

## Episode 244: Blockchain Takes Over The Podcast

**Alan Cohn:** [00:00:03] Welcome to Episode 244 of The Cyberlaw Podcast, brought to you by Steptoe & Johnson. Thanks for joining us. Stewart Baker is indisposed this week, so we have another episode of Blockchain Takes Over The Podcast. And so of course, as with all of our episodes, we are lawyers talking about technology, security, privacy, and government – and for this special takeover episode, we'll once again be talking all about blockchain. So today I'm joined by several of my colleagues here at Steptoe. First, special guest Gary Goldsholle, who recently joined us as a partner from the Securities and Exchange Commission, where he was the deputy director of the Trading and Markets Division and has a long and illustrious history in the financial regulatory world, which we'll talk a little bit more about in the interview session with Gary. Second is Will Turner, another new partner here at Steptoe, resident in our Chicago office, bringing all sorts of corporate as well as securities law expertise specifically in Advisor Investment Company Act issues for our blockchain and cryptocurrency practice. Welcome, Will. We're also joined by Evan Abrams from our international regulatory and compliance practice, talking all things anti-money laundering [AML], know your customer, sanctions compliance, and the various goings on of the New York Department of Financial Services [NYDFS]. And Josh Oppenheimer from our financial regulatory practice, talking more about all things going on in the financial regulatory world in blockchain and cryptocurrency. So without further ado, let's jump right into the News Roundup. And Will, I'm going to call on you first, and maybe we'll talk a little bit about you know some of the things that we are seeing in the market, particularly some mergers and acquisitions [M&A] activity, especially as we settle into what looks like a crypto bear market.

**Will Turner:** [00:02:11] Thanks, Alan. So to engage in a brief amount of past speak, it's been reported that M&A activity is up dramatically in 2018 as compared to 2017 in the industry. And we'd like to engage in a little future speak here and predict what might happen in 2019.

**Alan Cohn:** [00:02:38] And Will, is it useful to think about you know analogies to other industries when we think about why we think we're seeing this mergers activity?

**Will Turner:** [00:02:47] I think that's an excellent point. To me there are a couple of key drivers to the activity that has taken place in 2018, and they're really not unique to the industry. You can see trends in the activity as compared to other at least tech-driven industries. And the things that I would point to are the fact that many potential acquirers consider it cheaper to buy than build and increased regulation generally leads to consolidation.

**Alan Cohn:** [00:03:26] So it's interesting. So in that way, this industry really isn't all that different from other technology industries or really any kind of industry as a whole.

**Will Turner:** [00:03:37] I would agree with that. So what is industry specific is the fact that assets may be cheaper to buy than build. Certainly there was a phase in the industry where it was relatively easy to build because funds were relatively easy to acquire via ICO [initial coin offering], and if you invested your proceeds in Bitcoin or Ethereum or simply left the proceeds in Bitcoin and Ethereum being long in those tokens turned out to be a good economic decision for much of 2017 at least.

**Alan Cohn:** [00:04:21] Yeah, and I think we also have seen – I think the bear market is beginning to bring out and demonstrate that there are some teams out there that actually managed to nail it pretty well in the tech but maybe have struggled a bit on the management side, and there's other companies that have come together with really strong management teams where maybe the tech has lagged or hasn't turned out to have the potential that was hopped.

**Will Turner:** [00:04:47] Yeah. I would agree with that as well. Generally, I view consolidation as a positive for the industry, any industry, because it suggests that people are behaving economically rationally and are identifying where they may have strengths that they can supplement efficiently through an acquisition.

**Alan Cohn:** [00:05:10] So what are the kinds of things that we lawyers would be thinking about from mergers and acquisitions in the blockchain and cryptocurrency industry?

**Will Turner:** [00:05:21] The industry, like so many industries, is subject to regulation, but there are of course certain regulations that are particularly acute, especially for non-US businesses that may be looking to enter the US market via acquisition. And so if we were advising clients in that space, we would suggest that they consider several what I call "hot button" items that have been with us for a couple of years in the industry, and that would be AML and money transmitter compliance, securities law compliance, and commodities regulatory compliance. I'd also add that new this year – and it's really not specific to blockchain, but it's important for all non-US acquirers – are there recent amendments of CFIUS [Committee on Foreign Investment in the United States] regulations via FIRRMA [Foreign Investment Risk Review Modernization Act] which make filings under CFIUS mandatory rather than optional for acquisitions in industries that are among a number of designated categories with the important caveat being that those categories are in the process of expansion via Department of Commerce rulemaking.

**Alan Cohn:** [00:06:49] Yeah. Very interesting to see how CFIUS regulations may impact acquisition activity and really investment activity in this space where there is a significant amount of overseas interest in investing in US companies and entities. Probably also worth thinking about tax implications and also some of the novel intellectual property issues that we might find here. While a lot of the projects are largely open source, there are some proprietary aspects to them. And then of course customer information looks different in this space but still needs to be handled with care in any kind of merger/acquisition kind of scenario.

**Will Turner:** [00:07:35] Yeah. I think those points are well taken and almost taken for granted by those of us in this space but bear repeating because those are issues that surface routinely not only in the acquisition context but in the build context where someone is starting a business or developing a new line of business onto an existing platform.

**Alan Cohn:** [00:08:06] Yeah. Very interesting. I think just another indication of the industry maturing and maybe taking on some of the characteristics of more traditional technology industries or even just industry as a whole. So kind of along those same lines, Evan, we are seeing some more increased joint activity among US regulators thinking about things like anti-money laundering and counterterrorism financing.

**Evan Abrams:** [00:08:35] Yes, that's right. One interesting development was a joint statement issued by a number of regulators – FinCEN [Financial Crimes Enforcement Network], OCC [Office of the Comptroller of the Currency], FDIC [Federal Deposit Insurance Corporation], a couple other ones – encouraging use of innovative technology for Bank Secrecy Act and anti-money laundering compliance. And that statement was issued really with respect to banks but is nonetheless relevant to blockchain I think for a couple of reasons. One, there are banks who are either getting into the cryptocurrency and blockchain space or are looking to do so. But secondly, I think even though it's written with respect to banks, the general approach of these agencies in being supportive of innovative technology to comply with Bank Secrecy Act and anti-money laundering compliance has an obvious analogy to be brought to the cryptocurrency and blockchain space where so much of what's going on is highly innovative.

**Alan Cohn:** [00:09:33] So what do you take away from this joint statement? Anything different or new or just kind of a continued tightening of the reins in respect of this industry?

**Evan Abrams:** [00:09:46] So the statement overall was very positive with respect to companies, particularly banks, engaging in new and innovative approaches and bringing new technology like artificial intelligence, for example, to bear on their compliance. And there were a couple of interesting points with respect to that. The statement said that these type of new innovative approaches will not lead these entities to be penalized if they don't end up working out, and on the flip side of that, if they do end up working out and they, for example, identify suspicious activity that was going on that was not previously being caught under existing compliance programs, that in and of itself will not lead supervisors to say that what a bank or an entity was doing before this new innovative approach was insufficient.

**Alan Cohn:** [00:10:39] What's interesting – and you can kind of read it from the language of what's being said – it is recognizing and acknowledging that banks can and should be engaging with this industry and that there are ways to do that not only safely but perhaps even in ways that help illuminate what's going on in the industry and help fill out the information picture not just for banks but for law enforcement and regulators also.

**Evan Abrams:** [00:11:07] That's right. And I think, as people who have been in the cryptocurrency space have been saying for a while, if you take a really rigorous approach to cryptocurrency, you can get a much richer and fuller picture in many instances of what's going on than you can in a traditional fiat world. And so there is potential to bring some of these new technologies and really up what institutions are doing with respect to suspicious activity, counterterrorist financing, and so forth.

**Alan Cohn:** [00:11:39] Yeah, and it's interesting. I mean, in this industry it's always a balance to be struck between the types of privacy and integrity features that the technology brings but also the ability for the technology to help kind of advance shared interests of not allowing the technology to be used for financing terrorism, for evading sanctions, and for a variety of other types of unlawful activities.

**Evan Abrams:** [00:12:10] Yeah. Absolutely. Always balance there with respect to privacy, sometimes just with respect to how easy it is to access the technology and engage with it. And so weighing those is always key for businesses who are getting into this space.

**Alan Cohn:** [00:12:25] And so interestingly, along the same lines, the Office of Foreign Assets Control [OFAC] came out with a recent blocking order that actually is kind of custom made to drop right into the kind of automated systems that a lot of blockchain and cryptocurrency industry participants use to screen for that type of activity.

**Alan Cohn:** [00:12:47] That's right. OFAC, for the first time ever a couple of weeks ago in designating new individuals as specially designated nationals, put out specific wallet addresses that were linked to those designated persons. And that's the first time they've done this. And anytime there's a blocked person put out by OFAC, when assets of those blocked persons are within the possession or control of a US person or within the United States, they're required to be blocked. So by adding the wallet address to those blocked persons, you're just making it that much easier for people who are required to comply with those OFAC regulations to actually take those steps, identify whether or not they might have assets on their platform or within their custody or control that are linked to those designated persons, and then actually go forth and take the step of blocking those assets.

**Alan Cohn:** [00:13:42] Yeah. It's also an interesting indicator that OFAC's been doing some of their own homework in order to understand that those wallet addresses are linked to those individuals and other identifying information.

**Evan Abrams:** [00:13:55] Yes. Absolutely. And just as a more general point, I think we're seeing the world of economic sanctions and cryptocurrency converge more and more. OFAC sanctioned the Venezuelan Petro a while back, the cryptocurrency that Venezuela put out. There've been rumblings about other sanction jurisdictions like Iran or Russia considering different types of cryptocurrencies they might use to get around

US sanctions. And so I think the area of cryptocurrency is something that OFAC and other US agencies who are really focused on sanctions are looking at more and more.

**Alan Cohn:** [00:14:35] And so turning now to kind of the state level, you know we've taken the opportunity on previous times when blockchain has taken over the podcast maybe to bash a little on the New York Department of Financial Services for just the glacial pace that they've taken in terms of issuing BitLicenses after having put out kind of a very comprehensive set of regulations that made the industry very uncomfortable. They kinda buttressed that discomfort by you know having these licenses come out in very infrequent drips and drabs, but that wasn't really the case that we saw in 2018. Was it?

**Evan Abrams:** [00:15:13] No. There was more licenses and approvals granted in 2018 than there have been previous. Some of those were people actually went through the whole BitLicense application process, but there's also been entities who are regulated under other parts of the New York banking law – Signature Bank, for example, was chartered under New York State, was able to get a BitLicense – and if you're already regulated another aspect of New York banking law, you just need approval from the Department of Financial Services to move into the blockchain or cryptocurrency space. And so it's seen as a little bit easier than going through the whole BitLicense application process. Of course, to actually be chartered as a bank or a similar financial institution is quite an ordeal in and of itself, but for entities who are already in that space, it's seen as a slightly easier path.

**Alan Cohn:** [00:16:07] Yeah. So this is entities that might want to be considered a bank or a depository trust or some other type of financial services industry participant that may also want to handle cryptocurrency.

**Evan Abrams:** [00:16:21] That's exactly right. And one very interesting development from earlier this month is *Fortune* magazine actually sent the Department of Financial Services a FOIA request asking about specific numbers of applications, and so really for the first time in years there is some specific data on how many applications there have



been and how many have been granted. So just to highlight that briefly, according to the response to this FOIA request, there's been 36 applications since the launch of the BitLicense. There've been 10 issued BitLicenses, there've been five denials, and then the rest are still under review. So more than half are still under review. There's also been a real slowdown in the pace of people who are applying: 26 applications in the first year, and then since then only 10 applications. And I think that speaks to the general perception in the industry that getting a BitLicense is very difficult to do, and there're pretty significant compliance burdens. And so it's been common practice for a lot of entities to just avoid the state of New York, and I think that's reflected in that kind of downward trend in license applications.

**Alan Cohn:** [00:17:29] Yeah. So any thoughts on what we might see in 2019?

**Evan Abrams:** [00:17:32] Well, the BitLicense's supposedly under review. It's not clear when or if anything additional will come out on that, but I think there is a lot of pressure for additional guidance. When the BitLicense came out, there were some frequently asked questions that were posted on the DFS website, but they don't really add much beyond the regulations themselves. They just kind of summarize the regulations. And so, especially as technology has evolved pretty considerably since the BitLicense was initially issued, there is a lot of novel questions that people are struggling with. There's some kind of key terms in the BitLicense that are undefined. And so I think there's going to continue to be pressure on the agency to do something more, some type of public guidance or tweaks to the regulations, something of that variety just to help these companies who are trying to figure out if and how they fit under this regime.

**Alan Cohn:** [00:18:24] Yeah. Very interesting.

**Will Turner:** [00:18:26] What's interesting to me about 2019, to again engage in future speak, is businesses as capitalist enterprises need to make cost-benefit analyses on their expenditures, and that includes regulatory spend, of course. And so to the extent that businesses are perceiving that a BitLicense is either incredibly costly or impractical to obtain, it's economically rational for them to decide to remain out of the New York



market even though it is otherwise a very attractive capital market. So as more businesses have achieved licensure, if on top of that DFS provides some meaningful guidance, it may create a real tipping point in terms of the cost-benefit analysis and incentivize more businesses to apply, which in some ways I would think would help achieve some of the objectives of the NYDFS in creating the licensure regime to begin with.

**Alan Cohn:** [00:19:41] Yeah. I think that's right. I mean, we've had three years of kinda experience under that regime, a lot of development in the area, a lot more comfort among the regulatory community generally about this asset class. And I think that's right. I think we've seen where regulators have encouraged a regulated market to develop and have had greater insight into the markets. That's had a beneficial impact on the industry, and I think that that's where New York State was trying to get to, maybe a bit ham fisted at the beginning, but it would be great if some additional guidance in 2019 would help spur that along. Alright. And so finally, a few last pieces. Back up to the federal level: The Commodity Futures Trading Commission [CFTC] released a primer on smart contracts. What were they talking about?

**Josh Oppenheimer:** [00:20:31] That's right, Alan. In late November, while we were still all recovering from our Thanksgiving comas, the CFTC's LabCFTC released a primer on smart contracts. For those who don't know, the LabCFTC is the Commodity Futures Trading Commission's go-to resource for all things financial technology. It was launched in May 2017 and is designed to make the Commission more accessible to fintech innovators.

**Alan Cohn:** [00:20:55] Yeah. I think that it has helped give the CFTC a kinda changed reputation as being a friendlier home for cryptocurrency and blockchain industry companies.

**Josh Oppenheimer:** [00:21:10] So at the end of November, it released this primer on smart contracts, following a different primer published last year on virtual currencies.

Basically, these primers lay out the CFTC's understanding of these technologies, but they're not official policy statements. They're just educational tools.

**Alan Cohn:** [00:21:26] And so what's kind of the – what are your big picture takeaways from this primer?

**Josh Oppenheimer:** [00:21:31] Yeah. So the primer is pretty expansive. It talks about the history of smart contracts, the characteristics, and their potential everyday uses, but the big takeaway is that smart contracts are legal documents or legal processes that the federal government and specifically the CFTC will regulate.

**Alan Cohn:** [00:21:50] Yeah. Very interesting. And I think that by saying that they'll regulate, in a sense creating more regulatory certainty around their use, especially as contractual instruments. Again, it could definitely cause some beneficial activity within the industry. You're also looking at, Josh, some activity from the G20 leaders about crypto asset regulation. What's going on there?

**Josh Oppenheimer:** [00:22:17] That's right. Earlier this month, leaders of the G20, the group of 20 largest economies, met in Argentina and agreed to police crypto assets to prevent money laundering and the financing of terrorism.

**Alan Cohn:** [00:22:30] Yeah. So I mean, those countries that are members of the G20, it's a bit uneven across them about how they approach cryptocurrency regulation within their own jurisdictions.

**Josh Oppenheimer:** [00:22:41] That's right. And it wasn't until this past March when France first publicly brought up you know debating crypto and crypto assets. Japan is definitely pushing for this. They're one of the larger countries that have really embraced cryptocurrency and crypto asset regulation, and it's going to be interesting to see because they, Japan, will be the next leader of the G20. So we should be focused on how it will continue to push for international regulation.

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**Alan Cohn:** [00:23:12] And so what could the G20 do under kinda Japan's leadership in this area?

**Josh Oppenheimer:** [00:23:18] Well, what they're really pushing to do now is kind of set baseline regulations. What the G20 did this past meeting was agree to follow standards set forth by the Financial Action Task Force [FATF]. This is a big deal because the Task Force has insight into different regulatory approaches and constantly receives input from industry stakeholders.

**Alan Cohn:** [00:23:40] Yeah. And that group, FATF, is a broader group that regulates. It seeks to kind of create regulatory harmony across a range of different financial regulations.

**Evan Abrams:** [00:23:53] And they've done some work in the virtual currency space before. But as with much of the material that's been put out in the space, it's already become a little bit outdated. And there was a recent statement in the last couple of months that FATF put out. It didn't have a lot of meat on the bones, but the kind of rumblings around the organization seem to be that in 2019 they're going to look to do some more specific actions in this space. And so I think keeping an eye out for guidance from FATF is going to be an interesting thing to watch for in the new year.

**Alan Cohn:** [00:24:26] Yeah. So, Josh, that intersection between an interested G20 and an invigorated FATF could produce some interesting results on the international stage.

**Josh Oppenheimer:** [00:24:38] Absolutely. And we'll see if the international stage drives the domestic front.

**Alan Cohn:** [00:24:43] Yeah. That will be very interesting to see. And of course we've seen cantons in Switzerland agree to accept cryptocurrency for tax payments, but we actually started to see that right here in the USA recently. Right?

**Josh Oppenheimer:** [00:24:55] That's right. Ohio is set to become the first state in the country, actually, to accept tax payments using cryptocurrency. Under their system, businesses – and right now it's only businesses, not individuals – operating in Ohio can register online and make cryptocurrency payments to Ohio State Treasurer's office on 23 different related taxes, whether that's taxes on cigarettes sales or employee withholding.

**Alan Cohn:** [00:25:19] So we'll have to see if this turns out to be a novelty or if it really is kind of an early signal of a larger trend that we might see across states.

**Josh Oppenheimer:** [00:25:29] That's right. I mean, right now Ohio's only accepting Bitcoin as their cryptocurrency for payment, but as you said, it'll be interesting to see if other states catch on. Ohio is trying to establish itself as the blockchain/Bitcoin capital of the country.

**Alan Cohn:** [00:25:45] So very interesting. And you know kinda joining the competition among states as varied as Delaware, Illinois, Arizona, Wyoming, maybe New York, all the way over on the other side. So very interesting to see. Well, good. So thanks, Will and Evan and Josh, for a great roundup of things that are going on. Why don't we turn now to a little bit more of an in-depth discussion with Gary Goldsholle? Gary, let me first – first, I'll start by welcoming you to Steptoe into the blockchain and cryptocurrency practice here.

**Gary Goldsholle:** [00:26:21] Great. Well, thrilled to be here.

**Alan Cohn:** [00:26:23] And maybe, if I could ask you to, give folks maybe a minute or two about your background and kinda what kind of insights you're joining us with?

**Gary Goldsholle:** [00:26:33] Sure. Well, I've actually returned to Steptoe & Johnson, as you know, after 23 years as a financial regulator in a variety of different capacities. Most recently, I left the SEC, as you pointed out in the introduction, but prior to that, I was general counsel of the MSRB.

**Alan Cohn:** [00:26:48] What is the MSRB?

**Gary Goldsholle:** [00:26:49] Of course. The Municipal Securities Rulemaking Board. In fact, much of my regulatory career is a bit of alphabet soup with various federal agencies as well as two self-regulatory organizations, the MSRB as well as my work with FINRA, the Financial Industry Regulatory Association [Authority]. And I left Steptoe in 1995 to join the CFTC, Commodity Futures Trading Commission, which is a significant part of the firm's practice here today.

**Alan Cohn:** [00:27:18] Yeah. So you've really had a walk among a number of the different agencies, in particular CFTC, FINRA, and SEC, that are kinda in the headlines on blockchain and cryptocurrency, crypto asset issues.

**Gary Goldsholle:** [00:27:31] Yeah. Absolutely. And you know one of the things that I've always enjoyed about my time in the regulation world was the opportunity to work with really smart people on some real cutting edge and novel issues, and whether it was you know issues related to the Internet you know back in the late '90s or you know blockchain and DLT [distributed ledger technology] in recent years and in all the developments in between really has been very fortunate to work on some really interesting issues.

**Alan Cohn:** [00:28:00] You had the opportunity to work directly with the task force or specific working group within SEC that's looking at blockchain and cryptocurrency issues. Right?

**Gary Goldsholle:** [00:28:09] Sure. Yes. Well, so the SEC has been quite active in this space, both on the enforcement side as well as issuing guidance in various forms, and you know one of the things SEC does internally is make sure that it has the necessary offices and divisions and staff coordinate with each other so that it is considering all the implications of the activity that it sees. And I think one of the things that I did during my time at the SEC was really to carry forward throughout the agency the concerns or

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issues that are raised by the Division of Trading and Markets, issues that could include such things as broker-dealer registration, registration as an exchange or an ATS [alternative trading system], issues potentially around custody, and other intermediaries, sales practice concerns that could be raised. So it really gave me a good chance to be kind of an ambassador to other parts of the agency about the particular areas within the Division of Trading and Markets as well as to work with other offices and take their issues and their developments back to my colleagues within the Division of Trading and Markets.

**Alan Cohn:** [00:29:18] Yeah. Very interesting. It's been really interesting to watch the SEC, maybe from a bit of a late start, really jump into this area with two feet and begin working in a number of different directions. So one of the directions that has been most visible to people has been the Enforcement Division's action around initial coin offerings and tokens. What's your – can you give a summary of what's gone on in that space and where you think that's going?

**Gary Goldsholle:** [00:29:52] Sure. Happy to. I think one of the lingering questions throughout 2018 was what was going to happen from the SEC's perspective to all the unregistered ICOs. There were numerous statements by SEC staff and even Chairman Clayton that nearly all ICOs were securities, as to extent that might be useful going forward to those who listened but didn't really address what will happen to all the ICOs that were already out there in existence. And this was I think laying a significant cloud over ICOs issuers broadly.

**Alan Cohn:** [00:30:23] This was back at the end of 2017, early 2018, and it definitely cast a pall over the industry without a real clear sense of what are we supposed to do.

**Gary Goldsholle:** [00:30:35] So we had two cases that were issued or part of a settlement just in November. I'm not gonna go into the facts of the cases beyond maybe saying that Paragon was established to somehow bring blockchain to the cannabis industry and Airfox focused on the mobile telecom industry. What I will focus on is that the settlement seemed to offer a path forward with three basic elements. First, the

issuer will seek to register the securities under the Exchange Act of 1934 and provide the kinda ongoing periodic reports that one typically associates with public companies. Second, this path involves a civil monetary penalty. In this case, both issuers were required to pay a penalty of \$250,000. And third, the issuer must offer investors – in the case of Airfox, this will be about \$2,500, and in the case of Paragon, about \$8,000 – who purchased tokens as part of the ICO with the right of rescission. If you permit me to become legal for a few moments here, Section 12(a) of the 1933 act states that "an issuer conducts an offering of securities in violation of Section 5, the registration provisions, is liable to each purchaser in the amount equal to the purchase price plus interest, or if the purchaser has sold the security, their net loss from the investment." What I find interesting about the rescission process here is the SEC is going to be taking an active role in overseeing the process for notifying investors of their claim process as well as monitoring the acceptance of those claims. You know ICO issuers generally have a different relationship with their investors than those I think in more traditional financing arrangements. So I'm very curious to see how successful or effective the issuers are going to be in reaching investors and then the willingness of investors to participate in the claims process. My hope is the information about this process will be revealed in the periodic filings that each issuer will be required to make as a public company.

**Alan Cohn:** [00:32:40] Yeah. It's really interesting. These two cases suggest – and it's interesting that the SEC kinda issued them first – that there's a clear path if companies want to concede or accept that the tokens that they issued were in fact securities and that for whatever else was written in the documents that ultimately this was a capital formation activity and that, at the end of the day, the token should be registered and treated like any other security. And that kinda goes into some of their questions folks have been talking about in terms of security token offerings but also a real question about the viability of the concept of the utility token.

**Gary Goldsholle:** [00:33:30] Absolutely. One of the things on my sort of end-of-the-year wish list is for the SEC to give some guidance on what a utility or a consumptive token is. I think intuitively we all know that such a thing can exist, but we haven't seen



the SEC bless one yet. And I think it's going to be very, very helpful to the industry when the SEC articulates what it sees as a utility or consumptive token. I think it's going to be helpful for those who think that they can offer a consumptive token and perhaps equally helpful for those that thought they could achieve what would be a consumptive token to find out in fact the SEC's view on what it is might not align with theirs.

**Alan Cohn:** [00:34:13] Yeah. I think that's interesting. Jay Clayton, in his statements way back in December and January, talked about a token that kinda powered a book of the month club. And Bill Hinman, in his speech in June, talked about ether specifically, the native currency of the Ehtereum protocol, which is not just a currency like Bitcoin but also has utility properties of the kind that people think about when they think about utility tokens. But beyond that, it's been pretty spare in terms of what does this actually mean.

**Gary Goldsholle:** [00:34:50] Well, I think blockchain as a technology offers a great opportunity for people to exchange value and receive things. So when you can use that aspect of the technology and strip it away from the price appreciation or the investment aspect to it, I think we're going to see an opportunity to have this technology used in ways that we haven't seen before.

**Alan Cohn:** [00:35:12] And it's interesting. You talked about your wish list. Kinda on my wish list is there have been foreign jurisdictions that have recognized or at least have spoken about the idea that there may be kinda three categories of tokens: Currency tokens, like cryptocurrencies – Bitcoin; asset tokens – securities or commodities or other kind of financial instruments; and then utility tokens. But they have been slow to articulate beyond kind of basic definitions in guidance documents not only what does it mean to be a utility token but what is a prudential oversight and supervision regime that would apply to a utility token as opposed to a cryptocurrency or an asset token.

**Gary Goldsholle:** [00:35:58] No. Very, very good observations. And one of the things that I've been concerned or closely watching is the extent to which these utility or consumptive tokens were not securities, what regulatory regime would apply to them. I think you spoke recently of a book of the month club. I would think that that would be

perhaps regulated by FTC [Federal Trade Commission] or various state regulations. I don't think we'd want to see the SEC getting involved or other federal financial regulators getting involved in the book of the month club issues.

**Alan Cohn:** [00:36:31] That could be a real shock to all of the book of the month club participants out across the country. So if you had to kind of peer into a crystal ball, do you think that's in the cards for 2019 on the token side?

**Gary Goldsholle:** [00:36:46] Yeah. I think we will see. I think we will see that. The SEC staff has been hinting for some time that they are going to be issuing guidance to this industry or the market. This request for guidance has been really going on since the DAO report in 2017.

**Alan Cohn:** [00:37:07] The DAO, the decentralized autonomous organization. This was a concept that was floated back in the spring of 2016 that you would have almost like a venture fund that people could buy tokens and vote on investments by this fund. And the most novel thing was not only was it blockchain-based, but there were no people involved. It was just a protocol. And the founders intended to raise \$500,000 worth of ether by selling these DAO tokens, and they ended up raising about \$150 million worth of ether. Before we could get into all of the good juicy securities law issues about that, there was a "hack," and about \$36 million worth of ether was stolen and then that drew all the focus. But it took the SEC about a year, but they issued a report in July of 2017 kinda going through why it was that DAO token was in fact a security, and that was really the SEC's kinda first foray into larger guidance to the industry about what may or may not constitute an investment contract or a security under US securities law.

**Gary Goldsholle:** [00:38:23] Right.

**Will Turner:** [00:38:24] And I think for those of us that were in private practice at the time that report was issued, the staff subsequently took the position that the report, which I thought was very thoughtful, put issuers and practitioners on notice of the SEC's position. And really the staff often viewed the behavior of issuers and other actors in this

space differently if it was before the report was issued – what some people now refer to as pre-DAO – and after the report was issued. So Gary, do you envision something similar with the future staff guidance?

**Gary Goldsholle:** [00:39:11] So that's a very interesting point, and I think we're going to talk a little bit later about a case involving a decentralized exchange, the EtherDelta decision in which the SEC in its settled order drew a distinction between activity that occurred on the platform pre-DAO and post-DAO. So I think as more time passes from the DAO report, it becomes less of a relevant consideration. But to speak to the issue that both of you just identified, the SEC does seem to recognize that it needs to give guidance to the industry, and when there is ambiguity, it might hold back a little bit on some of its enforcement or other activity.

**Alan Cohn:** [00:40:00] Yeah. So turning to the EtherDelta case and this larger question about enforcement activities and regulatory guidance around exchanges. There's obviously two kinds of exchanges that you have: Centralized exchanges that may or may not have custody of funds but kinda actively participate in matching buyers and sellers, and then you have these decentralized exchanges. And the SEC has been active in both areas in terms of trying to give guidance to both types of exchanges, but it is very interesting to see that EtherDelta case come out because decentralized exchanges are relatively new and kinda almost felt like the SEC was getting out of the kinda catch-up posture and trying to lean a little bit forward into things that are coming in this space. I don't know if you thought the same way, Gary.

**Gary Goldsholle:** [00:40:58] Not necessarily. I mean, I think the issue of a centralized or decentralized exchange was something that was more a creation of the industry itself and less a function of the legal regime in which these entities operate. The statutory definition of an exchange includes a marketplace or facilities for bringing together purchasers and sellers of securities. And the regulation ATS released in 1998, which I had a chance to reread over the weekend given the lovely weather we had here in Washington, talks about the statutory definition and the Rule 3b16 that it adopted to interpret the statutory definition in light of market developments. So I think the thrust of

the 3b16 Rule is to define exchange as an entity that brings together the orders for securities for multiple buyers and sellers and uses established nondiscretionary methods whether by trading facility or by setting rules under which the orders interact and the parties agree to the terms of the trade. So if one looks at what EtherDelta did, it's pretty easy to see how the SEC viewed EtherDelta as an exchange. The fact that the transfer of securities occurred through smart contracts or through an entity that doesn't have custody of the securities really is immaterial. Again, also if you think about the national securities exchanges such as NYSE and Nasdaq, they're not acting as custodians of the securities that are trading on the exchanges. So I feel in some ways this decentralized/centralized exchanges as a way to differentiate certain parties from the application of the law might have a little bit misdirected.

**Alan Cohn:** [00:42:41] That's really interesting because I think that within the industry there's the sense that decentralized exchanges are a different animal and pose kinda different questions or even may not fall within the traditional regulatory structure, and so it's interesting you say to really to point out how in fact that may just not be the case.

**Gary Goldsholle:** [00:43:01] Again, when you go back and you look to see what the definition of an exchange is and how the SEC has approached it and how it has interpreted it, it is a little hard to understand how the decentralized nature really impacts the analysis all that much.

**Alan Cohn:** [00:43:17] Yeah. So the other thing that, as you know because we've talked about it, intrigued me about the EtherDelta decision was there was a lot of specificity around the provisions you discussed in a very compelling argument as to why you know decentralized versus centralized is immaterial. The decision kind of assumes without specifically stating that EtherDelta was enabling the trading of securities, simply assuming that one or more of the tokens that were being enabled for trading were in fact securities even though there's not been a decision from the SEC that those tokens were or were not secured.

**Gary Goldsholle:** [00:44:01] Yep. That was one of the first things that you came to me when you saw the decision and said, "Gary, it doesn't tell me what the securities are!" And I as I said then and I'll share now, the reason for that is because for the SEC to say that a particular digital asset is a security would have a very significant and pronounced effect on that asset, and for that statement to occur in a process in which the issuer is not involved, where the issuer cannot rebut various findings that the SEC might make, cannot produce facts, cannot challenge the legal conclusions, really would deprive that issuer of all the due process and other rights you would expect the government to exercise in its enforcement and regulatory activities. And so while I certainly appreciate everyone's disappointment that this case did not identify among the 2,500 assets that trade on the platform which were securities, I think when you think more deeply about what the implications of that would have been in a process where those issuers were not involved, perhaps you'll take greater comfort in the fact that that did not happen.

**Alan Cohn:** [00:45:08] Yeah. No, no. Definitely. I mean, I think that it would have certainly been a violation of due process to have not involved the issuers in some way in that decision, but it does also leave something of a gap for other exchanges, whether centralized exchange operators or administrators of decentralized exchanges, about you know if they are to call their token offerings on what grounds should they call them. It did seem though that there was something of a warning shot about ERC-20 tokens – tokens that adhere to the ERC-20 standard, which is an interoperability standard for fungible tokens that work on the Ethereum platform.

**Gary Goldsholle:** [00:45:57] I'm not sure I see it quite that way. I think many of the tokens were – ERC-20 was a very popular platform for tokens to be issued and traded during that time. The EtherDelta smart contract was written on the ERC-20 platform, so I'm not sure. That might be more a factual coincidence than it is really a legal distinction that will be drawn.

**Alan Cohn:** [00:46:24] Interesting. Yeah, because for our listeners, ERC-20 tokens – again, the ERC-20 is a standard for interoperability on the Ethereum protocol – if you create and use an ERC-20 token, you're using Ethereum as your base protocol. There

are other tokens where the developers or the issuers have actually coded its own protocol, and there's a lot of question within the industry as to what is the legal significance of that. And so I guess we'll have to wait and see what else the SEC has in store for the industry to get more insights on that.

**Will Turner:** [00:47:00] So Gary, just to delve into your New Year's wish once again, I take it the hope is for guidance that doesn't come in the enforcement context and that the staff might be a little freer to give a broader scope guidance without the concern of infringing upon any individual issuer's or other actor's rights.

**Gary Goldsholle:** [00:47:25] Sure. One of the challenges the SEC faces in giving guidance is that this is a very fast evolving space, and the SEC often addresses new issues in Notice and Comment Rulemaking, which affords the agency an opportunity to hear from all interested and affected parties. Without such a process, there is a heightened risk that guidance the SEC might issue will be based on less than complete and full information. I don't think for a number of reasons that rulemaking is practical this instant for cryptocurrencies or blockchain, but the SEC will want to make sure that any guidance it issues is as informed as possible. Again, it's much easier in the context of an enforcement action where the SEC has all the information to issue guidance or a statement. I think that's why you've seen that their practice in the past. So you know more holistic guidance around crypto would be significantly more difficult. That all said, I'm encouraged by statements from SEC staff that such guidance is anticipated in 2019, and I believe early 2019. I do wonder how much that will add to the legal dialogue that exists today, but we will certainly see. One area where I hope they will give guidance is on custody. So the SEC has said what it thinks is a security and what it thinks is an exchange and what to do if you've issued an ICO in violation of the registration provisions. What they haven't addressed is how digital assets should be custodied, whether they're securities or non-securities held by one of their registrants. The issue was raised in a staff letter from the Division of Investment Management in early 2019, so we know it's on their mind.

**Alan Cohn:** [00:49:19] 2018?

**Gary Goldsholle:** [00:49:19] 2018, correct. Sorry.

**Alan Cohn:** [00:49:22] That really is quite a crystal ball!

**Gary Goldsholle:** [00:49:26] But I'd really love to see them issue guidance. So you know custody is taking place right now but without any input or guidance from the SEC. My biggest worry – and I think this is one of the points that you maybe are getting at, Will – is that there'll be some custody failure or event that will animate the SEC or other regulators to issue guidance. And in that case, the guidance will be heavily focused on what had happened in the past and not necessarily that thoughtful, more measured guidance that is forward looking and helps the industry thrive and helps provide the necessary guidance to the industry.

**Alan Cohn:** [00:49:59] Yeah. I mean, as you said though, in a sense it's much easier for the Enforcement Division to look at a specific instance. Do you think that more of a Notice and Comment type of process could take place for custody, or are there any things that you see that the industry could do to encourage that?

**Gary Goldsholle:** [00:50:19] Sure. Well, Notice and Comment Rulemaking is one thing. Another process could be interpretive or no-action guidance, and in that case, parties will submit letters and there'll be usually a series of drafts going back and forth between the agency and the requesting party. And so while that may not offer the public exposure, it certainly allows the affected party in this case to really develop and drive down all the key issues in a back and forth.

**Alan Cohn:** [00:50:48] So good. Well, with our last minute, let me ask you: Other projections that you see for 2019 or last items on your wish list that you are looking for this industry in the coming year?

**Gary Goldsholle:** [00:51:02] No. I think I've really covered those. I guess my number one wish list is to see guidance around custody. I think it's been an area that's been



identified as critical to the forward progress in the industry, and to start that dialogue about what is effective custody with the SEC and other regulators I think is very, very important. And I think that the time is now ripe for that discussion to commence.

**Alan Cohn:** [00:51:29] Well, this has been great, Gary. Thanks so much for sharing your insights around this area. And I think for frequent and regular listeners to the podcast, we've now reached sufficient critical mass that we can begin arguing with each other over these issues. And so hopefully you will join us in subsequent episodes when Blockchain Takes Over The Podcast to hear just such arguments. So overall again, thank you to Gary Goldsholle. Thank you to Will Turner, Evan Abrams, Josh Oppenheimer for joining us today. This has been Episode 244 of The Cyberlaw Podcast, brought to you by Steptoe & Johnson. Don't forget: Suggest a guest interviewee and we may send you the highly coveted Cyberlaw Podcast mug, which I guess Gary we'll have to get you one of these now.

**Gary Goldsholle:** [00:52:20] Excellent!

**Alan Cohn:** [00:52:20] Send your questions, comments, and suggestions to [CyberlawPodcast@Steptoe.com](mailto:CyberlawPodcast@Steptoe.com). Get involved on Twitter by following @StewartBaker. Please, please, please rate the show and leave a review on iTunes, Google Play, or wherever you get your podcasts. This helps new listeners find us, and it also gives us valuable feedback. So coming up: Nothing. Holiday hiatus. We'll be back in January with new episodes. And finally, our show credits. Thanks to Laurie Paul and Christie Jorge, our producers, to Doug Pickett, our audio engineer, to Michael Beaver, our intern, and thank you to me, Alan Cohn, your fill-in host on behalf of Stewart Baker, thanking all of you for joining us through all of 2018. And we hope that you'll join us again next time in 2019 as we once again provide insights into the latest events in technology, security, privacy, and government.