

# As Blockchain Technology and Cryptocurrency Mature, so Do Their Regulation and Enforcement

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While the adoption of blockchain remains in its nascent stages, 2020 was in many ways a defining year for this decentralized technology. The “initial coin offering” wave of 2017 and 2018 gave way to new projects, including those for “stablecoins” (*i.e.*, coins backed by a fiat reserve or other assets, or algorithmically stabilized to create a nonvolatile means of payment and remittance). Innovations in decentralized finance (or “defi”) also demonstrate how blockchain-based solutions have the potential to disrupt many aspects of the financial services sector through lower-cost options. In addition, companies in industries from logistics to content distribution continued to explore ways in which blockchain technology can improve their own ecosystems.

The historical evolution of virtual currencies has resulted in an interesting mix of proposed regulations and enforcement activity. Given the industry’s past history, regulators view the virtual currency world as fraught with illegal activity that needs to be regulated or curtailed. However, the potential success of legitimate stablecoin projects is influencing various legislative efforts that seek to address concerns regarding their impact on monetary policy. Overall, regulators globally will likely try to find ways to protect consumers without creating regulatory environments so inhospitable they cause technologists to abandon their efforts.

We address below some of the key developments in the past year.

## US Cryptocurrency-Related Enforcement Continues To Increase

In 2020, regulators sharpened their focus on cryptocurrency-related enforcement actions. High-profile cases included Department of Justice (DOJ) and Commodities Future Trading Commission (CFTC) actions against BitMEX, a cryptocurrency exchange and derivatives trading platform, for Bank Secrecy Act and CFTC registration violations; Securities and Exchange Commission (SEC) enforcement actions

against several prominent digital asset developers and computer programmer and entrepreneur John David McAfee; and a DOJ prosecution and parallel enforcement action by the Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) against Larry Dean Harmon, the founder and operator of two alleged convertible virtual currency “mixers” or “tumblers.” “Mixing” and “tumbling” are techniques that combine potentially identifiable digital coins with other coins to make it difficult to trace the source, owner or recipient of the first set of coins.

Rulemaking and new guidance seem likely to continue in 2021, as 2020 ended with a flurry of activity:

- On October 8, 2020, the DOJ issued its Cryptocurrency Enforcement Framework, the first comprehensive public statement of the DOJ’s approach to investigating and prosecuting cryptocurrency-related crimes. The framework evinces concern about “business models and activities” in the cryptocurrency space that “may facilitate criminal activity,” particularly peer-to-peer exchanges and anonymity-enhanced cryptocurrencies.
- On October 23, 2020, the Federal Reserve and FinCEN announced a notice of proposed rulemaking to revise

travel rule regulations, lowering the applicable threshold at which financial institutions must collect, retain and transmit certain information related to international funds transfers and transmittals of funds from \$3,000 to \$250 and clarifying that the regulations apply to virtual currencies. This rule change would make many more transactions subject to these information requirements. (See our November 10, 2020, client alert, "[FinCEN and Federal Reserve Propose To Significantly Lower Threshold for International Funds Transfers Under Recordkeeping and Travel Rules.](#)")

- On December 18, 2020, FinCEN issued another notice of proposed rulemaking that would impose additional reporting, record-keeping and verification requirements on banks and money services businesses with respect to certain virtual currency transactions involving “unhosted wallets” (*i.e.*, wallets in which the user stores their own private keys). (See our January 19, 2021, client alert, "[FinCEN Proposes New Reporting, Recordkeeping and Verification Requirements for Transactions Involving Unhosted Wallets.](#)") FinCEN’s rationale for the proposed rule is that the inherent anonymity of unhosted wallets makes them more susceptible to use for illicit activity, and data open to public inspection on blockchains does not sufficiently mitigate the risks. FinCEN believes that the record-keeping and reporting requirements imposed by the proposed rule would help combat illicit finance occurring through unhosted wallets. Critics of the proposed rule assert three principal concerns: The rule would not provide meaningful protections against unlawful activity; it would harm unbanked and underbanked populations that stand to benefit most from unhosted wallets; and it could hamper the evolution and adoption of blockchain technology in the United States. A number of prominent cryptocurrency industry players publicly have opposed the proposed rule, and on January 14, 2021, FinCEN extended the comment period for the rule into the start of the Biden administration.

- Passed on January 1, 2021, over the president’s veto, the National Defense Authorization Act included the Anti-Money Laundering Act of 2020, which strengthens the government’s anti-money laundering capabilities and creates a Bank Secrecy Act whistleblower program. In addition, the legislation explicitly expresses the “sense of Congress” that virtual currencies can be used for criminal activity; includes the term “value that substitutes for currency” in key provisions of the Bank Secrecy Act, thereby codifying FinCEN’s long-held position that virtual currency businesses are subject to the act; and directs the Government Accountability Office to study the role of emerging technologies and payment systems, including virtual currencies, in human trafficking, drug trafficking and money laundering. (See our January 7, 2021, client alert, "[US Enacts Historic Legislation To Strengthen Anti-Money Laundering and Counterterrorist Financing Legal Framework.](#)")

Although their impact remains to be seen — shortly after President Biden was sworn in on January 20, 2021, the new administration directed a regulatory freeze pending further review — these developments likely foreshadow growing focus on illicit uses of cryptocurrency and ongoing efforts to curb them through both regulation and enforcement.

### **Proposed Legislation Seeks To Clarify US Digital Asset Regulation**

In 2020, U.S. lawmakers from both sides of the aisle introduced new legislation aimed at regulating digital assets. Three such bills, highlighted below, reflect the lawmakers’ goal of balancing the need to protect consumers with the need to foster technological innovation and are representative of the types of legislation being contemplated.

#### **Securities Clarity Act**

The Securities Clarity Act seeks to clarify that an asset (including a digital asset) does not become a security as a result of being sold or transferred pursuant to an investment

contract. The bill is a reaction to the SEC’s activity in this space, which, as SEC Commissioner Hester M. Peirce acknowledged in a February 2020 speech, has been criticized for eliding the distinction between a digital asset token and the investment contract under which it is offered. However, in its initial stage, the bill is a noteworthy step toward mitigating the uncertainty around application of the *Howey* test to digital tokens.

#### **Digital Commodity Exchange Act**

The Digital Commodity Exchange Act proposes to create a single, opt-in federal regulatory scheme for digital asset trading platforms under the exclusive jurisdiction of the CFTC. The proposed framework, based on the regulatory model for traditional commodity exchanges, aims to remove major regulatory roadblocks for innovators developing new digital asset projects and provide regulatory certainty in cash markets for digital assets while protecting retail consumers. As with the Securities Clarity Act, while it is unclear whether this bill will become law, its introduction will likely spark discussions as to how to improve the current regulatory landscape for cash markets in digital assets and for innovators of digital asset projects.

#### **STABLE Act**

The Stablecoin Tethering and Bank Licensing Enforcement (STABLE) Act seeks to fundamentally alter the stablecoin industry. If passed in its current form, it would add significant costs and complexity for market participants, thereby creating significant challenges for stablecoin development in the United States. Specifically, the act would subject prospective issuers of stablecoins to a host of new regulatory obligations, including (1) obtaining a banking charter; (2) following the appropriate banking regulations under the existing regulatory jurisdictions; (3) notifying and obtaining approval from the Federal Reserve, Federal Deposit Insurance Corporation (FDIC) and appropriate banking agency six months prior to issuance and maintaining an ongoing analysis of potential

systemic impacts and risks; and (4) obtaining FDIC insurance or otherwise maintaining reserves at the Federal Reserve to ensure that all stablecoins can be readily converted into U.S. dollars on demand.

### Financial Stability Board Recommendations on Stablecoins

On October 13, 2020, the Financial Stability Board (FSB) published its high-level recommendations for the regulation, supervision and oversight of stablecoins, which are designed to become common global standards and systemically important as a result. The recommendations call for regulation, supervision and oversight that is proportionate to the risks of “global stablecoins” — those stablecoins that become widely adopted with potential reach and use across multiple jurisdictions. To that end, the FSB sets out 10 recommendations, including that authorities ensure global stablecoins have effective risk management frameworks in place to deal with reserve management, operational resilience, cybersecurity safeguards and anti-money laundering measures. The FSB also recommends that global stablecoins be required to provide transparent information on their stabilization mechanisms and nature and enforceability of any redemption rights to users. In addition, it recommends that they must adhere to all applicable regulatory standards and address risks to financial stability before commencing operation.

We expect that the FSB recommendations are likely to become the bedrock of international cooperation between regulatory authorities as the universe of stablecoins develops. The FSB expects to continue its work over the coming months and to complete its international standard-setting work in relation to global stablecoins by December 2021. In the meantime, we anticipate that individual jurisdictions, such as the U.S. and U.K., will continue to develop their own legal and regulatory regimes.

### President’s Working Group Statement on Stablecoins

In late December 2020, the President’s Working Group on Financial Markets (PWG) released its assessment of the key regulatory and supervisory considerations for stablecoins primarily used for retail payments, which mirror certain of the FSB recommendations. The PWG recognized that stablecoins have the potential to lower payment costs, increase competition and broaden financial inclusion, but it emphasized that they should be designed in a manner that manages risk and maintains the stability of U.S. and international financial and monetary systems. The PWG’s key assessments provide a road map for the establishment of a stablecoin in the U.S.

- Stablecoins must meet (1) all applicable anti-money laundering and countering the financing of terrorism obligations and (2) sanctions obligations. The PWG noted that stablecoins designed to permit anonymous or pseudonymous transactions are likely to attract illicit actors;
- Stablecoins should be designed to address potential financial stability risks, including large-scale, potentially disorderly redemptions and general business losses. This includes ensuring a 1-1 reserve ratio and adequate financial resources to absorb losses and meet liquidity needs. U.S. dollar-backed stablecoins should additionally hold the reserve in high-quality U.S. dollar-denominated assets with U.S.-regulated entities and across multiple custodians;
- Stablecoin holders should be entitled to have enforceable direct claims against the issuer or the reserve assets to exchange their stablecoins for the underlying fiat currency on a 1-to-1 basis;
- Stablecoins should ensure operational reliability (such as adequate scalability) and provide cybersecurity and data protection;
- Stablecoins should not undermine confidence in and the stability of domestic fiat currencies. The PWG notes that stablecoins

whose value is determined by reference to more than one fiat currency (e.g., multicurrency stablecoins) may require additional protections; and

- Stablecoins operating in the U.S. may need to establish entities within the U.S. or rely on U.S.-regulated entities as intermediaries.

### UK Restrictions on Sale of Cryptoassets and Related Products Come Into Force

The U.K.’s Financial Conduct Authority’s (FCA) prohibition on the marketing, sale and distribution of crypto-derivatives to retail investors came into force on January 6, 2021. Crypto-derivatives were already subject to the U.K. financial promotion regime, which contained certain exemptions that were relied upon by unregulated service providers in relation to crypto-products. The FCA’s policy statement is intended to prohibit the use of these exemptions that enabled the sale of crypto-derivatives to U.K. retail clients by unregulated service providers and to prohibit FCA-regulated service providers from marketing such instruments to U.K. retail investors.

As a result of the new rules, service providers seeking to distribute such cryptoassets in the U.K. will be required to either rely on an exemption specified in the U.K. Financial Promotion Order and receive approval of their marketing material by an FCA-authorized entity before distribution or obtain authorization themselves before carrying out the marketing activity. We expect that the actions of the FCA are the first of many U.K. regulatory developments specifically related to cryptocurrencies, not least as a result of the work of the FSB described above.

### Conclusion

We expect that the regulatory momentum that began in 2020 will continue in 2021 as regulators around the world seek to either fit blockchain technology into existing regulatory frameworks or build out new approaches.