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- **Questions.** Direct MCLE questions and forms to Jeanine McKeown (her contact information is found on all MCLE forms provided):

Jeanine McKeown at 213-229-7140 or
jmckeown@gibsondunn.com

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Alan Bannister
Michael D. Bopp
Kendall Day
Arthur S. Long
Carl Kennedy
Jeffrey Steiner

Developments in Virtual Currency Law and Regulation

June 27, 2018

Agenda for Today's Webinar*

Introduction and Virtual Currency Landscape within the Last Six Months
Commodities and Derivatives Law
Securities Law
Law Enforcement and Regulatory Risks Posed by Virtual Currencies
Banking Law
Legislative Developments

*The presentation deck also includes a section on International and State Developments. We do not plan to cover these slides during today's webinar.

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Introduction and Virtual Currency Landscape within the Last Six Months

What Are Virtual Currencies?

- Virtual currencies are digital representations of value that are neither issued by a central bank or public authority, nor necessarily attached to legal tender
- Virtual currencies can enable purchases, sales and other financial transactions and can be transferred stored and traded
- Many are promoted as providing the same functions as long-established currencies, but without the backing of a government or other body
- Most popular and well known is bitcoin, but there are many, many others

Based on blockchain/distributed ledger technology (DLT)

- A distributed ledger is a decentralized database that exists across several locations or among multiple participants
- Data structure that makes it possible to create a digital ledger of data and share it among a network of independent parties
- The blockchain allows for the verification of transactions on the network and creates permanent records of transactions

Alternative Virtual Currencies

- Developed in 2008-2009, bitcoin is the oldest and most famous virtual currency
- However, as of June 24, 2018, investing.com had listed 1904 cryptocurrencies with a combined market capitalization of over $200 billion
- Many of these currencies are run on the Ethereum network, which allows for the use of smart contracts to facilitate more complex transactions; these cryptocurrencies may give their holders some combination of a variety of rights including profit, governance, access or other consumptive rights

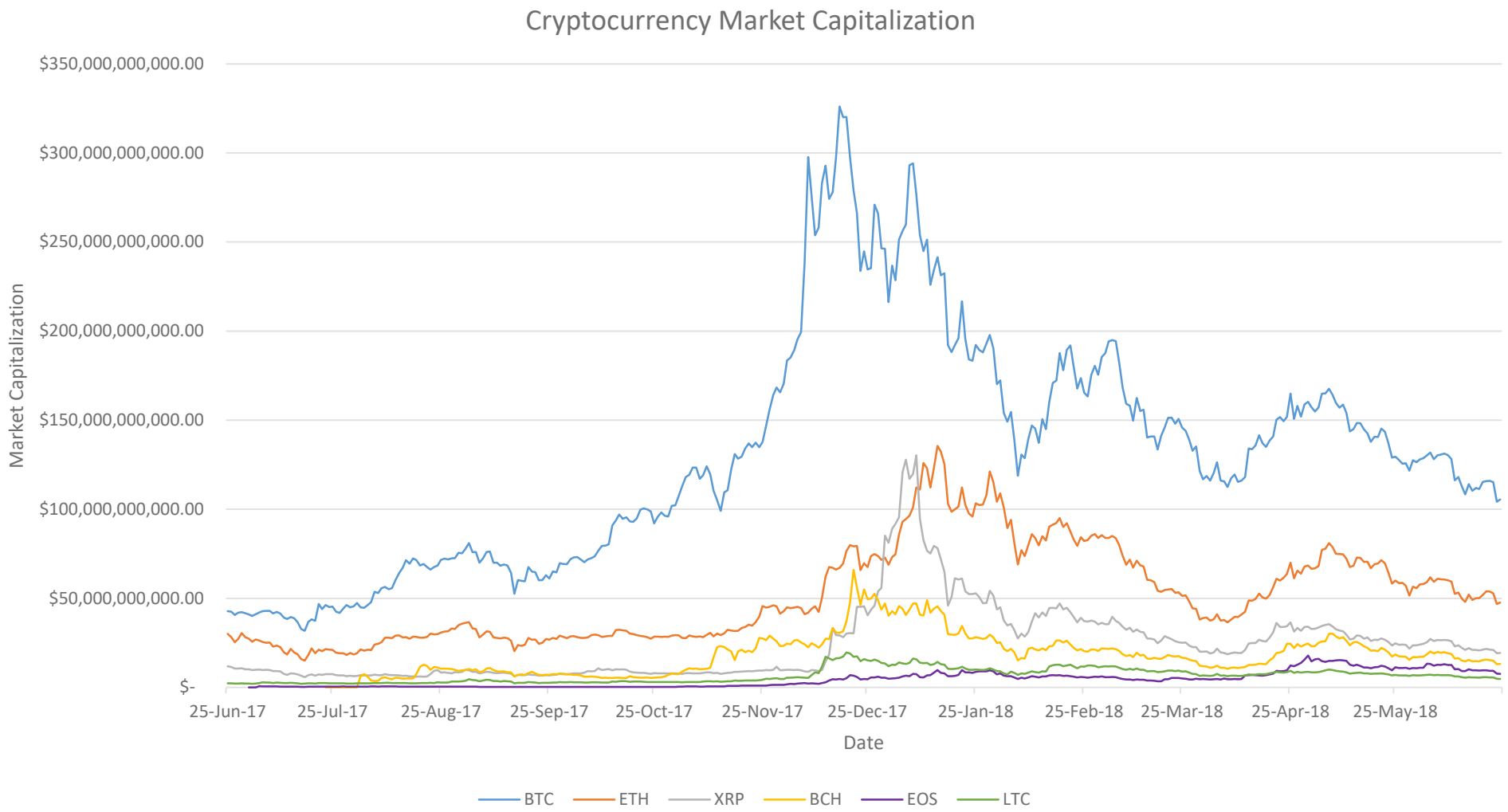
Growth and ICOs

- Often, alternative virtual currencies are sold through the use of an initial coin offering (ICO). ICOs serve different purposes, including as a crowdfunding mechanism for developers looking to raise capital for projects, and tokens may be used to access the platform, participate in the project or otherwise consume goods or services provided by the issuer or other parties
- According to Coinschedule, in 2017 there were 210 ICOs (globally) that collectively raised over $3.8 billion. So far in 2018, there have been 517 ICOs (globally) that have collectively raised more than $11+ billion

Top Cryptocurrencies by Market Cap

As of June 25, 2018

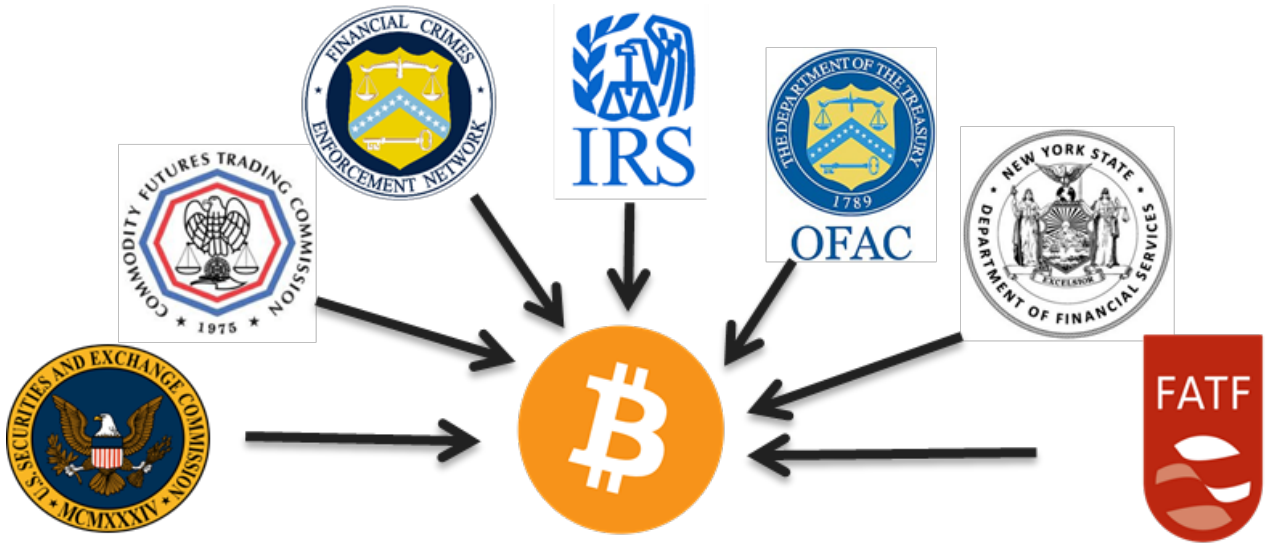
Fluctuation in Market Cap over the Last Year



Closing Price Since September 30, 2017

Regulatory Environment: Range of Regulators Involved in Virtual Currency

- Given the novelty of virtual currencies and absence of a comprehensive regulatory framework, a number of different federal, state, foreign, and international agencies and authorities have taken steps to regulate virtual currencies



Are Virtual Currencies Commodities or Securities?

Bitcoin and Ether Are Not Securities

SEC Director's Speech

- On June 14, 2018, SEC Director of Corporate Finance William Hinman announced at *Yahoo Finance's All Market Summit: Crypto* that ether and bitcoin are not securities
- Did not mention any other virtual currencies by name, but did provide a number of factors to consider in determining whether a particular token is a security
- Suggests that a token may start out as a security offering but transactions with those tokens may no longer represent such a security offering and the tokens may not be securities

Implications

- Ether and bitcoin are commodities under the Commodity Exchange Act and spot market trading is subject to the fraud and manipulation authority of the CFTC
- We are likely to see derivatives on ether (derivatives on bitcoin are already trading)
- Derivatives exchanges may try to list derivatives on other virtual currencies
- Not an official SEC or Division action
- Still requires a token by token analysis based on the facts and circumstances

Enforcement on the Rise

DOJ-CFTC Probe into Manipulation in the Spot Markets

- DOJ, working with the CFTC, opened a criminal probe into whether traders are manipulating the price of bitcoin and other virtual currencies, including whether there has been collusion among traders
- Focused on illegal trading practices that can influence price: Spoofing, wash trading, fictitious trades, banging the close, etc.

CFTC and NASAA Memorandum of Understanding

- On May 21, the CFTC and the North American Securities Administrators (NASAA) signed a mutual cooperation agreement to establish a closer working relationship between the CFTC and state securities agencies
- Focuses on the sharing of confidential information between the CFTC and state securities regulators to assist in enforcing the Commodity Exchange Act and state securities laws

CFTC and SEC Actions

- The agencies have been bringing enforcement actions and issuing subpoenas to fight against fraud and manipulation in the virtual currency markets
- Concerns are focused on customer protection

State-Level Enforcement

Operation Cryptosweep

- The NASAA announced on May 21, 2018 that more than 40 jurisdictions throughout North America (state and provincial regulators in the United States and Canada) have participated in "Operation Cryptosweep," a coordinated effort aimed at fraudsters in the ICO and virtual currency space
- Has resulted in 70 inquiries and investigations and 35 pending or completed enforcement actions related to ICOs and cryptocurrencies since the beginning of May 2018
- For example, Colorado has brought two actions as part of Operation Cryptosweep against out-of-state companies promoting ICOs for violating Colorado securities laws

NYDFS Requests to Virtual Currency Platforms

- On April 17, 2018, then-NY Attorney General Eric Schneiderman announced that his office had sent letters to 13 virtual currency trading platforms "requesting disclosures on their operations, use of bots, conflicts of interest, outages and other key issues"
- The sweeping request contained 34 in-depth questions and was sent to trading platforms inside and outside the United States

The persistently expanding exploitation of the crypto ecosystem by fraudsters is a significant threat to Main Street investors in the United States and Canada, and NASAA members are committed to combating this threat . . . The actions announced today are just the tip of the iceberg.

-Joseph P. Borg, NASAA President and Director of the Alabama Securities Commission

Current Developments

Rise of Decentralized Exchanges (DEXs)

- Who holds the funds?
  - Centralized: Exchange holds customer funds
  - Decentralized: Traders hold their own funds at all times
- What to know about DEXs
  - No custody risk
  - Not for everyone: difficult to access and hard to use
  - No fiat currency: limited to trading between cryptocurrencies
  - Listing of products may need to be approved by a centralized team that has some oversight, charges listing fees, etc., or it could be left to each participant (in which case scammers could become prevalent)
  - Creates difficulties for regulators to obtain data and for their oversight generally
- Centralized exchanges are thinking about DEXs
  - Coinbase bought Paradex, a DEX
  - Large global exchanges have announced that they hope to create a decentralized exchange

Current Developments (Cont'd)

Stable Coins

- A virtual currency designed to have a stable price or value over time, making it less volatile than other virtual currencies
- Stable coins may be fiat collateralized, crypto collateralized or non-collateralized
- Stable coins play an important role for exchanges and traders of virtual currencies

51% Attack

- On May 23, we saw a 51% or "double-spend" attack on the Bitcoin Gold network which is a fork off the original Bitcoin network and is the 26th largest virtual currency
- A 51% attack refers to an attack on a blockchain by a group of miners controlling more than 50% of the network's computing power. The attackers can prevent new transactions from being confirmed and can reverse transactions that were completed to double spend

Proof of Work (PoW) v. Proof of Stake (PoS)

- Proof of stake is a different way to validate transactions as the process does not involve solving block problems, and therefore uses much less electricity than proof of work validation (the manner of validation for bitcoin, ether and most of the other major cryptocurrencies)
- Ethereum has been working towards a switch to proof of stake validation

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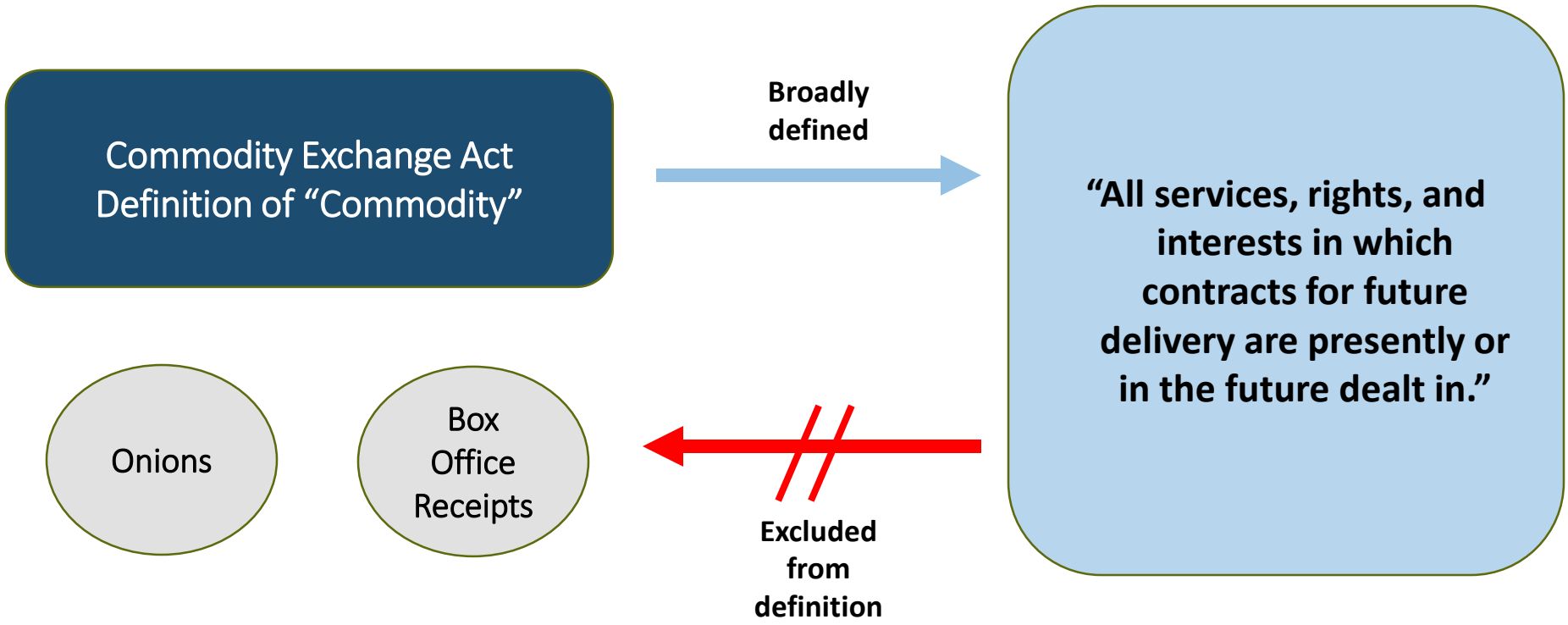
Commodities and Derivatives Law

Commodities and Derivatives Law Topics

Definition of Commodity
CFTC Authority over Virtual Currencies
Virtual Currency Derivatives
Earliest CFTC Actions on Virtual Currency Derivatives
Bitcoin Derivatives
Heightened Review of Virtual Currency Derivatives
The Future of Virtual Currency Derivatives
Early CFTC Enforcement Actions
Recent CFTC Investigations and Enforcement Actions
CFTC Oversight Approach
What to Look for in the Near Term?

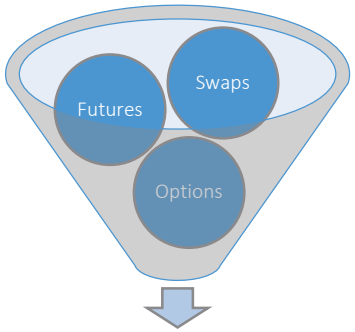
Definition of Commodity



- **The definition is broad enough to capture virtual currencies**
- **U.S. District Court in Eastern Dist. of NY Confirms: In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Riordan**

CFTC Authority over Virtual Currencies

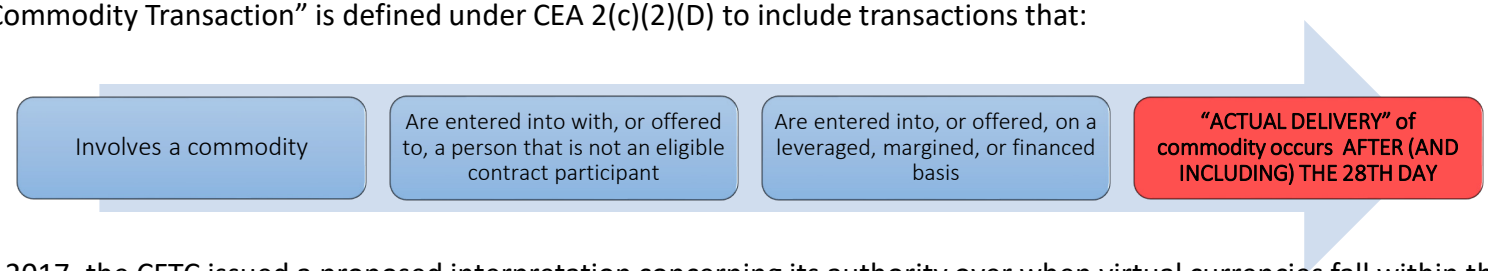
CFTC has direct oversight over futures, options and other derivatives, but not spot transactions



CFTC's Direct Authority

Dodd-Frank gave the agency authority over "Retail Commodity Transactions"

- Following the passage of the Dodd-Frank Act, the CFTC was given authority over "Retail Commodity Transactions"
- The term "Retail Commodity Transaction" is defined under CEA 2(c)(2)(D) to include transactions that:



- On December 15, 2017, the CFTC issued a proposed interpretation concerning its authority over when virtual currencies fall within the definition of retail commodity transactions

Virtual Currency Derivatives

Increasing demand for virtual currencies has resulted in the creation of virtual currency derivatives

- These derivatives allow investors to gain exposure to virtual currencies without having to purchase the currency
- These derivatives also allow owners of virtual currencies to hedge their exposures to volatile prices in the spot market

Listing process for derivatives

- The CEA and CFTC regulations establish procedures for exchanges to seek approval before listing new futures and derivatives for trading
- A CFTC-registered exchange must "list" the product for trading on its platform
- The process of "listing" a derivatives product is essentially the manner in which the CFTC "approves" the trading of that product on an exchange
- This approval can occur through two methods under the CEA and CFTC regulations

Virtual Currency Derivatives (cont'd)

Most common approval process: Self-certification

- Self-certification is a 10-day period of review
- CFTC reviews exchange's submitted plan; includes the terms and conditions of the derivatives products
- CFTC standard of review: Violation of CEA, CFTC regulations and existing law?
  - Generally criticized because standard lacks teeth

Scrutiny regarding approvals for virtual currency derivatives

- Increased scrutiny in the context of virtual currency derivatives
- The primary criticisms are:
  - Virtual currency spot markets are relatively new and volatile
  - Lack direct oversight
  - Markets are the subject of fraud, manipulation and serious cybersecurity concerns

Earliest CFTC Actions on Virtual Currency Derivatives

TeraExchange is the first CFTC-registered exchange to list bitcoin derivatives

- In September 2014, through the self-certification process, for the first time, the CFTC approved the trading of bitcoin index swaps on TeraExchange, which was at the time registered as a provisional swaps execution facility
- TeraExchange was granted a full registration in May 2016

Nadex bitcoin binary options

- Nadex, which is a registered derivatives exchange with the CFTC, self-certified a plan to list two types of bitcoin options for trading on November 2014
- The first type: a bitcoin spread has a one-week duration and a larger tick value of $0.10 per point of the underlying bitcoin index
- The second type: a bitcoin monthly mini spread is a month-long contract with a tick value of $0.01 per point of the underlying bitcoin index

Brief History of Virtual Currency Derivatives (Cont'd)

Chicago Mercantile Exchange (CME) bitcoin reference rate

- In November 2016, the CME launched a bitcoin reference rate and bitcoin real time index
- Provides a standardized reference rate and spot price index across several bitcoin exchanges and trading platforms, including Bitstamp, GDAX, itBit and Kraken

LedgerX bitcoin options contracts

- In July 2017, LedgerX—a registered swap execution facility—also received approval from the CFTC to become a registered derivatives clearing organization (DCO) allowing it to clear derivatives contracts on virtual currencies
- LedgerX offers a platform for trading bitcoins and bitcoin-to-dollar option contracts
- In September 2017, LedgerX self-certified a plan to list bitcoin options for trading on its SEF platform and for clearing on its DCO

Bitcoin Derivatives

At the end of 2017, the CFTC approved a few plans to list bitcoin derivatives

- Three large CFTC futures exchanges self-certified plans to list bitcoin derivatives; before December 2017, there was no significant market for bitcoin derivatives
- CFTC did not find any grounds for blocking the bitcoin derivatives from trading

Bitcoin futures

- On December 1, 2017, the CME and the CBOE Futures Exchange (CBOE) self-certified new contracts for bitcoin futures products
- On December 10, CBOE launched trading on its bitcoin futures under the ticker "XBT"
- On December 17, CME launched its product; bitcoin prices fell slightly (2%) after the launch

Bitcoin binary options

- On December 1, 2017, the Cantor Exchange (Cantor) also self-certified a new contract for bitcoin binary options
- Cantor has not yet announced the start date for trading of its bitcoin derivative

Heightened Review for Virtual Currencies Derivatives

- In May 2018, the CFTC issued an advisory setting forth its "heightened review" approach for virtual currencies and derivatives product listings
- "*Heightened review ensures that the agency has the legal authority and the means to police the underlying virtual currency spot markets for fraud and manipulation*" - **CFTC Advisory**
- Essentially entails placing pressure on CFTC self-regulatory organizations to mitigate risks posed by virtual currency derivatives and to more actively monitor virtual currency cash markets

Some Steps of the CFTC's Heightened Review Approach

- Higher clearinghouse margin requirements
- Exchange monitoring data from cash markets
- Direct and indirect information sharing agreements
- Coordinating with CFTC surveillance staff
- Initiating inquiries into trade settlement issues

The Future of Virtual Currency Derivatives

Bitcoin futures effects on bitcoin prices

- Since bitcoin futures launches, bitcoin prices have fallen from $20,000 to $6,500
- Bitcoin prices drop dramatically around the expiration dates of CBOE bitcoin futures
- Demand for bitcoin derivatives has not grown significantly since launch

Other exchanges have announced plans to offer bitcoin derivatives

- In March 2018, TrueEx SEF announced it would list bitcoin non-deliverable forwards
- Also in March, CBOE announced that it would offer other virtual currency derivatives

Early CFTC Enforcement Actions

In re TeraExchange LLC

- CFTC's first virtual currency-related case, CFTC settles with TeraExchange on Sept. 24, 2015
- Primarily concerned with traditional disruptive market conduct and not virtual currency trading in and of itself
- Failure to enforce prohibitions on wash trading and prearranged trading
- TeraExchange arranged for two market participants to enter into two transactions that offset each other to "test the pipes" of its platform

In re BXFNA Inc. d/b/a Bitfinex

- In June 2016, the CFTC fines Bitfinex for offering illegal off-exchange financed retail commodity transactions in bitcoin and other cryptocurrencies without registering as an FCM
- From April 2013 – February 2016 Bitfinex allowed users to borrow funds from other users to trade bitcoins on a leveraged, margined or financed basis
- Bitfinex also did not deliver bitcoin to those who purchased them

Recent CFTC Investigations

Bitfinex and Tether

- On December 6, 2017, the CFTC sent subpoenas to Bitfinex and Tether
- Allegations that Bitfinex and Tether were engaged in a price manipulation scheme involving tether and bitcoin

Bitstamp, Coinbase, itBit, and Kraken

- On June 10, 2018, subpoenas sent to 4 exchanges
- CME's bitcoin futures products are based on index prices from these 4 exchanges
- Exchanges denied CME's initial requests for information in December 2017
- Refusal to provide information instigated significant concern about possible manipulation in these markets

Recent CFTC Enforcement Actions

CFTC v. McDonnell and CabbageTech, Corp. d/b/a Coin Drop Markets

- On January 18, 2018, civil enforcement action in the U.S. District Court for the Eastern District of New York against CabbageTech, Crops. d/b/a Coin Drop Markets (CDM) and its owner, alleging fraud and misappropriation in purchases and trading of bitcoin and litecoin from approximately January 2017 to the present
- On May 6, the Court took several preliminary actions on the case, including upholding the CFTC's authority to prosecute fraud concerning not only virtual currency futures and derivatives, but also spot transactions in virtual currencies on the basis that such currencies are "commodities"

CFTC v. Dean and The Entrepreneurs Headquarters Ltd.

- On January 19, 2018, civil enforcement action in the U.S. District Court for the Eastern District of New York against Dillon Michael Dean and The Entrepreneurs Headquarters Limited for several claims, including its fraudulent scheme to solicit bitcoin from the public of at least $1.1 million worth of bitcoin from approximately April 2017 through the present
- The defendants are alleged to have misappropriated funds using the funds to pay other customers in a classic Ponzi scheme

CFTC v. My Big Coin Pay Inc., *et al.*

- On January 24, 2018, civil enforcement action in U.S. District Court for the District of Massachusetts against My Big Coin Pay, Inc. (MBC) and a number of related individuals alleging fraud and misappropriation in ongoing virtual currency scam whereby the defendants fraudulently solicited customers by making false claims about MBC's value, usage and trade status and used the nearly $6 million in misappropriated funds for personal purchases
- The defendants argue that, because the CME, CBOE and other derivatives exchanges have not listed derivatives referencing MBC currency, the CFTC has no authority over the virtual currency

CFTC's Oversight Approach

Consumer Education	CFTC 2.0	Coordination with State Regulators	Virtual Currency Taskforce within the Division of Enforcement
• Published a series of consumer education pieces, background materials on its authority, as well as a series of press releases	• Designed to foster and increase the CFTC's familiarity with FinTech and its own understanding of new technology • Deploy new technology to carry out their mission	• On May 21, 2018, the CFTC and NASAA signed a mutual cooperation agreement to establish a closer working relationship between the CFTC and state securities agencies	• In late 2017, the CFTC set up a special task force to prosecute fraud and manipulation in virtual currency spot and derivatives markets • Also established a special whistleblower program for virtual currencies

CFTC's Oversight Approach (cont'd)

Facilitating FinTech innovation, fair market competition, and proactive regulation and comprehension of emerging technologies

Public Consultation

LabCFTC

Guidepoint Online Portal

Coordination with International Regulators

What to Look for in the Near Term?

- More enforcement actions in both the cash markets and derivatives markets for virtual currencies
- CFTC will continue to request trade data and other information from virtual currency spot markets
- More coordination with the SEC, Department of Justice, state regulators, and other financial regulators both in the United States and abroad
- CFTC will finalize its interpretation of "retail commodity transactions"
- Additional virtual currency derivative exchanges self-certifying new virtual currency products and registering with the CFTC
- CFTC will receive increased funding to regulate this space

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Securities Law

Securities Law Topics

- ICOs
- Securities Law Issues Raised by ICOs
- Offering Issues
- Enforcement Trends
- The Decentralized Autonomous Organization (DAO)
- Various SEC Enforcement Actions
- SEC Senior Staff's Statements on the SEC's View of Virtual Currencies
- Two Types of ICOs
- Where Is This All Headed?

Initial Coin Offerings (ICOs)

- In a typical ICO, virtual “coins” or “tokens” are generated, disseminated and sold using blockchain technology
- Coin issuers may include “virtual” entities existing only in computer code
- Capital raised from sales is typically used for development of digital platforms or other projects
- Tokens or coins may be used to access the platform, or otherwise participate in the project, or consume goods and services provided by the issuer or other parties
- Purchasers of the coins may expect a return on, or gain on the value of, their investment or a share of the returns, revenues or profits generated by the project
- Many ICO promoters tout the initial offering and may provide a secondary market for the coins on virtual currency exchanges or other platforms

ICOs (Cont'd)

- Globally, almost $4 billion was raised through ICOs in 2017, according to data from Coinschedule
- For 2018, Coinschedule reports that projects had raised more than $11 billion in 517 ICOs since the beginning of the year
- Encrypted messaging service Telegram's ICO is the biggest initial coin offering in 2018, raising $1.7 billion, while the communications sector raised the most funds through ICOs in 2018 (Note that this number may understate the size of the ICO market (and the potential for loss) as many ICOs "trade up" after they are issued)
- SEC Chairman Clayton indicated in testimony before the Senate Banking Committee that the SEC does not have reliable information as to what percentage of offerings were conducted outside of the United States, but we anecdotally believe that many of these offerings at least originated in foreign jurisdictions and trade there

Securities Law Issues Raised by ICOs

- U.S. federal regulators, including the SEC, like the CFTC, and state regulators have wrestled with how to address initial coin offerings
- A threshold question for any ICO is whether the token or coin to be distributed should be characterized as a "security," and its offering and sale subject to regulation
- Generally, under Section 5 of the U.S. Securities Act of 1933 (the "Securities Act"), offers or sales of "securities" in a manner that uses "U.S. jurisdictional means" must be registered under that Act or exempt therefrom
- The framework commonly applied for determining whether an instrument is a "security" (or more precisely an "investment contract") under federal law is the *Howey* case (*SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946))
- Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the U.S. Securities Exchange Act of 1934 (the "Exchange Act"), "securities" include both formal investment vehicles such as stock, notes, and debentures and "investment contracts," a catch all category covering a wide variety of less traditional financial instruments, which may include coins or tokens
- Subsequent case law has made clear that *Howey* continues to guide the analysis of whether an investment is an "investment contract" and thus a security
- Under the *Howey* framework, for an investment contract to be a "security" all of the following characteristics must be present: (1) an investment of money; (2) in a common enterprise; (3) with an expectation of profit; (4) derived from the "entrepreneurial or managerial efforts of others" (*United Housing Found., Inc. v. Forman*, 421 U.S. 837, 853 (1975))

Offering Issues

- To date, only one company, to our knowledge, has attempted to register an ICO with the SEC; whether the Staff will declare the registration statement effective is uncertain
- To date, the SEC has not approved for listing and trading any exchange-traded products (such as ETFs) holding cryptocurrencies or other assets related to cryptocurrencies
  - Overstock.com has completed, however, a "digital securities" offering for a class of its equity securities using distributed ledger technology (not an ICO, though)
- **SEC Chair Clayton**: *"It is possible to conduct an offer and sale of securities, including an ICO, without triggering the SEC's registration requirements. For example, just as with a Regulation D exempt offering to raise capital for the manufacturing of a physical product, an ICO that is a security can be structured so that it qualifies for an applicable exemption from the registration requirements."*
  - Private placements are complex in practice
  - Certain issuers have purported to comply (see Coinlist offering that is apparently open only to Reg D "accredited investors" and prohibits sale of the security for a period)
  - In the case of a token that is an equity security, how to police Section 12(g) registration requirement?
  - Transfer restriction issues for privately placed tokens if trading is immediately permitted
  - Blue Sky issues
  - Note that while restrictions on general solicitation may no longer apply under Reg D, to the extent securities are simultaneously offered outside the United States in reliance upon Regulation S, limitations on directed selling efforts will limit promotional activities within the United States

Offering Issues (Cont'd)

Registration of the exchange or platform upon which coins or tokens may trade

- Generally, an "exchange," as defined under Exchange Act rules and definitions, must register with the SEC and be subject to SEC supervision, unless it qualifies as an "Alternative Trading System" (ATS) under SEC rules, which, unlike a national securities exchange, does not have the power to impose rules on its participants
- Chair Clayton has indicated his view that investors who do not use SEC-registered exchanges do not benefit from traditional protections, such as prohibitions on front-running and short-sale restrictions
- In other words, virtual currency and other exchanges, frequently operating outside the United States, are not U.S.-regulated stock exchanges. Main Street investors may not appreciate the difference
- To date, we are unaware of any platform that has registered in the U.S. as an ATS

Offering Issues (Cont'd)

U.S. Investment Company Act of 1940 ("ICA") issues

- Since many ICO issuers have no hard assets, ICA registration and compliance issues need to be considered carefully
- The most likely exemptions, Section 3(c)(1) (100 U.S.-holder limit) or Section 3(c)(7) ("qualified purchaser" exemption), will require the issuer to impose a method of monitoring the number or identity of the beneficial holders of its securities

Offering Issues (Cont'd)

Broker (agent)-dealer (acting as principal) registration of promoters and related persons

- Section 15(a)(1) of the Exchange Act generally makes it unlawful for any broker or dealer to use the mails to "effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless that broker or dealer is registered with the SEC in accordance with Section 15(b) of the Exchange Act
- State registration/licensing rules may also apply

Registration of advisors

- Section 202(a)(11) of the U.S. Investment Advisers Act of 1940 defines an investment adviser as any person or firm that: for compensation, is engaged in the business of, providing advice to others or issuing reports or analyses regarding securities
- Many exceptions apply
- State registration/licensing rules may also apply

Enforcement Trends

- "Main Street" emphasis (*e.g.*, warning against celebrity endorsements)
- In September 2017, the Division of Enforcement established a new Cyber Unit focused on misconduct involving distributed ledger technology and ICOs, the spread of false information through electronic and social media, brokerage account takeovers, hacking to obtain non-public information and threats to trading platforms
- The Cyber Unit works closely with SEC's cross-divisional Distributed Ledger Technology Working Group, which was created in November 2013
- Robert Cohen, Head of SEC's Cyber Unit, has recently warned that the agency may seek more severe sanctions against ICO issuers
- States are also focusing on abuses

The Decentralized Autonomous Organization (DAO)

- Report of Investigation Pursuant to Section 21(a) of the Exchange Act released July 25, 2017 recognized that tokens sold in an ICO may be considered investment contracts under the *Howey* test
- Purchasers of DAO tokens were aiming to buy rights in a decentralized organization that would allow them to vote on proposals of "for profit" projects
  - Any profits of the projects would then be redistributed to the holders of the DAO tokens
- Crucially, the SEC determined that holders of DAO tokens did not exercise significant control over the project (despite holding voting rights over proposals), and, rather relied on the efforts of others
  - "Curators" of the DAO were selected by the creators
  - The "Curators," according to the SEC, would: "(1) vet contracts, (2) determine whether and when to submit proposals for votes, (3) determine the order and frequency of proposals that were submitted for a vote, and (4) determine whether to halve the default quorum necessary for a successful vote on certain proposals"
  - SEC claims that the pseudonymity and decentralization of blockchain accentuate lack of "control"
  - A high bar is set to establish enough control as a holder to remove an ICO from the definition of a security
- The DAO represents a strong message by the SEC that many tokens (even with purported questions of control) will be considered securities

SEC v. REcoin Group Foundation, LLC, *et al.*

- SEC filed complaint on September 29, 2017
- REcoin was touted as "The First Ever Cryptocurrency Backed by Real Estate"
- Maksim Zaslavskiy, the promoter, raised $300,000 in a purported token offering, when no tokens ever existed. He also claimed to investors that he had raised between $2 million and $4 million, when it was really only $300,000
- Although the "ICO" never actually delivered the promised tokens, the SEC alleged that the investments offered during the ICO, which was to run until October 9, 2017, were securities.
  - "The investments offered during the REcoin ICO were "securities" within the meaning of Section 2(a)(1) of the Securities Act [15 U.S.C. § 77b(a)(1)] and Section 3(a)(10) of the Exchange Act [15 U.S.C. § 78c(a)(10)]."
- Thus, Zaslavskiy was, according the to the SEC, in violation of Section 5
  - "By virtue of the foregoing, (a) without a registration statement in effect as to that security, Defendants, directly and indirectly, made use of the means and instruments of transportation or communications in interstate commerce and of the mails to sell securities through the use of means of a prospectus, and (b) made use of the means and instruments of transportation or communication in interstate commerce and of the mails to offer to sell through the use of a prospectus, securities as to which no registration statement had been filed."
- Zaslavskiy filed a motion to dismiss in the Eastern District of New York on February 27, 2018, arguing that cryptocurrencies are not securities

SEC v. PlexCorps, *et al.*

- SEC filed complaint on December 1, 2017
- Though it is unclear what is being sold in the ICO, the offering raised $15 million
  - The PlexCoin Facebook Page described the PlexCoin Token as "the next decentralized worldwide cryptocurrency based on the Ethereum structure" whose "mission is to broaden the possibilities of uses and to increase the number of users by simplifying the process of managing cryptocurrency to the maximum"
- The promoter, Dominic LaCroix, promised investors that they would see returns of 1,354% in 29 days or less, pledging to pump up the value of PlexCoins
- Significantly, the SEC noted in its complaint that the ICO for PlexCoin tokens was an illegal offering "because there was no registration statement filed or in effect during its offer and sale, and no applicable exemption from registration"
- The SEC concluded PlexCoins were securities on the basis that investors in PlexCorps had a reasonable expectation of profits based on the efforts of others
  - "Investors in the PlexCoin ICO were promised returns stemming from: (i) the appreciation in value of the PlexCoin Token through investments PlexCorps would make with the proceeds of the PlexCoin ICO and based on the managerial efforts of PlexCorps' team of supposed experts; (ii) the distribution to investors of profits from the PlexCorps enterprise; and (iii) the appreciation in value of the PlexCoin Tokens based on efforts of PlexCorps' "market maintenance" team, which included listing the token on digital asset exchanges"

In re Munchee, Inc.

- SEC filed cease and desist order on December 11, 2017
- Munchee looked to sell what can be described as a utility token (a token that may be used for consumption rather than speculation, exclusively)
- Proposed Munchee ecosystem: the proposed platform, once established, would involve "eventually paying users in tokens for writing food reviews and selling both advertising to restaurants and 'in-app' purchases to app users in exchange for tokens" (SEC Press Release)
  - From the white paper: "The MUN token holds utility for the consumer as a payment method at participating restaurants, for use in the Munchee app, and for rewards and interactions"
- The SEC noted that MUN tokens would still be investment contracts because the value of the MUN token would rise if the actual ecosystem was successfully created
  - Particularly, the SEC noted the presence of a secondary trading market: "Munchee highlighted that it would ensure a secondary trading market for MUN tokens would be available shortly after the completion of the offering and prior to the creation of the ecosystem"
- The success of the MUN token (and the Munchee ecosystem) was also dependent on the efforts of others, i.e., those that would be building the platform
  - From the SEC's complaint: "Because of the conduct and marketing materials of Munchee and its agents, investors would have had a reasonable belief that Munchee and its agents could be relied on to provide the significant entrepreneurial and managerial efforts required to make MUN tokens a success"

SEC v. AriseBank, *et al.*

- SEC filed complaint on January 25, 2018
- AriseBank claims to be the world's first "decentralized bank" and attempted to raise $1 billion with promotion from celebrity boxer Evander Holyfield
- The SEC halted the offering, again noting a failure to file a registration statement with the SEC (or an applicable exemption)
- The marketing materials used in the offering were also materially false according to the complaint
  - A press release stated that AriseBank had purchased a 100-year-old bank and that it could offer customers FDIC-insured accounts and transactions
  - AriseBank also made false statements about its association with payment processing platform, Visa
- AriseBank purported to have raised $600 million, but according to *The Wall Street Journal* it only raised around $1.1 million
- AriseBank also failed to tell investors that one of the project originators was on probation for felony theft and tampering with government records
- The SEC complaint alleged a violation of Sections 10(b) and 17(a) of the Securities Act
  - "The ICO is an illegal offering of securities because there is no registration statement filed or in effect with the SEC, nor is there an applicable exemption from registration. The AriseCoin ICO is a general solicitation that uses statements posted on the Internet and distributed throughout the world – including the United States. These marketing efforts included statements made through websites the Defendants control and through various social media accounts, video and radio interviews, and even a a celebrity endorsement."

SEC v. Jon E. Montroll and BitFunder

- SEC filed complaint on February 21, 2018
- The complaint alleged that Montroll conducted an unregistered securities exchange and defrauded users of the exchange
  - Regarding the fraud: Montroll misappropriated users' Bitcoins and failed to disclose a cyberattack on BitFunder that resulted in the loss of 6,000 bitcoins
- More importantly, the complaint recognized that anyone attempting to set up an unregistered exchange to trade tokens that are securities would be committing a violation of the Exchange Act
  - This would not apply to exchanges that trade virtual currencies that are considered commodities like bitcoin, ether, etc.
- According to the complaint:
  - "Through BitFunder's platform, registered users of BitFunder ('Users') could create, offer, buy and sell shares in various enterprises (referred to as 'Assets' and 'Asset Shares' on the BitFunder website). The Assets listed on the platform primarily were virtual currency-related businesses, such as virtual currency mining operations. Shares in respective Assets were offered and sold by certain Users (referred to as 'Asset Issuer[s]' on the BitFunder website) to other Users on the platform in 'initial offerings.' Many of the offerings promised and paid dividends (referred to as 'dividend paying asset share[s]' on the BitFunder website). Users also were permitted to buy and sell these virtual shares in secondary market transactions on the platform at increased prices. Bitcoin was the only form of payment used and accepted by Users on the platform."
- Montroll and BitFunder tried to get around enforcement by switching terms. ICO was replaced with "initial offering" and tokens were replaced with "assets" and "shares." Consistent with SEC's view, however, "form should be disregarded for substance" (*United Housing Found.*, 421 U.S. at 849)

SEC v. Centra Tech, Inc.

- Centra Tech, Inc. raised over $32 million from thousands of investors selling tokens to raise money for a company that would supposedly offer a debit card backed by Visa and MasterCard, which would convert virtual currency assets into dollars (or other tender)
- The offering was promoted by celebrities Floyd Mayweather and DJ Khaled and *The New York Times* wrote a long-form story on the company on October 27, 2017
  - After the founders were arrested for drunk driving and made inaccurate statements about their ICO (as reported by *The New York Times*), investors brought a private class action complaint on December 13, 2017
- According to the SEC complaint, "Neither Visa nor MasterCard, however, had any relationship with Centra, and certainly none where Centra was authorized to issue, sell, or otherwise distribute Visa or MasterCard credit or other payment cards"
- Centra presents another example of fraudulent entrepreneurs capitalizing on the ICO boom (of 2017) and defrauding token purchasers out of millions of dollars
- Though the case involved fraud, the SEC, in addition, alleged a violation of Section 5 of the Securities Act
  - "By virtue of the foregoing, (a) without a registration statement in effect as to that security, Defendants, directly and indirectly, made use of the means and instruments of transportation or communications in interstate commerce and of the mails to sell securities through the use of means of a prospectus, and (b) made use of the means and instruments of transportation or communication in interstate commerce and of the mails to offer to sell through the use of a prospectus, securities as to which no registration statement had been filed."

SEC v. Longfin Corp., *et al.*

- SEC filed complaint on April 6, 2018
- Longfin Corp. is a Fintech company listed on the NASDAQ
- In December 2017, it announced an acquisition of Ziddu.com, "a blockchain-empowered global micro-lending solutions provider" which caused Longfin's stock to rise more than 1,200% allowing it briefly to have a market capitalization of over $6 billion partially due its limited public float (1.14 million shares sold in its IPO of 74.5 million shares outstanding)
- Longfin's CEO Venkat Meenavalli, a self-described "financial wizard," also happened to be the controlling shareholder of Ziddu.com
- Following the dramatic rise in the share price, individuals affiliated with Meenavalli then sold restricted Longfin shares to the public, reaping $27 million in profits and violating federal securities laws
  - "This action concerns over $27 million in unregistered distributions of Defendant Longfin securities in a public distribution by Longfin affiliates between December 2017 and February 2018. Defendants Altahawi, Tammineedi, and Penumarthi conducted these sales in violation of Section 5 of the Securities Act of 1933 ("Securities Act") [J 5 US. C. § 77e], which prohibits such unregistered sales unless a specific exemption applies under the federal securities laws. No exemption applied to these illegal transactions. Longfin and Defendant Meenavalli, Longfin' s Chairman and Chief Executive Officer, participated in and are liable for the Section 5 violations of Defendants Altahawi, Tammineedi, and Penumarthi."
- The SEC's freeze on Longfin stock then caused substantial problems for investors who bet against the stock (perhaps suspecting the fraud involved) and were unable to close out their short positions or exercise put options on the stock

SEC v. Titanium Blockchain Infrastructure Services, Inc.

- SEC filed complaint on May 29, 2018
- Titanium Blockchain Infrastructure Services, Inc. ("TBIS") raised as much as $21 million through an ICO of its digital asset called BAR
- The SEC complaint charged that "Titanium President Michael Stollaire, a self-described 'blockchain evangelist,' lied about business relationships with the Federal Reserve and dozens of well-known firms, including PayPal, Verizon, Boeing, and The Walt Disney Company" and that "Stollaire promoted the ICO through videos and social media and compared it to investing in 'Intel or Google.'"
- While the case presented evidence of clear fraud, the SEC also noted that TBIS, Inc. would be in violation of Section 5 of the Securities Act:
  - "The TBIS ICO is an offering of securities, in the form of BAR (and later TBAR) digital assets, which must be registered with the SEC unless an exemption applies. No registration exemption applies to the TBIS ICO or to the BARS or TBARs. The TBIS ICO was not limited by number of investors, or investor accreditation status. TBIS and Stollaire offered and sold securities in the form of BAR (later TBAR) digital assets to the general public, including to investors throughout the United States."
- Another example of the SEC's willingness to go after ICOs that involve clear fraud, and hesitancy to bring complaints against non-fraudulent companies that may still be in violation of securities laws

Enforcement Trends (Cont'd)

- The SEC has not yet brought another action purely over a registration violation (i.e., without contemporaneous allegations of fraud) since Munchee
- In the spring of 2018, the SEC subpoenaed many virtual currency funds and other digital currency market participants in a wide sweep
- According to reports in *The Wall Street Journal*, since December the agency has filed civil charges against companies and individuals in four separate cases involving ICOs. At least a dozen companies put their offerings on hold after the agency raised questions, an SEC official said in February
- Chair Clayton has also expressed concern with recent instances of public companies, with no meaningful track record in pursuing distributed ledger or blockchain technology, changing their business models and names to reflect a focus on distributed ledger technology without adequate disclosure to investors about their business model changes and the risks involved
  - Suspension of trading in publicly traded stocks that fit this profile (Longfin)

William Hinman's Statements on the SEC's View of Virtual Currencies

On June 14, 2018 William Hinman, Director of the Division of Corporation Finance, gave a speech purportedly reflecting the SEC's current view on virtual currencies, which made two distinctly important points

1. Ether is not a security: the Ethereum network has become sufficiently decentralized even if ether may have been when it was initially sold
    - "And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value."
2. Mr. Hinman gave support to the "magic frog" theory – the idea that tokens can begin their lives as securities and then morph into placeholders of consumption rights as the network is sufficiently developed or decentralized
    - "'Can a digital asset that was originally offered in a securities offering ever be later sold in a manner that does not constitute an offering of a security? . . . But what about cases where there is no longer any central enterprise being invested in or where the digital asset is sold only to be used to purchase a good or service available through the network on which it was created? I believe in these cases the answer is a qualified 'yes.'"

Splitting the Magic Frogs

There are broadly two cases of tokens that may start as a security when offered in an ICO and subsequently lose this status later on

1. Fully decentralized ecosystem, which is not owned, maintained, or managed by any person or company; it is self-maintaining; the tokens allow for the use of the system and create incentives to maintain it
    - One example of this case is Ether (ETH) (perhaps it started as a security when the ICO was issued to raise money for the building of the Ethereum platform, but has since ceased to be one now that it is a fully independent decentralized network)
    - Another prominent case is Filecoin, which again involves a decentralized ecosystem that will not be owned or managed by anyone (in this case, the tokens were sold under Regulation D using a SAFT)
    - **Mr. Hinman**: "Over time, there may be other sufficiently decentralized networks and systems where regulating the tokens or coins that function on them as securities may not be required. And of course there will continue to be systems that rely on central actors whose efforts are a key to the success of the enterprise. In those cases, application of the securities laws protects the investors who purchase the tokens or coins."

Splitting the Magic Frogs (Cont'd)

2. Genuine utility tokens, i.e., an entrepreneur has an idea for a product and raises money for that product by pre-selling through tokens, which in the meantime can be sold on a secondary market
    - The degree to which the token represents a consumption right rather than a tradeable investment on the secondary market seems to be the key
    - This may also turn on the continued involvement of management
    - Ripple, which uses tokens to facilitate money transfers and international settlements, presents an interesting borderline case
    - **Mr. Hinman**: "Central to determining whether a security is being sold is how it is being sold and the reasonable expectations of purchasers . . . As an investor, the success of the enterprise – and the ability to realize a profit on the investment – turns on the efforts of the third party. So learning material information about the third party – its background, financing, plans, financial stake and so forth – is a prerequisite to making an informed investment decision."

Where Is This Headed?

- There is little doubt that initial coin offering mania has cooled since last year, likely in response to SEC statements and enforcement actions
- Many coin offerings continue to operate as they initially have; from offshore locations, to offshore buyers
  - Interestingly, very few of the ICO whitepapers we have analyzed make references to US securities laws, and even fewer to compliance with Regulation S
- Still, it is foreseeable that one or more entities or actors will eventually "crack the code" and design a trading platform and methodology for completing ICOs in compliance with federal and applicable state law; at this point, the potential value proposition seems too high to be ignored
- Recent federal and state pronouncements and enforcement actions seem to have convinced many in the space that a "culture of compliance" is required; "going fast and breaking things" is unlikely to work when it comes to federal law

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Law Enforcement and Regulatory Risks Posed by Virtual Currencies

Legal and Regulatory Risks Posed by Virtual Currencies

- Many of the characteristics that have fueled the explosive growth of virtual currencies in recent years are also reasons why they have proven especially popular with criminal actors
- Even legitimate actors within the virtual currency realm may be vulnerable to the risks imposed by bad actors seeking to use virtual currency to promote or conceal criminal activity
- Types of money laundering laws applicable to virtual currency operators:
  - Criminal Laws (18 U.S.C. §§1956, 1957, 1960)
  - Forfeiture Laws (18 U.S.C. §§ 981, 982)
  - Regulatory Requirements (31 C.F.R. Chapter X)

Evolving Regulatory Approach: Early FinCEN Activity

2011: FinCEN issues Final Rule amending the definition of "money transmission services" to include those who transmit "other value that substitutes for currency"

2013: FinCEN issues specific guidance explaining applicability of BSA to parties involved in the transmission of virtual currencies

- Defines three classes of virtual currency actors with distinct regulatory consequences:
  - Users
  - Exchangers
  - Administrators

Evolving Regulatory Approach: The Ripple Labs Settlement

2015: Ripple Labs and subsidiary XRP II enter settlement with FinCEN and the Northern District of California USAO arising from the companies' failures to comply with BSA requirements

- Settlement includes $700,000 penalty and requires Ripple/XRP to take remedial actions to improve AML compliance

"Virtual currency exchangers must bring products to market that comply with our anti-money laundering laws. Innovation is laudable but only as long as it does not unreasonably expose our financial system to tech-smart criminals eager to abuse the latest and most complex products."

-FinCEN Director Jennifer Shasky Calvery, May 5, 2015

Evolving Regulatory Approach: The BTC-e Case

- BTC-e was a leading virtual currency exchange founded in 2011 that dealt in a variety of currencies
- Multi-agency investigation by FinCEN, DOJ/USAO, IRS-CI, FBI, Secret Service, HSI and FDIC into use of BTC-e by criminal actors and ties to cyberattacks, including attack on Mt. Gox and ransomware attacks
- July 2017: FinCEN/DOJ announce enforcement action against BTC-e, the first against a foreign MSB
  - $110 million civil money penalty against BTC-e
  - $12 million penalty against founder Alexander Vinnik
  - 21-count criminal indictment against Vinnik
- Implications of BTC-e enforcement action for financial institutions

"We will hold accountable foreign-located money transmitters, including virtual currency exchangers, that do business in the United States when they willfully violate U.S. AML laws. Today's action should be a strong deterrent to anyone who thinks that they can facilitate ransomware, dark net drug sales, or conduct other illicit activity using encrypted virtual currency."

-Jamal-El Hindi, Deputy Acting Director, FinCEN
July 26, 2017

BTC-e
Bitcoin Exchange

Evolving Regulatory Approach: Other Recent Developments

November 2017: Kenneth Blanco, former Acting Assistant Attorney General of the Criminal Division, named head of FinCEN

February 13, 2018: FinCEN responds to letter from Sen. Ron Wyden regarding BSA/AML regulations as applied to ICOs

- Complex regulatory overlap between FinCEN, SEC, and CFTC
- Inter-agency task force to delineate respective agency responsibilities

February 26, 2018: Deputy Attorney General Rod Rosenstein announces development of a "comprehensive strategy" for regulating and conducting enforcement actions relating to virtual currency

- Involvement of numerous law enforcement agencies
- Emphasis on training and skills development

Evolving Regulatory Approach: Changes in Regulator Posture

The tone with which officials discuss the virtual currency landscape has shifted as virtual currencies and blockchain technology have become more sophisticated and more widely accepted and used

"[O]ur current regulatory framework for decentralized virtual currencies, which guards the entryways and exits into the virtual world, provides sufficient oversight. . . virtual currencies have yet to overtake more traditional methods to move funds internationally, whether for legitimate or criminal purposes."

-Jennifer Shasky Calvery, Director, FinCEN, March 18, 2014

"We have see virtual currency exploited to support billions of dollars in what we could consider suspicious activity . . . FinCEN believes virtual currency presents specific illicit finance risks and that without vigilance and action, the scale of this activity could grow."

-Thomas P. Ott, Associate Director, Enforcement Division, FinCEN, June 20, 2018

THEN

NOW

"Exploitation by malicious actors is a problem faced by all types of financial services and is not unique to virtual currency systems. Although malicious actors have utilized emerging technologies to further their criminal schemes, the Department has thus far been able to apply existing tools to ensure vigorous prosecution of these schemes."

-Mythili Raman, Acting Assistant Attorney General, Nov. 18, 2013

"[C]riminals are also increasingly using virtual currency to perpetrate fraud schemes and conceal the proceeds. . . Criminals also use sophisticated tools, such as encryption, the dark web, and virtual currency to shield their identities from law enforcement . . .The crimes often span many jurisdictions, with no one District readily able to see the full scope of the scheme.

-Rod Rosenstein, Deputy Attorney General, May 23, 2017

Current Regulatory Priorities and Trends

- Emphasis on cooperation among federal, state, local, and international law enforcement and regulatory agencies
- Partnerships between law enforcement and private-sector actors
- Training law enforcement and regulatory personnel in virtual currency issues
- Emphasis on attracting and retaining law enforcement personnel with subject-matter expertise in this area
- Adaptation of statutory and regulatory framework to keep up with new technological developments, including rise of anonymity-enhanced currencies

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Banking Law

Banking Law Topics

- New York Trust Company Charters
- Limited Purpose Trust Companies and Virtual Currency
- BitLicense Regulation
- Many Banks' Concerns with Virtual Currencies
- Bank Support of Virtual Currencies
- Fintech Charter?

New York Trust Company Charters

Trust company as defined by New York Banking Law

- As defined in Section 2(2) and Article 3 of the New York Banking Law, a trust company is a financial institution that has the legal authority to make loans and transmit money but also to act as a fiduciary
- Such fiduciary powers include acting as trustee, custodian, or fiscal agent
- Required capital varies depending on statutory and regulatory minimums

What is a Limited Purpose Trust Company?

- Limited purpose trust companies were authorized as a response to the "paper crisis" in the securities industry in the early 1970s. Applicants were required to "demonstrate to the satisfaction of the Banking Board that public convenience and advantage would be promoted by the new facility."
- Restrictions include not being able to make loans or take deposits
- A trust company charter allows Fintech companies to avoid getting money transmitter licenses while maintaining less capital than a deposit-taking bank

Limited Purpose Trust Companies and Virtual Currency

New York Department of Financial Services (NYDFS) grants trust company charter to itBit

- On May 7, 2015, Bitcoin exchange "itBit" became the first virtual currency company to receive a New York trust company charter
- NYDFS conducted an extensive review of itBit's application, including with respect to consumer protection, cybersecurity, anti-money laundering, and capital
- The charter allows itBit exemptions from the money transmitter licensing schemes of many states
- With this license, itBit has regulatory oversight from NYDFS; it has also maintains accounts at an FDIC-insured bank, allowing customers FDIC-insurance for cash deposits

Gemini receives a limited purpose trust company license

- On October 5, 2015, NYDFS granted a charter to Gemini Trust Company to engage in bitcoin exchange
- Its customers may buy purchase and sell virtual currency for U.S. dollars and vice versa
- Gemini offered trading of Zcash, Litecoin, Bitcoin and other emerging virtual currencies

BitLicense Regulation

New York: what is a BitLicense?

- NYDFS may also grant a BitLicense to companies engaged in virtual currency activities
- Anyone engaging in virtual currency transmission, storing virtual currency, buying and selling or performing exchange functions on virtual currency, or issuing a virtual currency may obtain a BitLicense
- On September 24, 2015, Circle, a bitcoin wallet, became the first company to receive a BitLicense from NYDFS
- Square, a fintech company, has received the seventh and most recent Bitlicense
  - It offers New York customers the ability to buy and sell Bitcoin through a cash app
- Other firms that currently have BitLicenses: Coinbase, Xapo, Genesis, bitFlyer, XRP II

Many Banks' Concerns with Virtual Currencies

Why virtual currency exchanges have difficulties with banks

- Banks are highly-regulated and critical to the money supply
  - The U.S. dollar is both a medium of exchange and store of value long recognized by central banks
  - Bitcoin and other virtual currencies are more volatile on both accounts
- Digital currencies are decentralized and deregulated
  - Their value can fluctuate widely based on the market, derivatives and futures, and the value of other virtual currencies
  - They are also more susceptible to money laundering, fraud, and price manipulation
- Banks are worried that virtual currency is too volatile, lacks a centralized governing authority, and may be used for criminal activities
  - But in our modern world, people use physical cash less frequently and prefer to transfer funds through digital apps and mediums
- JPMorgan Chase, Bank of America, Citigroup, Capital One Financial, and Discover Financial Services have prohibited customers from buying bitcoin with credit cards

Bank Support of Virtual Currencies

Some Wall Street banks are embracing bitcoin

- Goldman Sachs has announced it is planning to launch a bitcoin trading operation
- Goldman will trade with clients using non-deliverable forward contracts linked to the price of bitcoin
- Goldman will not be buying and selling spot bitcoin until it obtains regulatory approval

Smaller banks are profiting from virtual currency businesses

- With major banks shunning virtual currency, the market has opened for smaller banks
- Silvergate Bank, Cross River Bank, and Metropolitan Bank are all offering premium virtual currency banking solutions
  - Silvergate Bank's asset base has grown from $978 million to more than $1.9 billion, its growth the result of virtual currency firms currently supported by the bank
  - These banks are offering virtual currency startups banking services and support
  - Similarly, Metropolitan Bank's revenue tripled in 2017 from the previous year because of its virtual currency business

Fintech Charter?

The Office of the Comptroller of the Currency (OCC) is considering expanding its authority to issue national charters for FinTech firms

- In December 2016, outgoing Comptroller of the Currency Thomas Curry announced that the OCC was considering expanding the national charters that could be issued, particularly for FinTech firms
- Curry's announcement was controversial with lawsuits being filed against the OCC
- Such a charter could benefit virtual currency exchanges in the same manner as a New York limited purpose trust company charter
- The OCC is expected to make a final decision on the FinTech charter soon
- Even without a FinTech charter, the OCC has the authority to grant trust company charters for institutions seeking to exercise fiduciary powers

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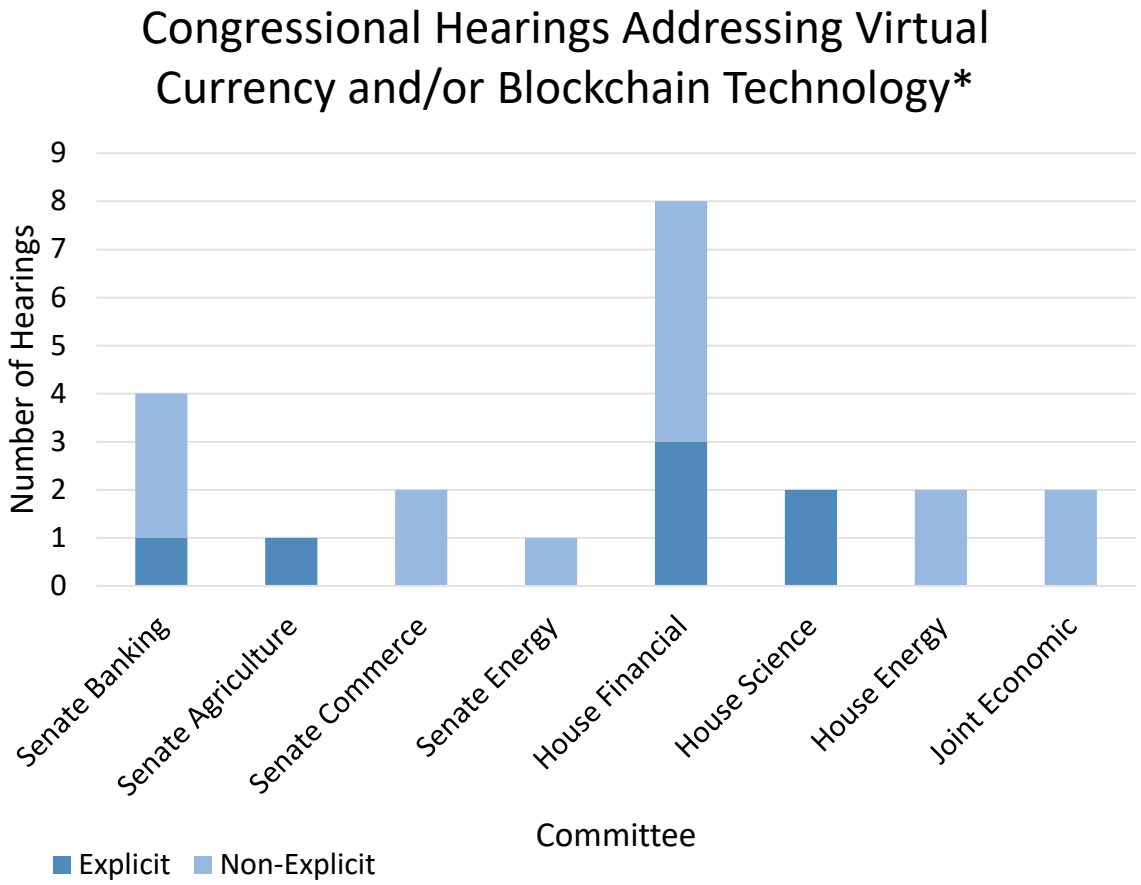
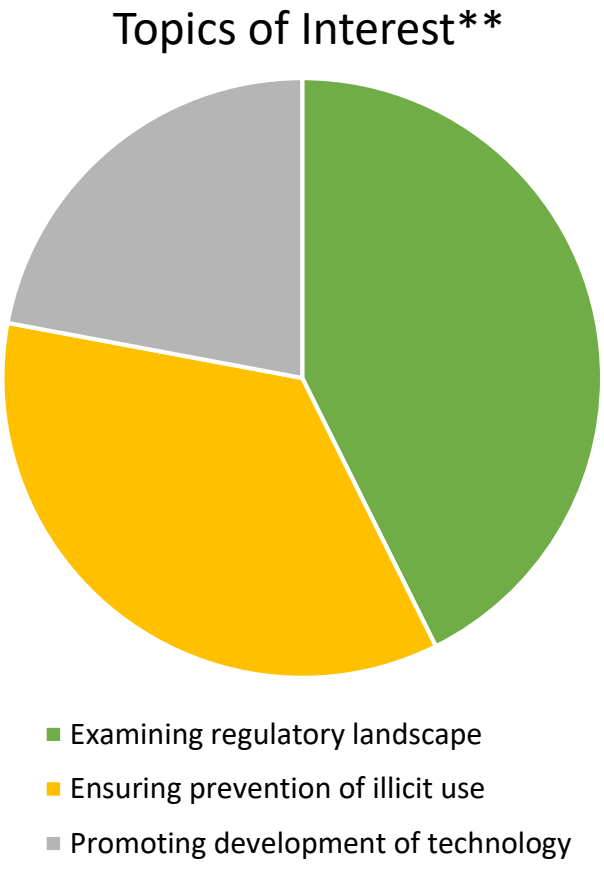
Legislative Developments

Virtual Currency and Blockchain Technology: Activity in the 115th Congress





*There were 7 hearings in the 1st Session of the 115th Congress and there have been 15 hearings in the 2nd Session as of June 20, 2017

**Based on an approximation of # of questions asked by Congressmen at hearings (not including introductory remarks/witness testimony)

Virtual Currency and Blockchain Technology: Legislation in the 115th Congress

Bill(s)	Sponsor(s)	Status	Topic	Purpose
S. Amdt. 1055	Sen. Portman (R-OH)	**Enacted**		Amends the National Defense Authorization Act for 2018, H.R. 2018 "to require a report on cyber applications of blockchain technology"
S.722 H.R. 3100 H.R. 3321 H.R. 3203 **H.R. 3364**	Sen. Bob Corker (R-TN) Rep. Krysten Sinema (R-AZ) Rep. Ted Budd (R-NC) Rep. Eliot Engel (D-NY) Rep. Edward Royce (R-CA)	Passed Senate 6/15/17 Introduced 6/28/17 Introduced 7/20/17 Passed House 1/9/18 **Enacted** 8/2/17		Requires the executive branch to "develop a national strategy for combating the financing of terrorism and related forms of illicit finance"; including conducting analysis of "emerging illicit finance threats" including "cryptocurrencies"
H.R. 2433 H.R. 5664	Rep. Kathleen Rice (D-NY) Rep. Kathleen Rice (D-NY)	Passed House 5/16/17 Introduced 4/27/18		Requires executive to assess terrorism threats posed by virtual currencies
H.R. 5227	Rep. Mark Meadows (R-NC)	Introduced 3/8/17		Requires executive to develop a strategy with respect to virtual currencies "and other related emerging technologies" being used to evade sanctions, finance terrorism, launder money, threaten national security
H.R. 6069	Rep. Juan Vargas (D-CA)	Introduced 6/12/18		Requires study of how virtual currencies are financing "sex trafficking or drug trafficking"
H.R. 2219	Rep. Edward Royce (R-CA)	Passed House 4/10/18		Amends the Victims of Trafficking and Violence Protection Act of 2000 to add the Secretary of the Treasury to task force; requires recommendations to changes in law if necessary to combat use of virtual currencies in human trafficking
H.R. 3708	Rep. David Schweikert (R-AZ)	Introduced 9/7/17		Amends the IRC "to exclude from gross income de minimis gains from certain sales or exchanges of virtual currency"
H.R. 4530	Rep. Frank Pallone (D-NJ)	Introduced 12/4/17		Providing that persons are not subject to federal liability for lawful state gambling; includes virtual currencies in definition of "bet or wager"

Virtual Currency and Blockchain Technology: Nascent Issue on the Hill

- **115th Congress: focused on understanding the issues**

"Problem is a lot of people up here with white hair, without hair, or people that have been around for a while don't even understand what they're talking about. And we worry that too much government could kill this thing before it can grow into something that's very good for our economy."

– Rep. Tom Emmer (R-MN) referring to cryptocurrencies and blockchain technologies at the HFS Subcommittee on Capital Markets Hearing on Oversight of the SEC's Division of Enforcement on May 16, 2018

- **116th Congress: perhaps focused on passing legislation**
  - At least two representatives are currently drafting legislation focused on clarifying the regulatory landscape surrounding ICOs

Rep. Warren Davidson (R-OH)

Rep. Carolyn Maloney (D-NY)

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International and State Developments

International and State Developments

Global and Transnational Regulation: Transatlantic Focus on Cooperation
Asia Tightens Virtual Currency Regulation in 2018
Major U.S. State Law Developments

Global and Transnational Regulation

The trend for virtual currency in 2018 is increased regulation and cooperation amongst nation states

- At a G20 meeting in March 2018, leaders from the member nations present announced that they would submit specific recommendations by July 2018 on what actions to take regarding virtual currency
- Nations present at the meeting included, among others: United States, United Kingdom, Argentina, Australia, Brazil, Canada, China, France, Germany, India, Italy, Russia and Mexico.
- The G20 also pledged to apply to its actions on virtual currencies the standards set under the Financial Action Task Force (FATF), which is an intergovernmental body created to combat terrorist financing and money laundering
- The G20 noted that its actions will address the risks posed by virtual currencies on investors, the world economy and crime

Despite Brexit, the UK and European Union are united in their plans to regulate virtual currencies

- In December 2017, the UK Treasury and EU made plans for ending anonymity of virtual currency traders, crackdowns on tax evasion and fighting money laundering
- The vice president of the European Commission, Valdis Dombrovskis, stated: *"There are clear risks for investors and consumers associated to price volatility, including the risk for complete loss of investment, operational and security failures, market manipulation and liability gaps."*

Asia Tightens Virtual Currency Regulation

Japan

- In April 2017, Japan passed a law recognizing bitcoin as legal tender and, in September 2017, Japan's Financial Services Agency (JFSA) recognized 11 companies as registered virtual currency exchange operators
- But on January 26, 2018, the Japanese Exchange Coincheck Inc. was hacked, resulting in the loss of $530 million worth of NEM coins; this hacking has prompted the JFSA to issue tighter regulations and implement closer oversight

China

- China has banned offshore virtual currency exchanges and ICO websites
- In contrast, China seems to be opening up to blockchain technology; in May 2018, President Xi Jinping noted that blockchain is a *"technological revolution"*
- In June 2018, the Chinese central bank developed a system to issue blockchain-based checks rather than paper ones

South Korea

- Discord amongst Korean officials over virtual currency regulation caused a market-wide sell-off of virtual currencies in January 2018 and since that time the country has passed a rule prohibiting virtual currency traders from trading anonymously

Major U.S. State Law Developments

Uniform Regulation of Virtual Currency Businesses Act ("URVCBA")

- A model law approved by the Uniform Law Commission ("ULC") in 2017 provides states with a framework for regulation of persons engaged in "virtual currency business activity"
- URVCBA provides a licensing structure for companies engaged in exchanging, storing, or transferring virtual currencies and includes a registration for virtual-currency businesses that handle more than $5,000 per year
- To date, it has been introduced in three states (Connecticut, Hawaii, and Nebraska)

New York "BitLicense"

- Pursuant to the New York State Administrative Procedure Act ("SAPA") Part 200. Virtual Currencies regulations, any persons involved in "virtual currency business activity" in New York must obtain a BitLicense
  - "Virtual currency business activity" is defined as "[1] receiving virtual currency for transmission or transmitting virtual currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of virtual currency; [2] storing, holding, or maintaining custody or control of virtual currency on behalf of others; [3] buying and selling virtual currency as a customer business; [4] performing exchange services as a customer business; and [5] controlling, administering, or issuing a virtual currency."
- To receive a BitLicense, an applicant must complete a 30-page application and pay a $5,000 fee
- The regulation has been subject to much criticism among crypto-enthusiasts

Other States

- Legislation has been introduced in California that would require companies that store, transmit, exchange, or issue digital currencies to enroll in a "Digital Currency Business Enrollment Program with a $5,000 fee. Banks, licensed money transmitter and merchants using virtual currencies as a means of payment would be exempt (CA AB 1123)
- New Jersey has proposed legislation that would require virtual currencies businesses to conform with certain regulations, security measures and consumer protections (NJ AB 1906); Vermont has also proposed regulation of virtual currencies that would include a $0.01 tax per transaction on virtual currency businesses (VT SB 269)

Major U.S. State Law Developments (Cont'd)

Money Transmitter Regulation

- Some states have sought to regulate virtual currency businesses through existing laws that apply to money transmitters
  - Washington state passed a law that subjects virtual currency businesses to money transmitter awls (WA SB 5031); Colorado has proposed a similar law (CO HB 1220)
  - Wyoming has taken the lead as the most crypto friendly state explicitly exempting virtual currencies from money transmitter laws (WY HB 19); it has also exempted "utility tokens" from the state's securities regulations as long as the cryptocurrency meets certain requirements (WY HB 70)
- New Hampshire has also passed a law exempting virtual currencies from money transmitter regulations

Other Forms of Regulation

- States have also used the tax system to regulate incentives for virtual currency businesses
  - New Jersey has proposed a bill that would allow payment of state taxes in virtual currencies (NJ AB 1906); Connecticut has proposed legislation that would impose a transaction tax on virtual currencies (CT HB 5001); Wyoming has exempted virtual currencies from state property tax laws (WY SF 111)
- Some states have proposed or enacted legislation allowing for payment of state services in virtual currencies
  - Arizona (AZ SB 1091), Georgia (GA SB 464), Illinois (IL 5335), New Jersey (NJ AB 1906), and New York (NY AB 9782) all fall in this category
- Concern over fraud has also led some states to pass legislation to address this
  - Florida has passed legislation prohibiting money laundering of virtual currency (FL HB 1379); Nebraska has followed suit (NE LB 691)
  - Hawaii's Commissioner of Financial Institutions dictated that companies transmitting or handling virtual currencies are in violation of money transmitter laws; however a proposed bill seeks to reverse this (HI SB 2853)

Overall

- Bitcoin Market Journal ranks state regulations for virtual currencies as "friendly," "murky," "hostile," or "no opinion"; as of May 29, 2018, the site counted 14 states as "friendly," 14 states as "murky," 14 states as "no opinion," and 8 states (including New York) as "hostile"

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Professional Profiles

Arthur S. Long

200 Park Avenue, New York, NY 10166-0193
Tel: +1 212.351.2426
ALong@gibsondunn.com

Arthur S. Long is a partner in the New York office of Gibson, Dunn & Crutcher, where he is a Co-Chair of Gibson Dunn's Financial Institutions Practice Group and a member of the Securities Regulation Practice Group. Mr. Long focuses his practice on financial institutions regulation, advising on the regulatory aspects of M&A transactions; bank regulatory compliance issues; Dodd-Frank issues, including the regulation of systemically significant financial institutions (SIFIs) and related heightened capital and liquidity requirements; resolution planning; and Volcker Rule issues with respect to bank proprietary trading and private equity and hedge fund operations. In addition, Mr. Long has significant experience with bank securities offerings, issues particular to foreign banks operating or seeking to operate in the United States, and state and federal regulations relating to virtual currency.

Mr. Long is ranked as a leading lawyer in Banking and Financial Services Regulation by *Chambers USA: America's Leading Lawyers for Business*. *Chambers* describes Mr. Long as "an outside-the-box thinker" and "a relentless worker" who is "careful and creative with difficult issues in both financial services law and corporate law."

Among Mr. Long's recent publications are "The New Corporate Governance Rules for Significant Foreign Banks Operating in the United States" in *Risk, Governance & Compliance for Financial Institutions 2015*, *The Financial Services Regulation Deskbook*, the Practising Law Institute treatise on the Dodd-Frank Act, and "The New Autarky? How U.S. and UK Domestic and Foreign Banking Proposals Threaten Global Growth," a Policy Analysis of The Cato Institute..

Mr. Long advised Banco Santander, S.A. in connection with its acquisition of Sovereign Bancorp, Inc., which resulted in protested applications to the Federal Reserve Board, the Office of Thrift Supervision and the New York State Banking Department. He also advised one of the first-round filing international banks on its resolution plan required by Section 165 of the Dodd-Frank Act.

Mr. Long served as law clerk to U.S. Supreme Court Justice Clarence Thomas from 1997 to 1998, and to Judge J. Michael Luttig of the U.S. Court of Appeals, Fourth Circuit from 1993 to 1994. In 1993, he graduated *magna cum laude* from Harvard Law School, where he served as the Supreme Court Editor for the *Harvard Law Review*. He received his A.B. *magna cum laude* from Harvard College in 1989.

Jeffrey Steiner

1050 Connecticut Avenue, N.W., Washington, DC 20036-5306
Tel: +1 202.887.3632
JSteiner@gibsondunn.com

Jeffrey L. Steiner is counsel in the Washington, D.C. office of Gibson, Dunn & Crutcher. He co-leads the firm's Derivatives team and is co-lead to the firm's Digital Currencies and Blockchain Technology team. Mr. Steiner is also a member of the firm's Financial Institutions, Energy, Regulation and Litigation, Investment Funds and Public Policy practice groups. Mr. Steiner advises a range of clients, including commercial end-users, financial institutions, dealers, hedge funds, private equity funds, clearinghouses, industry groups and trade associations on regulatory, legislative and transactional matters related to OTC and listed derivatives, commodities and securities. He frequently assists clients with compliance and implementation issues relating to the Dodd-Frank Act, the rules of the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), the National Futures Association and the prudential banking regulators. He also helps clients to navigate through cross-border issues resulting from global derivatives requirements, including those resulting from the Dodd-Frank Act, the European Market Infrastructure Regulation (EMIR), the Markets in Financial Instruments Directive II (MiFID II) and the rules of other jurisdictions.

Mr. Steiner also advises clients on issues related to digital currencies and distributed ledger technology, including analyzing regulatory and enforcement matters relating to their implementation and use. He regularly works with clients on structuring products involving the use of cryptocurrencies and blockchain technology, including digital tokens and initial coin offerings (ICOs). He also analyzes the cross-border impacts relating to clients' use of digital currencies and blockchain technology.

Chambers Global: The World's Leading Lawyers for Business 2017 has again ranked Mr. Steiner as an international leading lawyer for his work in derivatives. *Chambers and Partners* has also ranked Mr. Steiner as a leading derivatives lawyer in its *Chambers USA: America's Leading Lawyers for Business Guide* from 2014-2018.

Mr. Steiner began his career in private law practice where he focused on representing clients on OTC derivatives, futures and commodities related matters, capital markets transactions and hedge fund formation.

Mr. Steiner is a frequent speaker and author on issues relating to the Dodd-Frank Act, the CFTC, digital currencies (e.g., Bitcoin) and blockchain technology. He graduated from Tulane Law School in 2004. While at Tulane Law School, he served as a Business Editor of the *Tulane Environmental Law Journal*. Mr. Steiner received his B.B.A. in 2001 from Emory University's Goizueta Business School.

J. Alan Bannister

200 Park Avenue, New York, NY 10166-0193
Tel: +1 212.351.2310
ABannister@gibsondunn.com

Alan Bannister is a partner in the New York office of Gibson, Dunn & Crutcher and a member of the Firm's Capital Markets, Global Finance and Securities Regulation and Corporate Governance Practice Groups.

Mr. Bannister concentrates his practice on securities and other corporate transactions, acting for underwriters and issuers (including foreign private issuers), as well as strategic or other investors, in high yield, equity (including ADRs and GDRs), and other securities offerings, including U.S. public offerings, Rule 144A offerings, other private placements and Regulation S offerings, as well as re-capitalizations, NYSE and NASDAQ listings, shareholder rights offerings, spin-offs, PIPEs, exchange offers, other general corporate transactions and other advice regarding compliance with U.S. securities laws, as well as general corporate advice. Mr. Bannister also advises issuers and underwriters on dual listings in the U.S. and on various exchanges across Europe, Latin America and Asia.

Mr. Bannister also regularly advises companies in connection with cross-border equity tender offers. In addition, he also advises companies and dealer-managers on liability management transactions (including debt tenders, exchange offers and consent solicitations). Further, he has extensive corporate and securities experience in connection with corporate restructuring, routinely advising companies, creditors and hedge funds in connection with debt exchange offers, high yield refinancing, rescue rights offerings and other capital infusions (and the related liquidity issues for such investments).

Mr. Bannister regularly advises U.S. and non-U.S. registrants on their reporting obligations under the U.S. Securities Exchange Act of 1934, their obligations under the Sarbanes-Oxley Act, the Dodd Frank Act and stock exchange corporate governance requirements, as well as (for U.S. registrants) advising on other Exchange Act issues relating to Regulation FD, Section 16 and the proxy statement requirements of Regulation 14A.

Mr. Bannister received his Juris Doctor, *summa cum laude*, from the University of Alabama in 1988, where he was a member of the Order of the Coif, articles editor for the *Alabama Law Review* and a Hugo Black Scholar. He received a B.S. (Accounting) from Auburn University in 1984. Alan is a member of the Board of Trustees for the University of Alabama School of Law Foundation, and is a frequent writer and speaker on securities laws matters.

Carl Kennedy

200 Park Avenue, New York, NY 10166-0193
Tel: +1 212.351.3951
CKennedy@gibsondunn.com

Carl E. Kennedy is Of Counsel in the New York office of Gibson, Dunn & Crutcher. He is a member of the firm's Financial Institutions, Energy, Regulation and Litigation, Securities Regulation and Corporate Governance, Investment Funds and Public Policy practice groups. Mr. Kennedy applies his prior financial services and government experience to assisting clients with myriad regulatory, legislative, compliance, investigative and litigation issues relating to the commodities and derivatives markets.

Prior to joining Gibson, Dunn & Crutcher, Mr. Kennedy was an Executive Director and Assistant General Counsel at J.P. Morgan Chase in its Corporate and Investment Bank Legal Department. In that role, he was responsible for providing legal advice and support to J.P. Morgan's macro markets and clearing businesses on a variety of legal and regulatory matters, including issues relating to the implementation of regulations promulgated under Title VII of the Dodd-Frank Act and other global derivatives regulatory reforms.

Prior to working at J.P. Morgan, Mr. Kennedy served as Special Counsel and Policy Advisor to Commissioner Scott O'Malia at the U.S. Commodity Futures Trading Commission (CFTC) where he advised the commissioner on a full range of legal, regulatory and policy matters before the CFTC. While also at the CFTC, Mr. Kennedy was Legal Counsel in the Office of the General Counsel where he played a key role in the commission's adoption of several rulemakings and guidance implementing the Dodd-Frank Act. Of note, Mr. Kennedy was the primary drafter of several CFTC rulemakings and guidance, including the cross-border application of the CFTC's swaps regulations, the CFTC's process for determining block trade thresholds for swaps and several privacy-related rulemakings under Title X of the act.

Earlier in his career, Mr. Kennedy was Legal Counsel at Managed Funds Association (MFA), which represents the hedge fund industry on U.S. and international legislative and regulatory policy issues. While at MFA, Mr. Kennedy primarily monitored, analyzed and commented on regulatory and legislative developments related to OTC derivatives reform, including advocacy leading up to the passage of the Dodd-Frank Act. Mr. Kennedy began his legal career in the business and tax practices at large law firms in Philadelphia and Washington, D.C.

Mr. Kennedy graduated in 2000 from both Temple University School of Law and Temple University School of Business receiving his JD and M.B.A. Mr. Kennedy received his B.A. in 1997 from Temple University graduating *Magna Cum Laude*. His bar admissions include Pennsylvania and the District of Columbia.

M. Kendall Day

1050 Connecticut Avenue, N.W., Washington, DC 20036-5306
Tel: +1 202.955.8220
KDay@gibsondunn.com

M. Kendall Day is a partner in the Washington, D.C. office of Gibson, Dunn & Crutcher. He is a member of the White Collar Defense and Investigations and the Financial Institutions Practice Groups. His practice focuses on internal investigations, regulatory enforcement defense, white-collar criminal defense, and compliance counseling for financial institutions, multi-national companies, and individuals.

Prior to joining Gibson Dunn in May 2018, Mr. Day spent 15 years as a white collar prosecutor with the U.S. Department of Justice (DOJ), serving most recently as an Acting Deputy Assistant Attorney General of the DOJ's Criminal Division, the highest level of career official in the Criminal Division. In this role, Mr. Day supervised more than 200 Criminal Division prosecutors and professionals tasked with investigating and prosecuting many of the country's most significant and high-profile cases involving allegations of corporate and financial misconduct. He also exercised nationwide supervisory authority over Bank Secrecy Act and money-laundering charges, deferred prosecution agreements and non-prosecution agreements involving financial institutions.

Mr. Day previously served as Chief of the Money Laundering and Asset Recovery Section of the DOJ's Criminal Division from 2014 to 2017 and as Principal Deputy Chief from 2013 to 2014. During his tenure, he supervised 90 lawyers and managed investigations involving global financial institutions and enforcement of anti-money laundering and sanctions laws. He also directed the Kleptocracy Initiative, an international corruption unit focused on safeguarding the U.S. financial system from foreign bribe and corruption proceeds.

From 2005 through 2013, Mr. Day served as a deputy chief and trial attorney in the Public Integrity Section of the DOJ. During his tenure at the Public Integrity Section, Mr. Day prosecuted and tried some of the Criminal Division's most challenging cases, including the prosecutions of Jack Abramoff, a Member of Congress and several chiefs of staff, a New York state supreme court judge, and other elected local officials. From 2003 to 2005, he served as an Honors Program Trial Attorney in the DOJ's Tax Division. Mr. Day also served overseas as the Justice Department's Anti-Corruption Resident Legal Advisor in Serbia.

Mr. Day clerked for Chief United States District Court Judge Benson E. Legg of the District of Maryland. He earned his J.D. from the University of Virginia School of Law, where he graduated in 2002 after winning first place in the Lile Moot Court Competition and being selected to receive the Margaret G. Hyde Graduation Award. He graduated with honors and highest distinction from the University of Kansas in 1999 with a B.A. in Italian Literature and Humanities.

Mr. Day is licensed to practice in the Commonwealth of Virginia.

Michael D. Bopp

1050 Connecticut Avenue, N.W., Washington, DC 20036-5306
Tel: +1 202.955.8256
MBopp@gibsondunn.com

Michael Bopp is a partner in the Washington, D.C. office of Gibson, Dunn & Crutcher. He brings his extensive government and private-sector experience to help clients navigate through the most difficult crises, often involving investigations as well as public policy and media challenges. He is a member of the Firm's White Collar Defense and Investigations and Crisis Management Practice Groups, where he chairs the firm's Congressional Investigations Subgroup. He also chairs the firm's Public Policy Practice Group and is a member of its Financial Institutions Practice Group.

Mr. Bopp's practice focuses on congressional, internal corporate, and other government investigations, public policy and regulatory consulting in a variety of fields, and managing and responding to major crises involving multiple government agencies and branches. BTI Consulting named Mr. Bopp to its 2018 BTI Client Service All-Stars list, recognizing the "lawyers who truly stand out as delivering the absolute best client service" as determined by a poll of corporate counsel.

Mr. Bopp has extensive experience representing clients in congressional, executive branch, and internal investigations. During more than a decade on Capitol Hill, Mr. Bopp led or played a key role in major investigations in both the Senate and House of Representatives, including four special investigations. In these capacities, he developed the strategy and set the agenda, and managed the discovery efforts for numerous investigations and orchestrated more than 100 committee hearings.

Mr. Bopp has extensive knowledge of both legislative and regulatory processes, as well as of the powers and authorities of Congressional committees and has testified as an expert on Congressional investigations before Congress. He currently chairs the ABA's Committee on Legislative Process and Congressional Investigations. His contacts are extensive and strong in both Republican and Democratic circles.

Mr. Bopp served as Legislative Director and General Counsel to Senator Susan Collins of Maine from 1999 to 2003. He was Chief Counsel to the Subcommittee on Oversight and Investigations of the Committee on Education and the Workforce in the U.S. House of Representatives from 1998 to 1999, where he investigated alleged improper activities undertaken by Teamsters' officials. Before that, he worked on the Congressional investigation of campaign finance abuses as senior investigative counsel to the House Committee on Government Reform and Oversight and as counsel for the Senate Committee on Governmental Affairs. He also previously served as counsel on the Senate Permanent Subcommittee on Investigations. Mr. Bopp served as outside general counsel to the campaign to re-elect Senator Susan Collins.

Mr. Bopp received his law degree *cum laude* from Harvard Law School where he was Articles Editor on the *Journal of Law and Public Policy*. He graduated *magna cum laude*, with honors, in public policy from Brown University.

Our Offices

Beijing
Unit 1301, Tower 1
China Central Place
No. 81 Jianguo Road
Chaoyang District
Beijing 100025, P.R.C.
+86 10 6502 8500

Brussels
Avenue Louise 480
1050 Brussels
Belgium
+32 2 554 70 00

Century City
2029 Century Park East
Los Angeles, CA 90067-3026
+1 310.552.8500

Dallas
2100 McKinney Avenue
Suite 1100
Dallas, TX 75201-6912
+1 214.698.3100

Denver
1801 California Street
Suite 4200
Denver, CO 80202-2642
+1 303.298.5700

Dubai
Building 5, Level 4
Dubai International Finance Centre
P.O. Box 506654
Dubai, United Arab Emirates
+971 (0)4 318 4600

Frankfurt
TaunusTurm
Taunustor 1
60310 Frankfurt am Main
Germany
+49 69 247 411 500

Hong Kong
32/F Gloucester Tower, The Landmark
15 Queen's Road Central
Hong Kong
+852 2214 3700

Houston
1221 McKinney Street
Houston, TX 77010-2046
+1 346.718.6600

London
Telephone House
2-4 Temple Avenue
London EC4Y 0HB
England
+44 (0) 20 7071 4000

Los Angeles
333 South Grand Avenue
Los Angeles, CA 90071-3197
+1 213.229.7000

Munich
Hofgarten Palais
Marstallstrasse 11
80539 Munich
Germany
+49 89 189 33-0

New York
200 Park Avenue
New York, NY 10166-0193
+1 212.351.4000

Orange County
3161 Michelson Drive
Irvine, CA 92612-4412
+1 949.451.3800

Palo Alto
1881 Page Mill Road
Palo Alto, CA 94304-1125
+1 650.849.5300

Paris
166, rue du faubourg Saint Honoré
75008 Paris
France
+33 (0) 1 56 43 13 00

San Francisco
555 Mission Street
San Francisco, CA 94105-0921
+1 415.393.8200

São Paulo
Rua Funchal, 418, 35°andar
São Paulo 04551-060
Brazil
+55 (11) 3521.7160

Singapore
One Raffles Quay
Level #37-01, North Tower
Singapore 048583
+65.6507.3600

Washington, D.C.
1050 Connecticut Avenue, N.W.
Washington, D.C. 20036-5306
+1 202.955.8500