NELSON MULLINS

FinTech University

The View from Washington
December 6, 2022

Agenda

- Introductions
- Background – Blockchains and Digital Assets?
- 2022 Election
- What Will Change and What Will Stay the Same
- FTX Failure
- Regulation by Enforcement and Informal Guidance
- Presidential Working Group on Stablecoins
- Central Bank Digital Currencies
- Conclusion

Blockchain

- A blockchain is a database structure that can only be updated by appending a new set (or block) of valid transactions to the log of a previous transaction.

- As noted by Goldman Sachs in a note to clients:

  In its most basic form, the blockchain records ownership of bitcoin and transactions involving the crypto currency across a wide network of computers, as opposed to a centralized ledger. Transactions are signed off by the parties involved using the software, checked by the network or the "crowd", then added to the blockchain – a long string of code that records all activity. Encryption in the software ensures these 'blocks' cannot be tampered with or altered. And the decentralized nature means the 'crowd' police the whole system. The software cuts out the need for a "trusted middleman" to sit in between parties in a transaction, such as a bank or clearinghouse. This makes transactions quicker, cheaper, and easier when compared to the current systems banks use.

- Many firms in the financial services industry believe blockchain technology can be adapted for use in traditional financial services transactions in a way that "has the potential to redefine transactions and the back office of a multitude of different industries.

- From banking and payments to ... trade settlement ... a distributed shared ledger has the potential to make interactions quicker, less-expensive and safer".

Blockchain

Permissionless Networks

- On a public (permissionless) blockchain, access to the network is unrestricted.
- Despite public misconceptions of the technology, public blockchains are not anonymous.
- Users in a permissionless blockchain network use a pseudonym.
- On a public blockchain network, users can validate transactions.
- Validation is the process that ensures that all nodes are synchronised and that there is agreement on the legitimacy of transaction blocks.
- Consensus must be reached after each new block is added, and only after that can the block be considered immutable.

Blockchain

Permissioned Networks

- Permissioned blockchain networks are based on consensus mechanisms.
- Only approved participants can update a permissioned blockchain.
- A centralised authority must determine which consensus to use, how many nodes should participate in the network, and who authorises new nodes.
- In addition, someone must (determine and) validate cybersecurity requirements, and decide when to upgrade and validate the code.

Wallets and Keys

- Digital assets are stored by associating them with addresses called “wallets”, which can be stored on web servers, local hardware such as personal computers, jump drives and mobile devices, or on paper printouts.
- A digital asset wallet takes the form of a cryptographic public key, which is a string of numbers and letters.
- Each public key has a matching “private key”, known only to the user.
- Control of the private key is what assures one control of the digital assets at any address, so collections of private keys must be protected by passwords or other means of securing them.

Digital Assets

- For purposes of this presentation we use the term “digital asset” in the same manner as the U.S. Securities and Exchange Commission (“SEC”) to refer to "an asset that is issued and transferred using distributed ledger or blockchain technology.” Statement on Digital Asset Securities Issuance and Trading, Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets, SEC (Nov. 16, 2018).

- As the SEC has noted, digital assets include, but are not limited to virtual currencies, coins, and tokens.

- A digital asset may in certain instances be deemed a security under the federal securities laws.

- While not defined in the securities laws, the SEC often refers to digital assets that are securities as a “digital asset securities.”

- Bitcoin and Ether are digital, private crypto currencies that are exchanged by means of the Internet.

Praise for Blockchain

- Bitcoin has been described by Bill Gates as a “techno tour de force.”
- Peter Thiel, the co-founder of PayPal and an early investor in Facebook, believes Bitcoin has “world changing” promise for online transactions without fees.
- Fred Wilson of Union Square Ventures believes “Bitcoin represents something fundamental and powerful. . . .”
- Leading Silicon Valley investors, including Andreessen Horowitz, Lightspeed Ventures, and Hong Kong Billionaire Li Ka-shing’s Horizon Ventures, are supporters of the digital currency.
- Supporters believe blockchain technology has the potential to support more efficient global commerce and to help combat poverty.
- Goldman Sachs believes Blockchain could “change everything.”

Criticisms of Digital Assets

- Critics of digital assets have been equally as vocal in their skepticism of the digital currency and concern about its long-term viability as a unit of exchange as well as its potential impact on financial services and commerce.
- Digital assets has been derided as a “shady online currency” and as “a digital Wild West for narco traffickers and other criminals.”
- Senator Charles Schumer has described Bitcoin as a form of money laundering.
- Leading economist, Paul Krugman, has been critical of Bitcoin, suggesting that the structure of the currency incentivizes hoarding.
- Other analysts have raised concerns of a Bitcoin bubble.
- Former Secretary of the Treasury Larry Summers has been more circumspect in his evaluation of the digital currency and appears to be waiting to judge its potential.

Recent Action on Regulation of Digital Assets

- In recent years, the increasing popularity of blockchain technology and digital assets has garnered the attention of Capitol Hill.
- Though no legislation has passed, enough activity (from proposed bills, executive orders, and working group studies) has occurred that guarantee some form of digital asset legislation and regulation will come in the (near?) future.
- There have been several efforts in Washington, D.C.
  - Report on Stablecoins from the President's Working Group on Financial Stability
  - Executive Order on Ensuring Responsible Development of Digital Assets
  - Lummis-Gillibrand Responsible Financial Innovation Act (Bill)
  - Digital Asset Market Structure and Investor Protection Act (Bill)
  - U.S. Treasury Request for Comment on "Ensuring Responsible Development of Digital Assets"
- International Activity and Banking Regulators
  - FSOC Report on Digital Asset Financial Stability Risks
  - Federal Reserve Guidance for Banking Organizations Engaging in Crypto-Asset-Related Activities
  - OCC "No Objection" Requirement for National Banks to Engage in Crypto-Asset-Related Activities

President Biden

- In March 2022, President Joe Biden issued an Executive Order on Ensuring Responsible Development of Digital Assets (the “Executive Order”).
- The Executive Order called for an interagency effort to formulate policies related to the regulation of digital assets to ensure the safety and soundness of the financial system, to protect consumers, investors and businesses, and to provide broader access to safe and affordable financial services.
- In September 2022, the White House followed the Executive Order with the promulgation of a comprehensive framework for the “responsible development of digital assets.”
- Among the key pillars of the framework was fostering financial stability.
- The White House noted the potentially disruptive runs on digital assets if left unregulated and specifically identified the 2022 crash of TerraUSD that effectively led to the erasure of almost $600 billion in wealth within a few days.
- The White House has called on the Department of Treasury to work with U.S. financial institutions to bolster their capacity to identify and mitigate cyber-vulnerabilities related to digital assets, including stablecoins, and to engage with other regulatory agencies to identify, track, and analyze emerging strategic risks related to digital asset markets.

Lummis-Gillibrand

- Interest in blockchain and digital assets, particularly its regulation, continues to grow at the highest levels of government.
- In June 2022, Senators Cynthia Lummis (R-WY) and Kirsten Gillibrand (D-NY) introduced the *Responsible Financial Innovation Act* (the "Bill"), a bipartisan legislation that proposed a complete regulatory framework for digital assets designed to encourage responsible innovation and consumer protection while integrating digital assets into existing law.
- Included within the Bill was a proposed framework to define stablecoins and impose requirements on their creation and issuance.
- The Bill defined a "payment stablecoin" to mean a digital asset that is (i) redeemable on demand on a one-to-one basis for instruments denominated in U.S. dollars; (ii) defined as legal tender under U.S. law or under the laws of a foreign country; (iii) issued by a business entity; (iv) accompanied by a statement from the issuer that the payment stablecoin is redeemable upon demand from the issuer; (v) backed by one or more financial assets (excluding other digital assets); and (vi) intended to be used as a medium of exchange.
- The Bill established for depository institutions (as defined under the Federal Reserve Act) to "issue, redeem, and conduct all incidental activities" relating to payment stablecoins and set forth "high-quality liquid assets" that would be eligible to back a payment stablecoin.

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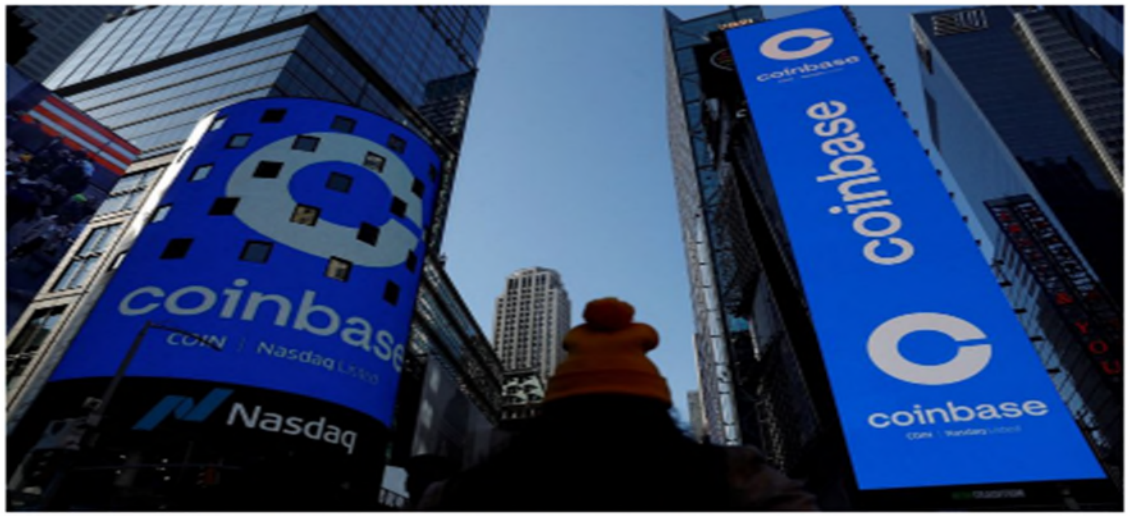
Crypto Firms, Executives Step Up Campaign Donations, Lobbying Ahead of Midterms

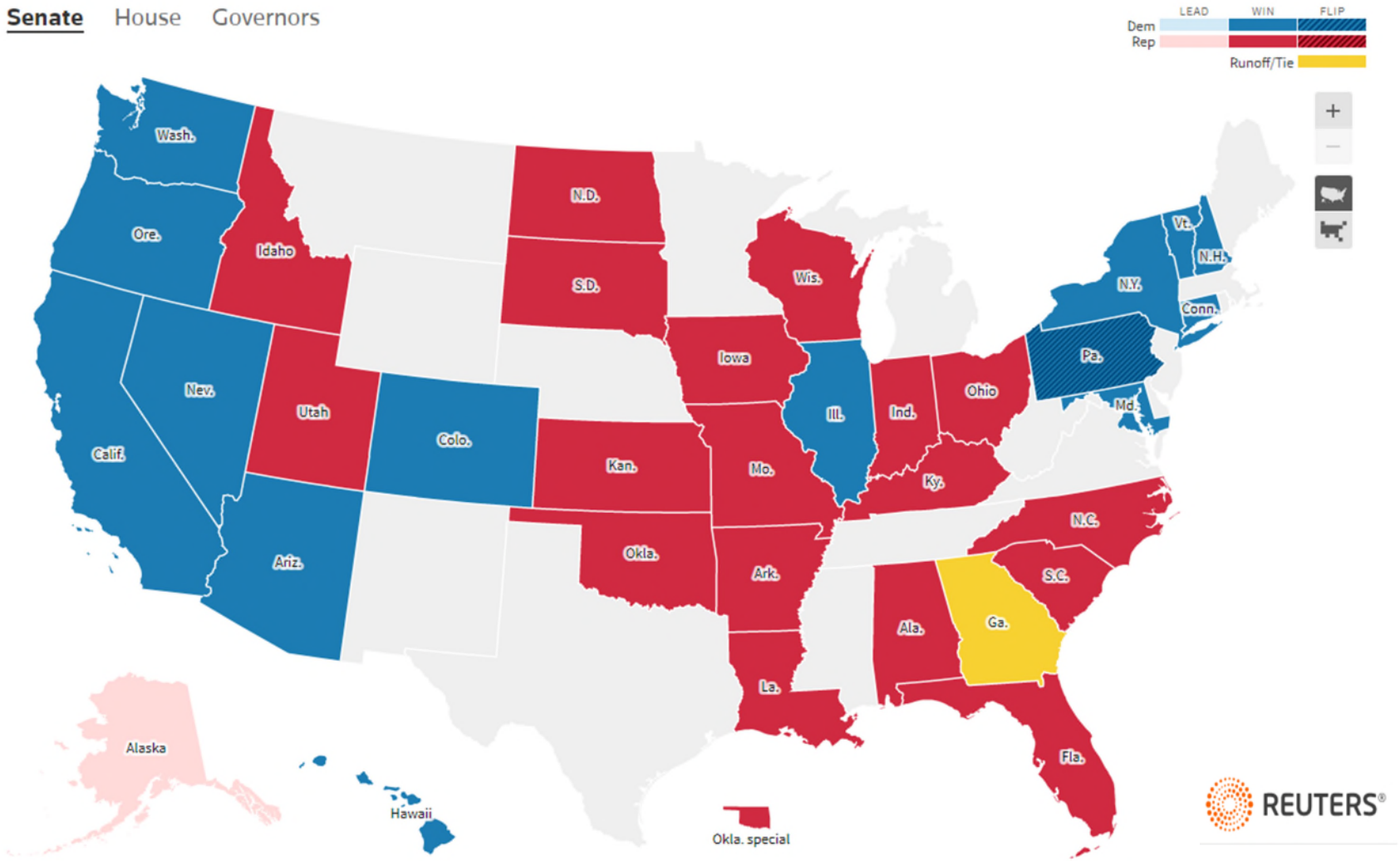
Industry seeks to gain influence in Washington as regulators increase scrutiny of digital assets



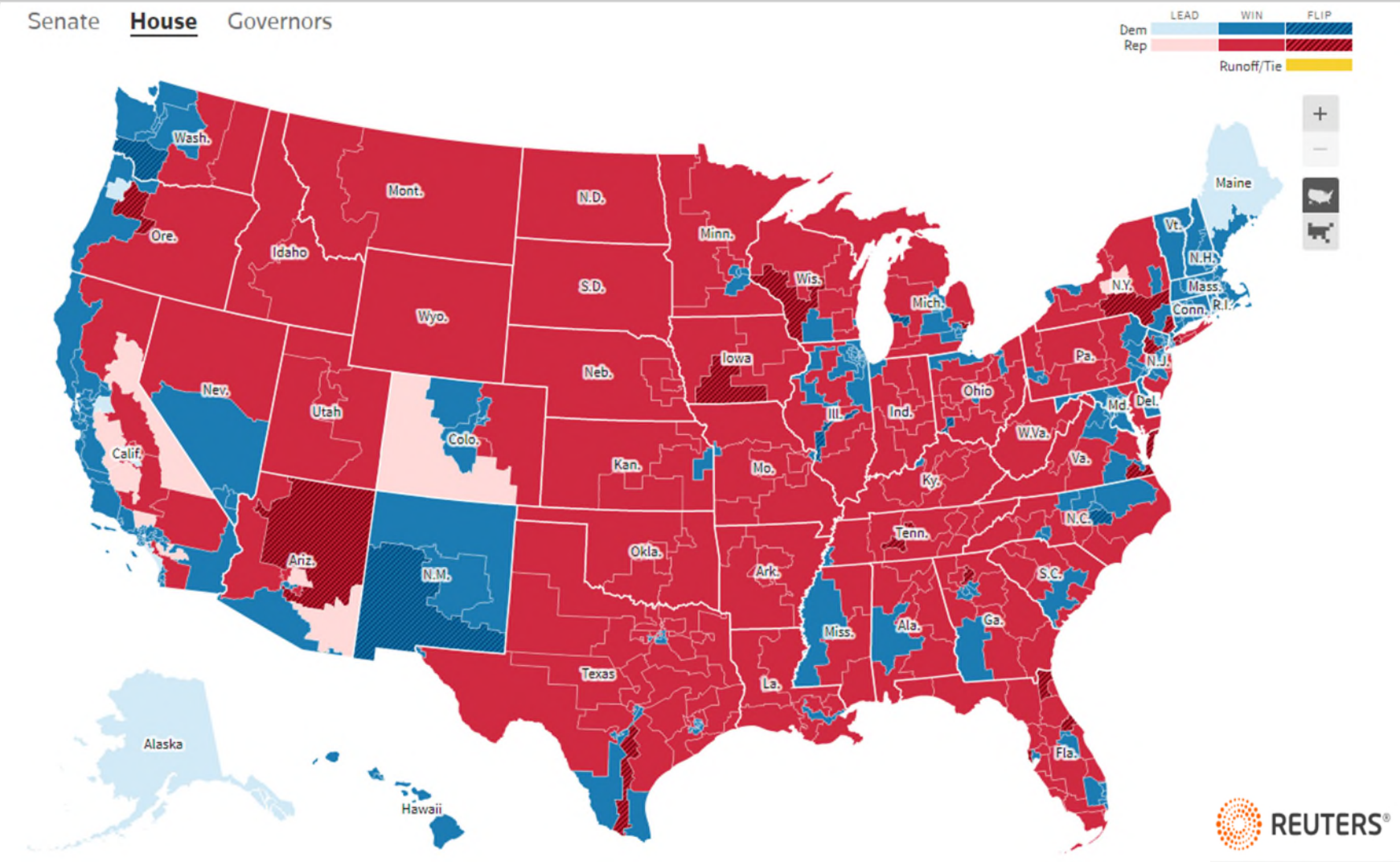
Coinbase is rolling out a scorecard that rates U.S. senators and representatives based on their crypto friendliness.
PHOTO: SHANNON STAPLETON/REUTERS

By Paul Kiernan Follow
Nov. 5, 2022 5:30 am ET

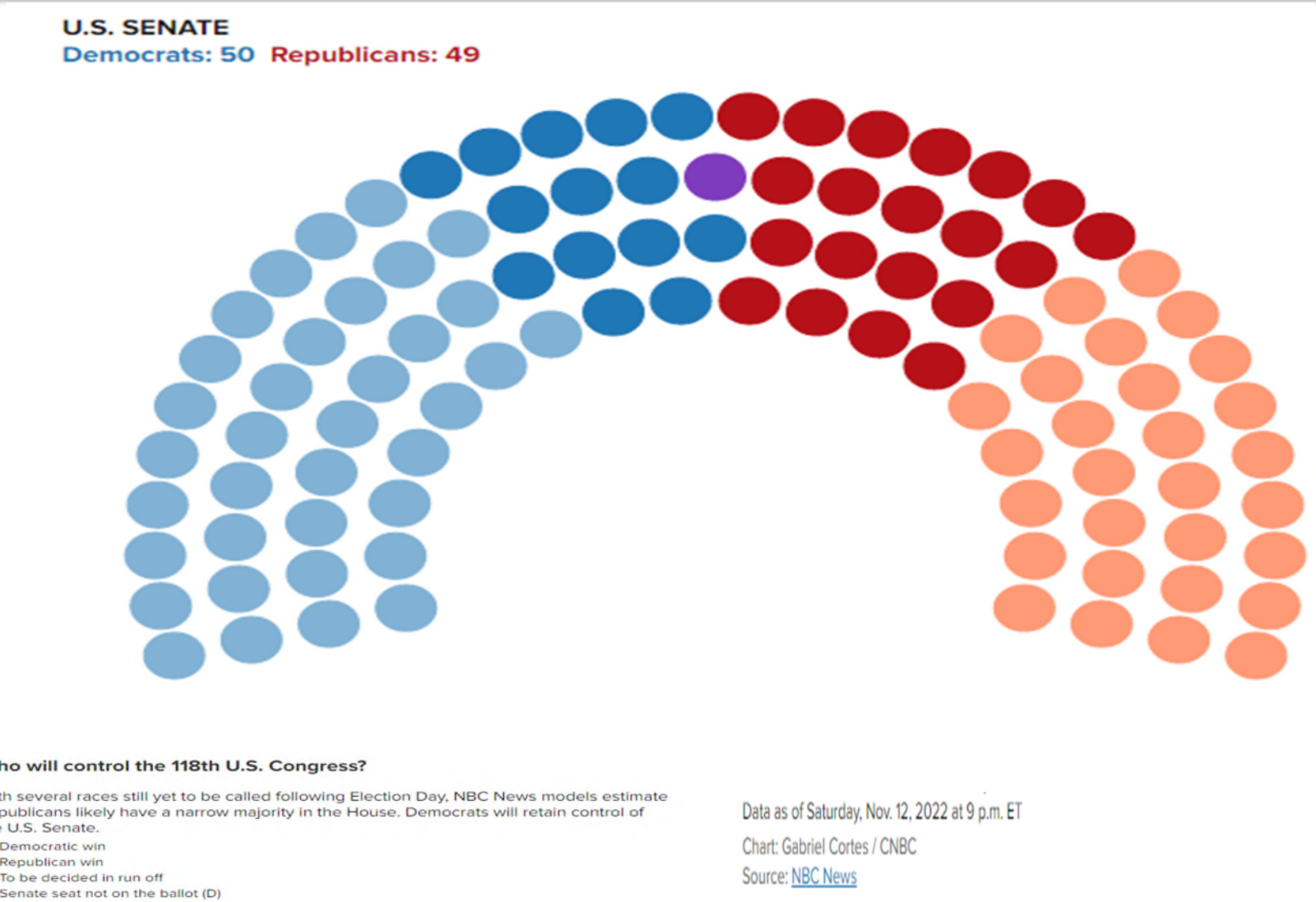
2022 Election - Senate



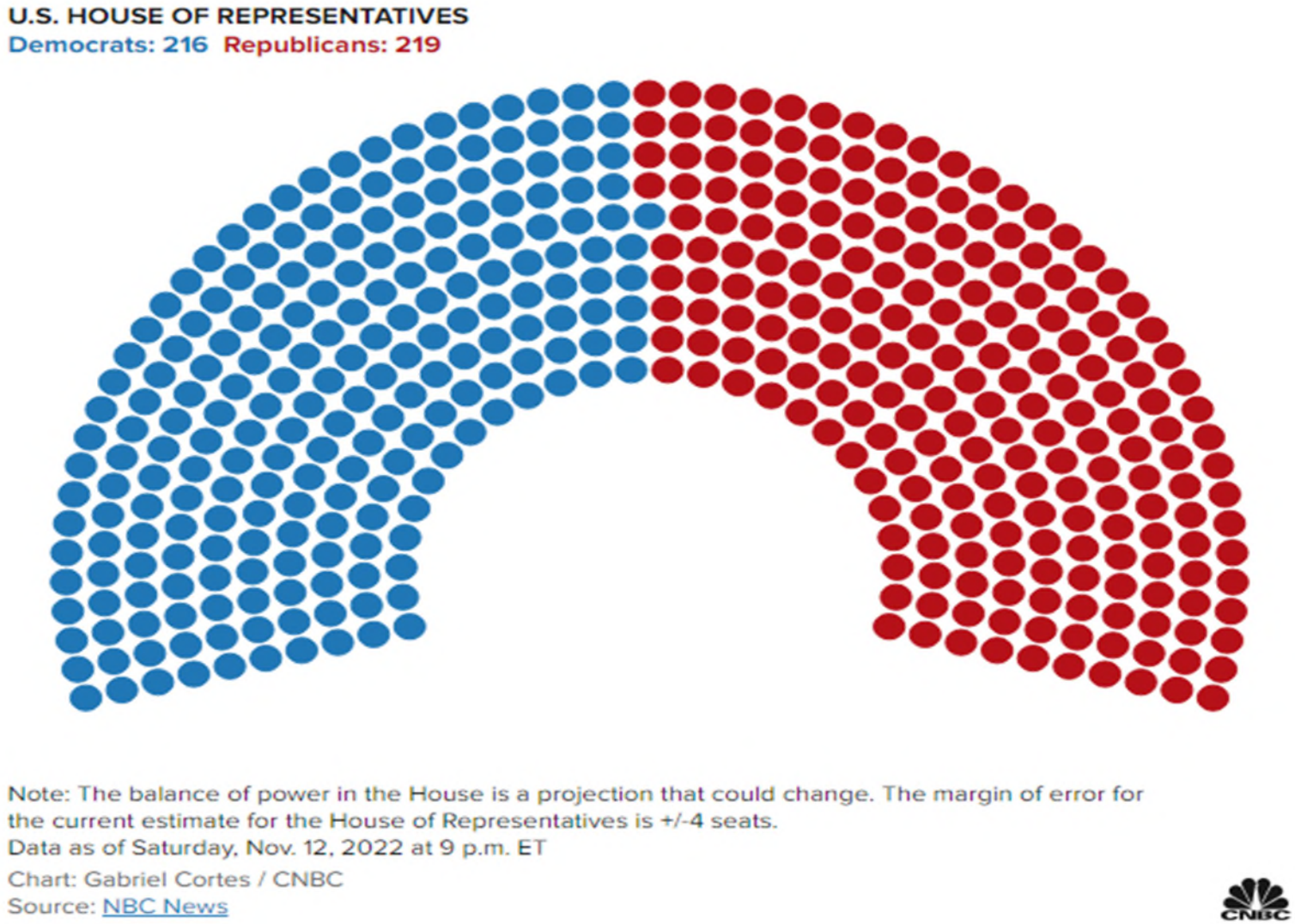
2022 Election – House of Representatives



U.S. Senate

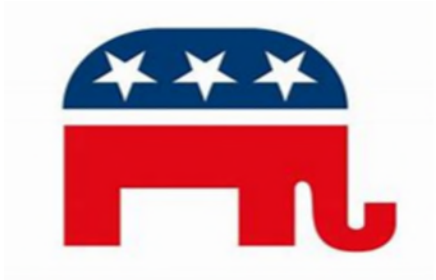

U.S. SENATE
Democrats: 50 Republicans: 49
Who will control the 118th U.S. Congress?
With several races still yet to be called following Election Day, NBC News models estimate Republicans likely have a narrow majority in the House. Democrats will retain control of the U.S. Senate.
Democratic win
Republican win
To be decided in run off
Senate seat not on the ballot (D)
Senate seat not on the ballot (R)
Data as of Saturday, Nov. 12, 2022 at 9 p.m. ET
Chart: Gabriel Cortes / CNBC
Source: NBC News
CNBC

U.S. House of Representatives



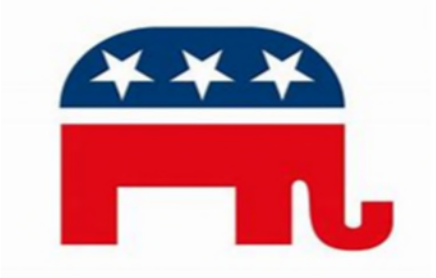
2022 Election – What Will Stay the Same

- Democrats will maintain at least a 50/50 margin in the Senate.
- If Senator Raphael Warnock of Georgia loses the runoff against Herschel Walker, Vice President Kamala Harris will give the Democrats the tie breaking vote.
- Senator Sherrod Brown of Ohio will likely continue as the chair of the Senate Banking Committee.
- Senator Tim Scott of South Carolina will likely be the ranking member on the Senate Banking Committee.



2022 Election – What Will Change

- Republicans will control the House of Representatives by a narrow margin.
- Republican House leadership may face a challenge from the Freedom Caucus.
- Representative Patrick McHenry of North Carolina will likely be the chair of the House Financial Services Committee.
- Congresswoman, Maxine Waters, the current chair of the House Financial Services Committee will likely become the ranking member of the committee.



Key FinTech Lawmakers

Senator Brown Recent Policy History

- July 27, 2021: Urges CFPB to address risks to consumers from fintechs
- April 15, 2022: Continues to warn consumers about the risks of fintechs/neobanks “that want to act like banks”
- July 28, 2022: Opening state discussing crypto risks and scams that put Americans’ money at risk.
- November 10, 2022: Statement on FTX

Representative McHenry Recent Policy History

- July 19, 2017: Rep. McHenry and Rep. Gregory Meeks (D-NY) introduce fintech bill to promote greater financial inclusion.
- April 20, 2021: Release of Republican Staff Report on Financial Innovation
- U.S. must lead in global payments
- Automation leads to better decision making
- Updates to regulations needed to keep apace with innovation
- October 11, 2022: Joint release with FinTech Task Force Republics urging Comptroller Hsu to provide certainty/clarity for bank-fintech partnerships.
- November 8, 2022: Statement on FTX and Binance.

FTX Timeline

- 2019 - May - Former Wall Street trader Sam Bankman-Fried and ex-Google employee Gary Wang founded FTX, the owner and operator of FTX.COM cryptocurrency exchange.
- 2020 - August - FTX acquired mobile portfolio tracking application, Blockfolio for $150 million.
- 2021
  - July - A $900 million funding round valued FTX at $18 billion.
  - September - FTX signed a sponsorship deal with Mercedes' Formula 1 team.
  - October - FTX raised capital at a valuation of $25 billion from investors including Singapore's Temasek and Tiger Global.
- 2022
  - Jan. 27 - FTX's U.S. arm said it was valued at $8 billion after raising $400 million in its first funding round from investors including SoftBank and Temasek.
  - Jan. 31 - FTX raised $400 million from investors including SoftBank at a valuation of $32 billion.
  - June 4 - FTX signed a reportedly $135 million sponsorship deal for naming rights of the Miami Heat's home court.
  - July 1 - FTX signed a deal with an option to buy embattled crypto lender BlockFi for up to $240 million.

Source: Reuters - TIMELINE-Rise and fall of crypto exchange FTX (Nov. 10, 2022)

FTX Timeline

- 2022

  - July 22 - FTX offered a partial bailout of bankrupt crypto lender Voyager Digital. Voyager called it a "low-ball bid".
  - July 29 - FTX said it won full approval to operate its exchange and clearing house in Dubai.
  - Aug. 19 - A U.S. bank regulator ordered crypto exchange FTX to halt "false and misleading" claims it had made about whether funds at the company are insured by the government.
  - Sept. 9 - FTX's venture capital fund said it would buy a 30% stake in SkyBridge Capital.
  - Nov. 2 - Crypto news website CoinDesk reported a leaked balance sheet that showed Alameda Research, Bankman-Fried's crypto trading firm, was heavily dependent on FTX's native token, FTT. Reuters was unable to verify the report.
  - Nov. 6 - Binance CEO Changpeng Zhao said his firm would liquidate its holdings of FTT due to unspecified "recent revelations".
  - Nov. 7 - Bankman-Fried said "FTX is fine. Assets are fine".
  - Nov. 8 - FTT collapses by 72% as clients swamp the exchange with withdrawal requests.
  - Nov. 9 - Binance decided against pursuing a nonbinding agreement to bail out FTX.
  - Nov. 11 – Binance files for bankruptcy.

  - Source: Reuters - TIMELINE-Rise and fall of crypto exchange FTX (Nov. 10, 2022)

FTX Failure

- A little-traded digital currency created by Sam Bankman-Fried's now-bankrupt FTX cryptocurrency exchange played a crucial role in the company's collapse.
- The digital currency is FTT, which was created by FTX.
- It is not unusual for a crypto exchange to issue its own currency, both to allow founders and early investors to profit if the value rises and to motivate traders to use the exchange.
- FTT was different though because of the tight connection between FTX and Mr. Bankman-Fried's trading firm, Alameda Research, which also collapsed last week.
- Alameda played an unusual dual role by holding most of the FTT outstanding and being the main trading partner for the currency, according to people familiar with the transactions.
- Alameda used FTT as collateral to get hundreds of millions in loans, people familiar with the matter said.
- FTX lent cryptocurrencies from its own customers to Alameda.
- It is unclear if FTT was used as collateral for the customer loans.

FTX Failure

- The arrangement also proved to be Mr. Bankman-Fried's undoing.
- A portion of Alameda's assets were made up of FTT, and that it may have overvalued those holdings, set off a run on FTX.
- FTX allegedly used customer money to prop it up.
- Before the fall in the price of FTT, Alameda owed a total of $1.5 billion in loans to counterparties outside of FTX.
- Alameda made a series of venture investments using the loans.
- At the same time, FTX was also on a spending spree, buying stadium naming rights and spending on Super Bowl ads.
- Mr. Bankman-Fried said in a tweet the exchange had borrowed more than 1.7 times the value of its assets.

FTX Failure

- A blurred line existed between FTX and Alameda's finances.
- On one recent occasion, an Alameda bank account paid millions of dollars to an FTX contractor.
- The CoinDesk report that set off the run on FTX said Alameda had $5.82 billion in the tokens as of June 30, out of $14.6 billion in assets.
- At that valuation, Alameda's holdings would have been worth more than the tokens' $3.4 billion market capitalization at the time.
- The news sent FTX customers and investors scrambling to withdraw their money from FTX, fearful Mr. Bankman-Fried's businesses were less solid than they looked.
- Most have been unable to get their money back.
- FTT, which was created in 2019, was a top-25 token by market capitalization at the start of the month. But the dollar-value of its daily trading only stood at roughly $60 million, according to CoinMarketCap.
- On the same day, BNB, which is a token issued by competitor exchange Binance, had $1.3 billion in trading volume.

FTX Failure

- Companies that accepted FTT as collateral from Alameda included crypto lender Genesis, according to people familiar with the matter.
- Alameda has long used FTT tokens as collateral, people who interacted with the company said.
- In the summer of 2021, Alameda approached a cryptocurrency market maker to borrow $100 million, using FTT collateral, said Max Boonen, the B2C2's co-founder.
- After the CoinDesk report was published, investors started selling the token heavily, according to cryptocurrency data provider Kaiko.
- For a while, however, price moves were modest, indicating there were buyers on the other side.

FTX Failure

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- But the dollar-value of its daily trading only stood at roughly $60 million, according to CoinMarketCap.
- On the same day, BNB, which is a token issued by competitor exchange Binance, had $1.3 billion in trading volume.
- Companies accepted FTT as collateral from Alameda.
- Alameda has long used FTT tokens as collateral, people who interacted with the company said.
- When the value of FTT fell, FTX allegedly used customer money to prop it up.

FTX Fallout

← Tweet

Elizabeth Warren ✓
@SenWarren

The collapse of one of the largest crypto platforms shows how much of the industry appears to be smoke and mirrors. We need more aggressive enforcement and I'm going to keep pushing @SECGov to enforce the law to protect consumers and financial stability.

wsj.com
SEC Investigates Crypto Platform FTX
The regulator expanded an investigation into cryptocurrency platform FTX following its sudden implosion this week, focusing on potential securities-law ...

Brian Armstrong ✓
@brian_armstrong · **Follow**

FTX.com was an offshore exchange not regulated by the SEC.

The problem is that the SEC failed to create regulatory clarity here in the US, so many American investors (and 95% of trading activity) went offshore.

Punishing US companies for this makes no sense.

6:05 PM · Nov 9, 2022

FTX Fallout

- FTX did not allow American residents to trade on its main platform, instead operating a separate exchange for them, FTX US.
- But the company had still found itself in the crosshairs of U.S. regulators, with the SEC, Department of Justice, and Commodities and Futures Trading Commission all reported to be investigating the subsidiary.
- Probes at the SEC and CFTC began months ago, according to Bloomberg, and are focused on the relationships between FTX and its US subsidiary, as well as its relationship with sister entity Alameda Research.
- In the U.S., a proposed bill to regulate cryptocurrency would introduce "a comprehensive framework" for crypto and create more clarity on where the SEC should have oversight of the industry and where this should fall to the CFTC.
- Critics such as Senator Warren have called for stronger rules to be put in place that would protect consumers.

FTX Fallout

- Senator Elizabeth Warren (D-Mass.), a longtime crypto critic, said that the U.S. needs “more aggressive enforcement, not ineffectual rules that the crypto industry is trying to write for itself.”
- But Coinbase co-founder Brian Armstrong said the SEC was itself the problem, in that it had “failed to create regulatory clarity here in the U.S., so many American investors (and 95% of trading activity) went offshore.”
- Since FTX operated offshore, it was not regulated by the SEC, with Armstrong adding, “punishing U.S. companies for this makes no sense.”
- SEC Chairman Gary Gensler recently said Crypto investors need better protection in a space that is "significantly non-compliant" despite clear regulations.

Regulation of Blockchain

- While blockchain technologies may be well suited to accomplishing the goals of the laws that regulate securities and commodities are not designed to regulate such innovative technologies.

- As noted by former Commissioner Kara Stein, "creative uses of blockchain are still in their infancy... [and] a lot of questions will need to be answered."

- Echoing Commissioner Stein's comments, a former SEC Chair noted: *"[b]lockchain technology has the potential to modernize*, ***simplify, or even potentially replace*** *current trading and clearing and settlement operations*."

- However, as White noted in the same speech:

  One key regulatory issue is whether blockchain applications require registration under existing [SEC] regulatory regimes, such as those for transfer agents or clearing agencies*. We are actively exploring these issues and their implications. [The SEC's] Advanced Notice of Proposed Rulemaking and Concept Release on transfer agent regulations... asked for public comment on the use of blockchain technology by transfer agents and how such systems fit within federal securities regulations.*

- While there is tremendous potential for blockchain technology in the financial services industry, it is less clear how regulators in the United States will treat platforms that use blockchain technology in the financial or securities sectors.

What is a Security?

- The definitions of "security" under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 are nearly identical and each is broad enough to include the various types of instruments that are used in commercial marketplaces that one might suspect to fall within the ordinary concepts of a security.

- This would include common instruments like stocks, bonds, and notes, as well as the various collective investment pools and common enterprises devised by persons seeking to generate profits from the efforts and investments of others (i.e. investment contracts and instruments commonly known as securities).

- Section 2(a)(1) of the Securities Act defines a "security" as:

> [A]any note, stock, treasury stock, security future, security-based swap, ***bond***, debenture, evidence of indebtedness, . . . transferable share, ***investment contract***, . . . any put, call, straddle, option, or privilege on any security, certificate of deposit, . . . or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

What is a Security?

- What constitutes an investment contract is determined based on the test articulated by the U.S. Supreme Court in *Securities and Exchange Commission v. W. J. Howey Co.*

- Under the *Howey* test, an investment contract is a contract, transaction, or scheme involving (i) an investment of money, (ii) in a common enterprise, (iii) with the expectation that profits will be derived from the efforts of the promoter or a third party.

- The SEC has taken the position that the investment does not have to be in the form of "money," but it can be any "specific consideration in return for a separable financial interest with the characteristics of a security."

- Courts generally have analyzed "common enterprise" as a distinct element of an investment contract. However, there is a split in authority among the federal circuit courts regarding what constitutes a "common enterprise."

- The courts are divided regarding whether horizontal or vertical commonality is required (and, in the latter case, whether the broad or narrow variety is required) to satisfy the *Howey* common enterprise requirement.

What is a Security?

- Under the Howey test, profits can be either capital appreciation resulting from the development of the initial investment or a participation in earnings resulting from the use of investors' funds.

- Profits are income or return that investors seek on their investment, not the profits of the scheme in which they invest.

- Profits include, for example, dividends, other periodic payments, or the increased value of the investment. The determining factor under this prong of the Howey test is that the investor is "attracted solely by the prospects of a return" on his or her investment.

- In determining whether an investor was "attracted or led" by the expectation of profits, courts look at whether the promoter induced prospective investors with proposed or promised profits.

What is a Security?

- Although the term “note” is specifically enumerated in the Securities Acts' definitions of “security,” courts have not found all notes to be securities because notes are used in a variety of contexts.

- A note may function as both a commercial vehicle, which is not a security,3 as well as an investment vehicle, which courts have deemed to be a security.

- In Marine Bank v. Weaver, 455 U.S. 551 (1982), the U.S. Supreme Court addressed whether the sale of a $50,000 certificate of deposit, with a 6-year maturity that featured a 7.5% interest rate was a security.

- The note also provided that, if the bank permitted early withdrawal, the depositor would earn interest at the bank's current savings passbook rate on the amount withdrawn, except that no interest would be paid for the three months prior to withdrawal.

- The Court noted that while the definition of “security” in the Securities Exchange Act of 1934 (the “1934 Act”) is quite broad, Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.

What is a Security?

- The Court cautioned, however, "[t]he definition of 'security' in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires."

- The Court also noted that a certificate of deposit is not the functional equivalent of the withdrawable capital shares of a savings and loan association held to be securities, nor is it similar to any other long-term debt obligation commonly found to be a security.

- The purchaser of a certificate of deposit is virtually guaranteed payment in full, whereas the holder of an ordinary long-term debt obligation assumes the risk of the borrower's insolvency.

- The Court held neither the certificate of deposit nor the agreement in question was a security within the meaning of § 10(b) of the Securities Act.

SEC Regulation of Digital Assets

U.S. SECURITIES AND EXCHANGE COMMISSION

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Crypto Assets and Cyber Enforcement Actions

Crypto Assets

Action Name	Description	Date Filed
SEC v. Braga, et al.	The Securities and Exchange Commission today announced charges against Douver Torres Braga, Joff Paradise, Keleionalani Akana Taylor, and Jonathan Tetreault for their roles in Trade Coin Club, a fraudulent crypto Ponzi scheme that raised more than 82,000 bitcoin, valued at $295 million at the time, from more than 100,000 investors worldwide.	11/4/2022

SEC FinHub

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Initial Coin Offerings

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- Fireside Chats
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Spotlight on Initial Coin Offerings (ICOs)

Companies and individuals are increasingly considering initial coin offerings (ICOs) as a way to raise capital or participate in investment opportunities. While these digital assets and the technology behind them may present a new and efficient means for carrying out financial transactions, they also bring increased risk of fraud and manipulation because the markets for these assets are less regulated than traditional capital markets.

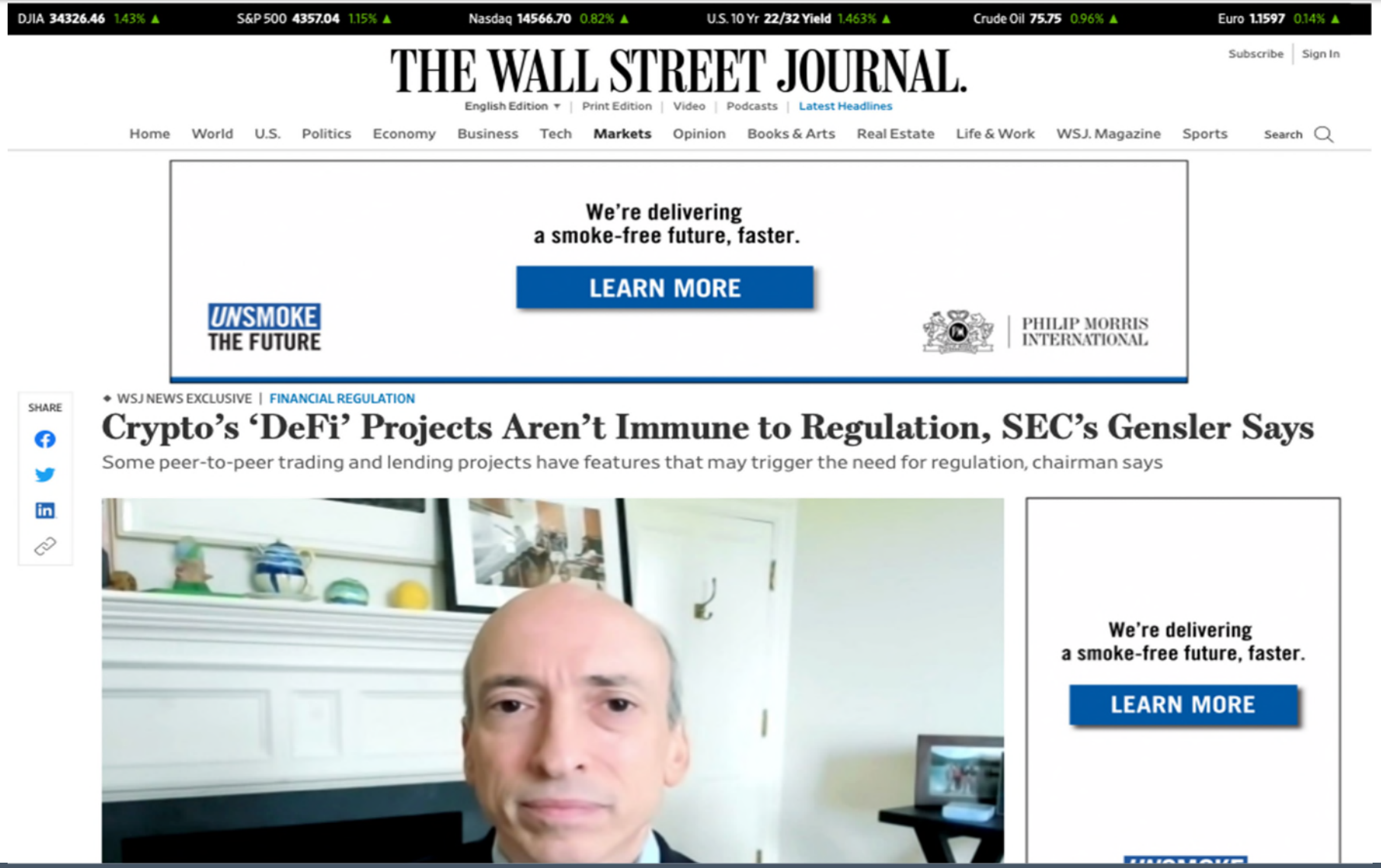
ICO Updates

SEC Charges Three Individuals in Digital Asset Frauds
Feb. 1, 2021

SEC Charges John McAfee With Fraudulently Touting ICOs

NELSON MULLINS

Decentralized Finance



DeFi

THE WALL STREET JOURNAL.

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MARKETS

Coinbase Says SEC Is Investigating Its Crypto Lending Program

Crypto company's chief executive criticizes regulator in series of tweets

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Stablecoins

The Washington Post
Democracy Dies in Darkness

Business

SEC's Gensler likens stablecoins to 'poker chips' amid call for tougher crypto regulation

The top Wall Street regulator described the digital assets frequently pegged to the U.S. dollar as a danger to consumers

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SEC Chairman Gary Gensler, who has been moving aggressively to impose tougher restrictions on cryptocurrency players, questioned whether digital assets will prove an enduring alternative to public currency. "History tells us that private forms of money don't last long," he said. (Washington Post Live)

By Tory Newmyer

Stablecoins

- On July 16, 2021, Treasury Secretary Yellen announced the formation of a Presidential Working Group to explore the regulation of stablecoins.

- The announcement noted:

  For the purposes of this statement, "stablecoins" are the digital assets themselves. A "stablecoin arrangement" includes the stablecoin as well as infrastructure and entities involved in developing, offering, trading, administering or redeeming the stablecoin, including, but not limited to, issuers, custodians, auditors, market makers, liquidity providers, managers, wallet providers, and governance structures.

- ***Depending on its design and other factors, a stablecoin may constitute a security, commodity, or derivative subject to the U.S. federal securities, commodity, and/or derivatives laws.***

- If so, the federal securities laws, and/or the Commodity Exchange Act ("CEA"), would govern the stablecoin itself, transactions in, and/or participants involved in the stablecoin arrangement.

- Whether a stablecoin is a security, commodity, or derivative will depend on the relevant facts and circumstances.

Exchanges

- Section 3(a)(1) of the Exchange Act defines an "exchange" as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange."

- Exchange Act Rule 3b-16(a) interprets the definition to mean any organization, association, or group of persons that: (1) ***brings together the orders of multiple buyers and sellers*** and (2) uses established, nondiscretionary methods (***whether by providing a trading facility*** or by setting rules) ***under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade***.

- Absent an exemption, an exchange must register as a national securities exchange pursuant to section 6 and section 19(a) of the Exchange Act.

- If a blockchain technology platform brings together multiple buyers and sellers of digital assets that are deemed securities, the platform could be required to register as a securities exchange unless it falls within an exclusion from registration.

Poloniex

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Press Release

SEC Charges Poloniex for Operating Unregistered Digital Asset Exchange

FOR IMMEDIATE RELEASE
2021-147

Washington D.C., Aug. 9, 2021 — The Securities and Exchange Commission today announced that Poloniex LLC has agreed to pay more than $10 million to settle charges for operating an unregistered online digital asset exchange in connection with its operation of a trading platform that facilitated buying and selling of digital asset securities.

The SEC's order finds that from July 2017 through November 2019, when Poloniex sold its platform, Poloniex operated a web-based trading platform that facilitated buying and selling digital assets, including digital assets that were investment contracts and therefore securities. According to the SEC's order, the Poloniex trading platform met the criteria of an "exchange" as defined by the securities laws because the trading platform provided the non-discretionary means for trade orders to interact and execute through the combined use of the Poloniex website, an order book, and the Poloniex trading engine. The order finds that notwithstanding its operation of the Poloniex trading platform, which was available to U.S. investors, Poloniex did not register as a national securities exchange nor did it operate pursuant to an exemption from registration at any time, and its failure to do so was a violation of Section 5 of the Exchange Act.

The SEC's order further finds that in or around August 2017, Poloniex employees stated internally that they wanted Poloniex to be "aggressive" in making available for trading new digital assets on the Poloniex trading platform, including digital assets that might be considered securities under the Howey test, in an effort to increase market share. Further, according to the SEC's order, in or around July 2018, Poloniex determined that it would continue to provide users of the Poloniex trading platform the ability to trade digital assets that it characterized as "medium risk" of being considered securities in light of the business rewards that would provide to Poloniex.

Related Materials

- SEC Order

Alternative Trading Systems

- In 1998, the SEC adopted Regulation ATS, which allows an ATS to choose whether to register as a national securities exchange or to register as a broker-dealer and comply with additional requirements of Regulation ATS.

- An "alternative trading system" means any organization, association, person, group of persons, or system: (1) that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Rule 3b-16 under the Exchange Act, and (2) that does not set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or discipline subscribers other than by exclusion from trading.

- A blockchain technology platform may be required by the SEC to register as an ATS if it maintains a marketplace or facilities for bringing together purchasers and sellers of digital assets that are deemed securities, and it does not set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such platform.

- If the platform is not required to register as an ATS, the operator of the platform may be required to register as a broker-dealer.

Broker-Dealers

- Section 15 of the Exchange Act requires registration with the SEC of all broker-dealers using interstate commerce or the facilities of any national securities exchange to effect transactions in securities (other than exempted securities and certain short-term debt instruments).
- Section 3(a)(4)(A) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."
- The Exchange Act and the rules thereunder do not define these terms.
- The courts and the SEC have taken an expansive view of the scope of these terms.
- The SEC and the courts apply a "facts and circumstances" analysis in evaluating whether a person has acted as a broker, with no single element being dispositive.
- Depending on the circumstances, the operator of a blockchain technology platform may be deemed a broker-dealer if the operator of the platform is deemed to be engaged in the business of effecting transactions in securities for the account of others.

Central Bank Digital Currencies

- CBDC is central bank-issued digital money denominated in the national unit of account that represents a liability of the central bank.
- If the CBDC is intended to be a digital equivalent of cash for use by end users (households and businesses), it is referred to as a "general purpose" or "retail" CBDC.
- As such, it offers a new option to the public for holding money. CBDC is different from cash, as it comes in a digital form unlike physical coins and banknotes.
- CBDC is also different from existing forms of cashless payment instruments for consumers such as credit transfers, direct debits, card payments and e-money, as it represents a direct claim on a central bank, rather than a liability of a private financial institution.

CBDC Models

Retail CBDC

- A retail CBDC would be a digital liability of a central bank that can be used by the public.
- A retail CBDC instrument would not be commercial bank money, credit cards, or mobile payment application balances because it would be a liability of the central bank.
- A retail CBDC would be different from traditional currency because it would only exist in digital form.[23]

Wholesale CBDC

- Wholesale CBDC is a digital liability of a central bank that is limited to certain financial institutions and is not available to the general public.
- Wholesale CBDC is designed for use by financial institutions and is similar to traditional central bank reserve and settlement accounts.

Presenter Biographies

KEVIN TRAN

Kevin assists clients in matters related to financial regulatory, FinTech, corporate and securities issues. He gained experience at the Federal Reserve Board in Washington, D.C., where he was a Financial Policy Analyst in the Capital and Regulatory Policy group in the Division of Supervision and Regulation. He also served the Board as the Policy Staff Adviser/Chief of Staff to the Deputy Director for Policy. In these roles, Kevin focused on developing regulations and guidance affecting banks and bank holding companies of all sizes, assisting the director with the day–to–day operations of the policy groups, and helping financial institutions and industry trade groups with regulatory interpretations.

RICHARD B. LEVIN

Richard is chair of the FinTech and Regulation Practice and was one of the first lawyers to focus on the regulation of blockchain and digital assets. He is considered a thought leader in the FinTech space. Richard brings his experience as a senior legal and compliance officer on Wall Street and in London to bear in advising clients on corporate, FinTech, securities, and regulatory issues. A problem-solver by nature, he has been advising FinTech clients on legal and regulatory issues since the start of electronic trading in the late 1990s. His practice focuses on helping financial services and technology clients identify and address regulatory issues as they build their businesses.

Richard's practice focuses on the representation of early stage and publicly traded companies in the FinTech space, including investment banks, broker-dealers, investment advisers, peer-to-peer lending platforms, digital currency trading platforms, alternative trading systems (ATSs), exchanges, and custodians. He represents these firms before the U.S. Securities and Exchange Commission (SEC), the U.S. Commodity Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA), the U.S. Department of the Treasury, Office of the Comptroller of the Currency (OCC), state regulators, and Congress. Richard has represented clients before regulators in Australia, Canada, France, Germany, Hong Kong, Ireland, Japan, Singapore, South Korea, and the United Kingdom. His current and past clients include leading national financial institutions, multinational financial services holding companies, leading firms in the FinTech space, and institutions engaging in global investment banking, investment management, securities, and other financial services with institutional clients.

Contact Details

To learn more about our FinTech and Regulation practice, or to contact a member of our team, click here or visit our website at nelsonmullins.com.

To learn more about this presentation, please call:

Kevin Tran
150 Fourth Avenue North
Suite 1100
Nashville, TN 37219
Tel. 615.664.5322
kevin.tran@nelsonmullins.com

Richard B. Levin
101 Constitution Ave., NW
Suite 900
Washington, DC 20001
Tel. 202.689.2845
richard.levin@nelsonmullins.com

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Appendix

- Letter from Sen. Elizabeth Warren and Sen. Richard Durbin to Sam Bankman-Fried and John Jay Ray III (November 16, 2022)
- Letter from Sen. Josh Hawley to Attorney General Merrick Garland, SEC Chair Gary Gensler, and CFTC Chair Rostin Behnam (November 18, 2022)
- Letter from Sen. Richard Durbin, Sen. Elizabeth Warren, and Sen. Tina Smith to Abigail Johnson (November 21, 2022)
- Letter from Sen. Elizabeth Warren and Sen. Sheldon Whitehouse to Attorney General Merrick Garland and Asst. Attorney General Kenneth Polite, Jr. (November 23, 2022)
- Letter from Sen. Sherrod Brown to Treasury Secretary Janet Yellen (November 30, 2022)
- US Senator Urges Congress to Pass Her Crypto Bill — Claims It Would've Prevented FTX Bankruptcy (Bitcoin.com) (December 6, 2022)