



The SEC's Spotlight on Digital Assets

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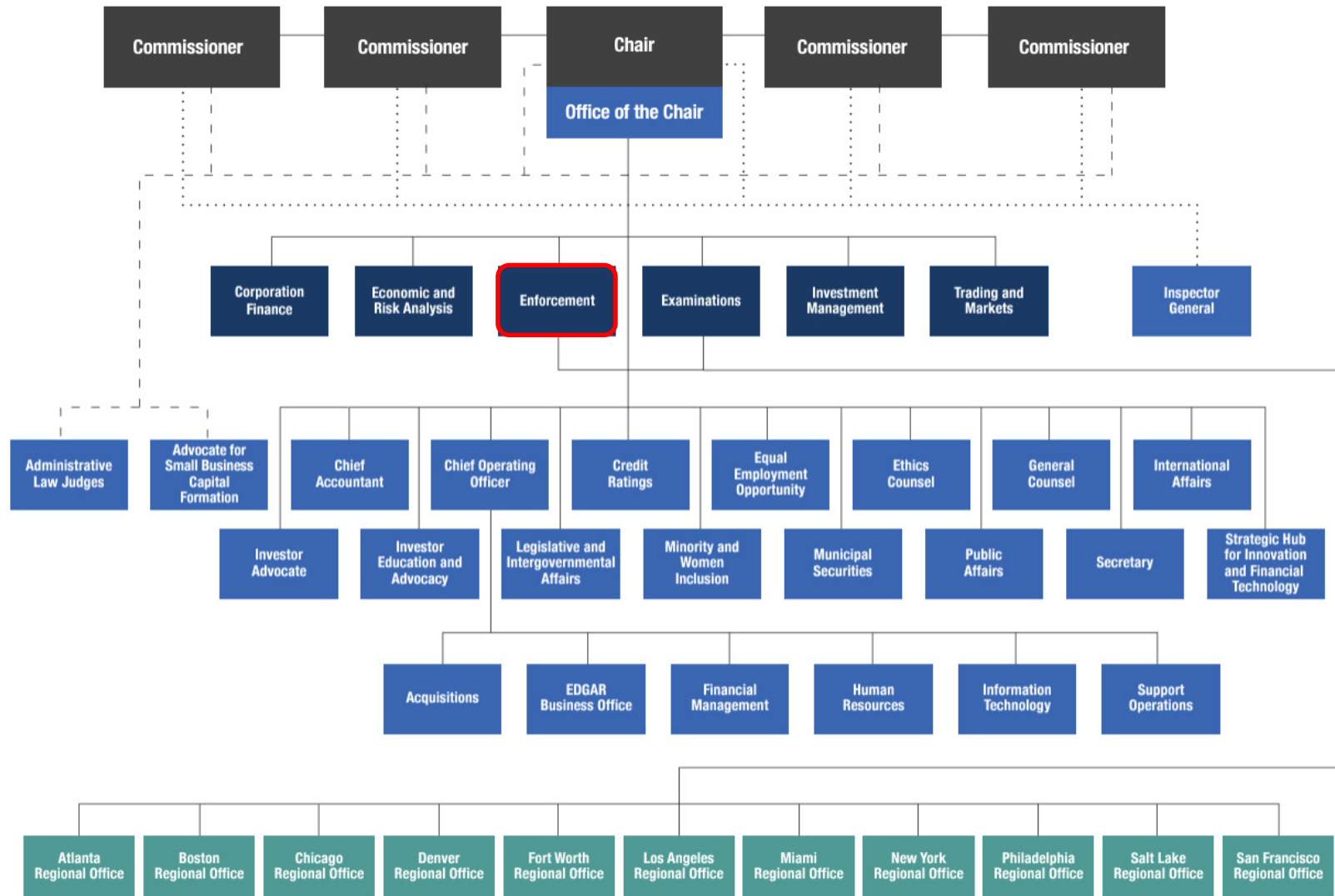
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Agenda

- ▶ SEC Structure and Approach to Digital Assets
- ▶ The Jurisdictional Reach of the SEC
- ▶ Phases of an SEC Investigation/Enforcement Action
 - and Getting Ahead of it
- ▶ What to do After Receipt of an SEC Subpoena

SEC Structure and Approach to Digital Assets

SEC Structure



Who does the SEC have oversight over?

- The SEC's authority comes from its creation by the U.S. Congress through the Securities and Exchange Act of 1934. This act, along with the Securities Act of 1933, established the SEC and outlined its broad powers to regulate the securities industry.
- The SEC's jurisdiction covers a broad range of participants in the financial markets:
 - Issuers of securities
 - Offerings and sales of securities must be registered or (more commonly within the digital asset environment) fall within a registration exemption (e.g., Reg D)
 - Market Intermediaries
 - This includes entities like “brokers,” “exchanges,” ATs, and promoters
 - Investment Professionals
 - Investment advisors and individuals managing investment funds

The SEC's Approach to Digital Assets

- No federal law or regulation governing the securities law treatment of digital assets = regulatory uncertainty.
- The SEC has taken an aggressive “regulation by enforcement” approach.
 - Threshold question: Which digital assets are “securities” under U.S. law?
- The SEC takes the view that many digital assets and related individuals/entities fall under its existing regulatory framework.
 - Is it an “investment contract”?
 - Core argument centers around the concept of an “investment contract” as defined by the Howey Test.
 - Issue is NOT whether a digital asset “is” a security, but whether it is sold as a part of an “investment contract.”
 - New-ish focus on “ecosystem.”
 - Is it a “note”?
 - An alternative SEC theory is that digital assets are “notes” under the Reves test.
 - E.g., Gemini, BlockFi.

Is an Entirely New Legal/Regulatory Framework Required?

Is it possible for many digital asset businesses to comply with the U.S. securities laws?

- Exchanges can't just “come in and register”
- Many digital assets are fundamentally different from “securities”

Will pending or future legislation help the U.S. correct course?

- FIT21 and other legislation
- Impact of a new Article II administration

Pending Litigation with Potential Impact on SEC's Reach over Digital Assets

SEC V. RIPPLE LABS

- In December 2020, the SEC sued Ripple alleging that by issuing and distributing its native XRP token, Ripple engaged in the unlawful issuance and sale of unregistered securities
- Question: Were various XRP transactions “investment contracts” and therefore “securities transactions” under U.S. law?
 - Institutional sales of XRP (primary issuance) – **YES**
 - Programmatic sales (secondary sales) – **NO**
 - Distributions to employees and third parties – **NO**

SEC V. TERRAFORM

- In February 2023, the SEC sued Terraform Labs alleging that Defendants engaged in the sale of unregistered securities in violation of securities laws.
- In July 2023, the *Terraform* court denied Terraform’s Motion to Dismiss, siding with the SEC and explicitly “reject[ing] the approach recently adopted in *Ripple*.”
- In December 2023, the *Terraform* court ruled on cross-motions for summary judgment, holding that there was “no genuine dispute” that the four subject crypto assets were securities under *Howey*.

SEC V. COINBASE

- In June 2023, the SEC sued Coinbase based on allegations that it was operating its digital asset trading platform as an unregistered national securities exchange, broker, and clearing agency.
- The Court denied Coinbase’s Motion for Judgement on the pleadings, but determined the SEC’s claim failed to establish how Coinbase acts as a “broker” by making the Wallet available to customers.

SEC's Targeting of DeFi Services and DEXs

UNISWAP

- The SEC served Uniswap with a Wells Notice on April 10, 2024.
- On May 21, 2024, Uniswap published its response to the Wells Notice. Its primary arguments were:
 1. Uniswap is not an exchange and thus not subject to regulation by the SEC.
 2. The SEC is overreaching by classifying cryptocurrencies such as BTC or ETH as securities.
 3. The SEC's accusation that Uniswap's interface and wallet are brokers fails for the reasons articulated in *Coinbase* with respect to Coinbase Wallet.
 4. The UNI governance token is not a security.

SEC's Targeting of DeFi Services and DEXs

CONSENSYS

- On April 10, 2024, Consensys also received a Wells Notice.
- Consensys took a more aggressive approach by filing a lawsuit against the SEC on April 25, 2024.
- Consensys is seeking a court ruling that ETH is not a security and that MetaMask is not an unregistered securities broker-dealer.
- Consensys's main objectives are:
 1. Protecting Ethereum
 2. Defending MetaMask

The Jurisdictional Reach of the SEC

SEC's Jurisdictional Reach

TRADITIONAL REACH (DOMESTIC)

- Transacting with U.S. persons
- Physical location in U.S.
- Issuing “securities” or selling “securities” to/for another into or from the U.S.

EXTRATERRITORIAL REACH

- Dodd-Frank expanded the SEC's reach.
- The SEC can assert jurisdiction over violations involving:
 - Significant conduct within the U.S. in furtherance of the violation, even if the transaction happens overseas and involves only foreign investors;
 - Conduct occurring outside the U.S. that has a foreseeable effect within the U.S.

Williams v. Binance

- Class action lawsuit against Binance alleging:
 - Sales of unregistered securities
 - Failure to register as a broker-dealer
 - Violations of state “Blue Sky” laws
- On March 8, 2024, the Second Circuit found that plaintiff’s claims involved domestic transactions since:
 - Purchase orders could have been matched with sellers on servers located in the U.S.
 - Binance’s Terms of Use stated that orders became irrevocable once they were sent, which occurred in the U.S. with U.S. customers
 - Binance cannot be immune from litigation/regulation everywhere

SEC v. Terraform Labs Pte Ltd. and Do Kwon

- On June 8, 2022, the Second Circuit affirmed the S.D.N.Y. District Court finding that it had personal jurisdiction over Terraform and Kwon
- Terraform and Kwon promoted digital assets to U.S.-based customers and investors.
Terraform and Kwon:
 - Created contacts with the U.S. by doing business while traveling in the U.S. and marketing products to U.S. consumers via the Internet.
 - Retained U.S.-based employees, including a director who promoted digital assets in the U.S.
 - Entered into agreements with U.S. entities to facilitate the trade of their digital assets
 - Admitted that 15% of its users were within the U.S.

How Offshore Digital Asset Companies Might Stay Beyond the SEC's Extraterritorial Reach

- **Offshore Domicile and Location**
 - Maintain a domicile and physical location outside of the U.S.
- **Avoid targeting U.S. investors**
 - If an offshore digital asset company solicits or sells investments to U.S. residents, even through online platforms, the SEC can still pursue enforcement actions.
- **Limit U.S. Marketing and Investor Access**
 - Refrain from marketing digital assets/platform in the U.S. or to U.S. users
 - Implement measures to verify and restrict U.S. users from accessing the platform.
- **Comply with Local Regulations**
 - Affirmatively submit to jurisdiction in a country other than the U.S.
 - Operate in jurisdictions with clear and robust digital asset regulations.
- **Transparency and Anti-Fraud Measures**
 - Have strong KYC/AML procedures in place and clear communication to avoid any potential for fraud.
- **Infrastructure**
 - Use servers/datacenters and other computer infrastructure outside the U.S.
- **Terms of Use/Service**
 - Terms and agreements should make clear that transactions occur outside the U.S.

The Phases of an SEC Investigation/Enforce ment Action – and Getting Ahead of it

The Phases of an SEC Investigation / Action

- The subpoena is often the opening salvo. If you're in the digital assets space, you need to be prepared.
- Typical life cycle of an SEC investigation:
 - Informal requests/inquiry letters
 - Formal order (happens behind the scenes)
 - Subpoena
 - Collection of documents and data
 - Interviews/testimony
 - Wells notice
 - Closure/settlement/litigation

Preparation is Key

HAVE COMPLIANCE POLICIES AND PROCEDURES

Develop a clear and documented plan outlining procedures for responding to regulatory inquiries, including subpoenas. The plan should designate a point person and outline steps for document collection, communication, and legal consultations.

MAINTAIN ACCURATE RECORDS

Implement a system for meticulously keeping records of all relevant transactions, customer data, communications, and internal policies. This ensures you can efficiently respond to requests for information.

REGULAR TRAINING

Educate employees, especially those involved in customer interactions and record-keeping, on SEC regulations and proper document retention practices.

Preemptive Steps for Blockchain Projects

In addition to being mindful of the “jurisdictional reach” issues discussed above, digital asset token issuers should be mindful of several important factors:

- **Structuring**
 - Consider offshore incorporation and/or bifurcation of a “Labs” entity and a “Foundation” where the ultimate goal is decentralization.
- **Token Utility**
 - Be prepared to defend yourself that the token has a genuine function
- **Distribution Model**
 - Consider implementing geographic restrictions to prevent individuals in the U.S. from participating.
 - Consider closing the network of those who can purchase or utilize the token even after primary allocation.
 - Consider issuing the token *after* the network becomes fully functional and do not disseminate for fundraising
 - Exposure may be diminished if the token is initially issued via airdrop or a migration process.
 - Avoid passive “investment staking” and taking custody of tokens
- **Marketing**
 - Focus marketing efforts on promoting the token’s functionality (not as an investment opportunity)
 - Include disclaimers on the project’s website, whitepapers, and marketing materials that the project and its tokens are not registered securities and token holders should not expect profits.
 - Avoid referring to token holders as “investors.”

What to do After Receipt of an SEC Subpoena

The SEC Sent A Subpoena!

Now What?

- Don't panic.
- Call your lawyer.
- Take steps to preserve documents.
- Limit circulation of the subpoena.
- Additional considerations:
 - Challenging the subpoena/failing to respond
 - Internal investigations
 - D&O insurance coverage
 - Privilege and work product
 - Controlling rumors

Investigative First Steps

- Outreach to SEC staff.
- Request for Formal Order.
- Discussions to narrow and focus requests.
- Identify “low-hanging fruit.”
- Consider internal investigation/cadence of reporting out to SEC.
- Determine who is “under the tent.”

Best Practices

EMAIL HYGIENE

- Clearly identify privileged communications.
- Clearly identify drafts.
- Assume the SEC will read everything, and that it has no sense of humor.

DOCUMENT PRESERVATION

- No off-channel communications.
- Follow retention policies.

CULTURE OF COMPLIANCE

- Consistent messaging in policies, procedures, and training.
- Risk/compliance should not be afterthoughts.

EXAMINATIONS

- Quick turnaround is expected, so organized documents are key.
- Keep your outside counsel involved.

Thank you.

Winston's Digital Assets & Blockchain Technology Group

Winston's cross-practice Digital Assets and Blockchain Technology Group provides accurate and efficient advice that helps clients navigate existing and developing legal challenges surrounding blockchain technologies. Our team draws upon experience from lawyers in our corporate, securities, tax, litigation, regulatory, and intellectual property practices, as well as others, to advise clients from startups to the largest financial services firms in the world.

Our attorneys are pioneers and thought leaders in this space—they are called upon by government officials, regulators, and major institutions to provide guidance regarding blockchain technology, and regularly speak and write on the legal and business considerations for companies adopting these technologies. Notably, two of our attorneys have taught a course at the University of Miami School of Law since 2018 on the regulation of blockchain and digital assets, one of the first courses offered of its kind. Additionally, they co-authored *Digital Assets and Blockchain Technology: US Law and Regulation*, the first textbook for law students examining the legal and regulatory approaches regarding the most significant issues impacting the blockchain space.

Bios



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Caitlin is an experienced defense attorney who focuses her practice on representing clients, both corporate and individual, in investigations and enforcement actions before the Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA), Congress, and the Consumer Financial Protection Bureau (CFPB), among others. Caitlin has many years of experience counseling her financial institution clients with regard to compliance with securities and consumer protection laws and regulations.



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Dan is a former Assistant Director of the United States Securities and Exchange Commission (SEC) and has decades of experience representing financial institutions, public companies, and individuals in high-profile investigations regarding federal securities laws and consumer protection laws.



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Daniel is one of the pioneering attorneys in the blockchain and digital assets sector, advising financial institutions and other businesses regarding a broad spectrum of legal and regulatory issues. He also represents financial institutions in investigations and controversy matters. Clients have described Daniel as a “top attorney in the field” and “on the cutting edge.”



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Kimberly is a leading financial services regulatory attorney, advising financial institutions and other businesses with respect to legal, regulatory, and corporate matters. She has extensive experience advising clients in the distributed ledger, blockchain, and digital assets sector.

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