

Beyond the Blockchain: Legal Challenges and Opportunities in the Era of Digital Assets

Web3 represents the next evolution of the internet, characterized by decentralized networks and blockchain technology, enabling user-centric platforms and applications with enhanced security and data ownership. Digital assets, a cornerstone of Web3, include cryptocurrencies, non-fungible tokens (“NFTs”) and other blockchain-based assets, offering novel methods of value exchange, investment and digital ownership. Every other week, Polsinelli puts out its **BitBlog Bi-Weekly**,ⁱ which breaks down the biggest legal developments in the blockchain, Web3 and crypto industry over the two preceding weeks.

Looking ahead, several discernible trends are surfacing that demand attention from companies actively involved in, contemplating entry into or indirectly influenced by the blockchain, Web3 and crypto sectors. The sphere of influence exerted by these emerging technologies extends far beyond the direct participants, potentially encompassing a broader range of industries and sectors than initially anticipated. This expanding impact underscores the importance for a wide array of businesses to stay informed and adapt to the evolving landscape of digital innovation.

Rise in Litigation in the Increasingly Legitimate and Valuable Industry

2023 saw an unprecedented amount of litigation in the industry, and we expect litigation will continue to rise in 2024. Thus far, the litigation has been primarily related to regulatory issues, with the three largest digital asset exchanges in the U.S. all currently subject to litigation with the Securities and Exchange Commission (“SEC”).ⁱⁱ Additionally, a conclusion is expected in the agency’s highly publicizedⁱⁱⁱ case against Ripple Labs, Inc., with both sides securing partial victories followed by a likely appeal after the decision is finalized. The high-profile criminal prosecutions and convictions of the former heads of FTX and Binance and others have dominated 2023 news, and 2024 will likely see other or related litigation.^{iv}

While regulatory litigation has been a constant in the industry, a new wave of private litigation is occurring and likely to increase, which can be expected, as industries in the billions have comparatively fewer economic incentives for litigation than do industries in the trillions, which the digital asset industry has risen into. After the digital asset market downturn in the spring of 2022, there was a wave of bankruptcy and insolvency filings and proceedings which will work

their way through the courts in 2024.^v We also expect continued growth in trademark and other intellectual property litigation,^{vi} as well as private securities^{vii} and ownership disputes.^{viii} As asset values go up, so do the incentives to incur litigation costs to resolve disputes over those increasingly valuable assets. With financial giants such as BlackRock and Fidelity^{ix} entering the crypto space through a range of exchange-traded funds and with the growing value and use of digital assets, we expect litigation will continue to rise into 2024. While these lawsuits will primarily involve traditional contract, statutory and tort legal issues which are not unique to digital assets, the knowledge of an attorney who is familiar with these assets and their unique features will be an essential factor in efficiently and successfully managing, addressing and resolving these lawsuits.

U.S. and International Regulation Specific to Digital Assets

Throughout the digital asset industry's growth thus far, digital assets have been forced to fit within general regulatory frameworks surrounding traditional securities and commodities. These existing regulations were designed for use of intermediary reporting mechanisms, do not address tax issues specific to barer assets like digital assets and have a variety of other shortcomings when applied to digital assets.

In short, this has led to square-peg-round-hole issues when it comes to regulating crypto. The new risks that digital assets introduce are not adequately addressed by the general regulatory framework for traditional securities and commodities. Additionally, certain historical risks which digital asset technology eliminates are also not acknowledged or reflected. As aptly stated during a congressional hearing on digital assets: "Shouldn't we take seriously the possibility that algorithms and open-source software that take a measure of human error, greed, negligence, fraud, and bias out of the system might make the system better on net even if there are some new risks that need to be examined and understood?"^x

In the U.S., the biggest issue has been, and will continue to be in 2024, the SEC's treatment of digital assets as if they were traditional securities and thus the lack of specific rulemaking for digital assets, which are not traded or used in the ways traditional securities are traded or used. That is an issue which has been thoroughly written about.^{xi} Furthermore, the SEC has recently rejected a request for rulemaking on this subject^{xii} while other jurisdictions have moved forward with comprehensive digital asset regulations. It is expected that the U.S. will follow this trend to some extent in 2024.

In 2023, the European Union ("EU") passed legislation titled Markets in Crypto Assets ("MiCA") designed to govern the cryptocurrency market within its member states.^{xiii} The primary objective of MiCA is to provide a harmonized set of rules across the EU for crypto assets, aimed at promoting innovation while ensuring consumer protection, market integrity and financial stability. In the U.S., two bills regarding digital assets proceeded on a bipartisan vote through the House Financial Services Committee: the Financial Innovation and Technology ("FIT") for the 21st Century Act^{xiv} and the Clarity for Payment Stablecoins Act of 2023.^{xv} In the Senate, the Lummis-

Gillibrand Responsible Financial Innovation Act¹ and the Digital Asset Anti-Money Laundering Act² were introduced, but neither passed through committee.

While none of these digital asset bills passed through Congress in 2023, that was more attributable to the general congressional backlog than to lack of motivation to get digital asset legislation passed. With fierce industry proponents (such as House Financial Services Chair Patrick McHenry) and detractors (such as Senate Banking Committee Chair Elizabeth Warren) making digital asset legislation a priority, we expect that some industry-specific legislation will be on the agenda in 2024. Additionally, with administrative agencies moving forward with formal rulemaking, such as the IRS's proposed digital asset broker rules^{xvi} and the Consumer Financial Protection Bureau's ("CFPB") proposed non-bank digital payment provider rules,^{xvii} we expect digital asset-focused regulation and legislation to come to the forefront in 2024.

Privacy Takes Center Role in Digital Assets

In the Executive Order on Safe, Secure, and Trustworthy Artificial Intelligence, President Biden emphasizes the need to "[s]trengthen privacy-preserving research and technologies, such as cryptographic tools to preserve individuals' privacy..."^{xviii} At the same time, there is ongoing litigation over the Department of Treasury's sanctioning of crypto mixing service Tornado.cash^{xix} and the criminal prosecution of one of its creators, Roman Storm.^{xx}

In the late 1990s, with the rise of email, there was also an attempt to regulate the publication and exportation of privacy-preserving cryptographic technologies so they wouldn't be used by terrorists and other bad actors to avoid government surveillance. The result of those laws and associated challenges was *Bernstein v. DOJ*,^{xxi} in which the Ninth Circuit recognized the proposition of "code-is-speech" and that any attempt to regulate the mere publication of computer code must pass the heightened scrutiny test required for government regulation of otherwise constitutionally protected speech.

While the ruling in *Bernstein* was for First Amendment protections, there is often overlooked *dictum* in the case, which states: "the government's efforts to retard progress in cryptography may implicate the Fourth Amendment, as well as the right to speak anonymously, the right against compelled speech, and the right to informational privacy."^{xxii}

The Bank Secrecy Act, the Patriot Act and a large number of the financial surveillance regulations currently in place are predicated on the assumption that people always need intermediaries to transact and thus surveillance can be done at the intermediary level. This is extended under the "third-party doctrine," which is the legal principle that a party lacks a reasonable expectation of privacy under the Fourth Amendment over information "revealed to a third party and conveyed [by that third party] to the Government authorities."^{xxiii}

¹ Digital Asset Anti-Money Laundering Act of 2023, S. 2669, 118th Cong. (2023).

² Lummis-Gillibrand Responsible Financial Innovation Act, S. 2281, 118th Cong. (2023).

While transfers of (most) cryptocurrencies occur on public and immutable blockchains, the records of which are available to all, these transactions are done through largely anonymous digital wallets free of any centralized intermediaries which could be regulated. Additionally, the creation of these wallets does not depend on any intermediary, and creation of a compatible digital wallet on most blockchain networks can be done with publicly available computer code and a random number generator.

We expect to see in 2024 an intense discussion and debate about whether the government can and should seek to impose financial surveillance at a more direct level and at an individual level, as opposed to the financial intermediary level consistent with historical practices. The rights of individuals to transact in digital assets through the use of privacy-preserving technologies such as zero-knowledge proofs, cryptocurrency mixing protocols, virtual private networks and anonymous digital wallets will be at the forefront of regulations and litigation in 2024.

Conclusion

The landscape of digital asset litigation and regulation is evolving rapidly, reflecting the dynamic nature of this burgeoning industry. As digital assets gain legitimacy and value, they attract more regulatory scrutiny and private litigation. The industry's fit within existing regulatory frameworks remains a square-peg-round-hole dilemma, particularly in the U.S. Internationally, however, strides are being made with comprehensive regulations like the EU's MiCA.

In the U.S., despite stalled legislation in 2023, there is a growing momentum for industry-specific laws and regulations in 2024, with key figures in Congress and various administrative agencies taking active roles. Privacy issues, particularly regarding transactions in digital assets, are set to take center stage, challenging traditional regulatory assumptions and possibly reshaping the legal landscape. This evolving regulatory and litigation environment underscores the need for specialized legal expertise in navigating the unique challenges and opportunities presented by digital assets.

ⁱ The BitBlog Bi-Weekly can be found every other week on Polsinelli's FinTech and Digital asset blog, available at <https://www.polsinellibitblog.com/>.

ⁱⁱ *SEC v. Coinbase, Inc.*, Case No. 1:23-cv-04738 (S.D.N.Y. June 6, 2023); *SEC v. Binance Holdings, Ltd.*, Case No. 1:23-cv-01599 (D.D.C. June 5, 2023); *SEC v. Payward, Inc.*, Case No. 3:23-cv-06003 (N.D. Cal. Nov. 20, 2023).

ⁱⁱⁱ Schmalfeld, Jonathan, [Will There Be a Ripple Effect? Federal Judge Rules Some Sales of XRP Were Not Securities Transactions](https://www.polsinellibitblog.com/new-blog/2023/7/20/will-there-be-a-ripple-effect-federal-judge-rules-some-sales-of-xrp-were-not-securities-transactions) (July 20, 2023) available at <https://www.polsinellibitblog.com/new-blog/2023/7/20/will-there-be-a-ripple-effect-federal-judge-rules-some-sales-of-xrp-were-not-securities-transactions>.

^{iv} *United States v. Samuel Bankman-Fried*, Case No. 22-CR-673 (S.D.N.Y. Dec. 13, 2022); *United States v. Changpeng Zhao*, Case No. CR23-179 (W.D. Wash. Nov. 21, 2023); *United States v. Braden John Karony*, Case No. CR23-433 (E.D.N.Y. Oct. 31, 2023).

^v Rutenberg, Stephen, [Blockchain & Cryptocurrency Laws and Regulations 2024 | False friends and creditors: The saga of recent crypto insolvencies](https://www.globallegalinsights.com/practice-areas/blockchain-laws-and-regulations/14-false-friends-and-creditors-the-saga-of-recent-crypto-insolvencies) (undated), available at <https://www.globallegalinsights.com/practice-areas/blockchain-laws-and-regulations/14-false-friends-and-creditors-the-saga-of-recent-crypto-insolvencies>.

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- ^{vi} *Yuga Labs, Inc. v. Ripps*, Case No. 2:22-cv-04355 (C.D. Cal. June 24, 2022).
- ^{vii} *Risley v. Universal Navigation, Inc.*, Case No. 1:22-cv-2780 (S.D.N.Y. April 4, 2022).
- ^{viii} *Anderson v. Consensus Systems, Inc.*, Index No. 655151/2023 (N.Y.S.C. Oct. 19, 2023).
- ^{ix} See iShares Blockchain and Tech ETF; Depository Trust and Clearing Corporation.
- ^x Statement of Brian Brooks, [Digital Assets and the Future of Finance: Understanding the Challenges and Benefits of Financial Innovation in the United States](#) (Dec. 8, 2021).
- ^{xi} Siera, Rodrigo, [Due to SEC Inaction, Registration is Not a Viable Path for Crypto Projects](https://policy.paradigm.xyz/writing/secs-path-to-registration-part-i) (March 23, 2023) available at <https://policy.paradigm.xyz/writing/secs-path-to-registration-part-i>.
- ^{xii} Gensler, Gary, [Statement on the Denial of a Rulemaking Petition Submitted on behalf of Coinbase Global, Inc.](https://www.sec.gov/news/statement/gensler-coinbase-petition-121523) (Dec. 15, 2023) available at <https://www.sec.gov/news/statement/gensler-coinbase-petition-121523>.
- ^{xiii} Regulation (EU) 2023/1114.
- ^{xiv} Financial Innovation and Technology for the 21st Century Act, H.R. 4746, 118th Cong. (2023).
- ^{xv} Clarity for Payment Stablecoins Act of 2023, H.R. 4766, 118th Cong. (2023).
- ^{xvi} Gross Proceeds and Basis Reporting by Brokers and Determination of Amount Realized and Basis for Digital Asset Transactions, Proposed Rule by IRS (Aug. 29, 2023), available at <https://www.federalregister.gov/documents/2023/08/29/2023-17565/gross-proceeds-and-basis-reporting-by-brokers-and-determination-of-amount-realized-and-basis-for>.
- ^{xvii} Defining Larger Participants of a Market for General-Use Digital Consumer Payment Applications, Proposed Rule by the CFPB, (Nov. 7, 2023) available at <https://www.consumerfinance.gov/rules-policy/rules-under-development/defining-larger-participants-of-a-market-for-general-use-digital-consumer-payment-applications/>.
- ^{xviii} Exec. Order No. 14110, 88 FR 75191 (Oct. 30, 2023).
- ^{xix} *Van Loon v. Dept. of Treasury*, Case No. 23-50669 (5th Cir. Nov. 13, 2023).
- ^{xx} *United States v. Roman Storm*, 23-CRIM-430 (S.D.N.Y. Aug. 23, 2023).
- ^{xxi} *Bernstein v. United States Department of Justice*, 176 F.3d 1132 (9th Cir. 1999).
- ^{xxii} *Id.* at 1146.
- ^{xxiii} *United States v. Miller*, 425 U.S. 435, 443 (1976).