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Blockchain Trends and Enforcement Surrounding the New Technology

Partners

Alexander C. Drylewski / New York

Stuart D. Levi / New York

In 2019, regulators continued to consider whether and how to regulate blockchain technology. After the two previous years that included a high number of initial coin offerings (ICOs), many of which involved allegedly fraudulent conduct, 2019 was marked by the growth of "stablecoins" (*i.e.*, coins that are stabilized through a computer algorithm or by being backed by a reserve asset). Many regulators and policymakers have turned their attention to the potential impact of stablecoins on monetary policy since, if successful, such nonvolatile coins could become a true medium of exchange to complement fiat currencies.

The fact that regulators have started to consider the possibility of these coins becoming an accepted means of global payment is a testament to the growth of the technology and the number of projects seeking to develop a useable virtual currency. Despite that shift, the U.S. Securities and Exchange Commission (SEC) continued to bring enforcement actions throughout 2019. These efforts likely will continue in 2020, increasing the probability that the courts may be called upon to provide some clarity around token sale activity that occurred in 2017 and 2018.

Regulatory advancements in a number of countries also highlighted that companies looking to monetize blockchain technology cannot have a U.S.-centric view.

SEC Enforcement Activity

The SEC brought a series of enforcement actions in 2019 and entered into a number of settlements with entities that engaged in ICOs, as well as others that allegedly took part in fraudulent activity.

For example, the SEC settled charges against SimplyVital Health, Inc., a New England-based blockchain company that had raised $6.3 million for a blockchain-based health care protocol using Simple Agreement for Future Tokens (SAFT) purchase agreements, under which SimplyVital would create tokens and deliver them to investors. The SAFTs were not offered pursuant to a registration statement, and many agreements were with individuals whom SimplyVital had failed to verify were accredited investors. The settlement included no civil penalty in part because SimplyVital had scrapped its token program and returned "substantially all" of the funds to those who had participated in the SAFTs presale. SimplyVital also agreed to a cease-and-desist order preventing it from "committing or causing any violations and any future violations of Section 5(a) and (c) of the Securities Act," without admitting or denying the SEC's findings.

Also in 2019, the SEC announced that it had settled charges against Bitqyck, Inc. and its founders in connection with their operation of a digital asset exchange, TradeBQ, which allowed the trading of a single security, Bitqy, one of two digital assets the SEC alleged Bitqyck fraudulently offered to investors. The SEC asserted, in part, that Bitqyck persuaded investors to purchase Bitqy by falsely claiming that it provided an interest in a cryptocurrency mining facility powered by below-market-rate electricity. As part of the settlement, Bitqyck agreed to injunctive relief, without admitting or denying the SEC's findings. The company also agreed to pay over $8 million in disgorgement, interest and penalties; and its founders each agreed to pay over $850,000 in disgorgement, interest and penalties.

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Four Times Square
New York, NY 10036
212.735.3000

In December 2019, the SEC settled charges with Blockchain of Things, Inc. (BCOT), which had conducted a "presale" and "public sale" through which it offered and sold BCOT tokens. Without admitting or denying liability, BCOT agreed, among other things, to register the BCOT tokens as a class of securities under Section 12(g) of the Securities Exchange Act of 1934, and to inform BCOT purchasers of their ability to recover any consideration paid for such tokens.

Also in 2019, the SEC's Strategic Hub for Innovation and Financial Technology (FinHub) issued its second no-action letter in the blockchain industry to Pocketful of Quarters (PoQ) regarding a token for video games on what is largely a closed, permissioned platform. Similar to FinHub's first no-action letter — a 2018 letter to TurnKey Jet, Inc. regarding tokens to be used on a private, permissioned blockchain platform to purchase charter jet services from the company — the PoQ letter dealt with a narrow use case that does not provide substantial guidance for other decentralized blockchain projects.

Finally, in 2019, the SEC brought high-profile enforcement actions in federal court against two digital asset developers, Kik and Telegram.[1] Notably, neither action involves fraud allegations, but assert violations of the Securities Act of 1933 based on the developers' alleged failure to register their offerings under the federal securities laws. Both cases are being watched closely, as the rulings may provide much-anticipated judicial guidance in this new area of the law.

New York BitLicense 2.0

In 2015, seeking to regulate the growing cryptocurrency industry, the New York State Department of Financial Services (NYDFS) began requiring companies engaged in "virtual currency business activity" to obtain a license (BitLicense). The BitLicense has come under fire for having onerous requirements and a lengthy procurement time, with some saying this has caused cryptocurrency companies to leave New York. Acknowledging these issues, in 2019 NYDFS Superintendent Linda Lacewell established a new Research and Innovation Division to consider, among other matters, whether the BitLicense process could be improved while still protecting consumers. To that end, in December 2019, the NYDFS proposed two new measures to enhance the BitLicense: (i) a public list of coins that are permitted for virtual currency business activities without the NYDFS' prior approval, and (ii) a model framework for creating a self-certification process for virtual currency businesses. Although in its early stages, these proposals reflect that regulators are seeking to strike a balance between fostering innovation and protecting consumers.

Report on GDPR and the Need for Regulatory Guidance

Since the European Union's General Data Protection Regulation (GDPR) went into effect in May 2018, many have questioned how the regulation can be applied to blockchain applications given the technology's highly decentralized and immutable structure. A lengthy July 2019 report commissioned by the European Parliament Panel for the Future of Science and Technology (the STOA Report) provides the most comprehensive and thorough analysis to date of these issues. Not surprisingly, the STOA Report concludes developers need to consider GDPR requirements and cannot simply determine that the law is incompatible with the technology. However, the STOA Report is also a call to action to European data protection regulators, noting that various GDPR provisions do not work in blockchain-based systems and further regulatory guidance is required. As the STOA Report states, attempts to draft the GDPR to be technology-agnostic have created ambiguities requiring further clarification. Whether such guidance emerges, and whether it resolves these ambiguities, remains to be seen, but the STOA Report was significant in acknowledging that regulatory openness is required in order for blockchain technology to achieve its potential.

Stablecoin Reports

In 2019, stablecoins drew the attention of regulators and financial sector policymakers. For example, in October 2019, the Financial Stability Board (FSB), which coordinates the national financial authorities and international standard-setting bodies to develop effective financial sector policies and regulation, issued its own report on stablecoins. The FSB acknowledged that the financial system could benefit from stablecoins by providing lower costs in cross-border transactions and facilitating financial inclusion given the widespread use of smartphones. The report notes the need for regulators to determine how existing country-specific and international standards and principles can support stablecoins. Similarly, in December 2019, the Council of the European Union and the Commission on Stablecoins issued a joint statement on stablecoins, in which they highlighted the opportunities stablecoins present in terms of cheap and fast payments but also the challenges and risks they pose. The council and commission concluded that no global stablecoin arrangement should begin operating in the European Union until "the legal, regulatory and oversight challenges and risks have been adequately identified and addressed."

2020 Outlook

In 2020, we anticipate that regulators and policymakers will continue to search for a balance between fostering a technology that could have significant positive impacts on financial services and other industries with existing laws and regulations. We also anticipate greater cross-border cooperation in addressing these issues.

[1] Skadden is counsel of record for Telegram in its proceedings.