

# Technology Marathon 2022

Our Technology Marathon is an annual series of tailored webinars focused on hot topics, trends, and key developments in the technology industry that are of essential importance to our friends and clients. Now in its 12th year, our expansive curriculum kicks off in May and continues into June.

For more information:

**<https://www.morganlewis.com/events/technology-marathon>**

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# Before we begin

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## Q&A

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## Audio

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You will hear sound through your computer speakers/headphones automatically. Make sure your speakers are ON and UNMUTED.

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The background is a vibrant, abstract digital composition. It features a dark blue and black base with streaks of bright blue and white light, suggesting data flow or a digital landscape. Scattered throughout are various elements: binary digits (0s and 1s) in different sizes and colors (white, blue, yellow), some appearing to float or move. There are also glowing rectangular shapes and lines that create a sense of depth and motion. The overall effect is high-tech and futuristic.

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# TECHNOLOGY MARATHON

**Investing in Digital Asset Startups:  
What Lawyers Need to Know**

Sarah V. Riddell, Steven Lightstone, Jacob J.O. Minne,  
and Christina Wlodarczyk

**June 23, 2022** | 12:00-1:00 pm ET



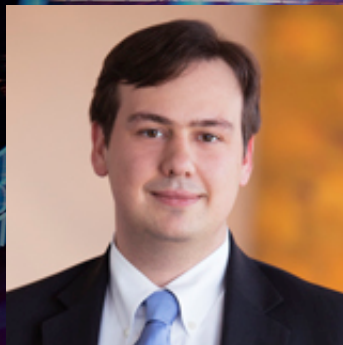
# Presenters



**Sarah V. Riddell**  
Chicago



**Steven Lightstone**  
London



**Jacob J. O. Minne**  
Silicon Valley



**Christina W. Włodarczyk**  
Washington, DC

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# Product & Market Developments

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# A Terrible, Horrible, No Good, Very Bad Year

Bitcoin to USD Chart



<https://coinmarketcap.com/currencies/bitcoin/>



# Key Recent Events: The Terra De-peg



On May 9, Terra—UST—lost its peg to the dollar.

- This was a so-called “algorithmic” stablecoin, supported by its own blockchain
- The fall in price triggered the de-peg

# Key Recent Events: The Celsius Freeze



On June 13, Celsius froze withdrawals.

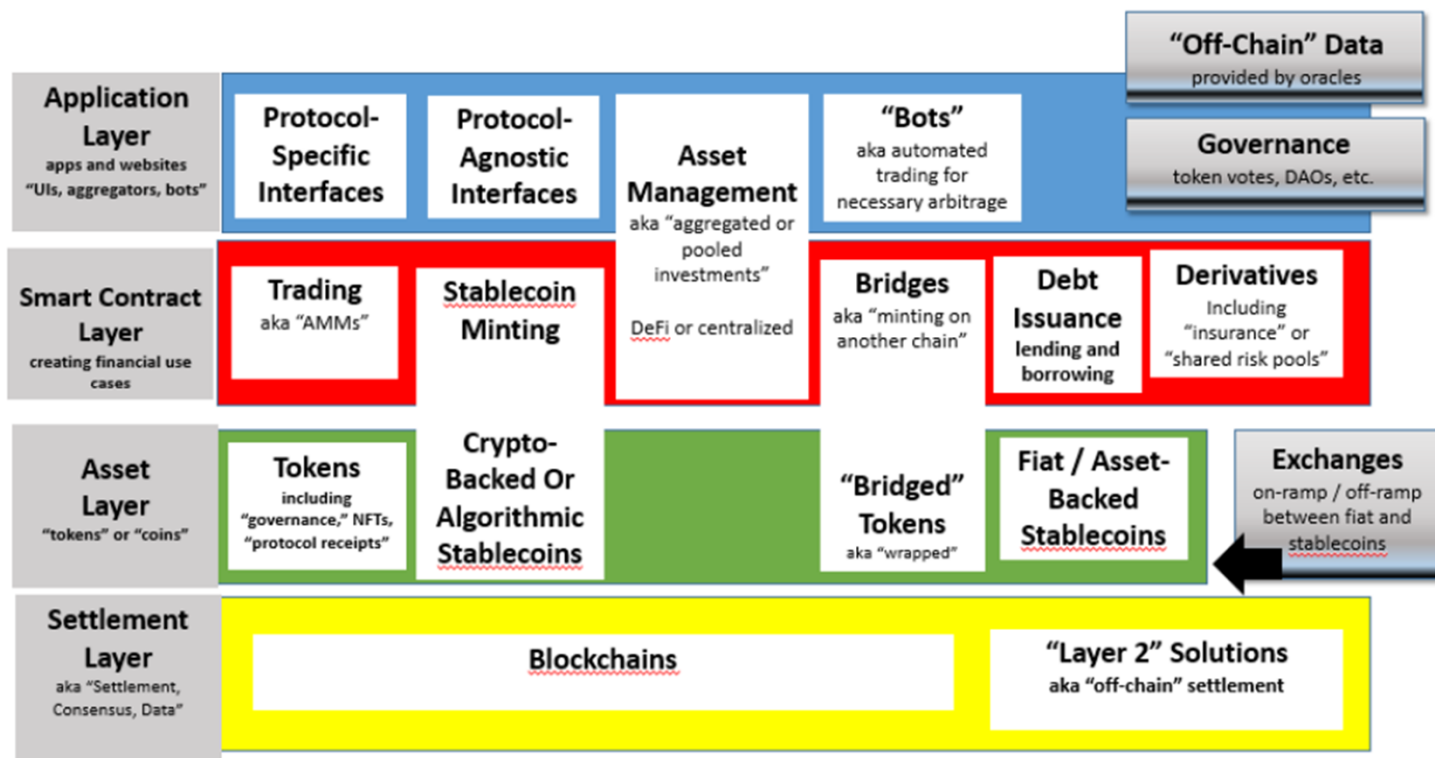
- Celsius was a major blockchain lending platform.
- Again, the fall in price seems to have triggered the freeze.



# The Rise (and Fall) of DeFi



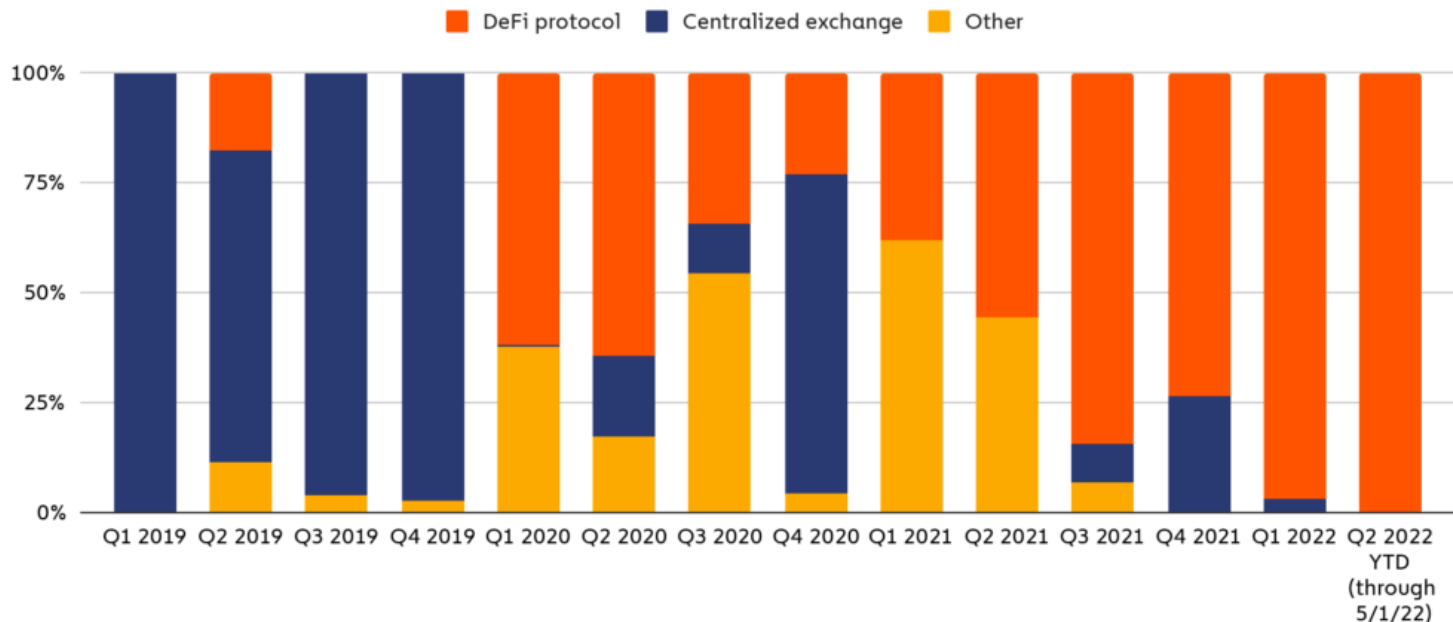
# What Is "DeFi"?





# DeFi Hacks Are on the Rise

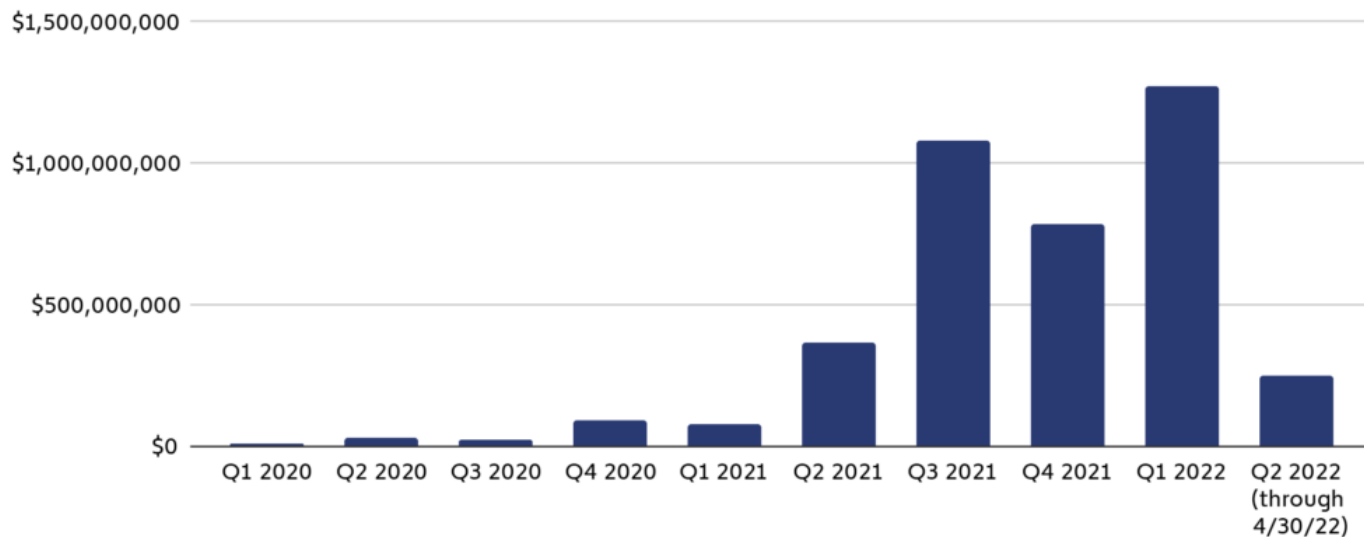
Cryptocurrency value stolen by victim platform type, Q1 2019 - Q2 2022 YTD



© Chainalysis

# DeFi Hacks Are on the Rise

Quarterly cryptocurrency value stolen from DeFi protocols, Q1 2020 - Q2 2022  
YTD



© Chainalysis

## Other Macroeconomic Considerations

- Massive fiscal injections in 2020 and 2021, followed by inflation-induced market pull-back. S&P 500 is down 23.5% for the year.
  - Bitcoin failed to act as a hedge against inflation — compare to Pax Gold
- Substantial interest rate increases leave lower-risk positions for investors seeking alpha.
- Increasing calls for regulatory certainty.

# **US Regulatory Developments**

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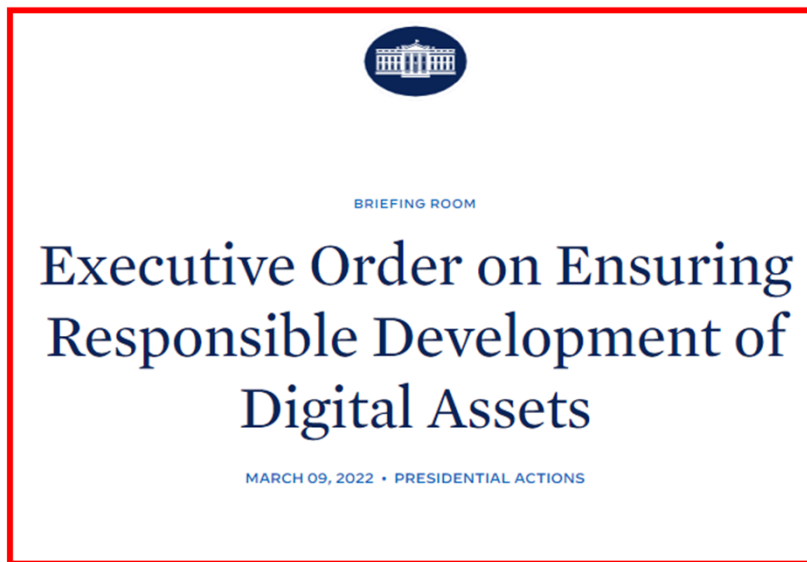


# U.S. Regulatory Considerations – Current Landscape

- CFTC Anti-Fraud and Anti-Manipulation Authority
- Derivative Products
- NFA Disclosure Requirements for NFA Members Engaged in Virtual Currency Activities
- NFA Reporting Requirements
- SEC Division of Examinations Risk Alert

# U.S. Regulatory Developments

- SEC Chairman Gensler's statements on digital assets
- Biden Administration's Executive Order
- Federal Reserve Discussion Paper on the Pros and Cons of a CBDC
- The Responsible Financial Innovation Act, introduced by Senators Lummis (R-WY) and Gillibrand (D-NY)



# The Responsible Financial Innovation Act



- **Jurisdiction:** The bill would expand the CFTC's jurisdiction, assigning regulatory authority over digital asset spot markets to the CFTC, while maintaining the SEC's jurisdiction 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 other financial benefits. Ancillary assets would be considered commodities and not securities. Issuers of ancillary assets would be subject to semi-annual SEC disclosure requirements but if an ancillary asset were to become fully decentralized, the SEC disclosure obligation would end.
- **Stablecoins:** The bill would require payment stablecoin issuers to hold reserves that are comprised of 100% eligible high-quality liquid assets and 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 (OCC) to issue national bank charters for payment stablecoin issuers.

# The Responsible Financial Innovation Act

- **Taxes:** The bill would amend the taxation regime for digital assets in several ways. It provides a de minimis exclusion of \$200 per virtual currency transaction, clarifies the definition of “broker” set forth in the bipartisan infrastructure package, and requires Congress to investigate whether individuals should be able to invest retirement savings in digital assets. It also would clarify the entity status of decentralized autonomous organizations (DAOs).
- **Disclosures:** Digital asset service providers would be required to disclose consumer protection information to investors and to agree on terms of settlement finality with customers. The bill would codify individuals’ rights to keep and control digital assets that they purchase.
- **Money Transmission:** State bank supervisors would be required to adopt substantially uniform standards relating to the treatment of digital assets under money transmission laws within a two-year period.

# **Regulatory Due Diligence Considerations**

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# What Are You Investing in?

## Security?

### Relevant considerations include:

- *Howey* and *Reves* tests
- Division of Examinations Risk Alert (for registered investment advisers)
- Has the SEC taken enforcement action against similar offerings?
- Potential liquidity issues in the future?

## Commodity?

### Relevant considerations include:

- Retail commodity transaction?
- If the contract is a derivatives contract:
  - Is the fund manager registered or exempt from registration as a CPO?
  - Are NFA disclosure and reporting requirements implicated?
  - Is the platform that offers the contracts properly registered?

# What Are You Investing in?

## A Private Fund?

### Relevant considerations include:

- What does the fund invest in, and what diligence has the manager done on the portfolio companies or tokens?
- What are the investment restrictions?
- Do you need a wallet for distributions in kind?
- What is the valuation policy for digital asset investments?
- Where are digital assets held?

## A Startup Company?

### Relevant considerations include:

- What are the company's business activities?
- Do these activities implicate registration requirements?
- In what jurisdictions does the company offer its products or services? Where are its customers located?
- Where are digital assets held?

# Other Regulatory Considerations

**1**

**FinCEN and state law  
money transmitter  
registration**

**2**

**New York State  
Department of  
Financial Services  
BitLicense**

**3**

**OFAC/Sanctions**

# Product Considerations



Do the token's characteristics change over time? If so, how does this affect the securities analysis?



Is the product a loan that pays interest based on staking digital assets? Have you applied the *Howey* and *Reves* tests to the loan and determined whether the loan could be considered a security?



Consider IP implications for Non-Fungible Tokens (NFTs). NFTs are tokens that can be used to represent ownership of unique items (e.g., art, collectibles, and real estate). Generally, NFTs can be owned by only one owner at a time, and they are secured by the Ethereum blockchain.



Other regulatory considerations may arise if fractionalization is involved. Fractionalization occurs when a market participant tokenizes underlying assets and sells fractions of the token (e.g., baseball cards, comic books, and sports memorabilia). The fractionalization process generally will result in the creation of securities. Consider whether Regulation A+ applies.

# Unique Digital Asset Questions



## Technology

- What technology is involved?
- Does the fund manager or portfolio company have appropriate knowledge of the technology to make informed decisions?



## Custody

- Self-custody?
- Third-party custodian?
- Multi-authentication?
- Cold storage?



## Insurance

- Does the fund maintain any relevant insurance?
- Cybersecurity insurance?



## UCC

- Have you granted another party a security interest in your digital assets? If so, have you confirmed that your agreement is consistent with the UCC?
- Are digital assets improperly commingled?
- Are digital assets bankruptcy remote?



# Due Diligence – Thematic Areas

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The Fund's Investments or the Company's Business Activities

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Underlying Asset Risk

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Custody vs. Self-Custody

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Technological Experience

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AML/KYC

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Asset Valuation

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Conflicts of Interest

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Regulation

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Litigation / Enforcement Actions

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# **UK Regulatory Developments**

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# UK Regulatory Developments

- The FCA currently divides cryptoassets into:
  - **security tokens**
  - **e-money tokens**
  - **unregulated tokens**
- UK regulation is **technology neutral**, but the FCA sees regulation “as an **enabler of positive innovation** based on new technologies as well as a means of containing undue risk”
- Kalifa Review: HM Treasury published independent report last year, recommending:
  - digital finance package creating new regulatory framework for emerging technology
  - providing additional support to firms focusing on innovative technology
  - securing FinTech’s position as integral part of UK trade policy
- Government announced plans in April 2022 to make UK **global hub for cryptoasset technology and investment**

# UK Regulatory Developments

- Government consultation on UK regulatory approach to cryptoassets:
  - stablecoins used for payment to be brought within regulatory regime
  - plans for further consultation on regulating a wider set of cryptoasset activities
- Government/FCA consultations on UK financial promotion regime:
  - unregulated cryptoassets to be brought within financial promotion regime
  - plans to strengthen financial promotion rules for high-risk investments, which would include qualifying cryptoassets
- AML registration:
  - 33 cryptoasset firms registered under AML regime as of April 2022
  - the FCA said that its rejection of applications should not be interpreted as anti-innovation

# Capital Raising with Tokens

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# Types of Capital Raising and Considerations

- **Initial Coin Offerings (ICO)**
  - Offer and sale of unregistered securities
- **Initial Exchange Offerings (IEO)**
  - Offer and sale of unregistered securities
  - Not to US investors
  - Exchange considerations
- **Airdrops**
  - “Free” stock offering / programs
- **Simple Agreement for Future Tokens (SAFT)**



# Technical Due Diligence

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# Unique Technology Due Diligence Considerations

- Consensus mechanism – potential ESG implications
- How will assets be custodied
  - ✓ Key sharding
  - ✓ Multi-sig
  - ✓ Hardware vs. Software
  - ✓ Hot vs. Cold
- Independent code audits
- Dealing with security flaws
- On-chain vs. off-chain assets



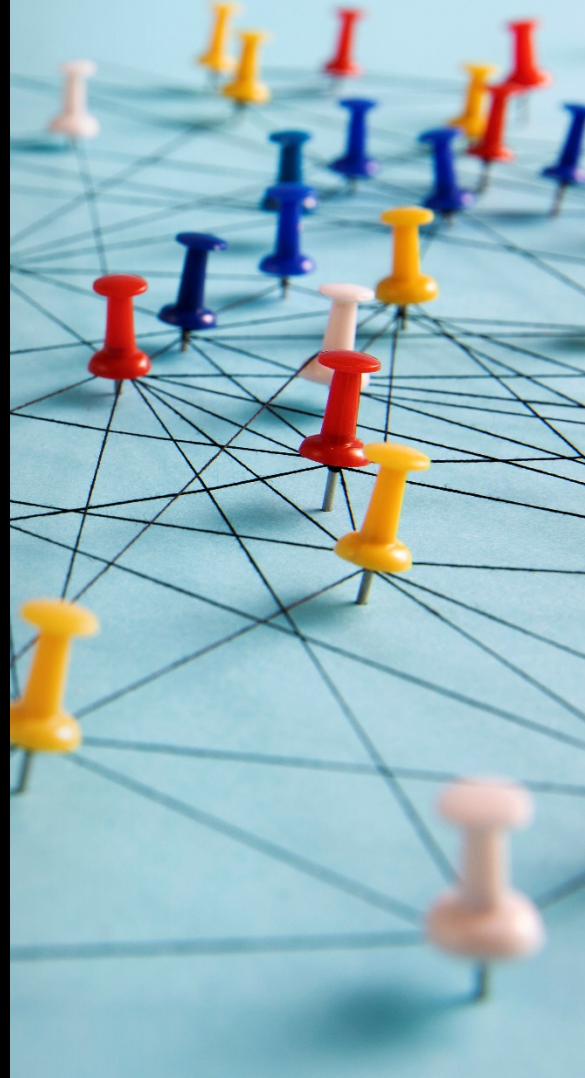
# Ukraine Conflict Resources

Our lawyers have long been trusted advisers to clients navigating the complex and quickly changing global framework of international sanctions. Because companies must closely monitor evolving government guidance to understand what changes need to be made to their global operations to maintain business continuity, we offer a centralized portal to share our insights and analyses.

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To help keep you on top of developments as they unfold, visit the website at [www.morganlewis.com/topics/ukraine-conflict](https://www.morganlewis.com/topics/ukraine-conflict)

To receive a daily digest of all updates, please visit the resource page to **subscribe** using the “Stay Up to Date” button.



# Biography



**Sarah V. Riddell**

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Leveraging her experience as a lawyer at the US Commodity Futures Trading Commission (CFTC), **Sarah** advises domestic and foreign exchanges, derivatives clearing organizations, swap execution facilities, and other financial institutions on a broad range of regulatory matters, including CFTC registration and compliance. Sarah also assists hedge fund and swap dealer clients with CFTC and National Futures Association (NFA) registration, compliance, and examination questions. While at the CFTC, Sarah worked on Dodd-Frank-related rulemakings and participated in examinations of derivatives clearing organizations, including those designated as systemically important.

In addition, Sarah helps clients understand and comply with the NFA's Information Systems Security Program interpretive notice and the New York Department of Financial Services (NYDFS) Cybersecurity Regulation, as well as related cybersecurity questions. Sarah has assisted clients who have experienced cybersecurity attacks, assisted in the cybersecurity investigations and assessments of forensic analyses about the incident, and has drafted and submitted notifications to customers and regulatory agencies. Sarah also advises funds, digital wallet businesses, and exchanges that invest in or issue crypto assets on regulatory issues, including the applicability of NYDFS regulations and federal and state laws and regulations.

# Biography



**Steven Lightstone**

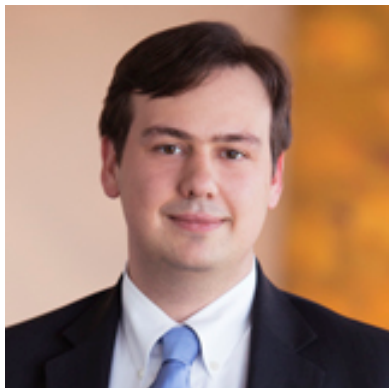
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**Steven** advises on financial services, securities, and derivatives regulatory issues. His clients include asset managers across a wide range of asset classes and their funds, banks, broker-dealers, fintech firms, payment institutions, institutional investors, insurers, lenders, and market associations.

# Biography



## Jacob J.O. Minne

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**Jacob** advises clients on a wide range of technology and IP issues, including work with semiconductor processing, cryptoassets, fintech, blockchain, and devices. Jacob's patent and trade secret litigation experience includes helping companies develop a comprehensive strategy for US litigation. He also works on software copyright matters that touch on a range of unfair competition and antitrust concerns.

Jacob has experience with blockchain technology and has reviewed node hosting agreements for permissioned blockchains and evaluated regulatory concerns related to money transmitter registration, custody requirements, and CFTC scrutiny of certain bitcoin transactions. He presents regularly at conferences such as LendIt and through Morgan Lewis's First Cup of Coffee program and Hedge Fund Practice Conference.

Through his IP practice, Jacob has experience in analyzing copyright, patent, trademark and trade secret issues and advising clients on protecting and developing their IP portfolio. His litigation experience includes cases for clients in a diverse range of technology fields such as semiconductor chip manufacturing methods, medical devices, and mobile software. He has experience in forums including the US District Court for the Central District of California, the US Court of Appeals for the Federal Circuit, and the US International Trade Commission (USITC).

Before he joined Morgan Lewis, Jacob completed an externship with Judge Steven B. Berlin in the Office of the Administrative Law Judge for the US Department of Labor (DOL). He also worked as a patent litigation analyst for Lex Machina on a variety of quantitative analytics projects, including a comparison of average time to final judgment in US federal district courts as compared to the USITC.

Jacob also uses his legal education to give back to the community. Serving as pro bono counsel, he assists refugees in filing asylum applications and has won restraining orders for clients in domestic violence disputes. In late 2016, Jacob submitted an application for presidential clemency for a pro bono client who was sentenced to life in prison for drug crimes committed while he was a minor; then-President Barack Obama granted the petition for clemency in January 2017. During the COVID-19 pandemic in 2020, Jacob helped three ICE detainees secure bail from facilities with active COVID-19 outbreaks.

# Biography



**Christina (Nina) Wlodarczyk**

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**Nina** is a part of a team of lawyers that advises clients in a variety of corporate transactional matters, including public securities offerings, securities regulation, mergers and acquisitions, and corporate governance across various industries. She advises clients ranging from Fortune 500 companies to emerging companies. Christina is admitted in New York only, and her practice is supervised by DC Bar members.

Prior to joining the firm, Christina was an attorney Excelsior Service Fellow with the New York State Department of Financial Services, Research and Innovation Division. While with DFS, she gained a deep understanding of the cryptocurrency, blockchain, and digital assets industries by regulating and supervising companies engaged in Virtual Currency Business Activity.

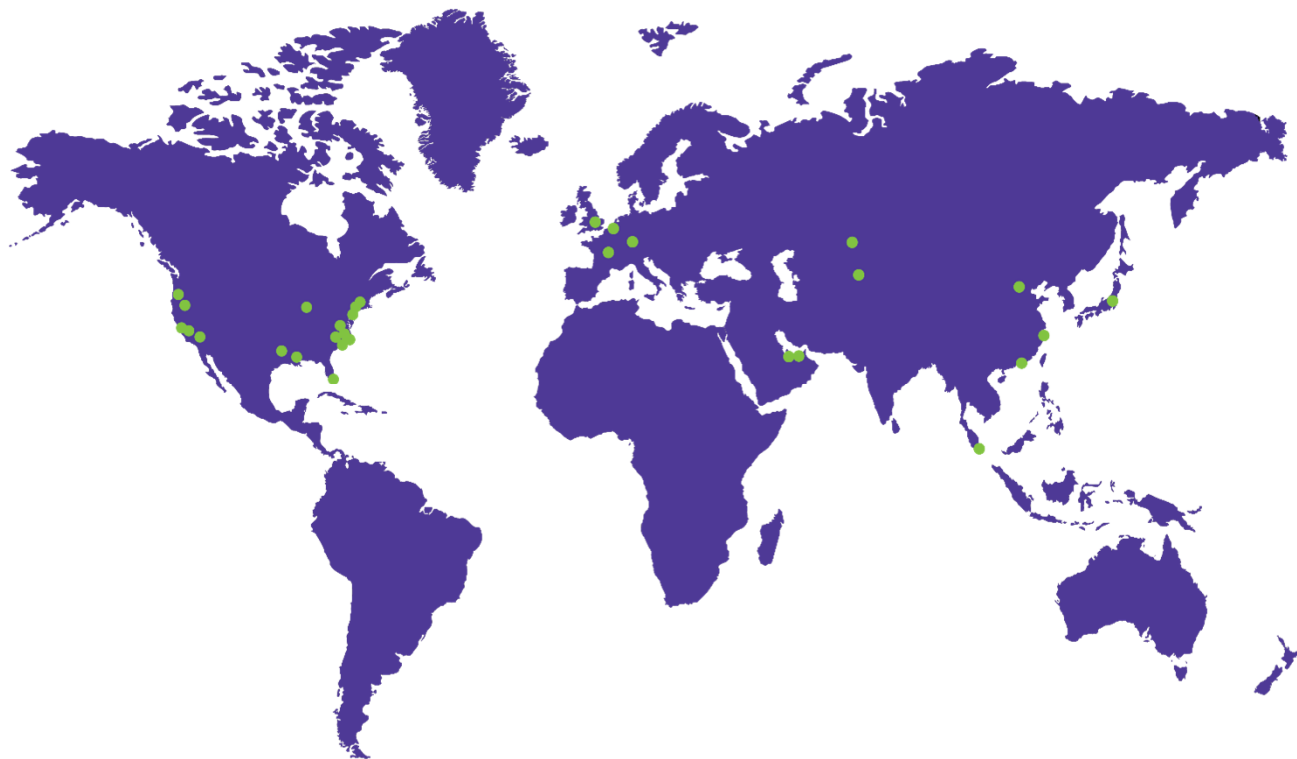


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