ROPES & GRAY

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CRYPTO QUARTERLY

DIGITAL ASSETS, BLOCKCHAIN AND RELATED TECHNOLOGIES UPDATE

THE LANDSCAPE OF GOVERNMENT ENFORCEMENT, private litigation and federal and state regulation of **DIGITAL ASSETS, BLOCKCHAIN AND RELATED TECHNOLOGIES** is constantly evolving. Each quarter, Ropes & Gray attorneys analyze government enforcement and private litigation actions, rulings, settlements—and other key developments in this space. We distill the flood of industry headlines so that you can identify and manage risk more effectively. Below are the takeaways from this quarter's review.

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ENFORCEMENT LANDSCAPE

Continued SEC and CFTC enforcement activity. In the third quarter of 2023, both the U.S. Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") continued to bring enforcement actions in this space. However, a number of court decisions issued in the same period are likely to have a substantial impact on future actions.

1. *RIPPLE* RULING ROCKS CRYPTO INDUSTRY AND THEN FACES IMMEDIATE PUSHBACK

- Just after the close of Q2, Judge Analisa Torres issued the long-awaited summary judgment decision in *SEC v. Ripple Labs, et al.*, 20-cv-10832 (S.D.N.Y.), ("Ripple"). The main issue was whether Ripple's native token, XRP, is a security under *Howey* as applied to three types of transactions: (1) institutional sales, (2) programmatic sales, and (3) other distributions of XRP (including those compensating employees and third parties). The court analyzed all three types of transactions under *Howey*, finding that:
  - **Institutional sales constituted securities.** Regarding the second and third *Howey* elements, the court found that Ripple's pooling of investor proceeds and Ripple's communications and marketing allowed for findings of a common enterprise and a reasonable expectation of profits.
  - **Programmatic sales are not securities.** The court noted that programmatic sales—which constituted less than 1% of global XRP trading volume—occurred on crypto exchanges in blind bid/ask transactions, such that (1) buyers could not know that their payments were going directly to Ripple to fund its operations, and (2) most purchasers of XRP on exchanges were not investing directly in Ripple at all.
  - **Distributions to employees and third parties for compensation were not securities.** Here, the court found that employee and third-party compensation in XRP did not involve an investment of money, and so these allegations could not meet the first prong of *Howey*. The court also analyzed third-party sales similarly to programmatic sales, because "buyers" in these transactions did not know the identity of the seller. Following the decision, the court denied the SEC's request for an interlocutory appeal. Although the SEC has since dropped its claims against individual defendants Bradley Garlinghouse and Christian Larsen, trial is currently scheduled for April 23, 2024. We will continue to follow notable updates in future *Crypto Quarterly* editions. For a full, detailed review of the decision, see Ropes & Gray's analysis in Changing Tides or a Ripple in Still Water? Examining the SEC v. Ripple Ruling.

- **However, it seems that great (legal) minds do not always think alike.** On July 31, 2023, another judge in the Southern District of New York explicitly "reject[ed] the approach recently adopted by [Judge Analisa Torres] in a similar case, *SEC v. Ripple Labs, Inc.*" By denying the motion to dismiss, Judge Jed S. Rakoff allowed the SEC to proceed with its case against Terraform Labs ("Terraform") and its CEO, Do Hyeong Kwon, alleging a failure to register the offer and sale of Terraform's digital assets and fraud in connection with those transactions.
  - The key difference between each judge's analysis was whether the court accounted for "manner of sale" when determining whether investors had an "expectation of profit." As described above, Judge Torres distinguished between institutional sales, programmatic sales, and distributions or third-party compensation in XRP; however, in *Terraform Labs*, Judge Rakoff writes that "*Howey* makes no such distinction between purchasers" because an investor would have "every bit as good a reason to believe that the defendants would take their capital contributions and use it to generate profits on their behalf," regardless of how the investors received their digital asset. *See* Opinion and Order, *Securities And Exchange Commission v. Terraform Labs Pte Ltd. et al.*, No. 1:23-cv-1346 (S.D.N.Y. July 31, 2023).
  - Since Judge Rakoff's decision, both parties in *Terraform* have engaged in heated discovery battles, culminating in competing motions for summary judgment filed after the close of Q3. We will cover these competing briefs in the upcoming edition of our *Crypto Quarterly*, and will track whether future decisions in S.D.N.Y. and elsewhere will follow Judge Torres's or Judge Rakoff's approach to digital assets under the *Howey* test.

2. OTHER SEC AND CFTC ENFORCEMENT ACTIONS

- **CFTC targets "pig butchering" scheme.** On June 22, 2023, the CFTC filed an enforcement action against Cunwen Zhu ("Zhu") and Justby International Auctions ("Justby") in the U.S. District Court for the Central District of California, alleging that Zhu and Justby engaged in a "pig butchering" scheme to fraudulently misappropriate over $1.3 million in customer funds that were invested for digital asset and forex trading.
  - Here, "pig butchering" has nothing to do with pork. In "pig butchering" schemes, the perpetrators of the fraud engage in friendly or romantic dialogue with potential customers. After "fattening" them up, the fraudsters solicit investments in the fraudulent financial scam.
  - Ian McGinley, the CFTC's Director of Enforcement, explained that "[a]s people sought to escape the isolation of the pandemic and form a connection to others online, fraudsters saw a new venue to prey on and to take advantage of the public." The CFTC is seeking restitution, disgorgement, civil penalties, trading bans and permanent injunctions against Zhu, Justby and other individuals involved in the scam.
- **SEC and CFTC both target Celsius.** On July 13, 2023, two enforcement actions put Celsius in the regulatory crosshairs of both the SEC and the CFTC. Although both complaints allege material misrepresentation, the SEC also alleges violations of federal securities laws, while the CFTC alleges that Celsius did not register with the CFTC.
  - The SEC charged Celsius Network Limited ("Celsius") and its founder/former CEO, Alex Mashinsky ("Mashinsky") in the District Court for the Southern District of New York ("S.D.N.Y.") with violating federal securities laws. According to the complaint, Celsius's "Earned Interest Program" permitted investors to tender their crypto to Celsius in exchange for interest payments, which constituted the unregistered offer and sale of securities. The complaint also alleges that Celsius and Mashinsky misrepresented "core aspects" of Celsius's business—including trading, business strategy, risks, the company's business model, financial health, financial success—and the safety of customer assets. More specifically, the complaint alleges that Celsius falsely claimed that it did not make collateralized loans with investors' assets, that Celsius did not engage in directional trading, and that Celsius returned 80% of revenue back to its investors. Finally, the complaint alleges that Celsius and Mashinsky violated market manipulation rules by engaging in buybacks of its native token, CEL, to increase and support its pricing. Thus far, Celsius is cooperating with the SEC, which is seeking a permanent injunction against Mashinsky, civil penalties, disgorgement of profits and prejudgment interest.

- Simultaneously, the CFTC charged Mashinsky and Celsius Network, LLC in S.D.N.Y., alleging fraud and material misrepresentations in connection with its digital asset finance platform. The complaint alleges that Mashinsky and Celsius falsely touted high profits through multiple media platforms. They allegedly promised secure investments while engaging in risky investment strategies that caused liquidity issues and, ultimately, bankruptcy in summer 2022. The complaint also alleges that Celsius did not register with the CFTC as a Commodity Pool Operator, and Mashinsky did not register as an Associated Person of that Commodity Pool Operator. While the CFTC and Celsius resolved its dispute with Celsius by agreeing to a permanent injunction prohibiting future violations of the Commodity Exchange Act, the CFTC has not let up against Mashinsky, and still seeks monetary damages, permanent registration and trading bans on top of a permanent injunction.

- **CFTC alleges "Blessings of God" was Ponzi-like scheme.** On July 25, 2023, the CFTC filed a complaint against Michael and Amanda Griffis in the U.S. District Court for the Middle District of Tennessee for fraud and failure to register with the CFTC in connection with a commodity pool scheme they operated. Defendants are owners of a real estate company based in Tennessee who offered potential customers the opportunity to pool funds and trade digital asset commodity futures contracts. Despite the defendants' total lack of trading experience, they successfully convinced more than 100 people to send them over $6 million to participate in a commodity pool called "Blessings of God Thru Crypto." The defendants allegedly represented that pooled funds would be used to trade crypto futures on the "Apex Trading Platform"—however, after gaining control of the investors' funds, defendants quickly transferred over $4 million to digital wallets outside defendants' control. Defendants misappropriated another $1 million to pay debts and to purchase personal items, like expensive jewelry and an all-terrain vehicle. The remainder was paid out to investors in "Ponzi-like payments" to perpetuate the scheme for as long as possible. The CFTC seeks restitution, civil penalties, permanent trading and registration bans, and a permanent injunction against defendants.

- **SEC targets Hex and related entities.** On July 31, 2023, the SEC charged Richard Heart ("Heart") and three entities he controls with the unregistered offering of crypto asset securities in the District Court for the Eastern District of New York. The three companies—Hex, PulseChain and PulseX—allegedly raised more than $1 billion from investors. Heart and PulseChain were additionally charged with fraud for misappropriating at least $12 million from the offerings to purchase luxury goods, including "The Enigma," the world's largest black diamond.

- **SEC freezes assets of Digital Licensing Inc.** On August 3, 2023, the SEC announced it obtained an emergency temporary asset freeze and restraining order against Digital Licensing Inc., a Utah business entity doing business as DEBT Box, as well as four of its principals. The complaint alleges that defendants engaged in a scheme to sell unregistered securities they called "node licenses." Through various media platforms and investor events, the defendants allegedly told investors that the node licenses would generate various crypto tokens through mining activity and that the value of these tokens would be driven by revenue-generating businesses, resulting in gains. According to the SEC, the node licenses were a total sham, because in reality, the total token supply was not mined, but was created by DEBT Box instantaneously using code on a blockchain. The complaint further alleges that the principals and certain other defendants lied to investors, claiming that the business's success drove the purported value of the tokens. The complaint seeks permanent injunctive relief, return of alleged ill-gotten gains and civil penalties.

- **Crypto-Gold for a charitable cause - or a total scam?** On August 11, 2023, the CFTC filed a complaint against three defendants from Florida, Arkansas and New Orleans and their unincorporated entity, Fundsz, in the U.S. District Court for the Middle District of Florida, charging the defendants with fraudulent solicitation from clients to purportedly trade in cryptocurrencies and precious metals. The complaint alleges that since October 2020, defendants solicited participants with various bold claims—for example, that their entity yielded 3% returns on a weekly basis or that a one-time contribution of $2,500 could grow to $1 million in 48 months. The defendants also allegedly mischaracterized Fundsz as a charitable venture, falsely implying the entity

would support clean water, humanitarian, health, education and disaster relief efforts. The scheme was apparently successful—the CFTC claims that defendants secured more than 14,000 participants. Regardless of the pitches' success, these promises were illusory: Fundsz did not trade customer funds at all, and any "gains" were merely fictitious weekly returns reported to customers. Before the complaint was filed, Judge Wendy Berger signed an *ex parte* restraining order freezing defendants' assets, preserving records and appointing a receiver.

- **SEC pursues NFT activity.** On August 28, 2023, the SEC entered a cease-and-desist order against Impact Theory LLC ("Impact"), a California-based media and entertainment company, for the unregistered offering of crypto asset securities in the form of non-fungible tokens ("NFTs"). According to the order, Impact offered and sold $30 million in NFTs that they coined "Founder's Keys." The keys were offered at three tiers (legendary, heroic and relentless) and were portrayed to investors as investments in the business itself. Impact stated that their business was "trying to build the next Disney," which, if successful, would bring "tremendous value" to purchasers of Founder's Keys. The cease-and-desist finds that the keys were offered and sold as unregistered securities, and Impact was ordered to pay over $5 million in disgorgement with pre-judgment interest and a civil penalty of $500,000. Additionally, Impact agreed to destroy all remaining Founder's Keys within 10 days of the entry of the order.

- **Crypto lender settles with SEC.** On September 7, 2023, the SEC settled charges against Linus Financial Inc. ("Linus") for failing to register the offer and sale of its crypto lending product, the Linus Interest Accounts. According to the settlement, Linus permitted the tender of U.S. dollars in exchange for Linus's promise to pay interest in March 2020. Linus used the investments to purchase crypto assets, which it pooled and controlled, allowing it to generate income for itself and interest payments to investors. Shortly after the SEC brought charges against a similar product, Linus voluntarily ceased its offering of the Linus Interest Accounts. Due to Linus's prompt cooperation and remedial actions, the SEC did not impose civil penalties against the company.

- **SEC cages the Stoner Cats.** On September 13, 2023, the SEC announced entry of an administrative order against Stoner Cats 2 LLC ("SC2") for its offer and sale of unregistered crypto assets in the form of NFTs. According to the order, on July 27, 2021, SC2 sold over 10,000 of its NFTs for approximately $800 each. SC2 sold all its available NFTs on that date. The order also notes that SC2 highlighted benefits associated with ownership of the NFTs—including resale on the secondary market—and configured the NFTs to provide a 2.5% royalty on each sale on the secondary market. This caused over 10,000 transactions and more than $20 million spent. SC2 agreed to pay a civil penalty of $1 million and established a Fair Fund to return monies to injured investors.

  - In connection with the order, Gurbir Grewal, Director of the SEC Enforcement Division, stated: "Regardless of whether your offering involves beavers, chinchillas or animal-based NFTs, under the federal securities laws, it's the economic reality of the offering—not the labels you put on it or the underlying objects—that guides the determination of what's an investment contract and therefore a security."

- **Cryptobravos no match for the CFTC.** On September 29, 2023, the CFTC filed a civil enforcement action in the U.S. District Court for the District of New Jersey, charging fraud against individual defendants from Israel, Italy, Germany and Ukraine and a Seychelles company (collectively, Cryptobravos). The complaint alleges a global fraudulent scheme based in Israel, Ukraine, Albania, South Africa and other locations. In this scheme, defendants misappropriated tens of millions of dollars from individuals in the U.S. and other countries by falsley claiming that Cryptobravos would trade digital asset commodities for them. In fact, Cryptobravos did not do any trading for customers; it simply accepted customers' funds and refused to return them, encouraging individuals to deposit funds from retirement accounts and take out loans to pay fake taxes or commissions. The complaint notes a majority of customers who made deposits did not have their funds returned. The CFTC is seeking restitution, disgorgement, civil penalties, permanent trading and registration bans, and a permanent injunction.

3. DOJ ENFORCEMENT

- **DOJ enhances its criminal crypto-enforcement capabilities.** In a speech delivered on July 20, 2023, a senior Department of Justice ("DOJ") official announced that the DOJ's National Cryptocurrency Enforcement Team ("NCET"), which was established in 2021, will more than double in size by merging with the DOJ's Computer Crime and Intellectual Property Section. The DOJ indicated that this change is intended to increase collaboration and maximize resources, in recognition that "cryptocurrency work and cyber prosecutions are intertwined." Notably, the DOJ indicated that this merger elevates cryptocurrency work within the Criminal Division by giving it equal status to intellectual property work or cybercrime, and granting the Director of NCET the authority to approve steps in investigations and litigation, like charging decisions. With this change, the director of NCET will now have the authority to approve charging decisions and other steps in investigations and litigation.

- **DOJ pushes ahead with high-profile enforcement actions.** This quarter, the DOJ announced milestones in several enforcement actions against individuals from high-profile crypto enterprises.

  - **Indictment against Celsius founder unsealed.** On July 13, 2023, the United States Attorney for the Southern District of New York announced the unsealing of the indictment charging Celsius Network LLC's founder, Alexander Mashinsky, with securities fraud, commodities fraud and wire fraud in connection with misleading customers about Celsius's operations.

  - **Tornado Cash co-founders are indicted on federal charges.** On August 23, 2023, the DOJ, Federal Bureau of Investigation and the U.S. Attorney's Office for the Southern District of New York announced the indictment of Roman Storm and Roman Semenov, two of the three founders of Tornado Cash. The indictment charges Storm and Semenov with conspiracy to commit money laundering, conspiracy to violate sanctions and conspiracy to operate an unlicensed money transmitting business in connection with their creation, operation and promotion of Tornado Cash. The indictment alleges that despite knowing that Tornado Cash was being used to launder criminal proceeds, Storm and Semenov chose not to implement "know your customer" or anti-money laundering measures. In particular, the indictment states that Storm and Semenov knowingly facilitated laundering of criminal proceeds through an algorithm that increased the anonymizing effects of the platform, their communications demonstrated that they were aware that cybercriminals were using their protocol, and they nevertheless chose not to implement compliance controls. In parallel with the announcement of the indictment, the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC") sanctioned Roman Semenov.

  - **OneCoin co-founder sentenced to 20 years in prison.** On September 12, 2023, the U.S. Attorney for the Southern District of New York announced that a co-founder of OneCoin, Karl Sebastian Greenwood, was sentenced to 20 years in prison after pleading guilty to fraud and money laundering charges in December 2022. The sentencing judge also ordered Greenwood to forfeit $300 million. OneCoin, which was based in Sofia, Bulgaria, fraudulently marketed and sold a fake cryptocurrency that resulted in billions of dollars in losses around the world. Greenwood initiated and led the global multilevel-marketing structure through which OneCoin's cryptocurrency was sold and was OneCoin's top distributor and primary promoter.

- **DOJ Targets Crypto Thefts.** Several of the DOJ's enforcement actions this quarter focused on schemes to steal digital assets.

  - **Security engineer charged with wire fraud and money laundering.** An unsealed indictment from July 10, 2023, reveals that a cybersecurity professional, Shakeeb Admed, allegedly stole $9 million of cryptocurrency from an unnamed decentralized cryptocurrency exchange. According to the indictment, Ahmed manipulated a smart contract by inserting fake pricing data to miscalculate the amount he had contributed to the liquidity pool and generate fraudulently inflated fees that he then withdrew in the form of cryptocurrency.

  - **OpenSea impersonator charged with fraud.** The DOJ indicted Soufiane Oulahya in connection with a scheme to impersonate OpenSea, an NFT marketplace, to steal cryptocurrency and NFTs. Oulahya allegedly created a

look-alike website of OpenSea and paid for his website to appear first in search engine searches. The indictment describes only one victim, who lost $450,000 worth of Ethereum and NFTs by logging into the website and entering his crypto-wallet details. Once those details were entered, Oulahya transferred the victim's wallet to a wallet in his control and sold the victim's NFTs.

- **"Crypto Couple" plead guilty in connection with bitcoin hack.** A New York couple arrested in February 2022 and charged with trying to launder $4.5 billion in bitcoin pursuant to a 2016 hack pleaded guilty to money laundering conspiracy charges. Ilya Lichtenstein and Heather Morgan hacked Bitfinex's network and fraudulently authorized thousands of transactions to transfer Bitcoin to a wallet in their control. They deleted access credentials and log files to cover their tracks within the Bitfinex network and used fictitious identities, automated transactions, darknet market accounts and cryptocurrency conversion to conceal the stolen assets.

4. ENFORCEMENT UPDATES FROM PRIOR QUARTERS

- **Coinbase files motion for judgment on the pleadings, with support from industry players.** In our Q1 Quarterly, we discussed the SEC's enforcement action against Coinbase, which alleged that the platform "intertwine[d] the traditional services of an exchange, broker, and clearing agency without having registered any of those functions with the Commission as required" by federal securities laws. Since the initial complaint was filed, Coinbase filed a motion for judgment on the pleadings, chiefly arguing that the SEC's complaint does not plead "securities" transactions because there was no "contractual undertaking." Rather, Coinbase argues that the transactions were more akin to commodity sales. And even if the transactions in question were "investment contracts," Coinbase argues, the SEC's enforcement would require "clear congressional authorization" under the major questions doctrine. Coinbase's motion has been supported by numerous amicus briefs from securities and digital asset supporters, including the Chamber of Digital Commerce, Blockchain Association and Crypto Council for Innovation. The SEC filed its oppositional brief on October 3, 2023, and Coinbase filed its reply on October 24, 2023. We will include coverage of oral argument—which is scheduled to take place January 17, 2024—in a 2024 edition of the *Crypto Quarterly*.

- **Binance defendants file motions to dismiss, also with help from industry players.** In Q1 we also discussed the SEC's enforcement action against Binance.US. Recall that the SEC alleges Binance.US, its CEO, Changpeng Zhao, and business affiliates violated antifraud and registration provisions of the Securities Act of 1933 and the Exchange Act of 1934. On June 17, Binance entered into a consent order with the SEC, barring defendants from securing the assets of U.S. customers and facilitating customer withdrawals during litigation. On September 21, 2023, two Binance.US business affiliates and named defendants, Binance Holdings Limited ("BHL") and BAM Management US Holdings, Inc. ("BAM"), filed a joint motion to dismiss the complaint. The SEC has not yet filed its opposition. As in the Coinbase case, several industry groups, including well-known crypto investment firms, have filed amicus briefs in support of BHL and BAM.

REGULATORY UPDATES

1. Proposed regulation to crack down on tax evasions. On August 25, 2023, the U.S. Department of the Treasury and Internal Revenue Service unveiled proposed regulations relating to tax reporting for cryptocurrency, NFTs and other digital assets. The regulations would require brokers of digital assets to report certain sales and exchanges via Form 1099-DA. According to the announcement, the proposed regulations seek to "close the tax gap," address crypto tax evasion and align tax reporting on digital assets with that of other kinds of assets.

2. The Federal Reserve establishes program to strengthen oversight of digital asset risks. On August 8, 2023, the Federal Reserve announced that it has established a Novel Activities Supervision Program to enhance supervision of certain activities involving "emerging issues, technologies and new products" conducted by banking organizations supervised by the Federal Reserve. The program will "focus on novel activities related to crypto-assets, distributed ledger

technology (DLT), and complex, technology-driven partnerships with nonbanks to deliver financial services to customers." The program will work with existing Federal Reserve supervisory teams to monitor these areas and to develop appropriate risk-management controls.

3. New York seeks to strengthen its oversight of digital currencies. On September 18, 2023, the New York State Department of Financial Services ("DFS") announced guidance for listing and delisting cryptocurrencies. The guidance seeks to encourage crypto exchanges to draft robust coin listing and delisting policies. The original framework issued by DFS in 2020 required crypto companies to submit firm-specific coin listing policies to DFS for approval prior to listing or offering custody for a coin unless the coin was already DFS-approved. Once DFS approved the company's coin listing policy, companies could self-certify listings of coins not already approved by DFS and provide written notice to DFS of all coins offered or used by the company. The new proposed framework asks companies to draft a coin listing policy that covers governance of the listing process, risk assessments and monitoring procedures, and asks companies to explain to DFS how they decide on and carry out delisting of any coin.

PRIVATE LITIGATION

1. PRIVATE LITIGATION AGAINST DECENTRALIZED EXCHANGES

Several decisions from Q3 have addressed the scope of third-party liability for decentralized exchanges with varying results. In particular, the Second Circuit and Ninth Circuit are shaping up to be major battlegrounds over these exchanges.

- **In Second Circuit, decentralized exchange successfully moves to dismiss in case of first impression.** In *Risley v. Universal Navigation Inc. dba Uniswap Labs et al.*, No. 1:22-cv-02780 (S.D.N.Y. filed April 4, 2022), Judge Katherine Polk Failla of the Southern District of New York dismissed a class-action suit that users brought against Uniswap and its developers for "rampant fraud" purportedly allowed on its platform. In its August 30 decision, the court rejected plaintiffs' claims that poor vetting led to alleged monetary losses, reasoning in part that the scammers—not the platform developers—are responsible because "collateral, third-party human intervention cause[d] the harm." Uniswap plaintiffs are now looking to take this battle to the Second Circuit.
  - Reading between the lines, Judge Failla's decision also seemed to put the burden on Congress to make "a definitive determination as to whether such tokens constitute securities, commodities, or something else." Further, Judge Failla offhandedly characterized Ether and Bitcoin as "crypto commodities," which implicitly signals that she personally may not believe securities laws apply. Digital asset proponents are following Judge Failla's decisions closely, because she is also overseeing the SEC's high-profile suit against Coinbase.
  - For more Ropes & Gray insights on this case, check out Helen Gugel's remarks to Bloomberg Law on this decision.
- **In Ninth Circuit, investment firms liable as statutory sellers.** On September 20, 2023, Judge William H. Orrick of the Northern District of California denied a motion to dismiss a class-action complaint alleging that various co-founders and investment firms solicited investments in a crypto asset called COMP, an unregistered security controlled by Compound DAO. In their amended complaint, plaintiffs allege defendants are liable as "statutory sellers," who either pass title or other interest in a security directly to the buyer, or "successfully solicit" someone else to buy a security to serve their own or the security owner's financial interests. In Judge Orrick's order denying defendants' motion to dismiss, the court rejected defendants' claims that they were merely "collateral" participants in the transaction.
  - Notably, Judge Orrick contrasted Ninth Circuit and Second Circuit standards for solicitation, remarking that under the Ninth Circuit's broad solicitation standard, "a company's comprehensive involvement with the design, operation and monetization of a cryptocurrency enterprise was sufficient to allege statutory seller liability." *See* Order at 5. This broader standard might pave the way for further digital asset solicitation suits in the Ninth Circuit.

- To complicate matters, since the end of Q3, defendants have individually filed five motions for leave to file motions for reconsideration, arguing that plaintiffs, in opposing the motion to dismiss, had "expressly abandoned any claim that so-called partner defendants were directly liable for solicitation." In future updates, we will continue to track developments in *Houghton et al. v. Leshner et al.*, No. 3:22-cv-07781 (N.D. Cal., filed Dec. 8, 2022).

2. CLASS-ACTION UPDATES

- **Data analysis signals possible record number of crypto class actions.** 2023 might be another record-breaking year in digital asset class-action litigation. Midyear research compiled by Cornerstone Research shows that plaintiffs filed 114 securities class actions in federal and state courts in Q1 and Q2 2023. This represents a 23% increase from the second half of 2022. According to the report's co-author, "[i]f this pace continues through the rest of the year, it is likely that the total number of cryptocurrency filings will near the record high seen in 2022." However, the midyear maximum dollar loss increased sharply as well—signaling that the stakes for digital asset defendants are higher than ever before.

- **Ripple investors secure class certification in California federal court.** In *Zakinov et al. v. Ripple Labs Inc. et al.*, No. 4:18-cv-06753 (N.D. Cal. filed Nov. 7, 2018), Ripple Labs investors secured class certification in a suit alleging that Ripple and its CEO engaged in an unregistered securities offering, in violation of federal and state securities laws. In their motion opposing class certification, defendants argued that plaintiffs did not demonstrate the necessary factors of (1) adequacy (in part because the plaintiff, having purchased most of his digital assets from secondary sellers, cannot adequately represent Ripple "direct purchasers"); and (2) typicality (because the named plaintiff "acted as a day trader," which is "inconsistent with him having any expectation that XRP would increase in value due to Ripple's efforts"). However, these arguments were not convincing to Judge Phyllis J. Hamilton, whose order reasoned:
  - Regarding adequacy, the court compared XRP purchases on the secondary market to "an unregistered securities claim against solicitor sellers," which can survive class certification.
  - Regarding typicality, the court remarked that "plaintiff's status as a day trader will not affect the analysis one way or the other."

3. PRIVATE PARTY RESPONSES TO DIGITAL ASSET REGULATION

- **Crypto nonprofit must "wait and see" the impact of IRS regulations.** On July 19, 2023, a Kentucky federal judge dismissed a crypto nonprofit's challenge to the Infrastructure Investment and Jobs Act, 26 U.S.C. § 6050I, an amendment to IRS regulations that requires digital asset owners to disclose details of "trade or business" transactions that exceed $10,000 in cryptocurrency. The amendment does not take effect until January 1, 2024. According to Judge Karen Caldwell, plaintiffs' alleged harms are "merely hypothetical, conjectural, or speculative" until the amendment actually takes effect; until that time, plaintiffs' First, Fourth and Fifth Amendment claims lack standing.

- **Tornado Cash must remain on OFAC "specially designated nationals" list.** On August 17, roughly one year after OFAC placed Tornado Cash on its specially designated watch list, a federal district court judge in the Western District of Texas dashed the DAO's hopes of removal. In *Joseph van Loon et al. v. Department of Treasury et al.*, No. 1:23-cv-00312, Tornado Cash filed a motion for summary judgment, arguing that OFAC lacked authority to put it on the watch list, since a DAO is not a "person" or "property" within the meaning of OFAC's authorizing statute. Unpersuaded, Judge Robert Pitman granted the government's cross-motion for summary judgment, reasoning that the DAO has a property interest in its smart contracts because it benefits from use of the protocol by its very design. This, according to Judge Pitman, placed Tornado Cash within OFAC's statutory authority.

- **Grayscale scores major win against SEC.** On August 29, 2023, the D.C. Circuit Court of Appeals unanimously sided with Grayscale in its long-running battle with the SEC regarding its application to launch the first bitcoin exchange-traded fund. In the fall of 2021, NYSE Arca had proposed listing shares of Grayscale Bitcoin Trust ("GBTC") on its exchange. Nearly eight months after GBTC made its application, the SEC denied it because the exchange's proposed rule change was not designed to prevent fraudulent and manipulative acts and had failed to satisfy the SEC's significant market test. After its application was denied, GBTC sued the SEC under the Administrative Procedures Act, arguing the denial was "arbitrary and capricious," given the SEC's approval of two similar market funds in spring 2022— the Teucrium Bitcoin Futures Fund and the Valkyrie XBTO Bitcoin Futures Fund. The D.C. Circuit agreed that GBTC was materially similar to the approved funds and, on that basis, vacated the SEC's denial. For more insights and observations by Ropes attorneys, check out our full article.

LEGISLATION

1. U.S. Congress inches closer to regulatory clarity for the crypto industry. In July 2023, the U.S. Congress undertook a flurry of legislative activity relating to cryptocurrency.

- The U.S. House of Representatives Financial Services Committee approved the Republican-led Financial Innovation and Technology for the 21st Century Act, which seeks to establish rules for regulator jurisdiction over digital asset markets and sets forth definitions for digital assets, exemptions, disclosure frameworks, and regulator registration processes for digital asset intermediaries. The bill gives the CFTC primary jurisdiction over digital asset issuers but allocates oversight of digital assets between the SEC and CFTC and allows the SEC to contest issuers' designations.
  - The Committee also passed the Blockchain Regulatory Certainty Act, which aims to remove hurdles for "blockchain developers and service providers" such as miners, multisignature service providers and decentralized finance platforms.
- The Responsible Financial Innovation Act (Lummis-Gillibrand Bill), originally introduced in the U.S. Senate in June 2022, was updated and reintroduced on July 12, 2023. The bill, which focuses heavily on consumer protection measures, likewise provides the CFTC with primary jurisdiction over crypto issuers while giving the SEC a more limited role. Notable changes to the bill include (1) requiring crypto asset exchanges to register with the CFTC; (2) limiting ability to issue payment stablecoins to banks or credit unions; (3) detailing penalties for violating anti-money laundering laws and Bank Secrecy Act examination standards; (iv) establishing a customer protection and market integrity authority led jointly by the SEC and the CFTC; and (v) creating mandatory segregation and third-party custody requirements and providing for CFTC supervisory authority over affiliates and holding companies.
- Two Senate amendments relating to Bank Secrecy Act requirements were added to the National Defense Authorization Act, which the Senate passed on July 28, 2023. The amendment requires the Treasury's Office of Foreign Assets Control ("OFAC") to undertake risk-focused examinations relating to cryptocurrency businesses and to develop reports on anonymity-enhanced cryptocurrencies and tools.

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LOOKING AHEAD

To stay ahead of the curve, we look for insights from Ropes & Gray litigation and enforcement lawyers working in the field. This quarter's featured insight:

While Congress inches gradually toward cryptocurrency legislation, California has taken a giant leap toward digital asset regulation. On October 13, 2023, California Governor Gavin Newsom signed Assembly Bill 39 (the Digital Financial Assets Law), to take effect on July 1, 2025. Industry reactions have been mixed, and the exact implementation of the bill is still unclear. Even Newsom signaled that the "ambiguity of certain terms and the scope of this bill will require further refinement" before its target date in 18 months. As the U.S. Congress and federal regulators grapple with digital asset regulation, will other states take a page from New York and California's book? How will California regulators and industry proponents clarify the "ambiguity" of the Digital Financial Assets Law?

We will provide further analysis of this legislative update—and other new digital asset legislation—in our Q4 edition.

CONTACTS

For more information on any of these issues, or if you would like to speak with someone with particular experience in any of these areas, please reach out to any of the attorneys below or your usual Ropes & Gray contact.

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