



# Web3 Law and Regulation

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# About Me



## Presently

- Head of Policy @ Blockchain Association
- Lawyer, but not yours
- Advisor @ Variant Fund / Board @ DeFi Education Fund

## Formerly

- General Counsel @ Compound Labs, Inc.
- Government Enforcement Defense @ Kobre & Kim LLP
- Compliance and Investigations @ Baker McKenzie LLP

## Futurely

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# Roadmap

- 1) **Introduction**
- 2) **Regulators and Frameworks**
- 3) **Current Issues to Watch**
- 4) **Web3 Legal Strategy**
- 5) **Questions?**



# Basics of Regulation

## **What are regulations?**

- Rules that prohibit conduct or condition it on compliance with certain obligations
- Violations are punishable by fines, restrictions, and imprisonment (for crimes)

## **Why do we have them?**

- “The market cannot be left to its own devices”
- To control market power, facilitate competition, promote stability, attract investment, protect consumers, and achieve other governmental interests

## **Who makes and enforces them?**

- US has regulations on both state and federal levels; we will focus on US federal
- Legislature makes laws, executive enforces laws, judiciary interprets laws

## **How should you think about them?**

- Learn the basics for issue-spotting; hire a lawyer before doing anything risky!



# Regulators and Frameworks

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# Securities Laws



## The Securities and Exchange Commission (“SEC”)

- The SEC has a three-part mission: to protect investors, facilitate capital formation, and maintain fair, orderly, and efficient markets
- The federal securities laws originated in the 1930s after the Great Depression, which was thought to be caused by financial abuse and information asymmetry
- The SEC regulates “securities” and a broad range of securities market actors, including issuers, exchanges, advisers, brokers, dealers, investment firms, etc.

## Crypto x Securities Laws

- Securities must be registered with the SEC (an IPO) or exempt from registration
- Registered securities are subject to onerous requirements that don’t work for crypto: traded on SEC-regulated venues, held by SEC-approved custodians, etc.
- Because a securities designation is a death blow for most digital assets, the crypto industry spends a lot of time and money avoiding SEC regulation



# Securities Laws

## Investment Contracts and the *Howey* Test

- Many types of securities: stocks, bonds, notes, investment contracts, etc.
- SCOTUS defined an “investment contract” in *SEC v. W.J. Howey Co.* (1948):
  - (1) an investment of money
  - (2) in a common enterprise
  - (3) with a reasonable expectation of profit
  - (4) based on the efforts of others

## SEC Guidance

- [DAO Report](#), July 2017: DAO tokens are securities under the *Howey* test
- [Bill Hinman](#), June 2018: bitcoin and ether are “sufficiently decentralized”
- [SEC Framework](#), April 2019: dozens of factors relevant to the *Howey* test
- [SEC Chair Gary Gensler](#), October 2022: “The law is clear. I believe based on the facts and circumstances most of these tokens are securities.”



# Securities Laws

## The Hinman Test

- “If the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise’s success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful. And so, when I look at Bitcoin today, I do not see a central third party whose efforts are a key determining factor in the enterprise. . . .”





# Securities Laws

## The Hinman Test

- “. . . And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions.”

## Initial Coin Offerings

- SEC v. Telegram, March 2020
- SEC v. Kik Interactive, September 2020
- SEC v. LBRY, November 2022

## Beyond Token Issuers

- Crypto Asset Management, September 2018: fund manager
- EtherDelta, November 2018: “decentralized” exchange
- BlockFi, February 2022: lending platform

# Commodities Laws



## The Commodity Futures Trading Commission (“CFTC”)

- The CFTC's mission is to promote the integrity, resilience, and vibrancy of US derivatives markets: futures, options, swaps, etc.
- The CFTC was created in 1974 when most futures trading occurred in agricultural markets and is still overseen by the House and Senate Ag Committees
- The CFTC's role and responsibilities greatly expanded after the Global Financial Crisis under the Dodd-Frank Act due to the impact of complex financial derivatives

## Crypto x Commodities Laws

- It is unlawful for a US person who is not an eligible contract participant (ECP) to enter into, or offer, a derivatives transaction outside of a CFTC-regulated venue
- [CFTC v. Bitmex](#), August 2021
- [CFTC v. Polymarket](#), January 2022
- [CFTC v. bZx/Ooki DAO](#), September 2022

# Anti-Money Laundering Laws



## The Financial Crimes Enforcement Network (“FinCEN”)

- FinCEN enforces the US anti-money laundering (“AML”) laws under the Bank Secrecy Act (“BSA”) and implementing regulations
- The BSA requires regulated financial institutions to have an AML compliance program that meets certain requirements, including customer due diligence (“KYC”), essentially deputizing financial intermediaries to perform the task of surveilling transactions and reporting on them to the government

## Crypto x AML Laws

- The BSA applies to crypto just like any other financial instrument, so crypto institutions like exchanges and custodians have to comply with AML laws
- How does the BSA work in a disintermediated financial system like crypto?
- [FinCEN Guidance](#), May 2019: explains the definition of “money transmitter” in the context of specific crypto market participants



# Anti-Money Laundering Laws

## FinCEN Guidance, May 2019

- Money transmitters are entities that *accept* funds from one person and *transmit* those funds to another person or location by any means.
- FinCEN gives examples of when this definition applies and when it doesn't
  - For example, anonymizing service providers vs. software providers
  - But, a confusing treatment of “DApps” and “DApp developers”

## Simple Cases

- *In re Eric Powers*, April 2019
- *US v. Larry Dean Harmon*, August 2021
- *US v. Arthur Hayes et al.*, February 2022

## Complex Cases

- DeFi protocols with admin keys?
- Multisigs? DAOs with treasuries?

# Sanctions Laws



## The Office of Foreign Assets Control (“OFAC”)

- Sanctions are a foreign policy tool used to influence the behavior and diminish the capabilities of foreign actors through economic penalties
- OFAC administers US sanctions by designating targets on the Specially Designated Nationals (“SDN”) List, who are then cut off from the US markets
- It’s illegal for a US person to transact with, or facilitate transactions for, SDNs
- [OFAC’s Sanctions Compliance Guidance](#), October 2021

## Crypto x Sanctions Laws

- Because sanctions laws are so broad, violations are strict liability offenses, and crypto is borderless by nature, sanctions compliance is paramount
- [BitGo](#), December 2020
- [Bittrex](#), October 2022
- Industry standards: geofencing, blockchain forensics



# Tax Laws



## Internal Revenue Service (“IRS”)

- The IRS is responsible for collecting US federal taxes and administering the US Tax Code, including how it applies to digital assets
- There are many unanswered questions about how crypto should be taxed:
  - Mining and staking?
  - Hard forks and airdrops?
  - DeFi transactions and interest income?
  - Transactions involving DAOs?

## Infrastructure Bill

- Last year, the Infrastructure Investment and Jobs Act (“IIJA”) amended the Tax Code with five new provisions specific to crypto — all problematic
  - KYC through the back door of the Tax Code
  - We are awaiting guidance or rulemaking on implementation

# And on, and on, and on . . . .

## Consumer Protection Laws

- Primarily focused at the state level on “deceptive and unfair trade practices” statutes, which are very broad — accuracy is key

## Banking Laws

- Primarily focused on “depository institutions” with heavy regulation

## Unique State Regimes

- Some are restrictive — New York BitLicense
- Some are accommodative — Wyoming SPDI

## Barely Scratching the Surface

- There are many other important regulators at the US state and federal level, as well as in other countries that are active in crypto
- Regulations are also fluid and ever changing, so it’s critical to stay up to date as global crypto regulation develops and evolves





# Current Issues to Watch

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# Current Issues to Watch

## 1) **Secondary Markets**

- Congress is considering proposals to regulate secondary markets for digital assets, most likely under a new framework under the CFTC

## 2) **Stablecoins**

- US policymakers concerned about stablecoins are considering ways to regulate centralized issuers and possibly restrict models like TerraUSD

## 3) **Privacy**

- Global AML regulators concerned about illicit activity in crypto are pushing to restrict peer-to-peer transactions and expand surveillance

## 4) **DAOs**

- Are DAOs merely unincorporated associations with unlimited liability?

## 5) **Politics!**

- How will the US midterms change the outlook for crypto policy?



# Web3 Legal Strategy

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# Web3 Legal Strategy

## Disclaimer

- I'm not your lawyer! If you're a Web3 entrepreneur, seek good legal advice

## General Approach

- Understand that regulatory risk and uncertainty are unavoidable in Web3
- Make, and demonstrate, a strong commitment to compliance on day one

## Startup Specifics

- Adopt and make sure everyone follows written policies for compliance
- Involve legal counsel from the early stages of product development
- Conduct a risk assessment to identify risks and how to mitigate them
- Spend the time (and money) to hire great lawyers, outside and in-house

## Resources

- Guide: [5 Essential Elements of Corporate Compliance](#), May 2018
- Podcast: [Navigating the Legal Landscape in Crypto](#), February 2022



# Questions?