrate that Moments were securities. According to the judge, "[p]laintiffs have adequately alleged that the value of Moments is 'causally related to the profitability of [Dapper Labs] as a whole' because their value depends on the success of the Flow Blockchain" -- the blockchain developed by Dapper Labs on which Moments are supported.⁴⁵

Recent News and Events

Banking Crisis

- Silvergate Bank and Signature Bank were two of the larger banks servicing the crypto industry. Due to the FTX crisis and general market conditions such as rising interest rates, crypto related companies were facing severe business challenges. That led to declining deposits and large cash withdrawals. When the cash demands got high enough, Silvergate had to sell many assets at major losses. These losses, which were publicly reported, eventually resulted in a classic “bank run.” Silvergate announced on March 8, 2023, that they plan to wind down operations and voluntarily liquidate.⁴⁶
- SVB went through a similar timeline of events. SVB was the 16th largest bank in the nation holding over \$200 billion. It held approximately eight percent of the reserves of Circle Internet Financial for its USDC stablecoin.⁴⁷ Due to rising interest rates the value of SVB’s bond portfolio decreased drastically. SVB sold many instruments at close to \$2 billion loss. This caused the stock for SVB’s holding company to significantly decline and customers attempted to withdraw \$42 billion. Federal regulators stepped in and took over the bank. Deposits were moved to a bridge bank created by the Federal Deposit Insurance Corporation (FDIC).⁴⁸
- Two days after the FDIC took over SVB, New York regulators shut down Signature Bank. Signature Bank was one of the more crypto friendly banks in the U.S. In 2018, Signature made the decision to allow customers to deposit of crypto assets. After Silvergate and SVB went under, Signature saw a large amount of withdrawals which caused its stock to drop drastically and the regulators stepped in before any further damage could take place.⁴⁹

Pending Matters

- Grayscale, a digital asset management company, applied to create a spot Bitcoin ETF. The SEC denied Grayscale's application citing concerns of fraud and manipulation in the spot market. Grayscale sued the SEC claiming that the SEC's denial is arbitrary decision making at best. During oral arguments, Judge Neomi Rao of the U.S. Court of Appeals for the D.C Circuit, said that it seems that the futures price of Bitcoin is a derivative of the asset's spot price and 99.9% of the time the futures price will track the spot price. Judge Rao said that the SEC must explain "how it understands the relationship between Bitcoin futures and the spot price of Bitcoin."⁵⁰
- In January 2023, Binance.US received initial court approval to buy bankrupt crypto lender Voyager Digital for \$1 billion.⁵¹ The SEC objected to the deal saying that the re-distribution of Voyager's assets, specifically the VGX token, may constitute a sale of unregistered securities. In early March, U.S. Bankruptcy Court Judge Michael Wiles approved the deal stating that the "Bankruptcy Code doesn't contemplate an endless period of time." Judge Wiles pointed to the fact that creditors are waiting therefore the bankruptcy process can't be put on hold until there is clear guidance from regulators as to what the regulatory status of cryptocurrency is.⁵²
- The Department of Justice responded to the bankruptcy court's decision by filing an appeal stating that "the court cannot tell the Government to speak now or forever hold its peace before Voyager and Binance.US wed." The U.S. Trustee also appealed the Court's ruling as it has concerns that the deal would absolve Voyager and its staff from breaches of tax and securities law.⁵³

Katten Locations

CHARLOTTE

550 South Tryon Street
Suite 2900
Charlotte, NC 28202-4213
+1.704.444.2000 tel
+1.704.444.2050 fax

CHICAGO

525 West Monroe Street
Chicago, IL 60661-3693
+1.312.902.5200 tel
+1.312.902.1061 fax

DALLAS

2121 North Pearl Street
Suite 1100
Dallas, TX 75201-2591
+1.214.765.3600 tel
+1.214.765.3602 fax

LONDON

Paternoster House
65 St Paul's Churchyard
London EC4M 8AB
United Kingdom
+44 (0) 20 7776 7620 tel
+44 (0) 20 7776 7621 fax

LOS ANGELES – CENTURY CITY

2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
+1.310.788.4400 tel
+1.310.788.4471 fax

LOS ANGELES – DOWNTOWN

515 South Flower Street
Suite 4150
Los Angeles, CA 90071-2212
+1.213.443.9000 tel
+1.213.443.9001 fax

NEW YORK

50 Rockefeller Plaza
New York, NY 10020-1605
+1.212.940.8800 tel
+1.212.940.8776 fax

ORANGE COUNTY

100 Spectrum Center Drive
Suite 1050
Irvine, CA 92618-4960
+1.714.966.6819 tel
+1.714.966.6821 fax

SHANGHAI

Suite 4906 Wheelock Square
1717 Nanjing Road West
Shanghai 200040
P.R. China
+86.21.6039.3222 tel
+86.21.6039.3223 fax

WASHINGTON, DC

2900 K Street NW
North Tower - Suite 200
Washington, DC 20007-5118
+1.202.625.3500 tel
+1.202.298.7570 fax

Katten refers to Katten Muchin Rosenman LLP and the affiliated partnership as explained at katten.com/disclaimer.

Attorney advertising. Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.