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INVESTING IN CRYPTO ASSET STARTUPS: REGULATORY CONSIDERATIONS IN AN EVER-EVOLVING MARKET

In this comprehensive article on the ever-evolving crypto asset startups market, the authors begin by describing trends in product and market developments, including emerging opportunities in DeFi platforms. They then turn to capital raising by initial coin offerings, initial exchange offerings, simple agreements for future tokens, and airdrops. Next, they turn to U.S. regulatory developments, recent SEC and CFTC enforcement actions, and U.K. regulatory developments. Finally, they close with unique due diligence considerations for fintech investors.

By Erin E. Martin, Sarah V. Riddell, Steven Lightstone, Jacob Minne, and Christina Wlodarczyk *

On November 10, 2021, Bitcoin reached a high of approximately $68,789. Just months later, in June 2022, the price of Bitcoin sunk to below $20,000. Despite the high degree of volatility in Bitcoin and other crypto asset markets, innovation and investor interest continue to support the growth of this new asset class. In this article, we first discuss trends in product development and the crypto asset markets, and how regulation is (or, in some cases, is not) keeping pace. We also discuss trends and considerations in capital raising for fintech start-ups through the use of crypto assets, such as tokens, as well as the U.S. and U.K. regulatory considerations and developments associated with the industry. Finally, we discuss the due diligence considerations that arise in such investment opportunities.

I. TRENDS IN PRODUCT AND MARKET DEVELOPMENTS

During the spring of 2022, crypto assets experienced a precipitous fall-off in value, driven by market volatility and the collapse of the major stablecoin project, Terra, and associated contagion effects in the market, as well as broader macroeconomic factors.[1] Although the collapse

[1] Krisztian Sandor & Ekin Genç, *The Fall of Terra: A Timeline of the Meteoric Rise and Crash of UST and LUNA*, COINDESK (June 1, 2022), https://www.coindesk.com/learn/the-fall-of-terra-a-timeline-of-the-meteoric-rise-and-crash-of-ust-and-luna/. For Bitcoin and other digital asset prices during this period, *see* COINMARKETCAP, https://coinmarketcap.com/. For a discussion of Bitcoin's reaction to broader macroeconomic trends, *see* David Yaffe-Bellany, *Bitcoin Is Increasingly Acting Like Just*

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of Terra caused many market participants to retreat from the nascent decentralized finance ("DeFi") market, many of the tools established during the recent bull run remain intact.[2]

A. Platform Collapses and Freezes Roil the Market

Crypto assets are generally highly speculative, leading to significant market volatility. For example, market volatility became an issue for Terra, an algorithmic stablecoin that depended on the value of its underlying platform to support its peg of one Terra ("UST") to one U.S. dollar ("USD"). When the market decreased over 50% from all-time highs, Terra's peg began to wobble on May 7, 2022, and cratered a few days later on May 9, 2022.[3] A month later, the Celsius Network, a cryptocurrency lending platform, halted withdrawals to prevent a run on its platform. When this occurred, Celsius announced that "[d]ue to extreme market conditions, . . . Celsius is pausing all withdrawals, Swap, and transfers between accounts."[4]

During this same timeframe, Bitcoin experienced a downward price trend as the global economy faced substantial inflationary pressures. Bitcoin's decreasing value during this period appears to undercut a common argument for its immediate usefulness as a "store of value," an argument common throughout 2021 when some investment firms characterized the seminal cryptocurrency as "a hedge against inflation."[5]

B. Beyond Buy and Hold – Emerging Opportunities in DeFi

Despite recent market volatility, investors continue to develop strategies for investing in the crypto asset space and, in particular, are moving beyond simple buy-and-hold strategies. Increasingly, investor attention is focused on DeFi platforms. DeFi aims to provide a broad range of financial functions — such as exchange services, asset collateralization, lending, arbitrage, asset management, market making, and liquidation services — using distributed ledgers and blockchains like Ethereum, Solana, and BNB Chain. In addition to these financial services, other key functions within the DeFi community include:

- **Staking**: A token holder "locks" tokens associated with a certain blockchain or smart contract in exchange for the right to participate in the administration or governance of the blockchain or smart contract. A token holder also often earns a regular percent yield on the locked tokens.

- **Bridges**: Smart contracts on two or more blockchains that allow users to trade proxies of tokens (i.e., "wrapped" tokens) on a chain on which the smart contracts were not originally hosted. For example, the Wormhole project allows a proxy for Bitcoin — "wrapped Bitcoin" or "wBTC" — to be traded on the Ethereum network.[6]

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Another Tech Stock, N.Y. TIMES, (May 11, 2022), https://www.nytimes.com/2022/05/11/technology/bitcoin-price-crashing-stocks.html.

[2] For a listing of and accounting of total value locked into various DeFi Platforms, *see* DEFI PULSE, https://www.defipulse.com/ (last accessed Jun. 29, 2022).

[3] N. 1, *supra.*

[4] *A Memo to the Celsius Community*, CELSIUS BLOG (Jun. 12, 2022), https://blog.celsius.network/a-memo-to-the-celsius-community-59532a06ecc6.

[5] Ron Shevlin, *Bitcoin or Ethereum: Which Cryptocurrency Is The Best Hedge Against Inflation*, FORBES (Dec. 28, 2021), https://www.forbes.com/sites/ronshevlin/2021/12/28/bitcoin-or-ethereum-which-cryptocurrency-is-the-best-hedge-against-inflation/?sh=42b5039d1d22.

[6] Bridges are necessary because, even though (for example) Ethereum and Bitcoin are both instantiated with distributed ledger technology, their underlying blockchains depend on different computer code and cannot inherently talk to each other. For a more comprehensive discussion of the DeFi ecosystem,

- **Flash Loans**: Functionally unlimited, uncollateralized loans that are borrowed and repaid in the same transaction, allowing technically savvy but undercollateralized users to claim arbitrage opportunities.

II. CAPITAL RAISING

Since 2014, there has been an increase in capital raising efforts by fintech start-up companies through the issuance of crypto assets, particularly through the distribution of tokens. A significant consideration for a fintech start-up raising capital is the application of U.S. federal securities laws, and, in particular, whether the distribution of a crypto asset, such as a token, would be deemed to be an offer and sale of a security. In this respect, Section 5 of the Securities Act of 1933 (the "Securities Act") requires an issuer to register an offer or sale of securities unless an exemption from registration is available, such as the exemption for a private placement under Section 4(a)(2) of the Securities Act. As detailed below, various types of capital raising efforts utilizing crypto assets have been pursued by the industry, each of which may invite regulatory scrutiny.

A. Initial Coin Offerings

Initial Coin Offerings ("ICOs") were a popular method of fundraising for emerging crypto asset-related projects because such transactions allowed for an early-stage project to not only raise funds but also to establish a community for the token.[7] For example, the Ethereum ICO in 2014 was highly successful when Ethereum sold 50 million Ether tokens ("ETH") at $0.311 per token and raised a total of $18 million. The initial distribution and wide adoption of ETH allowed a diverse ecosystem of decentralized applications ("Dapps") to develop.[8] However, ICOs came under legal scrutiny by the Securities and Exchange Commission ("SEC"), which issued an investigatory report in 2017 warning that when crypto assets with characteristics of a security are offered and sold in the U.S., the issuer is required to adhere to the U.S. securities laws (the "DAO Report of Investigation").[9] Following the DAO Report of Investigation, the SEC brought a number of enforcement actions and also entered into settlements related to ICOs that were conducted without registration.[10] In addition, the SEC released various investor alerts on ICOs, which highlight the risks of fraud and manipulation involved in certain ICOs.[11] Since 2018, the use of ICOs for capital raising has significantly decreased, which could be a result of the increased regulatory scrutiny in addition to shifting market conditions.[12]

B. Initial Exchange Offerings

Shortly after ICOs became subject to greater regulatory scrutiny, Initial Exchange Offerings ("IEOs") arose as another method for fintech start-up companies to raise capital. Through an IEO, a company raises capital by conducting token sales on a centralized exchange rather than through a direct issuance and distribution of tokens in an ICO. In January 2019, the first IEO with a major centralized exchange occurred with the sale of BitTorrent Tokens ("BTT") on Binance

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see IOSCO, IOSCO DECENTRALIZED FINANCE REPORT 4 (2022), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD699.pdf.

[7] Laura Shin, *Here's The Man Who Created ICOs and This Is The New Token He's Backing,* FORBES (Sept. 21, 2017), https://www.forbes.com/sites/laurashin/2017/09/21/heres-the-man-who-created-icos-and-this-is-the-new-token-hes-backing/?sh=372d21581183.

[8] Annika Feign, *What Is an ICO?*, COINDESK (Mar. 9, 2022), https://www.coindesk.com/learn/what-is-an-ico.

[9] SEC, EXCHANGE ACT RELEASE NO. 81207, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934: THE DAO (2019); *see also* Press Release, SEC, SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities (Jul. 25, 2017), https://www.sec.gov/news/press-release/2017-131.

[10] *See, e.g.*, Press Release, SEC, Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities (Nov. 16, 2018); Press Release, SEC, Company Settles Unregistered ICO Chargers After Self-Reporting to the SEC (Feb. 20, 2019); Press Release, SEC, SEC Orders Blockchain Company to Pay $24 Million in Penalty for Unregistered ICO (Sept. 30, 2019). *see also* Press Release, SEC, Company Halts ICO After SEC Raises Registration Concerns (Dec. 11, 2017).

[11] SEC, *Spotlight on Initial Coin Offerings*, https://www.sec.gov/ICO (updated Jul. 14, 2021).

[12] LARS HAFFKE & MATHIAS FROMBERGER, ICO MARKET REPORT 2017 PERFORMANCE ANALYSIS OF INITIAL COIN OFFERINGS 9 (2018) (showing the United States as the top country by number and volume of ICOs); LARS HAFFKE & MATHIAS FROMBERGER., ICO MARKET REPORT 2018/2019 PERFORMANCE ANALYSIS OF 2018'S INITIAL COIN OFFERINGS 10 (Dec. 31, 2019) (showing the United States as the top country by number of ICOs and third highest by volume); LARS HAFFKE & MATHIAS FROMBERGER., ICO MARKET REPORT 2019/2020 PERFORMANCE ANALYSIS OF 2019'S INITIAL COIN OFFERINGS 10 (Dec. 31, 2020) (showing a sharp decrease in the number of ICOs in the United States from the previous years in both number and volume of ICOs).

Launchpad, where users purchased tokens with funds directly from their own digital wallets held with the exchange.[13] In its initial sale, BitTorrent sold 23.76 billion BTT priced at 0.00001824 Binance Coin ("BNB").[14] However, IEOs are generally not open to U.S. investors due to concerns that IEOs involving crypto assets that may be deemed securities may not be conducted in compliance with the federal securities laws. Such concerns were underscored by the SEC, which noted the similarities between IEOs and ICOs and cautioned U.S. investors participating in IEOs, given the potential for fraud and manipulation and lack of investor protections.[15] Specifically, the SEC warned that claims of platform-vetted new technologies and financial products with promises of high returns may improperly entice potential investors.[16] As noted above, many IEO issuers and exchanges, such as Binance Launchpad, restrict such offerings to U.S. investors.[17] Additionally, there is a concern that these exchanges may be considered national securities exchanges pursuant to Section 6 of the Securities Exchange Act of 1934 (the "Exchange Act") or broker-dealers subject to registration with the SEC and membership in self-regulatory organizations ("SRO"). In this respect, national securities exchanges and broker-dealers are subject to specific regulatory requirements by the SEC or their respective SRO.

C. Simple Agreements for Future Tokens

Another avenue for fintech companies to raise capital is through Simple Agreements for Future Tokens ("SAFTs"), which aim to provide a compliant framework for token sales through a commercial instrument used to convey rights in tokens prior to the development of a token's functionality.[18] The premise to such transactions is that the SAFT itself is a security, and, as such, the offer and sale of the SAFT would be subject to registration under Section 5 of the Securities Act unless an exemption from registration is available. However, the tokens are ultimately delivered to the investors as fully functional assets and, therefore, some issuers and practitioners take the position that the tokens would not be considered securities under the U.S. federal securities laws.[19] For example, there are several entities that have filed notice filings on Form D with the SEC in relation to issuances of SAFTs.[20] For example, a recent filing from Utherverse Digital, Inc. indicates the issuer's reliance on Rule 506(c) of Regulation D for the issuance of a "Simple Agreement for Future Token relating to non-security tokens" for a total amount sold of $230,994.[21] In addition, Life Code Global Blockchain Technology Cloud Service & Datacenters Providers LLC filed a Form D for its "sale and issuance to receive CDS tokens in the future via a Simple Agreement for Future Tokens," relying on Rule 506(c) for a total offering amount of $100 million.[22]

However, it is important to note that while a SAFT is intended to provide a compliant capital raising framework, the use of a SAFT does not guarantee issuers protection from regulatory scrutiny. For example, in 2017, Kik Interactive, Inc. ("Kik")[23] engaged in numerous offerings of its "Kin" token to investors, including whereby it raised approximately $50 million through the offer and sale of SAFTs.[24] The SAFTs provided investors with the right to receive the Kin

[13] *Binance Launchpad: BitTorrent Token Sale Results*, BINANCE BLOG, https://www.binance.com/en/blog/all/binance-launchpad-bittorrent-token-sale-results-296665704096014336 (Jan. 28, 2019).

[14] *Id.*

[15] SEC Investor Alert, Initial Exchange Offerings (IEOs) (Jan. 14, 2020).

[16] *Id.*

[17] Binance, *Initial Exchange Offering*, BINANCE ACADEMY, https://academy.binance.com/en/glossary/initial-exchange-offering.

[18] THE SAFT PROJECT, https://saftproject.com/.

[19] *Id.*

[20] A Form D is a notice of an exempt offering of securities that an issuer is required to file with the SEC using its EDGAR system when it has sold securities without registration in reliance on Rule 504 or 506 of Regulation D or Section 4(a)(5) of the Securities Act. In addition to federal regulation, many states also require a filing of a Form D notice.

[21] Utherverse Digital, Inc., Form D Notice of Exempt Offering of Securities (Jun. 3, 2022).

[22] *See* Life Code Global Blockchain Technology Cloud Service & Datacenters Providers LLC, Form D Notice of Exempt Offering of Securities (Aug. 27, 2020); *see also* Crypto Sluggers, Inc., Form D Notice of Exempt Offering of Securities (May 4, 2022) (indicating the offer of SAFTs in reliance of Rule 506(c)); RareMint Ltd., Form D Notice of Exempt Offering of Securities (Oct. 19, 2021) (indicating the offer of SAFTs in reliance of Rule 506(b)).

[23] *SEC v. Kik Interactive Inc.*, 492 F.Supp.3d 169 (S.D.N.Y. 2020).

[24] Complaint, *Kik Interactive*, 492 F.Supp.3d 169 (https://www.sec.gov/litigation/complaints/2019/comp-pr2019-87.pdf). Note that Kik ultimately raised approximately $100 million through its various unregistered offerings.

token at a discount to the public offering. During this same time period, Kik also offered Kin tokens to the general public, raising another $50 million. Kik subsequently filed a Form D claiming that the offer and sale of the SAFTs was exempt under Rule 506(c) of Regulation D. The SEC brought an action against Kik in the Southern District of New York in 2019[25] where the federal court granted the SEC's motion for summary judgment in 2020, holding that the Kin token was a security and that the offer and sale of the SAFTs to investors was integrated with the public offering such that the combined offerings constituted an unregistered offering of securities without a valid exemption.[26] The court's decision demonstrates the importance of careful and compliant fundraising in an evolving marketplace.

D. Airdrops

Another notable method commonly used for token distributions are airdrops, where issuers will send "free" tokens to members of its community (e.g., current token holders of ETH) in an effort to distribute the token and aid more broadly in its initiative to create a market in the community for the token, with no monetary investment required by the recipient. The lack of monetary consideration is not necessarily dispositive from a regulatory perspective. There is significant SEC precedent on whether "free" stock programs constitute sales within the meaning of Section 2(a)(3) of the Securities Act.[27] The SEC's Division of Corporation Finance indicated in its "Framework for Investment Contract Analysis of Digital Assets" guidance that airdrops may implicate the securities laws.[28] As such, for tokens that are securities, an open question remains as to whether an airdrop of that token constitutes a "free" stock offering or "free" stock program.

Beyond the SEC regulatory considerations, fintech start-ups contemplating capital raising transactions through the issuance of crypto assets have other regulatory considerations, such as whether a token is a commodity, state securities law concerns, potential tax implications (for the issuer and purchaser), state banking and money transmitter license requirements, or crypto-specific regulations in states such as New York and Louisiana. Finally, start-ups should consider the international implications of capital raising as distributed ledger technology may transcend borders and, thus, the use of tokens for capital raising can be very much tied to the jurisdiction in which the purchaser sits. Thus, issuers must consider the full scope of the domestic and international regulatory scheme.

III. REGULATORY DEVELOPMENTS

A. U.S. Regulatory Developments

The U.S. legal and regulatory framework for digital assets consists of various agencies (e.g., the Commodity Futures Trading Commission (the "CFTC"), the SEC, the Financial Crimes Enforcement Network, state agencies that oversee money transmitter registration, the New York State Department of Financial Services, and the Office of the Comptroller of the Currency, among others). Although some agencies have provided regulatory guidance, such as the National Futures Association ("NFA") and the SEC, and the Biden-Harris administration has issued an executive order on digital asset regulation, Senators Lummis (R-WY) and Gillibrand (D-NY) proposed new legislation that would provide even more certainty by clarifying when a digital asset is a security and when it is a commodity, among other initiatives.

[25] *Id.*

[26] *Kik Interactive*, 492 F.Supp. 3d. 169.

[27] Section 2(a)(3) of the Securities Act provides that a sale of securities includes "every contract of sale or disposition of a security or interest in a security, for value." Vanderkam & Sanders, SEC Staff No-Action Letter, (Jan. 27, 1997); Vista Bancorp Inc, SEC Staff No-Action Letter (Feb. 1, 1999); Simplystocks.com, SEC Staff No-Action Letter (Feb. 4, 1999); Andrew Jones and James Rutten, SEC Staff No-Action Letter (Jun. 8, 1999). In addition to SEC no-action letters, there were a number of Enforcement actions involving "free stock" programs and violations of Section 5 of the Securities Act. *See, e.g.*, Joe Loofbourrow, Exchange Act Release No. 7700 (Jul. 21, 1999); UniversalScience.com and Rene Perez, Exchange Act Release No. 7879 (Aug. 8, 2000). Furthermore, in *Tomahawk Exploration LLC and David Thompson Laurance*, the SEC entered into a settlement agreement with the respondents for violations of the federal securities laws, including Section 5 of the Securities Act, for the sale of securities in exchange for promotional efforts by the recipients of the TOM tokens, noting that the promotional efforts of the recipients was "value" and, thus, a sale under Section 2(a)(3) of the Securities Act occurred. Tomahawk Exploration LLC and

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David Thompson Laurance, Exchange Act Release 10530 (Aug. 14, 2018).

[28] SEC, FRAMEWORK FOR "INVESTMENT CONTRACT" ANALYSIS OF DIGITAL ASSETS (2019), https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_ednref9, at note 9.

1. NFA Disclosure and Reporting Requirements

Since 2018, the NFA's disclosure requirements applicable to futures commission merchants ("FCMs"), introducing brokers ("IBs"), commodity pool operators ("CPOs"), and commodity trading advisors ("CTAs"), have required firms to include disclosures about virtual currencies in their disclosure documents, offering documents, and promotional materials.[29] The NFA's disclosure requirements stemmed from its concerns that market participants may not fully comprehend the nature of virtual currencies and virtual currency derivatives, the substantial risk of loss that may arise from trading these products, or the limitations of the NFA's regulatory authority over spot-market virtual currencies. Pursuant to the NFA interpretative notice, NFA members must include prescribed disclosures as well as tailored disclosures in offering documents and promotional materials, among other types of materials. The NFA also requires CPOs and CTAs that execute transactions involving virtual currencies *or* virtual currency derivatives and IBs that solicit or accept orders in virtual currency derivatives to immediately notify the NFA by amending the firm-level section of the NFA annual questionnaire.[30]

2. SEC Risk Alert

The SEC issued a Risk Alert in 2021 to clarify the focus of future SEC examinations related to digital assets.[31] More specifically, the Risk Alert highlights key issues that investment advisers, broker-dealers, national securities exchanges, and transfer agents should consider when reflecting upon their supervisory, oversight, and compliance programs. In 2022, the SEC reiterated that these issues remain a priority for the Division of Examinations.[32]

The Risk Alert identifies risks facing investment advisers who manage digital assets and highlights six areas of compliance that will constitute the focus of future examinations: (1) portfolio management (e.g., classification of digital assets, due diligence on digital assets, evaluation and mitigation of risks, and fulfillment of any fiduciary duty with respect to investment advice); (2) recordkeeping; (3) custody issues (e.g., occurrences of unauthorized transactions, such as theft, controls around safekeeping of digital assets, reliability of software, storage of digital assets, and security procedures related to software and hardware wallets); (4) disclosure of risks (e.g., the complexity of the product and underlying technology, price volatility, and conflicts of interest); (5) pricing client portfolios, such as a review of the valuation methodologies utilized; and (6) a review of compliance matters related to registration.[33]

According to the Risk Alert, future examinations of broker-dealers will focus on: (1) safekeeping of funds and operations; (2) registration requirements, such as the potential requirement that an affiliate of a registered broker-dealer register as a broker; (3) adequacy of anti-money-laundering ("AML") programs; (4) offerings, particularly when broker-dealers are involved in underwriting and private-placement activity with respect to digital asset securities that can raise unique disclosure and due diligence obligations;[34] (5) the existence and disclosure of conflicts of interest; and (6) outside business activities, or whether the activities of registered persons constitute outside business activities or an outside securities activity and therefore should be subject to the approval, supervision, and recordation of the broker-dealer.[35]

The Risk Alert states that its staff would examine platforms that facilitate trading in digital asset securities and review whether they meet the definition of an

[29] NFA, Interpretive Notice 9073, Disclosure Requirements for NFA Members Engaging in Virtual Currency Activities (Oct. 31, 2018) https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9073.

[30] NFA, Notice I-17-28, Additional reporting requirements for CPOs and CTAs that trade virtual currency products (Dec. 14, 2017), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4974; NFA, Notice I-17-29, Additional reporting requirements for IBs that solicit or accept orders in virtual currency products (Dec. 14, 2017), https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4975.

[31] SEC Div. Exam'ns, Risk Alert on The Division of Examinations' Continued Focus on Digital Asset Securities (Feb. 26, 2021), https://www.sec.gov/files/digital-assets-risk-alert.pdf.

[32] SEC Div. Exam'ns, 2022 Examination Priorities 16 (Mar. 30, 2022), https://www.sec.gov/files/2022-exam-priorities.pdf.

[33] SEC Div. of Exam'ns, *supra* note 7, at 1.

[34] Securities Act of 1933, 15 U.S.C. § 77q; Securities Exchange Act of 1934, 15 U.S.C. § 78j; Regulatory Notice 10-22, Financial Industry Regulatory Authority, Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings, https://www.finra.org/rules-guidance/notices/10-22.

[35] SEC Division of Examinations, *supra* note 7, at 7.

exchange. To the extent that a platform operates as an "exchange,"[36] the platform must register with the SEC unless it is exempt.[37] The SEC will, furthermore, examine whether the platform complies with Regulation ATS (i.e., an exemption from national securities exchange registration that is available to an entity that meets the definition of an exchange under the Exchange Act).[38] As clarified in the Risk Alert, the SEC staff will review whether registered transfer agents servicing digital asset securities are operating in compliance with rules intended to facilitate prompt and accurate clearance and settlement of securities transactions.[39]

3. Federal and State Executive Orders

The growth of digital asset use among retail and institutional customers has drawn the attention of state and federal agencies to the cryptocurrency industry. Among other efforts by federal and state governments to deal with the challenges of digital asset regulation, the Biden-Harris administration released the Executive Order on Ensuring Responsible Development of Digital Assets in March 2022. Following this executive order, California Governor Gavin Newsom signed Executive Order N-9-22 in May 2022, introducing California's regulatory approach to blockchain technology.[40]

The Biden Executive Order focuses on the absence of uniform oversight and standards in the digital asset industry.[41] The Biden Executive Order explains that this absence may result in inadequate protections for sensitive financial data, custodial and other arrangements related to customer assets and funds, or disclosures of risks associated with investments in digital assets. The Biden Executive Order lays out six policy objectives to address the lack of uniform digital asset oversight and standards: (1) customer, investor, and business protections; (2) financial stability and systemic risk mitigation; (3) illicit finance mitigation and national security risks; (4) continued leadership in the global financial system and economic competitiveness by the United States; (5) financial inclusion; and (6) responsible development and use of digital assets.[42] To achieve these objectives, the Executive Order directs federal departments and agencies, by working in collaboration, to produce various reports, frameworks, analyses, and regulatory and legislative recommendations to the administration.[43]

4. Bipartisan Legislative Efforts

In addition to the Biden Executive Order and state and federal interest in digital assets, Congress has introduced various legislative proposals related to digital assets. Perhaps the most comprehensive proposal, introduced on June 7, 2022 by Senators Cynthia Lummis and Kirsten Gillibrand, is titled the Responsible Financial Innovation Act ("RFIA"). The RFIA "seeks to create a complete regulatory framework for digital assets that encourages responsible financial innovation, flexibility, transparency, and robust consumer protections while integrating digital assets into existing law."[44] The RFIA is a bipartisan effort to develop and provide greater regulatory clarity to the eclectic digital asset industry; it would create a more coherent and consistent regulatory framework for the digital asset industry and encourage responsible financial innovation, flexibility, transparency, and robust consumer protection. In particular, the bill addresses a number of

[36] 15 U.S.C. § 78c(a)(1).

[37] Section 5 of the Securities Exchange Act prohibits transactions of securities on exchanges that are unregistered and nonexempt under the Securities Exchange Act. 15 U.S.C. § 78e.

[38] 17 C.F.R. § 242.301.

[39] SEC Div. Exam'ns, *supra* note 7, at 7.

[40] Exec. Order No. N-9-22 (May 4, 2022), https://www.gov.ca.gov/wp-content/uploads/2022/05/5.4.22-Blockchain-EO-N-9-22-signed.pdf. Building on the Executive Order, Governor Newsom's Executive Order seeks to harmonize California with any forthcoming federal rules and guidelines to create regulatory clarity for businesses and to protect consumers. Governor Newsom's Executive Order sets out seven priorities: (1) create a transparent and consistent business environment for companies operating in blockchain; (2) collect feedback to create a regulatory approach; (3) collect feedback for potential blockchain applications and ventures; (4) develop a comprehensive regulatory approach; (5) encourage regulatory clarity; (6) explore opportunities to deploy blockchain technologies to address public service and emerging needs; and (7) identify opportunities to create a research and workforce environment. *Id.*

[41] Exec. Order No. 14,067, 87 Fed. Reg. 14,143 (Mar. 9, 2022), https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/.

[42] *Id*.

[43] *Id*.

[44] Press Release, Off. of U.S. Senator Kirsten Gillibrand, Lummis, Gillibrand Introduce Landmark Legislation to Create Regulatory Framework for Digital Assets (Jun. 7, 2022), https://www.gillibrand.senate.gov/news/press/release/-lummis-gillibrand-introduce-landmark-legislation-to-create-regulatory-framework-for-digital-assets.

significant issues involving the digital asset industry, including the following:

- **Definitions**: The RFIA would provide much-needed clarity in the digital asset industry by defining key industry terms such as "digital asset," "ancillary asset," "virtual currency," "distributed ledger technology," and "smart contract."

- **Jurisdiction**: The RFIA would expand the jurisdiction of the CFTC, assigning regulatory authority over digital asset spot markets to the CFTC while maintaining the jurisdiction of the SEC over digital assets that are deemed securities. The bill attempts to address the overlapping regulatory jurisdictions between the SEC and CFTC by distinguishing between digital asset commodities and digital asset securities through the designation of "ancillary assets," which are presumed to be commodities.

- **Ancillary Assets**: The bill would define "ancillary assets" as assets that are not fully decentralized and have some sort of management in place but are not securities because they do not offer debt or equity, create rights to profits, or offer other financial benefits. While the bill would require issuers of ancillary assets to make disclosures to the SEC semi-annually, it would allow such ancillary assets to be considered commodities rather than securities. If an ancillary asset were to become fully decentralized, the SEC disclosure obligation would end.

- **Spot Markets**: The RFIA would give the CFTC exclusive jurisdiction over spot markets in all digital assets that are not considered securities, including ancillary assets. The bill would allow digital asset exchanges to conduct trading activities through registration with the CFTC. The bill would also allow the CFTC to charge a user fee on digital asset exchanges to fund the agency.

- **Stablecoins**: The bill would require payment stablecoin issuers to hold reserves that comprise 100% eligible high-quality liquid assets and are subject to periodic audit, and permit customers to redeem all stablecoins at any time. It also would set a framework for the Office of the Comptroller of the Currency to issue national bank charters for payment stablecoin issuers.

- **Self-Regulatory Organizations**: The RFIA would instruct the CFTC and SEC to investigate potential ways to create a self-regulatory organization for the digital asset markets and to develop a proposal for the establishment of registered digital asset associations.

- **Taxes**: The bill would amend the taxation regime for digital assets in several ways. The RFIA would provide a *de minimis* exclusion of $200 per virtual currency transaction, clarify the definition of "broker" set forth in the bipartisan infrastructure package, and require Congress to investigate whether individuals should be permitted to invest retirement savings in digital assets. The bill also would clarify the entity status of decentralized autonomous organizations.

- **Disclosures**: The RIFA would impose disclosure requirements on digital asset service providers to help reduce the information disparity between digital asset issuers and purchasers. The bill stipulates that digital asset service providers must disclose consumer-protection information to investors, requires digital asset service providers to agree on terms of settlement finality with customers, and codifies individuals' rights to keep and control the digital assets that they purchase.

- **Money Transmission**: State bank supervisors would be required to adopt within a two-year period substantially uniform standards related to the treatment of digital assets under money-transmission laws.

- **Interagency Cooperation**: The bill directs various government agencies, including the Treasury Department, CFTC, SEC, Federal Reserve Board, and Federal Energy Regulatory Commission, to study, report on, and propose guidance, regulations, and industry standards.

5. Regulatory Enforcement

During the last several years, the SEC and CFTC have vigorously pursued enforcement actions against digital asset firms. In August 2021, Poloniex, LLC ("Poloniex"), a digital asset trading platform, agreed to pay more than $10 million to settle SEC charges of operating an unregistered online digital asset exchange in connection with its trading platform, which facilitated the buying and selling of digital asset securities.[45] The SEC found that some of the digital assets that Poloniex

[45] Press Release, SEC, SEC Charges Poloniex for Operating Unregistered Digital Asset Exchange (Aug. 9, 2021), https://www.sec.gov/news/press-release/2021-147#.

sold on its platform constituted securities and that the Poloniex trading platform met the criteria of an "exchange."[46] As a result, the SEC found that Poloniex's failure to register as a national securities exchange (or operate pursuant to an exemption from registration) was a violation of Section 5 of the Exchange Act.[47]

In 2016, the CFTC settled an enforcement action with BFNXA Inc. (d/b/a "Bitfinex"). Bitfinex's trading platform allowed users, including those who did not meet the definition of eligible contract participant ("ECP") or eligible commercial entity, to trade bitcoin and Litecoin on a leveraged, margined, or financed basis.[48] At no time during the period at issue was Bitfinex registered with the CFTC.[49] The CFTC determined that Bitfinex satisfied the definition of an FCM (in relevant part, an FCM is an individual, partnership, corporation or trust that is engaged in soliciting or accepting orders for retail commodity transactions, or that accepts money in connection with such transactions) without registering with the CFTC as an FCM.[50] Accordingly, the CFTC found that Bitfinex violated Sections 4(a) and 4d(a) of the Commodity Exchange Act.[51] Five years later, the CFTC again settled an enforcement action with Bitfinex for engaging in illegal off-exchange retail commodity transactions, operating as an unregistered FCM, and violating the prior CFTC order.[52] Despite updating its terms of service to prohibit U.S. persons (subject to certain exceptions for ECPs) from accessing the platform's services, the CFTC alleged that Bitfinex was aware that non-ECP U.S. persons continued to engage in retail commodity transactions on its platform.[53] Notably, the CFTC enforcement orders did not allege a violation by Bitfinex with respect to U.S. customers who did qualify as ECPs.

In August 2021, the CFTC settled charges in federal court against HDR Global Trading Ltd., 100x Holdings Ltd., ABS Global Trading Ltd., Shine Effort Inc Ltd. and HDR Global Services (Bermuda) Ltd., all doing business as BitMEX, "a peer-to-peer 'crypto-products platform' that offers the trading of crypto currency derivatives, including derivatives on bitcoin, ether, and Litecoin," among other defendants.[54] The settlement order requires BitMEX to pay a $100 million civil monetary penalty for AML violations, failure to supervise, violations of the Commodity Exchange Act for operating a facility to trade or process swaps without being approved as a designated contract market or swap execution facility, and violations of the Commodity Exchange Act for operating as an unregistered FCM.[55]

The CFTC's recent trend of investigating and taking enforcement action against unregistered platforms involving retail-margined, leveraged, or financed digital assets has not abated. One month after the BitMEX order, in September 2021, the CFTC charged 12 digital asset entities with failing to register as FCMs.[56] In one of these actions, the CFTC found that Payward Ventures, Inc. violated Sections 4(a) and 4d of the Commodity Exchange Act when it offered to enter into, entered into, executed, and/or confirmed the execution of margined or leveraged retail commodity transactions with non-ECP U.S. residents that did not result in actual delivery within 28 days.[57] Also, earlier in 2021, Bloomberg reported that Binance Holdings Ltd. was under CFTC investigation for allowing U.S. persons to trade on its platform.[58]

[46] *Id.*; 15 U.S.C. § 78c(a)(1).

[47] 15 U.S.C. § 78e.

[48] *BXFNA Inc.*, CFTC Docket No. 16-19, 2 (Jun. 2, 2016), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfbfxnaorder060216.pdf.

[49] *Id.* at 2.

[50] *Id.* at 7.

[51] *Id.* at 6-7. *See* 7 U.S.C. §§ 6(a), 6d.

[52] *iFinex Inc.*, CFTC Docket No. 22-05 (Oct. 15, 2021), https://www.cftc.gov/media/6651/enfbfxnaincorder101521/download.

[53] *Id.* at 4.

[54] *CFTC v. HDR Glob. Trading Ltd., et al.*, Case No. 1:20-cv-08132 (SDNY Aug. 10, 2021), https://www.cftc.gov/media/6261/enfhdrglobaltradingconsentorder081021/download.

[55] *Id.*

[56] Press Release, CFTC, CFTC Charges 14 Entities for Failing to Register as FCMs or Falsely Claiming to be Registered (Sept. 29, 2021), https://www.cftc.gov/PressRoom/PressReleases/8434-21.

[57] *Payward Ventures, Inc.*,CFTC Docket No. 21-20 (Sept. 28, 2021), https://www.cftc.gov/media/6426/enfpaywardorder092821/download.

[58] Ben Bain et al., *Binance Probed by CFTC Over Whether U.S. Residents Made Trades*, BNN BLOOMBERG (Mar. 12, 2021), https://www.bnnbloomberg.ca/binance-probed-by-cftc-over-whether-u-s-residents-made-trades-1.1576124.

B. U.K. Regulatory Developments

1. Current U.K. regulatory framework

The U.K. Financial Conduct Authority ("FCA") currently divides crypto assets into:[59]

a) security tokens, which are regulated tokens akin to specified investments, such as shares and debt instruments (and are subject to existing regulation applying to specified investments);

b) e-money tokens, which are regulated crypto assets that meet the definition of electronic money (and are subject to existing regulation applying to electronic money); and

c) unregulated tokens, which are any crypto assets that are not security tokens or e-money tokens (and include cryptocurrencies such as Bitcoin that the FCA refers to as exchange tokens and utility tokens that allow access to a service or network).

Unregulated tokens currently fall outside the U.K. regulatory perimeter, so activities related to them do not generally require FCA authorization. U.K. regulation is "technology-neutral" (i.e., it is the activities that require regulation rather than the underlying technology), but the FCA's pro-competition mandate has meant that the FCA is supportive of innovation. However, while the FCA may consult on changes to its rules and guidance, changes to the scope of what is within the U.K. regulatory perimeter are the purview of the government, as they involve amending legislation.

The U.K. government, which is working with the FCA to develop a crypto asset regime that supports innovation and competition, announced in April 2022 plans to make the U.K. a global hub for crypto asset technology and investment.[60] These plans include proposed measures introducing a new regulatory regime for stablecoins used as a means of payment and extending the financial promotion regime to certain types of unregulated crypto assets.

2. Government consultation on the U.K. regulatory approach to crypto assets

The U.K. government in April 2022 published its response to its consultation on the general regulatory approach to crypto assets and stablecoins.[61] It confirmed its intention to take legislative steps to bring the issuance of, and services related to, stablecoins used as a means of payment into the U.K. regulatory perimeter, mainly by amending existing electronic-money and electronic-payments legislation. It considers that amending the existing U.K. framework for electronic money under the Electronic Money Regulations 2011 and Payment Service Regulations 2017 can deliver a consistent framework in which to regulate the issuance of stablecoins and the provision of wallets and custody services.

The U.K. government believes that risks and opportunities related to stablecoins are most urgent, particularly in light of their broad use for payment, and concerns over their ability to provide stable value and redeemability.[62] If appropriate standards and regulations can be met, the government considers that certain stablecoins have the potential to play an important role in retail and cross-border payments, including settlement, and that bringing stablecoins into the regulatory framework can enable consumers to use stablecoin services with confidence.

In addition, the government further plans to consult later in 2022 on regulating a wider set of crypto asset activities, in light of the continued growth and use of crypto assets worldwide. It is continuing to assess the appropriate regulatory response to the use of crypto assets other than stablecoins used as a means of payment and will work with the U.K. financial regulators and industry to consider appropriate future regulation. The government welcomes the work happening at an international level on the regulation of crypto assets and will ensure that sufficient flexibility is built into the U.K.'s regulatory framework to allow regulators to adapt rules and requirements as international work concludes.

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[59] Fin. Conduct Auth. Policy Statement PS19/22, Guidance on Cryptoassets, at 14 (Jul. 2019), https://www.fca.org.uk/publication/policy/ps19-22.pdf.

[60] Press Release, HM Treasury, Government sets out plan to make UK a global cryptoasset technology hub (Apr. 4, 2022), https://www.gov.uk/government/news/government-sets-out-plan-to-make-uk-a-global-cryptoasset-technology-hub.

[61] HM Treasury, *U.K. regulatory approach to cryptoassets, stablecoins, and distributed ledger technology in financial markets: Response to the consultation and call for evidence* (Apr. 2022).

[62] HM Treasury, *U.K. regulatory approach to cryptoassets, stablecoins, and distributed ledger technology in financial markets: Consultation and call for evidence*, 4 (Jan. 2021).

3. Government consultation on extending U.K. financial promotion regime

The U.K. government also published its response at the beginning of 2022 to its proposals to bring the promotion of certain types of unregulated crypto assets within the scope of the U.K. financial promotion regime.[63] As respondents agreed that a lack of suitable information and misleading advertising lead to consumer risks in the crypto assets market, the government intends to amend the U.K. financial promotion regime to cover certain crypto assets and related activities.

In particular, it is intended for "qualifying crypto assets" to be added to the list of investments covered under the Financial Promotion Order. The precise definition of "qualifying crypto assets" is still under development, but the government indicates that the crypto assets in scope will be cryptographically secured digital representations of value or contractual rights that are fungible and transferable. The government has decided not to include a reference to distributed ledger technology in the definition, so as to "future-proof" it for innovations in the underlying technology used by crypto assets. When the amendments to the Financial Promotion Order are in force, the promotion of qualifying crypto assets will be subject to FCA rules, in line with the same standards to which other financial promotions are subject (the FCA is also consulting on strengthening its financial-promotions rules for high-risk investments, which would include qualifying crypto assets).[64] In light of feedback, the government intends to put in place a transitional period of approximately six months from the finalization of the amended rules until they apply.

4. AML registration

Even where regulated activities are not carried on by virtue of the crypto assets being unregulated tokens (and so U.K. authorization is not required), AML requirements still apply to unregulated crypto assets.

The U.K. in January 2020 implemented the Fifth EU Money Laundering Directive,[65] which introduced requirements for crypto asset exchange and custodian wallet providers alongside the latest Financial Action Task Force standards on regulating crypto assets and crypto asset service providers. Accordingly, crypto asset businesses need to be compliant with the U.K. Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, as amended, including the requirement to be registered with the FCA, before they begin conducting business in the U.K.[66]

The FCA flagged in a speech in April 2022 that it had at that point registered 33 crypto asset firms under the U.K. AML regime for crypto asset businesses.[67] It explained that it worked with many firms to help improve their capabilities instead of simply rejecting or approving applications with no feedback or advice, and that its rejection of those that did not meet the standards should not be interpreted as anti-innovation.

IV. UNIQUE DUE DILIGENCE CONSIDERATIONS FOR FINTECH INVESTORS

After considering industry trends, different forms of capital raising, and regulatory factors (related to the method of raising capital as well as the regulatory environment of the startup), an investor must determine whether to proceed with a fintech investment. Due diligence can inform the investor of any red flags or dealbreakers. In addition to an investor's standard due diligence requests, the investor may wish to incorporate crypto-specific questions in its due diligence. Examples of due diligence considerations in the crypto asset startup space include:

- Consider the activities that the company carries on in relation to crypto assets, what types of crypto assets the company deals with, whether it has plans to expand the range of those activities and the range

[63] HM Treasury, *Cryptoasset promotions: Consultation response* (Jan. 2022).

[64] Fin. Conduct Auth. Consultation Paper CP22/2, Strengthening our financial promotion rules for high-risk investments, including cryptoassets (Jan. 1, 2022), https://www.fca.org.uk/publications/consultation-papers/cp22-2-strengthening-our-financial-promotion-rules-high-risk-investments-includingcryptoassets.

[65] Directive 2018/843, of the European Parliament and of the Council of 30 May 2018.

[66] Regulation 56, U.K. Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, SI 2017/692 (Eng.).

[67] Speech by FCA CEO Nikhil Rathi, Fin. Conduct Auth., Critical issues in financial regulation (Apr. 26, 2022), https://www.fca.org.uk/news/speeches/critical-issues-financial-regulation-fca-perspective.

of crypto assets and how it categorizes those crypto assets for regulatory purposes, so as to determine the applicable regulatory regime.

  - When the company categorizes crypto assets, does the company use the *Howey* and *Reves*[68] tests to determine whether the assets are securities? What other factors are part of the company's analysis? Does the company periodically monitor the status of crypto assets?

  - Consider whether additional expertise is needed when performing due diligence. For example, if non-fungible tokens are involved, has the investor reviewed intellectual property implications?

  - The investor should have an understanding of how crypto assets are custodied, the security protocols related to custody and any insurance that the company maintains.

- When considering the company's activities, ask whether it is appropriately registered or has considered licensure and registration requirements in each relevant jurisdiction.

  - CFTC and SEC permissions, and any state or other licenses, should be confirmed.

  - Similarly, to the extent the company carries on activities in the U.K., the FCA register should be checked to confirm the scope of any U.K. regulatory permission the company has and whether the company is registered for AML purposes, so as to determine what the company can do in the U.K. from a regulatory perspective in relation to crypto assets.

  - If the investment is in a fund managed by a registered investment adviser, an investor should consider the steps the investment adviser took to comply with the SEC's Risk Alert and, even if the adviser is not registered with the SEC, whether the adviser reviewed the Risk Alert when establishing best practices.

  - An investor should also check whether the CFTC, SEC, NFA, FCA, or any other regulator has conducted an examination or investigation on the company and, if so, what the results of that were.

- Consider what types of investors and clients the company targets, as retail investors and clients require more protection and the regulatory risks associated with them are higher.

- Consider whether the company is subject to AML and KYC procedures and whether it adheres to such procedures or has had any issues in the past.

- Consider how the company is monitoring regulatory developments in the context of crypto assets, given that regulatory frameworks are changing at a fast pace. ■

[68] The *Howey* test sets forth the test for determining when an investment contract (and, thus, a security) exists; the test requires an (1) investment of money (2) in a common enterprise (3) with an expectation of profit (4) that is derived from the effort of others. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Another U.S. Supreme Court case, *Reves v. Ernst & Young*, adopted the "family resemblance" test to determine whether a note is a security. *Reves v. Ernst & Young*, 494 U.S. 56 (1990). The test begins with the presumption that a note is a security unless the presumption is rebutted by examining: (1) the motivations that would prompt a reasonable seller and buyer to enter into the transaction; (2) the plan of distribution of the note; (3) the reasonable expectations of the investing public; and (4) whether another regulatory scheme or another factor exists, making it is unnecessary to apply the Securities Acts to the transaction. *Reves*, 494 U.S. at 66-67.