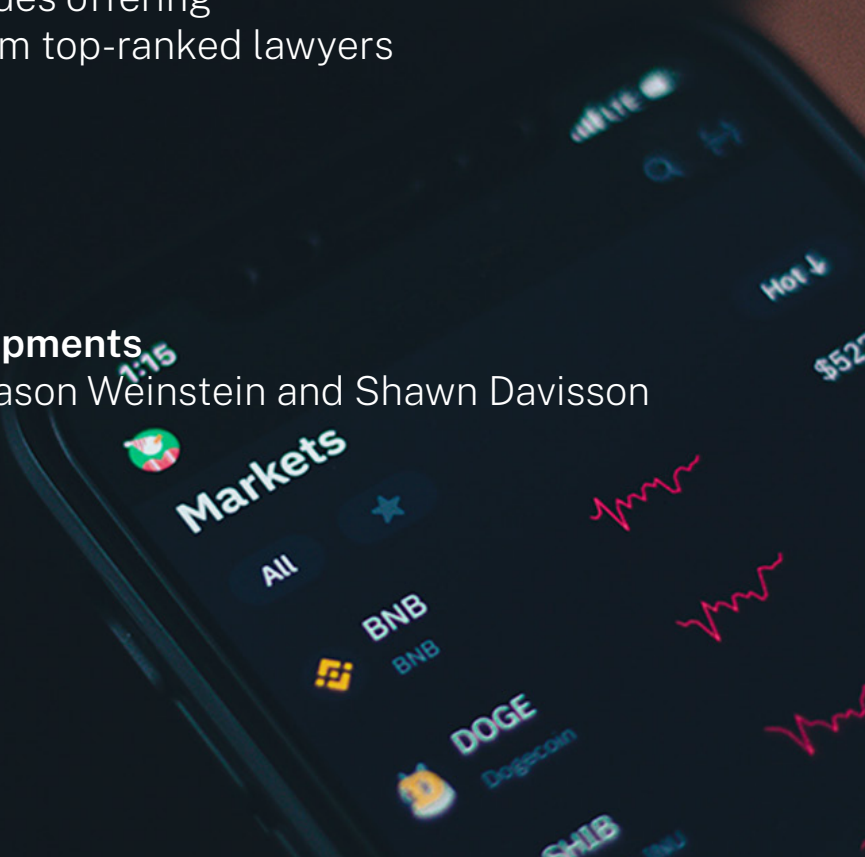

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Blockchain 2023

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USA: Trends and Developments

Alan Cohn, Galen Kast, Jason Weinstein and Shawn Davisson
Steptoe & Johnson LLP



Trends and Developments

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Steptoe & Johnson LLP

Steptoe & Johnson LLP has earned an international reputation for vigorous representation of clients before governmental agencies, successful advocacy in litigation and arbitration, and creative and practical advice in structuring business transactions. Steptoe's blockchain and cryptocurrency team combines legal and regulatory experience across dozens of practices with industry-specific knowledge to advise clients navigating the complex legal and regulatory environment surrounding cryptocurrencies and crypto-assets in the United States and across the globe. The firm's multidisciplinary

blockchain team is made up of lawyers with a depth of experience in anti-money laundering, economic sanctions and countering terrorism financing compliance, commodities and derivatives regulation, securities regulation (including issuers, exchanges and investment companies), tax law, public policy and government enforcement issues. Steptoe has more than 500 lawyers and other professional staff across offices in Beijing, Brussels, Chicago, Hong Kong, London, Los Angeles, New York, San Francisco and Washington, DC.

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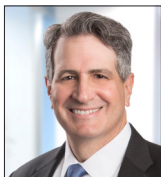
cryptocurrency companies to legal issues associated with novel uses of blockchain technology. His clients include cryptocurrency trading platforms, investment funds, start-ups developing new blockchain protocols, and corporations interested in exploring potential applications of blockchain technology. He helped found Steptoe's blockchain and cryptocurrency practice, and serves as its co-chair. Alan also serves as counsel to the Blockchain Alliance, a public-private forum comprised of a broad coalition of companies, organisations and government agencies dedicated to helping combat criminal activity on the blockchain.



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Blockchain in the USA: 2022–2023 Developments

The blockchain and digital asset universe experienced a series of unprecedented events from mid-2022 through early 2023 that will continue to shape the digital asset landscape, including:

- a new “crypto winter” caused by the cascading collapse of multiple digital asset-related entities;
- resultant aggressive enforcement by the Department of Justice (DOJ), the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC);
- new executive and agency attention to digital assets; and
- increased focus on digital asset-related legislative solutions.

These events are likely to continue to reverberate in 2023 and beyond, including through:

- a new effort by bank regulators to “shadow ban” crypto companies from obtaining banking services, often referred to as Operation Choke Point 2.0;
- continued interagency turf battles;
- continued aggressive enforcement by DOJ, the SEC and the CFTC; and
- a reinvigoration of digital asset legislation in the 118th Congress.

2022–2023 Blockchain Year in Review *Cascading collapses*

2022 saw the onset of a new crypto winter, during which cryptocurrencies including Bitcoin, Ethereum and others dropped in value by more than 50%, alongside a similarly significant drop in the value of many non-fungible tokens (NFTs). Perhaps the biggest driver of this loss of market confidence was a cascading series of collapses

and investor losses beginning in May 2022, which then continued through the remainder of the year.

LUNA

If there was a ground zero for the cataclysmic events of 2022, it was the collapse of the algorithmic stablecoin TerraUSD (UST) and its sister token LUNA in May 2022, resulting in the loss of approximately USD40 billion in investor funds, and a more than 99% reduction in the value of the LUNA token. The crash of UST and LUNA sent shockwaves throughout the industry, triggering crises at entities that were significantly exposed to UST/LUNA and at counterparties of such entities.

Three Arrows Capital

The first domino to fall after the LUNA crash was Three Arrows Capital (3AC). 3AC had significant exposure to LUNA, and the collapse of LUNA and the subsequent reduction in the value of 3AC’s investments resulted in a margin call 3AC was unable to satisfy. As a result, in June 2022, 3AC was ordered to liquidate by a court in the British Virgin Islands. 3AC subsequently filed for bankruptcy in the Southern District of New York (SDNY), at which time the fund owed approximately USD3.5 billion to over 25 creditors, according to court documents.

Voyager Digital

The next month, crypto brokerage firm Voyager Digital collapsed, due in part to exposure to 3AC. Voyager allowed users to deposit cryptocurrency in exchange for yields as high as 12%. In turn, Voyager lent user funds to traders and institutions, including 3AC. 3AC was Voyager’s largest counterparty, and was the recipient of a USD650 million unsecured loan. Following 3AC’s collapse and the broader market downturn, Voy-

ager filed for bankruptcy in the SDNY on 6 July 2022.

Celsius Network

Also in July 2022, virtual currency lender Celsius Network collapsed. Celsius similarly allowed users to deposit cryptocurrency, which Celsius in turn lent to others, in return for a significant annual percentage yield of up to 17%. Following the LUNA crash and the collapse of 3AC, Celsius Network depositors began withdrawing funds en masse at a rate Celsius was ultimately unable to satisfy, resulting in Celsius freezing customer transactions and filing for bankruptcy.

FTX and Alameda

Four months later, on 11 November 2022, FTX Trading Ltd. filed for Chapter 11 bankruptcy protection. FTX had formerly operated one of the largest and most popular cryptocurrency exchanges, and operated alongside quantitative cryptocurrency trading firm Alameda Research. The sudden collapse of FTX further destabilised the crypto industry, and its effects continue to be felt well into 2023. According to charges later filed by DOJ, FTX founder Sam Bankman-Fried misappropriated FTX customer funds to cover losses incurred by Alameda, among other offences.

The collapse of FTX and the crimes allegedly committed by Bankman-Fried were particularly jarring in Washington, where Bankman-Fried had cultivated an image as a paragon of compliance and had been well regarded by many on Capitol Hill. Many government officials who had embraced Bankman-Fried felt burned, and the result was increased demagoguing among some in Congress against the entire cryptocurrency industry.

DOJ, SEC and CFTC enforcement

The past year has been marked by remarkably aggressive enforcement activity. DOJ, the SEC and the CFTC have individually and collectively accelerated enforcement activity in the digital asset space.

The most prominent case brought by DOJ was FTX, where DOJ charged Bankman-Fried with 13 offences relating to his operation of the exchange and secured guilty pleas from three former FTX or Alameda executives (Gary Wang, Caroline Ellison and Nishad Singh). The SEC and CFTC brought parallel enforcement actions against FTX and Bankman-Fried, among others.

The same was true in the case against Do Kwon. On 16 February 2023, the SEC charged Terraform Labs PTE Ltd. and Do Kwon with the offer and sale of unregistered securities. The SEC complaint also alleged that Terraform and Do Kwon “engaged in a fraudulent scheme to mislead investors about the Terraform blockchain” and on-chain assets, including through repeated claims that certain tokens would increase in value. The complaint further alleged that they failed to provide full disclosure regarding certain assets, such as Terra protocol tokens LUNA and TerraUSD, which the SEC alleged are securities. On 23 March 2023, Do Kwon was arrested in Montenegro and subsequently charged by DOJ with eight criminal counts of fraud and conspiracy.

But perhaps the most important US enforcement development has been the dramatic escalation of the SEC’s campaign to regulate the digital asset industry by enforcement.

Wahi

In parallel proceedings on 21 July 2022, DOJ and the SEC initiated actions based on an alleged

insider trading scheme against Ishan Wahi, a former product manager for Coinbase Global, Inc. (Coinbase), Ishan's brother Nikhil Wahi, and a friend. The SEC complaint alleged that the defendants used confidential information regarding digital assets that Coinbase planned to list, as well as the timing of listing announcements, to make trading profits of at least USD1.5 million. The SEC complaint was notable because the SEC specifically alleged that several of the relevant digital assets were securities, and thus subject to federal securities laws, but without engaging with, or bringing any actions against, the issuers of those tokens or otherwise giving them an opportunity to defend themselves. In short, with Wahi the SEC moved from "regulation by enforcement" to "regulation by enforcement against someone else".

DOJ's indictment charged the defendants with wire fraud and conspiracy to commit wire fraud, in what prosecutors called the first insider trading case involving cryptocurrency. Notably, however, the indictment did not refer to the assets as securities. DOJ eventually secured wire fraud guilty pleas from the two Wahi brothers.

Despite pleading guilty to the criminal charges, the defendants challenged the SEC's parallel civil charges, arguing that securities laws do not apply to the crypto-assets in question. In a motion to dismiss filed on 6 February 2023, the defendants accused the SEC of "trying to seize broad regulatory jurisdiction over a massive new industry via an enforcement action", and argued that the SEC should engage in rulemaking if it believes that digital assets are securities.

In light of the significant implications of the SEC's expanding view that secondary trades in crypto tokens should be considered SEC-regulated transactions involving investment

contracts, it is unsurprising that there were a number of amicus briefs filed in the case. For example, the Blockchain Association filed a brief challenging the SEC's approach of seeking to apply the securities laws to tokens without any formal SEC action or court ruling. The Blockchain Association brief also argued that "the SEC is engaging in regulation by enforcement against absent third parties", in reference to the SEC's labelling of various crypto tokens as securities, which could impair their value and impact secondary market trading. The Investor Choice Advocates Network filed an amicus brief arguing that the SEC exceeded its statutory authority in attempting to regulate digital assets. Likewise, the Chamber of Digital Commerce filed an amicus brief urging dismissal of the case, which the Chamber called a "dramatic overreach by the SEC".

On 30 May 2023, the SEC released proposed settlements with Ishan and Nikhil Wahi. Notably, the settlements do not require either defendant to pay a penalty independent of the defendants' disgorgement in the parallel criminal matters, and do not address the security status of any of the tokens alleged in the SEC complaint to be securities.

Kraken

In February 2023, the SEC charged Payward Ventures Inc. and Payward Trading Ltd., the entities behind the Kraken exchange, with the unlawful offer and sale of Kraken's crypto-asset staking services. On 9 February 2023, the SEC announced that Kraken had settled charges alleging that it violated securities laws, agreeing to pay USD30 million in fines and to discontinue offering its staking service to US customers.

Bittrex

On 17 April 2023, the SEC filed a complaint against Bittrex Inc. and Bittrex Global, alleging that the former had been operating as an unregistered national securities exchange, broker-dealer and clearing agency, and the latter as an unregistered exchange, since 2014. In a similar fashion to its Wahi complaint, the SEC's complaint against Bittrex alleged that six crypto-assets traded on the Bittrex exchange constituted securities, and engaged in a Howey analysis of the crypto-assets in question. Shortly after the SEC complaint was filed, Bittrex Inc. shut down its operations and declared bankruptcy. Bittrex Global indicated that it plans to continue its operations, servicing customers outside of the US.

Binance

On 27 March 2023, the CFTC filed a complaint against Binance, alleging that the company actively solicited US users and subverted the exchange's own "ineffective compliance program" in offering crypto derivatives, such as futures or options contracts, with leverage for assets such as Bitcoin, Ether and Litecoin. According to the complaint, Binance encouraged employees to communicate with US-based customers via auto-deleting messaging applications, and instructed customers on how to evade Binance's prohibition on US customers, including through the use of virtual private networks that obscured customers' locations. Among other violations, the complaint alleges that Binance failed to register with the CFTC as a futures commission merchant, designated contract market or swap execution facility. Notably, the CFTC identified BUSD as a commodity, which runs counter to a determination reached by the SEC a few months later.

On 5 June 2023, the SEC followed suit and filed its own complaint against Binance, BAM Trading and Binance's founder, Changpeng Zhao, alleging, among other things, that:

- Binance subverted its compliance controls to secretly allow VIP US customers to trade on Binance.com, despite publicly prohibiting US customers;
- Zhao and Binance.com secretly exercised control over Binance.US, the ostensibly independent trading platform for US investors; and
- Zhao and Binance improperly exercised control over the platforms' customer assets.

According to the complaint, Zhao and Binance "consciously chose to evade [SEC rules] and put their customers and investors at risk", and "attempted to evade U.S. securities laws by announcing sham controls they disregarded behind the scenes" in an effort to "keep high-value U.S. customers on their platforms". The complaint alleges, among other things, that:

- Binance and BAM Trading failed to register with the SEC as a national securities exchange, broker-dealer and clearing agency;
- BAM Trading defrauded investors about purported surveillance and controls over manipulative trading on the Binance.US platform that were non-existent; and
- Binance and BAM Trading sold BNB Coin and BUSD as unregistered securities.

Similar to the approach started in Wahi, the SEC identified ten crypto-assets allegedly offered and sold as investment contracts on the Binance platform, and included a Howey analysis for each asset.

Coinbase

On 23 March 2023, Coinbase received notice that the SEC planned to pursue an enforcement action against the exchange regarding the listing of unregistered securities. The notice came after extensive – but ultimately futile – efforts by Coinbase to seek constructive engagement with, and regulatory clarity from, the SEC. In a defiant response, Coinbase sued the SEC on 24 April 2023 to compel the SEC to rule on its July 2022 rulemaking petition, asking the SEC to provide guidance for the crypto industry through rulemaking. Additionally, on 27 April 2023, Coinbase maintained that it does not “list, clear, or effect trading in securities”, and argued that the SEC’s legal justification for a potential enforcement action “appears to rest on superficial and incorrect analogies to products and services offered by others”.

On 6 June 2023, the SEC filed a complaint against Coinbase, according to which Coinbase made billions of dollars by buying and selling crypto securities without registering with the SEC. The complaint alleges that Coinbase’s failure to register as a national securities exchange, broker-dealer or clearing agency “deprived investors of significant protections, including inspection by the SEC, recordkeeping requirements, and safeguards against conflicts of interest, among others”.

Ooki DAO

On 22 September 2022, the CFTC issued an order filing and settling charges against blockchain-based software company bZeroX, LLC (bZx) and its founders. According to the CFTC, the activities of the decentralised blockchain protocol operated by bZx required the company to register as a designated contract market or futures commission merchant with the CFTC, which bZx failed to do.

The CFTC simultaneously filed a federal civil enforcement action in district court against bZx’s successor, Ooki DAO (a decentralised autonomous organisation), as the current operator of the protocol, for the same violations. There has been controversy surrounding the action against Ooki DAO based on the CFTC’s theory that all token holders who voted for the operation of the protocol could be held liable for violations of the Commodity Exchange Act and CFTC regulations. On 8 June, a federal judge entered a default judgment order requiring Ooki DAO to pay a monetary penalty of over USD643,000, imposing a permanent trading and registration ban, and directing the DAO and any third party providing web-hosting or domain name registration services to shut down the DAO’s website. In doing so, the court – without opposition, since there was no defendant to appear in court – held that the DAO constituted a “person” under the Commodity Exchange Act and could be held accountable for violations of that statute.

White House framework and agency reports on digital assets

The White House’s rhetoric on digital assets also appeared to be influenced by the events of 2022. On 16 September 2022, the Biden Administration released the first comprehensive framework for the responsible development of digital assets. The framework was informed by nine reports submitted to the White House by various agencies in response to President Biden’s 9 March 2022 Executive Order on Ensuring Responsible Development of Digital Assets (EO 14067). The White House Framework identified four key steps that the Biden Administration plans to take in this area, including:

- encouraging SEC and CFTC investigation and enforcement;

- encouraging the enforcement and monitoring of consumer complaints by the Consumer Financial Protection Bureau and the Federal Trade Commission;
- encouraging the issuing of guidance and rules by agencies to address digital asset-related risks; and
- the launching of a public awareness campaign on digital asset risks.

Among the agency reports issued in response to EO 14067, DOJ's report – entitled "The Role of Law Enforcement in Detecting, Investigating, and Prosecuting Criminal Activity Related to Digital Assets" – offered a range of legislative and regulatory recommendations, focusing on enhancing efforts to address digital asset-related crime. DOJ also announced the creation of the Digital Assets Coordinators Network (DAC Network), comprised of over 150 federal prosecutors focused on combatting digital asset-related crime and led by the National Cryptocurrency Enforcement Team (NCET).

For its part, the Treasury Department issued three reports in response to EO 14067. One of the reports, titled "Crypto-Assets: Implications for Consumers, Investors, and Businesses", discussed the opportunities and risks associated with digital assets, and provided recommendations to enhance consumer protection. Another Treasury report, titled "Action Plan to Address Illicit Financing Risks of Digital Assets", set forth seven broad "Priority Actions" – along with specific supporting actions under each broader category – that the government is committed to taking in order to combat illicit finance involving digital assets.

In March 2023, the White House also released its annual Economic Report of the President, which for the first time included a chapter on

digital assets. The report strongly criticised the utility of crypto-assets in the marketplace, and emphasised the need for compliance with existing regulatory regimes, despite the widespread absence of regulatory guidance for crypto entities seeking to comply. The report also aligned with SEC Chairman Gary Gensler's view that most digital assets are securities, stating that "[m]uch of the activity in the crypto asset space is covered by existing regulations and regulators are expanding their capabilities to bring a large number of new entities under compliance".

Legislation introduced during the 117th Congress

The 117th Congress saw a number of legislative proposals aimed at the regulation of cryptocurrency and other digital assets, with several bills seeking to advance a consumer-protection-focused framework garnering bipartisan support. While numerous proposals were introduced, the three bills highlighted in this section generated some of the most significant discussion prior to the end of the legislative session.

The Lummis-Gillibrand Responsible Financial Innovation Act (RFIA)

The RFIA was introduced by Senators Kirsten Gillibrand (D-NY) and Cynthia Lummis (R-WY) on 7 June 2022. It creates a comprehensive regulatory framework for digital assets, and specifically provides regulatory authority over digital asset spot markets and newly established digital commodity exchanges to the CFTC. The RFIA also:

- addresses issues arising under the Internal Revenue Code;
- establishes a digital asset-specific disclosure regime regulated by the SEC;
- codifies consumer protection standards as applied to customers in digital assets;

- provides for comprehensive regulation of payment stablecoins;
- establishes related requirements for federal financial regulators; and
- provides direction on interagency co-ordination and co-operation relating to rulemaking and research in connection with the digital asset sector.

The Digital Commodities Consumer Protection Act of 2022 (DCCPA)

The DCCPA was introduced by Senators Debbie Stabenow (D-MI) and John Boozman (R-AR) in August 2022. It provides the CFTC with the authority to regulate the trading of digital commodities, filling the regulatory gap by applying existing standards to a new “digital commodity” asset class and expanding the jurisdiction of the CFTC to include the regulation of digital commodity spot markets. The DCCPA requires all digital commodity platforms and companies to register with the CFTC through newly defined registration categories.

The Waters-McHenry Stablecoin Bill

The Waters-McHenry Bill was the centre of negotiations among former House Financial Services Committee (HFSC) Chair Maxine Waters (D-CA), current HFSC Chair Patrick McHenry (R-NC) and the Treasury Department since mid-2022, though it was not introduced in the House during the 117th Congress. The Waters-McHenry Bill provides a comprehensive regulatory framework for payment stablecoins, including a licensing regime that allows the issuance of payment stablecoins by three types of entities:

- subsidiaries of an insured depository institution;
- non-bank entities licensed by the Federal Reserve; and
- state-qualified payment stablecoin issuers.

As discussed below, the Waters-McHenry Bill was expected to be introduced in the 118th Congress.

Looking Forward to 2023 and Beyond *Operation Choke Point 2.0*

2023 began with yet another series of unprecedented events, as shockwaves that at first appeared limited to crypto-specific entities gathered speed and were fuelled by parallel macro-economic events, including rapid interest rate increases by the Federal Reserve Board and a commensurate cooling of the crypto and broader innovation economy.

In March 2023, three significant US banks failed over a span of five days, all three of which operated as crucial banking partners for crypto-related businesses. On 8 March 2023, Silvergate Bank announced plans to wind down and liquidate, due in part to its crypto exposure. Specifically, Silvergate suffered asset losses following the 2022 post-LUNA collapses and general crypto market turbulence, triggering a bank run that led to its collapse. Silvergate’s demise further destabilised already fragile financial markets, especially for those firms that catered to crypto businesses.

Shortly thereafter, Silicon Valley Bank – the preferred bank for many venture capital-backed start-ups in the tech industry, including some crypto companies– experienced a bank run, resulting in its collapse on 10 March 2023. Two days later, Signature Bank (another regional bank) experienced a bank run due to customer withdrawals following the collapse of Silicon Valley Bank, and was closed by its regulator.

Many members of the industry have pointed to evidence of a co-ordinated effort among banking regulators to discourage banks from engag-

ing in crypto-related activities or doing business with crypto firms, in an effort that has been dubbed “Operation Choke Point 2.0” (“Operation Choke Point” was, an effort during the Obama Administration to choke off banking services to businesses such as payday lenders that the administration feared were harming consumers). Whether or not it is part of a co-ordinated campaign, there is no question that regulators have made the banking environment for digital asset companies significantly more challenging – only compounding the economic and regulatory pressures the industry was already confronting after the events of 2022 and early 2023.

Continued enforcement – and regulation by enforcement

While the digital asset landscape continues to change rapidly, one thing is certain: DOJ and other federal agencies will continue aggressive enforcement against digital asset platforms and actors. Indeed, unless and until the courts or Congress put a stop to it, the SEC is expected to continue its regulation by enforcement campaign, engaging in continued jurisdictional turf grabs. And the SEC and CFTC will continue to assert jurisdiction over the same digital assets – a turf war that can likely only be resolved by Congress.

Legislative progress in the 118th Congress?

In March 2023, Senator Lummis announced a plan to introduce a revamped version of the RFIA as early as April 2023. At the time of writing, the RFIA has not yet been introduced in the 118th Congress. Similarly, the DCCPA has not been reintroduced, although Senators Stabenow and Boozman indicated continued enthusiasm for the DCCPA during a December 2022 hearing before the Senate Agriculture Committee on the collapse of FTX. It is possible that the DCCPA

has received less traction due to its public support from Bankman-Fried.

On 2 June 2023, the HFSC and House Agriculture Committee released a draft proposal to create a regulatory regime for digital assets.

- First, the discussion draft creates a new exemption from registration for the sale of digital assets pursuant to an investment contract with important investor protection provisions, including an aggregate offering limit, individual investment limits for non-accredited investors, tailored initial and ongoing disclosure requirements, and limitations on resales by insiders.
- Second, the discussion draft provides for the secondary trading of these restricted digital assets on alternative trading systems (ATSs), and directs the SEC to modernise Regulation ATS in key ways. The current issue of digital asset securities not being permitted to trade against non-security digital assets would be resolved by requiring ATSs to be allowed to trade restricted digital assets, digital commodities and payment stablecoins on the same platform. Additionally, Regulation ATS would be amended to accommodate the benefits of blockchain technology by permitting disintermediated trading and real-time settlement of digital assets, with appropriate safeguards.
- Third, the discussion draft tackles the problem of when a digital asset that is sold pursuant to a securities transaction can become a digital asset that is no longer part of a securities transaction because the network is sufficiently decentralised. A certification process would be established at the SEC, giving the agency the ability to rebut a presumption of certification and providing the applicant due

process both in the agency and through the courts.

- Fourth, the discussion draft gives the CFTC authority to regulate the spot markets for digital commodities. Digital commodity exchanges, dealers, brokers and qualified custodians would have to register with the CFTC.

Overall, the 162-page bill is significantly more detailed than some other prior proposals, and is likely to reinvigorate congressional interest in digital asset regulation.

Finally, there is a segment of Congress interested in passing legislation regulating stablecoins during the current Congress, apart from a more comprehensive framework for all digital assets. A revision of the Waters-McHenry Stablecoin Bill was reportedly underway at the start of the 118th Congress. During an April hearing before the HFSC's Subcommittee on Digital Assets, Financial Technology and Inclusion, however, Ranking Member Maxine Waters indicated that bipartisan negotiations relating to a rewrite of the Waters-McHenry Bill had stalled. Chair McHenry subsequently introduced a new "House GOP Stablecoin Bill", with Ranking Member Waters announcing circulation of a "House Democrats Stablecoin Bill" shortly thereafter.

Conclusion

2022 and 2023 brought about dramatic changes to the crypto industry, including high-profile collapses and broader financial market instability, coupled with aggressive enforcement actions by DOJ, the SEC and the CFTC. While the immediate shockwaves appear to have subsided, the impacts – in terms of enforcement, regulation, legislative attitudes and public perception – will continue to be felt for quite some time.

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