

The Regulatory Adventures of a Crypto Startup: Part Deux

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Remember NoDoubt Crypto LLC (NoDoubt Crypto)? [Last year](#) we wrote about the fictitious innovative new FinTech startup in the digital assets or blockchain/distributed ledger technology space. We discussed the regulatory challenges faced by firms like NoDoubt Crypto that aspire to balance innovation with the desire to remain regulatorily compliant in a space that continues to evolve. In this follow up article, we highlight select regulatory developments including new legislation related to blockchain and digital assets that took place in 2019 and discuss what is to come in 2020.

Re-Introduction of the Token Taxonomy Act

In April 2019, blockchain-friendly bill the [Token Taxonomy Act of 2019](#) was re-introduced. The new version provides additional regulatory clarity with a definition for digital tokens more inclusive of changing technology and exemptions for certain digital assets from federal securities laws. It also seeks to direct the Securities and Exchange Commission (SEC) to implement regulations regarding digital units secured through public key cryptography and to create certain tax exemptions for virtual currencies. See [Token Taxonomy Act To Address Blockchain, Innovation Flight in America](#), Press Release (April 9, 2019).

2019 Ends With a Legislative Bang

In December 2019, a discussion draft bill called the [Crypto-Currency Act of 2020](#) was proposed. The bill defines a digital asset as a “crypto-commodity,” “crypto-currency” or “crypto-security” and proposes that the Commodity Futures Trading Commission

(CFTC), the Department of Treasury acting through the Financial Crimes Enforcement Network (FinCEN), and the SEC act as the “Federal crypto regulator” for each respective digital asset category. It also proposes that the respective federal crypto regulators make available to the public a list of licenses, certifications, or registrations required to create or trade digital assets.

NoDoubt Crypto is cautiously optimistic that Congress will shed more light on policy for blockchain projects and clarify terminology used in the digital assets/blockchain industry.

It Takes Three To Tango?

NoDoubt Crypto is impressed that in 2019 regulators collaborated to issue guidance for digital assets and used terminology common in the blockchain space. In October, the CFTC, FinCEN and the SEC issued a joint statement to remind certain financial institutions engaged in activities involving digital assets of their anti-money laundering and countering the financing of terrorism obligations under the Bank Secrecy Act. See [Leaders of CFTC, FinCEN, and SEC Issue Joint Statement on Activities Involving Digital Assets](#), Public Statement (Oct. 11, 2019).

Earlier in the year, the SEC and FINRA also issued a joint statement focusing on the Customer Protection Rule. The statement discussed noncustodial broker-dealer models for digital asset securities, defining them as “virtual currencies,” “coins,” and “tokens” and for purposes of the joint statement, referring to digital assets that are securities as “digital asset securities.” [Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities](#), Public Statement (July 8, 2019).

Bit by Bit

NoDoubt Crypto is pleased to learn that, in response to changes in the marketplace, the New York State Department of Financial Services (DFS) is proposing new requirements for firms that are already “bitlicensed” in New York and want to list new coins. See [First Step in DFS Review of New York’s Four-Year-Old BitLicense](#);

[DFS Seeks Comment on Proposal by Jan. 27, 2020](#), Press Release (Dec. 11, 2019). The DFS will issue its final guidance following review of comments due Jan. 27, 2020.

No-Action (Letters) Speak Louder ...

NoDoubt Crypto is getting the regulatory message loud and clear. The SEC's [Strategic Hub for Innovation and Financial Technology](#) (FinHub) published a framework expanding on the analysis of whether a digital asset is an investment contract (a concept initially discussed in the 1946 case of [SEC v. Howey](#)) and whether offers and sales of digital assets are security transactions. See [Framework for "Investment Contract" Analysis of Digital Assets](#) (April 3, 2019).

On the same date, the SEC issued the first of several no-action letters in 2019, declaring that the tokens in the case of [TurnKey Jet](#) were not securities and not subject to registration pursuant to federal securities laws. The SEC considered whether the network was fully developed and operational, among other factors, such as, the immediate use of the tokens for the intended functionality, token transfer restrictions, token price restrictions, repurchase restrictions and token marketing. Additional no-action letters also include [Pocketful of Quarters](#) (July 25, 2019) and [Paxos Trust Company](#) (Oct. 28, 2019).

Martin Act Is Not a 'Roving Mandate' To Regulate

NoDoubt Crypto watched the regulatory developments continue with [New York's Martin Act](#), a law that gives the New York Attorney General the ability to investigate and prevent fraud in connection with securities or commodities. In April 2019, the New York Attorney General won a [court order](#) against Bitfinex, a virtual asset trading floor, and Tether Limited, issuer of the virtual currency tether, who represented that tether was backed 1 to 1 in U.S. dollars and allegedly covered up an \$850 million loss to investors. The order prevented the companies from loaning, extending credit to, or making any other claim about the cash reserves of tether, among other things. The following month, the order was modified and Bitfinex and Tether continued their regular business practices. In so doing, the court stated that the Martin Act "does not

provide a roving mandate to regulate commercial activity.” See [New York Court Grants Bitfinex’s Motion to Modify Injunction](#), Bitfinex (May 16, 2019).

NY’s New Data Security Law

NoDoubt Crypto saw that last year also brought New York to the forefront of privacy and data security laws with the passage of the [Stop Hacks and Improve Electronic Data Security Act \(the SHIELD Act\)](#). The implications in the FinTech community can be widespread because the law imposes data breach notification requirements on any business that owns or licenses private information of New York residents, regardless of whether it conducts business in New York.

In March 21, 2020, the second part of the Act goes into effect that requires businesses to develop, implement and maintain a data security program. NoDoubt Crypto is preparing so it can avoid penalties for noncompliance, which can include up to \$250,000 for breach notification violations and an uncapped amount for data security violations.

Now About That ICO ...

Though Initial Exchange Offerings (IEOs) are now the rage, NoDoubt Crypto is still thinking about raising money through an Initial Coin Offering (ICO). Whether securities laws apply to ICOs may gain clarity from the SEC’s much-publicized 2019 lawsuit against Kik Interactive Inc. (Kik). See [SEC v. Kik Interactive](#). The SEC alleges that Kik’s sale of digital assets known as “Kin tokens” to investors using Simple Agreements for Future Tokens and its simultaneous sale to the general public constituted the sale of unregistered non-exempt investment contracts in violation of the Securities Act.

Kik argues that the SEC wrongly equates having aligned incentives with a common enterprise and that it misapplies the Howey test for an investment contract. See [SEC v. Kik Interactive, Answer](#), Scribd. The case may go to trial and with its potential impact on the industry it is a case NoDoubt Crypto will continue to watch.

SEC Fights Alleged \$1.7 Billion Unregistered Token Offering

In October 2019, the SEC filed an enforcement action against Telegram Group (Telegram) to prevent an alleged \$1.7 billion unregistered token offering. See [SEC v. Telegram Group and Ton Issuer](#). According to the SEC, Telegram raised capital to finance the development of its own blockchain and mobile messaging application by selling approximately 2.9 billion digital tokens called “Grams” at discounted prices to initial purchasers worldwide, including 1 billion Grams in the United States. In return, Telegram was supposed to deliver the Grams to the purchasers by October 2019 who could then sell those Grams in the United States.

The SEC claims it filed an emergency action to stop Telegram from flooding the U.S. markets with unlawfully sold tokens. In emphasizing its enforcement powers, the SEC stated, “We have repeatedly stated that issuers cannot avoid the federal securities laws just by labelling their product a cryptocurrency or a digital token.” See [SEC Halts Alleged \\$1.7 Billion Unregistered Digital Token Offering](#), Press Release (Oct. 11, 2019)

Takeaway

From proposed crypto legislation to aggressive enforcement actions, last year brought significant developments in the crypto/digital asset space. With the SEC’s announcement that FinTech, and in particular firms engaged in the digital asset space, is an exam priority for 2020, it is critically important for businesses to monitor developments in the year ahead. See [SEC Office of Compliance Inspections and Examinations Announces 2020 Examination Priorities](#) (Jan. 7, 2020). Stay tuned as we provide more insights to help your business navigate the FinTech space.

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