



# Staff Memorandum

## HOUSE OF DELEGATES Agenda Item #8

REQUESTED ACTION: None, as the report is informational.

Jackie Drohan and Dana Syracuse, co-chairs of the Task Force on Emerging Digital Finance and Currency, will present on the work of the Task Force and review recent and upcoming programming.

By way of background, the Task Force was formed by President Sherry Levin Wallach in June 2022 to study and evaluate the legal issues and questions surrounding the expansion and regulation of the digital assets, digital finance, and digital currency industries in New York State, including technological innovations with the Metaverse.

The Task Force has prepared an interim report, a copy of which is attached to this memo. The interim report provides a primer on blockchain and digital assets, identifies the key regulatory frameworks that currently apply to digital assets, and outlines the Task Force's intended areas of focus.

**N.B. – This item is informational only.** The interim report is not scheduled for formal consideration at the January 2023 meetings of the Executive Committee and House of Delegates.

## Informational Report - Task Force on Emerging Digital Finance and Currency

### I. INTRODUCTION

Fourteen years ago, Satoshi Nakamoto released a white paper entitled “Bitcoin: A Peer-to-Peer Electronic Cash System.”<sup>1</sup> Nakamoto proposed a protocol that would allow an individual to transfer Bitcoin—a digital and decentralized alternative to fiat currency—directly to another individual without the need to involve a bank or other financial institution.<sup>2</sup> Unlike prevailing payment ecosystems, which relied on trust between individuals and financial institutions, the Bitcoin protocol relied on cryptography.

Bitcoin’s innovation was not the creation of a digital-only alternative to fiat currency; proposed substitutes for government-issued money predated Bitcoin. Instead, Bitcoin’s innovation was the creation of a blockchain: a type of distributed ledger in which a group of computers programmatically reach agreement on the state and changes to certain shared data.

Blockchain technology has the potential reshape how we transact: it decreases the need to trust centralized parties—who charge rent for their services and represent a single point of failure—by creating immutable and auditable records that no single person controls. Rather than being reliant on financial institutions to carry out instructions faithfully, individuals have the capability, through blockchain technology, to digitally transact with one another directly and then cryptographically prove that the transaction occurred (not just trust that it did).

The launch of the Ethereum network, for example, extended a blockchain’s utility by introducing embedded software applications—commonly called “smart contracts”—onto the blockchain ledger itself.<sup>3</sup> Smart contracts have enabled decentralized finance (referred to colloquially as “DeFi”) applications through which financial services like borrowing, lending, and trading take place on the blockchain without intermediary financial institutions. Non-fungible tokens (“NFTs”), which are unique blockchain-based digital assets that often link to other digital or real-world assets, enable claims of ownership of specific items—everything from concert tickets to property titles—to be directly and transparently proven. The Web3 ecosystem seeks to utilize blockchain technology to decrease some of the reliance on centralized third parties and democratize commerce by empowering developers, operators, and users of a platform to own or directly benefit from their efforts.

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<sup>1</sup> Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, <https://bitcoin.org/bitcoin.pdf>. The name Satoshi Nakamoto is believed to be a pseudonym for an individual or group of individuals. *Who is Satoshi Nakamoto?* COINDESK (Aug. 5, 2022), <https://www.coindesk.com/learn/who-is-satoshi-nakamoto/>.

<sup>2</sup> Nakamoto, *supra* note 1.

<sup>3</sup> Vitalik Buterin, *Ethereum: A Next-Generation Smart Contract and Decentralized Application Platform* (2014), at 13, [https://ethereum.org/669c9e2e2027310b6b3cdce6e1c52962/Ethereum\\_Whitepaper\\_-\\_Buterin\\_2014.pdf](https://ethereum.org/669c9e2e2027310b6b3cdce6e1c52962/Ethereum_Whitepaper_-_Buterin_2014.pdf).

These innovations have also introduced new challenges. The ability to engage in peer-to-peer, pseudonymous transfers of digital assets with real-world value has resulted in digital assets becoming the preferred payment method on darknet marketplaces<sup>4</sup> and in ransomware schemes.<sup>5</sup> Bad actors have taken advantage of the hype around digital assets to defraud consumers, with the U.S. Department of Treasury estimating that \$7.8 billion in digital assets were stolen in 2021 through scams.<sup>6</sup> The smart contracts underlying DeFi applications have been exploited, leading to billions of additional dollars in lost assets.<sup>7</sup> Most recently, FTX, previously one of the world's largest digital asset exchanges, filed for bankruptcy after reports of shaky financials led to the blockchain-equivalent of bank run on the exchange<sup>8</sup> and ultimately resulted in civil and criminal charges against its founder and former CEO that centered around allegations that he fraudulently misappropriated funds that customers had deposited with the exchange<sup>9</sup>.

As the home of the world's largest financial center, New York State and, by extension, members of the New York State Bar Association ("NYSBA") have played key roles in the emerging digital asset ecosystem. NYSBA members have guided innovators and entrepreneurs seeking to launch new products and services utilizing digital assets. NYSBA members at the New York State Department of Financial Services, recognizing the limitations of existing regulatory frameworks, shaped the department's BitLicense regulations, a first-of-its kind regulatory regime tailored to the risks associated with digital asset activities. And NYSBA members have held bad actors to account when they sought to misuse digital assets for illicit purposes.

NYSBA members who have not already encountered blockchain-related issues in their legal practices likely will soon. The technology is not just relevant to financial services lawyers: it has the potential to broadly impact everything from how elections are held to how the supply chain is managed. Anywhere that is reliant upon whether information or data is trustworthy has the potential to be impacted by the technology. Where such change occur, NYSBA members will have to advise on, advocate for, and decide (in the case of judges) how the existing laws apply and, where change is needed, help draft new laws.

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<sup>4</sup> *Advisory on Illicit Activity Involving Convertible Virtual Currency*, FINCEN ADVISORY, FIN-2019-A003 (May 9, 2019), <https://www.fincen.gov/sites/default/files/advisory/2019-05-10/FinCEN%20Advisory%20CVC%20FINAL%20508.pdf>.

<sup>5</sup> *Advisory on Ransomware and the Use of the Financial System to Facilitate Ransom Payments*, FINCEN ADVISORY, FIN-2021-A004 (Nov. 8, 2021), [https://www.fincen.gov/sites/default/files/advisory/2021-11-08/FinCEN%20Ransomware%20Advisory\\_FINAL\\_508.pdf](https://www.fincen.gov/sites/default/files/advisory/2021-11-08/FinCEN%20Ransomware%20Advisory_FINAL_508.pdf).

<sup>6</sup> *Crypto-Assets: Implications for Consumers, Investors, and Businesses*, U.S. DEPT. OF TREASURY, at 27-28, [https://home.treasury.gov/system/files/136/CryptoAsset\\_EO5.pdf](https://home.treasury.gov/system/files/136/CryptoAsset_EO5.pdf).

<sup>7</sup> The U.S. Department of Treasury estimates that \$2.3 billion worth of digital assets were stolen from DeFi applications in 2021. *Id.* at 28.

<sup>8</sup> *FTX creditors may number over 1 million as regulators seek answers*, REUTERS, Nov. 15, 2022, <https://www.reuters.com/technology/ftx-officials-contact-with-us-regulators-filing-2022-11-15/>.

<sup>9</sup> See *SEC v. Bankman-Fried*, No. 22-cv-10501 (S.D.N.Y. 2022); *CFTC v. Bankman-Fried*, No. 22-cv-10503 (S.D.N.Y. 2022); *United States v. Bankman-Fried*, No. 22-cr-00673 (S.D.N.Y. 2022).

Applying the law to blockchain-technologies is frequently difficult, raising risks for those attorneys who provide blockchain-related legal services. NYSBA members have an ethical obligation to provide “competent representation.”<sup>10</sup> Because the blockchain ecosystem is quickly evolving and the legal questions that arise are often novel, attorneys risk violating their ethical obligations when they merely dabble in blockchain-related legal issues. Attorneys also face “gatekeeper liability” risks, in which attorneys may be liable for their client’s violations of law where the attorney’s services facilitated the violation. Officials from the Securities and Exchange Commission (“SEC”) have highlighted the duty of attorneys, as gatekeepers to U.S. capital markets, to prevent clients from engaging in digital asset activities that violate the securities laws<sup>11</sup> and warned that enforcement against gatekeepers is a priority for the agency<sup>12</sup>.

NYSBA’s mission is to “shape the development of law, educate and inform the public,” and “respond to the demands of [a] diverse and ever changing legal profession.”<sup>13</sup> In line with that mission, NYSBA’s Task Force on Emerging Digital Finance and Currency (the “Task Force”) has been directed to “study and evaluate the legal issues and questions surrounding the expansion and regulation of the digital finance and digital currency industries in New York State.”<sup>14</sup>

The Task Force’s mission has three components:

1. Develop and educate members on best practices for attorneys representing clients on digital finance and digital currency matters.
2. Study and evaluate the legal issues and questions surrounding the expansion and regulation of the digital finance and digital currency industries in New York State.
3. Promote the appropriate use of digital assets and Web3 resources to keep pace with the industry and expand global membership.

This interim report represents the beginning of the Task Force’s work and has three parts. First, we provide a primer on blockchain and digital assets. Second, we identify the key regulatory frameworks that currently apply to digital assets. Third, we outline the Task Force’s intended areas of focus.

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<sup>10</sup> 22 N.Y. C.R.R. Part 1200.0, Rule 1.1.

<sup>11</sup> *See. e.g.*, Jay Clayton, Chairman, SEC, Opening Remarks at the Securities Regulation Institute (Jan. 22, 2018).

<sup>12</sup> Gurbir Grewal, Director, Division of Enforcement, SEC, Testimony on “Oversight of the SEC’s Division of Enforcement” Before the United States House of Representatives Committee on Financial Services Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets (July 21, 2022) <https://www.sec.gov/news/statement/grewal-statement-house-testimony-071922>.

<sup>13</sup> *About*, NEW YORK STATE BAR ASSOCIATION, <https://nysba.org/about/#:~:text=Our%20mission%20is%20to%20shape,access%20to%20justice%20for%20all>. (last visited Nov. 15, 2022).

<sup>14</sup> *Task Force on Emerging Digital Finance and Currency*, NEW YORK STATE BAR ASSOCIATION, <https://nysba.org/committees/task-force-on-emerging-digital-finance-and-currency/> (last visited Nov. 15, 2022).

## II. BACKGROUND

### A. Overview of Blockchain Technology

A blockchain is a type of digital ledger consisting of time-stamped blocks—i.e., groups of transactions—that are chained (hence, the term “blockchain”) together in chronological order through cryptography. Blockchains have three key components:

1. A peer-to-peer network of computers (commonly called “nodes”);
2. A consensus protocol, which is a preprogrammed mechanism by which nodes reach agreement on the state of, and updates to, the ledger; and
3. Certain shared data, often embodied as a digital token.

In a typical blockchain transaction, a node broadcasts the proposed transaction to other nodes. The nodes then combine the proposed transaction, along with other proposed transactions, into a proposed block. The underlying protocol’s consensus mechanism determines which node will mine the next block and receive compensation (often in the form of block rewards—i.e., newly created digital assets—and/or transaction fees) for adding a new block to the ledger. However, before the block is actually mined to the blockchain, the other nodes—using cryptography—check whether the miner’s block is valid. If the nodes agree, the accepted block is added to the ledger.

Bitcoin was the first blockchain-based digital asset and was intended as a general-purpose medium of exchange, but a recent report by the Bank for International Settlements estimated that there are over 10,000 distinct types of blockchain-based digital assets.<sup>15</sup> Digital asset features and functionality can vary significantly, but they broadly fall into five categories:

1. **Virtual Currencies.** Virtual currencies are fungible digital assets designed to be used as a general-purpose medium of exchange. Under this framework, Bitcoin would be considered a virtual currency.
2. **Stablecoins.** Stablecoins are fungible digital assets whose value is intended to be pegged to another asset (commonly, fiat currency). USD Coin (“USDC”) is an example of a stablecoin that is pegged to the U.S. dollar.
3. **Utility Tokens.** Utility tokens are fungible digital assets designed for use within a particular application or platform. An example of a utility token is VCOIN. VCOIN was designed by IMVU, the asset’s issuer, as a way for users of IMVU’s virtual world platform to buy goods and services from vendors within that platform.

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<sup>15</sup> *The Future Monetary System*, BIS ANNUAL ECONOMIC REPORT 2022, at 78, <https://www.bis.org/publ/arpdf/ar2022e3.pdf>.

4. **Security Tokens.** Security tokens are digital assets that expressly (or implicitly or indirectly) represent equity in a company.
5. **Non-fungible Tokens (“NFTs”).** NFTs are unique blockchain-based digital assets with metadata that, as most commonly used today, link to or embody one or more physical or digital items. The NFT functions as a verifiable and transferable digital record that evidences the holder’s right to access and use these items. NFTs can represent rights to everything from digital artwork and concert tickets to real property.

Developers have built upon Bitcoin’s protocol to launch new blockchains that incorporate new features. The most important innovation has been the blockchain-based smart contract, first implemented in the Ethereum protocol.<sup>16</sup> A blockchain-based smart contract is computer code—written to the blockchain itself—that is capable of running automatically and autonomously based upon the occurrence or nonoccurrence of a specified condition or conditions (e.g., delivery of an asset, change in a reference rate, or weather conditions).<sup>17</sup> If the smart contract is triggered, the code’s output is written onto the ledger.

## B. The Emerging Digital Asset Ecosystem

Blockchain technology has spurred significant initiatives to reshape commerce through decentralization. This subsection seeks to define key aspects of the emerging digital asset ecosystem.

### 1. Web3

Many observers view blockchain technology as being a key component of a new era of the internet called Web3.<sup>18</sup> The first iteration—Web1—enabled consumers to connect to the internet and access mostly static, noninteractive content.<sup>19</sup> Web2 enabled social media, removing most barriers for end users to publish their own content to the internet.<sup>20</sup> The tradeoff was that, in order to do so, consumers placed control of personal data in the hands of centralized providers.<sup>21</sup>

Web3 is frequently defined as a decentralized version of the internet that decreases end-user reliance on centralized, often noninteroperable platforms.<sup>22</sup> Optimists view blockchain, in its role as a part of Web3, as ultimately returning some control over personal data to the end user and

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<sup>16</sup> Broadly defined, the smart contract predated the blockchain by at least 15 years, comprising computerized transaction protocols that execute terms of a contract. See Nick Szabo, *Formalizing and Securing Relationships on Public Networks*, FIRST MONDAY, <https://firstmonday.org/ojs/index.php/fm/article/view/548/469> (last visited Nov. 15, 2022).

<sup>17</sup> Buterin, *supra* note 3.

<sup>18</sup> *What is Web3?*, ETHEREUM.ORG, <https://ethereum.org/en/web3/> (last updated Nov. 14, 2022).

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

democratizing commerce by enabling both platform developers and users to directly benefit from their contributions with less intermediation.<sup>23</sup>

## 2. Decentralized Finance

DeFi applications are the most visible arm of the current Web3 ecosystem. DeFi is an umbrella term for financial services deployed on and accessible via public blockchains.<sup>24</sup> Using smart contracts, DeFi applications are intended to enable users to earn interest, borrow, lend, buy insurance, trade derivatives, trade assets, and more without intermediaries. Frequently, DeFi developers provide a front-end website through which end users can access the DeFi application (albeit in an intermediated way).<sup>25</sup> However, because these smart contracts often exist on a public, often permissionless blockchain, many DeFi application contracts can be accessed directly by those with sufficient technical skills.<sup>26</sup>

## 3. Metaverses

Over the longer term, Web3 proponents expect metaverses to be a key component of the decentralized internet by providing digital analogs to the real world. Although definitions vary, at a high level, a metaverse is a virtual- or augmented-reality environment in which users interact on a peer-to-peer basis.<sup>27</sup> Virtual reality environments are not new, but incorporation of blockchain-based digital assets within the metaverse itself is. Bringing these assets into the metaverse allows individuals to transact on a peer-to-peer basis in assets that have real-world value.<sup>28</sup>

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<sup>23</sup> *The web3 Landscape*, A16Z (Oct. 2021), <https://a16z.com/wp-content/uploads/2021/10/The-web3-Reading-List.pdf>.

<sup>24</sup> *What is Blockchain Technology?*, CBINSIGHTS (Nov. 9, 2021), <https://www.cbinsights.com/research/what-is-blockchain-technology/>.

<sup>25</sup> *How DeFi Platforms are Using Data from TRM Labs to Respond to Tornado Cash Sanctions*, TRM Labs (Aug. 15, 2022), <https://www.trmlabs.com/post/how-defi-platforms-are-using-data-from-trm-labs-to-respond-to-tornado-cash-sanctions>.

<sup>26</sup> *Id.*

<sup>27</sup> *The Metaverse in 2040*, PEW RESEARCH CENTER (June 30, 2022), <https://www.pewresearch.org/internet/2022/06/30/the-metaverse-in-2040/> (“In today’s terms, the metaverse is the realm of computer-generated, networked extended reality, or XR, an acronym that embraces all aspects of augmented reality, mixed reality and virtual reality (AR, MR and VR)”).

<sup>28</sup> *The Block 2022 Digital Asset Outlook*, GSR (Dec. 2022) (“The term metaverse dates back to Neal Stephenson’s 1992 novel, *Snow Crash*, in which he refers to the metaverse as a persistent virtual world. The idea is that the metaverse is a real-time 3D social medium where people collaborate and participate in an economy. . . . One of the common aspects is about how the metaverse will also be integral to digital economies. And if this is the case, asserting ownership, proving digital scarcities will be vital attributes of the metaverse. Imagining a metaverse without blockchains and NFTs is difficult as they already have the characteristics of the metaverse.”).



#### 4. Decentralized Autonomous Organizations

Blockchain has also spurred efforts to decentralize organizational governance. So-called decentralized autonomous organizations (“DAOs”) are organizations with (purportedly) no central authority (e.g., no board of directors or executive officers).<sup>29</sup> Instead, governance decisions are made by the holders of governance tokens—digital assets that represent a right to participate in the organization’s governance—who vote on proposals made by community members.<sup>30</sup> Commonly, portions of the organization’s governance structure are enforced through smart contracts, enhancing the transparency and auditability of governance decisions and, in some cases, allowing the outcomes of those decisions to automatically and autonomously execute on the blockchain.<sup>31</sup> DAOs are generally not incorporated, creating uncertainty as to the organization’s proper legal classification.

### III. KEY FRAMEWORKS APPLICABLE TO DIGITAL ASSETS

Regulators have largely sought to apply existing financial services regulatory frameworks to digital assets, where the applicable regulatory framework depends on the digital asset involved and the activity being performed. There are notable exceptions, including New York’s BitLicense framework, which was developed by the regulators at the New York State Department of Financial Services to provide a regulatory framework tailored to digital asset activities.

Federal regulators have been active in enforcing the application of statutes within their authority to digital asset activities. However, those regulators with supervisory authority—such as the SEC which oversees securities broker-dealers and exchanges, and the Office of the Comptroller of the Currency, which supervises national banks—have been reluctant to register or charter new entities seeking to engage in digital asset activities. The result is that supervision of persons engaged in regulated digital asset activities has largely been left to the states, typically pursuant to state money transmitter and/or trust company statutes. Because these statutes do not authorize regulated digital asset service providers to operate nationwide, digital asset service providers are supervised by dozens of state regulators. By contrast, the European Union (“EU”) is developing an overarching supervisory framework for digital asset activities that will provide a passporting mechanism to avoid country-by-country licensing within the EU.<sup>32</sup>

Initial regulatory and enforcement efforts have focused on centralized providers of digital asset services, such as exchanges that facilitate the trade of digital assets on internal, non-

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<sup>29</sup> Although DAOs aim to operate in a decentralized manner, the U.S. Government has warned that many purportedly decentralized services are “decentralized more in name than in fact.” *The Report of the Attorney General Pursuant to Section 5(b)(iii) of Executive Order 14067: The Role of Law Enforcement in Detecting, Investigating, and Prosecuting Criminal Activity Related to Digital Assets*, U.S. DEPT. OF JUSTICE (Sep. 6, 2022), <https://www.justice.gov/ag/page/file/1535236/download>.

<sup>30</sup> What is Web3?, *supra* note 18.

<sup>31</sup> *Id.*

<sup>32</sup> Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and Amending Directive (EU) 2019/1937, COM (2020) 593 final (Sep. 24, 2020).



blockchain-based orderbooks and ledgers. More recently, regulators and law enforcement have sought to apply financial services laws to persons that the government believes are operating or controlling DeFi applications. The premise underlying these recent actions is that if DeFi protocols perform regulated financial activities, those in control of the protocols are responsible for complying with applicable laws.<sup>33</sup>

Below, we provide an overview of the key financial services-related regulatory frameworks that currently apply to digital assets.

### **A. Bank Secrecy Act**

The Bank Secrecy Act (“BSA”) is the principal federal statute aimed at preventing money laundering. The BSA and its implementing regulations (the “BSA Regulations”), adopted by the Financial Crimes Enforcement Network (“FinCEN”), impose a wide range of anti-money laundering (“AML”) obligations on financial institutions, including:

- State or federally chartered banks;
- Broker-dealers registered with the SEC and persons required to be registered as broker-dealers (i.e., unregistered broker-dealers);
- Futures commission merchants registered with the Commodity Futures Trading Commission (“CFTC”) and persons required to be registered with the CFTC as futures commission merchants (i.e., unregistered futures commission merchants); and
- A class of nonbank financial institutions called “money services businesses” (“MSBs”).<sup>34</sup>

As applied to digital assets, FinCEN guidance and enforcement efforts have focused on MSBs. MSBs are persons “wherever located doing business, whether or not on a regular basis or as an organized or licensed business concern, wholly or in substantial part within the United States” acting in one of seven enumerated capacities, including as a “money transmitter.”<sup>35</sup> A “money transmitter” is a person that (i) accepts “currency, funds, or other value that substitutes for currency

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<sup>33</sup> See, e.g., *Action Plan to Address Illicit Financing Risks of Digital Assets*, U.S. DEP’T OF TREASURY, , <https://home.treasury.gov/system/files/136/Digital-Asset-Action-Plan.pdf>, (last visited Nov. 11, 2022) (“Frequently, DeFi services purport to run autonomously without the support of a central company, group, or person, despite having a controlling organization—through a decentralized autonomous organization, concentrated ownership or governance rights, or otherwise—that provides a measure of centralized administration or governance. When such an entity accepts and transmits currency, funds, or value that substitutes for currency, it may be operating as a money transmitter and have AML/CFT obligations, and may be decentralized only or partly in name.”).

<sup>34</sup> 31 C.F.R. § 1010.100(t).

<sup>35</sup> *Id.* § 1010.100(ff).

from one person” and transmits “currency, funds, or other value that substitutes for currency to another location or person by any means” or (ii) is “engaged in the transfer of funds.”<sup>36</sup>

Among other requirements, MSBs must (i) register with FinCEN; (ii) develop, implement, and maintain an effective AML program; and (iii) adhere to recordkeeping and reporting obligations (including filing suspicious activity reports). Operating as an unlicensed MSB may result in civil and potentially criminal penalties under federal law.

FinCEN has published guidance outlining which blockchain-related activities it interprets as being regulated money transmission and, thus, render an entity an MSB under the BSA. Specifically, in March 2013, FinCEN released the “Virtual Currency Guidance,”<sup>37</sup> in which FinCEN interpreted the definition of a money transmitter to cover transactions involving “convertible virtual currency” (“CVC”).<sup>38</sup> FinCEN defines CVC as a “type of virtual currency [that] either has an equivalent value in real currency, or acts as a substitute for real currency.”<sup>39</sup>

FinCEN reiterated in the guidance that “[a]ccepting and transmitting anything of value that substitutes for currency makes a person a money transmitter.”<sup>40</sup> FinCEN then concluded that persons are engaging in “money transmission services”—and thus are MSBs—when (1) they accept and transmit CVC or (2) they buy and sell CVC *and* they are either

- An “exchanger,” which is a person engaged as a business in the exchange of CVC for real currency, funds, or other CVC; or
- An “administrator,” which is a person engaged as a business in issuing CVC, and who has the authority to redeem such CVC.<sup>41</sup>

On May 9, 2019, FinCEN issued guidance that explained how it interprets the BSA Regulations as applying to certain CVC business models.<sup>42</sup> Most notably, FinCEN concluded that some “decentralized applications” (“dApps”) are engaged in money transmission. As defined by FinCEN, dApps are software programs that run on the blockchain and are “designed such that they are not controlled by a single person or group of persons.”<sup>43</sup> FinCEN analogized dApps to Bitcoin ATMs, stating that “[t]he same regulatory interpretation that applies to mechanical agencies” like Bitcoin ATMs—which accept cash and then typically transfer CVC to the purchaser—applies

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<sup>36</sup> *Id.* § 1010.100(ff)(5).

<sup>37</sup> *Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, FinCEN, FIN-2013-G001 (Mar. 18, 2013), <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* at 1.

<sup>40</sup> *Id.* at 3.

<sup>41</sup> *Id.* at 2, 3.

<sup>42</sup> *Application of FinCEN’s Regulations to Certain Business Models Involving Convertible Virtual Currencies*, FinCEN, FIN-2019-G001 (May 9, 2019), <https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf>.

<sup>43</sup> *Id.* at 18.

equally to “[d]Apps that accept and transmit value, regardless of whether they operate for profit.”<sup>44</sup> In other words, FinCEN’s guidance indicates that a dApp might be engaged in money transmission if it accepts and transmits value and the operator of the dApp may be an MSB.<sup>45</sup> FinCEN clarified that developing a dApp is not money transmission, “even if the purpose of the [d]App is to issue a CVC or otherwise facilitate financial activities denominated in CVC.”<sup>46</sup> But if a person uses or deploys the dApp to conduct money transmission, then that person will generally be an MSB.<sup>47</sup>

## B. State Money Transmitter Statutes

Every U.S. state, except Montana, regulates “money transmission” as a licensable activity, in some fashion. These statutes are primarily consumer protection statutes that aim to protect consumers by ensuring that licensees can meet their outstanding financial obligations to their customers.<sup>48</sup> If a person engages in money transmission as defined by a particular state, that person likely would need to obtain a license in order to lawfully offer services to customers within that state.

State money transmission statutes generally define money transmission to include three often overlapping categories of activity:

1. Receiving money or monetary value for transmission.<sup>49</sup>
2. Selling or issuing stored value. “Stored value” is generally defined as money or monetary value that is evidenced by an electronic record.<sup>50</sup> A closed-loop prefunded card/certificate/code issued by a seller for the future provision of goods or services is commonly exempt from regulation as stored value.

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<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 27.

<sup>47</sup> *Id.*

<sup>48</sup> RCW 19.230.005 (“It is the intent of the legislature to establish a state system of licensure and regulation to ensure the safe and sound operation of money transmission and currency exchange businesses, to ensure that these businesses are not used for criminal purposes, to promote confidence in the state’s financial system, and to protect the public interest.”); *see also The State of State Money Services Businesses Regulation & Supervision*, CONFERENCE OF STATE BANK SUPERVISORS & MONEY TRANSMITTERS REGULATORS ASSOCIATION (May 2016), <https://www.csbs.org/sites/default/files/2017-11/State%20of%20State%20MSB%20Regulation%20and%20Supervision%202.pdf> (identifying “customer protection, safety and soundness and adherence to Bank Secrecy Act and Anti-Money Laundering (“BSA/AML”) requirements” as the principal goals of the state regulatory requirements for money transmitters and other money services businesses).

<sup>49</sup> *See, e.g.*, Cal. Fin. Code § 2003(s); Iowa Code Ann. § 533C.201; Kan. Rev. Stat. § 286.01; Ariz. Rev. Stat. Ann. § 6-1201.

<sup>50</sup> *See, e.g.*, A.C.A. § 23-55-102(12)(A); Cal. Fin. Code § 2003(x); Conn. Gen. Stat. § 36a-596(12).

3. Selling or issuing payment instruments. The term “payment instrument” is typically defined as “a check, draft, warrant, money order, travelers check or other instrument or payment of money, whether or not negotiable.”<sup>51</sup>

“Money” is frequently defined as “a medium of exchange that is authorized or adopted by a domestic or foreign government.”<sup>52</sup> Notably, Texas has advised that a digital asset backed by a sovereign currency (i.e., currency-backed stablecoins) constitutes “money.”<sup>53</sup> Many states define “monetary value” as “a medium of exchange, whether or not redeemable in money.”<sup>54</sup> A few states have amended their statutes to expressly cover digital asset activities, although most have not.<sup>55</sup> Several states that have not done so have nonetheless construed their existing money transmission statutes to cover digital asset activity, concluding that fungible digital assets like Bitcoin are monetary value.<sup>56</sup>

State regulators often have varying views regarding into which money transmission prong a given activity falls—i.e., one regulator will consider selling Bitcoin to be the sale of stored value while another might consider that activity to involve the sale of a payment instrument. Broadly speaking, state regulators take the position that an entity is engaged in money transmission when it exercises custody or control over money or monetary value owned by or owed to another.

### C. BitLicense Regulations

New York has implemented a separate regulatory regime, commonly called the BitLicense, that—unlike state money transmitter regulations—is specific to “virtual currency” activities. Under the BitLicense regulations, “virtual currency” is generally defined to mean “any type of digital unit that is used as a medium of exchange or a form of digitally stored value,” irrespective of whether the digital units have a centralized repository or administrator.<sup>57</sup>

The regulations require any entity providing one or more of the following services to New York residents to obtain a BitLicense: (1) receiving virtual currency for transmission or transmitting virtual currency; (2) storing, holding, or maintaining custody or control of virtual

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<sup>51</sup> See, e.g., Florida Statutes § 560.103(29).

<sup>52</sup> See, e.g., Ariz. Rev. Stat. § 6-1201; Iowa Code § 533C.102; Kan. Rev. Stat. § 286.11-003(16).

<sup>53</sup> Texas Dep’t of Banking, Supervisory Memorandum 1037, Regulatory Treatment of Virtual Currencies Under the Texas Money Services Act (April 1, 2019), <https://www.dob.texas.gov/public/uploads/files/consumer-information/sm1037.pdf> (stating that a sovereign-backed stablecoin constitutes “money” if the stablecoin provides the holder with a redemption right for sovereign currency and thus is subject to regulation under the Texas Money Services Act).

<sup>54</sup> See, e.g., Cal. Fin. Code § 2003(m); Conn. Gen. Stat. § 36a-596; Fla. Stat. Ann. § 560.103; Iowa Code Ann. § 533C.102; Kan. Stat. Ann. § 9-508(f).

<sup>55</sup> See, e.g., RCW 19.230.010(18); Conn. Gen. Stat. § 36a-596(9), (18).

<sup>56</sup> See, e.g., *General FAQs*, NEW MEXICO REGULATION & LICENSING DEPT., <https://www.rld.nm.gov/financial-institutions/about-us/faqs/>, (last visited Nov. 11, 2022); *Digital or virtual currencies what are they?*, CONSUMER PROTECTION, OREGON.GOV, <https://dfp.oregon.gov/help/Documents/5342-virtual-currencies.pdf> (last visited Nov. 11, 2022).

<sup>57</sup> 23 N.Y. C.R.R. Part 200.2(p).

currency on behalf of others; (3) buying and selling virtual currency; (4) performing virtual currency exchange services; or (5) controlling, administering, or issuing a virtual currency.<sup>58</sup> The BitLicense regulations exempt from its licensing requirements persons engaging in the activities as (a) an entity chartered under New York Banking Law and approved by the New York State Department of Financial Services to engage in virtual currency business activities or (b) a merchant or consumer that uses virtual currency “solely for the purchase or sale of goods or services or for investment purposes.”<sup>59</sup>

The BitLicense regulations impose several supervisory requirements that go beyond the requirements imposed pursuant to state money transmitter statutes. The regulations, for instance, authorize the Superintendent of the New York State Department of Financial Services to impose capital requirements that account for the BitLicense holder’s particular safety and soundness risks.<sup>60</sup> In practice, this can mean that a BitLicense holder may be required to maintain a positive net worth in the tens of millions of dollars at all times if the Superintendent determines that circumstances warrant it. By contrast, capital requirements under state money transmitter statutes are considerably less flexible and, at the high end of the spectrum, require a positive net worth of a few million dollars. BitLicense holders must generally receive preapproval to launch materially new products and services, which differs from state money transmitter statutes which typically only require the license holders notify the regulator of the change. And the BitLicense regulations also impose specific AML and cybersecurity requirements on BitLicense holders.<sup>61</sup>

#### **D. Trust Company Laws**

Trust companies are non-depository financial institutions chartered under state law to offer fiduciary services to the public. Trust companies are subject to prudential regulation and supervision, meaning these institutions are commonly subject to supervisory requirements that go beyond the requirements imposed on money transmitter licensees, including, for example, (i) capitalization requirements that account and control for categories of risks, such as price risks, liquidity risks, and market risks; (ii) enhanced supervisory controls; and (iii) restrictions on business activities.

Trust companies are increasingly being used as a vehicle to custody digital assets, particularly the assets of institutional customers. The process for obtaining a trust charter is more involved than the process for obtaining a money transmitter license, as the state is effectively assessing whether there is a business case to issue a charter. However, obtaining a trust charter does offer several benefits, including the following:

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<sup>58</sup> *Id.* Part 200.2(q).

<sup>59</sup> *Id.* Part 200.2(q).

<sup>60</sup> *Id.* Part 200.9.

<sup>61</sup> *Id.* Part 200.15-16.

- Because state trust companies are subject to prudential regulation, they are frequently perceived as a safer vehicle for holding digital assets compared to a money transmitter licensee.
- A state trust company has a stronger legal argument than a money transmitter licensee that customer assets should not become part of a bankruptcy or receivership estate.
- Obtaining a trust charter potentially enables the entity to serve as a “qualified custodian” under the Investment Advisers Act of 1940. Status as a qualified custodian<sup>62</sup> allows the entity to custody funds on behalf of registered investment advisers, who are required to place client funds and securities with a qualified custodian<sup>63</sup>. The definition of a “qualified custodian” includes state trust companies but only to the extent “a substantial portion of the business” of such entities “consists of exercising fiduciary powers similar to those permitted to national banks.”<sup>64</sup>
- If the state trust company seeks to engage in activities beyond custody (and is authorized to do so)—e.g., settlement or exchange services—the state trust company potentially would be able to avail itself of money transmitter license exemptions in ten or more states.<sup>65</sup>

Which activities a state-chartered trust company can engage in depends largely on which state issued the charter. South Dakota, for instance, has granted trust charters to digital asset service providers, but those charters generally limit the trust company to the provision of custodial services. By contrast, limited-purpose trust companies chartered by the New York State Department of Financial Services and authorized to engage in virtual currency business activity may also provide virtual currency exchange services with the department’s approval.

## **E. Federal Securities Laws**

The federal securities laws define the term “security” broadly to cover virtually all types of investment instruments. The laws generally cover digital assets that are intended to be securities—e.g., digital assets that are intended to represent equity in a company—and digital assets that qualify as “investment contracts.” In determining whether digital assets are investment contracts under federal law, the “*Howey*” test typically applies. The *Howey* test requires an assessment of whether there is (i) an investment of money (ii) in a common enterprise (iii) with an

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<sup>62</sup> 17 C.F.R. § 275.206(4)-2(d)(6) (defining as “qualified custodian” to include an entity that meets the definition of a “bank” under 15 U.S.C. 80b-2(a)(2)); *see also* 15 U.S.C. 80b-2(a)(2) (defining a bank to include a state chartered trust company if a “substantial portion of the business . . . consists of . . . exercising fiduciary powers”).

<sup>63</sup> *Id.* § 275.206(4)-2(a).

<sup>64</sup> 15 U.S.C. 80b-2(a)(2))

<sup>65</sup> *See, e.g.*, Fla. Stat. § 560.104 (exempting trust companies from the provisions of the state’s money transmitter statute).



expectation of profits (iv) derived from the entrepreneurial or managerial efforts of others.<sup>66</sup> Classification as a security has wide-reaching implications affecting, among other things, how the digital asset can be issued and where it can be traded on secondary markets.

In July 2017, the SEC issued a Report of Investigation (the “DAO Report”) in response to the increasing use by “virtual organizations and associated individuals and entities [of] distributed ledger technology to offer and sell instruments such as DAO tokens to raise capital.”<sup>67</sup> The SEC issued the report “to stress that the U.S. federal securities law may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular offer or sale.”<sup>68</sup> The DAO Report confirmed that, unless properly conducted, selling tokens that are transferable on a distributed ledger may violate the Securities Act of 1933 (“Securities Act”), the Securities Exchange Act of 1934 (“Exchange Act”), and other federal and state securities laws.<sup>69</sup>

After the SEC issued the DAO Report, it brought an enforcement action against Munchee, Inc., a token issuer, for issuing unregistered securities.<sup>70</sup> Munchee had issued a “utility token,” but it had also made statements in its marketing materials such as the fact that it would ensure a secondary market for its tokens and guarantee high levels of returns.<sup>71</sup> Because the marketing materials contained such statements and were directed toward virtual currency investors rather than likely potential users of Munchee’s product, the SEC determined that the Munchee token was a security under the *Howey* test.<sup>72</sup> In particular, the SEC focused on the prong of “reasonable expectation of profits,” finding that it was reasonable to conclude that the marketing materials from Munchee gave potential investors certain expectations of a passive increase in value over time.<sup>73</sup>

On June 14, 2018, William Hinman, then-director of the SEC’s Division of Corporation Finance, gave a speech at a conference in which he outlined that, in his view, the sale of digital assets may not be a securities offering under certain circumstances.<sup>74</sup> Such circumstances include

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<sup>66</sup> *S.E.C. v. Edwards*, 540 U.S. 389, 394 (2004).

<sup>67</sup> Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, SEC, Exchange Act Release No. 81207 (July 25, 2017) [hereinafter DAO Report]; See also SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities, SEC (July 25, 2017), <https://www.sec.gov/news/press-release/2017-131>.

<sup>68</sup> DAO Report, *supra* note 67, at 10.

<sup>69</sup> *Id.* at 1-2.

<sup>70</sup> *In re Munchee Inc.*, Securities Act Release No. 10445 (SEC Dec. 11, 2017), <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.

<sup>71</sup> *Id.* at 3-7.

<sup>72</sup> *Id.* at 6.

<sup>73</sup> *Id.* at 5-7.

<sup>74</sup> William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, SEC (June 14, 2018), <https://www.sec.gov/news/speech/speech-hinman-061418>.

when the network is sufficiently decentralized that “purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts.”<sup>75</sup>

Director Hinman emphasized that the economic substance of the transaction matters when determining whether a token is a security and outlined several factors that the SEC will consider when evaluating token sales.<sup>76</sup> These factors include, among other things, whether:

- a sponsor or promoter’s efforts play a significant role in the development and maintenance of the token or token network;
- a sponsor or promoter retains a stake or interest in the token such that the person or entity is motivated to expend efforts to cause an increase in the value of the token;
- purchasers are motivated by a financial return when purchasing the token; and
- persons or entities other than the promoter or sponsor exercise governance rights or influence.<sup>77</sup>

On April 3, 2019, the SEC’s Strategic Hub for Innovation and Financial Technology published a framework (the “SEC Framework”) for analyzing whether a digital asset is offered and sold as a security under the federal securities laws.<sup>78</sup> The SEC Framework consolidated into one document previous SEC staff guidance, positions, and statements as to how digital assets may be covered under the *Howey* test for investment contracts.

According to the SEC Framework, “[u]sually, the main issue in analyzing a digital asset under the *Howey* test is whether a purchaser has a reasonable expectation of profits (or other financial returns) derived from the efforts of others.”<sup>79</sup> For this reason, the SEC Framework focused principally on these considerations, which are the third and fourth factors in the *Howey* test. The SEC Framework also introduced a new term, “active participant,” which is broadly defined to include participants in a digital asset network whose efforts may form the basis of a purchaser’s expectation of profits.<sup>80</sup>

The SEC Framework also emphasizes the SEC staff’s view that even if a token has partial utility at launch, under certain circumstances, the token might still be a security at launch if the digital asset’s functionality is still being developed or improved:

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<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> Framework for “Investment Contract” Analysis of Digital Assets, SEC, (Apr. 3, 2019), <https://www.sec.gov/files/dlt-framework.pdf>.

<sup>79</sup> *Id.* at 2.

<sup>80</sup> *Id.* at 3.

Even in cases where a digital asset can be used to purchase goods or services on a network, where that network's or digital asset's functionality is being developed or improved, there may be securities transactions if, among other factors, the following is present: the digital asset is offered or sold to purchasers at a discount to the value of the goods or services; the digital asset is offered or sold to purchasers in quantities that exceed reasonable use; and/or there are limited or no restrictions on reselling those digital assets, particularly where an [active participant] is continuing in its efforts to increase the value of the digital assets or has facilitated a secondary market.<sup>81</sup>

To date, SEC staff have applied the *Howey* test to digital assets in three “no-action” letters (the “SEC Staff No-Action Letters”).<sup>82</sup> In each of the SEC Staff No-Action Letters, SEC staff listed several facts that it found to be persuasive in determining that the digital assets involved were not securities. Of relevance is the weight that SEC staff gave to the following factors: (i) that the digital assets involved would be immediately usable; (ii) that the issuers would market the digital assets *exclusively* for their consumptive use; and (iii) that the issuers would build in restrictions on transfer or other price controls to limit the potential for purchasers to realize any capital appreciation.<sup>83</sup>

The SEC has also applied the securities laws to DeFi. In November 2018, the SEC settled charges against James Coburn for contributing to violations of Section 5 of the Exchange Act through his operation of a decentralized exchange—EtherDelta—which utilized a smart contract on the Ethereum network to allow buyers and sellers to trade tokens on a peer-to-peer basis.<sup>84</sup> The SEC concluded that EtherDelta traded in securities without first registering as an exchange or operating pursuant to an exemption from registration, in violation of the Exchange Act.<sup>85</sup> The SEC concluded that Coburn contributed to EtherDelta's violations because he “exercised complete and total control over EtherDelta's operations” and, as a result, he “should have known that his actions” would contribute to EtherDelta's violations.<sup>86</sup> Ultimately, the SEC and Coburn entered into an agreement whereby Coburn agreed to disgorge \$313,000 and pay a \$75,000 penalty.

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<sup>81</sup> *Id.* at 11.

<sup>82</sup> *TurnKey Jet, Inc.*, SEC Staff No-Action Letter (Apr. 3, 2019), <https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm>; *Pocketful of Quarters, Inc.*, SEC Staff No-Action Letter (July 25, 2019), <https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1>; *IMVU, Inc.*, SEC Staff No-Action Letter (Nov. 17, 2020), <https://www.sec.gov/corpfin/imvu-111920-2a1>.

<sup>83</sup> *In re Zachary Coburn*, Exchange Act Release No. 84553 (SEC Nov. 8, 2018), <https://www.sec.gov/litigation/admin/2018/34-84553.pdf>.

<sup>84</sup> *Id.* at 4-5.

<sup>85</sup> *Id.* at 8-9.

<sup>86</sup> *Id.* at 9.

## F. Federal Commodities Laws

Transactions involving commodities are governed by the Commodity Exchange Act of 1936, as amended (the “CEA”), and regulations promulgated thereunder (collectively, “Commodities Laws”) by the CFTC. The CEA broadly defines the term “commodity” to encompass virtually all goods, services, and interests.<sup>87</sup>

The CFTC has supervisory authority over three types of “commodity interest” transactions and various market participants involved in those transactions:

- **Futures Contracts.** Futures contracts are contracts for the future delivery of a commodity. Generally, futures contracts must be offered on a regulated exchange platform, known as a designated contract market (“DCM”), and through a regulated broker, known as a futures commission merchant (“FCM”). Futures contracts may only be offered on a DCM regardless of whether the contracts are marketed to retail investors or more sophisticated investors, known as “eligible contract participants” (“ECPs”).
- **Swap Agreements.** The CEA broadly defines “swap” to include (i) an option of any kind<sup>88</sup> for the purchase or sale, or based on the value of, a financial or economic interest or property of any kind; (ii) a contract or transaction that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence; and (iii) a contract that provides, on an executory basis, for the exchange of one or more payments based on the value of the commodity (or economic interests or property of any kind) and that transfers the financial risk associated with a future change in any such value without also conveying a current or future ownership interest in an asset or liability incorporating such financial risk.<sup>89</sup>

Transactions involving a counterparty that is not an ECP must be executed on a DCM. However, swaps involving ECPs may be executed over-the-counter in most circumstances or on a swap execution facility.

- **Retail Commodities Transactions.** The CFTC also has supervisory jurisdiction over retail commodities transactions that are not technically futures or swaps but which are (1) offered to retail investors, (2) involve “leverage, margin, or financing,” and (3) do

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<sup>87</sup> 7 U.S.C. § 1a(9).

<sup>88</sup> The CEA defines the term “option” as, “an agreement, contract, or transaction that is of the character of, or is commonly known to the trade as, an ‘option’, ‘privilege’, ‘indemnity’, ‘bid’, ‘offer’, ‘put’, ‘call’, ‘advance guaranty’, or ‘decline guaranty.’” 7 U.S.C. § 1a(36).

<sup>89</sup> 7 U.S.C. § 1a(47)(A).

not result in actual delivery of the underlying commodity within 28 days.<sup>90</sup> All retail commodities transactions must be offered on a DCM.

Finally, the CFTC also has *enforcement* jurisdiction over the spot market for commodities to prevent fraud and market manipulation that could have an adverse effect on the prices of commodities.<sup>91</sup>

Since 2015, the CFTC by public comment, enforcement posture, and civil advocacy has taken the position that “virtual currencies” constitute “commodity transactions” for purposes of the CEA.<sup>92</sup> The CFTC has interpreted the term “virtual currency” broadly, to encompass any digital representation of value that functions as a medium of exchange, and any other digital unit of account used as a form of currency.<sup>93</sup>

In September 2022, the CFTC commenced enforcement actions against persons the CFTC believed were responsible for illegal, off-exchange trading that occurred through the bZx protocol, a DeFi application, in violation of the CEA.<sup>94</sup> The CFTC announced a settlement with bZeroX LLC and two principals, who initially developed and controlled the protocol’s smart contracts before turning control of the protocol over to the bZx DAO (now called the Ooki DAO).<sup>95</sup> Additionally, the CFTC filed suit against the Ooki DAO, alleging that because the DAO was not incorporated it was as a general partnership that is amenable to suit.<sup>96</sup>

The CFTC alleges that the bZx protocol allowed individuals to engage in CEA-regulated margined or leveraged retail commodities transactions.<sup>97</sup> Even though the bZx protocol consisted of a series of smart contracts on the Ethereum network, the CFTC alleged that the persons in control of the protocol—first, bZeroX LLC and later the DAO—were responsible for ensuring that financial activities that occurred through the protocol were done in compliance with CEA.<sup>98</sup> Thus, because neither bZeroX LLC nor the Ooki DAO had registered with the CFTC in any capacity, they violated the CEA by unlawfully engaging in retail commodities transactions that could only be offered on a CFTC-registered DCM and acting as an unregistered FCM.<sup>99</sup> In addition, the CFTC

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<sup>90</sup> 7 U.S.C. § 2(c)(2)(D)(i).

<sup>91</sup> 7 U.S.C. § 9 (providing the CFTC with general anti-fraud and anti-manipulation enforcement authority relating to a “contract of sale of a commodity” in interstate commerce)

<sup>92</sup> *In re Coinflip, Inc.*, CFTC Docket No. 15-29, 2015 WL 5535736 (Sept. 17, 2015) (consent order).

<sup>93</sup> Retail Commodity Transactions Involving Certain Digital Assets, 85 Fed. Reg. 37734, (June 24, 2020) (to be codified at 17 C.F.R. pt. 1).

<sup>94</sup> Press Release, CFTC, CFTC Imposes \$250,000 Penalty Against bZeroX, LLC and its Founders and Charges Successor Ooki Dao for Offering Illegal, Off-Exchange Digital-Asset Trading, Registration Violations, and Failing To Comply with Bank Secrecy Act (Sep. 22, 2022), <https://www.cftc.gov/PressRoom/PressReleases/8590-22> [hereinafter Ooki DAO Press Release]

<sup>95</sup> *In the Matter of: bZeroX*, CFTC Docket No. 22-31, 2022 WL 4597664 (consent order).

<sup>96</sup> *Sarcuni v. bZx DAO*, 3:22-cv-00618 (S.D. Cal. 2022).

<sup>97</sup> Ooki DAO Press Release, *supra* note 94.

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

alleged that by failing to implement procedures for verifying the identity of users of the bZx protocol, bZeroX LLC and the Ooki DAO violated CEA regulations requiring FCMs—whether or not registered with the CFTC—to comply with the BSA’s anti-money laundering requirements.<sup>100</sup>

## G. U.S. Sanctions Laws

Sanctions are legal restrictions issued by the United States that target countries, governments, regions, entities, and individuals.<sup>101</sup> Sanctions may impose asset freezes and other financial prohibitions, controls, or requirements in order to advance national security or foreign policy objectives.<sup>102</sup>

The sanctions programs, which are administered by the U.S. Office of Foreign Assets Control (“OFAC”), are complex and range from targeted measures against individuals or entities designated for specific activities to comprehensive embargoes against entire countries or regions.<sup>103</sup> Some recent sanctions are “sectoral sanctions,” targeting individuals and entities associated with specific sectors of a foreign country’s economy.<sup>104</sup> Some sanctions designations, frequently referred to as “secondary sanctions,” target non-U.S. individuals and entities for their dealings with persons already subject to U.S. sanctions.<sup>105</sup>

OFAC sanctions generally prohibit “U.S. persons” from transacting with or providing services to (or facilitating a transaction with or the provision of services to) individuals or entities subject to U.S. sanctions. The definition of “U.S. person” varies across individual sanctions programs, but generally covers:

- U.S. citizens or legal permanent residents (wherever located);
- U.S. entities (including foreign branches); and
- Any person in the United States.<sup>106</sup>

Some sanctions programs also define the term to include foreign-organized entities owned or controlled by U.S. persons.<sup>107</sup> Certain programs also apply to foreign persons in possession of

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<sup>100</sup> *Id.*

<sup>101</sup> *Financial Sanctions Frequently Asked Questions*, at No. 1, U.S. DEP’T OF THE TREASURY, <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/topic/1501> (last visited Nov. 11, 2022)

<sup>102</sup> *Id.*

<sup>103</sup> *Sanctions Compliance Guidance for the Virtual Currency Industry*, OFFICE OF FOREIGN ASSETS CONTROL (Oct. 2021), at 2-3, [https://home.treasury.gov/system/files/126/virtual\\_currency\\_guidance\\_brochure.pdf](https://home.treasury.gov/system/files/126/virtual_currency_guidance_brochure.pdf).

<sup>104</sup> *Id.* at 3.

<sup>105</sup> *Economic Sanctions: Overview for the 117th Congress*, CONGRESSIONAL RESEARCH SERVICE (Jan. 15, 2021), <https://sgp.fas.org/crs/row/IF11730.pdf>.

<sup>106</sup> *Sanctions Compliance Guidance for the Virtual Currency Industry*, OFFICE OF FOREIGN ASSETS CONTROL (Oct. 2021), [https://home.treasury.gov/system/files/126/virtual\\_currency\\_guidance\\_brochure.pdf](https://home.treasury.gov/system/files/126/virtual_currency_guidance_brochure.pdf).

<sup>107</sup> *Id.*



U.S.-origin goods.<sup>108</sup>

At a high level, U.S. persons are generally prohibited from the following activities:

- Transacting with or providing services to individuals or entities identified by OFAC as subject to U.S. sanctions. OFAC publishes a sanctions list that is publicly available on the OFAC website,<sup>109</sup> divided into a list of “Specially Designated Nationals and Blocked Persons,” (“SDNs” and the “SDN List”)<sup>110</sup> and a consolidated list of all non-SDN sanctions (the “Consolidated List”).<sup>111</sup> These lists contain the names, known pseudonyms, and other identifying information of individuals, groups, and entities that have been *specifically* designated by the U.S. government as being subject to economic sanctions pursuant to one or more of the sanctions programs administered by OFAC.
- Transacting with or providing services to entities where one or more SDNs own, in the aggregate, more than 50% of the entity.<sup>112</sup>
- Transacting with or providing services to individuals or entities subject to U.S. blocking sanctions *but not listed on* an OFAC sanctions list.<sup>113</sup> For instance, U.S. persons are generally prohibited from transacting with a person that has acted, directly or indirectly, on behalf of the “Government of Venezuela,” even if that person has not been designated by OFAC as an SDN.<sup>114</sup>
- Transacting with entities owned, in the aggregate, by one or more individuals or entities

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<sup>108</sup> *Id.*

<sup>109</sup> OFAC’s sanctions list is available here: *Sanctions List Search*, OFFICE OF FOREIGN ASSETS CONTROL, <https://sanctionssearch.ofac.treas.gov/> (last visited Nov. 11, 2022).

<sup>110</sup> *Specially Designated Nationals and Blocked Persons List (SDN) Human Readable Lists*, U.S. DEP’T OF THE TREASURY, <https://home.treasury.gov/policy-issues/financial-sanctions/specially-designated-nationals-and-blocked-persons-list-sdn-human-readable-lists> (last updated Nov. 9, 2022).

<sup>111</sup> Consolidated Sanctions List (Non-SDN Lists), U.S. DEP’T OF THE TREASURY, <https://home.treasury.gov/policy-issues/financial-sanctions/consolidated-sanctions-list-non-sdn-lists> (last updated Aug. 2, 2022).

<sup>112</sup> *Revised Guidance on Entities Owned by Persons Whose Property and Interests in Property are Blocked*, U.S. DEP’T OF THE TREASURY (Aug. 13, 2014), [https://home.treasury.gov/system/files/126/licensing\\_guidance.pdf](https://home.treasury.gov/system/files/126/licensing_guidance.pdf).

<sup>113</sup> *See, e.g.*, Exec. Order No. 13884, 84 Fed. Reg. 152, (Aug. 5, 2019). (blocking the property of the “Government of Venezuela,” which the executive order defines as state and Government of Venezuela, any political subdivision, agency, or instrumentality thereof . . . , any person owned or controlled, directly or indirectly, by the foregoing, and any person who has acted or purported to act directly or indirectly for or on behalf of, any of the foregoing, including as a member of the Maduro regime.”).

<sup>114</sup> *Frequently Asked Questions*, U.S. DEP’T OF THE TREASURY, <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/680> (last visited Nov. 11, 2022) (“Please note that persons meeting the definition of Government of Venezuela and persons that are owned, directly or indirectly, 50 percent or more by the Government of Venezuela are blocked pursuant to E.O. 13884, regardless of whether the person appears on the Specially Designated Nationals and Blocked Persons list (SDN List), unless exempt or authorized by OFAC.”).

subject to U.S. blocking sanctions *but not listed on* an OFAC sanctions list.<sup>115</sup>

- Transacting with individuals or entities ordinarily resident in a sanctioned region. OFAC’s current sanctioned regions are Iran, Cuba,<sup>116</sup> North Korea, Syria, the Crimea region of Ukraine, and the so-called Donetsk People’s Republic and Luhansk People’s Republic regions of Ukraine.

In addition to generally prohibiting transactions with, and the provision of services to, individuals and entities subject to U.S. sanctions, certain sanctions programs require assets and accounts in which a sanctioned party has an interest be blocked—i.e., frozen—when such assets or accounts are located in the United States, are held by U.S. individuals or entities, or come into the possession or control of U.S. individuals and entities.<sup>117</sup>

Moreover, even if a U.S. person does not transact directly with a person subject to U.S. sanctions, U.S. persons may also violate U.S. sanctions laws if they approve or facilitate a transaction that a U.S. person would be prohibited from engaging in directly.<sup>118</sup>

U.S. sanctions operate on the basis of strict liability, i.e., a person or entity subject to U.S. jurisdiction may be held civilly liable for sanctions violations even if that person or entity did not know, or have reason to know, that it was engaging in a transaction prohibited under sanctions laws and regulations administered by OFAC.<sup>119</sup> Civil penalties can be higher than \$330,000 per violation or twice the amount of the violative transaction.<sup>120</sup>

The Office’s Framework for OFAC Compliance Commitments “strongly encourages” persons subject to U.S. jurisdiction to maintain a risk-based compliance program designed to mitigate potential sanctions violations.<sup>121</sup> The framework highlights what OFAC views as the five “essential components” of an appropriate sanctions program: (1) commitment by management to support a sanctions compliance program; (2) routine (or ongoing) assessments of potential sanctions risks; (3) the development and implementation of appropriate internal controls, as informed by the risk assessment, to “identify, interdict, escalate, report (as appropriate), and keep records” related to potential sanctions exposure; (4) a testing or audit function; and (5) an effective

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<sup>115</sup> Frequently Asked Questions, *supra* note 114; Revised Guidance on Entities Owned by Persons Whose Property and Interests in Property are Blocked, *supra* note 112.

<sup>116</sup> The Cuban sanctions also apply Cuban nationals outside of Cuba unless certain conditions are met (e.g., the Cuban national establishes permanent residence outside of Cuba). *Frequently Asked Questions*, U.S. Dep’t of the Treasury, <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/791> (last visited Nov. 11, 2022).

<sup>117</sup> *Office of Foreign Assets Control-Overview*, BSA/AML MANUAL, <https://bsaaml.ffiec.gov/manual/OfficeOfForeignAssetsControl/01> (last visited Nov. 11, 2022).

<sup>118</sup> *Sanctions Compliance Guidance for the Virtual Currency Industry*, OFFICE OF FOREIGN ASSETS CONTROL (Oct. 2021), [https://home.treasury.gov/system/files/126/virtual\\_currency\\_guidance\\_brochure.pdf](https://home.treasury.gov/system/files/126/virtual_currency_guidance_brochure.pdf).

<sup>119</sup> *Id.*

<sup>120</sup> 31 C.F.R. § Pt. 501, App. A § V(B)(2)(a)(v).

<sup>121</sup> *A Framework for OFAC Compliance Commitments*, OFFICE OF FOREIGN ASSETS CONTROL, [https://home.treasury.gov/system/files/126/framework\\_ofac\\_cc.pdf](https://home.treasury.gov/system/files/126/framework_ofac_cc.pdf) (last visited (Nov. 11, 2022).

sanctions training program.<sup>122</sup> In determining the proper response to a sanctions violation, OFAC has stated that it will “consider favorably subject persons that had effective SCPs [sanctions compliance programs] at the time of an apparent violation.”<sup>123</sup>

OFAC has made clear that U.S. sanctions compliance obligations “apply equally to transactions involving virtual currencies and those involving traditional fiat currencies,” noting that “the virtual currency industry including technology companies, exchangers, administrators, miners, wallet providers, and users, play[] an increasingly critical role in preventing sanctioned persons from exploiting virtual currencies to evade sanctions and undermine U.S. foreign policy and national security interests.”<sup>124</sup> In its detailed guidance to the virtual currency industry, OFAC highlighted what it termed “sanctions compliance best practices” for U.S. virtual currency industry participants to comply with U.S. sanctions.<sup>125</sup>

Additionally, OFAC has designated individuals and entities based upon connections to illicit activity involving digital assets, in many cases including on the SDN list entry various blockchain addresses as “Identifications.” For instance, in May 2022, OFAC imposed secondary sanctions on Blender.io, a virtual currency mixer that makes tracing bitcoin transactions more difficult, because Blender.io’s services helped North Korean hackers to launder the proceeds of cybercrimes.<sup>126</sup>

Most recently, in August 2022, OFAC sanctioned Tornado Cash, a virtual currency mixer that, like Blender.io, had been used by malicious actors, including North Korean hackers, to launder the proceeds of illicit cyber activities.<sup>127</sup> But unlike Blender.io, which was a centralized mixing service, Tornado Cash operated automatically and autonomously on the Ethereum network using smart contracts, creating uncertainty about what exactly OFAC sanctioned—i.e., the smart contract code or some unidentified group of persons that OFAC believes are Tornado Cash and control the smart contract’s code.<sup>128</sup> Following the designation, several lawsuits were filed challenging the legality of OFAC’s designation of Tornado Cash.<sup>129</sup> On November 8, 2022, OFAC rescinded its prior designation of Tornado Cash and redesignated Tornado Cash. According to

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<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.* For more details on OFAC’s recommendations, please see *OFAC Releases New Detailed Guidance for the Digital Currency Industry*, PERKINS COIE (Oct. 19, 2021) <https://www.perkinscoie.com/en/news-insights/ofac-releases-new-detailed-guidance-for-the-digital-currency-industry.html>.

<sup>126</sup> *U.S. Treasury Issues First-Ever Sanctions on a Virtual Currency Mixer, Targets DPRK Cyber Threats*, U.S. DEP’T OF THE TREASURY (May 6, 2022), <https://home.treasury.gov/news/press-releases/jy0768>.

<sup>127</sup> *U.S. Treasury Sanctions Notorious Virtual Currency Mixer Tornado Cash*, U.S. DEP’T OF THE TREASURY (Aug. 8, 2022), <https://home.treasury.gov/news/press-releases/jy0768>.

<sup>128</sup> For a discussion of the issue, please see *OFAC Takes Action Against Virtual Currency Tornado Cash in Novel Application of Sanctions Authorities / Virtual Currency Report*, PERKINS COIE (Aug. 31, 2022), <https://www.virtualcurrencyreport.com/2022/08/ofac-takes-action-against-virtual-currency-tornado-cash-in-novel-application-of-sanctions-authorities/>.

<sup>129</sup> *Coin Center v. Yellen*, 3:22-cv-20375 (N.D. Fla. 2022); *Van Loon v. U.S. Dept. of Treasury*, 6:22-cv-00920 (W.D. Tex. 2022).

OFAC, the delisting and redesignation was to add additional bases for designating Tornado Cash as an SDN.<sup>130</sup> In its press release, OFAC characterized Tornado Cash “as an *entity* that provides virtual currency mixing services through smart contracts that primarily operate on the Ethereum blockchain.”<sup>131</sup> The same day, OFAC clarified that it considers Tornado Cash to be an entity consisting of:

[I]ts founders and other associated developers, who together launched the Tornado Cash mixing service, developed new Tornado Cash mixing service features, created the Tornado Cash Decentralized Autonomous Organization (DAO), and actively promoted the platform’s popularity in an attempt to increase its user base; and (2) the Tornado Cash DAO, which is responsible for voting on and implementing new features created by the developers. Tornado Cash uses computer code known as “smart contracts” to implement its governance structure, provide mixing services, offer financial incentives for users, increase its user base, and facilitate the financial gain of its users and developers.<sup>132</sup>

In redesignating Tornado Cash, OFAC attempted to stress that it was designating the *unincorporated entity* Tornado Cash as an SDN and that the Tornado Cash *smart contracts* were the mechanism used by *the entity* Tornado Cash provided mixing services.<sup>133</sup>

#### IV. EFFORTS OF THE TASK FORCE

In line with our directive to “study and evaluate the legal issues and questions surrounding the expansion and regulation of the digital finance and digital currency industries in New York State,<sup>134</sup> the Task Force’s mission has three components:

1. Develop best practices for attorneys representing clients on digital finance and digital currency matters and provide member education resources on those practices.
2. Study and evaluate the legal issues and questions surrounding the expansion and regulation of the digital finance and digital currency industries in New York State.

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<sup>130</sup> *Treasury Designates DPRK Weapons Representatives*, U.S. Dept. of Treasury (Nov. 8, 2022), <https://home.treasury.gov/news/press-releases/jy1087>.

<sup>131</sup> *Id.* (emphasis added).

<sup>132</sup> *Frequently Asked Questions*, OFFICE OF FOREIGN ASSETS CONTROL, <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/1095> (last visited Nov. 15, 2022).

<sup>133</sup> *Treasury Designates DPRK Weapons Representatives*, OFFICE OF FOREIGN ASSETS CONTROL (Nov. 8, 2022), <https://home.treasury.gov/news/press-releases/jy1087>.

<sup>134</sup> Task Force on Emerging Digital Finance and Currency, *supra* note 14.

3. Promote the appropriate use of digital assets and Web3 resources to keep pace with the industry and expand global membership.

The Task Force has formed three subcommittees, each of which maps to a component of the Task Force’s mission. The Education Subcommittee’s focus is on developing programming designed to help attorneys spot the legal and ethical issues that may arise in connection with blockchain-related representation and help attorneys engage appropriately and effectively. The Task Force’s Regulation and Legislation subcommittee will evaluate the legal and regulatory issues presented by the growth of the digital finance and digital currency industries in the state. Finally, the Blockchain, Web3, and Metaverse subcommittee will explore how Web3 technologies can be used to benefit NYSBA and its members.

## V. CONCLUSIONS

Blockchain technology has the potential to reshape how we transact by decreasing the need to trust centralized parties, which necessarily carries wide-ranging legal implications. Because New York State is home world’s largest financial center, NYSBA members have played and will continue to play key roles in shaping how the law applies to the emerging blockchain ecosystem. Through resolutions soon to be proposed, and in line with NYSBA’s mission,<sup>135</sup> the Task Force seeks to respond to the opportunities and challenges posed by blockchain technologies and advance NYSBA members’ and the public’s understanding of how the law applies and promote the appropriate use of the technology within the legal profession.

In keeping with these goals, the Task Force is working in the near term to develop specific recommendations for the NYSBA Executive Committee and proposed resolutions for the NYSBA House of Delegates that would potentially include: (i) NYSBA positions on existing and pending New York legislation, executive order and enforcement posture supporting rational regulation balancing consumer and environmental protection with encouragement of digital currency and digital finance business in the state; (ii) feasibility studies on initiatives to expand global interest, membership and access to NYSBA and its resources, including income-generating activities, by expanding NYSBA’s Web3 footprint and presence.

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<sup>135</sup> *About – New York State Bar Association*, *supra* note 13 (“Our mission is to shape the development of law, educate and inform the public, and respond to the demands of our diverse and ever changing legal profession.”).