

Top 10 Web3/blockchain legal developments of 2023

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FEBRUARY 6, 2024

The past year was neither the “the best of times nor the worst of times” for the development of the crypto/blockchain ecosystem (the “ecosystem”). In 2023, the crypto blockchain development landscape showcased both resilience and challenges. At the start of the year, Bitcoin’s price hit a two-year low, and the industry faced a crisis following the failure of FTX, a prominent crypto company.

However, as the year progressed, it became evident that 2023 could be seen as a pivotal year for crypto blockchain development.

Despite some setbacks in 2023, hopes are high that increased pricing and coherent regulation will attract investments into innovative projects, moving the industry closer to a more equitable, transparent, and efficient financial system.

Here are the top ten legal developments effecting the Web3 and blockchain ecosystem in 2023:

1. Summary judgment in *SEC v. Ripple* sends shockwaves through the ecosystem

Background: On June 13, a Motion for Summary Judgment Order in the *SEC v. Ripple*¹ case was released, with a ruling many in the industry have been advocating for: “XRP, as a digital token, is not in and of itself a contract, transaction, or scheme that embodies the *Howey* requirements of an investment contract.” (internal quotes omitted).

On August 9, the SEC requested leave to file an interlocutory appeal of the Court’s ruling, but that request was denied. This resulted in the SEC dismissing the remaining claims against Ripple, seemingly to clear the way to appeal the decision without needing to wait for a trial.

What this means for the ecosystem: Although this ruling was not a total loss for the SEC, it sent shockwaves through the blockchain ecosystem. This ruling was the first major loss by the SEC in digital asset cases and it demonstrated that the SEC’s current view — that virtually all digital assets are securities — is not unambiguously settled law.

As such, this ruling was likely a key factor in members of Congress calling for renewed efforts toward creating a workable digital asset regulatory framework in the United States. This ruling creates a split within the courts, leaving the industry with even less clarity as to when the contract underlying the offer and sale of a digital asset may be a security and whether the digital asset itself is a security under United States securities laws.

2. The European Union’s Markets in Crypto Assets (“MiCA”) passes

Background: After multiple delays, the European Union voted in favor of its Markets in Crypto Assets regulation (“MiCA”), which is the EU’s attempt at comprehensive digital asset regulations. The bill passed with 517 votes in favor and 38 against, with 18 abstentions, showing overwhelming support from the European participants in getting ahead of digital asset regulation.

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The bill gives fairly wide latitude to local authorities to adopt policies which fit their specific jurisdictions. Many believe that MiCA allows EU banks to get more involved in the digital asset space where previously the regulatory uncertainty prevented highly regulated banks from providing banking services to Web3/crypto participants or offering Web3/crypto focused offerings themselves.

What this means for the ecosystem: It is certainly a vote of confidence in the development of the blockchain ecosystem to have the world’s second largest economy poised to implement such comprehensive legislation. It would not be surprising to see developers flock to EU countries where they can gain some level of regulatory certainty.

Ireland is already trying to be a MiCA hotspot, with the country’s “Innovation Hub” courting Web3 businesses looking to do business in a compliant manner in the EU. The failure in the United State to pass comprehensive legislation while other jurisdictions move forward could have devastating effects on the growth of the industry domestically.

3. Sam-Bankman (“SBF”) Fried convicted of criminal fraud after FTX collapse

Background: The SBF trial started on October 3, 2023, and it was the biggest financial fraud trial since Bernie Madoff. SBF ended up

taking the stand in his own defense, and the trial resulted in many headline grabbing moments.

In the end, after weeks of trial it only took the jury a few hours to come back with a guilty verdict on all counts. These verdicts carry a maximum sentence of 110 years, with sentencing scheduled for March 28, 2024. It was announced that there will not be a second trial on the remaining campaign finance and other related charges.

The SEC has brought lawsuits against Coinbase, Inc., Binance Holdings Limited, and Payward Inc. (AKA, "Kraken"), representing the three most prominent digital asset exchanges in America.

What this means for the ecosystem: While this case wasn't uniquely crypto-related, it highlights the need to prevent fraud and mismanagement in crypto-adjacent companies. The FTX incident may spur the development of more decentralized exchanges. Trust in code with limited human intervention poses potential complications, but use of opensource software and algorithms may be able to take a measure of human error, greed, and fraud out of the system.

As stated in a blog post from the co-creator of Ethereum, "the crypto world is a perfect testbed environment to take its open and decentralized approach to security and actually apply it in a realistic high-stakes environment, and mature it to the point where parts of it can then be applied in the broader world."

4. SEC sues largest digital asset exchanges in America

Background: This year, the SEC brought lawsuits against Coinbase, Inc. ("Coinbase"), Binance Holdings Limited ("Binance"), and Payward Inc. (AKA, "Kraken"). These entities and the related entities named in the lawsuits represent the three most prominent digital asset exchanges in America. Earlier in the year, the SEC dropped allegations against a former Coinbase employee.

It is unclear what, if any, investor protection would have been achieved through that earlier lawsuit or many of the current lawsuits including against the publicly traded company Coinbase. Coinbase filed for an early dismissal through a request for judgement on the pleadings while the Binance entities filed their own motions to dismiss.

What this means for the ecosystem: The resolution of these cases will likely determine if it is practical to trade self-custodial digital assets in the United States in a legally compliant manner. While trading digital assets generally does not need centralized intermediaries, digital assets are still largely inaccessible to all but the most tech-savvy without some centralized intermediary and workable interface.

The fact that the SEC brought an action against Kraken despite earlier settlements shows that no exchange is safe against these agency lawsuits.

5. Digital asset regulation remains under consideration in Congress

Background: In 2023, digital asset regulation was actively discussed in Congress with the House Financial Services Committee setting up a sub-committee specific to digital assets. Two digital asset bills passed through the House Financial Services Committee on bipartisan votes: (1) the Financial Innovation and Technology ("FIT") for the 21st Century Act; and (2) the Clarity for Payment Stablecoins Act of 2023.

In the Senate, Senator Warren introduced the controversial Digital Asset Anti-Money Laundering Act, and the Lummis-Gillibrand Responsible Financial Innovation Act was introduced with neither being brought to a committee vote. Unfortunately, no digital asset focused bill of any substance was brought to a vote for Congress at large, and none is expected to pass in the immediate future.

What this means for the ecosystem: Given the SEC's refusal to provide rules for digital assets, Coinbase filed a mandamus action asking the Third Circuit to Order the SEC to respond to Coinbase's Petition for Rulemaking. This ended in the SEC denying Coinbase's request for agency rulemaking. Any form of legal clarity on digital assets' legal status in America will need to come from Congress or the courts.

While the FIT for 21st Century Act (previously known as the Digital Asset Market Structure Act) represents the most comprehensive and workable approach seen to-date, it would appear that industry participants will be left with another year in 2024 with no nationwide legislative framework to work under.

6. Grayscale finally clears the way for spot bitcoin ETF after appellate win

Background: For almost a decade, the SEC has rejected entreaties by major asset managers to approve an exchange-traded fund (ETF) that captures the spot value of Bitcoin. The rejections have all been due to some version of the SEC being unable to prevent deceptive practices.

However, on August 29 the Court of Appeals of the District of Columbia Circuit found that the SEC acted in an arbitrary and capricious manner when rejecting Grayscale's application to convert its Grayscale Bitcoin Trust into an ETF. This led to a flood of revised applications for Bitcoin ETFs, with the first approvals granted in January 2024.

What this means for the ecosystem: A Bitcoin ETF is one of the most direct paths to mainstream corporate adoption of BTC, at least as an investment. It will make it easier for fiduciaries such as benefit plan managers to get exposure to Bitcoin and allows registered investment advisers easy access to Bitcoin without needing a plethora of new policies pertaining to holding crypto, which could become extremely difficult if the SEC's proposed "Safeguarding Rule," is passed as currently drafted.

This ruling, along with the SEC's failure to appeal the ruling and approval of an Ether futures ETF, also makes it very difficult for the SEC to argue in good faith that ETH is or might be a security. This

level of digital asset accessibility could have extensive impacts in a lot of ways we can't yet predict.

7. Bankruptcy cases get closer to resolution of 2022's institutional collapses

Background: In 2022, a number of key institutional players in the crypto space collapsed, due to a cascade of bad business choices, excess borrowing, and, in some cases, outright fraud. These included Celsius Networks, Voyager Holdings, Three Arrows Corporation (3AC) and FTX.

Interestingly, none of these failures were the result of protocol failures, hacks, or even regulatory issues but rather primarily due to fraud, excess debt, and inadequate compliance. See our Chapter "False Friends and Creditors" in the Global Legal Insights 2023 Volume on Crypto Regulation.

What this means for the ecosystem: Over the course of 2023, these companies made progress working out their future and the fate of their creditors. An initial determination in the Chapter 11 cases that disappointed most creditors was the Courts' ruling that crypto assets deposited in these platforms became property of the debtors' bankruptcy estates, denying them the benefit of any increase in the price of these crypto assets after the filing date.

Several of these companies attempted to restructure their businesses, instead of simply liquidating underperforming their assets to repay creditors. These efforts have not succeeded to date with interference by the SEC being a crucial factor in their continued failure. However, the increased price of Bitcoin and Ether, while not directly affecting the claims of most creditors, does provide the debtors' estates with more assets to satisfy claims — and more to fight over.

8. LBRY shuts down after asset sales ruled to be unregistered sales of securities

Background: While the underlying ruling technically occurred in 2022, it wasn't until 2023 that the ruling in *SEC v. LBRY, Inc.*² was finalized. In July of 2023, the Court overseeing the matter refused to provide any relief to LBRY and allowed for the SEC to impose an injunction and civil fines against the entity.

After the ruling, the SEC lowered its requested damages from \$44 million to just over \$100,000 due in large part to the fact that LBRY did not have any further funds to cover a greater damages award. While LBRY initially filed a Notice of Appeal, due to lack of funding that appeal was abandoned and the company began to wind down.

What this means for the ecosystem: While *Ripple* represented a step forward for the industry, LBRY represented a step back. The decision to bring this case at all was widely criticized by SEC Commissioner Hester Peirce and others as LBRY, for the most part, tried to comply with SEC and other regulators. Particularly problematic for the industry are some controversial statements in *dicta*. However, the principle holding of this case is simply that utility alone not overcome a *Howey* test challenge.

LBRY follows a disturbing pattern of what appears to be regulators not focusing on entities trying to skirt the law, but instead trying to go after the lowest hanging fruit.

9. Binance and founder CZ settle with CFTC and DOJ

Background: On November 21, 2023 Binance and its CEO Changpeng Zhao ("CZ") admitted to violations of anti-money laundering laws along with sanctions violations and operating as an unlicensed money transmitter. As a part of the deal, CZ agreed to step down as CEO, have no involvement with Binance for three years, and Binance is required to appoint an independent compliance monitor for three years. Total fines and sanctions were just under \$4 billion.

In 2022, a number of key institutional players in the crypto space collapsed, due to a cascade of bad business choices, excess borrowing, and, in some cases, outright fraud. Interestingly, none of these failures were the result of protocol failures, hacks, or even regulatory issues but rather primarily due to fraud, excess debt, and inadequate compliance.

CZ will plead guilty to a single count under the Bank Secrecy Act, which carries a maximum sentence of five years. Due to various sentencing guidelines and downgrades, he is likely looking at a maximum of 18 months.

What this means for the ecosystem: This represented a clearing of the old guard of digital assets who brought out the widespread availability of digital assets but may have cut a few regulatory corners during the wild west of early crypto. The CFTC lawsuit had some damning internal communications which indicated that the company knew it was not abiding by known KYC/AML obligations.

The CFTC is calling the Binance settlement a template for compliance. Which may be true for FTC/CFTC/Criminal compliance, but since most other major exchanges are already KYC/AML compliant the issue remains the SEC, which was not a part of this settlement.

10. Tornado case sanctions and criminal charges raise questions on digital privacy

Background: In 2022, the U.S. Department of the Treasury's Office of Foreign Assets Control issued sanctions against digital asset mixing protocol Tornado.cash. Coinbase funded a challenge to those sanctions in the Western District of Texas, and Coin Center challenged the sanctions in the Northern District of Florida. Both lawsuits lost in the lower courts and are currently being appealed.

Additionally, the U.S. Attorney's Office for the Southern District of New York has brought criminal charges against Tornado Cash developers Roman Storm and Roman Semenov for the protocol's role in allegedly "more than \$1 billion in money laundering transactions" including transactions by certain North Korean hackers known as the Lazarus Group.

What this means for the ecosystem: These challenges raise important questions regarding the potential liability for developers of a neutral protocols it is illegally used by unrelated third parties. While neither of the sanctions lawsuits raised Fourth Amendment issues, the *dicta* in *Bernstein v. DOJ* may support such a challenge

and others have commented that the criminal charges go against FinCEN's own guidance.

Either way, these types of clashes can be expected to become more frequent as decentralized digital assets become more mainstream in a financial system which has long relied on centralized intermediaries for surveillance functions.

Notes

¹ *Securities and Exchange Commission v. Ripple Labs Inc. et al.*, No. 20-cv-10832, 2023 WL 4507900 (SDNY July 13, 2023).

² *Securities and Exchange Commission v. LRBY Inc.*, No. 21-cv-260, 2023 WL 4459290 (D.N.H. July 11, 2023).

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This article was first published on Westlaw Today on February 6, 2024.