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TECHNOLOGY MARATHON

**Post-FTX: How US and UK Regulators
Propose to Regulate Digital Assets (Part 2)**

Steven Lightstone, Ignacio Sandoval, Sarah Riddell
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Presenters



Steven Lightstone

Partner



Ignacio Sandoval

Partner



Sarah V. Riddell

Of Counsel

Morgan Lewis

Agenda

- Introduction: Digital Assets
- Regulatory Treatment of Digital Assets: United States
 - Federal regulatory bodies, initiatives
 - State-level regulatory bodies, initiatives
 - Enforcement
- Regulatory Treatment of Digital Assets: United Kingdom
- Takeaways



Section 01 Introduction

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Digital Asset Regulation: The Big Question?

Q: How are cryptocurrency and digital assets regulated in the United States and the United Kingdom?

A: it depends on the nature (type) of product, entity and activity.

Section 02

Regulatory Treatment of Digital Assets: United States

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Overview: Digital Asset Treatment in the US

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

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

Digital Asset Regulation: Federal

Primary US federal regulators with jurisdiction over parties accessing US markets

Securities and Exchange Commission (SEC)

Investor protection, enforcement of US securities laws

Commodity Futures Trading Commission (CFTC)

Commodities, antifraud, registration of exchanges/platforms, FCMs

Financial Crimes Enforcement Network (FinCEN)

Bank Secrecy Act (BSA)/Anti-Money Laundering (AML) – money services businesses (“money transmitters”)

Office of Foreign Assets Control (OFAC)

International sanctions, AML, countering the financing of terrorism (CFT)

Prudential Bank Regulators: OCC, FDIC, Federal Reserve/FRB

Digital asset and crypto activities of banks (November 23, 2021, joint statement)

US Treasury/Internal Revenue Service (IRS)

Taxation

US Department of Justice (DOJ)

Criminal enforcement

Digital Asset Regulation: State

Applicable state statutes and regulations:

- State virtual currency business statutes – including New York State BitLicense framework
- State money services business (MSB) statutes and money transmitter laws and related licensing requirements
- State securities laws – BlockFi action (NJ, AL, TX, VT, KY), NYAG (Coinseed, GTV)
- State business statutes – NY General Obligations Law (NYAG – Tether/Bitfinex)
- State DAO statues (WY)
- State crypto banking regulations (TX)
- State money-laundering statutes (FL)

Also subject to regulation by:

- Self-regulatory organizations (SROs) – FINRA (broker-dealers), NFA (swap dealers, CPOs, CTAs)
- Global standard-setting bodies – FATF, BCBS, IOSCO, BIS (CPMI), FSB

Digital Asset Legislative Proposals

Focused on Investor Protection



Bankruptcy Protections

Disclosures

Advertising Rules



Significant legislative proposals
are in “discussion draft” form.

States are taking action in the
meantime.

Crypto and the SEC (CONT'D)



DAO Report

On July 25, 2017, the SEC issued a report, known as the DAO Report, which indicated that digital coins sold in ICOs may be securities subject to the federal securities laws under the ***Howey test***.



Howey test: SEC v. W.J. Howey Co., 328 U.S. 293 (1946) – Is there an investment contract?

- Investment of money
- In a common enterprise
- Reliance on the efforts of others
- Reasonable expectation of profits

Crypto and the SEC (CONT'D)

SEC April 2019 Framework for analyzing offer and sale of digital assets

On April 3, 2019, the SEC Strategic Hub for Innovation and Financial Technology (FinHub) provided additional guidance on these elements as applied to digital assets—based on June 14, 2018, speech by former Director of SEC Division of Corporation Finance William Hinman. Coincided with TurnKey Jet no-action.

TurnKey Jet No-Action (April 2019):

Issued on the same day as SEC Framework for analyzing offer and sale of digital assets and provided no-action relief to the company that the tokens used on its platform were not securities.

Crypto and the SEC (CONT'D)

Reves test: *Reves v. Ernst & Young*, 494 U.S. 56 (1990): is a “note” a security?

Under *Reves*, absent any statutory exception, a “note” is presumed to be a security unless it “bears a strong resemblance” under a four-factor test to one of the court’s enumerated non-securities. The four factors are (1) motivations, (2) plan of distribution of the instrument, (3) reasonable expectations of the public, and (4) presence of a risk-reducing factor.

Notes that are not considered “securities” include the following: a note delivered in consumer financing; a note secured by a mortgage on a home; a short-term note secured by a lien on a small business or some of its assets; a note evidencing a character loan to a bank customer; short-term notes secured by an assignment of accounts receivable; a note that simply formalizes an open-account debt incurred in the ordinary course of business; and notes evidencing loans by commercial banks for current operations.

Regulation by Enforcement

2014 to Present

1. Crypto Assets
2. Insider Trading
3. Market Manipulation/False Tweets/Fake Websites/Dark Web
4. Public Company Disclosure and Controls

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Securities Topics

- Crowdfunding
- Cybersecurity
- Enforcement Cooperation Program
- Enforcement Task Force Focused on Climate and ESG Issues
- Foreign Corrupt Practices Act
- Initial Coin Offerings (ICOs)
- Implementation of Dodd-Frank Act
- Market Structure and Data Analysis
- Microcap Fraud
- Ombudsman
- Regulation Best Interest
- Saving and Investing for Military Personnel

Crypto Assets and Cyber Enforcement Actions

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Crypto Assets

Action Name	Description	Date Filed
SEC v. Green United, LLC, et al.	The Securities and Exchange Commission charged Utah-based company Green United, LLC, its founder Wright W. Thurston, and one of its promoters, Kristoffer A. Krohn, with allegedly defrauding investors in connection with an unregistered offering of crypto asset securities.	3/8/2023
SEC v. Singh	The Securities and Exchange Commission charged Nishad Singh, the former Co-Lead Engineer of FTX Trading Ltd. (FTX), for his role in a multiyear scheme to defraud equity investors in FTX, the crypto trading platform started by Singh along with Samuel Bankman-Fried and Gary Wang. Investigations into other securities law violations and into other entities and persons relating to the alleged misconduct are ongoing.	2/28/2023
SEC v. BKCoin Management	The Securities and Exchange Commission announced	2/23/2023

Regulation by Enforcement

CFTC

- Is a decentralized autonomous organization (DAO) an unincorporated association that may be sued?
- Is it possible to engage in oracle manipulation?

SEC

- Heightened regulatory risk
- Past enforcement actions involved the offering of unregistered securities
- More recent enforcement actions allege that digital asset exchanges are operating an unregistered exchange, broker, and clearing agency

Crypto and the SEC (CONT'D)

United States Case Law on Digital Asset Securities

- ***SEC v. LBRY, Inc.***

- The New Hampshire District Court determined that the defendants engaged in an unregistered securities offering with the token LBRY, finding that LBRY was a security under *Howey*.

- ***SEC v. Telegram Group Inc.***

- On March 24, 2020, the US District Court for the Southern District of New York issued a preliminary injunction barring the delivery of Grams and finding that the SEC had shown a substantial likelihood of proving that Telegram's sales were part of a larger scheme to unlawfully distribute the Grams to the secondary public market. The court concluded that the entire pre-sale scheme as a whole, including the Gram purchase agreements and the accompanying understandings and undertakings made by Telegram, were securities. Telegram ultimately settled with the SEC.

- ***SEC v. Kik Interactive Inc.***

- A federal district court entered a final judgment on consent against Kik Interactive Inc. to resolve the SEC's charges that Kik's unregistered offering of digital "Kin" tokens in 2017 violated the federal securities laws. The SEC's complaint, filed in the US District Court for the Southern District of New York, alleged that Kik sold digital asset securities to US investors without registering its offer and sale as required by the US securities laws. The court granted the SEC's motion for summary judgment on September 30, 2020, finding that undisputed facts established that Kik's sales of "Kin" tokens were sales of investment contracts.

Crypto and the SEC (CONT'D)

SEC Policy Statement on the Custody of Digital Assets by Special-Purpose Broker-Dealers (April 27, 2021)

Intended to address the questions surrounding compliance with the customer protection rules, which require broker-dealers to maintain the physical possession or control of all fully paid securities and excess margin securities carried or received by the broker-dealer for the account of customers.

Crypto and the SEC (CONT'D)

- **The “Special Broker-Dealer” Policy Statement outlined the steps that broker-dealers of digital asset securities must take to comply with a safe harbor available for five years following its publication:**
 - Broker-dealer may not deal in, effect transactions in, maintain custody of, or operate an alternative trading system for *traditional securities*;
 - Broker-dealer must establish, maintain, and enforce policies and procedures to establish whether the digital asset is a security offered and sold in compliance with the federal securities laws;
 - Broker dealer must establish, maintain, and enforce policies and procedures to assess the digital asset security’s DLT and associated network;
 - Broker-dealer must establish, maintain, and enforce reasonably designed policies, procedures, and controls for safekeeping and demonstrating the broker-dealer has exclusive possession or control over digital asset securities that are consistent with industry best practices to protect against the theft, loss, and unauthorized and accidental use of the private keys necessary to access and transfer the digital asset securities the broker-dealer holds in custody;
 - Broker-dealer must establish, maintain, and enforce policies, procedures, and arrangements to address specific event responses;
 - Broker-dealer must provide written disclosures to prospective customers about the risks of investing in or holding digital asset securities; and
 - Broker-dealer must enter into a written agreement with each customer that sets forth the terms and conditions with respect to receiving, purchasing, holding, safekeeping, selling, transferring, exchanging, custodying, liquidating, and otherwise transacting in digital asset securities on behalf of the customer.

Crypto and the SEC (CONT'D)

Prometheum Ember Capital LLC announced on May 23, 2023 that it received the first approval from FINRA to operate as a special purpose broker-dealer for digital asset securities. The FINRA approval permits Prometheum to custody digital asset securities on behalf of retail and institutional clients.

Crypto and the SEC: Important Cases and Matters



SEC v. Genesis Global Capital, LLC and Gemini Trust Co. – SEC charged Genesis and Gemini with engaging in the unregistered offer and sale of securities in the form of the Gemini Earn program. SEC found that the “Gemini Earn” Agreement for the program wherein investors tendered crypto assets to Genesis and, in exchange, Genesis promised to pay interest on those assets was a note pursuant to *Reves* and an investment contract under *Howey*. The complaint seeks permanent injunctive relief and disgorgement of ill-gotten gains.



BlockFi Lending LLC (Feb. 2022) – BlockFi agreed to pay \$100 million in penalties stemming from SEC charges that it failed to register the offers and sales of its retail crypto lending product; this represented the first time that the SEC charged a crypto lending platform with violating the provisions of the Investment Company Act of 1940.

Crypto and the SEC: Important Cases and Matters (CONT'D)

Exchanges and platforms:

- Coinschedule: Touting digital asset securities (note Peirce/Roisman dissent).
- Poloniex: Unregistered offer and sale of digital asset securities.
- Blockchain Credit Partners DeFi Money Market (DMM) – Offer and sale of unregistered digital asset debt securities.
- BitConnect: Unregistered digital asset securities lending program; fraud.
- Coinseed: Unregistered securities offering.
- Bittrex: SEC action alleging unregistered exchange, broker dealer, and clearing agency status
- Binance: SEC action alleging unregistered exchange, broker dealer, and clearing agency status
- Coinbase: SEC action alleging unregistered exchange, broker dealer, and clearing agency status

Other Regulatory Developments

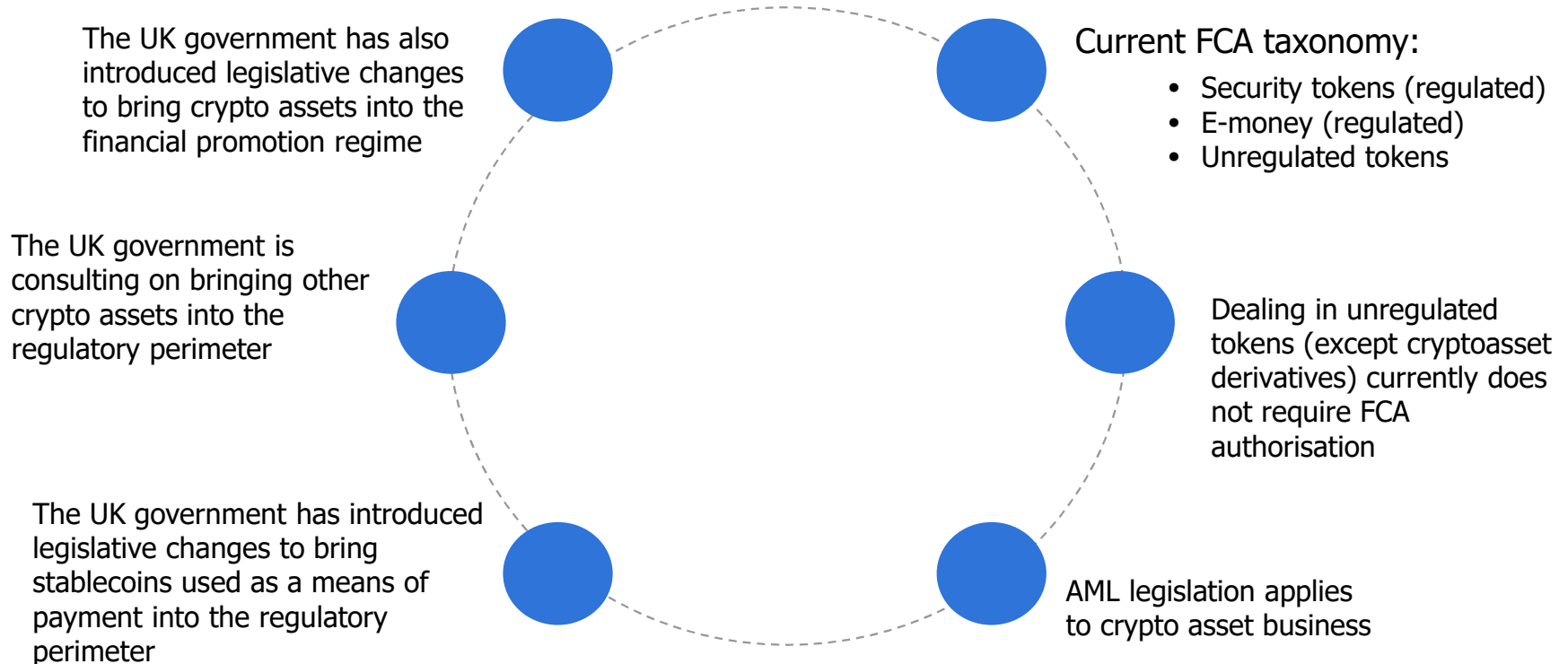
- Securities and Exchange Commission (SEC)
 - Proposed Amendments to the Custody Rule
- Commodity Futures Trading Commission (CFTC)
 - Staff Advisory to derivatives clearing organizations (DCOs) on importance of system safeguards, conflicts of interest, and physical settlement procedures when clearing digital assets products.
 - Amended Order of DCO Registration issued to Cboe Clear Digital, LLC, allowing it to offer margined futures on digital assets.
- National Futures Association (NFA)
 - Disclosure requirements in place since 2018
 - New Compliance Rule 2-51 (effective May 31, 2023)
 - Imposes antifraud, just, and equitable principles of trade, and supervision requirements on NFA members that engage in digital asset commodity activities
 - Currently applies only to Bitcoin and Ether

Section 03

Regulatory Treatment of Digital Assets: United Kingdom

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UK Regulatory Treatment of Digital Assets





Section 04 Presentation Takeaways

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Takeaways



Overview

The growth of digital assets presents a challenge for global regulators, but also an opportunity to facilitate development of revolutionary access to the modern financial system.

A successful way forward will require international collaboration and alignment of the regulatory spheres into which components of a stablecoin ecosystem will fall.



Global regulation

The cross-border nature of stablecoin gives rise to the need for consistent regulation in relevant jurisdictions. IOSCO's report demonstrates the patchwork of regulation needed to comprehensively regulate stablecoin.



US regulation

The SEC, CFTC, and FinCEN are on the forefront of crypto asset and stablecoin regulatory issues. Based on legislative efforts, we will see FinCEN take the lead on stablecoin issues with the SEC and CFTC responsible for more traditional oversight (such as clearing agency registration).



UK regulation

Digital assets fall within existing regime, but new regulation is being introduced and the UK government is consulting on bringing further activities relating to digital assets into the regime.

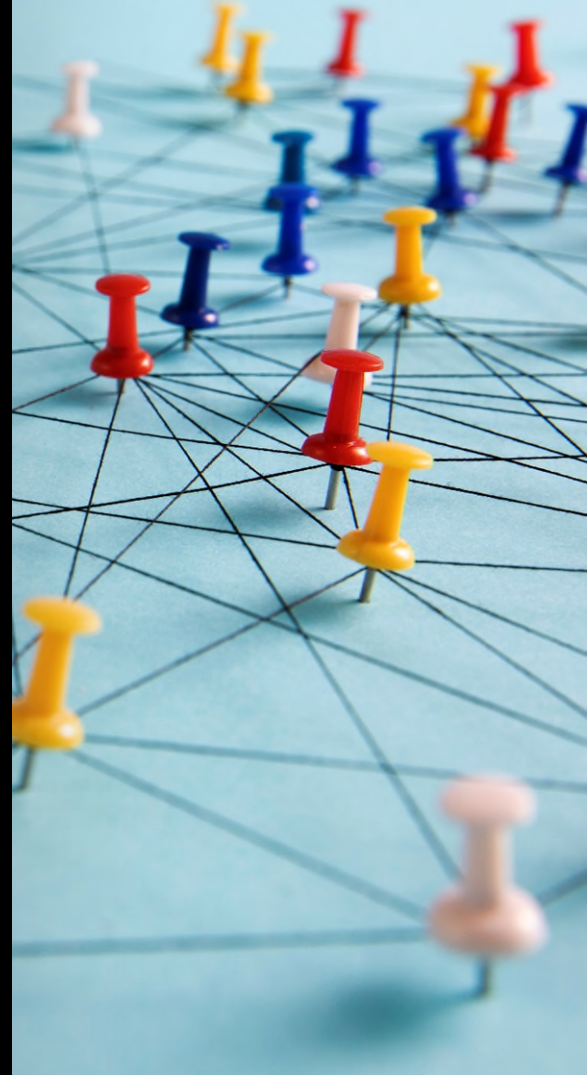
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Biography



Steven Lightstone

London, UK

+44.20.3201.5663

steven.lightstone@morganlewis.com

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

Steven is a founding member of the firm's fintech group and regularly contributes to the firm's fintech blog.

Biography



Ignacio Sandoval

Washington, DC

+1.202.739.5201

ignacio.sandoval@morganlewis.com

Ignacio Sandoval is a securities and financial institutions lawyer who helps clients meet their business objectives in a manner consistent with their regulatory obligations.

Drawing on his experience as a special counsel in the Office of Chief Counsel in the US Securities and Exchange Commission Division of Trading and Markets, Ignacio actively counsels broker-dealers, securities exchanges, alternative trading systems, transfer agents, clearing organizations, banks, and other domestic and foreign market participants in both traditional and emerging industries, such as digital assets and the use of artificial intelligence.

Biography



Sarah V. Riddell

Chicago

+1.312.324.1154

sarah.riddell@morganlewis.com

Leveraging her experience as a lawyer at the US Commodity Futures Trading Commission (CFTC), **Sarah V. Riddell** 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 clients with CFTC and National Futures Association (NFA) registration, compliance, and examination questions.

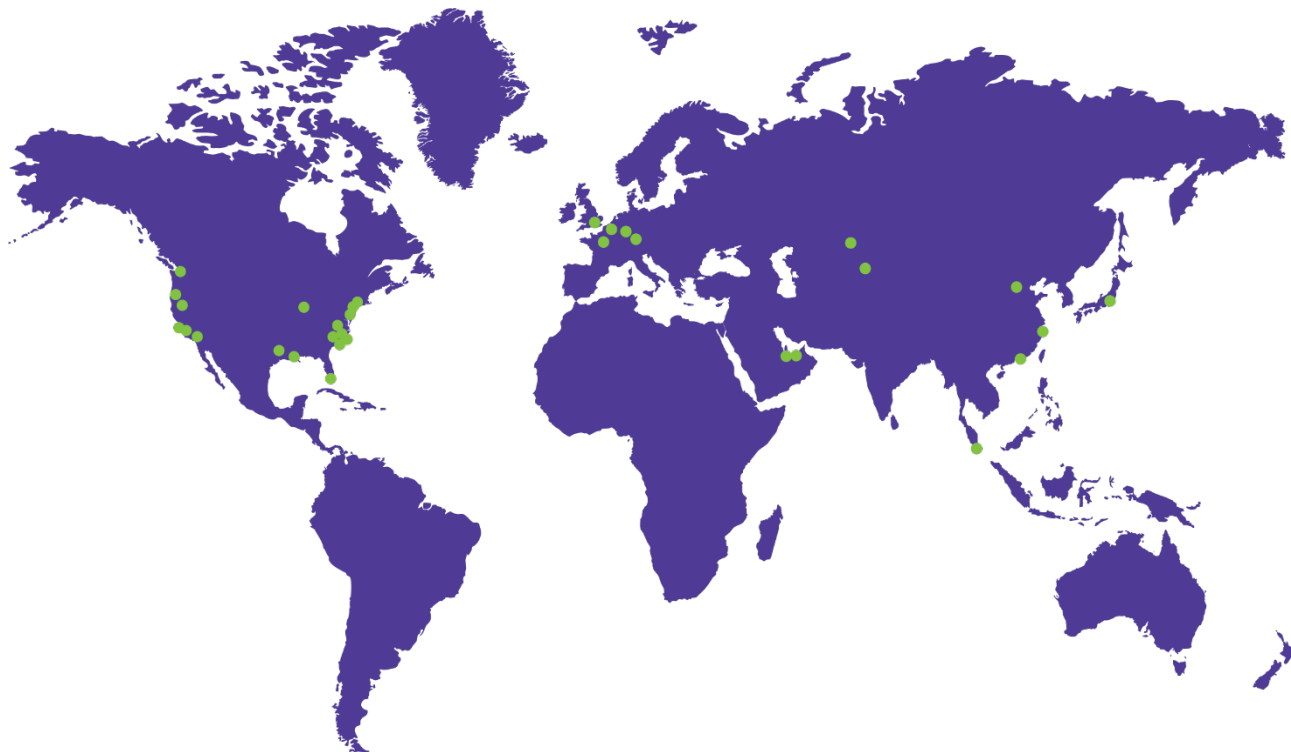
Sarah helps clients understand and comply with the NFA's Information Systems Security Program interpretive notice and the New York Department of Financial Services (NYDFS) Cybersecurity Regulation, as well as related cybersecurity questions.

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