



Cryptocurrencies and the Blockchain: Compliance Challenges and Benefits



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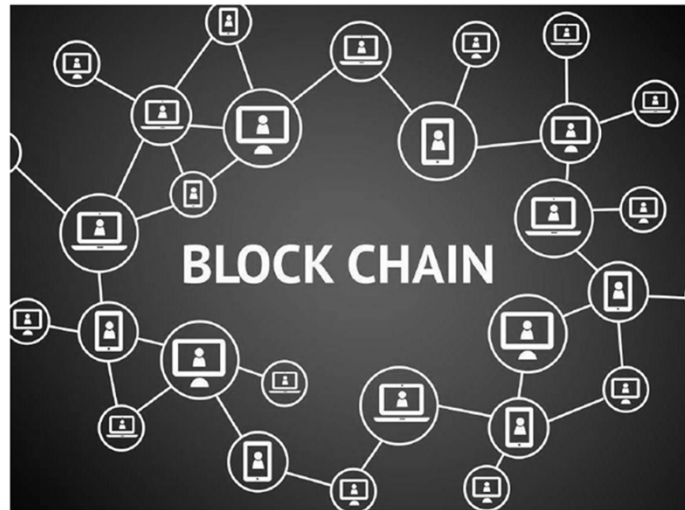
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2

Background

<https://www.youtube.com/watch?v=3xGLc-zz9cA>



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3

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What is a Virtual Currency?

- Although precise definitions offered by others are varied, an IRS definition provides us with a general idea:
 - “Virtual currency is a digital representation of value that functions as a **medium of exchange, a unit of account, and/or a store of value.**
 - In some environments, it operates like ‘real’ currency . . . but it **does not have legal tender status** [in the U.S.].
 - Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as ‘convertible’ virtual currency. **Bitcoin is one example of a convertible virtual currency.**
 - Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies.”[†]

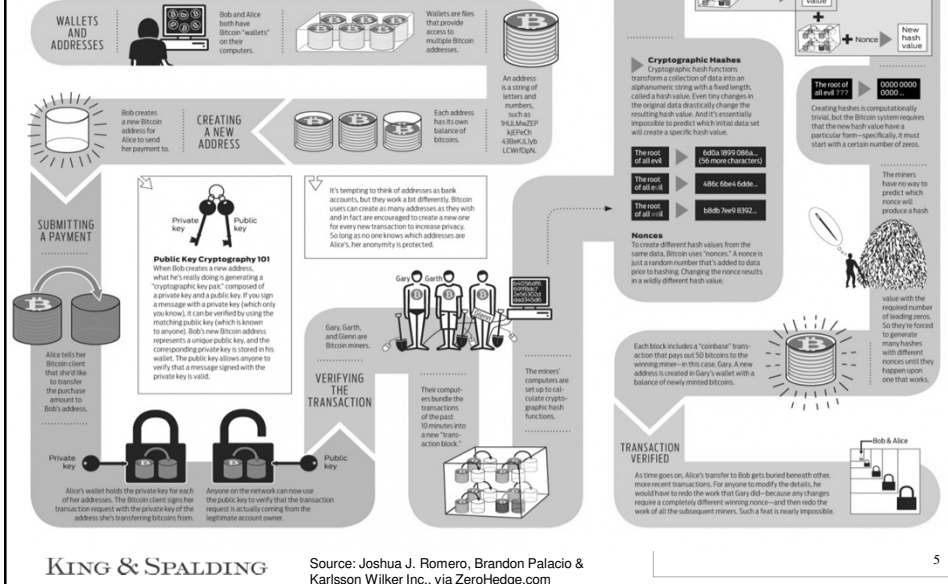
[†]IRS Notice 2014-21, available at <https://www.irs.gov/businesses/small-businesses-self-employed/virtual-currencies> (emphasis added). Please note that this definition is not a statement of the Commission's view, and is instead offered as an aid to enhance public understanding of virtual currencies. We further note that one prominent type of virtual currency is cryptocurrency. Cryptocurrency has been described as “an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party.” Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (Oct. 31, 2008), available at <https://bitcoin.org/bitcoin.pdf>.

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How a Bitcoin transaction works

Bob, an online merchant, decides to begin accepting bitcoins as payment. Alice, a buyer, has bitcoins and wants to purchase merchandise from Bob.



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Source: Joshua J. Romero, Brandon Palacio & Karlsson Wilker Inc., via ZeroHedge.com

5

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Sample Potential Use Cases of Blockchain/DLT Technology

Blockchain, or distributed ledger technology,* underpins many virtual currencies, but can also be used within private, permissioned ledger systems – versions of public and private systems may be used by:

- **Financial Institutions**
 - Trading & Payment Platforms / Clearing and Settlement
 - Regulatory Reporting, Compliance & Audit
 - Know Your Customer (KYC) / Anti-Money Laundering (AML)
 - Repurchase Agreement Transactions ("Repos," i.e., short-term borrowing of securities)
- **Governments**
 - General Records Management
 - Title & Ownership Records Management (e.g., real property deeds and title transfer)
 - Regulatory Reporting and Oversight
- **Cross-Industry**
 - Smart Contracts (i.e., self executing agreements)
 - Resource / Asset Sharing Agreements (e.g., allowing rental of a personal car left behind during a vacation or allowing rental of excess computer or data storage)
 - Digital Identity (e.g., proof of identity when entering into a contract)

* See generally Marco Iansiti and Karim R. Lakhani, *The Truth About Blockchain*, Harvard Business Review (Jan-Feb 2017), available at <https://hbr.org/2017/01/the-truth-about-blockchain> (for a general overview of how a public Blockchain works).

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6

Pros and Cons of Smart Ledgers and Smart Contracts

Pros	Cons
<ul style="list-style-type: none">• Efficient and effective• Anti-Corruption/FCPA and AML/KYC controls can be built in• Sanctions risks can be identified and monitored• Transactions can be tracked and audited	<ul style="list-style-type: none">• Controls defeated by anonymous, self-executing transactions• Smart contracts are only as smart as the design of the contract• Information sharing may carry corruption or collusion risk• Concerns about hacking and fraud

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7

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What is the Difference between Public and Private Ledger Systems?

- Certain virtual currencies operate on public distributed ledger systems that capture "blocks" of transactions – there is no inherent trust in this decentralized system.
 - Virtual currencies create an economic incentive for dispersed, independent, computers, or groups of computers, around the world to confirm transactions and perform verifiable "work" (that creates consensus) to publish a new block of transactions on the public ledger in exchange for a payment of the applicable virtual currency.
- Private / permissioned distributed ledger networks typically have some degree of trust between participants.
 - Private ledger systems allow a network of known participants to share transaction information between themselves more efficiently.
 - While cryptography and consensus may still be involved in private ledger systems, these systems do not necessarily involve a virtual currency that may serve as the economic incentive for miner or validator participation in public networks.

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8

Examples of Ways to Participate in Virtual Currency Markets

Participate in an initial coin offering	Otherwise invest in ICO tokens	Create an ICO token exchange
Accept/transmit ICO tokens	Create a virtual currency exchange	Accept/transmit virtual currency transactions (e.g., remittances, international payments)
Conduct other transactions over a blockchain (e.g., HSBC – Fx trades)	Purchase a target with virtual currency business/exposure	Traditional investment in blockchain venture companies

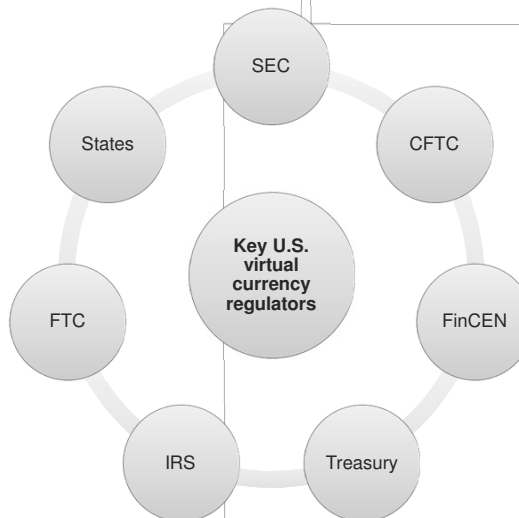
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9

Key U.S. Regulators

Still defining jurisdictional lines

- There is no single dedicated U.S. regulator
- Multiple regulators claim oversight of analogous markets that gives them oversight of crypto
 - SEC generally views tokens as “securities”
 - CFTC views virtual currencies as “commodities.”
 - FinCEN imposes KYC and AML restrictions on “money services businesses.”
 - U.S. Treasury Dep’t restricts transactions with sanctioned countries and individuals.
 - IRS views virtual currency as “property” (txn = capital gain/loss).
 - FTC monitors for deceptive marketing schemes.
 - FINRA oversees broker-dealers involved in crypto markets, follows SEC’s lead.
- U.S. States maintain own regulatory and licensing regimes, for e.g.:
 - NY Dep’t of Financial Services
 - NY Attorney General



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10

U.S. Securities and Exchange Commission (SEC)

Recent public statements and enforcement actions

- Through speeches, public statements, enforcement actions, and Congressional testimony, SEC has expressed view that tokens offered in ICOs are generally "securities" and therefore subject to U.S. securities laws requirements
- After the ICO, there are further considerations:
 - Trading restrictions on tokens (e.g., Reg S)
 - Ongoing reporting obligations
- Token exchanges must be registered (none yet in the U.S.)
- Token investors may be seen as Investment Companies
- Initial waves of subpoenas and information requests
- Numerous recent cases...

"[B]y and large, the structures of ICOs that I have seen involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws."

- Jay Clayton, SEC Chairman
(Feb. 6, 2018)



"Over time, there may be [...] sufficiently decentralized networks and systems where regulating the tokens or coins that function on them as securities may not be required."

- William Hinman, Corp. Fin. Director
(June 14, 2018)



"We have tried to strike the balance by being proactive and working collaboratively with experts both within the agency and outside of it. [...] We are very focused on considering – at the outset – whether and why pursuing a particular matter is a good use of our resources. [...] We are very focused on considering – at the outset – whether and why pursuing a particular matter is a good use of our resources."

- Stephanie Avakian, Enforcement Director
(Sept. 20, 2018)



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11

U.S. Securities and Exchange Commission (SEC)

Selection of cases filed (in addition to dozens of outstanding subpoenas and document requests)

Case	Date	Key Points
The DAO	July 25, 2017	Without bringing an enforcement action, the SEC issued a report, <u>establishing that the SEC views such tokens as "securities."</u> The SEC's report compared the tokens to "investment contracts" and evaluated them under the <i>Howey</i> test.
Munchee	Dec. 11, 2017	SEC staff contacted Munchee on the second day of their ICO. The <u>company determined within hours to stop its offering</u> , did not ultimately deliver any tokens, and returned the proceeds it had received.
Recoin	Sept. 11, 2018	Maksim Zaslavskiy and his two companies, REcoin and Diamond Reserve Club, sold unregistered tokens purportedly backed by real estate and diamonds. The SEC obtained an emergency asset freeze. In a parallel criminal case, an E.D.N.Y. judge held that a <u>reasonable jury could find the tokens were securities</u> .
TokenLot	Sept. 11, 2018	TokenLot and its founders operated an "ICO Superstore" for ICO sales and secondary trading of more than 200 digital tokens. This was the SEC's first case charging an <u>unregistered broker-dealer</u> for selling digital tokens.
Crypto Asset Management	Sept. 11, 2018	Hedge fund CAM invested more than 40% of funds in digital assets and claimed (falsely, according to the SEC) to be registered with the Commission. This was the first case alleging a <u>digital asset fund manager failed to register as an investment company</u> .
Coburn (EtherDelta)	Nov. 8, 2018	Zachary Coburn, the founder of EtherDelta, was charged in the first enforcement action against a digital token platform for operating as an <u>unregistered national securities exchange</u> .
CarrierEQ / Paragon Coin	Nov. 16, 2018	In two cases announced on the same day, the SEC established a <u>framework for settling cases against unregistered ICOs</u> , which included: (1) compensating token purchasers, (2) registering the tokens as securities, (3) <u>limiting periodic reports</u> with the Commission for a period of time, and (4) paying civil monetary penalties.

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12

U.S. Commodity Futures Trading Commission (CFTC)

Regulating virtual currency futures, options, swaps, and other markets

- On Mar. 6, 2018, a federal judge ruled that virtual currencies are "commodities" under the Commodity Exchange Act.
- It appears that CFTC's jurisdiction overlaps with the SEC's with respect to schemes involving thinly traded virtual currencies.
 - The CFTC has broad authority over some markets: commodity futures, commodity options, and swaps.
 - The CFTC has more narrow anti-fraud/anti-manipulation authority over commodity spot, cash, and forward markets, including fraudulent conduct involving crypto spot transactions.
 - The CFTC also has narrow authority over retail commodity transactions with retail investors where some leverage is involved and where actual delivery does not occur within 28 days.
- In its own enforcement actions, the CFTC has:
 - Obtained preliminary injunction against virtual currency investment company alleged to have defrauded customers (CabbageTech)
 - Charged unregistered Bitcoin futures exchanges (BitFinex)
 - Issued proposed guidance on what is a derivative market, versus a spot market in the virtual currency context
- On Dec. 11, 2018, the CFTC published a request for input regarding "similarities and distinctions between certain virtual currencies, including here Ether and Bitcoin, as well as Ether-specific opportunities, challenges, and risks."

"...the CFTC, working closely with the SEC and other fellow financial enforcement agencies, will aggressively prosecute bad actors that engage in fraud and manipulation regarding virtual currencies."

- J. Christopher Giancarlo, CFTC Chairman
(Feb. 6, 2018)



"When market participants engage in fraud under the guise of offering digital instruments – whether characterized as virtual currencies, coins, tokens, or the like – the SEC and the CFTC will look beyond form, examine the substance of the activity and prosecute violations of the federal securities and commodities laws."

- Joint statement from
CFTC and SEC Enforcement Directors
Reaches Virtual Currency
Enforcement Action
(Jan. 19, 2018)



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13

U.S. Financial Crimes Enforcement Network (FinCEN)

Staking out an early position

- First U.S. regulator to address Bitcoin in part because the agency already had experience with Liberty Reserve, another digital currency system allegedly used to support trade in illegal goods and services.
- In March 2013, FinCEN released an interpretation directing that exchangers and administrators of virtual currencies were required to register as money services businesses; ordinary users were excluded.
- FinCEN has also started expanding its definition of a money services business to include virtual currency exchanges and virtual currency platforms that act as intermediaries.
- Like with many other federal regulatory actions, they claim jurisdiction on the basis of transactions that find their way through U.S. servers.
- FinCEN now receives more than 1,500 SARs per month that involve virtual currency.

➤ FinCEN Director Kenneth Blanco, Aug. 9, 2018

Key Enforcement Actions:

Ripple Labs, Inc. (May 5, 2015): FinCEN assessed a \$700,000 civil money penalty for willfully failing to register as a money services business, failing to implement an adequate AML program, and failing to file SARs in connection with multiple incidents. Ripple consented to FinCEN's assessment in connection with a settlement entered with the U.S. Attorney's Office for the Northern District of California related to the same misconduct.

BTC-e and Alexander Vinnik (July 26, 2017): FinCEN assessed a \$110 million penalty against the exchange BTC-e and a \$12 million penalty against its principal, Vinnik, in connection with allegations of willful failure to register as an MSB, willful failure to implement an adequate AML program, and willful failure to file SARs. BTC-e allegedly tried to conceal that it was servicing customers in the United States.

- breaches cost American
companies more than
\$100Bn

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14

Other Key U.S. Regulators

Treasury	<ul style="list-style-type: none"> Announce it may add virtual currency addresses to its sanctions list if officials can tie them to a blacklisted person (and later did so for two Iranian actors). —Wants to use sanctions in the fight against bad actors abusing currencies and has banned U.S. transactions in Venezuela's Petro. August 20 FinTech report encouraged harmonizing state money-transmitter laws and creation of a regulatory sandbox.
IRS	<ul style="list-style-type: none"> Views virtual currencies as property, rather than currency, which means it is subject to capital gains income taxes. Arguably every transaction involving virtual currency results in capital gain/loss. IRS Commissioner Rettig flagged cryptocurrency in his first public speech.
FTC	<ul style="list-style-type: none"> Maintains a Blockchain Working Group to build expertise, facilitate communication and coordination on enforcement actions, and serve as a forum for brainstorming potential impacts on the FTC's dual missions to protect consumers and promote competition. Has also brought enforcement actions against "chain referral schemes" involving virtual currencies.
States	<ul style="list-style-type: none"> States maintain separate regulatory and money transmission licensing regimes. —Some exploring the possibility of obtaining a national bank license. —NYDFS BitLicense; issued subpoenas in August 2017 —NYAG issued <i>Virtual Markets Integrity Initiative Report</i> in September 2018 —NY established a crypto task force to report by Dec. 15, 2020

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15

Virtual Currency Regulation in Other Counties

International treatment of Bitcoin and other virtual currencies

Country	Key Points
Japan	In 2017 Japan approved 11 companies to operate as virtual currency exchanges, and in October 2018 gave the country's cryptocurrency industry self-regulatory status. Japan is also the location of several of the largest virtual currency exchange failures ever, including a breach in September resulting in theft of \$60 million in virtual currency.
South Korea	The third largest market for virtual currencies in 2017. South Korea announced in January 2018 that it would ban all trading. After a public backlash, the country reversed and announced plans to normalize and regulate trading, including security audits of several exchanges in late 2018.
United Arab Emirates	UAE regulators have issued warnings to consumers regarding unregulated ICOs, but they have not sought to ban cryptocurrency transactions or new ICO offerings. In October, the UAE announced plans for new rules that will allow domestic companies to raise funds through ICOs.
Brazil	In September, Brazil's antitrust regulator began investigating whether the country's banks were abusing power as financial players by improperly closing brokerage accounts trading in Bitcoin.
China	Because Bitcoin and other cryptocurrencies represented a threat to China capital controls, in 2017 the country shut down several major exchanges and banned new ICOs in the country. Before this move, China had been the number one market in the world for buying and selling Bitcoin. China remains a major player in Bitcoin mining.
Russia	Russian officials initially proposed a ban of virtual currencies. Since 2017, this tone has changed, and Vladimir Putin has made comments encouraging greater virtual currency adoption. Official regulation is still pending.
Switzerland	Businesses and government offices in Switzerland have worked to establish Switzerland as a leader in adoption of virtual currency. The Swiss town of Zug, referred to as "Crypto Valley," accepts tax payments in Bitcoin. Swiss regulators have issued frameworks for ICOs.
United Kingdom	In September, U.K. Parliament (Treasury Committee) published a report on Digital Currencies Inquiry, calling for regulation of the "Wild West" crypto market. In October, the U.K. established a joint Cryptoassets Taskforce (H.M. Treasury, Financial Conduct Authority, Bank of England) published its own report, committing the agencies to clarify jurisdiction over cryptoassets, to potentially ban the sale of crypto derivatives to retail investors, to explore how tokens, exchanges, and wallet providers should be regulated, and to address crypto-related illicit activities.

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16

Risk Mitigation

- Conduct risk assessment: is crypto or blockchain being used?
- Evaluate existing internal controls
- Implement or update/revise policies to address inherent risks
- Build in “smart” controls to monitor for signs of improper payments, money laundering, or other concerns
- Train employees
- Remember anti-corruption/FCPA and AML/KYC basics
- Stay informed and up-to-date – fast moving and always evolving

Conclusion

THANK YOU



Those 1,000 data breaches cost American companies more than \$100Bn