Appendix A: An Overview of US Legal, Tax, and Regulatory Considerations

Payments Law Considerations

Participation in the cryptocurrency economy may trigger obligations under applicable payments-related laws and regulations, notably those related to money transmission. In the US, money transmission is regulated at both the federal and the state levels. Federal law requires money services businesses (MSBs), which include money transmitters, to register with the US Treasury's Financial Crimes Enforcement Network (FinCEN) and comply with anti-money-laundering (AML) requirements under the Bank Secrecy Act (BSA). Under FinCEN regulations, a "money transmitter" is a "person that provides money transmission services" or "[a]ny other person engaged in the transfer of funds." The meaning of "money transmission services" is the acceptance of money (defined as currency, funds, or other value that substitutes for currency) from one location or person and its delivery to another location or person by any means.

In addition to money transmitters, FinCEN recently reaffirmed its interpretive guidance on the application of the BSA and its implementing regulations to people administering, exchanging, or using virtual currencies that are convertible into real currency or that act as a substitute for real currency. An "exchanger," defined as a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency, must register with FinCEN. An "administrator," defined as a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency, must also register with FinCEN.

Forty-nine states and the District of Columbia also require individuals or entities engaged in money transmission activities to obtain a license from the relevant state agency. Although each state has its own interpretations and exemptions, the statutory definitions of "money transmission" are substantively similar and generally require the receipt of money from one party for the purpose of transmitting it to another. Federal regulation of MSBs focuses on preventing money laundering, while state laws generally focus on ensuring the safety and soundness of nonbank money transmitters and the protection of state consumers.

Within this framework, it is critical for industry participants to analyze their operations in order to determine whether they must comply with federal or state payments-related laws and regulations.

Tax Law Considerations

The US Internal Revenue Service (IRS) treats crypto assets as property for federal tax purposes and determines that virtual currency transactions are taxable just like transactions in any other property. Current federal tax law does not treat virtual currency as currency that could generate foreign currency gain or loss for US federal tax purposes. In computing gross income, however, a taxpayer who receives virtual currency as payment for goods or services must include the fair market value of the virtual currency as of the date of receipt of the virtual currency. To calculate fair market value of a virtual currency listed on an exchange with an exchange rate that is established by market supply and demand, the virtual currency must be converted into US dollars (or into another currency convertible into US dollars) at the exchange rate.

An IRS revenue ruling from October 2019 draws a distinction between the tax treatment of cryptocurrencies acquired as result of a "hard fork" versus those acquired as result of an "airdrop." According to the IRS, a hard fork occurs when a cryptocurrency undergoes a protocol change resulting in a permanent diversion from the existing distributed ledger. This may result in the creation of a new cryptocurrency on a new distributed ledger, in addition to the existing cryptocurrency on the existing distributed ledger. An airdrop, on the other hand, is a means of distributing a cryptocurrency to multiple distributed-ledger addresses. The IRS asserted that the creation of a new cryptocurrency as result of a hard fork does not necessarily create tax consequences. A taxpayer may, however, constructively receive cryptocurrency created as a result of a hard fork prior to the recording of an airdrop on the distributed ledger, altering the tax treatment of the acquisition.

As the IRS continues to adjust its treatment of cryptocurrencies, there may be serious tax consequences resulting from transactions in cryptocurrencies.

Securities Law Considerations

Cryptocurrencies may be subject to US securities laws, leading to different legal considerations for different market participants.

What Is a Security? A key threshold issue that remains in flux is whether a digital asset is a "security" under federal securities laws. The SEC interprets the term "security" to include instruments such as stocks, bonds, and transferable shares, and, importantly for the crypto industry, "investment contracts." The US Supreme Court has set forth the "*Howey* test" as the applicable analytical framework to determine whether an "investment contract" exists. According to the test, an investment contract exists when all three of the following conditions are satisfied: (1) money is invested; (2) in a common enterprise; (3) with a reasonable expectation of profits to be derived from the efforts of others. The SEC does not consider a single factor determinative, and it is therefore important for industry participants to understand the contours of the *Howey* test and its evolving application to digital assets.

Instructively, the SEC issued two no-action letters that help illuminate its treatment of digital assets. In April 2019, the SEC did not deem blockchain-based digital assets in the form of "tokenized" cards to be securities. The SEC noted, among other factors, that these tokens would be marketed in a manner that emphasizes their functionality, rather than their potential for an increase in market value. Similarly, in July 2019, the SEC did not deem a blockchain-based in–video game currency a security. The SEC noted, among other factors, the limited ability to transfer the currency outside of the gaming platform.

As regulators continue to confront novel cryptocurrency applications, industry participants should remain aware of the potential for the SEC to deem a virtual asset a security. Courts have sided with the SEC in various cases including, most recently, *SEC vs Kik*, finding that the token issued by Kik via an ICO is a security.

Implications for Broker-Dealers. In the event that a market participant is deemed to deal in "securities," it may be subject to federal and state broker-dealer regulations. The Securities Exchange Act of 1934 (Exchange Act) defines a broker broadly as any person engaged in the business of effecting transactions in securities for the account of others. A dealer is defined as any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise. Any broker or dealer must register with the SEC, subjecting it to strict conduct-based regulations, including antifraud obligations such as a duty of best execution and consumer disclosures, as well as privacy requirements. Brokers and dealers are also subject to net capital rules, risk assessment requirements, anti-money-laundering obligations, and many other consumer and industry protection rules. Such broker-dealer obligations may be triggered in the event that the SEC deems a digital asset a security.

The SEC has released guidance on noncustodial models for a broker-dealer to operate an alternative trading system, including a recent no-action letter, paving the way for the exchange trading of crypto assets.

Implications for Registered Investment Advisers. Similar to the regulatory requirements for brokers and dealers, if a digital asset is deemed a "security" by the SEC, any "investment adviser" dealing in such assets must comply with the Investment Advisers Act of 1940 (Advisers Act). The Advisers Act defines an "investment adviser" as any person or firm that: (1) for compensation; (2) is engaged in the business of; (3) providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications. Such people or firms must register with the SEC and be subject to antifraud and disclosure obligations, recordkeeping requirements, advertising and fee restrictions, and custody rules, as well as fiduciary obligations to provide suitable investment advice.

Whether or not a player in the digital asset market must satisfy regulatory requirements imposed on investment advisers depends on the SEC's classification of the digital assets at issue.

Implications for Investment Companies. The Investment Company Act of 1940 (Investment Company Act) defines an investment company as an issuer that is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in "securities." Public investment companies are classified as management companies, unit investment trusts, or face-amount certificate companies. In the event that a market participant dealing in digital assets falls into an investment company category, it must register with the SEC, triggering ongoing reporting obligations and minimum capital requirements, among other obligations.

Private funds, on the other hand, must operate within an exemption to the Investment Company Act if they are to avoid SEC registration and its attendant requirements. Two of the most common exemptions are found in Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act. Section 3(c)(1) exempts any issuer whose outstanding securities (other than short-term paper) are beneficially owned by 100 or fewer people and does not make a public offering of such securities.

Section 3(c)(7) exempts any issuer whose outstanding securities are owned exclusively by people who, at the time of the acquisition of such securities, are "qualified purchasers" and does not make a public offering of such securities.

Depending on how a digital asset is classified by the SEC, it is vital that market participants remain aware of their obligations with respect to the operations of public and private funds.

Implications for Clearing Agencies. The Exchange Act requires entities to register with the SEC prior to performing the functions of a clearing agency. Clearing agencies are broadly defined, commonly serving the functions of a central counterparty (CCP) or a central securities depository (CSD). A clearing agency serves as a CCP when it interposes itself between counterparties to securities transactions, practically serving as buyer and seller. A clearing agency serves as a CSD when it operates a centralized system for the handling of securities certificates. Lately, companies using blockchain technologies have entered the clearing-agency space in an effort to offer greater efficiency and security.

The SEC recently published a no-action letter addressing the interplay of blockchain technologies and clearing-agency registration requirements. In this case, a company aiming to settle equity securities trades on a blockchain platform for broker-dealers was cleared to operate without registering with the SEC as a clearing agency pursuant to the Exchange Act. The SEC mandated a feasibility study phase, whereby the platform's operations would be designed to limit its scope and manage financial and settlement risks using, among other items, participation requirements and limits, securities eligibility criteria, margin collection, volume limits, ongoing monitoring, and regular reporting to the SEC.

As the SEC's treatment of clearing agencies continues to evolve, it is important for market participants to monitor regulatory developments in order to ensure compliance and avoid potential enforcement actions.

Derivatives Law Considerations

Recently, the chairman of the US Commodity Futures Trading Commission (CFTC) Heath Tarbert stated that he believes the cryptocurrency Ether is a commodity and would therefore fall under the jurisdiction of the CFTC. This signals a potentially significant development for market participants. Commodities are generally subject to the regulatory requirements of the Commodity Exchange Act (CEA) and its respective regulations. Market participants in commodities face CFTC registration requirements for traders, advisers, agents, and exchanges as well as enforcement actions brought by the CFTC's Division of Enforcement for violations of fraud and manipulation rules and regulations. Since Ether and related cryptocurrencies may now be categorized as commodities, industry participants should prepare for the landscape to be subject to the full gamut of the CFTC's regulations and actions, and the CFTC has maintained an active enforcement agenda in the cryptocurrency space.

Importantly, the CFTC maintains rules and regulations prohibiting the employment, or attempted employment, of manipulative or deceptive conduct. The CEA's fraud rule was modeled after Section 10(b) and Rule 10b-5 of the Securities and

Exchange Act of 1934 to broadly prohibit fraud and fraud-based manipulation. In a related regulation, the CFTC's manipulation rule makes it unlawful for any person directly or indirectly to manipulate or attempt to manipulate the price of any swap or commodity in interstate commerce. These new rules broadened the CFTC's existing authority to prohibit fraud and manipulation by eliminating the requirement to show an artificial price, lowering scienter from specific intent to recklessness in certain instances, and expanding the prohibition on false reporting to include "any false statement of material fact" to the CFTC in any context. The CFTC also requires the registration of certain industry participants, including commodity pool operators and commodity trading advisers and introducing brokers.

Following Chairman Tarbert's recent statements, the foregoing obligations may now extend to digital asset market participants.

Sanctions Law Considerations

US sanctions laws are imposed, administered, and enforced by the US Treasury Department's Office of Foreign Assets Control (OFAC) and the US Department of State. Sanctions violations are strict liability offenses, and a person or entity may be held liable for inadvertent violations of US sanctions authorities. Based on historical enforcement actions, there is less risk of a significant enforcement action by OFAC in cases where a person did not know, and had no reason to know, that he or she was dealing with a designated person or people whose assets and accounts located in the US were blocked by sanctions, particularly where those dealings were indirect.

Market participants should remain aware of the strict enforcement of sanctions laws as related to their virtual-asset operations.

New York and Louisiana Law Considerations

New York was the first US state to implement a comprehensive regime for virtual currency regulation. Pursuant to the so-called BitLicense law, "[N]o Person shall, without a license obtained from the superintendent . . . engage in any Virtual Currency Business Activity." A person is defined as "an individual, partnership, corporation, association, joint stock association, trust, or other entity, however organized." Virtual currency business activity means the conduct of any one of the following types of activities involving New York or a New York resident:

- Receiving virtual currency for transmission or transmitting virtual currency, except where the transaction is undertaken for nonfinancial purposes and does not involve the transfer of more than a nominal amount of virtual currency

- Storing, holding, or maintaining custody or control of virtual currency on behalf of others

- Buying and selling virtual currency as a customer business

- Performing exchange services as a customer business

- Controlling, administering, or issuing a virtual currency

Exchange services means “the conversion or exchange of fiat currency or other value into virtual currency, the conversion or exchange of virtual currency into fiat currency or other value, or the conversion or exchange of one form of virtual currency into another form of virtual currency.” New York resident means “any Person that resides, is located, has a place of business, or is conducting business in New York.” Virtual currency, subject to certain limitations, means “any type of digital unit that is used as a medium of exchange or a form of digitally stored value,” and is “broadly construed to include digital units of exchange that (i) have a centralized repository or administrator; (ii) are decentralized and have no centralized repository or administrator; or (iii) may be created or obtained by computing or manufacturing effort.” Transmission means “the transfer, by or through a third party, of Virtual Currency from a Person to a Person, including the transfer from the account or storage repository of a Person to the account or storage repository of a Person.”

The New York Department of Financial Services has provided limited guidance on the BitLicense’s scope of application. Thus, entities participating in the market for virtual assets involving New York or a New York resident must consider the applicability and implications of New York’s BitLicense law.

Following New York, Louisiana has recently adopted a comprehensive regulatory regime—the Virtual Currency Business Act (VCBA)—for virtual currency business activity. While different in scope and exemptions from New York’s BitLicense law, Louisiana’s VCBA prohibits a person from engaging in virtual currency business activity with a Louisiana resident without first having obtained a license. Virtual currency business activities include:

- Exchanging, transferring, or storing virtual currency or engaging in virtual currency administration, whether directly or through an agreement with a virtual currency control services vendor

- Holding electronic precious metals or electronic certificates representing interests in precious metals on behalf of another person or issuing shares or electronic certificates representing interests in precious metals

- Exchanging one or more digital representations of value used within one or more online games, game platforms, or family of games for either of the following:

  - Virtual currency offered by or on behalf of the same publisher from which the original digital representation of value was received

  - Legal tender or bank credit outside the online game, game platform, or family of games offered by or on behalf of the same publisher from which the original digital representation of value was received

The VCBA is a law currently in force, but the local regulatory authority has yet to enact regulations to fully implement the law.