

Strafford

Presenting a live 90-minute webinar with interactive Q&A

Legal Issues With Blockchain in Banking and Fintech: Implementing New Applications

Leveraging DLT Platforms for Recordkeeping, Payments, KYC, and More;
Concerns With Regulation, Privacy, Adaptation

TUESDAY, JUNE 2, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Michael C. Egan, Partner, **Baker McKenzie**, Washington, D.C.

Rebecca J. Simmons, Partner, **Sullivan & Cromwell**, New York

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1.**

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.



Agenda

- 1 Blockchain (Distributed Ledger) Explained

- 2 Regulatory Framework – US and International

- 3 Applications in Banking + FinTech

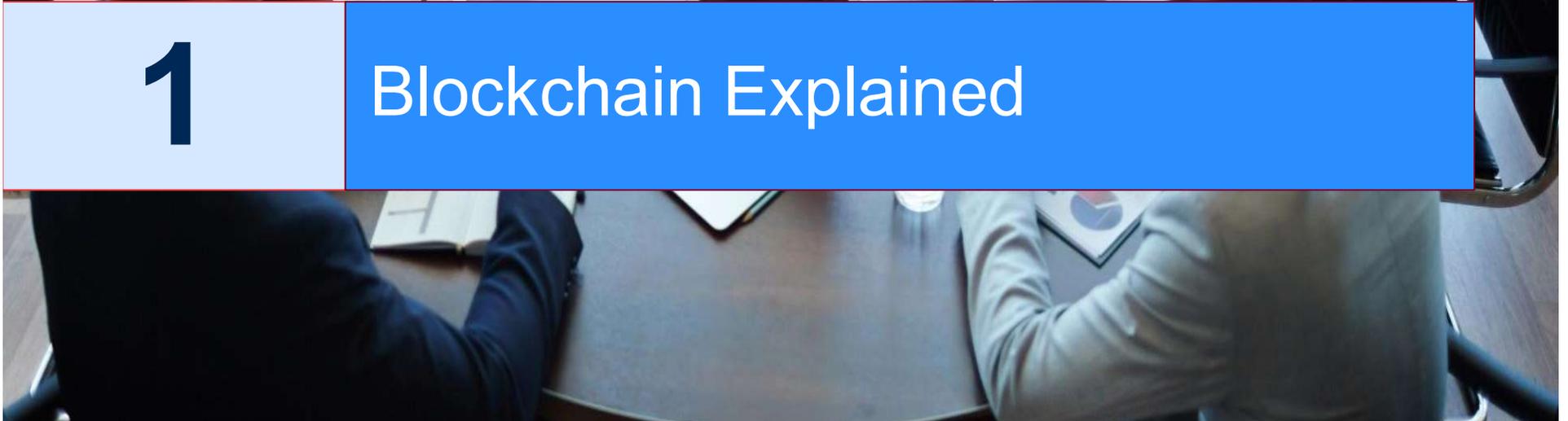
- 4 Challenges to Implementation

- 5 Questions



1

Blockchain Explained



Blockchain Explained

Current Transactions System

Current System

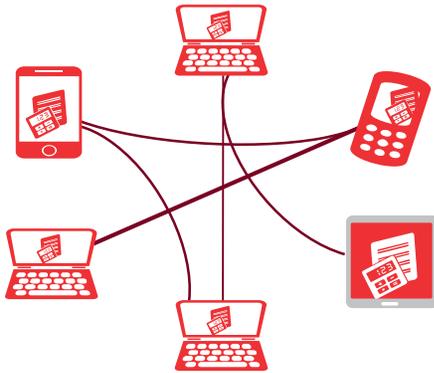


A centralised system where each party keeps its own ledger

- Time
 - Requires time for settlement and reconciliation
- Cost
 - Intermediaries
 - Documentation
- Risk
 - Susceptible to error and tampering
 - Difficult to verify accuracy

Blockchain Explained

Blockchain Transaction Solutions



A digital ledger of transactions is shared, transparent to and run by participants in a peer-to-peer network by consensus, with verification in the tracking and immutability of transaction records

Types of Blockchains

- **Public blockchain**
 - Accessible to anyone (permissionless)
 - Anonymous participation and validation
- **Consortium blockchain**
 - Restricted or permissioned access
 - Managed by trusted intermediaries/parties
- **Private blockchain**
 - Write permissions are kept centralized to one company or organization.

Blockchain Explained

How blockchain works

1 A wants to transfer value to B



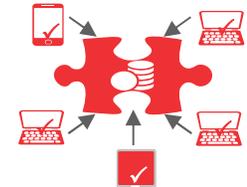
2 The transaction is represented online as a 'block'



3 The block is broadcast to every party in the network



4 Participants in network verify the block is valid



5 The block can then be added to the chain, which provides an indelible and transparent record of all transactions



6 The transaction is confirmed



Blockchain Explained

Applications across industries



Nature

- Payments
- Reconciliation
- Securities
- Supply chain
- Record keeping
- Asset management
- Digital identity
- Compliance
- Smart contracts



2

Regulatory Landscape



Key federal regulators

- No direct comprehensive US legal approach to blockchain
 - Congress
 - White House
 - Regulators
 - Self-Regulatory Organizations
- May take years, if at all –blockchain is a technology that can be used for so many different purposes (like the internet); different regulators may regulate it for different purposes

Key federal regulators

- Securities and Exchange Commission
 - Regulates only securities
 - Mission: to facilitate capital formation, promote fair, orderly, and efficient markets, and protect investors
 - Illustrative enforcement actions and dot.com déjà vu
 - Unlawful celebrity touting (Floyd Mayweather, Jr., DJ Khalid)
 - Unregistered ICOs / digital tokens
 - Unregistered national securities exchange / digital token trading
 - Market participants promoting distribution or trading of digital tokens without registration
 - ICOs falsely claiming relationships with leading companies / pump and dump
 - Unregistered investment companies

Key federal regulators

- Securities and Exchange Commission
 - Leading guidance and dearth of formal rulemaking
 - Enforcement actions and no-action letters
 - Investor bulletins
 - Speeches
 - Mock ICO website / HoweyCoins.com where investors will be redirected to the SEC website if they try to invest
 - Guidance regarding custody of tokens that are securities
 - ETFs
- Private plaintiffs can bring suits based on securities law violations
 - Plaintiffs' lawyers may sue for the unregistered sale of securities, seeking return of investment plus interest.

Key federal regulators

- Financial Industry Regulatory Authority (“FINRA”)
 - Mission: FINRA is dedicated to investor protection and market integrity through effective and efficient regulation of broker-dealers.
 - FINRA is a self-regulatory organization (SRO) for US –registered broker-dealers
 - FINRA rules/guidance applies only to member firms
 - FINRA is overseen by the SEC
 - Actions
 - Investor alerts and podcasts
 - Information request to members
 - Brought disciplinary actions against members for securities fraud for scam cryptocurrency
 - SEC and FINRA joint statement on crypto custody issues

Key federal regulators

- Commodity Futures Trading Commission (“CFTC”)
 - Mission: The mission of CFTC is to foster open, transparent, competitive, and financially sound markets.
 - Jurisdiction
 - Regulates commodities derivative contracts based on underlying commodities
 - Anti-fraud and anti-manipulation enforcement authority of spot commodities trades
 - CFTC takes position that cryptocurrencies are commodities
 - Actions
 - Has allowed Bitcoin futures contracts to be traded on certified exchanges.
 - Injunctive relief, restitution and monetary penalties for virtual currency scams
 - Final guidance on “actual delivery” of virtual currencies

Key federal regulators

- National Futures Association (“NFA”)
 - CFTC SRO analogue to FINRA.
 - Issues guidance and rules applicable to its members (futures commission merchants, introducing brokers, commodity pool operators, commodity trading advisors, swap dealers)
 - Overseen by CFTC
 - Mission: safeguard the integrity of the derivatives markets, protect investors and ensure Members meet their regulatory responsibilities
 - Actions
 - Requires members to disclose certain information about the risks of investing in cryptocurrencies and outline them for the customers
 - Requires certain members, in response to annual questionnaire, to report if they trade, advise or solicit orders in cryptocurrency or cryptocurrency derivatives.

Key federal regulators

- Department of Justice (“DOJ”)
 - Mission: To enforce the law and defend the interests of the United States according to the law, among other things
 - Jurisdiction: Federal crimes
 - Relevant actions
 - Investigating price manipulation by Bitcoin insiders, with CFTC
 - Prosecuting securities fraud, with SEC
 - Money laundering investigations
 - Special counsel Mueller
 - Civil enforcement authority, forfeitures

Key federal regulators

- The Financial Crimes Enforcement Network (“FinCEN”)
 - Mission: Includes safeguarding the financial system from illicit use and combat money laundering
 - Focus on registering money services businesses and ensuring they have proper AML compliance programs for money transmission
 - Actions
 - With DOJ, \$110 million Civil Money Penalty against foreign money services business for willfully violating US anti-money laundering laws
 - Joint statement with the SEC and the CFTC on the AML/CFT obligations under the Bank Secrecy Act in activities involving digital assets
- OCC
 - Fintech Charter

Key federal regulators

- IRS
 - Actions
 - Notice 2014-12, describing how IRS applies US tax principles to virtual currency
 - Affirmative searching for cryptocurrency tax evaders and sending letters to cryptocurrency owners advising them to pay back taxes / John Doe Summons to major crypto exchange.
 - Rev. Rul. 2019-24 described under what circumstances tax payers recognizes income as a result of a hard fork of a cryptocurrency
 - CFPB and FTC
 - Have authorities to go after crypto businesses under their jurisdiction for defrauding consumers

Congress

- Congress is continuing to explore blockchain issues
 - Congressional Blockchain Caucus, bipartisan Caucus dedicated to the advancement of sound public policy toward blockchain-based technologies and digital currencies.
 - Senate Banking Committee, Hearing: Exploring the Cryptocurrency and Blockchain Ecosystem
 - Senate Banking Committee, Hearing: Virtual Currencies: The Oversight Role of the SEC and the CFTC
 - Senate Banking Committee, Hearing: Examining Facebook's Proposed Digital Currency and Data Privacy Considerations
 - House Small Business Committee: The Benefits of Blockchain Technology for Small Business
 - House Fintech Task Force: Is Cash Still King? Reviewing the Rise of Mobile Payments

Congress

- Various legislation has been introduced, e.g.,
 - Blockchain Promotion Act of 2018, would create a working group to study blockchain and a definition of blockchain
 - Resolution Expressing Support for Digital Currencies and Blockchain
 - Blockchain Regulatory Certainty Act
 - Cryptocurrency Act of 2020

States

- Nearly every state is taking some action in the blockchain space. Here are just a few examples:
 - Alabama, businesses dealing in cryptocurrency must obtain money transmitter license
 - Arizona, authorizes blockchain and smart contracts for sale of goods and services, creates a Fintech sandbox
 - Florida, enacts a money laundering law that covers Bitcoin. Seminole, Florida, permits payments in cryptocurrency
 - New York, requires any company engaging in virtual currency business activity to obtain a BitLicense, employ a compliance officer, and meet capital requirements.
 - Texas is a leader in the prosecutions of scams
 - Vermont, creates blockchain limited liability company
 - Wyoming creates a special purpose depository institution charter which enables the bank to offer digital asset custodial services, among other things

Different Approaches to Oversight:

- Wait and See
- Regulate (e.g., China)
- Guidance and Sandboxing (e.g., UK)

Regulators include:

- Financial regulators
- Securities/Exchange regulators
- Data protection authorities
- National security authorities

Key Regulatory Challenges Outside the US

- Securities regulation (similar to the US)
- Regulation of cryptocurrencies
- Privacy/Data Protection
- Data Residency
- National Security

- Regulation of Cryptocurrencies
 - Certain countries limit the ability to use cryptocurrencies for transactions (e.g., do not consider them legal tender) or outright ban them
 - China (except the state-issued cryptocurrencies), Vietnam, Ecuador all restrict or ban cryptocurrencies use
 - Rules related to cryptocurrencies are constantly evolving and often depend on how they are categorized (asset, commodity, currency, security)

- Privacy/Data Protection
 - Generally not focused on blockchain as a technology, but a regulatory concern given the immutability of the records
 - EU's General Data Protection Regulation regulates all processing of personal data and allows individuals, among other things, rights of rectification and deletion
 - European Parliament issued a study in July 2019 on the challenges blockchain presents in compliance with the GDPR
 - Other countries (and some US states) are following the EU's approach to data privacy (e.g., Brazil)

- Data Residency/Export Controls
 - Certain countries require certain types of data, including personal data of residents or controlled data, be stored in country or otherwise not be sent to certain countries
 - Distributed ledgers make complying with data residency requirements challenging



- National Security
 - A number of countries are contemplating restricting encryption or requiring disclosure of content to authorities
 - Where the distributed ledger solution is encrypted, this may present challenges





3

Applications in Banking + Finance

Record Keeping / Know Your Customer (“KYC”)

- Current application: Financial institutions perform KYC individual and upload information
- Possible blockchain option: Creation of shared customer registry using blockchain technology, with each customer have a unique identifier
- Benefits
 - Avoid duplication
 - Distribution of encrypted updates to client details
 - Historical records for audit trail purposes
 - Possibility of referring to records held elsewhere, to avoid creating an identity “honeypot”
- Joint Statement on Innovative Efforts to Combat Money Laundering, Dec. 3, 2018

Record Keeping

- Potential Privacy issues
 - GDPR right to be forgotten vs. immutable ledger
 - Solutions
- Smart contracts to control access to private data
- Other potential governmental uses: record management, identity management, voting, taxes, etc.
 - Illinois Blockchain Initiative: A consortium of state and county agencies

Capital Markets

- Initial Coin Offerings
 - Securities laws broadly define “security,” and includes debt, equity, and “investment contracts.”
 - The *Howey* test (for investment contracts)
 - Elements
 - Investment of money
 - Common enterprise
 - Expectation of profit derived from efforts of others
 - “Economic reality”
 - Bitcoin/ether distinguished
 - Consumptive vs. investment motive (“utility tokens”)
 - Offering of cryptos that have attributes of securities should comply with securities laws.

Capital Markets

- Initial Coin Offerings (cont'd)
 - Offering digital assets as securities may provide several advantages to traditional capital raising methods:
 - Marketing
 - Crowdfunding / democratization
 - Lower cost to raise capital
 - Can combine creation of funding and creation of network

Capital Markets

- Initial Coin Offerings (cont'd)
 - The Securities Act requires securities to be registered unless an exemption applies
 - Exemptions from the registration requirement that are potentially available to ICOs
 - Regulation D (Private Placement)
 - Regulation S
 - Regulation Crowdfunding (“Reg CF”).
 - Regulation A+

Capital Markets / Asset Management

- There is more to the use of blockchain to raise capital than ICOs
 - Blockchain Stock Issuance
 - Blockchain Debt Issuance
 - Syndicated Loans
- Similarly, blockchain may be useful in asset management and the selling and purchasing of real estate and other properties
 - Decreases reliance on intermediaries
 - Enhances security and more efficient record-keeping
 - Facilitates communications with beneficial owners
 - Accelerates client onboarding for funds or exchanges
- Framework for holding “traditional” securities in virtual form is developing slowly (transfer agents, custodians, trading platforms and other mechanisms are developing)

Bitcoin + Virtual Currencies

- Virtual Currencies or Cryptocurrencies are digital assets that are transferred and stored in a decentralized manner.
- The first use-case for blockchain.
 - Creation of stablecoins (may be backed by a fiat currency, commodity or another cryptocurrency)
- Advantages
 - Allows for transfer of value between network of untrusted participants
 - Digital identity may be encrypted
- Challenges
 - Uncertain regulatory landscape
 - Prevention of fraudulent and criminal activities
- Central bank digital currencies are increasingly being discussed, studied and tested

Current Market Cap/Prices of Top 10

1	 Bitcoin	\$165,458,934,428	\$9,000.87	\$37,244,985,089	18,382,543 BTC	-5.39%
2	 Ethereum	\$21,873,896,936	\$197.02	\$12,611,536,791	111,021,907 ETH	-5.90%
3	 Tether	\$8,827,321,273	\$1.00	\$45,216,194,655	8,798,069,379 USDT *	0.43%
4	 XRP	\$8,536,368,213	\$0.193512	\$1,682,490,781	44,112,853,111 XRP *	-3.91%
5	 Bitcoin Cash	\$4,163,282,944	\$226.10	\$2,896,060,378	18,413,200 BCH	-5.39%
6	 Bitcoin SV	\$3,524,895,366	\$191.45	\$1,775,710,212	18,412,008 BSV	-2.20%
7	 Litecoin	\$2,750,257,054	\$42.46	\$3,111,695,453	64,778,356 LTC	-3.53%
8	 Binance Coin	\$2,523,117,531	\$16.22	\$294,079,685	155,536,713 BNB *	-3.23%
9	 EOS	\$2,295,167,611	\$2.46	\$2,416,969,754	932,817,489 EOS *	-4.63%
10	 Tezos	\$1,876,833,485	\$2.64	\$105,597,944	711,199,859 XTZ *	-5.61%

Payments/Money Transactions Businesses

Blockchain solutions for B2B and cross-border payments and financial market infrastructures

- Largely private or consortium driven
- Distributed ledger system that allows verification of all the details across the various participants
- Advantages
 - Reduces costs and time
 - Provides enhanced security
 - Reduces systemic and counterparty credit risks



Commodities and Derivatives Trading

Current System

Place
Order



Confirm
Receipt



Confirm
Price

Blockchain System

Order,
Confirmation,
and Settlement
occur in the
same system

Companies and consortiums can provide users with blockchain-based solutions for trading of commodities, equities, etc.

- Advantages

- Provides a real-time view of each record
- Reduces market frictions (e.g., reconciliation and settlement)
- Reduces costs and time
- Provides enhanced security

Smart Contracts

Application layer on top of the distributed ledger – allows for programmable transactions that recognize the fulfillment of conditions and automatically executes contract

- Often requires an “Oracle” to interact with data outside of the smart contract
- Advantages
 - Reduces costs and time
 - Provides enhanced security
 - Ability to reduce the risk of a “trust-gap”



Blockchain and Legal Issues

"It depends"

- No one-size-fits-all approach
- Depends on use case and nature of technology (and, in particular, whether public/private)
- Needs multi-disciplinary legal team

Issues which could be relevant include:

- data privacy
- governing law and jurisdiction
- anti-money laundering law
- regulatory compliance
- contract law
- consumer protection
- competition law
- corporate law
- securities law
- intellectual property
- dispute resolution

Other Legal Issues to Consider

1. Personal jurisdiction and choice of law
2. Statute of frauds
3. Issues relating to immutability
4. Coding errors
5. Arbitration
6. Standard of duties imposed on the “controlling person” (or the trust-worthy party) of a private ledger



4

Challenges in Implementation

Rapid Evolvment

- Rapidly advancing technology
- Increasing number of use cases and pilot projects
- Hype v. reality
- Legal issues
 - Characterization and jurisdiction
 - Who is liable?
 - Intellectual property
 - Cybersecurity
 - Data privacy
 - Settlement finality, “holder in due course” and similar commercial law issues

Joining a Blockchain Consortium

Don't go it alone

- **G**overnance
- **A**nti-trust
- **I**ntellectual Property
- **N**itty-Gritty

Joining a Blockchain Consortium

- **G**overnance
 - Formal consortium agreement.
 - Who makes the key decisions?
 - Who votes on projects?
 - What are the levels of participation?
 - Can you negotiate your level of participation?

Joining a Blockchain Consortium

- **Anti-trust**
 - Historically, trade associations and consortia have been ripe for anti-trust violations
 - Anti-trust laws, enforced by the DOJ and FTC, are designed to promote competition.
 - What is competitive: fierce competition, lower prices, greater choices, greater output, innovation, efficiency.
 - What is anti-competitive: market dominance, restricted output, high prices, collusion that achieves the foregoing.
 - Tips
 - Just the facts, Jack
 - Have a chaperone
 - Have an agenda

Joining a Blockchain Consortium

- **I**ntellectual Property
 - What IP are you expected to contribute?
 - If you contribute IP, how are your ongoing rights protected?
 - What can the consortium do with the IP you contribute?
 - Who owns the IP that consortium develops?
 - How will that IP be shared/licensed?

Joining a Blockchain Consortium

- **Nitty-Gritty**
 - What are the consortium's goals?
 - What are its projects?
 - What are the steps to the project?
 - What are the deadlines?
 - What are the consequences if the project doesn't stay on schedule?
 - Who pays for project costs? How? Each bears own cost? Dues?
 - What are you expected to contribute to the project?
 - What are the duties of confidentiality?
 - What happens if a someone drops out?



5

Questions

Questions



Michael Egan
Partner

Baker McKenzie

(202) 452-7022

michael.egan@bakermckenzie.com



Rebecca Simmons
Partner

Sullivan & Cromwell

(212) 558-3175

simmonsr@sullcrom.com