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QE on the Block

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Just Minted: News Sweep June-July 2021

- The Chinese government took further action to crack down on cryptocurrencies. In late May, the People's Bank of China (PBOC) issued guidance (1) forbidding banks and online payment processors from accepting virtual currencies as a means of payment or settlement and (2) barring institutions from exchanging virtual currencies for yuan. In early June, the Chinese government moved to block prominent cryptocurrency-related accounts on Weibo, a platform similar to Twitter. And on June 21, the PBOC told the country's leading financial institutions (including the Industrial and Commercial Bank of China, the Agricultural Bank of China, and Alipay) to cease all support for cryptocurrency transactions.
- A video of one Chinese mining operation being shut down recently went viral, adding credibility to China's pledged crackdown on cryptocurrency generally, and cryptocurrency mining specifically.
- The United States General Services Administration ("GSA") auctioned eleven lots of seized cryptocurrency in June. The lots totaled 8.93 bitcoins and 150.2 Litecoins—marking the first time Litecoin was available in a GSA auction.
- American interest in cryptocurrency is rising, according to a report by Miq Digital, an independent marketing intelligence company. The report found that approximately 6% of the U.S. population now uses or owns cryptocurrency, with as many as 25% of U.S. investors holding cryptocurrencies.
- The SEC recently filed a lawsuit against the promoters of BitConnect, an unsuccessful cryptocurrency that used a "lending program" that some called a Ponzi scheme. The suit alleges that the promoters were obligated to register as broker-dealers and to register the coin as a security, but failed to do so.
- In an official statement, the Central Bank of Portugal (Banco de Portugal), announced that it had recognized the cryptocurrency exchanges "Criptoloja" and "Mind The Coin" as "virtual asset service providers." This is the first time exchanges have been licensed to operate in Portugal.
- Two Tennessee taxpayers have sued the IRS, arguing that stakers, who generate tokens on a

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INSIDE

Unstable Ground: The Uncertain State of Stable Coins Regulation under *Howey*

Stablecoins are cryptocurrencies that aim to maintain a stable value relative to an underlying benchmark such as fiat, cryptocurrency, a commodity, or a basket of assets like real estate. Cryptocurrencies and digital assets, including stablecoins, are an area of intense regulatory focus, much of which has addressed whether digital assets satisfy the test in the United States Supreme Court's decision in *SEC v. W.J. Howey Co.* The so-called *Howey* test provides that various instruments are securities subject to the Securities Act's regulatory system and SEC oversight if: "a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party."[1] In 2020, two important federal district court decisions, *Sec. & Exch. Comm'n v. Telegram Grp. Inc.*, and *Sec. & Exch. Comm'n v. Kik Interactive Inc.*, generated detailed opinions applying

1 328 U.S. 293, 298-99 (1946).

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proof-of-stake network, should not have to pay taxes on those tokens until they are sold.

- Colonial Pipeline, after a recent ransomware attack, paid a ransom in bitcoin to hackers holding its systems hostage. However, the U.S. Department of Justice was able to recover a significant portion of these funds. The DOJ says this recovery is just one example of the department's ability to trace digital assets used by criminals.
- On June 4, Texas Governor Greg Abbott signed into law House Bill 4474, a measure that amends Texas's Business and Commerce Code to include a definition of virtual currency, establishes requirements to demonstrate ownership of these assets, and provides a process for resolution of adverse claims on virtual currency ownership.
- A major change to the Ethereum fee market, Ethereum Improvement Proposal 1559 ("EIP-1559") is scheduled for activation by mid-July. The proposal seeks to stabilize transaction fees by, among other things, switching the current mechanism for determining fees, which is similar to an auction and which can cause costs to "skyrocket at a moment's notice depending on the ups and downs of the crypto markets," to a as a "fixed price sale," where fees remain relatively static.
- Volatility in cryptocurrency prices continued across tokens of various types. TITAN, a cryptocurrency token with high profile investors, sharply declined in price, dropping from $60 to $.00000003 at its lowest point. Bitcoin prices tumbled below $30,000 for the first time since January, bringing the year-to-date gain down to just 3%, before recovering slightly to above $33,0000.
- Goldman Sachs has begun trading bitcoin futures with Galaxy Digital, a crypto investment firm, making Goldman Sachs the first major U.S. bank to begin trading cryptocurrencies.
- TSB Bank, a bank with over 500 branches across the United Kingdom, is reportedly preparing to block its customers from directing money to cryptocurrency trading sites. TSB Bank cited fraud concerns and was particularly concerned about Binance, one of the world's largest cryptocurrency exchanges. Britain's Financial Conduct Authority also recently released a statement that Binance's U.K. division "is not permitted to undertake any regulated activity in the U.K."
- One June 23, the Southern District of New York approved Block.one's $27.5 million settlement in the class action lawsuit filed by the Crypto Assets Opportunity Fund. The suit alleged both that Block.one's token, EOS, should have been registered as a security and that Block.one misrepresented the nature of its token. Block.one continues to deny any wrongdoing, stating that "accepting this settlement allows us to focus more time and energy on running our business and delivering new products."
- In South Korea, a class action lawsuit was filed against V Global, a Korean cryptocurrency exchange. The suit alleges that V Global operated as a Ponzi scheme and defrauded tens of thousands of people out of over $3 billion. Four V Global executives were arrested for criminal activity arising out of the same purported scheme, and South Korean police continue to investigate.
- The Basel Committee for Banking Supervision, which coordinates international regulation of banks and other financial institutions, proposed new, tougher rules on banks that hold bitcoin and other digital assets. If the proposed regulations are enacted, banks holding these assets would be required to hold additional capital reserves to protect against declines in the value of their digital assets.
- El Salvador will become the first country to recognize bitcoin as legal tender, President Nayib Bukele announced on June 5. Bukele hopes that adopting bitcoin at the national level will help create a more inclusive financial system for Salvadorans, as, according to Bukele, 70% of Salvadorans lack bank accounts.
- On May 31, the Reserve Bank of India withdrew a rule that prohibited Indian banks from facilitating cryptocurrency exchanges. The RBI made this change in response to a March ruling from the Supreme Court of India, which held that the RBI could not prevent domestic financial institutions from providing banking services to crypto exchanges.
- Cryptocurrency-related crimes appear to be on the rise. A new study, based on data from the United States Federal Trade Commission, the U.K.'s National Fraud & Cyber Crime Reporting Center, and the Australian Competition and Consumer Commission, found that in 2020 there were 35% more reports of cryptocurrency-related crimes in the United States than in the

previous year. The study also found slightly smaller increases in Australia and the UK.

- Crypto.com, a cryptocurrency trading platform, is now a sponsor of Formula 1 racing. The deal is reported to give Crypto.com numerous benefits, including "brand presence around F1 events," "and trackside slots for the rest of the F1 season. F1 and Crypto.com also plan to develop non-fungible tokens ("NFTs") aimed at "connecting fans to the sport in new and innovative ways."
- Investors lost billions as the ICP crypto token lost over 90% of its initial value in the first month following its initial coin offering. A report released earlier this week by Arkham Intelligence, a crypto analysis firm, posited that manipulation and malicious activity by insiders caused the crash.
- Cryptocurrency litigation rulings issued in the hip hop world. On June 21, the United States Court of Appeals for the Eleventh Circuit dismissed a class action suit against Clifford "T.I." Joseph Harris Jr. which alleged a sale of unregistered securities. The Eleventh Circuit affirmed the dismissal of the suit on statute of limitations grounds. Around the same time, a class of plaintiffs obtained a default judgment against rapper "The Game" for federal securities violations in connection with Paragon Coin, Inc.'s sale of PRG tokens.
- Coinbase announced they will offer a "crypto savings account" that will allow users to earn interest by lending USDC stablecoins, a cryptocurrency where the value of 1 USDC is pegged to the value of 1 USD. Coinbase stated that its service will tout rates "more than 50x the national average of a traditional savings account."
- Blockware Mining raised $25 million as North American bitcoin mining operations look to take advantage of China's recent regulatory crackdown on bitcoin mining.
- Major League Baseball launched their debut NFT commemorating Lou Gehrig's famous 'Luckiest Man' speech. The NFT features video excerpts from Gehrig's retirement speech after his ALS diagnosis and a three-dimensional bust of the Hall of Fame New York Yankee in an iron finish, a reference to his nickname "Iron Horse." The auction for the NFT commenced on July 4, the 82nd anniversary of the speech, and closed July 8.
- Germany's Fund Location Act went into effect on Thursday, July 1. The law allows German *spezialfonds* (literally translated, "special funds"), the most common institutional investment vehicle in Germany, to invest up to 20 percent of their holdings in cryptocurrencies.
- At a recent virtual event, House Blockchain Caucus co-chair Rep. Bill Foster (D-IL) called for legislation that would allow illicit cryptocurrency transactions to be reversed. Rep. Foster also called for judicial processes that would allow for the identities of cryptocurrency participants to be "unmask[ed]" when law enforcement requires it.
- The Indian government is reportedly considering whether foreign cryptocurrency exchanges should be subject to an additional tax on transactions involving Indian nationals. If the government were to go ahead with this move, cryptocurrency exchanges would be would be subject to an 18% tariff. Q

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(Unstable Ground: The Uncertain State of Stable Coins Regulation under Howey *continued from cover)*

the *Howey* test to "non-stable" cryptocurrencies. While the *Howey* test's application to stablecoins has not yet been litigated, the *Telegram* and *Kik* decisions offer early insights into judicial reasoning on the matter, and suggest that stablecoin projects should remain vigilant to possible litigation against both regulators and private plaintiffs' counsel.

Stablecoins offer a mechanism by which to transact over the blockchain or on cryptocurrency exchanges. This allows stablecoins to offer some of the benefits of crypto, namely fungibility (the ability to trade one currency with another) and permissionless access (the ability for anyone to participate in the system, without prior approval required), without exposure to the exchange rate volatility typical of non-stable cryptocurrencies. Stablecoins use different methods to achieve price stability, ranging from manual purchases by a central party to algorithmic systems that, following a ramping up process, are meant to maintain a target price through automated purchases, sales, and other trading mechanisms. Following the 2014 launch of Tether, the first successful and still dominant stablecoin, it took years for stablecoins to gain traction.[2] However, the stablecoin market is now growing exponentially, doubling over four months in 2020,[3] with total dollar-pegged stablecoin supply reaching $100 billion in May of 2021.[4] This explosion has been driven by the continued growth of Tether and the introduction of new stablecoins, most prominently USD Coin, Binance USD, DAI, TerraUSD, and TrueUSD.[5] With more new issuances, including the Facebook-backed Diem,[6] still on the horizon, rapid growth is likely to continue.

Although there is no specific guidance from the SEC or recent cases on the application of *Howey* to stablecoins, and the *Howey* test generally is a highly fact-specific inquiry, *Telegram* and *Kik* offer some insight into how courts may address the issue.

In *SEC v. Telegram Group Inc.*, decided in March 2020, the Southern District of New York granted the SEC's request for a preliminary injunction preventing the distribution of Gram tokens by Telegram Group Inc., finding that Telegram's initial private sale coupled with the potential for public resale constituted a scheme to distribute unregistered securities into the secondary public market.[7] Following on the heels of the *Telegram* decision, on September 30, 2020, the Southern District of New York again ruled in favor of the SEC at the summary judgment phase in *SEC v. Kik Interactive Inc*, finding that the Kin tokens offered and sold through a pre-sale and initial coin offering by Kik constituted securities under the *Howey* test.[8]

With respect to the first, second, and fourth prongs of the *Howey* test, many stablecoin projects share similarities with other cryptocurrency projects. Briefly addressing *Howey*'s first prong, both *Telegram* and *Kik* noted that there was there was no dispute that an investment of money had occurred. Next, in finding that the defendants had established a common enterprise under the second prong, the two opinions relied on similar reasoning: both Telegram and Kik pooled money they earned from initial offerings and used it to fund their operations and develop the blockchain system they promoted.[9] Although every project and situation is fact-specific, there are stablecoin projects that are arguably similar in this respect, in that they offer stablecoins for other currencies that they then use to fund operations and the development of a blockchain ecosystem.

The fourth prong of the *Howey* test states that expectations of profits should stem "*solely* from the efforts of the promoter or a third party," but lower courts have relaxed this prong, asking whether the "*reasonable expectation* of profits [were] derived from the entrepreneurial or managerial efforts of another."[10] The *Telegram* court appears to further lower the bar, endorsing the "Bahamas test"[11]: "if the sellers fled to the Bahamas or ceased to show up to work—like Satoshi Nakamoto—would the project still be capable of existing?"[12] The court found that without Telegram's development and oversight of the TON Blockchain, Grams would "lack the mass adoption, vibrancy, and utility" that would enable successful operation and the potential for profit.[13] The court's reasoning in *Telegram* suggests that if activity by any other party constitutes a necessary condition for a coin's ultimate success, *Howey*'s fourth prong is met. The *Kik* court likewise noted that without Kik's role in the development of the Kin ecosystem, "Kin would be worthless," providing sufficient evidence of buyer intent to derive profit from the efforts of another.[14]

This line of reasoning potentially implicates stablecoin projects. The SEC staff or a private plaintiff may contend that some centralized stablecoin projects—algorithmic, crypto-collateralized, and fiat-collateralized—arguably meet this version of the

2 Coin Metrics Research, The Rise of Stablecoins (2021).

3 Id.

4 Yogita Khatri, Total Stablecoin Supply Crosses the $100 Billion Mark (May 26 2021), https://www.theblockcrypto.com/post/106082/total-stablecoin-supply-100-billion-mark.

5 See https://coinmarketcap.com/view/stablecoin/.

6 Ed Drake, Facebook Diem Announces US Stablecoin Launch (May 20, 2021), https://coingeek.com/facebook-diem-announces-us-stablecoin-launch/.

7 Sec. & Exch. Comm'n v. Telegram Grp. Inc., 448 F. Supp. 3d 352 (S.D.N.Y. 2020), appeal withdrawn sub nom. United States Sec. & Exch. Comm'n v. Telegram Grp., Inc., No. 20-1076, 2020 WL 3467671 (2d Cir. May 22, 2020).

8 Sec. & Exch. Comm'n v. Kik Interactive Inc., 492 F. Supp. 3d 169 (S.D.N.Y. 2020).

9 See Kik, 492 F. Supp. 3d at 178; Telegram, 448 F. Supp. 3d at 369-71.

10 Id. at 375.

11 Id.

12 Todd Henderson and Max Raskin, A Regulatory Classification of Digital Assets: Toward an Operational *Howey* Test for Cryptocurrencies, ICOs, and Other Digital Assets, 2 Colum. Bus. L. Rev. 443, 461 (2019).

13 Telegram, 328 488 F. Supp. 3d at 375.

14 492 F. Supp. 3d at 180.

"efforts of another" prong. Stabilization mechanisms generally rely on the minting entity's efforts in initial development and ongoing management and verification. However, not all stablecoin projects may be treated equally, and may not be treated equally at different points in their life cycles; an argument could be made that a purely algorithmic stablecoin project would not meet this prong, at least after the algorithm was operating successfully, thereby eliminating the ongoing management and verification that was at play in *Telegram*.

The third prong in the *Howey* Test—whether an individual is led to expect profits—is one of the most discussed, and is where stablecoins are more likely to diverge from other cryptocurrencies. Analyzing *Howey*'s third prong, *Telegram* held that an investor possesses an expectation of profit when her motivation to partake in the relevant scheme is the prospect of a return on investment, even where that motivation is secondary to a motive unrelated to profit.[15] In evaluating the expectation of profit, the *Telegram* court discounted the initial purchasers' legal disclaimers of an intent to resell, finding sufficient evidence of such intent in the "economic realities" of the sale, including the initial sale of Grams at a discount relative to the expected market price in a post-launch public market.[16] The *Kik* decision likewise analyzed the economic realities underpinning the Kin offering, finding a reasonable expectation of profit where purchasers depended on a centralized entity, there Kik, to ensure that the coin's "consumptive use," and hence value, would materialize.[17]

Stablecoins are certainly distinguishable from the "non-stable" cryptos at issue in *Telegram* and *Kik*. Where cryptocurrencies have become vehicles for some to seek high growth, high risk investment, stablecoins aim for constancy. Nevertheless, the *Telegram* and *Kik* courts' flexible reasoning and focus on economic realities might allow the SEC or private counsel -the latitude necessary to argue that *Howey* is applicable to stablecoins. Algorithmic stablecoins that must ramp up to a stable value sometimes offer discounted sales prior to successful stabilization. These sales may support an argument that initial purchasers, despite formal disclaimers by issuers and purchasers alike, buy with the intent for resale following stabilization at the higher price. Likewise, stablecoins pegged to assets other than fiat (such as gold, a consumer price index, or diamonds, for example) may be analyzed to assess whether potential growth in the value of the underlying asset is sufficient evidence of an expectation of profit under *Telegram*'s realities-driven analysis.

Even fiat-pegged stablecoins may not be impervious to creative SEC staff (or plaintiffs' counsel) armed with *Telegram* and *Kik*. Despite their name, stablecoins present reasonably foreseeable opportunities for profit through arbitrage. For example, the March 12th, 2020 collapse in bitcoin prices drove investors to the safe-harbor of stablecoins, increasing demand and causing the price of most dollar-pegged stablecoins to jump up to between \$1.03 and \$1.06, opening profit opportunities for holders willing to sell.[18] Endemic instability in the crypto market, coupled with the relatively small market caps of stablecoins and their growing role as safe harbors for crypto investors promises further profit opportunities. "Investors" in fiat-pegged stablecoins can expect to sell their holdings in excess of the peg during downturns in the crypto market, when those holding non-stable cryptocurrencies flock to the safe harbors of Tether *et al.*, and strain supply. Aggressive regulators may try to assert that this is a sufficient, if secondary, expectation of profit under *Telegram* and *Kik*'s economic realities test. While these arguments may ultimately fail to persuade the courts, they do present at least some investigative or litigation risks to stablecoin projects.

Successive extensions of the *Howey* test have raised more questions than answers for cryptocurrencies, including stablecoins. The complexity of the findings of the *Telegram* and *Kik* opinions continue to demonstrate the opacity of the regulatory landscape. It continues to be difficult to draw broader conclusions or extrapolate rules or principles from enforcement actions that, as the *Telegram* court notes, are specific to the facts of a particular project and digital asset. However, the trends signaled in *Telegram* and *Kik* will undoubtedly enrich the regulatory landscape and invite further interest by the SEC, plaintiffs' counsel, and stablecoin issuers. Q

15 Id. at 371.
16 Id. at 372.
17 492 F. Supp. 3d at 178.
18 Coin Metrics Research, The Rise of Stablecoins, 8-9 (2021).

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