
THE CRYPTO EXCHANGE PODCAST – S01 Ep8, CRYPTO AND THE SEC**HOSTS: KEITH BARNETT AND ETHAN OSTROFF****GUEST: JAY DUBOW****Ethan Ostroff:**

Welcome to another episode of the Crypto Exchange, a Troutman Pepper podcast focusing on the world of digital assets and payments. As longtime leaders in the intersecting worlds of law, business, and government regulations, our lawyers can go beyond the buzzwords and headlines to make sense of the emerging legal and regulatory frameworks for operating in the digital asset and payments industries. I'm Ethan Ostroff, one of the hosts of the podcast and a partner at Troutman Pepper.

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Today I'm really excited to be joined by my colleagues, Jay Dubow and Keith Barnett, to discuss recent updates in the crypto space, particularly as it relates to activities by regulators on the state and federal level around questions involving securities.

Jay and Keith, thanks again for being here. Just setting the backdrop here in September, we had the White House publish the framework for responsible development of digital assets That followed up on the president's executive order on digital assets earlier this year, which set forth some principle policy objectives in furtherance of US initiatives in the crypto and digital asset space. The framework directs the financial regulators to provide innovative US firms developing new technologies with regulatory guidance, best practices, sharing and technical assistance, and reinforces the United States' leadership and competitiveness and digital assets.

At the same time, the framework encourages the SEC and the CFTC to aggressively pursue investigations and enforcement actions against unlawful practices in the digital assets space. And presumably these executive actions will inform the broader federal government's approach to digital assets, particularly how the SEC approaches this space. Going back to July of 2017, the SEC released its DOW report and for all intents and purposes, appeared to set out a roadmap that the agency would use for its approach on crypto clamping down on unregistered securities offerings, unregistered securities broker dealer activity, and unregistered securities exchange activity. So in the five years since that, we've seen a lot of activity including enforcement actions. In addition to that, we've seen, the SEC in particular, specifically putting more resources into the crypto space. Jay, what are we seeing right now at the SEC in particular?

Jay Dubow:

The SEC in May of this year announced that it was going to nearly double the size of its crypto assets and cyber unit within the division of enforcement. That unit has been active in pursuing cases involving crypto assets as well as cybersecurity breaches. And by doubling this size, by

adding 33 attorneys to the group out of 125 new hires for the SEC overall, that indicates a significant attention to this space.

Ethan Ostroff:

And in my understanding, Jay, is in addition to that, they've made a lot of recent public statements, including the director of the SEC's Division of Enforcement specifically saying they're going to continue to aggressively pursue enforcement actions against crypto companies. I believe that was in a conference in September. In the addition to the SEC, I mean on the federal level, who are some of the other regulators that are in this space?

Jay Dubow:

Certainly the other largest regulator in this space has been the CFTC through the Commodities Futures Trading Commission. The CFTC also has been very active in bringing enforcement actions in the cryptocurrency arena, and there has been a noted turf war, so to speak, between the SEC and the CFTC. Both agencies, while denying that there's such a war, each are seeking more and more jurisdiction over this space.

What's interesting is, to date, both agencies have been working with old laws on the books to regulate in this space, many of these laws and regulations dating back to 1933 and 1934, and waiting for Congress to enact new laws with regard to crypto. Each of the agencies is lobbying to get a bigger slice of the pie in the enforcement arena once those are adopted.

Ethan Ostroff:

There's a lot of recent statements right by Gensler, by Benham, by Yellen, all with respect to this interplay as to what role each of those federal regulators could or should play with respect to the digital asset space and with the state. Now, Boozman legislation that's I believe is now in front of the Senate Agriculture Committee. Do you have any thoughts about that legislation and its attempt to give the CFTC jurisdiction?

Jay Dubow:

I think right now on Capitol Hill, it's very tough to get most legislation past Democrats have slim majorities, don't have enough members in the Senate to overcome a filibuster if that's the way the Republicans want to go. So I would be very surprised if there's any legislation that gets passed through the remainder of this session. Once we see a new Congress, there may be reason for more negotiation among the two sides, and perhaps in that vein, they will try to get something done that will address crypto and allocate in some way regulation. I would think at the end of the day, both agencies will have some piece that remains to be seen how much either will get.

Ethan Ostroff:

Yeah, and it's certainly possible that the Federal Reserve could play a significant role in regulating this space as well. Keith, do you have any thoughts or insights about that intersection between the SEC, the CFTC, and the Federal Reserve in covering this space?

Keith Barnett:

Yeah, I have some thoughts on that. My thoughts also include the states, right? We cannot forget about the states, especially in light of the fact that a lot of states have amended their money transmitter laws to include cryptocurrencies, but also we've seen state enforcement actions concerning securities related cryptocurrency issues. As Jay pointed out, it's the SEC and the CFTC that's getting all the attention when you read the financial websites or hear about things in the news.

But my practice has mainly seen the states and FinCEN. FinCEN stands for the Financial Crimes Enforcement Network. They are regulators that are pretty active, and if you don't mind, I'll give an example from the states. It actually shows the fallout from the bankruptcy of a crypto company that has extended beyond the bankruptcy court to state securities regulators.

Last month, the state of Alaska division of banking and securities issued an order to seasoned assist against a crypto company that was in bankruptcy. And according to Alaska's finding a fact that crypto company offered and sold unregistered securities to Alaska residents through what it called its cryptocurrency investment program in which it advertised high rates of return for investors.

The way that it worked, actually, it's actually pretty interesting because the crypto company customers essentially deposited their cryptocurrency with the company and assigned control rights for the cryptocurrency to the company, and the customers earned in kind interest on the deposited cryptocurrency. The company in turn loaned the cryptocurrencies to large borrowers, and the interest earned on those loans partly funded the interest payments to the customers. So they operated like a bank even though they were not a bank. And this is actually where the intersection comes in with securities and payments. The company was actually registered as a money transmitter in Alaska and in other states, but at least according to Alaska, that money transmitter license under Alaska law was not sufficient to allow the company to engage in the activities that I just described. Alaska found that these activities were beyond the scope of money transmission and were instead securities because the customers received passive income generated by the company staking cryptocurrency on its customer's behalf or by lending out the cryptocurrencies.

And this is really interesting because a lot of people don't know this, but having a money transmitter license actually allows licensees under certain circumstances to invest money that they receive from their customers. And so I found it interesting that Alaska found that this company crossed over that thin line between money transmission and securities.

What that tells me is that at the end of the day, at least with respect to the state regulators, they are concerned about consumer protection. And this particular case, the state regulators were saying to themselves and to others, "We have a crypto company that's in bankruptcy. There is no recourse for the customers." And this is where the intersection of other state regulators come in. Companies like the one here, they're not a bank, so therefore there's no FDIC protection. They're not a brokerage firm, so there's no civic protection. I found that very interesting with the state.

Ethan Ostroff:

It is really interesting, Keith, if I'm remembering correctly, California's DFPI joined seven other states, I believe including Alaska, in recently pursuing enforcement actions against another company, specifically dealing again with earned interest product accounts.

And if I remember correctly from that case, one of the things that California had mentioned was the failure to qualify these accounts as securities and to register these accounts as securities prevented investors from receiving all the material information needed to evaluate whether to open these types of crypto interest accounts such as the risks that are being taken by the provider with the deposited funds. So it seems like there is a particular interest amongst the state regulators in this particular type of product where there's an offer to consumers of interest bearing crypto asset accounts. Jay, any comments or thoughts about that recent activity and the particular focus on those types of accounts?

Jay Dubow:

I think it's interesting and the whole, it goes to whether these are securities and whether or not they need to be registered, in part because if they're not securities, then they don't have to be registered, and that's being litigated right now in cases involving the SEC.

Keith Barnett:

Yeah, and the other thing it does show is that you have companies who believe that their money transmitter licenses are sufficient to allow them to engage in these activities, and the states are saying, no, that's not the case. So it really shows how companies before they start engaging in these types of activities really need to seek competent legal counsel who can provide an opinion on the issue of what licenses are needed in order to continue this activities without running afoul of the regulators.

Ethan Ostroff:

Definitely a great point, Keith. I know you also mentioned some activity in your work, particularly with FinCEN, anything that's happened recently in that space that our listeners might be interested in?

Keith Barnett:

So once again, it goes back to what Jay was talking about, this turf war between the SEC and the CFTC, but you also have FinCEN and OFAC both saying, "Hey, don't forget about us." Because there are circumstances under which something is not a security and it's not a commodity, but it's still something that the federal government is interested in.

FinCEN is definitely looking at crypto companies to determine whether they're registered as a money services business if they don't fall within either a commodity or security. And here's the critical thing. FinCEN is looking at whether these companies have an anti-money laundering program in place that is commensurate with the level of risk associated with transactions. And I'm not talking about securities transactions, I'm not talking about commodities transactions. These are just daily transactions involving cryptocurrencies.

Here's an example. About a week or two ago, FinCEN settled a case with a crypto company for 29 million dollars. The crypto company had to pay 29 million arising out of FinCEN's findings

that the crypto company did not have an effective anti-money laundering program. According to the settlement agreement, the crypto company processed about 20,000 transactions per day and nearly 100 million dollars on a daily basis, but only employed two people to work in their AML compliance department. This was an exchange and a liquidity provider.

The other thing to add to that is the two people who worked in that department, they manually did the job, and they only did it on a part-time basis. They had other duties within the company. FinCEN said in the settlement agreement that there were circumstances in which a suspicious activity report should have been filed, but they were not, and they were blaming that on the lack of an adequately structured AML program. They went on to say that an acceptable AML program is one that employs a sufficient number of people, has management buy-in, adequate training and things of that nature. Given that this company did not file a suspicious activity report, notwithstanding the high risk activities in which it was processing, they hadn't filed one in four years, FinCEN found that as just a breakdown of the program.

This is another example that the regulators are looking out, and it's also an example of sometimes a company may grow too fast before they have an adequate compliance system in place because you can start off doing 10 transactions a day, at a thousand bucks, but when you start getting thousands of transactions and tens of millions or hundreds of millions, you need to scale your compliance program to be adequate so you don't fall within regulatory scrutiny.

Ethan Ostroff:

The Bittrex enforcement action is incredibly important for everyone who's moving crypto, right? Because not only is it the largest civil penalty ever imposed by OFAC in the virtual currency industry, it's also the first parallel enforcement action by both OFAC and FinCEN. They had an agreement and a settlement with both FinCEN and OFAC in this instance. So people in this space need to be aware that OFAC and FinCEN are starting to work together in these types of enforcement actions, and they're going to be expecting companies in this space to be fully compliant. That goes for not just US companies, but if you're in the virtual currency industry and you're a non-US company that engages in US nexus transactions, you've got to have robust sanction screening in place.

Keith Barnett:

Right. And this company did not. They did not screen for individuals, and they also did not screen for regions. In the settlement agreement, it said that they were engaging in transactions in Cuba, North Korea, Iran, the Crimea region of Ukraine, areas in which they should not have been conducting transactions. So you're right, That's why OFAC was involved.

Jay Dubow:

And the SEC also gets involved in foreign companies that touch upon the US investors, and they have a long history of doing that and reaching out overseas when they can get access to them. They have MOUs with many countries and their securities regulators, and so they have a very robust international enforcement effort as well.

Ethan Ostroff:

Totally agree, Jay, and thanks for bringing it back to the SEC in particular. What types of enforcement actions by the SEC and the crypto space do you think our listeners need to be paying attention to and aware of?

Jay Dubow:

As I said earlier, the SEC is using its old traditional statutory provisions to enforce in this space, their general anti-fraud provisions they're using as well as their registration provisions. Those go back again to the start of the SCC 1933, 1934. They're bringing fraud claims when issuers and other participants make false in misleading statements about a particular crypto security. They will bring fraud claims in those circumstances.

Many of the claims that they've brought, we've touched upon are registration claims. Many issuers have distributed crypto assets, taken the position that they were not securities and therefore did not need to follow the registration requirements or seek exemption within the securities laws, and the SEC has brought many actions with regard to that and including one that's been an ongoing litigation involving Ripple, which has been in the press quite a bit.

Most SEC enforcement actions in the crypto space, as well as other areas settle for various reasons. So you don't often get judicial oversight of the SEC's enforcement program. The Ripple case is one where they're fighting back and it's been a vigorous litigation, and at some point we will get a ruling from the court unless the parties do settle, does not appear that they're on that path.

Another area, it's gotten a lot of press recently. There was a case in the earlier part of this month brought against Kim Kardashian. You usually don't associate Kim Kardashian and SEC enforcement, but Ms. Kardashian had been paid to promote a crypto asset token on social media. She did so through Instagram, and then she touted a EMAX tokens from EthereumMax, and she did not disclose that she was being paid to do so. That's a violation of section 17(b) of the Securities Act 1933. That section of law has been, in the past, mostly used with individuals who were touting stocks either online or through newsletters without disclosing that they were being paid to do so.

Ms. Kardashian settled for around 1.2 million dollars, which was substantially more than what she had been paid, which was \$250,000. She's not the first celebrity endorser that the SEC brought in action against in the crypto space. Previous actions were against actor Steven Seagal and Boxer Floyd Mayweather for similar type of conduct.

The SEC certainly likes bringing actions against individuals for whom there will be a lot of press, as the Kardashian action did, because they can't be everywhere. And when bringing an action against someone that's going to get a lot of publicity, it promotes the SEC's division enforcement much more and makes it seem like they are everywhere.

Ethan Ostroff:

Yeah. The Ripple case is, in particular, very important for the entire crypto space on this question of how you determine whether or not a virtual currency is a security or not.

My understanding is both Ripple and the government have filed motions for summary judgment, and we're going to get a determination at some point as to whether or not XRP is a

security that falls within the ambit of the registration and disclosure requirements of the 1933 Securities Act, or if the court accepts Ripple's argument as to why it's not a security subject to registration or disclosure.

Let me ask you this. I mean, in the meantime, if you're in this space and you're looking at these competing arguments in the Ripple case, both applying obviously the same, quote, unquote, simple three-part test, right, that we've been using for a very, very long time. If you're looking at that and you're seeing this activity by the regulators on the state and federal level where there's a lot of uncertainty as to the framework or the guideposts, what do companies in this space who are trying to figure out whether or not they need to go about registration under federal and state securities laws, what do they need to do right now?

Jay Dubow:

Well, I think in the first instance, they need to consult with attorneys who are knowledgeable in this space. It's, I think, very risky to go forward with an offering that may fall on the wrong side of the line with the SEC until we get some guidance from the courts on the Ripple case. Otherwise, at a minimum, you're at risk of investigation from the SEC or other agency. And even if you ultimately maybe proven right, you have the cost and distraction of having to potentially go through that whole process.

As you said, it was a three part test. Both are using, it's from a Supreme Court case in 1946, the Howey test, and it's pretty, again, straightforward. If the investment contract is a contract or transaction or scheme whereby a person invests his or her money in a common enterprise and is led to expect profits solely from the efforts of a third party, then that has been deemed to be a security. Ripple claims that the sale of their XRP are not illegal securities and it's an investment contract, it is a virtual currency, and therefore not subject to the securities laws. A court will decide and lawyers are going to interpret that decision. I would suspect that whatever the district court decides, it will be appealed. And so it'll be some time before we have some really good precedential authority in this space.

Ethan Ostroff:

And in the meantime, we may get legislation that actually gets passed by both chambers and signed by the president. We might get more regulations. So a lot of moving parts. Keith, what are your thoughts with respect to the intersection of these different federal regulators with different perspectives or objectives and the state regulators in this space as well?

Keith Barnett:

Well, I think it goes back to some of the things that Jay was saying earlier. One of the things, Jay, that you said that really caught my mind was when you set they're operating off of these old laws and they're trying to shoehorn it in new things, but using old laws you find that as well with the state laws and also with FinCEN. Now they're engaging in advisory opinions and belated rule making, but nothing very significant that really deals with these core issues. So that is one of the things that you're going to see in common with these state and the different federal regulators.

And also back to Jay's earlier point, you're going to see circumstances under which something is both a payment product and a security, and quite frankly, also a commodity. And so the

regulators really need to work together to see who's doing what. And you saw that with the FinCEN in and OFAC example. In the FinCEN in enforcement action, there was a component there where there was a violation of OFAC regulations. So they worked together there. And I expect that to continue over the next few years because my guess is we're going to have more MOUs and more cooperation amongst the regulators before we see Congress radically change any of the laws that have not been changed in dozens of years.

Ethan Ostroff:

Yeah, definitely. I mean, if anything, the practical reality of budget and manpower constraints would militate in favor of these regulators working together when they're interacting with the stakeholders in the crypto ecosystem. So Keith and Jay, thank you very much for joining us today. Thank you to our audience for listening to today's episode. Don't forget to visit our blog, consumerfinancialserviceslawmonitor.com and subscribe so you can get the latest updates. Please make sure to also subscribe to this podcast via Apple Podcast, Google Play, Stitcher, or whatever platform you use, and we look forward to the next time.

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