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Blockchain Bites: US Regulation by Enforcement takes a Non Fungible Turn, Grayscale wins Bitcoin ETF appeal against SEC, NZ recommends new approach to digital assets, US indicts Tornado Cash Duo, Ripple Effect: SEC Appeal of Torres Decision Does not Dispute XRP is not a security under US law

Michael Bacina, Steven Pettigrove, Jake Huang, Luke Higgins, Luke Misthos and Kelly Kim of the Piper Alderman Blockchain Group bring you the latest legal, regulatory and project updates in Blockchain and Digital Law.

US Regulation by Enforcement takes a Non Fungible Turn

The Securities and Exchanges Commission (**SEC**) has charged Impact Theory LLC for conducting an alleged unregistered offering of crypto-asset securities in the form of Non-Fungible Tokens (**NFTs**). Impact Theory sold approximately USD$30 million in Founder's Keys NFTs and agreed to a cease-and-desist deal with the SEC.

Under the announced settlement deal, Impact Theory will pay USD$6.1 million in penalties and other charges to the SEC and will destroy all the NFTs under its control. Additionally, the company will forfeit any royalties it received from the sales of these NFTs on secondary markets.

Interestingly, the SEC has cited the language used by the company as a potential trigger for enforcement. The SEC's press release, referring to the SEC order against Impact Theory from 2021, states that:

> *The order finds that Impact Theory encouraged potential investors to view the purchase of a Founder's Key as an investment into the business, stating that investors would profit from their purchases if Impact Theory was successful in its efforts*

Impact Theory is alleged to have told buyers that it was "trying to build the next Disney" and if successful this would deliver "tremendous value" to NFT purchasers. It appears in this instance that the SEC is sending a message to projects that purport to use puffery or strong language promising financial returns that they will be treated as if they are offering financial investments.

The news appears to be having a serious ripple effect in the NFT world.

Commissioners Hester Pierce and Mark Uyeda, released a dissenting statement disagreeing with the New York SEC's interpretation of the *Howey* analysis and its use to charge Impact Theory. Ms Pierce and Mr Uyeda argue that the NFTs were not remotely shares in a company and did not pay dividends, such that they should not be treated as securities:

> *We understand why the Commission was concerned about this NFT sale. Even through we believe strongly that adults should be able to spend their money as they choose, we share our colleagues' worry about the type of hype that entices people…*

But that:

> *This legitimate concern, however, is not a sufficient basis to pull the matter into our jurisdiction.*

The dissenting statement refers to companies that sell watches, paintings or collectibles and make vague promises about the increase in value, which are not subject to similar enforcement by the SEC, and rightly infers that NFTs are far more similar to these products than traditional securities.

This dissent shows the difficulty some factions of the SEC are having with the classification of NFTs and the application of the *Howey* test to them in the US. Importantly, the dissenting Commissioners suggest a discussion about NFTs and recommended 9 questions for exploration:

1. Non-fungible tokens are not an easy-to-characterize asset class, particularly because they can give the owner a wide array of rights to digital or physical assets. People are experimenting with a lot of different uses of NFTs. Consequently, any attempt to use this enforcement action as precedent is fraught with difficulty. Are there useful ways for the Commission to categorize NFTs for purposes of thinking about whether and how the securities laws apply to offers and sales?
2. If the Commission were to craft guidance for NFT creators seeking to understand potential intersections with the

securities laws, what questions would be helpful for us to address?
3. How should recent legislative efforts to construct a framework for crypto inform SEC thinking about the application of securities laws to NFTs?
4. Is a securities law regime best suited to ensure that NFT purchasers obtain the information they need before buying an NFT? What type of information do these purchasers want? Might other regulatory frameworks be more appropriate?
5. If a securities law regime is best, how could SEC registration requirements be tailored to reflect the unique nature of NFTs? Would compliance with any requirements be prohibitively costly? If so, what alternative approaches would be more workable, but still achieve the Commission's objectives of protecting investors and the integrity of the marketplace?
6. Does this action indicate that the Commission generally views previous NFT offerings as securities offerings? If so, will the Commission provide specific guidance to those issuers describing what they need to do to come into compliance?
7. What, if any, restrictions should apply to secondary market sales of NFTs that the issuer sold as the object of an investment contract?
8. This settlement includes an undertaking by the issuer to destroy NFTs in its possession. What precedent does this set for future cases in which the NFTs at issue represent unique pieces of digital art or music?
9. The settlement includes an undertaking to "[r]evise the smart contract(s) or any other programming code(s) or computer protocol(s) underlying the KeyNFTs to eliminate any royalty." Given that one of the promising features of NFTs is the ability to reward creators with royalties every time an NFT they created is sold, what precedent does this set for future cases?

On that last point, the dissenting Commissioners might need to get up to speed on the issues around royalty enforcement (i.e. it's not occurring on a number of platforms). Many had considered NFTs to be, from a regulatory perspective, a far safer space than token sales, but the SEC appears to be playing some cards which suggest they consider the contrary position to be the case.

Grayscale wins Bitcoin ETF appeal against SEC

The United States Court of Appeals for the District of Columbia Circuit has today granted Grayscale Investments, LLC's petition for review against the Securities and Exchanges Commission (**SEC**). This case, which deals with the SEC's denial of Grayscale's proposed Bitcoin Exchange-Traded Product (**ETP**), has important implications for the regulatory landscape of blockchain and Web3 technologies, particularly given the history of Bitcoin ETFs in Australia and the ongoing efforts of businesses to have Bitcoin trading in traditional markets.

Grayscale Investments, a major player in the cryptocurrency market and owner of 3.4% of all mined bitcoin (worth around USD$30 billion), sought approval for its Bitcoin spot ETP to be listed on NYSE Arca, which is part of the NY stock exchange. The SEC denied this application citing various regulatory concerns, particularly regarding security and consumer protection.

However, the Court was critical of those concerns, finding that the SEC had acted in an "arbitrary and capricious" manner by approving similar Bitcoin ETPs which were futures based, while denying Greyscale's application for a spot ETP, and not providing an adequate explanation. This is the second time in as many months that the SEC has been handed a less than favourable judgement.

The Court emphasised that similar cases must be treated similarly as a foundation principle of administrative law and that:

> *the Commission failed to provide the necessary "reasonable and coherent explanation" for its inconsistent treatment of similar products.*

The SEC's decision to reject the ETP, which has been followed was based primarily on the "significant market requirement", which Grayscale allegedly failed to meet. The significant market test is designed to assess the potential impact of a product on the market, and gauge its susceptibility to manipulation. Factors which must be considered under the "significant market requirement" include the market influence of the product, market surveillance and/or market depth and liquidity.

The Court, however, found that the SEC had not provided a "rational explanation" for why the SEC believed Grayscale's ETP was more likely to contravene the significant market requirement than the previously approved Bitcoin futures ETP, and that the SEC's explanation was "arbitrary and capricious".

Australian businesses have been keenly observing the regulatory developments in the United States, but Bitcoin ETPs in

Australia have a mixed history with a futures ETF being delisted last year due to lack of investor (noting that the ETF launched on the day Terra/Luna collapsed) and Monochrome recently having a Bitcoin ETF for the ASX move forward in the approval process.

The Grayscale case could serve as a reminder of the importance of regulators to work to properly understand blockchain and crypto-assets, and move away from past narratives of "fraud and scams" which increasingly are shown to be inaccurate. A movement to fit for purpose regulations would help avoid the risk of further litigation of this kind.

Touchdown! NZ recommends new approach to digital assets

The New Zealand Parliament's Finance and Expenditure Committee has released a report on its Inquiry into the current and future nature, impact and risks of cryptocurrencies (the **Report**). The Report endorses 22 recommendations to Government prepared by independent advisors who were tasked with researching and reporting on various policy matters relating to cryptocurrency.

The Recommendations

The Report's recommendations provide a comprehensive framework to enable New Zealand to nurture the burgeoning digital assets and blockchain sectors. The report encourages a cautious and flexible approach to regulation that evolves with the technology, suggesting that a fully integrated and consistent regulatory regime for digital assets may be premature at this stage.

This cautious approach aims to address problems as they arise rather than pre-emptively stifling innovation with overly strict rules. On the other hand, there is a clear focus on consumer protection with proposals to resource regulatory bodies like the Financial Markets Authority to act against bad actors in the digital asset space.

Some of the key recommendations from the Report are discussed below and include:

1. Recommendation 1: that the government of New Zealand adopt policy settings to encourage developments in digital assets and blockchain.
2. Recommendation 2: the Government and regulators create coherent and consistent guidance on the treatment of digital assets under current law.
3. Recommendation 4: that a best practice code or guidance with minimum standards is developed for the custody of digital assets.
4. Recommendation 8: that there is no primary regulator for digital assets, as digital assets cover a spectrum of use cases.
5. Recommendation 9-11: that there be enhanced coordination across Government to tackle policy challenges and foster the development of the industry.
6. Recommendations 18, 20-21: that steps be taken to address AML/CTF concerns and ensure access to banking services for organizations dealing in digital assets.
7. Recommendation 22: that the Reserve Bank of New Zealand continue with design work on its Central Bank Digital Currency.

The Overwhelming Message

In a measured response to the rapidly evolving digital assets landscape, New Zealand has so far adopted a "wait and see" regulatory approach. While this approach was intended to balance the risks and opportunities of digital assets, the Report indicates that New Zealand may risk missing out by being too passive.

The Finance and Expenditure Committee supported the recommendations made by the advisers which seek to encourage developments in digital asset policy, noting that regulatory uncertainty can be a barrier to the development of new products.

The Report suggests that creating a robust regulatory system may constrain future growth in the fast-changing industry, and instead there is room for consistent and informative guidance from government agencies about how existing policy applies to digital assets and associated technology.

Is "Cryptocurrency" the right term?

The Report relevantly questions whether "cryptocurrencies" is the correct term, and instead opts to refer to many of the products discussed as "digital assets" as they do not share the same characteristics as "currencies".

This part of the Report speaks to the wider importance of increasing education and technical knowledge with respect to

digital assets, not least among policy makers, but by all relevant professions.

Time for a Sandbox

The Report encourages the establishment of a regulatory sandbox for digital assets and related services. The proposal would allow innovators to test new products and services, and regulators to maintain visibility and consider policy options. The ultimate goal is to use these real-world tests to develop evidence-based, adaptive regulatory frameworks that can manage the opportunities and risks posed by rapidly advancing technologies.

The Report raises potential challenges and uncertainties that come with implementing a sandbox policy. These include defining the post-sandbox regulatory requirements and the limited scope and time for testing innovations, which may inhibit large scale testing. This notwithstanding, the Report mentions the success of similar initiatives in other countries, like the United Kingdom, to argue its effectiveness.

Decentralised Autonomous Organisations (DAO)

The report recommends that New Zealand continue to monitor international developments on legal recognition and treatment of DAOs and, in the meantime, adopt a tolerant approach to allow experimentation of new use cases.

Immigration

New Zealand's proactive approach to integrating digital assets into their economy extends to Immigration policy. The Report considers that one way integration may be accelerated is to expand the skills shortage list to include people with skills in the areas of digital assets and blockchain, promoting migration of those with these skills.

Token Mapping

The Report refers to the Token Mapping Consultation Paper released by the Australian Treasury in February as "comprehensive" and notes that New Zealand can benefit from this without needing to conduct a similar exercise.

Conclusion

If adopted by Government, the Report's recommendations would position New Zealand as a front runner in terms of the country's progressive attitude to adopting digital assets and blockchain technology. The Report contains a number of very sensible recommendations for policy action to support industry while tackling issues as they arise. With an election due in early October, it remains to be seen whether these recommendations are taken up by the next Government.

US indicts Tornado Cash Duo

Following a US District Court's unfavourable judgment against Tornado Cash earlier this month, US prosecutors announced a fresh indictment charging two Tornado Cash co-founders for their roles in operating Tornado Cash, a cryptocurrency mixer that allowed its customers to engage in untraceable transfers of cryptocurrency.

Roman Storm and Roman Semenov, the principal co-founders who developed and operated Tornado Cash since its public launch, have been charged with three counts of crimes, including:

- conspiracy to commit money laundering,
- conspiracy to commit sanctions violations, and
- conspiracy to operate an unlicensed money transmitting business.

The US prosecutors that brought charges include the US Attorney's office for the South District of New York. The prosecutors said the charges:

> *arise from the defendants' alleged creation, operation, and promotion of Tornado Cash.*

and alleged that the cryptocurrency mixer:

> *facilitated more than $1 billion in money laundering transactions and laundered hundreds of millions of dollars for the Lazarus Group, the sanctioned North Korean cybercrime organization.*

Operation of the Cryptocurrency Mixer

Storm and Semenov are alleged to have liability including because they were involved in Tornado Cash as they:

> *created the core features of the Tornado Cash service, paid for critical infrastructure to operate the Tornado Cash service, promoted the Tornado Cash service, and made millions of dollars in profits from operating the Tornado Cash service.*

The prosecutors alleged that the founders knowledge of Tornado Cash being misused for illegal activities should be reason to hold the founders liable, due to the lack of KYC or AML/CTF programs in Tornado Cash. The prosecutors further allege that the founders had actual knowledge of money laundering and received complaints and requests for help from victims of hacking and other cybercrimes but declined to assist or take steps to prevent that use of the product.

North Korean Cybercrime Involvement

The indictment further claims that the Tornado Cash service played a pivotal role in laundering hundreds of millions of dollars in hacking proceeds for the Lazarus Group. Storm and Semenov are alleged to have allowed the group to launder criminal proceeds through their platform – and that a change was made in the service so that the founders could make a public announcement about being compliant with sanctions laws, but it is alleged they had knowledge the change would be ineffective.

The Future of Cryptocurrency and DAO Enforcement

The indictment of Storm and Semenov marks a significant step in the legal battle against cryptocurrency-related crime but also is being cast as a similar prosecution to the battle in the 1990s over exporting of encryption algorithms, which led to a T-Shirt being sold which could, in theory, lead to the wearer being prosecuted (no one actually went to jail):

A new shirt is now available for sale with the Tornado Cash code, highlighting that the code can be deployed and Tornado Cash recreated if anyone wished to do so:

This case has been attacked as criminalisation of computer code, and highlights the determination of US law enforcement agencies to seek to prosecute those who exploit cryptocurrencies for illegal activities and demonstrates the increasing cooperation between domestic and international agencies in pursuing criminals who use digital assets for financial gain.

Storm was arrested on 23 August in Washington and presented in the US District Court for the Western District of Washington, while Semenov remains at large. Alexey Pertsev, another developer of Tornado Cash, is facing ongoing prosecution by the Dutch authority for violating Dutch law for allegedly concealing or disguising the origin and movement of funds.

This case also sheds light on US prosecutors' views on potential legal liabilities of developers and operators for automated software and Decentralised Autonomous Organizations (i.e. DAOs), particularly as it impacts those who create interfaces for smart contract in blockchain systems.

Ripple Effect: SEC Appeal of Torres Decision Does not Dispute XRP is not a security under US law

In a significant development to the ongoing Ripple case, Judge Analisa Torres has granted the United States Securities and Exchange Commission (**SEC**) permission to file an interlocutory appeal in its case against Ripple Labs. This move could set a precedent for other pending and future cases involving digital assets.

The SEC's request for an appeal was met with opposition from Ripple Labs. Ripple's legal team put forth three main arguments against the SEC's appeal. They argued that an appeal requires a "pure question of law" and claimed that the SEC's request raised no new legal issues warranting review. Ripple also contended that an immediate appeal would not advance the termination of litigation proceedings.

An important aspect of note in the appeal is that the SEC does not seek to appeal what is rightly one of the more important aspects of the underlying judgment, namely the finding of Judge Torres that XRP:

> *is not in and of itself a "contract, transaction[,] or scheme"*

The SEC's appeal borders on snarky, stating that:

> *the SEC does not seek appellate review of any holding relating to the fact that the underlying assets here are nothing but computer code with no inherent value*

Brad Garlinghouse, one of Ripple's chief executives, expressed optimism about the case in an interview with Bloomberg, saying the SEC would face a lengthy appeals process and emphasised that "the law of the land right now is that XRP is not a security."

The appeal of Judge Torres' decision could have far-reaching implications as a US Court of Appeals for the Second Circuit would create binding precedent and potentially affect multiple pending court cases related to the sale of digital assets. The case against Ripple has been underway since December 2020 and has garnered significant attention from both the legal and crypto communities as those wishing to sell tokens in the US have had no practical way to seek any regulated path to make such sales, a fact highlighted by Coinbase repeatedly, and the main regulator, the SEC, has declined to make rules, asserting the law is clear.

Ripple wrote to Judge Torres on 18 August proposing that the appeal be disallowed until after final judgment, and the main cause appears to be likely to be set down for a full hearing after mid-April next year.