

Cryptocurrency Regulatory Developments

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I. Taxonomy of digital assets

- **Cryptocurrency** – Digital assets that are not securities and exist on decentralized networks
- **Stablecoins** – Digital assets pegged to an underlying asset (e.g., USD) intended to maintain a stable value
- **Digital Asset Securities** – “Investment contracts” and traditional securities issued in digital form
- **CBDCs** – Digital forms of legal tender issued by central banks
- **Non-Fungible Tokens (NFTs)** – Cryptographically secured unique tokens stored on a digital ledger



Incomplete and Evolving Patchwork



II. Framework of U.S. Digital Asset Regulation

Regulatory framework driven by status of a particular asset and the institution involved

Is it a security under Howey test?

- An investment of money in
- a common enterprise
- with a reasonable expectation of profits
- to be derived from the efforts of others

Non-securities digital assets are commodities

- CFTC reg. and anti-fraud jurisdiction over derivatives (swaps, futures, actual delivery longer than 28 days, etc.).
- CFTC anti-fraud authority over spot markets
- BSA applies to issuers and exchangers of cryptocurrency
- Applicability of state money transmission law depends on specific activity

But . . .

- Federal bank regulators playing increased role as banks move into digital assets
- State supervision of trust companies
- And possibility of increased regulation coming



II. Regulatory Overview and Recent Developments—FinCEN

FinCEN and OFAC set an important tone in regulation of cryptocurrency to combat financial crime and to enforce sanctions

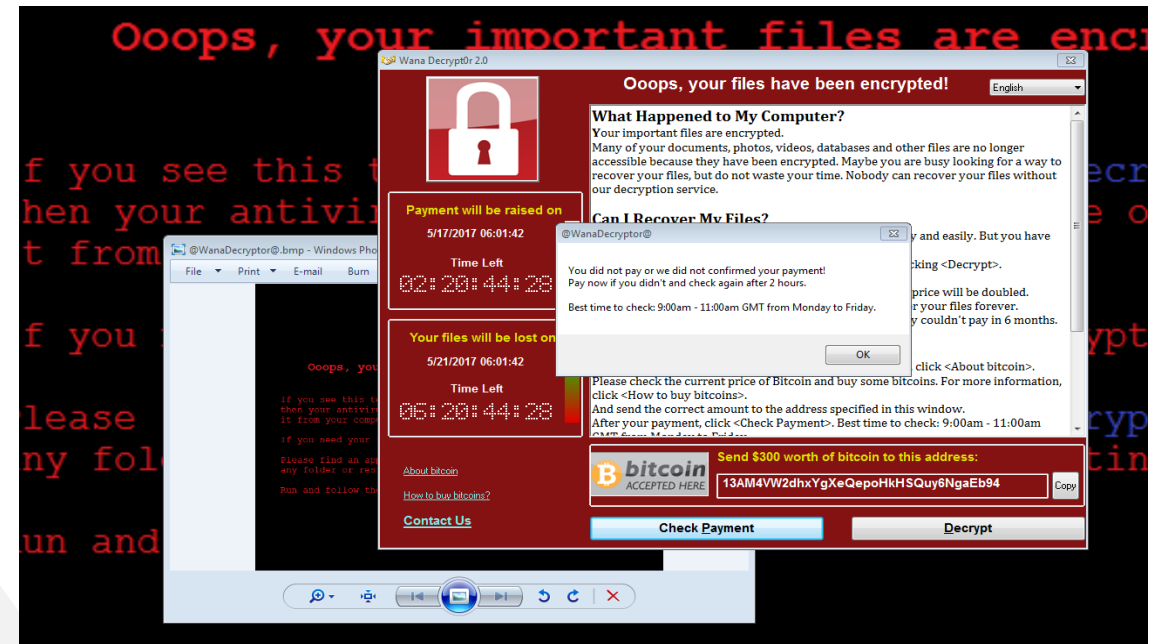


- Administrators and exchangers of “value that substitutes for currency” are money transmitters subject to BSA
- Significant guidance and several enforcement actions since 2013 (esp. foreign located MSBs)
- Increasing costs of ransomware may spur additional regulatory action
- FinCEN “Unhosted wallet” NPRM still pending
 - New reporting and recordkeeping requirements
 - Controversial counterparty identification requirement

II. Regulatory Overview and Recent Developments—OFAC

Existing regulations apply to cryptocurrency activity with unique challenges in the context of the blockchain

- OFAC began adding wallet addresses for a number of different cryptocurrencies to SDN list entries in 2018
- First enforcement actions in 2021 against digital asset companies BitGo and BitPay for failure to use available customer data to detect transactions with customers in sanctioned jurisdictions
 - May suggest future OFAC enforcement actions





II. Regulatory Overview and Recent Developments— Infrastructure Bill (Sec. 80603)

➤ **Reporting Requirement (to take effect Jan. 2024)**

- Imposes reporting obligation for “brokers” that effectuate transfers in cryptocurrency
- Failure to report can be a felony

➤ **“Broker” defined VERY broadly**

- Defined as “any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.”
- Concern that this definition includes miners, node operators, and software developers that do not have access to the type of information the law requires
 - Treasury officials have noted that the Treasury is unlikely to target the above groups, but....

➤ **Requirements difficult to implement**

- Exchanges don’t have access to investors’ self-custody wallets or DeFi applications, which could lead to inaccurate reporting



II. Regulatory Overview and Recent Developments—OCC

Principal regulator of National Banks; significant role in the digital asset regulatory landscape as more established financial institutions enter cryptocurrency business

➤ **Interpretive Guidance**

- Interpretive Letter 1170
 - Clarifies National Banks' authority to custody digital assets (July 22, 2020)
- Interpretive Letter 1172
 - Clarifies National Banks' authority to custody reserves supporting stablecoins (Sept. 21, 2020)
- Interpretive Letter 1174
 - Identifies "business of banking" authorities related to payment-related activities involving digital assets (Jan. 4, 2021)

➤ **Charters**

- Three cryptocurrency firms received conditional approval for national bank charters within the first months in 2021 – Anchorage (Jan. 13, 2021), Protego (Feb. 4, 2021), Paxos (April 23, 2021)



Regulatory Overview and Recent Developments—OCC



- **Michael Hsu named Acting Comptroller**
 - Hsu testified before the House Committee on Financial Svcs. (May 19, 2021): “Concerned” that recent actions “were not done in full coordination with all stakeholders. Nor do they appear to have been part of a broader strategy related to the regulatory perimeter.” “[W]e created an Office of Innovation, updated the framework for chartering national banks and trust companies, and interpreted crypto custody services as part of the business of banking. I have asked staff to review these actions.”



- **U.S. Sen. Sherrod Brown (D-OH), letter to Hsu (May 20, 2021)**
 - Questioned whether the OCC engaged in the “appropriate due diligence” before granting the charters; called on Hsu to “reassess any conditional national trust charters and halt the approval of any additional charters to nonbank entities”



II. Regulatory Overview and Recent Developments— Federal Reserve & FDIC

Fed/FDIC taking more incremental steps toward openness to cryptocurrencies

Federal Reserve

- Seriously exploring CBDC – Federal Bank of Boston is involved in a project with MIT to develop and test use cases
 - Jerome Powell, Lael Brainard discuss advantages of digital dollar
 - Powell noted discussion paper to be released in summer 2021
 - Proposed rule establishing standards for granting account and payment services access to FIs with “novel types of banking charters”

FDIC

- Issued RFI about insured depository institutions’ digital asset activities in effort to explore future action



II. Regulatory Overview and Recent Developments— Federal Reserve, FDIC & OCC

Joint Statement on Crypto-Asset Policy Sprint Initiative and Next Steps (Nov. 23, 2021)

- Provided results of interagency “policy sprints” focused on crypto-assets
- Agencies identified a number of areas in which additional clarity is warranted
- Throughout 2022, the agencies will provide greater clarity on whether certain activities related to crypto-assets conducted by banking organizations are legally permissible, and expectations for safety and soundness, consumer protection, and compliance with existing laws and regulations related to:
 - Crypto-asset safekeeping and traditional custody services
 - Ancillary custody services
 - Facilitation of customer purchases and sales of crypto-assets
 - Loans collateralized by crypto-assets
 - Issuance and distribution of stablecoins
 - Activities involving the holding of crypto-assets on balance sheet

II. Regulatory Overview and Recent Developments—SEC

Digital assets that are securities are required to comply with applicable registration requirements (or qualify for an exemption) and exchanges that deal in securities are subject to SEC regulation

➤ **DAO Report, June 2017**

- The SEC confirmed that offers and sales of digital asset securities are subject to the requirements of the federal securities laws.
- Confirmed application of Howey test to digital assets, regardless of the term used to describe the assets.





II. Regulatory Overview and Recent Developments—SEC

Bill Hinman Speech on Digital Assets: When Howey Met Gary (Plastic), June 2018

- William Hinman, the director of the SEC's Division of Corporate Finance at the time, gave a speech that discussed the potential for a digital asset that was originally classified as a security to be later sold in a manner that did not constitute a securities offering.
- According to Hinman, the key factor in determining if a digital asset is a security is whether the actions of a third party are a key factor for determining the enterprise's success. If a network is fully decentralized, then the task of identifying a single issuer or promoter to make the disclosures required for a securities offering is difficult and not particularly meaningful for investors. At that point, the asset is no longer a security.
- Hinman also confirmed bitcoin and ether are not securities.



II. Regulatory Overview and Recent Developments—SEC

Commissioner Peirce's Safe Harbor Proposal, February 2020

- SEC Commissioner Peirce gave a speech in which she outlined a proposal for a potential safe harbor within the regulatory system for individuals seeking to build functional or decentralized token networks. Although the safe harbor is only a proposal and would need to be passed by all the SEC commissioners to move forward, it is a good example of a potential future regulatory scheme for the development of cryptocurrency networks.
- Under Peirce's proposed safe harbor, a team developing a token network would have a three-year period—beginning at the time of the first token sale—to build a functional or decentralized network. The safe harbor would also be available for tokens that were previously sold in a registered or exempt offering.



Digital Assets

SEC Statement Regarding the Custody of Digital Asset Securities by Special Purpose Broker-Dealers, December 2020

- For a five-year period, broker-dealers that maintain custody of digital asset securities under the conditions set forth in the statement will not be subject to an enforcement action for compliance with Rule 15c3-3(b)(1) (part of the Customer Protection Rule).
- These conditions, among other things, include that the broker-dealer establishes and implements reasonably designed policies and procedures, including those to analyze whether a particular digital asset is a security offered and sold pursuant to an effective registration statement or an available exemption from registration, and the broker-dealer enters into a written agreement with each customer setting out the terms and conditions with respect to transacting in digital asset securities.
- The relief is available only to a “special purpose broker-dealer”—a broker-dealer that limits its business exclusively to dealing in, effecting transactions in, maintaining custody of and/or operating an ATS for digital asset securities.



Digital Assets

Commissioner Peirce's Token Safe Harbor Proposal 2.0, April 2021

- SEC Commissioner Peirce repropose an updated version of a token safe harbor originally proposed in February 2020.
- The safe harbor would provide network developers with a three-year grace period within which, under certain conditions, they can facilitate participation in and the development of a functional or decentralized network, exempted from the registration provisions of the federal securities laws.
- The updated proposal requires semiannual disclosures and the submission of an exit report to the SEC including an analysis by outside counsel explaining why the network is decentralized or functional (or an announcement that the tokens will be registered).



Digital Assets

SEC Order—EtherDelta, November 2018

- In 2018, the SEC settled charges against Zachary Coburn, the founder of EtherDelta, a ***decentralized platform*** for secondary market trading of ERC20 tokens, for allegedly operating an unregistered national securities exchange.
- Users interacted with the EtherDelta smart contract, which allowed for the trading of any Ether/ERC20 token pair.
- Without admitting or denying the findings, Coburn consented to the order and agreed to pay \$300,000 in disgorgement plus \$13,000 in prejudgment interest and a \$75,000 penalty.



Digital Assets

SEC Order—Poloniex, August 2021

- In 2021, the SEC settled charges against Poloniex LLC for allegedly operating an unregistered national securities exchange.
- According to the SEC's order, Poloniex operated a web-based trading platform that matched the orders of buyers and sellers in digital assets, including digital assets that were investment contracts and therefore securities—however, the order did not specify *which* assets were securities.
- Without admitting or denying the findings, Poloniex consented to the order and agreed to pay \$10.3M in disgorgement, prejudgment interest and a civil penalty.



Digital Assets

SEC Order—Poloniex, August 2021 (cont'd.)

- Commissioner Peirce criticized the SEC’s “enforcement-centric approach to crypto” in a dissenting statement:
 - “Given how slow we have been in determining how regulated entities can interact with crypto, market participants may understandably be surprised to see us to come onto the scene now with our enforcement guns blazing and argue that Poloniex was not registered or operating under an exemption as it should have been.”
 - **“How can a trading platform and its customers determine whether a particular digital asset is a security? . . .** The Commission has been reluctant to help provide clarity, even, as evidenced by today’s action, refusing to alert the market to securities determinations it has made in connection with enforcement actions like this one.”



Digital Assets

Chairman Gensler Calls for Tougher Regulation

- In recent months, SEC Chairman Gensler has repeatedly called for tougher restrictions on the digital asset market:
 - ***Trading Platforms Are Likely Selling Securities; Come Speak to the SEC.***
 - “I’ve suggested that platforms and projects come in and talk to us. Many platforms have dozens or hundreds of tokens on them. While each token’s legal status depends on its own facts and circumstances, the probability is quite remote that, with 50, 100, or 1,000 tokens, any given platform has zero securities. Make no mistake: To the extent that there are securities on these trading platforms, under our laws they have to register with the Commission unless they qualify for an exemption.”
(*Testimony Before the Senate Banking Committee, Sept. 14*)
 - ***Lending Platforms Are Likely Selling Securities.***
 - “The world of crypto finance now has platforms where people can trade tokens and other venues where people can lend tokens. I believe these platforms not only can implicate the securities laws; some platforms also can implicate the commodities laws and the banking laws. . . . Make no mistake: If a lending platform is offering securities, it also falls into SEC jurisdiction.” (*Aspen Security Forum, Aug. 3*)



Digital Assets

Chairman Gensler Calls for Tougher Regulation (cont'd.)

- ***Stablecoins Are Like “Poker Chips at the Casino.”***
 - “These stablecoins are acting almost like poker chips at the casino right now; so, add to the Wild West analogy. I mean, we've got a lot of casinos here in the Wild West and the poker chip is these stablecoins, you know, at the casino gaming tables. And so, I think there's just a lot of kind of warning signs and flashing lights that we might have a spill in aisle three, and I'd rather get ahead of it.”
(*Washington Post*, Sept. 21)
- ***SEC is Working With Other Regulators.***
 - “With respect to investor protection, we’re working with our sibling agency, the CFTC, as our two agencies each have relevant, and in some cases, overlapping jurisdiction in the crypto markets. With respect to a broader set of policy frameworks, we’re working with not only the CFTC, but also the Federal Reserve, Department of Treasury, Office of the Comptroller of the Currency, and other members of the President’s Working Group on Financial Markets on these matters.” (*Testimony Before the Senate Banking Committee*, Sept. 14)



Regulatory Overview and Recent Developments—CFTC

The CFTC's Regulatory Framework:

- The Commodity Futures Trading Commission (“CFTC”) has determined that virtual currencies are commodities under the Commodity Exchange Act, subject to the CFTC’s general anti-fraud and manipulation enforcement authority.
 - The CFTC in recent months has settled cases for \$100 million against crypto exchange BitMEX and \$41 million against stablecoin issuer Tether Ltd.
- Acting CFTC Chairman Rostin Behnam, who was nominated by President Biden to serve as the CFTC’s permanent chairman, recently testified before the Senate Agriculture Committee: “Given the size, the scope and the scale of this emerging market, how its interfacing and affecting customers, retail customers, and then with the scale of the growth being so rapid, potential financial stability risks in the future, I think it’s critically important to have a **primary cop on the beat** and certainly the CFTC is prepared to do that if this committee so wishes.”



Regulatory Overview and Recent Developments—PWG

- On Nov. 1, 2021, the President’s Working Group on Financial Markets (PWG)—which includes Treasury Secretary Yellen, Fed Chairman Powell, SEC Chair Gensler, and CFTC Chair Behnam—issued a report on stablecoins, joined by the OCC and the FDIC.
 - **Risks.** The report notes that stablecoins pose market integrity and investor protection risks, illicit finance concerns and risks to financial integrity, including AML/CFT concerns, as well as prudential concerns.
 - **Recommendations.** The report recommends that Congress act promptly to enact legislation to ensure that payment stablecoins are subject to a federal prudential framework on a consistent and comprehensive basis.
 - **To address risks to stablecoin users and guard against stablecoin runs**, legislation should require stablecoin issuers to be insured depository institutions, which are subject to appropriate supervision and regulation, at the depository institution and the holding company level.
 - **To address concerns about payment system risk**, in addition to the requirements for stablecoin issuers, legislation should require custodial wallet providers to be subject to appropriate federal oversight, and should provide the federal supervisor of a stablecoin issuer with the authority to require any entity that performs activities that are critical to the functioning of the stablecoin arrangement to meet appropriate risk-management standards.
 - **To address additional concerns about systemic risk and economic concentration of power**, legislation should require stablecoin issuers to comply with activities restrictions that limit affiliation with commercial entities. Supervisors should have authority to implement standards to promote interoperability among stablecoins. In addition, Congress may wish to consider other standards for custodial wallet providers, such as limits on affiliation with commercial entities or on use of users’ transaction data.



II. Regulatory Overview and Recent Developments—State Banking Regulators

State banking regulators, as principal regulators of trust companies and money transmitters, on the front lines of cryptocurrency regulation; some states are competing to attract business

Wyoming

- Adopted a law recognizing Decentralized Autonomous Organizations (DAOs) as limited liability companies under the WY Limited Liability Company Act
- Special Purpose Depository Institution (SDPI) – Kraken Digital Bank
- Wyoming Division of Banking custody opinion
 - Wyoming-chartered public trust company is permitted to act as a “qualified custodian” for digital assets under the Investment Advisers Acts of 1940 ...
 - ...but, SEC has stated that it is not bound by the statements of state regulators



South Dakota

- Division of Banking has granted trust company charters to *institutional cryptocurrency custodians*
- Home to a number of trust companies offering digital asset services

New York

- Department of Financial Services (NYDFS) created bespoke cryptocurrency license framework (“Bitlicense”) in 2015
- NYDFS continues to evolve its cryptocurrency licensing framework
 - Limited purpose trust charter and BitLicense
 - Token “Greenlist”
 - “Techsprint” on regulatory reporting



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