

THE RIDE CONTINUES: FURTHER UNPACKING OF REGULATORY AND ENFORCEMENT TRENDS WITH CRYPTOCURRENCY AND DIGITAL ASSETS

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PRESENTED BY:

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Agenda

- Recent Market Developments
- SEC Enforcement and Regulatory Developments
- Private Securities Actions
- NFTs
- CFTC Enforcement and Regulatory Developments
- White House and Congressional Activity
- International Regulatory Activity
- Q & A

Recent Market Developments

- Collapse of TerraUSD (UST) algorithmic stablecoin
- Sharp drop in bitcoin and other cryptocurrency prices
- Restrictions on customer withdrawals; loan defaults; bankruptcy risks
 - Vault
 - Voyager Digital
 - Three Arrows Capital
 - Celsius Network

SEC Enforcement

- **Investigation of Terraform Labs**
 - SEC investigating whether Terraform and Do Kwon, its CEO, violated federal securities laws in “their participation in the creation, promotion, and offer to sell various digital assets related to the ‘Mirror Protocol,’ a blockchain technology.” *SEC v. Terraform Labs Pte Ltd.* (2d Cir. June 8, 2022).
 - Mirror Protocol is a DeFi platform built on Terra blockchain to create synthetic assets that mimic price behavior of traditional and digital financial assets.
 - SEC investigation appears to have predated, and to be independent of, Terra USD collapse.
 - Second Circuit affirmed order requiring compliance with SEC subpoenas for documents and testimony.

SEC Enforcement

- **Update on *SEC v. Ripple Labs, Inc.*** – S.D.N.Y. (Dec. 22, 2020)
 - SEC alleges that XRP token is an “investment contract” under *Howey* test.
 - Key issue is defendants’ knowledge or reckless disregard of whether XRP is a security.
 - March 2022: District Judge denies SEC motion to strike Ripple’s “fair notice” defense.
 - April 2022: Magistrate denies SEC motion for reconsideration of holding that internal SEC emails concerning and drafts of June 2018 Hinman speech are not shielded by deliberative process privilege.
 - Issues of attorney-client privilege are still pending.
 - April 2022: Magistrate declines to strike supplemental SEC expert report but finds that “*SEC has conducted itself improperly by serving an unauthorized supplemental report on the last day of discovery.*”
 - Motions for summary judgment to be filed in September 2022.

SEC Regulation

- **Continuing SEC resistance to Bitcoin Spot ETFs**

- On June 29, 2022, SEC denied an application to list and trade shares of Grayscale Bitcoin Trust—a fund holding bitcoin directly, not bitcoin futures—on NYSE Arca exchange.
 - Grayscale immediately filed a petition for review in the U.S. Court of Appeals for the D.C. Circuit.
- SEC’s Grayscale denial is consistent with agency’s past denials of bitcoin spot ETFs but approvals of bitcoin futures ETFs.
 - SEC argues that regulatory requirement that exchange have procedures “designed to prevent fraudulent and manipulative acts and practices” and “to protect investors” can be met where ETFs hold assets (such as bitcoin futures) traded on a regulated market.
 - Thus far, SEC has concluded that regulatory requirement is not met where ETF holds bitcoin, which is not traded on a regulated market.

Private Securities Actions

Class Actions Related to Collapse of Terra USD (UST)

- *Lockhart v. BAM Trading Services Inc.* (“Binance U.S.”) (N.D. Cal. June 13, 2022)
 - Alleges that Binance U.S. (a) illegally sold unregistered securities in form of UST; and (b) falsely represented that UST was “safe,” “stable” and “fiat-backed.”
- *Patterson v. Terraform Labs Pte. Ltd.* (N.D. Cal. June 17, 2022)
 - Alleges that Terraform, a foreign company, assisted by six U.S.-based VC groups (a) illegally sold unregistered securities in form of various Terra tokens, including but not limited to UST and LUNA; and (b) committed securities fraud through false representations about UST and LUNA.
 - VC groups allegedly “promised to support and fund the Terra ecosystem and to ‘defend the peg’ in the event that high volatility caused the UST/LUNA pair to become untethered from one another.”
 - Suit charges VC groups with securities fraud, participating in a RICO enterprise, and control person liability.

Private Securities Actions

Other Class Actions

- *Young v. Solana Labs, Inc.* (N.D. Cal. July 1, 2022)
 - Alleges that (a) Solana tokens (SOL) are securities and (b) Solana Labs and Multicoon Capital, a financial advisor to Solana Labs and an early-stage investor and purchaser of SOL, engaged in illegal sales of unregistered securities in form of SOL.
 - Alleges that defendants made false and misleading statements about total circulating supply of SOL and strength, reliability and decentralization of the Solana blockchain network, which were designed to inflate the price of SOL.
- Given recent sharp drop in token prices, additional class actions are likely.

NFTs – Potential enforcement by SEC, CFTC, DOJ

NFTs are garnering closer scrutiny by regulators and law enforcement

- Non-fungible tokens are blockchain-based digital records that evidence the holder's rights with respect to a unique and non-fungible set of rights.
 - This unique ownership record is transferable solely by virtue of transfer of the underlying NFT; the NFT is a unique, collectible form of digital property.
- NFTs present potential securities regulatory risk if fractionalized or if created, packaged or sold in a manner where purchasers expect investment returns.
 - Is your NFT purely a collectible item rather than a store of value packaged for trading and capital appreciation?

NFTs – Potential enforcement by SEC, CFTC, DOJ

- SEC is scrutinizing creators of NFTs and the marketplaces in which they are traded to determine whether these NFTs constitute investment contracts under *Howey* and other caselaw.
 - SEC issued subpoenas demanding information about NFT offerings, focusing on whether NFTs are being used to raise funding like traditional securities.
 - Using theory established in *Gary Plastic* case, SEC may also be considering whether services provided by marketplaces constitute investment contracts with NFT holders even if NFTs themselves are not securities.
 - SEC also wants to understand “fractional” NFTs – NFTs that are broken down into smaller units so that there are multiple owners of portions of NFTs that can more easily be bought and sold on the secondary market.
 - Commissioner Peirce has stated that “the breadth of the NFT landscape” suggests certain NFTs fall within the SEC’s jurisdiction. CoinDesk TV (12/30/21).

NFTs – Potential enforcement by SEC, CFTC, DOJ

- **CFTC Enforcement**

- NFTs likely fall within the definition of “commodity” under Commodity Exchange Act.
- CFTC has longstanding authority to bring enforcement actions to address fraud and manipulation in commodities markets.

- **DOJ Enforcement**

- ***U.S. v. Chastain*** (S.D.N.Y. June 1, 2022)
 - Defendant charged with wire fraud based on alleged insider trading in NFTs on OpenSea.
 - Chastain was OpenSea employee responsible for selecting NFTs to be featured on homepage; he is charged with purchasing NFTs he knew would shortly appear on homepage and thereby rise in price.
 - Although DOJ didn’t allege that the NFTs were securities, charged facts and DOJ statements may bolster argument that NFTs can be securities:
 - USAO is “commit[ted] ... to stamping out insider trading - whether it occurs on the stock market or the blockchain.”
 - “With the emergence of any new investment tool, such as blockchain supported non-fungible tokens, there are those who will exploit vulnerabilities for their own gain.”

NFTs – Potential enforcement by FinCEN

- In February 2022, the Treasury Department’s Financial Crimes Enforcement Network (FinCEN) published a report which noted that:
 - NFTs “that are used for payment or investment purposes in practice” may qualify as a type of virtual currency; and
 - transmitters of these “payment or investment purpose” NFTs would be required to register with FinCEN as a money services business (MSB) and comply with MSB anti-money laundering and Bank Secrecy Act obligations when doing business in the U.S.

CFTC Enforcement

- The CFTC has **exclusive** jurisdiction over digital asset derivatives.
- The Division of Swap Dealer and Intermediary Oversight of the CFTC [issued an advisory](#) related to the custody of crypto by Futures Commission Merchants.
- In 2018, the CFTC issued a request for input seeking public comment and feedback on the technology, mechanics, and markets for Ether and its use on the Ethereum network.
- In March 2020, the [CFTC finalized interpretive guidance](#) on the definition of actual delivery for retail digital asset transactions.

CFTC Enforcement

- ***CFTC v. Gemini Trust Company, LLC*** (S.D.N.Y. June 2, 2022)
 - The CFTC recently filed a complaint in the U.S. District Court for the Southern District of New York against Gemini for making false or misleading statements of material facts to the CFTC in connection with the self-certification of a bitcoin futures product.
 - The CFTC seeks disgorgement of ill-gotten gains, civil monetary penalties, injunctions relating to registration and trading, and an injunction against further violations of the Commodity Exchange Act.
- ***CFTC v. Mirror Trading International Proprietary Limited, and Cornelius Johannes Steynberg*** (W.D. Tex. June 30, 2022)
 - The CFTC has filed a complaint alleging that that Steynberg, individually and as the controlling person of MTI, engaged in an international fraudulent multilevel marketing scheme, and created and operated a global foreign currency commodity pool that only accepted Bitcoin to participate, with a value of over \$1,733,838,372.
 - This action is the largest fraudulent scheme involving Bitcoin charged in any CFTC case.

CFTC Enforcement

- ***In the Matter of Blockratize, Inc. d/b/a Polymarket.com*** (Jan. 3, 2022)
 - CFTC alleged that Blockratize was operating an unregistered facility or non-designated contract market.
 - Polymarket platform facilitated buying and selling binary options contracts related to some event taking place in the future that are susceptible to a “yes” or “no” resolution.
- ***CFTC v. Dwayne Golden, et. al*** (E.D.N.Y. March 8, 2022)
 - The CFTC accused four individuals of fraud for carrying out a Ponzi scheme involving bitcoin, fraudulently soliciting more than \$44 million from investors and misappropriation of millions of dollars.

CFTC Regulatory

- FTX US Derivatives, which operates a CFTC-registered DCO, is requesting a change to its registration to allow it to offer direct access to clearing for margined Bitcoin futures contracts.
- If approved, traders would not need to go through an FCM to trade Bitcoin futures on FTX but could simply make the trade and clear it directly on FTX's platform, without any intermediaries.
- To manage this risk, FTX proposes a model where it automatically calculates each member's margin requirements on a second-by-second, 24/7/365 basis, and auto-liquidates the portfolio of members with insufficient margin.
- The CFTC requested public comment on FTX's request and is currently evaluating the over 1500 comments it received on FTX's proposal.

White House and Congressional Activity

- March 9, 2022: President Biden issues executive order, “Ensuring Responsible Development of Digital Assets.”
 - Order requires written report from departments and agencies: Treasury, DOJ, SEC, CFTC, FTC, CFPB.
- June 6, 2022: Senators Lummis and Gillibrand introduce proposed legislation “to provide for responsible financial innovation and to bring digital assets within the regulatory perimeter.”
 - Act would make CFTC the primary regulator of most digital assets, but token issuers would be required to make periodic public disclosures to the SEC providing information regarding the issuer and the tokens.
- Congress likely to move on stablecoins before broad-based legislation covering cryptocurrencies and other digital assets.

White House and Congressional Activity

- November 2021: President's Working Group on Financial Markets (PWG), FDIC and OCC publish report on stablecoins.
 - Report evaluates risks associated with widespread stablecoin adoption and includes recommendations for stablecoin oversight.
- Key Takeaways:
 - Confidence in redeemability of a stablecoin is crucial to its success; confidence can be undermined by the fall in price of the reserve assets, failure to safeguard reserve assets, lack of clarity regarding redemption rights, and risks associated with cybersecurity and data storage.
 - As stablecoins scale, additional risks may develop including systemic risks from failure of any entity in stablecoin arrangement (e.g., issuer or custodial wallet provider).
 - Report recommends that Congress limit stablecoin issuances, and redemption and maintenance of reserve assets, to insured depository institutions.

International Regulatory Activity

- International regulators are also looking into digital assets:
 - On June 30, 2022, European Parliament and EU Council struck a provisional agreement on the text of the Markets in Crypto-assets (MiCA) Regulation, first proposed in 2020. Key provisions include:
 - Regulation of public offers of crypto-assets
 - Disclosures to consumers on risks, costs and charges
 - Measures to prevent market manipulation, money laundering and terrorist financing
 - The potential that certain NFTs will be subject to MiCA.
 - European Securities and Markets Authority (ESMA) issued warning in March 2022 that digital assets are highly speculative and not suitable for retail consumers.

International Regulatory Activity

- International Organization of Securities Commissions (IOSCO) published reports on digital assets in December 2020 and on Decentralized Finance (DeFi) in March 2022.
- Financial Action Task Force (FATF) updated its 2019 guidance for virtual assets and virtual asset service providers (VASPs) in 2021.
 - Among other things, the guidance now notes that stablecoin issuers will qualify as either a financial institution or a VASP.
- In late 2021, U.K. government provided guidance on implementation of FATF Travel Rule.

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