

An hourglass with blue sand is centered in the frame against a solid blue background. The sand is flowing from the top bulb to the bottom bulb. The hourglass is made of clear glass, and the sand is a vibrant blue color. The background is a uniform, light blue color.

This webinar will begin shortly.

**FIA**



# DeFi and Other Fi

—  
30 March 2023



# Reminders

- The webinar will be recorded and posted to the FIA website within 24 hours of the live webinar.
- Please use the “question” function on your webinar control panel to ask a question to the moderator or speakers.



# Presenters

## Host:

**Michael Sorrell**, *Deputy General Counsel, FIA*

## Panelists:

**Katherine Cooper**, *Partner, Banking and Financial Services, Davis Wright Tremaine*

**Elizabeth Davis**, *Partner and Co-Chair of Banking and Financial Services, Davis Wright Tremaine*

**Harris Kay**, *Partner, Banking and Financial Services and Managing Partner in Chicago, Davis Wright Tremaine*

**Maggie Sklar**, *Partner, Banking and Financial Services, Davis Wright Tremaine*



# Davis Wright Tremaine's Commodities and Derivatives Team

- Our team brings an unparalleled depth of understanding to legal issues involving commodities and derivatives, drawing on decades of experience in and out of government.
- We advise on the full spectrum of regulatory and compliance questions arising in connection with the offering or use of commodities, derivatives, and digital assets, and represent our clients in high-stakes litigation and enforcement actions surrounding these increasingly important drivers of the global financial marketplace.
- Our group includes former senior compliance officers at major financial institutions, former federal prosecutors, and enforcement or regulatory attorneys who have served as Chief Trial Attorney in the CFTC's Division of Enforcement, Senior Counsel to the CFTC Chairman and a CFTC Commissioner, Counsel in the CFTC's Division of Market Oversight, Department of Justice Criminal Division liaison to the CFTC and FERC, and Associate Director of the SEC's Division of Market Regulation (now the Division of Trading and Markets).
- Our client base includes institutions and entities that use derivative instruments to hedge commercial price exposure and currency risk, as well as financial services industry members such as futures commission merchants, swap dealers, swap execution facilities, exchanges, clearinghouses, commodity trading advisors, commodity pool operators, proprietary trading firms, brokerage firms, digital asset firms and investors, and banks.



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## 70+ Attorneys

- 30+ with government experience, 25+ with financial services in-house experience

Our clients include 8 of the largest banks in the U.S. and 6 fintech unicorns

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- Recipient of Citi's 2022 Law Firm Diversity Champion Award
- Recognized by Discover Financial Services and U.S. Bank for efforts to advance individual development and long-term success of each of our diverse lawyers



# What is DeFi?

TradFi (Traditional Finance)

- e.g., Banks, FCMs

CeFi (Centralized Finance)

- e.g., Cryptocurrency exchanges

DeFi (Decentralized Finance)

- e.g., Stablecoins, DAOs

CoFi (Community Finance)

- a web3 application that allows users to raise and direct funding

And “DiNOs” (DeFi in name only)



# DeFi Applications

## DAOs (Decentralized Autonomous Organizations)

- an algorithmic organization with a set of rules in a smart contract that “governs” the behavior

## DEXes (Decentralized Exchanges)

- an “exchange” that relies on P2P, blockchain, and smart contracts that may mimic the functions of a regulated exchange-uses automated market makers (AMM)

## DeFi lending

- a non-Trad-Fi or non-intermediated way of exchanging assets

## DApps (Decentralized Applications)

- applications that allow direct P2P interactions, and without functions like central clearing





# Stablecoins

Stablecoins account for a major share of liquidity for many crypto exchanges and DeFi protocols.

There are various forms of stablecoins.

Some are 1:1 pegged to the USD, others are not.

There is currently no federal regulation to require them.

Several years ago, and even more recently in the Binance complaint, the CFTC has said that some stablecoins (e.g., Tether) are and have been commodities and that CFTC has fraud/manipulation jurisdiction.

SEC Chair Gensler has said that some stablecoins are securities and others are commodities. The banking regulators continue to look at stablecoins from a prudential side.



# Legislation

There have been a number of legislative efforts to address stablecoins and cryptocurrency.

- Lummis-Gillibrand Responsible Financial Innovation Act, S. 4356, 117th Cong. (2022)
- Stabenow-Boozman Digital Commodities Consumer Protection Act (DCCPA), S. 4760, 117<sup>th</sup> Cong. (2022)
- Digital Commodity Exchange Act (DCEA), H.R. 7614, 117<sup>th</sup> Cong. (2022)

Given the change of leadership in the House and other changes in the Senate, it is still unclear and a work in progress.

There have been bills to address specifically to create a crypto SRO, give the CFTC more jurisdiction, further establish the SEC's jurisdiction, give the OCC/Fed more jurisdiction, and there is a lot of legislation that does not address DeFi at all.

Importantly, some states are going on their own to address these regulatory gaps.

- Digital Assets and Money Transmitter Modernization Bill, Illinois H.B. 3479 (2023)



# GameFi and Other Fi



# What is GameFi?

- Short for “Game Finance”
- Refers to the use of decentralized finance protocols and other technologies in connection with online gaming.
- Facilitates purchase, sale or transfer of assets of value within a particular game – e.g., “Power-Ups,” “Skins” (graphical enhancements to a character’s appearance), more powerful weapons, etc.
- These enhancements are frequently earned via online gameplay.
- The “market” consists of sellers (those who own the material, either through gameplay time and efforts or through the purchase themselves) and buyers (those who are willing to pay for these enhancements rather than expend the time and effort necessary to earn).



# GameFi – Opportunities for Participants

- In traditional games, the rights to these enhancements are held on a centralized server owned by the gaming company.
- The decentralized nature of blockchain games permits the easier transfer of enhancements, via smart contract applications.
- The purchase, sale and transfer of these enhancements are done by tokens – whether non-fungible tokens (“NFTs”) or fungible tokens.
- GameFi offers unique opportunities versus those from traditional gaming rewards:
  - Full ownership that cannot be limited by the game company
  - Transferability via other platforms and exchanges
  - The ability to earn money from gaming in an otherwise closed environment



# Issues regarding GameFi – *The Tokens*

- General concern in light of view that “most cryptocurrencies are securities.”
- How are the tokens initially marketed?
- Is there an investment of money under *Howey* – particularly by the Play-to-Earn gamers?
- Is there an “expectation of profit” under *Howey*?
  - Do the “play-to-earn” gamers expect profit when they earn?
  - Do buyers buy for profit, or for exciting game enhancements?
  - How about “speculators” – traders who believe that the token value will increase?



# Issues regarding GameFi – *The Platform*

- Platforms that permit or facilitate the sale of digital assets could be deemed security exchanges.
- Determination is dependent upon other determination regarding the tokens offered on the platform.
- Concerns – March 7, 2018 Guidance – that they give the appearance of regulated exchanges
  - “Misimpression to investors that they are regulated or meet the regulatory standards of a national securities exchange.”
  - SEC does not review the standards associated with asset selection.
  - SEC does not review trading protocols.
  - No reason to believe that the exchanges offer accurate order books with updated bid/ask information.



# Regulatory Actions Against GameFi – *Unikrn, Inc.*, SEC Admin Proc. 3-20003

- Unikrn conducted an ICO that raised \$31 million by the sale of UKG.
- The tokens would provide access to “a variety of products and services . . . including placing bets on professional eSports and video game matches,” with more features available over time.
- These current and future features would “increase the demand for and in turn, the value of the tokens.” Thus, SEC concluded that the tokens were “offered and sold as investment contracts, and therefore securities,” under *Howey*.
- Unikrn violated SEC rules by failing to register the tokens as securities.





# Regulatory Actions Against GameFi – *NVIDIA Corporation, SEC Admin Proc. 3-20844*

- NVIDIA failed to disclose significance of cryptomining to its profits.
- SEC considered this an omission of material facts, in violation of the Securities Act rules regarding disclosure.
- **NOTE:** this is not tied to any tokens, but rather to the business operations of a gaming company.



# Other Regulatory Implications of GameFi

- **Money Transmission?**

- Applies to persons in the business of “exchanging virtual currency for real currency.”
- Would not be a concern if game tokens could not be cashed out – they would not be a thing of value. Given their value on the secondary market – does this change?

- **State Gambling Laws**

- **Intellectual Property Laws**

- Use of game company’s technology to operate the enhancements – patent issues?
- Is any trademarked material “tied in” to the enhancements?



# What is “Other Fi”

- Smart contract and blockchain technology is not limited to currency or gaming tokens.
- The key benefits of NFTs – unchallengeable ownership and frictionless trading – could raise regulatory issues.
- Requires scrutiny of the any token on a case-by-case-basis.
  - What is the purpose of acquisition?
  - Do you own the underlying asset?
  - Is there a use for the token other than buy and sell?



# CFTC Enforcement Actions



# CeFi

- *In re Coinbase Inc.*, CFTC Dkt. No. 21-03 (Mar. 19, 2021)
  - Reckless, false, misleading, or inaccurate reporting concerning transactions in digital assets, including Bitcoin, on its GDAX platform
  - Wash trading by a former employee in the Litecoin/Bitcoin trading pair on GDAC in violation of Section 6(c)(1)(A) and Regulation 180.1
  - Imposed CMP of \$6.5 million



# CeFi

- *CFTC v. HDR Global Trading Limited, et al*, Case No. 1:20-cv-08132 (S.D.N.Y. Aug. 10, 2021). See also *In re HDR Global Trading Limited, et al.*, FinCEN No. 2021-02 (Aug. 10, 2021); *United States v. Arthur Hayes, et al.*, Case No. 20-cr-500 (S.D.N.Y.)
  - Complaint filed in SDNY in October 2020
  - Consent order finding BitMEX violated:
    - ❑ Sections 4(a), 5h(a)(1) by operating a facility to trade or process swaps without being approved or registered as a designed contract market or a swap execution facility
    - ❑ Section 4d by operating a futures commission merchant without CFTC registration, including by accepting Bitcoin to margin digital asset derivative transactions and acting as a counterparty to leveraged retail commodity transactions
    - ❑ Section 6c(b) and CFTC Regulation 32.2 by offering illegal off-exchange commodity options
    - ❑ CFTC Regulation 42.2 by failing to implement a Customer Information Program and Know-Your-Customer procedures, and an adequate Anti-Money Laundering program
    - ❑ CFTC Regulation 166.3 by failing to supervise its partners, officers, employees, and agents
  - Ordered to pay \$100 million CMP



# CeFi

- ***In re Payward Ventures, Inc. (d/b/a Kraken), CFTC Dkt. No. 21-20 (Sep. 28, 2021)***
  - Illegally offering margined retail commodity transactions in digital assets, including Bitcoin, with non-ECP U.S. residents that did not result in actual delivery within 28 days, in violation of Section 4(a)
  - Failing to register as a futures commission merchant in violation of Section 4d(a)(1) by accepting orders for and entering retail commodity transactions with customers, and accepting money or property to margin those transactions
  - Imposed CMP of \$1.25 million



# CeFi

- ***CFTC v. Gemini Trust Company, LLC, Case No. 22 Civ. 4563 (S.D.N.Y.)***
  - Making false or misleading statements of material facts or omitting to state material facts to the CFTC in connection with the self-certification of a bitcoin futures product in violation of Section 6(c)(2)
- ***CFTC v. Adam Todd, et al., Case No. 1:22-cv-23174 (S.D. Fla.)***
  - Failing to register as a designated contract market and also attempting to manipulate the price of the platform's native token in violation of Sections 6(c)(1), 6(c)(3), and CFTC Regulations 180.1(a)(1) and 180.2
  - Failing to maintain effective KYC procedures or an effective customer identification program pursuant to CFTC Regulation 42.2





# CeFi

- ***CFTC v. Samuel Bankman-Fried, FTX Trading Ltd. d/b/a FTX.com, and Alameda Research, LLC, Caroline Ellison, and Zixiao “Gary” Wang, Case No. 1:22-cv-10503 (S.D.N.Y.). See also United States v. Samuel Bankman-Fried, a/k/a “SBF”, 22 Cr. 673 (LAK) (S.D.N.Y.)***
  - Fraud by comingling, mishandling, and misappropriated customer funds, and making of misrepresentations related to the operation of FTX and Alameda in violation of Section 6c(1) and CFTC Regulation 180.1
  - Complaint amended to charge Ellison and Wang with engaging in a fraudulent scheme with the other charged defendants
  - *See also CFTC v. Nishad Singh, Case No. 1:23-cv-01684 (S.D.N.Y.) (charging fraud by misappropriation and aiding and abetting fraud committed by Sam Bankman-Fried, FTX, and Alameda)*



# DeFi

- ***CFTC v. Ooki DAO*, Case No. 3:22-cv-05416 (N.D. Cal.). See also *In re bZeroX, LLC, et al.*, CFTC Dkt. No. 22-31 (Sep. 22, 2022)**
  - First CFTC enforcement case against a DAO
  - Consent order against the predecessor protocol and its founders
  - Alleged to have illegally offered leveraged and margined retail commodity transactions in digital assets in violation of Section 4(a), engaging in activities only registered future commission merchants can perform in violation of Section 4d, and failing to adopt a registered identification program as part of a Bank Secrecy Act compliance program as required of FCMs in violation of CFTC Regulation 42.2



# DeFi

- ***CFTC v. Avraham Eisenberg, Case No. 1:23-cv-00173 (S.D.N.Y.). See also United States v. Avraham Eisenberg, 23 Crim 010 (S.D.N.Y.)***
  - First CFTC enforcement action for a fraudulent or manipulative scheme involving trading on a decentralized digital asset platform
  - First CFTC enforcement action involving a scheme that is sometimes called “oracle manipulation”
  - Alleges misappropriation of over \$110 million in digital assets from Mango Markets, manipulation, and attempted manipulation in violation of Sections 6(c)(1) and 6(c)(3), and CFTC Regulations 180.1 and 180.2



# SEC 2022-23 Crypto Enforcement Actions

**2022 SEC brought a total of 30 enforcement actions involving cryptocurrency**

- Up 50% from 2021

**In 2022 Many familiar charges:**

- 22 cases charged unregistered securities offerings
  - 14 of these involved ICOs
- 21 cases alleged fraud in connection with the offer or sale of securities
  - 2 included claims of touting without disclosing compensation

**Newer Product/Service Targets in SEC Enforcement Actions 2022-23:**

- Lending/Interest Paying Products
- Staking
- Stablecoins



# SEC 2022-23 Crypto Enforcement Action Trends

## Lending

- **Wells Notice to Coinbase re lending product (Sept. 2021)**  
Coinbase decides not to launch Lend product
- ***In re Blockfi Lending LLC (Feb. 14, 2022)***  
SEC charged that the BlockFi's Interest Account product constituted the sale of securities in that they were notes under *Reves* and investment contracts under *Howey*  
In addition, SEC charged BlockFi was an unregistered investment company because it was an issuer of securities which engaged in investing, reinvesting, owning, holding or trading in securities with a value exceeding 40% of its total assets
- ***SEC v. Genesis Global Capital, LLC & Gemini Trust Co. , LLC (Dkt. 23-cv-287 SDNY Jan. 12, 2023)***  
SEC alleges that Gemini Earn program involved the unregistered offer and sale of notes or investment contracts
- ***In re Nexo Capital Inc. (No. 3-21281) (Jan. 19, 2023)***  
SEC charged Nexo Earn Interest Product was a note and investment contract



# SEC 2022-23 Crypto Enforcement Action Trends

## Staking

- ***SEC v. Payward Ventures, Inc. (d/b/a Kraken)* (Dkt. 23-cv-588 N.D. Cal. Feb. 9, 2023)**

SEC charged Kraken’s “staking-as-a-service” constituted the offer and sale of investment contracts, alleging:

- Kraken retained discretion to determine what percentage of staking awards received to pay customers
- Kraken did not generally disclose the amount of rewards received from the staking protocol that are retained by Kraken and not shared with customers
- Kraken did not disclose the fees charged to customers or what their operating costs were
- Kraken advertised that customers could withdraw tokens without being bound by minimum bonding and unbonding periods that one would be subject to if they were staking on their own
- Liquidity was achieved by not staking all of the tokens
- Kraken was under no obligation not to commingle customer tokens with Kraken’s own tokens
- Kraken marketed staking-as-a-service as an investment opportunity

Kraken consented to entry of final judgment ceasing the s-a-a-s and pay a \$30 million penalty



# SEC 2022-23 Crypto Enforcement Action Trends

## Stablecoins

### CeFi

- **SEC delivered a Wells Notice to Paxos re Binance USD token (“BUSD”) (Feb. 3, 2023)**

Enforcement staff were prepared to recommend an enforcement action against Paxos on the basis that BUSD was a security offered and sold by Paxos without being registered

Paxos claims that BUSD was always backed 1:1 with US dollar-denominated reserves, fully segregated and held in bankruptcy remote accounts and BUSD did not offer interest or dividends or other income generating benefits

- **NYS DFS directs Paxos to stop minting BUSD (Feb. 13, 2023)**

### DeFi

- ***SEC v. Terraform Labs PTE Ltd.* (Dkt. 23-cv-1346 S.D.N.Y Feb. 16, 2023)**

SEC alleged that in addition to the Terraform’s LUNA token, its stablecoin Terra USD (“UST”) was a security, even though it was designed to algorithmically maintain a 1 to 1 peg to the US Dollar

- Terraform’s Anchor Protocol pooled UST to lend to borrowers and passed interest back to lenders, thus satisfying the 3 prongs of the Howey test
- UST was also a security because it gave holders the right to subscribe or purchase another security, namely the LUNA token



# Future of Regulation

- **CFTC Chair Behnam noted in the 2022 Enforcement Report that “the CFTC continues to aggressively police new digital commodity asset markets with all of its available tools.”**
  - *bZeroX* – action against DAOs.
  - *Bitfinex* – actions against exchange operators for failure to register as FCM and conducting illegal off-exchange futures trading.
  - *Tether* – regarding statements made in connection with its coin offering.
- **Continued concern over SEC’s view that “most digital assets are securities.”**
- **Performance in 2022 bring these issues to the fore.**
  - GameFi token market cap dropped from nearly \$30 billion to just over \$3 billion.
  - Volume of transactions declined.



# Questions or Comments?



Katherine Cooper

Partner, New York  
[KatherineCooper@dwt.com](mailto:KatherineCooper@dwt.com)  
(212) 880-3630



Elizabeth Lan Davis

Partner, Washington, D.C.  
[ElizabethDavis@dwt.com](mailto:ElizabethDavis@dwt.com)  
(202) 220-1933



Harris L. Kay

Partner, Chicago  
[HarrisKay@dwt.com](mailto:HarrisKay@dwt.com)  
(312) 820-5130



Maggie Sklar

Partner, Chicago  
[MaggieSklar@dwt.com](mailto:MaggieSklar@dwt.com)  
(312) 820-5117



William Walsh

Partner, Chicago  
[williamwalsh@dwt.com](mailto:williamwalsh@dwt.com)  
(312) 820-5114



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