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The Distributed Ledger

Blockchain, Digital Assets and Smart Contracts

1 Regulating the Digital Asset Space

4 Are Nonfungible Tokens Subject to US Anti-Money Laundering Requirements?

6 DOJ Pursues Cryptocurrency-Related Investment Fraud Cases

7 SEC Issues Risk Alert Highlighting Focus on Digital Assets

9 US Litigation

10 International Developments

Regulating the Digital Asset Space

The advent of bitcoin more than a decade ago spawned an explosion in decentralized, peer-to-peer financial structures using distributed ledger technology, such as blockchain, that pose a stark challenge to the traditional financial regulatory landscape. U.S. regulators have sought to apply principles and rules from a different era to protect the financial markets for public investment without stifling innovation.

Federal regulatory agencies like the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) have used their enforcement authority to combat fraud in the digital asset space, and the SEC has challenged what it has determined to be unregistered securities offerings. Nevertheless, the absence of clear rules or regulatory authority to impose rules for the trading and transfer of digital assets has left regulators, market participants and the public exposed and frustrated. Some legislation has been proposed to address the mismatch between the current federal regulatory framework and the digital asset revolution, but none has yet come close to becoming law.

Leading regulators have recently voiced their concerns about this mismatch, with Acting CFTC Chairman Rostin Behnam expressly calling for a new regulatory regime for digital assets, and the newly confirmed SEC chairman, Gary Gensler, using his confirmation hearing to highlight the importance of laws keeping pace with profound technological changes. Given the recent volatility in digital asset prices and the burgeoning investor demand for access to digital asset products, the environment is ripe for regulatory reform.

The Patchwork Approach of Regulation in the United States

Digital asset innovation has put pressure on the fragmented nature of U.S. regulation of financial markets. Across the nation, individual states have adopted varying approaches to the new products and technology, while Congress to date has left the task to numerous federal agencies with a range of regulatory mandates designed for a 20th century financial system.

State Regulation

At the state level, two approaches have emerged. One is the approach taken by states such as California and New York, which have pursued robust enforcement. For example, in February 2021, the New York Attorney General's Office (NYAG) announced an $18.5 million fine against the issuer of the tether stablecoin (Tether) and the owner of the Bitfinex Trading Platform (iFinex), which the NYAG had been investigating for false statements relating to the nature of the stablecoin and the alleged loss of customer funds.

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(For more, see "New York Attorney General's Office Settles Fraud Charges Against Cryptocurrency Exchange and Cryptocurrency Issuer" on page 9.) The companies did not admit wrongdoing as part of a settlement agreement that prohibits Tether and Bitfinex from trading with New York customers. The settlement came one month after the NYAG sued another actor in the cryptocurrency space, Coinseed Inc., alleging that its initial coin offering (ICO) should have been registered as securities and subject to broker-dealer registration requirements.[1] In connection with the suit, Attorney General Letitia James warned that "[u]nregulated and fraudulent virtual currency entities, no matter how big or small, will no longer be tolerated in New York."[2] The NYAG has since issued two public alerts in response to the "extreme risk" posed to New Yorkers investing in virtual or cryptocurrencies.[3]

Other states, such as Colorado and Wyoming have enacted pro-cryptocurrency legislation to attract investment. Wyoming has been particularly welcoming to cryptocurrency businesses: It has issued charters for special purpose depository trust institutions, permitting companies focused on blockchain to provide banking services in the state. Additionally, the state has enacted the Wyoming Utility Token Act, which defines cryptocurrency as an asset class separate from securities and commodities, and thus not subject to regulation as such.

Federal Regulation

In the United States, the federal regulation of digital assets exists in a type of jurisdictional netherworld. The laws applicable to digital assets often depend on how the asset is categorized — either a commodity, security, currency or property. While the agencies endeavor to coordinate so that digital assets are effectively regulated, the lack of clear definitional boundaries and legal authority has created gaps in the regulatory framework that are difficult to overcome.

The two main regulatory players in this space are the SEC and CFTC, and each agency's approach to digital assets has largely involved enforcement actions. The SEC has sought to protect investors by requiring offerings of digital assets to be registered as securities where the agency has determined that the offering satisfies the elements of the *Howey* test for an investment contract.[4] Application of the 1946 *Howey* test to digital assets has generated debate, however. In 2019, SEC staff published guidance that sets forth numerous factors to be used in applying the *Howey* test to determine whether a given digital asset is a security.[5] Staff also published the first digital asset-related no-action letters, in which it determined that digital assets that functioned as stored-value cards would not be deemed securities.[6] Despite the staff's intent to provide industry guidance, these issuances have only highlighted the challenges involved in applying a 75-year-old test that evaluated the status of orange groves to the digital world. One SEC commissioner has criticized the agency's reliance on enforcement actions and urged that a safe harbor be created to avoid deterring innovation.[7]

In addition to bringing enforcement actions, the SEC has consistently declined to approve vehicles designed to invest in digital assets; indeed, to date, the SEC has rejected every application — more than a dozen — to offer a bitcoin exchange-traded fund (ETF). The commission has made well known its concern that cryptocurrency markets are prone to fraud and manipulation,[8] and it has repeatedly tied that concern to the absence of regulation of the spot market in cryptocurrencies. For example, in February 2020, the SEC disapproved a rule change by NYSE Arca, Inc. to list and trade shares of the United States Bitcoin and Treasury Investment Trust sponsored by Wilshire Phoenix Funds, LLC. In doing so, the SEC said that, among other things, to satisfy applicable statutory requirements as interpreted in its prior orders, NYSE Arca had to demonstrate that the portion of the spot market represented by the Bitcoin Reference Rate was

[1] *See New York v. Coinseed, Inc.* (Feb. 17, 2021). The SEC filed a parallel action against Coinseed and its CEO in federal court for the sale of unregistered securities in violation of Sections 5(a) and 5(c) of the Securities Act of 1933 (15 U.S.C. §§ 77e(a) and 77e(c)). *SEC v. Coinseed, Inc.*, No. 1:21-cv-01381, compl. A 2 (S.D.N.Y. Feb. 17, 2021).

[2] *See* Press Release, "Attorney General James Sues To Shut Down Illegal Cryptocurrency Trading Platform and Virtual Currency, Seeks To Recoup Defrauded Funds for Thousands of Investors," N.Y. State Office of the Att'y Gen. (Feb. 17, 2021).

[3] *See* "Investor Alert: Virtual Currency Risks," N.Y. State Office of the Att'y Gen.); "Industry Alert: Registration of Commodity Brokers-Dealers, Salespersons and Investment Advisors Doing Business Relating to Virtual or 'Crypto' Currency," N.Y. State Office of the Att'y Gen.

[4] *See SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). *See also* "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO," Securities Act Release No. 81207, at 11, SEC (July 25, 2017) (stating the SEC's position that many virtual currencies fall within the definition of a security under the *Howey* test); *In the Matter of CarrierEQ, Inc., d/b/a Airfox*, Securities Act Release No. 10575 (Nov. 16, 2018) and *In the Matter of Paragon Coin, Inc.*, Securities Act Release No. 10574 (Nov. 16, 2018) (applying the *Howey* test in entering cease-and-desist orders against ICO issuers). Courts, too, have applied *Howey* to digital assets. *See, e.g.*, *SEC v. Kik Interactive, Inc.*, No. 1:19-cv-05244-AKH (S.D.N.Y. Sept. 30, 2020).

[5] "Framework for 'Investment Contract' Analysis of Digital Assets," SEC, Strategic Hub for Innovation and Financial Technology (April 3, 2019).

[6] No-Action Letter on TurnKey Jet, Inc., SEC, Division of Corporation Finance (April 3, 2019); No-Action Letter on Pocketful of Quarters, Inc., SEC, Division of Corporation Finance (July 25, 2019).

[7] *See* Hester M. Peirce, Commissioner, "Running on Empty: A Proposal To Fill the Gap Between Regulation and Decentralization," SEC (Feb. 6, 2020).

[8] *See, e.g.*, Staff Letter, "Engaging on Fund Innovation and Cryptocurrency-Related Holdings," SEC, Division of Investment Management (Jan. 18, 2018) (addressing issues arising from funds potentially focused on cryptocurrency-related products); *see also, e.g.*, Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, To List and Trade Shares Issued by the Winklevoss Bitcoin Trust, Release No. 34-80206 (Mar. 10, 2017), at 2; Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, Relating to the Listing and Trading of Shares of the SolidX Bitcoin Trust Under NYSE Arca Equities Rule 8.201, Release No. 34-80319 (Mar. 28, 2017).

"uniquely and inherently resistant to manipulation," and that it had a surveillance sharing agreement with a "regulated bitcoin market of significant size." The SEC determined that NYSE Arca failed to meet these requirements, concluding that the level of regulation of the five spot markets on which the Bitcoin Reference Rate would be based did not render them uniquely invulnerable to fraud and manipulation, and that they did not constitute a sufficiently supervised market. In the SEC's view, the combination of potential Financial Crimes Enforcement Network (FinCEN) and state oversight of the five spot markets or the CFTC's limited jurisdiction over spot market commodities such as bitcoin did not match the level of oversight it exercises over national securities exchanges.[9] In light of the SEC's position, regulation of the spot market in cryptocurrencies could expand the array of cryptocurrency products available to investors.

Like the SEC, the CFTC has used its enforcement authority in the digital asset space. Under the Commodity Exchange Act (CEA), the definition of "commodity" is expansive, covering, in addition to several enumerated agricultural products, "all other goods and articles ... and all services rights and interests ... in which contracts for future delivery are presently or in the future dealt in."[10] The CFTC has used this definitional flexibility to assert that all "virtual currencies" fit within the definition of a commodity, declaring in its first cryptocurrency enforcement action that "bitcoin and other [cryptocurrencies] are encompassed in the definition and properly defined as commodities."[11] The CFTC's enforcement authority over cryptocurrencies was upheld in *CFTC v. McDonnell*, with the court finding that cryptocurrencies "are 'goods' exchanged in a market for a uniform quality and value" and, as such, "[t]hey fall well within the common definition of 'commodity' as well as the CEA's definition of 'commodities.'"[12]

While the CFTC has therefore obtained success in pursuing fraud cases involving cryptocurrency, the CFTC's oversight of the spot market in cryptocurrencies is nevertheless limited to enforcement of violations of the CEA. It has no statutory authority to set rules or establish principles specifically for trading of physical cryptocurrencies, because the CFTC's mandate is to regulate the trading of derivatives — products such as futures, options and swaps that derive their value from an underlying asset. (In this capacity, the CFTC has allowed the listing and trading of derivatives using cryptocurrency, such as the Chicago Mercantile Exchange's bitcoin and ethereum futures contracts.) The anti-fraud and anti-manipulation enforcement authority over the physical commodity markets that Congress provided the CFTC is in service of that mandate.[13] The distinction is important, because the ability to prosecute bad actors after misconduct has occurred does not offer the same protections as do rules that can help guard against misconduct occurring in the first place.

The difficulties that digital asset innovators have faced in determining whether their products are securities and the related challenges other market participants have faced in deciding how to handle such products has spurred calls for more clarity in regulation. At the same time, the absence of regulation of spot market transactions in digital assets has prompted proposals to subject them to federal oversight. The urgency of these challenges has grown as the demand for cryptocurrency products has dramatically increased. While some prominent cryptocurrency companies maintain headquarters in the United States, without providing a clear legal framework, the United States risks hobbling their growth as well as deterring new entrepreneurs in the cryptocurrency space from entering the U.S. financial markets. We discuss below how Congress might seek to update the regulatory framework to help the SEC and the CFTC constructively oversee digital asset markets to protect the markets' integrity without unduly hampering their development.

Congressional Response to Calls to Action

Recognizing that the lack of a clear and cohesive approach to regulation will serve neither innovators nor investors, federal lawmakers and regulators have begun developing proposals to clarify the legal and regulatory framework governing digital assets and cryptocurrencies. On March 9, 2021, Reps. Patrick McHenry, R-N.C., and Stephen Lynch, D-Mass., introduced H.R. 1602, the Eliminate Barriers to Innovation Act of 2021, which would mandate the establishment of a working group composed of industry experts and representatives from both the SEC and CFTC to evaluate the current U.S. legal and regulatory framework for digital assets. The proposed law would task the working group with providing a report of its analysis and recommendations with respect to improving the U.S. regulatory framework, specifically in the primary and secondary markets for digital assets.

In particular, the bill directs the working group to develop:

- An analysis of the legal and regulatory framework relating to digital assets, including the impact of lack of clarity in regulation on the primary and secondary markets for digital assets;

[9] *See* Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, To Amend NYSE Arca Rule 8.201-E (Commodity-Based Trust Shares) and To List and Trade Shares of the United States Bitcoin and Treasury Investment Trust Under NYSE Arca Rule 8.21-E (Bitcoin Trust Disapproval Order), Release No. 34-88284, at 23-24 (Feb. 26, 2020).

[10] 7 U.S.C. § 1a(9).

[11] *In the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC No. 15-29, (Sept. 17, 2015).

[12] *See CFTC v. McDonnell*, 287 F. Supp. 3d 213, 220-22 (E.D.N.Y. 2018).

[13] See 7 U.S.C. §§ 6(b), 9, 13(a)(2).

- An analysis of how the U.S. regulatory framework and certain developments in other countries impact the competitive position of the United States;
- Recommendations for the creation, maintenance and improvement of primary and secondary markets for digital assets;
- Recommendations for standards concerning custody, private key management, cybersecurity and business continuity in digital markets; and
- Recommendations for best practices to reduce fraud and manipulation, improve investor protections, and assist in compliance with anti-money laundering (AML) obligations under the Bank Secrecy Act.

In formally bringing together the SEC and the CFTC to work through some of the key structural issues that have rendered legal clarity for digital assets elusive, this bill would present an opportunity for stakeholders to address these impediments in a methodical and more coordinated manner.

On the same day, Rep. Warren Davidson, R-Ohio, introduced H.R. 1628, the Token Taxonomy Act of 2021. The bill is co-sponsored by Reps. Ted Budd, R-N.C., Darren Soto, D-Fla., Scott Perry, R-Pa., and Josh Gottheimer, D-N.J. H.R. 1628 seeks to clarify the categorization of digital assets — specifically by excluding "digital token" from the definition of a security under the federal securities laws. As noted above, relying on the *Howey* test, the SEC has brought numerous enforcement actions alleging that digital asset-based offerings have constituted the unlawful sale of unregistered securities. And as discussed above, the *Howey* test faces challenges when applied to digital tokens, given their reliance on emerging technology and decentralized networks. The Token Taxonomy Act's proposed definition of "digital token" is an effort to provide digital token issuers with some clarity in this regard.

As proposed, a "digital token" would be defined as a token that is created pursuant to rules ensuring that the creation and supply of the token are not controlled by a central group or single person, among other requirements. The token's transaction history must be able to resist modification or tampering, and the token must be capable of being transferred between persons without an intermediate custodian. Additionally, the bill proposes amending the Securities Act of 1933 and the Securities Exchange Act of 1934 to: (i) direct the SEC to enact certain regulatory changes regarding digital units secured through public key cryptography; (ii) adjust taxation of virtual currencies held in individual retirement accounts; and (iii) create certain tax exemptions related to transfers or sales of virtual currency.

How successful these two bipartisan measures will be remains to be seen. Regardless of whether the bills are passed, their introduction highlights the importance of the subject of digital market regulation and reflects the recognition among at least some lawmakers of the need to enhance the regulatory landscape for digital assets.

The new administration also presents an opportunity for fresh ideas and progress addressing the issues surrounding digital assets. During his hearing before the Senate Banking Committee on March 2, 2021, for confirmation as SEC chairman, Gary Gensler stated that "[b]itcoin and other cryptocurrencies have brought new thinking to payments and financial inclusion" and indicated his intention to "work with fellow commissioners to both promote the new innovation but also, at the core, ensure for investor protection." Chairman Gensler, a former CFTC chairman, Treasury undersecretary and professor at MIT who focused on the intersection of technology and finance, is viewed by stakeholders in the digital asset space as an expert who can bring his knowledge to bear on the challenges digital assets present to regulators and market participants under the outdated regulatory framework.

Like the SEC, the CFTC will become a majority-Democratic commission and may seek a new approach to digital asset regulation, though its ability to do so could turn on whether Congress will give the agency regulatory authority over digital asset spot markets. The CFTC's inclination to seek new approaches could also turn on who will lead the agency, and the Biden administration has yet to nominate a new chair. The acting chairman, Rostin Behnam, has called for federal regulators to oversee spot cryptocurrency markets.[14]

Whatever ultimate form the regulation of digital asset takes, its importance cannot be overstated. The burgeoning interest in investing in digital assets, the rapid pace of innovation and the volatility of the digital asset markets have provided an imperative to federal lawmakers and regulators to enhance the current regime in order to better protect investors and promote innovation.

Are Nonfungible Tokens Subject to US Anti-Money Laundering Requirements?

Rapidly growing interest in nonfungible tokens (NFTs) has been fueled by recent headlines of multimillion-dollar transactions, such as the $69 million sale of an NFT by digital artist Beeple — the third-highest price ever paid for the work of a living artist. An NFT is a certificate of ownership stored on a blockchain

[14] "The State of the Commodity and Futures Trading Commission: Hearing Before the Subcommittee on Commodity Exchanges, Energy and Credit," 116th Cong. (2020) (statement of Rostin Behnam).

typically associated with a digital asset, such as art, videos, music, games, or tweets. Unlike certain other virtual assets on the blockchain, such as cryptocurrencies, NFTs are unique or "nonfungible." While the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) has not yet indicated whether certain NFT market participants (*e.g.*, creators, sellers, dealers, marketplace operators) are or may become subject to U.S. anti-money laundering (AML) regulatory requirements, recent developments and concerns of U.S. lawmakers and regulators regarding the financial crime risks associated with virtual assets make regulatory scrutiny of NFTs likely. (FinCEN is the Treasury Department bureau responsible for administering and enforcing the Bank Secrecy Act (BSA) — the main AML legislative and regulatory framework applicable to U.S. financial institutions.)

Recent Developments

In March 2021, the Financial Action Task Force (FATF) — an intergovernmental organization that develops standards to combat money laundering and terrorism financing — issued draft updated virtual asset guidance,[15] which could have potential implications for the regulation of NFTs. While FATF is not a regulatory agency, its membership is comprised of 37 countries, including the United States, and two regional bodies, and it has played an active role in proposing a regulatory framework for virtual assets. In its updated draft guidance, FATF replaced a previous reference to "assets that are fungible" with "assets that are convertible and interchangeable," in defining the scope of virtual assets that in FATF's view warrant regulation. FATF further stated that "[f]lexibility is particularly relevant in the context of [virtual assets] and [virtual asset] activities" and that "some items — or tokens — that on their face do not appear to constitute [virtual assets] may in fact be [virtual assets] that enable the transfer or exchange of value or facilitate [money laundering or terrorism financing]." FATF's latest stance may represent an effort to pave the way for the regulation of certain NFTs that have currency attributes or function as stored value.

Similarly, U.S. AML legislation passed earlier this year provides regulators flexibility and wide latitude to regulate a quickly evolving virtual asset industry. In particular, the Anti-Money Laundering Act of 2020 (AMLA) expanded the definition of "money transmitting business" and "financial institution" under the BSA to include businesses involved in the exchange or transmission of "value that substitutes for currency." (For additional discussion of this legislation, see our January 7, 2021, client alert "US Enacts Historic Legislation To Strengthen Anti-Money Laundering and Counterterrorist Financing Legal Framework.")

While this amendment aligns with the existing position regarding virtual currencies taken by FinCEN, Congress's expansion of these definitions provides FinCEN with additional statutory authority to regulate not only existing virtual currencies, but also other emerging payment methods or novel asset classes. To date, FinCEN has not issued any guidance or rules specifically on NFTs. However, given the wave of interest in NFTs, the high value of recent NFT sales and AML-related risk factors, we anticipate NFTs will attract U.S. regulatory scrutiny.

Could NFTs Be Treated Like Virtual Currencies?

While the regulatory classification of NFTs is sure to be the subject of much discussion, to the extent that FinCEN were to treat a particular NFT or certain types of NFTs as "value that substitutes for currency," FinCEN could potentially seek to regulate such activity under its money transmission regime. FinCEN's determination to classify an NFT as such may depend on the specific characteristics of the NFT, how it is used, and the apparent money laundering risks involved.

In the United States, persons that accept currency, funds, or other "value that substitutes for currency" from one person and transmit it to another location or person by any means fall within the federal definition of "money transmitter." FinCEN has made clear in its guidance that virtual currency "has an equivalent value in real currency or acts as a substitute for real currency" and that "[a]ccepting and transmitting anything of value that substitutes for currency makes a person a money transmitter." In its May 2019 virtual currency guidance, FinCEN expressed a broad view of money transmission and advised that "if assets that other regulatory frameworks define as commodities, securities, or futures contracts were to be specifically issued or later repurposed to serve as a currency substitute, then the asset itself could be a type of value that substitutes for currency, the transfer of which could constitute money transmission."[16]

A money transmitter is a type of money services business (MSB). MSBs are required to register with FinCEN and must comply with extensive requirements under the BSA, including implementing a risk-based AML compliance program, filing suspicious activity reports and maintaining certain records. Foreign-located companies that do business as an MSB wholly or in substantial part within the United States are also required to register with FinCEN and comply with the BSA's requirements. Violation of these obligations can result in substantial civil and criminal penalties. (In addition to complying with federal AML requirements, money transmitters may also be required to obtain

[15] FATF, Public Consultation on FATF Draft Guidance on a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers (March 2021).

[16] Fin. Crimes Enf't Network, FIN-2019-G001, Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies at 6 (May 9, 2019).

a license in each state in which they conduct money transmission activities. Each state defines money transmission differently, and some states have developed licensing and regulatory schemes that specifically apply to virtual currency businesses.)

Focus on Risks in Art Trade

Growing concerns regarding money laundering and sanctions evasion risks in the art trade could have potential implications for persons that deal in certain NFTs, to the extent regulators perceive similar financial crime risks in digital art. FinCEN issued guidance in March 2021 emphasizing that financial institutions with existing BSA obligations "should be aware that illicit activity associated with the trade in antiquities and art may involve their institutions."[17] The Office of Foreign Assets Control (OFAC) similarly issued an advisory in October 2020 highlighting the sanctions risks associated with dealings in high-value artwork involving sanctioned persons.[18] In OFAC's view, the opacity of the art market can make it especially vulnerable to sanctions violations.

Although participants in the art trade currently are not subject to the BSA, recent legislative developments suggest that this may change in the near future. Specifically, as part of the AMLA, Congress commissioned the secretary of the Treasury to perform a study of how trade in artwork facilitates money laundering and the financing of terrorism and to report its findings to Congress by January 1, 2022. The AMLA's extension of the BSA to "persons engaged in the trade in antiquities" might be a bellwether of forthcoming change in AML regulation of the art trade.

While it is too early to say whether traders of artwork may become subject to AML regulatory requirements, any such expansion of the BSA could capture traders of digital art or similar items on the blockchain.

For more on NFTs, see our March 29, 2021, client alert "Nonfungible Tokens and the Music Industry: Legal Considerations," our March 30, 2021, *Law360* article "Decoding the Fine Print on Nonfungible Token Licenses" and our March 30, 2021, *Bloomberg Law* article "NFTs Raise Novel and Traditional IP and Contract Issues."

A version of this article was originally published as a client alert on April 16, 2021.

[17] Fin. Crimes Enf't Network, FIN-2021-NTC2, FinCEN Informs Financial Institutions of Efforts Related to Trade in Antiquities and Art (March 9, 2021).

[18] Dept. of the Treasury, Advisory and Guidance on Potential Sanctions Risks Arising from Dealings in High-Value Artwork (Oct. 30, 2020).

DOJ Pursues Cryptocurrency-Related Investment Fraud Cases

In the first three months of 2021, the Department of Justice (DOJ) announced several significant developments in criminal cases involving cryptocurrency-related investment fraud. None of the alleged schemes was particularly unusual — the FBI even referred to one as "an age-old pump-and-dump scheme" — except for the fact that they involved cryptocurrency, cryptocurrency-related businesses or both. The conduct charged in all three cases occurred in 2017 and 2018 and, in one case, even earlier, at a time when cryptocurrency was far less prominent than it is today. But they suggest that as cryptocurrency becomes more commonly used, and as interest in it builds, fraud involving cryptocurrencies (and criminal investigations and prosecutions of such fraud) will increase correspondingly.

On February 2, 2021, the DOJ charged John DeMarr, a California-based promoter of cryptocurrency companies, with an $11 million conspiracy to commit securities fraud in the U.S. District Court for the Eastern District of New York. Later that month, a federal grand jury in the same district indicted the companies' founder, Serbian national Kristijan Krstic, for securities fraud and conspiracy to commit securities fraud, wire fraud and money laundering. According to the charging documents, Mr. Krstic established Start Options, a purported cryptocurrency exchange and provider of cryptocurrency mining services, and B2G, a company that supposedly offered its own digital tokens. Mr. Krstic and Mr. DeMarr collaborated to create a website through which Start Options claimed to sell investment contracts to investors around the world, with investments accepted in Bitcoin, U.S. dollars, or euros. According to Start Options, investors would earn a guaranteed profit within a certain number of days. In fact, according to the government, their money was diverted to an account and a digital wallet that Mr. Krstic controlled. With respect to B2G, Mr. Krstic, Mr. DeMarr and other co-conspirators allegedly made false statements in marketing materials, investor calls and whitepapers; on social media; and to the press, that investors could buy B2G tokens that then could be exchanged for various fiat currencies. But those tokens never existed. Instead, the conspirators created a fake online interface so that investors who logged on to check their accounts would believe that they actually owned B2G tokens. When investors tried to withdraw their investments, Mr. DeMarr sought to dissuade them and eventually went so far as to fake his own disappearance in Montenegro while he in fact was living in California.

On March 4, 2021, a Swedish citizen residing in Thailand, Roger Nils-Jonas Karlsson, pleaded guilty in the U.S. District Court for the Northern District of California to defrauding more than

3,500 victims of more than $16 million by inducing them to use cryptocurrencies to invest in fake securities. Mr. Karlsson created a website for a company called Eastern Metal Securities, headquartered in Singapore, which supposedly sold shares of a "Pre Funded Reversed Pension Plan." Using the website and various pseudonymous email addresses, Mr. Karlsson promised potential investors enormous returns. Investments were accepted only in certain cryptocurrencies, including Bitcoin. Mr. Karlsson exchanged the cryptocurrency that investors sent to Eastern Metals Securities for fiat currency, which he transferred to personal accounts. Of note, the affidavit in support of the criminal complaint against Mr. Karlsson, which was dated March 4, 2019 (nearly two years prior to the charging documents in the other two cases), states: "[B]y design, Bitcoin, Perfect Money, and C-Gold all have no, or very minimal, anti-money laundering checks in place and are frequently used for fraud."

On March 5, 2021, an indictment against John David McAfee, founder of the McAfee antivirus software company, and Jimmy Gale Watson Jr., an executive adviser of Mr. McAfee's "cryptocurrency team," was unsealed in the U.S. District Court for the Southern District of New York. The indictment charged the pair criminally for conduct that previously had been the subject of civil enforcement actions brought by the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC). The indictment charged Mr. McAfee and Mr. Watson with fraud and conspiracy offenses stemming from their promotion of cryptocurrencies. In one scheme, Mr. McAfee, Mr. Watson and other members of the "cryptocurrency team" allegedly bought publicly traded cryptocurrency altcoins (which the government defined as virtual currencies other than Bitcoin), some of which qualified as commodities and/or securities, at low prices. Mr. McAfee then tweeted false and misleading endorsements about the altcoins without disclosing that he owned large quantities of them. When the altcoins' price rose, Mr. McAfee and his co-conspirators sold their holdings and tried to convert the proceeds into fiat currency. In another scheme, Mr. McAfee promoted initial coin offerings without disclosing that the issuers were compensating him for his statements, in violation of federal securities laws. Mr. McAfee and his co-conspirators also sought to convert the digital asset proceeds of their activities into fiat currency. According to the government, Mr. McAfee, Mr. Watson and their co-conspirators fraudulently obtained more than $13 million from investors.

Going forward, it appears likely that cryptocurrency will feature increasingly in criminal investment fraud investigations and prosecutions.

SEC Issues Risk Alert Highlighting Focus on Digital Assets

On February 26, 2021, the staff of the Securities and Exchange Commission's (SEC) Division of Examinations issued a risk alert offering insight into the division's examinations of investment advisers, broker-dealers, national securities exchanges and transfer agents that engage in digital asset-related activities.[19] The staff explained that the alert is intended to provide transparency for industry participants seeking to engage in digital asset-related activities and to assist firms in developing and enhancing their compliance programs.

While the alert highlights the division's continued focus on digital assets that are securities (Digital Asset Securities), it does not provide further insight into whether and to what degree the SEC intends to seek to apply the constructs of the various federal securities laws to digital assets that are not securities under the Securities Act of 1933 (Securities Act). Additionally, it remains an open question whether digital assets will be analyzed differently under the Investment Company Act of 1940 (1940 Act) and the Investment Advisers Act of 1940 (Advisers Act), which define "securities" more broadly than the Securities Act and the Securities Exchange Act of 1934 (Exchange Act).

Investment Advisers

The alert notes that the division's examinations of investment advisers will focus on regulatory compliance associated with portfolio management, books and records, custody, disclosures, valuation and registration issues.

Portfolio Management. The staff will review policies, procedures and practices of investment advisers investing client assets in Digital Asset Securities and other digital assets, and focus on the proper classification of digital assets, including whether a digital asset is classified as a security under federal securities laws. The staff will also review due diligence performed by an investment adviser, the investment adviser's evaluation and mitigation of risks related to trading venues and trade execution or settlement facilities, and the investment adviser's management of risks and complexities associated with "forked" and "airdropped" digital assets. Finally, the staff will review whether the investment adviser is fulfilling its fiduciary duties with respect to investment advice across all client types.

[19] The staff noted that the term "digital asset," as used in the alert, refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology, including, but not limited to, "virtual currencies," "coins" and "tokens," that may or may not meet the definition of "security" under federal securities laws.

Books and Records. With respect to books and records, the staff will review whether investment advisers are making and keeping accurate books and records, as required by Rule 204-2 of the Advisers Act. The staff noted that an investment adviser's record-keeping practices should take into account that "[d]igital asset trading platforms vary in reliability and consistency with regard to order execution, settlement methods, and post-trade recordation and notification."

Custody. Investment advisers' practices relating to the custody of digital assets will be examined for compliance with the custody rule (Rule 206(4)-2 under the Advisers Act), "where applicable." The question of applicability here may indicate that the staff believes certain digital assets are neither client funds nor client securities for purposes of the custody rule.

The staff cited the November 9, 2020, statement issued by the staff of the SEC's Division of Investment Management (IM Division) in response to the letter by the Wyoming Division of Banking regarding its views on the definition of "bank" and "qualified custodian" under the Advisers Act and the custody rule.[20] In the statement, the IM Division staff emphasized that the SEC and the staff are not bound by statements of state regulators and encouraged interested parties to engage directly with the staff on the application of the custody rule to digital assets, including with respect to whether an entity is a "qualified custodian."

Disclosures. The sufficiency of disclosures to investors regarding the unique and/or heightened risks associated with digital assets will be another area of focus for the staff, which identified the following specific risks: complexities of the products and technology underlying such assets; technical, legal, market and operational risks (including potential custody and cybersecurity issues); price volatility; illiquidity; valuation methodology; related-party transactions; and conflicts of interest.

Valuation. Another area of review is the valuation methodologies used by investment advisers. The staff will also review disclosures regarding valuation methodologies, advisory fee calculations and the impact valuation practices have on advisory fees.

Registration. The staff will examine whether an investment adviser providing advice on digital assets is appropriately registered under the Advisers Act, which may include reviewing how an investment adviser calculates its regulatory assets under management and characterizes the digital assets in the pooled vehicles it manages, and reviewing the status of clients (*e.g.*, whether such client would be considered an investment advisory client). For private funds managed by investment advisers, the staff will review how the funds determine applicable exemptions from registration as investment companies under the 1940 Act. These topics largely turn on whether digital assets are treated as securities for purposes of registration requirements and may indicate a heightened interest by the staff in investment advisers and private funds that view their digital asset activities as outside the scope of the Advisers Act and the 1940 Act.

Broker-Dealers

The alert notes that the division's examinations of broker-dealers will focus on the safekeeping of funds, registration requirements, anti-money laundering (AML), underwriting and private offerings, disclosure of conflicts of interest and outside business activities related to digital assets.

Safekeeping of Funds and Operations. The staff will examine whether broker-dealers properly custody Digital Asset Securities.

Registration Requirements. The staff will examine whether the broker-dealer and any affiliated entity engaged in effecting transactions in Digital Asset Securities are in compliance with applicable broker-dealer registration requirements.

AML. The staff will examine broker-dealer compliance with AML obligations.

Offerings. The staff will review whether and to what extent broker-dealers involved in underwriting and/or private placement offerings of Digital Asset Securities provide sufficient disclosures and perform due diligence with respect to such Digital Asset Securities.

Disclosure of Conflicts of Interest. The staff will review the conflicts of interest that arise when broker-dealers operate in multiple capacities, the disclosures relating to such conflicts of interest, and the compliance policies and procedures addressing conflicts of interest.

Outside Business Activities. The staff noted that it observed instances of representatives of broker-dealers engaging in outside business activities related to digital assets. The staff will review compliance processes for broker-dealers that are members of the Financial Industry Regulatory Authority in connection with the evaluation, approval and monitoring of outside business activities.

National Securities Exchanges

The staff will examine platforms that facilitate trading in Digital Asset Securities to determine whether they meet the definition of an "exchange" under Section 3(a)(1) of the Exchange Act and therefore must register as a national securities exchange.

[20] One industry participant submitted a public comment letter in response to the staff statement, asserting that the custody rule does not apply to the custody of digital assets that are not considered securities for the purposes of the Securities Act or the 1940 Act.

Transfer Agents

The staff will review whether registered transfer agents servicing Digital Asset Securities are operating in compliance with the applicable rules for registered transfer agents. The staff noted that distributed ledger technology is increasingly being used by issuers of securities to perform various shareholder administration functions and cautioned that certain of these functions may cause an entity to fall within the definition of "transfer agent" under Section 3(a)(25) of the Exchange Act.

US Litigation

Court Rejects Extraterritorial Application of US Securities Laws to Foreign ICO

On January 22, 2021, Judge Louis L. Stanton of the U.S. District Court for the Southern District of New York dismissed a putative class action complaint against HelBiz, Inc. and numerous individual defendants alleging various claims, including those under the U.S. securities laws, in connection with a $40 million initial coin offering (ICO) for HelBiz's cryptocurrency, HelBizCoins. The plaintiffs alleged that they were deceived into purchasing HelBizCoins through false claims that HelBiz would use the proceeds to develop a transportation rental platform utilizing HelBizCoins as its exclusive currency, which in turn would increase in value as the rental platform gained popularity. Instead, the plaintiffs allege that the defendants misappropriated the proceeds from the ICO for personal use, built a subpar platform, used fiat currency rather than HelBizCoins for almost every rental as legal tender for the platform and sold off their own holdings of HelBizCoins while its value was inflated from the ICO.

Despite concluding that HelBizCoins met the definition of a security under the *Howey* test, the court declined to apply U.S. securities law under the extraterritoriality principles announced in the U.S. Supreme Court case *Morrison v. National Australia Bank*. The court concluded that there was no "domestic transaction" — and thus U.S. securities laws could not apply — because HelBizCoins were not listed on a domestic exchange and there were no domestic off-exchange purchases of the coins. The court rejected the plaintiffs' arguments that sales of HelBizCoins had more nexus to the United States than any other country because (1) transactions for the coins occurred via an Ethereum blockchain, which has validation "nodes" in the U.S., and (2) the defendants' interactive website was housed on servers located in Kansas.

In doing so, the court explained that *Morrison* "dealt with the location of the change in the legal relationship between persons, not the electronic operations of creation, transport, and delivery of the product." In other words, regardless of where the "machinery for generating, administering, and delivering" a cryptocurrency is located, the *Morrison* test turns on the "location of the offer and acceptance of the purchase," according to the court. Here, because investors purchased HelBizCoins while located in countries like England and the United Arab Emirates, rather than the United States, there was no basis to apply U.S. securities law to the case, and the plaintiffs' complaint was dismissed as a result. The plaintiffs appealed the case in February 2021.

Given the borderless nature of many blockchain projects, the issue of where a distributed ledger transaction takes place — and the implications of that question on whether the U.S. securities laws will apply to the transaction — will continue to be a significant issue in cryptocurrency litigation going forward.

New York Attorney General's Office Settles Fraud Charges Against Cryptocurrency Exchange and Cryptocurrency Issuer

On February 17, 2021, the New York Attorney General's Office (NYAG) settled fraud allegations against Bitfinex, a cryptocurrency exchange platform, and Tether, a cryptocurrency issuer, in connection with the Bitfinex trading platform and Tether's cash reserves practices. Tether is the issuer of a cryptocurrency called tether, a stablecoin in which one tether is equivalent to one U.S. dollar. Tether represents that it maintains this 1:1 ratio by holding one U.S. dollar in reserve for every issued tether, thereby "backing" the cryptocurrency.

The NYAG alleged that Tether and Bitfinex misrepresented Tether's reserve practice to investors in 2017, when Tether supposedly did not have sufficient reserves in its accounts to back the number of outstanding tethers in the marketplace. It further alleged that Tether and Bitfinex misrepresented the status of Tether's reserves in 2019. The NYAG alleged that these actions were in violation of various state fraud laws, including the Martin Act and Executive Law Section 63(12). Without admitting or denying the allegations, the respondents settled with the NYAG and agreed to, among other things: (1) pay an $18.5 million penalty; (2) refrain from doing business with New York persons and entities; (3) provide quarterly reports for two years to the NYAG regarding their business operations, including information relating to Tether's reserve accounts and fund transfers among Tether and Bitfinex; and (4) publish the amount and form of Tether's reserves for a period of two years.

Although much attention is paid to the involvement of U.S. regulatory agencies (like the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission) in the digital asset space, this settlement is a reminder that many state regulators also have broad investigative and enforcement authority over activities occurring within their borders. State authorities in New York, Texas and Massachusetts, for example, have been active in policing what they perceive to be unlawful or deceptive conduct involving the offer or sale of digital assets.

Court Dismisses Unregistered Securities Offerings Class Action Against Swiss-Based Blockchain Company

On February 22, 2021, Judge Alvin K. Hellerstein of the Southern District of New York dismissed a class action complaint concerning allegations of unregistered securities offerings against BProtocol Foundation, its founders, and its chief technology officer. BProtocol Foundation, or Bancor, is a Swiss-based blockchain-focused software development company and issuer of a cryptocurrency called Bancor Network Tokens (BNT). All of the individual defendants are alleged to be citizens of Israel.

According to the complaint, from June 12, 2017, up to the filing of the complaint, the defendants raised nearly $153 million via an ICO of BNT without registering the offering under U.S. law or seeking an exemption from the registration requirements. The plaintiff further alleged that the defendants marketed the tokens in a manner designed to make them seem more favorable to investors, and made numerous false statements and omissions to lead investors to conclude that BNT tokens were not securities subject to the registration requirements. The plaintiff alleged that the defendants violated Sections 5 and 12 of the Securities Act of 1933, in addition to other state law claims.

In dismissing the plaintiff's complaint, the court held that the plaintiff lacked standing to pursue his claims because he did not demonstrate a diminution in value of the BNTs he purchased, thus failing the injury-in-fact requirement. The court further concluded that it lacked personal jurisdiction over the defendants. Although the plaintiff alleged that the defendants promoted the sale of the tokens across the United States, including in New York, the court found that such promotional activities were insufficient to establish personal jurisdiction over citizens of another country. The court reasoned that "[s]pecific jurisdiction requires a causal relationship between the wrong and the damage caused by the wrong," and that the plaintiff failed to allege that the defendants' wrongful actions caused the plaintiff to purchase BNTs.

Of note, Judge Hellerstein presided over the SEC enforcement action brought against Kik, which resulted in the SEC obtaining summary judgment in its favor relating to Kik's offer and sale of its native cryptocurrency, called Kin. The court's recent decision highlights the significance of threshold issues in litigation, such as personal jurisdiction and standing, before a court will even address the merits of private litigation claims. Given that there are a large number of similar actions currently pending before different judges in the Southern District of New York, many of which raise similar threshold issues, it remains to be seen whether Judge Hellerstein's decision is a bellwether of things to come.

Delaware Chancery Court Says SEC Enforcement Action Not the Final Determination of Whether a Cryptocurrency Is a Security

On March 19, 2021, the Delaware Court of Chancery granted summary judgment in favor of Ripple Labs (Ripple), denying plaintiff investor Tetragon Financial Group, Ltd.'s (Tetragon) request to redeem its Ripple equity for cash amid an ongoing legal battle between Ripple and the SEC in the Southern District of New York concerning whether Ripple's cryptocurrency, XRP, qualifies as an unregistered security.

In 2019, Tetragon was a lead investor in Ripple's $200 million Series C financing. As part of the parties' stockholders agreement, Ripple allegedly agreed to a redemption obligation that would be triggered if the SEC "determined on an official basis" that the XRP "constitute[d] a security on a current and going forward basis." On December 23, 2020, the SEC brought an enforcement action against Ripple regarding its ongoing sales of the XRP token, alleging that the sale constituted an unregistered offering of a security. In the Delaware court, Tetragon argued that the enforcement action should be considered a "final determination" of whether XRPs are securities under the stockholders agreement.

Delaware Vice Chancellor Morgan T. Zurn disagreed, holding that "XRP is no more security after the SEC filed the enforcement action than it was before it" because "[a] determination ... resolves the question of whether XRP is a security. The Enforcement Action, by contrast, asks that question. The question is not yet resolved, so a 'determination' has not yet been made; and when it is made, it will be made by the District Court."

International Developments

Cryptoasset Regulation in the EU

The European Commission has proposed legislation, known as the "MiCA Regulation," governing markets in cryptoassets. The September 24, 2020, proposal sets out wide-ranging and detailed rules on the issuance of cryptoassets as well as the provision of services relating to them. On the issuance of cryptoassets, the proposed legislation sets out disclosure obligations that are similar to those applicable to issuers of securities. These obligations include the requirement to publish a prospectus conforming to the disclosure and transparency standards set out in the proposed legislation as well as an obligation to register that prospectus with the regulator.

The proposed rules governing cryptoasset service providers (*e.g.*, firms dealing in cryptoassets on a professional basis and firms operating cryptoasset trading venues) largely mirror those applicable to investment firms in the European Union and borrow certain principles from the EU legislation governing payment services providers. Accordingly, there is an obligation for EU cryptoasset service providers to obtain authorization from an EU regulator. Authorized service providers must comply with requirements governing the operating conditions of such firms, including the obligation to act honestly, fairly and professionally; prudential safeguards; rules on safekeeping of client assets; rules on outsourcing; and rules on managing conflicts of interest.

EU Proposes Regulation on Use of Distributed Ledger Technology by Financial Market Infrastructure

The European Commission has proposed legislation governing the use of distributed ledger technology (DLT) by trading venues and securities settlement systems. The legislation, also proposed on September 24, 2020, imposes limitations on the types of financial instruments that can be admitted to trading on a trading venue using DLT. For instance, shares issued by companies with a market capitalization or tentative market capitalization in excess of €200 million cannot be admitted, and sovereign bonds are prohibited from admission to trading on such a platform entirely. Securities settlement systems operating DLT settlement functionality is similarly subject to quantitative limits. For such systems, the total market value of DLT transferable securities recorded in the system must not exceed €2.5 billion. Clearinghouses are not within scope of the proposed legislation. This omission is striking given the multiple potential use cases for DLT in clearing, although under current regulation it is unlikely that EU clearinghouses could implement DLT operations without regulatory approval and oversight.

Kalifa Review of UK Fintech

On February 26, 2021, the U.K. government published a review of the U.K. fintech industry. The Kalifa Review, as it is known, contains wide-ranging proposals covering most aspects of fintech regulation in the U.K. and concludes that U.K. exchanges and clearinghouses should be subject to a framework that easily enables trading and the clearing of digital assets. Such financial market infrastructure should also be able to adopt alternatives to traditional methods of service delivery without being seen to be in breach of financial services regulations, including through the use of distributed ledger and blockchain technology in clearing and settlement.

This conclusion has been well received by market infrastructure participants in the U.K. who have lobbied for maximum flexibility in the implementation of DLT-based services. (For more, see our March 11, 2021, client alert "The Kalifa Review: A Road Map for the Future of UK Fintech?")

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