



Blockchain and Digital Assets News and Trends

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To remain competitive, companies find themselves increasing their efforts to digitally transform their businesses by developing new offerings based on emerging technologies and integrating these technologies into existing product and service offerings.

This is our second monthly bulletin, aiming to help companies identify important and significant legal developments governing the use and acceptance of blockchain technology, smart contracts and digital assets.

While the use cases for blockchain technology are vast, from copyright protection to voting, most of the current adoption is in the financial services section, and this bulletin will primarily focus on the use of blockchain and smart contracts in that sector. With respect to digital assets, we have organized our approach to this topic by discussing it in terms of traditional asset type or function (although the types and functions may overlap); that is, digital assets as:

- Securities
- Virtual currencies
- Commodities

- Deposits, accounts, intangibles
- Negotiable instruments
- Electronic chattel paper
- Digitized assets

Digital assets can themselves be assets or instead can reflect the ownership of an underlying asset. For example, electronic records that are the equivalents of negotiable instruments and electronic chattel paper would be digital assets, as would an electronic recording of a security interest in the underlying asset, such as recording title to real or personal property and the use of tokens to represent revenue streams from otherwise illiquid assets such as patents and commercial real estate (sometimes referred to as a "tokenized" or digitized asset).

In addition to reporting on the law and regulation governing blockchain, smart contracts and digital assets, this bulletin will also report on the legal developments to support the infrastructure and ecosystems enabling the use and acceptance of these new technologies.

Each issue will feature in-depth insight on a timely and important current topic. In this issue, we take a look at the US Securities and Exchange Commission's Strategic Hub for Innovation and Financial Technology "Framework for 'Investment Contract' Analysis of Digital Assets" and the SEC Division of Corporation Finance's first "No Action" letter to a startup planning to sell digital assets.

For related information regarding digital transformation, please see our monthly bulletin, *eSignature and ePayment News and Trends*.

INSIGHT

Consortium blockchain governance: four critical issues for enterprise blockchain projects

By Mark Radcliffe

Blockchain project governance is a widely discussed topic in the blockchain community. However, a second level of blockchain governance has rarely been discussed: consortium project blockchain governance. Many enterprise blockchain solutions will be implemented by a "consortium" of enterprises building one or more applications on top of a "blockchain platform." These more traditional consortiums are already forming in many industries to deal with the particular problems of those industries. Read more.

FEDERAL DEVELOPMENTS

Securities

- **Digital asset regulation: SEC suggests possible path from security to non-security.** Since the Securities and Exchange Commission (SEC) issued the DAO Report in June 2017, pulled the plug on the Munchee Inc. ICO in December 2017, and then initiated its "crypto industry sweep" in early 2018, companies have been waiting anxiously for clear guidance from the regulator on what types of digital assets fall under the SEC's jurisdiction. Nearly two years later, the SEC has responded with its "Framework for 'Investment Contract' Analysis of Digital Assets," a 13-page memorandum that describes the factors used by SEC staff for assessing whether digital assets are "investment contracts" subject to federal securities laws. After providing a high-level overview of the Framework and explaining how the SEC staff is likely to analyze digital assets, this article examines the concept that digital assets can reach a tipping point – an "evolutionary moment" in their development – where they transform from a security to non-security. While SEC staff referenced this concept in passing during two speeches last year, it was not until the issuance of the Framework that it was more formally addressed. Read more.
- **SEC Commissioner Peirce critiques SEC crypto regulatory inaction, potential missteps.** In a thought-provoking speech given on May 9 to the Securities Enforcement Forum held in East Palo Alto, California, SEC Commissioner Peirce expressed concern that the SEC's unwillingness to take regulatory action and lack of clarity in certain areas may be stifling the crypto industry. She commented that the SEC staff's recently issued

framework on digital assets could raise more questions and concerns than it answers, noting that while the *Howey* test has 4 factors to assess whether a digital asset is a security, the SEC staff's guidance lists 38 factors including several sub-points. Commissioner Peirce expressed concerns that non-lawyers and lawyers not experienced in securities laws will not know how to understand the guidance and forgo opportunities or pursue them outside of the US. She also expressed her view that the digital asset discussed in the SEC's Turnkey Jet no action letter was "so clearly *not* an offer of securities" that it raised concerns that the staff's issuance of the letter effectively broadens the reach of the US securities laws by effectively imposing conditions on a non-security. The Commissioner also pointed out that the SEC has been nearly silent on questions of how market participants can comply with securities regulations related to custody, obligations of selling platforms and auditor obligations, among others. As a result of this SEC inaction, according to Commissioner Peirce, market participants are "stuck in a frustrating waiting mode; they are unable to get clear answers to questions about how they may proceed in the market." According to Commissioner Peirce, this lack of guidance risks the existence of a functional secondary market and puts retail investors at risk of losing the protection of the securities laws. The Commissioner urges the SEC to act soon to provide necessary guidance to answer the numerous open questions she identifies in her speech.

- **SEC Staff announces agenda for May 31 FinTech Forum.** The Securities and Exchange Commission has released the agenda for its 2019 FinTech Forum, to be held at the SEC's headquarters in Washington, DC on Friday, May 31. The event is open to the public on a first-come, first-served basis. Doors open at 8:00 am ET and the event begins at 9:30 am ET. Topics will include Distributed Ledger Technology Innovations (industry trends and specific use cases for financial markets), as well as Capital Formation, Trading and Markets, and Investment Management. The forum will be hosted by the SEC's Strategic Hub for Innovation and Financial Technology (FinHub). A live webcast will be available on the SEC's main website and archived on the FinHub page for later viewing.
- **SEC Staff requests input on "custody" issues posed by digital assets.** Noting that some investment advisers have invested in digital assets on behalf of their clients, the staff of the SEC's Division of Investment Management, together with the SEC's Strategic Hub for Innovation and Financial Technology (FinHub), has engaged with investment advisers, broker-dealers and service providers on the issue of whether and how digital assets impact compliance with the Rule 206(4)-2 under the Investment Advisers Act of 1940 (the Custody Rule). To inform its consideration, the staff identified several questions on which it is seeking input, including challenges that investment advisers face in complying with the Custody Rule with respect to digital assets; whether advisers are treating digital assets as "funds" or "securities" for purposes of the Rule; whether advisers are including digital assets in calculating their regulatory assets under management; whether advisers are using state chartered trust companies or foreign financial institutions to custody digital assets; and whether (and how) client losses due to misappropriation of digital assets can be remedied. The staff also asked for input on differences between peer-to-peer and intermediated transactions in digital assets, and asked generally whether distributed ledger technology may provide enhanced or diminished client protection in the context of non-delivery versus payment transactions as well as securities transactions more generally.

Securities and commodities

- **SEC and CFTC issue investor alert warning against fraudulent digital asset and "crypt" trading websites.** In late April, the investor education offices of the SEC and CFTC issued an alert to investors regarding potentially fraudulent digital asset or cryptocurrency advisory and trading businesses. The alert identified red flags for potentially illegitimate businesses such as offers of high guaranteed returns with little or no risk, complicated jargon, unlicensed sellers, "too good to be true" offers, unsolicited offers and pressure to buy immediately. The alert describes some of these schemes and cautions investors to read any materials, verify the truth of all statements about the investors and investigate the firm and individuals offering the investment. The alert lists resources for investors and urges investors to report such schemes to the SEC or CFTC.
- **FINRA and the BBB Institute provide advice to investors about cryptocurrency trading platforms.** The Financial Industry Regulatory Authority and the Better Business Bureau Institute for Marketplace Trust have joined forces to issue Cryptocurrency Trading Platforms: Do Your Homework, an investor alert that provides a number of tips for investors considering use of cryptocurrency trading platforms. Noting that a number of service providers have emerged to assist users in managing cryptocurrency investments and transactions through online platforms that let users buy, sell, exchange, and in some cases, store cryptocurrencies, FINRA

and the BBB Institute are issuing this guidance so that users of these platforms will be better able to assess the benefits and risks involved.

Virtual currency

- **OCC solicits comments on proposed innovation pilot program.** On April 30, 2019, the OCC opened a 45-day public comment period on a proposed Innovation Pilot Program. The voluntary program "supports testing of novel or innovative products, services, and processes (hereinafter, activities) that could present significant opportunity or benefits to consumers, businesses, financial institutions, and communities." The OCC is soliciting for comment answers to the following questions:
 1. As a supplement to existing agency processes, will the program provide additional value?
 2. Are the eligibility criteria and evaluation process appropriate for an effective program? Why or why not?
 3. Are the general program parameters appropriate? Why or why not?
 4. What may be the preferred nature of regulatory engagement through the program?
 5. What type of innovative activities would be best served through this program?
 6. Are there suggestions or feedback as to how the program should work?

Responses may be submitted here to the OCC by June 14, 2019.

- **FinCEN publishes guidance on virtual currencies.** The Financial Crimes Enforcement Network (FinCEN) published guidance entitled "Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies"> and issued a press release on May 9 to introduce the guidance. The guidance is in response to questions raised by financial institutions, law enforcement, and regulators concerning the regulatory treatment of multiple variations of businesses dealing in CVCs. The guidance does not establish any new regulatory expectations, but rather consolidates current FinCEN regulations, guidance and administrative rulings that relate to money transmission involving virtual currency, and applies the same interpretive criteria to other common business models involving CVC.
- **FinCEN issues new advisory to warn of threats posed by virtual currency misuse.** The Financial Crimes Enforcement Network (FinCEN) issued an Advisory on Illicit Activity Involving Convertible Virtual Currency to assist financial institutions in their efforts to identify and report suspicious activity related to criminal exploitation of CVCs for money laundering, sanctions evasion, and other illicit purposes. The advisory highlights prominent types of activity and "red flags" associated with such activity, and identifies information likely to be most valuable to law enforcement if contained in suspicious activity reports.
- **Members of Congress send letter to IRS seeking guidance for virtual currency.** The co-chairs of the Congressional Blockchain Caucus and 17 other members of Congress on Thursday, April 11 sent a letter to Commissioner Charles Rettig of the IRS requesting guidance on tax consequences and reporting requirements for taxpayers who use virtual currency. They requested guidance on 1) methods for calculating the cost basis of virtual currencies; 2) methods of cost basis assignment and lot relief for virtual currencies; and 3) tax treatment of forks.
- **House Financial Services Committee creates FinTech Task Force.** On Thursday, May 9, the House Committee on Financial Services appointed Representative Stephen Lynch (D-MA) as the chair of the FinTech Task Force and appointed Representative Bill Foster (D-IL), a co-chair of the Congressional Blockchain Caucus, as the chair of the Artificial Intelligence Task Force.

STATE DEVELOPMENTS

Blockchain

- **Blockchain technology endorsed by Maryland.** On April 30, 2019, Maryland Governor Hogan signed Senate Bill 136, which amends the Maryland General Corporation Law to permit certain corporate records (including a company's stock ledger) to be maintained on electronic networks or databases, including through the use of distributed ledgers and blockchain technology. The amendment also permits a company to transmit communications (such as annual statements and stockholder notices) by means of a distributed electronic network or database, which includes by means of blockchain technology. The amendments become effective October 1, 2019.
- **North Dakota and Oklahoma amend state UETA for blockchain.** In late April, North Dakota (HB1045) and

Oklahoma (SB700) enacted amendments to their respective state Uniform Electronic Transactions Acts to recognize blockchain technology. The North Dakota and Oklahoma amendments provide that a signature or record secured through blockchain technology is considered to be in electronic form and an electronic signature or electronic record, as applicable. The amendments take effect on August 1 and November 1.

- **Washington adopts law regarding legality of electronic records created using distributed ledger technology.** On April 29, 2019, the governor of Washington signed into law a bill (SB 5638) that addresses the legal validity of electronic records that are generated, communicated, received, or stored using distributed ledger technology. As noted in our companion newsletter, Washington recently repealed its Electronic Authorization Act.

Securities

- **Montana exempts utility tokens from certain securities laws.** On May 8, 2019, the governor of Montana signed into law a bill (HB 584) that exempts utility tokens from certain securities laws, provided that, in part, the primary purpose of the utility token is consumptive rather than speculative or for investment purposes. The law takes effect on July 1.

Virtual currency

- Oregon enacted HB2488 on May 2, 2019 which prohibits the State government or any candidate for state office from accepting payments in the form of cryptocurrency. The law takes effect on January 1, 2020.

ENFORCEMENT ACTIONS

FEDERAL

Virtual currency

- **DOJ announces sentencing for operator of unlicensed money transmission business.** The Department of Justice announced on April 8 that Jacob Burrell Campos was sentenced to serve two years in prison and forfeit \$823,357 he received in profits as the operator of an unlicensed money transmission business. Campos was arrested in August 2018 for buying and selling bitcoin on behalf of others.
- **DOJ announces indictments related to bank fraud and unlicensed money transmission.** The Department of Justice announced the indictment of Reginald Fowler and Ravid Yosef for conspiracy to commit bank fraud and committing bank fraud. Fowler is also charged with conspiracy to operate an unlicensed money transmitting business and operating an unlicensed money transmitting business. The defendants allegedly falsely represented to banks that the accounts they opened would be used for investing in real estate. The accounts were instead used to transmit funds related to an unlicensed money transmitting operation related to virtual currency exchanges. Bloomberg asserts that the defendants may have been indicted because of their involvement with Crypto Capital, Inc., the company to which Bitfinex claims it deposited \$850 million for safekeeping, and their potential role in the loss of those monies.

STATE

Virtual currency

- **OneCoin now defends civil lawsuit.** The people behind OneCoin LTD. were sued in New York Federal Court on Tuesday, May 7 in a proposed class-action lawsuit for using the company to run a \$4 billion Ponzi scheme linked to the OneCoin crypto currency. Allegedly, the cryptocurrency that was sold never existed. The complaint relies heavily on the DOJ's various cases against OneCoin insiders. See more in our April issue.
- **Texas securities regulator issues cease and desist order against company offering virtual currency investment products.** The Texas State Securities Board (TSSB) on April 9 issued an emergency cease and desist order to FXBitGlobe (formerly known as Fidelity Trading Company) for offering investment products related to virtual currencies without registering with the TSSB and fraudulent activity related to the offer of unregistered investment products.

Securities and commodities

- **NY AG action regarding Bitfinex and Tether (USDT).** The New York Attorney General's Office has obtained an

injunction against iFinix, Inc., which operates the well-known Bitfinex cryptocurrency exchange, and Tether Limited, issuer of the popular tether (USDT) stablecoin, from violations of New York's Martin Act, which broadly prohibits fraud in connection with securities or commodities. The Attorney General's Office claims that Bitfinex engaged in a coverup to hide the apparent loss of \$850 million dollars of commingled client and corporate funds. In connection with its exchange operations, Bitfinex used a Panamanian entity, Crypto Capital Corp., to process withdrawals from its platform by cryptocurrency traders, providing \$851 million to Crypto Capital for this purpose without any contract or assurance of return. These funds went missing. Bitfinex claims that regulatory authorities in several jurisdictions seized Crypto Capital's funds. Because Bitfinex and Tether are under common control, Bitfinex was able to fill the gap by giving itself access to up to \$900 million of Tether's cash reserves through a line of credit, of which it has drawn \$700 million. The Attorney General's office asserts that investors were told repeatedly that each tether USDT is "backed 1-to-1" by US dollars but were not told about these undisclosed "conflicted corporate transactions" which may call into question the adequacy of 1-to-1 backing. Tether recently began stating that USDT is backed by reserves that may include other assets and receivables, including loans from affiliated parties.

Banking

- **NY federal court allows DFS lawsuit against OCC's FinTech Charter decision to continue.** On Thursday, May 2, *American Banker* reported that the New York Department of Financial Services (DFS) was granted permission by the US District Court for the Southern District of New York to proceed with its lawsuit against the Office of the Comptroller of the Currency seeking to block the OCC from issuing specialized national bank charters to FinTech companies. The court denied the OCC's motion to dismiss, finding that the DFS's challenge to the FinTech charter "is ripe for adjudication" as "threats to New York's sovereignty are so clear that the OCC does not even mention, let alone contest, the state's interests."

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