ABA BUSINESS LAW HYBRID SPRING MEETING 2023

Blockchain, Smart Contracts, Crypto and Web 3.0 For Business Lawyers

Understanding the Technology and Key Legal Issues

April 28, 2023

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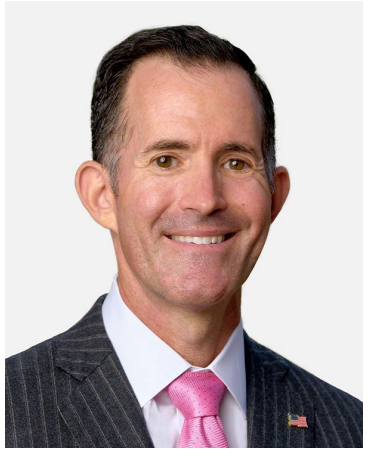
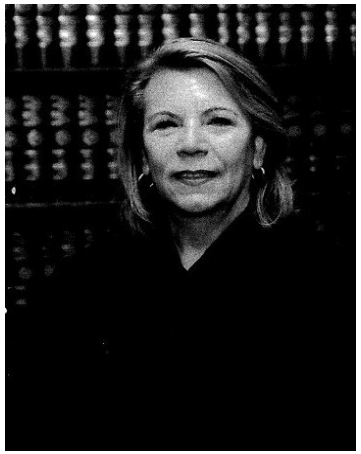
Agenda

1. Decentralization v. Centralization: A Quick Blockchain Primer
2. Why Cryptocurrency Continues to Matter: The Promise of Web 3.0 and Smart Contracts
3. Key Business, Litigation, and Regulatory Risks
4. FTX, Central Exchanges and Garden Variety Fraud
5. The Future of Blockchain Technology

Speakers



Bradford K. Newman
Baker & McKenzie LLP
Leader, AI & Blockchain Practice
Co-Chair ABA AI and Blockchain Subcommittee
bradford.newman@bakermckenzie.com



Justice Saliann Scarpulla
New York Supreme Court
Appellate Division
Co-Chair ABA AI and Blockchain Subcommittee
sscarpul@nycourts.gov

David Cass
Law & Forensics LLC
Senior Partner, Cryptocurrency & Digital Banking Practice
and Cyber Security & Forensics Practice
Former Regulator Large Institution Supervision,
VP Cyber & IT Risk
Federal Reserve Bank of New York
david@lawandforensics.com

PLEASE TELL US...

Raise your hand if you:

- have a strong understanding of how crypto works
- have ever prepared a smart contract
- have a client who has ever executed a smart contract
- are involved with litigation concerning either (a) cryptocurrency and/or (b) smart contracts

Where did this all come from?

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Decentralization v. Centralization: A Quick Blockchain Primer

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In the Beginning……

- Bitcoin was born after the Great Recession of 2008
- Bitcoin.org was registered in August 2008; first bitcoin was mined by “Satoshi Nakamoto” in January 2009.
- Was meant to be decentralized.
- Created in response to centralized banking system – where all perceived abuse occurred (fraud, financial crises, bailouts).

Satoshi Nakamoto: Bitcoin P2P e-cash paper

October 31, 2008

"I've been working on a new electronic cash system that's fully peer-to-peer, with no trusted third party."

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Traditional Finance

- Represented by:
  - Central Bank Notes
  - Central Bank Reserves
  - Commercial Bank Deposits
- Relies on a system of ledgers
- Network effects

Decentralized vs. Centralized

- In centralized systems, an authority is trusted to publish true information and prevent false or fraudulent information from being spread throughout the network.
- In traditional decentralized systems, there is no reliable source of information and no way of verifying the information each player receives from other members of the network.
- The blockchain solves this problem for decentralized systems – all players agree to the blockchain as the universal reference.

Blockchain Technology

- In its simplest form, blockchain is a data structure on which transactional data which are highly resistant to modification may be stored.
- As a data structure, blockchain is a form of distributed ledger technology that enables data sharing across a network of individual computers.
- The main appeal of blockchain technology is twofold:
  - all data and transactions that are on the blockchain are nearly impossible to modify or hack; and
  - the data itself is transparent.

Proof of Work Or Stake To Verify On Chain Transactions

- Tokenization -- assets or rights (real estate, stocks, commodities, loyalty points, gaming items, personal data) can be converted into digital tokens on a blockchain.
- Tokenization enables token holders to participate in PoS system by staking tokens as collateral.

Proof of Work And Crypto As a Reward

- In PoW, the crypto "miner" solves a difficult math problem which serves to (1) validate and verify transactions on the blockchain network, and (2) add new blocks to the blockchain.
- When a new transaction is initiated on the blockchain, it is broadcast to all nodes on the network, and miners race to solve that problem based on the transaction data.
- Mi are rewarded with newly minted crypto.

Proof of Stake

- Proof of *stake* (PoS) is an alternative to proof of work.
- In PoS, "forgers" create new blocks based on the number of tokens (or "stakes") they hold, which they "lock up" as collateral to guarantee their honesty to the network.
- In PoS system, token holders participate in consensus process by staking their tokens as collateral and running a node to validate transactions and create new blocks. By doing so, they are rewarded new tokens or transaction fees.

One Problem: Centralization of Crypto Exchanges

- Despite initial decentralized nature + intent, centralized crypto exchanges emerged: Kraken (2011), Coinbase (2012), Binance (2017), FTX (2019)
- Offer benefits of liquidity and maintaining custody of users' private keys
- Allow retail investors to participate; increases speculation, volatility, etc.
- History teaches: Centralized crypto exchanges suffer from same problems as centralized sovereign banking systems.

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Why Cryptocurrency Continues to Matter: The Promise of Web 3.0 and Smart Contracts

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Web 2.0 vs. Web 3.0

Web 2.0	Web 3.0
Centralized Application delivery, cloud services and platforms are governed and operated by centralized authorities.	**Decentralized** Edge computing, peer-to-peer and distributed consensus increasingly become the norm in Web 3.0.
Fiat currency Payments and transactions occur with government-issued currency such as $USD.	**Cryptocurrency** Transactions can be funded with encrypted digital currencies such as Bitcoin and Ethereum.
Cookies Using cookies helps to track users and provide personalization.	**NFTs** Users can get unique tokens that are assigned value or provide some form of perk.
CSS and Ajax Web 2.0 is defined by layout technologies that provide more dynamic control than Web 1.0.	**AI** Smarter, autonomous technologies, including machine learning and AI, will define Web 3.0.
Relational databases Databases underpin the content and applications of Web 2.0.	**Blockchain** Web 3.0 makes use of blockchain immutable ledger technology.
Social networks Web 2.0 ushered in the era of social networking, including Facebook.	**Metaverse worlds** With Web 3.0, metaverse worlds will emerge to meld physical, virtual and augmented reality.

Smart Contracts

- Nick Szabo is credited with the first use of the term "Smart Contract"
  - 1996 paper Smart Contracts: Building Blocks for Digital Markets
- Similarities and differences between software-based clauses (code) vs. legal contract clauses.
- Software automated value transfer based on conditions established in the code.

```
/* Allow another contract to spend some tokens in your
function approve(address _spender, uint256 _value)
    returns (bool success) {
    allowance[msg.sender][_spender] = _value;
    return true;
}

/* Approve and then comunicate the approved contract in
function approveAndCall(address _spender, uint256 _valu
    returns (bool success) {
    tokenRecipient spender = tokenRecipient(_spender);
    if (approve(_spender, _value)) {
        spender.receiveApproval(msg.sender, _value, thi
        return true;
    }
}

/* A contract attempts to get the coins */
function transferFrom(address _from, address _to, uint2
    if (balanceOf[_from] < _value) throw;
    if (balanceOf[_to] + _value < balanceOf[_to]) throw
    if (_value > allowance[_from][msg.sender]) throw;
    balanceOf[_from] -= _value;
    balanceOf[_to] += _value;
    allowance[_from][msg.sender] -= _value;
    Transfer(_from, _to, _value);
    return true;
}

/* This unnamed function is called whenever someone tri
function () {
    throw;     // Prevents accidental sending of ether
```

What is a Smart Contract?

- Smart contracts are programs stored on a blockchain that run when predetermined conditions are met.
- They typically are used to automate the execution of an agreement so that all participants can be immediately certain of the outcome, without any intermediary's involvement or time loss.
- They can also automate a workflow, triggering the next action when conditions are met.

- With smart contracts, you simply drop a bitcoin into the vending machine (i.e. ledger on blockchain), and your product or service is transferred to your account.
- Example: I buy a car with bitcoin via a smart contract. As soon as I authorize the transaction, the car unlocks automatically and I can start using it. There is no intermediary.

Why Use a Smart Contract?

Accuracy
- Since this type of contract is based on "if/then" relationships written into the code, when all conditions are met, contracts are executed. Therefore, they allow for infinitely more precision in their execution than what is allowed by traditional judicial frameworks, while at the same time they leave no room for subjective interpretation by human participants.

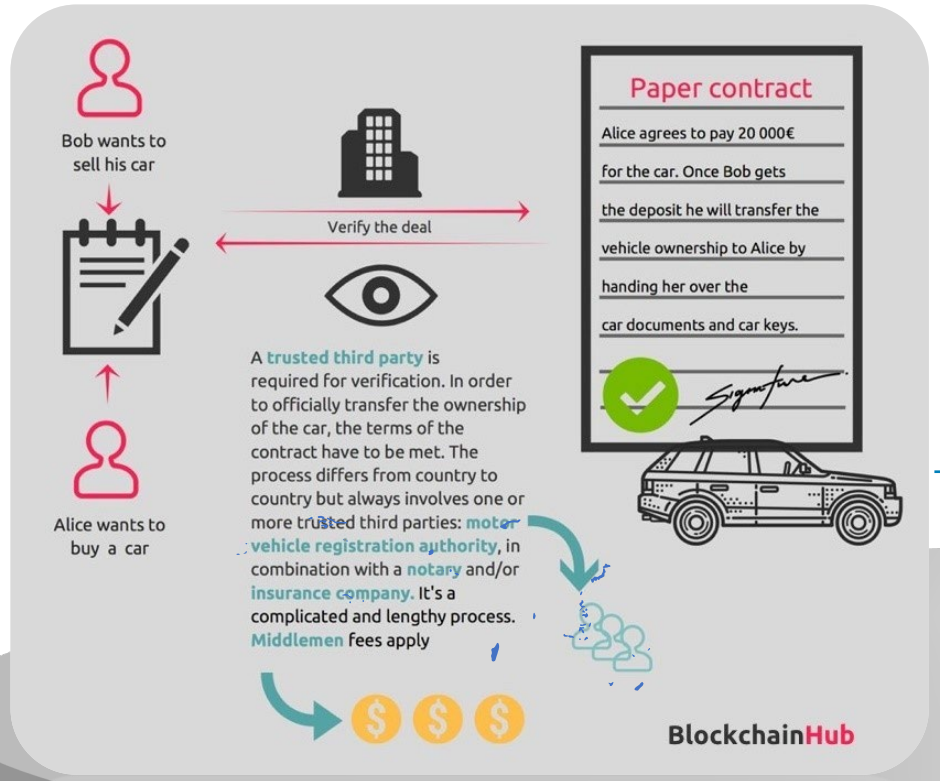
Speed
- As a paperless business tool, smart contracts are very quickly processed. Moreover, their automated and digital nature allows for incredibly fast data input and modification. When time is equalized with money, this is a significant advantage to have over the competition, for instance.

Cost-effectiveness
- Having in mind that utilizing these contracts eliminates all need to employ intermediaries that would vouch for the unviolated nature of information, using agreements of this type is less costly for companies than traditional ones. In this sense, trust is built into the mechanism of recording and executing the terms of the agreement – blockchain.

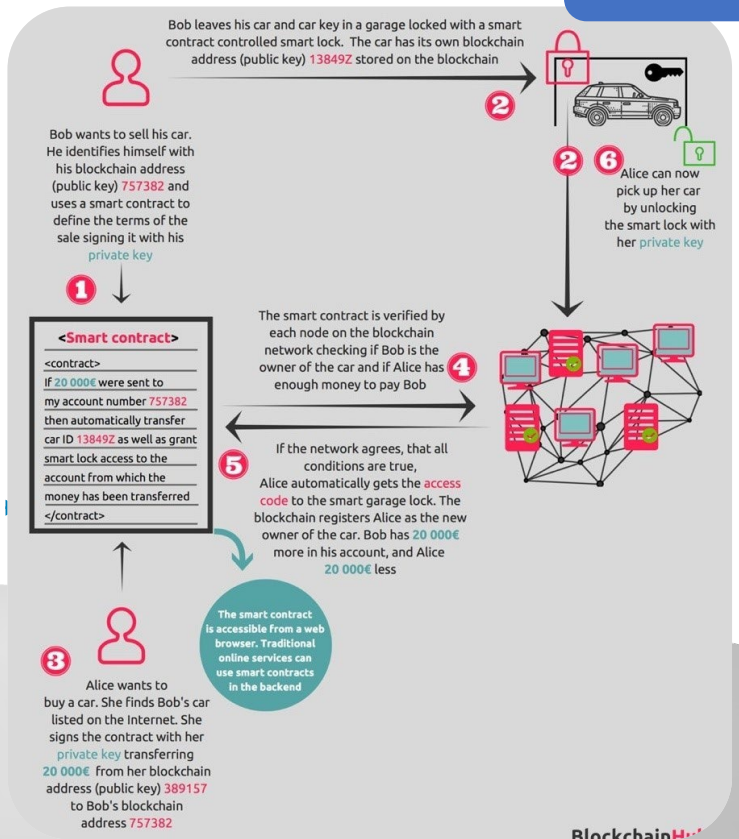
Trust
- Encoded into the blockchain platform, and based on the same principles, smart contract technology inherently invokes the rule of trust. Encrypted fragmented records of legal relationships and financial transactions are shared between all blockchain participants, thus ensuring their intended undamaged condition free of malicious modification.

Security
- Again, the fact that all information related to this type of contract – or anything stored in blockchain really – is broken down into encrypted sections distributed across the network is precisely what makes it safe from tampering. To change a piece of information within a smart contract, the entire chain would need to be altered and that is only done through a validation consensus.

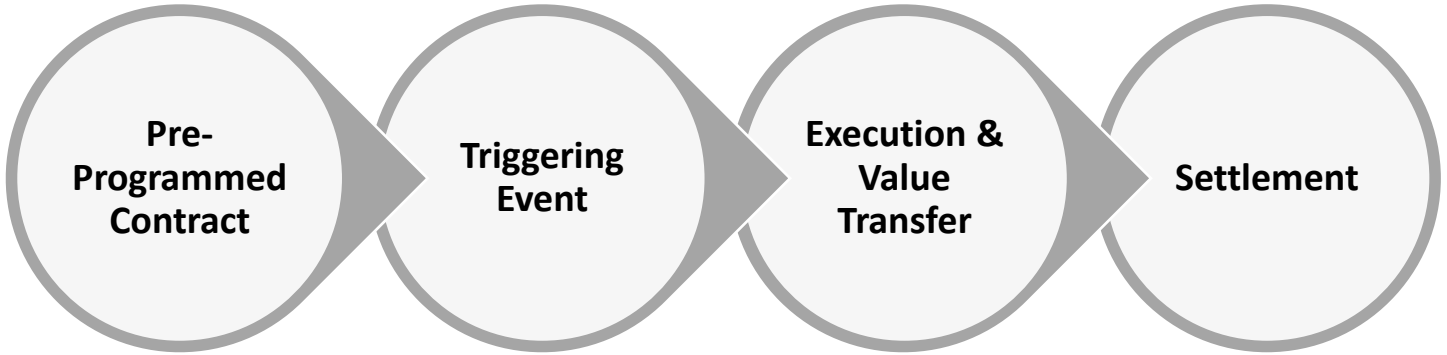
Traditional Contract



Smart Contract



How do smart contracts operate



Traditional contracts	*Smart contracts*
1-3 Days	Minutes
Manual remittance	Automatic remittance
Escrow necessary	Escrow may not be necessary
Expensive	Fraction of the cost
Physical presence (wet signature)	Virtual presence (digital signature)
Lawyers necessary	Lawyers may not be necessary

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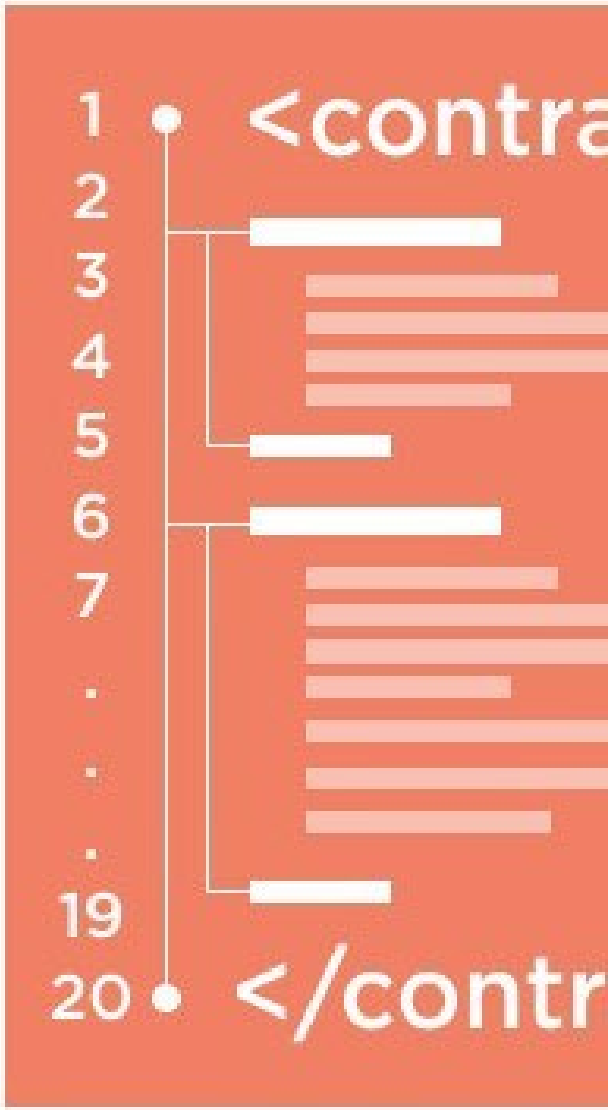

What Do You Need to Create a Smart Contract?

Subject of the Contract

- The program must have access to goods or services under contract to lock and unlock them automatically.

Digital Signatures

- All the participants initiate an agreement by signing the contract with their private keys.

Contract Terms

- Terms of a smart contract take the form of an exact sequence of operations. All participants must sign these terms.

Decentralized Platform

- The smart contract is deployed to the Blockchain of this platform and distributed among the nodes of the platform.

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Smart Contract Use Cases

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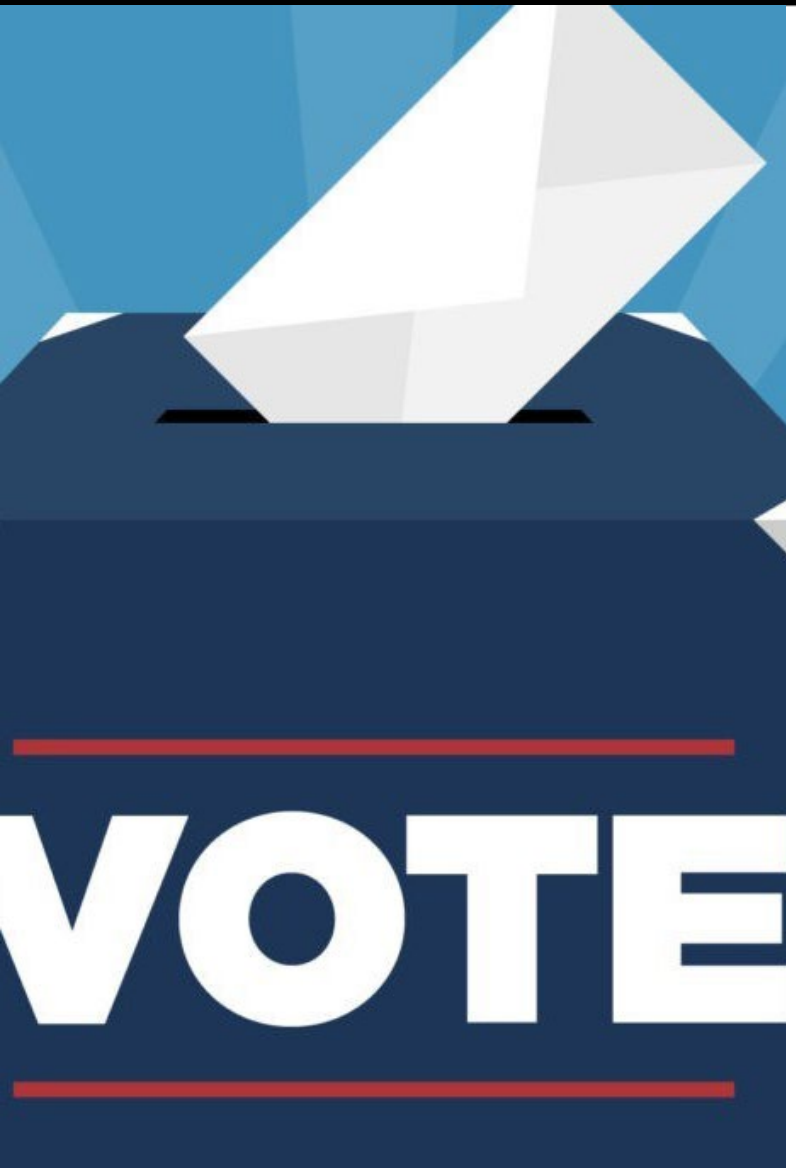

Government Voting System

- Smart contracts provide a secure environment making the voting system less susceptible to manipulation.
- Votes using smart contracts would be ledger-protected, which is extremely difficult to decode.
- When transferred online using smart contracts, can increase the number of participants in a voting system.

Healthcare

- Store the encoded health records of patients with a private key.
- Granular access controls to manage privacy.
- Research can be conducted more efficiently because confidentially and securely using smart contracts.
- All hospital receipts of patients can be stored on the blockchain and automatically shared with insurance companies as proof of service
- Manage medical supplies, supervising drugs, and regulation compliance.

Supply Chain

- Deliver an accessible and secure digital version of paperwork to parties involved in the chain.
- Inventory management and the automation of payments and tasks.

Financial Services

- Transform traditional financial services in multiple ways.
- Streamline insurance claims by performing error checking, routing, and transfer payments to the user if everything is found appropriate.
- Incorporate critical tools for bookkeeping and eliminate the possibility of infiltration of accounting records.
- Enable shareholders to take part in decision making in a transparent way.
- Assist in trade clearing, where the funds are transferred once the amounts of trade settlements are calculated.

What can go wrong with Smart Contracts?

Programming Language

- While smart contracts are gaining traction due to a growing interest in blockchain-based financial services programs, their complexity makes them inaccessible to many.

Audit

- Auditing a smart contract is inefficient and challenging.

External Data

- Smart contracts that access external data (via oracles) introduce operational issues (i.e., corrupted data stream).

High Stake Flaws

- Decentralized Autonomous Organization ("DAO") faced an infamous malicious attack in 2016. DAO smart contracts were manipulated to steal approximately 2 million Ether (50 million USD at the time).

Relationships and Liability

- Smart contracts face several other challenges including legal, and privacy issues.

Smart Contract Challenges

- Scalability
- Transparency
- Liability
- Modification/Amendment
- Legal Status/Recognition

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Are Smart Contracts Enforceable?

- Do not confuse Smart Contracts with fully negotiates contracts between two parties.
- There is no federal contract law in the United States; rather, the enforceability and interpretation of contracts is determined at the state level.
- So, while certain core principles apply consistently across state lines, and there has been a drive to harmonize state laws by the National Conference of Commissioners on Uniform State Laws, any conclusions regarding smart contracts must be tempered by the reality that states may adopt different views.

DeFi (Decentralized Finance)

- DeFi is a category of blockchain-based financial applications that provide traditional financial services in a decentralized and permissionless manner.
- DeFi transactions are executed on a blockchain, typically using smart contracts.

Examples of DeFi

- Decentralized exchanges (DEXs) – allow users to trade crypto without a central intermediary.
- Lending and borrowing platforms – allow users to lend and borrow crypto, and earn interest, without an intermediary.
- Stablecoins – cryptocurrency designed to maintain a stable value relative to a traditional currency.

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Key Business, Litigation, and Regulatory Risks

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Current State of Law

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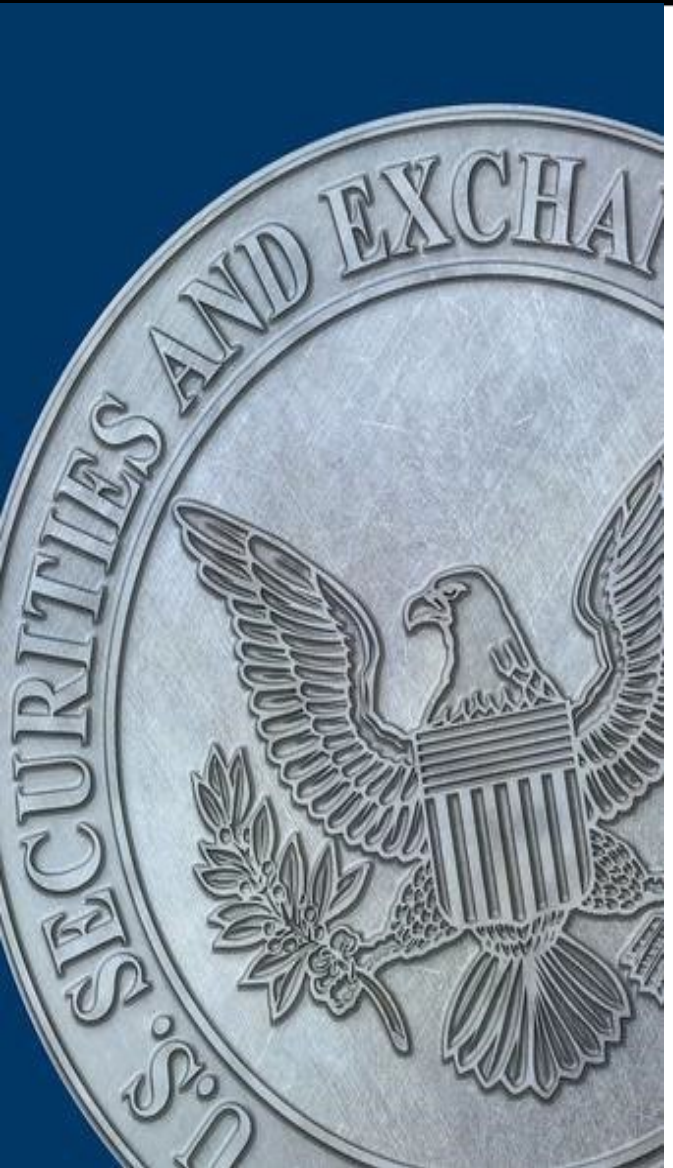
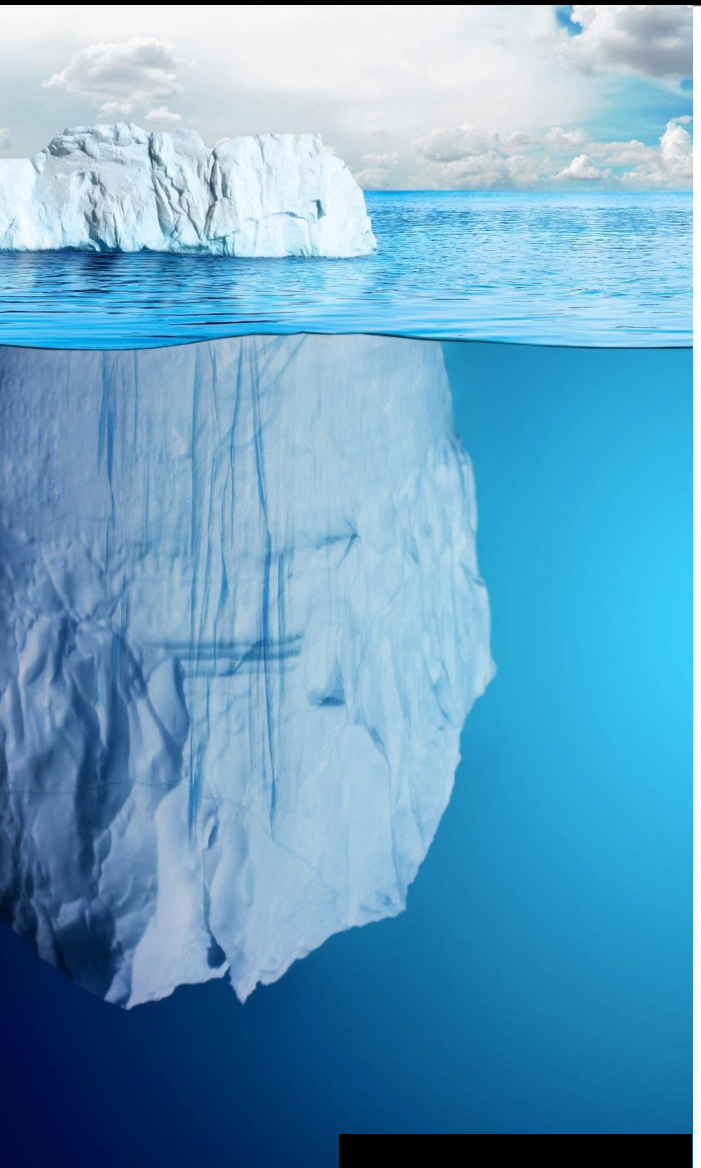


SEC, Utility Tokens and ICOs

The SEC has asserted that:

- ICOs can be securities offerings and fall under the SEC's jurisdiction enforcing federal securities laws.
- ICOs and (utility) tokens may be considered securities and need to be registered or an exception filed.
- Calling a token a “utility” token does not necessarily prevent it from being a security.
- ICOs pose significant financial risk with manipulation and cybersecurity risks.



ICO Buyer Risks

- Investing in relatively inexperienced teams.
- Unproven (experimental) business model.
- High risk of default.
- No regulatory protection.
- Limited transparency.
- The value of ICO tokens may be speculative.
- Wild fluctuations.

ICO Organizer Risks

- Uncertain regulations -- fines, extra costs, or sentences
- Utility and security tokens
- Unstable investment currencies
- No visibility into token holders
- Security compromise impact
- Running afoul of state-specific regulations

Identifying Tokens as Securities

- The *Howey* test of whether something is an "investment contract" (and therefore a security):
  - ➢ The investment of money,
    - Satisfied by the offer and sale of a digital asset, which is purchased or acquired in exchange for value.
  - ➢ Common enterprise, and
  - ➢ Reasonable expectations of profits derived from the effort of others.
    - The analysis of this element is "focused on the transaction itself and the manner in which the digital asset is offered and sold."

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What is a Utility Token?

- A utility token is a crypto token that serves some use case within a specific ecosystem.
- These tokens allow users to perform some action on a certain network.
- Utility tokens are not mineable cryptocurrencies. They are usually pre-mined, being created all at once and distributed in a manner chosen by the team behind the project.

Crypto vs. Utility Tokens

- Coins, or currencies, have one function: to transfer monetary value. Bitcoin (BTC) and Litecoin (LTC) are good examples of currencies.
- Tokens, on the other hand, are a different class of cryptos entirely. Security tokens and utility tokens are the most common types.

Utility Token Examples

Basic Attention Token (BAT):

- BAT token works with the Brave browser, which is designed to be secure and private. The Basic Attention Token allows for a new advertising revenue model that does away with the need for constant tracking of user behavior.

Chainlink (LINK):

- Chainlink (LINK) is what's known as an "oracle," which smart contract
- application that needs real-time price data.

0x (ZRX):

- 0x hopes to create a secure and fast crypto trading platform that incorporates
- elements of both centralized and decentralized exchanges.

Binance Coin (BNB):

- BNX falls under the category of "exchange tokens," or a token that is native to a specific crypto exchange's ecosystem. Instead of the fees being taken in the form of fiat or the crypto being traded, fees are deducted from the trader's BNB balance instead.

SEC Securities Enforcement for Tokens

- Determining whether a token is a security can often be confusing and case-specific.
- Yet the SEC stresses that it is on "high alert" for securities law violations and will hold attorneys advising clients on ICOs accountable for failing in their responsibility as gatekeepers of the market.
- In 2022, the SEC issued charges against an unregistered ICO issuer, Bloom Protocol LLC, who was ordered to register their coins, compensate investors and pay up to $30.9 million in penalties if they fail to do so.

SEC Securities Enforcement for Tokens

- Telegram to Return $1.2 Billion to Investors and Pay $18.5 Million Penalty to Settle SEC Charges regarding unregistered crypto assets (June 26, 2020)
- SEC Charges Ripple and Two Executives with Conducting $1.3 Billion Unregistered Securities Offering (December 22, 2020)
- SEC Charges Genesis and Gemini for the Unregistered Offer and Sale of Crypto Asset Securities through the Gemini Earn Lending Program (January 12, 2023)
- Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay $30 Million to Settle SEC Charges (February 9, 2023)
- SEC Charges Crypto Entrepreneur Justin Sun and his Companies for Fraud and Other Securities Law Violations (March 22, 2023)
- SEC Charges Crypto Trading Platform Beaxy and its Executives for Operating an Unregistered Exchange, Broker, and Clearing Agency (March 29, 2023)

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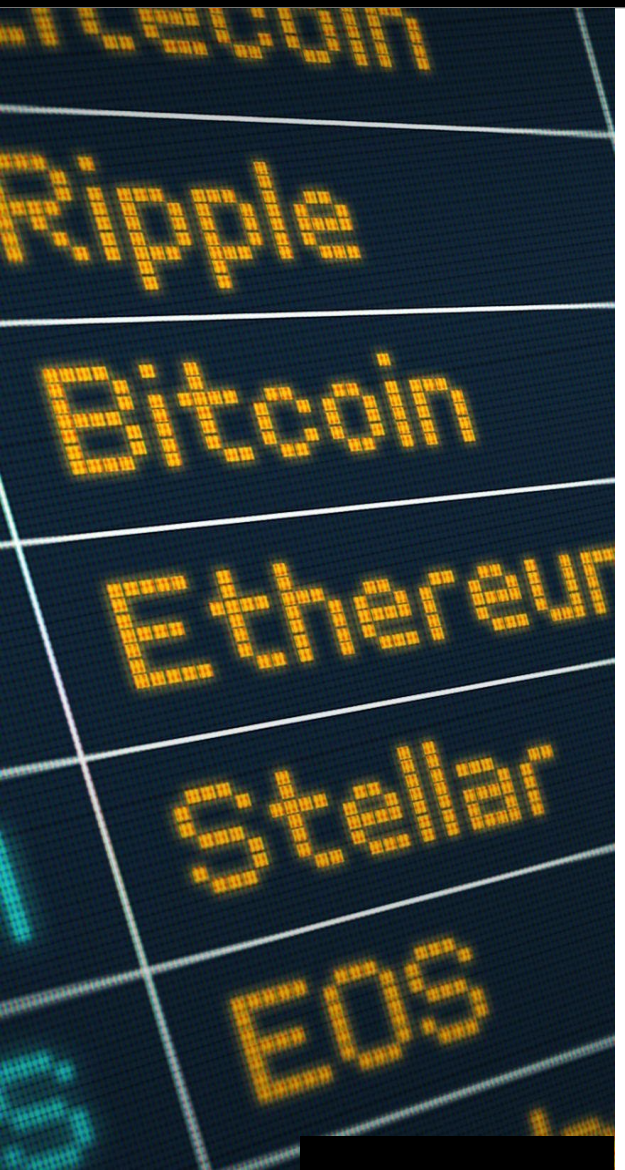
Civil Lawsuits

- Cryptocurrency litigation has spiked – about half are class actions or private suits.
- *Picha v. Gemini Trust Company, LLC* (SDNY) – Ongoing class action lawsuit against Gemini and Winklevoss twins alleging fraudulent sales of unregistered securities.
- *Underwood v. Coinbase* (SDNY) -- Class action lawsuit against Coinbase alleging sales of unregistered securities offerings. Dismissed Feb. 2023 – Coinbase had no direct role in the token sales (users instead interacted directly with each other).
- *Anderson v. Binance* (SDNY) – Class action lawsuit against Binance similar to *Underwood*. Dismissed March 2022 -- largely for statute of limitations and extraterritoriality reasons.



Expansion of Crypto Assets Units

- In May 2022, the SEC announced the expansion of its Crypto Assets and Cyber Unit.
- The expansion included 20 new positions:
  - Supervisors,
  - Investigative staff attorneys,
  - Trial counsel, and
  - Fraud analysts.
- The group was created within the SEC's Division of Enforcement to address cyber-related misconduct impacting retail investors.

Significance of the Expansion

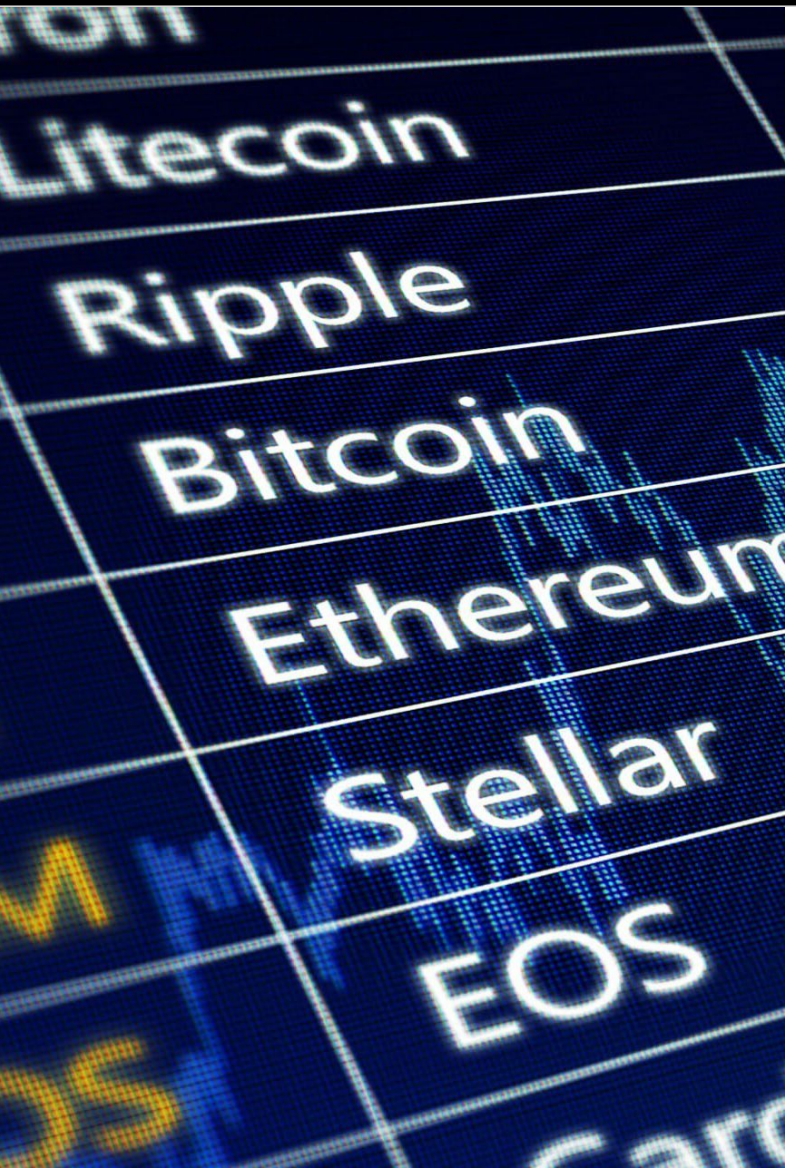
- The expansion shows that the SEC is serious about regulating crypto-related conduct.
- Specifically, the SEC will be targeting consumer-focused crypto trading services, including DeFi and NFTs & crypto insider trading.
- Companies providing such services must begin to consider adjusting their operations to ensure security compliance.

Why was the Unit Expanded?

- SEC Chair, Gary Gensler, believes investors are not receiving enough disclosures for the sales of crypto.
- Disclosures occur at a much lesser rate than those with securities because of the lack of rules regulating them.
- Crypto platforms do not separate market making, buying and selling of assets, and safekeeping services. This leaves companies often trading against their customer's interests.

U.S. Treasury Financial Crimes Enforcement Network

- FinCEN released guidance in May of 2019 with respect to the potential obligations of DeFi platforms.
- In the 2019 guidance, FinCEN indicated that the "determination of (a) whether the specific person meets the definition of a particular type of financial institution and (b) what regulatory obligations are associated with the specific activities performed within the business model" is dependent on key facts and circumstances



Crypto Wallet

- In December 2020, FinCEN proposed a rule requiring crypto exchanges to collect counterparty information from transactions sent to "unhosted wallets" dubbed "Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets."
- Under the rule, cryptocurrency exchanges would need to maintain personal data on transactions above $3,000. In the event a transaction is over $10,000, the exchange would need to gather, store and report it to FinCEN.

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New York State Department of Financial Services

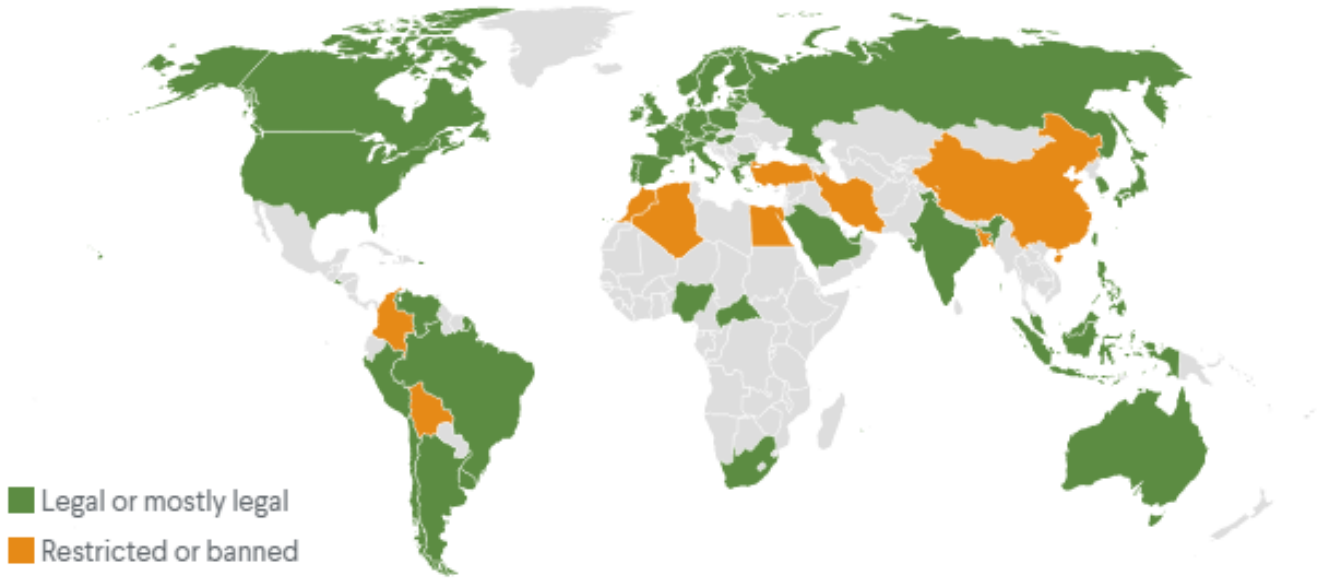
- In June 2015, NY DFS issued regulation 23 NYCRR Part 200 “relating to the conduct of business involving virtual currency”
- Under 23 NYCRR 200.3, anyone engaging in “virtual currency business activity” must be licensed.
- On February 22, 2023, the AG sued CoinEx for failing to register as a securities and commodities broker-dealer and for falsely representing itself as a crypto exchange.
- On February 23, 2023, the AG settled with Bitfinex and Tether regarding fraudulent statements that their stablecoins were fully backed by cash at all times.

International Developments

- In 2021, China banned all crypto trading and mining.
- In 2021, El Salvador officially made Bitcoin legal tender, allowing residents to pay taxes and settle debts with it.
- International actors (groups, states) have used crypto to evade US sanctions.

Most Governments Have Permitted Cryptocurrencies

Regulation of cryptocurrencies as of February 2023, selected governments



Sources: Thomson Reuters Institute; CFR research.

COUNCIL on FOREIGN RELATIONS

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FTX and Garden Variety Fraud

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Caroline Ellison wanted to make a difference. Now she's facing prison.

A close colleague of crypto king Sam Bankman-Fried, Ellison is now pleading guilty, saying she knew what they did was illegal

Divisions in Sam Bankman-Fried's Crypto Empire Blur on His Trading Titan Alameda's Balance Sheet

Alameda had $14.6 billion of assets as of June 30, according to a private document CoinDesk reviewed. Much of it is the FTT token issued by FTX, another Bankman-Frie company.

FTX Founder Sam Bankman-Fried Led Yearslong Fraud at Company, SEC Says

Founder diverted customer funds from start of crypto exchange to support his hedge fund, regulator's lawsuit says

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

TERRAFORM LABS PTE LTD. and
DO HYEONG KWON,

Defendants.

No. 1:23-cv-1346

JURY TRIAL DEMANDED

COMPLAINT

Plaintiff Securities and Exchange Commission (the "SEC" or "Commission"), for its Complaint against Defendants Terraform Labs PTE Ltd. ("Terraform") and Do Hyeong Kwon ("Kwon"

Kwon offered and sold crypto asset securities in unregistered transactions and perpetrated a fraudulent scheme that led to the loss of at least $40 billion of market value, including devastating losses for U.S. retail and institutional investors.

2. Defendants' crypto asset securities offerings involved an array of interrelated tokens that were created, developed, promoted, offered, and sold by Defendants as profit-seeking investments.

SEC Charges Terraform and CEO Do Kwon with Defrauding Investors in Crypto Schemes

FOR IMMEDIATE RELEASE
2023-32

Washington D.C., Feb. 16, 2023 — The Securities and Exchange Commission today charge Singapore-based Terraform Labs PTE Ltd and Do Hyeong Kwon with orchestrating a multi-b dollar crypto asset securities fraud involving an algorithmic stablecoin and other crypto asse securities.

U.S., South Korea Vie Over Extradition of Crypto Fugitive Do Kwon

Both countries are asking Montenegro to hand ov

Kerner at Blockchain Coinvestors says Terra was a Ponzi strategy

The crypto community is still dealing with the fallout from the multibillion-dollar collapse of Terra-LUNA. At a Davos event organized by Forkast, we asked what caused the crash and if it was foreseeable.

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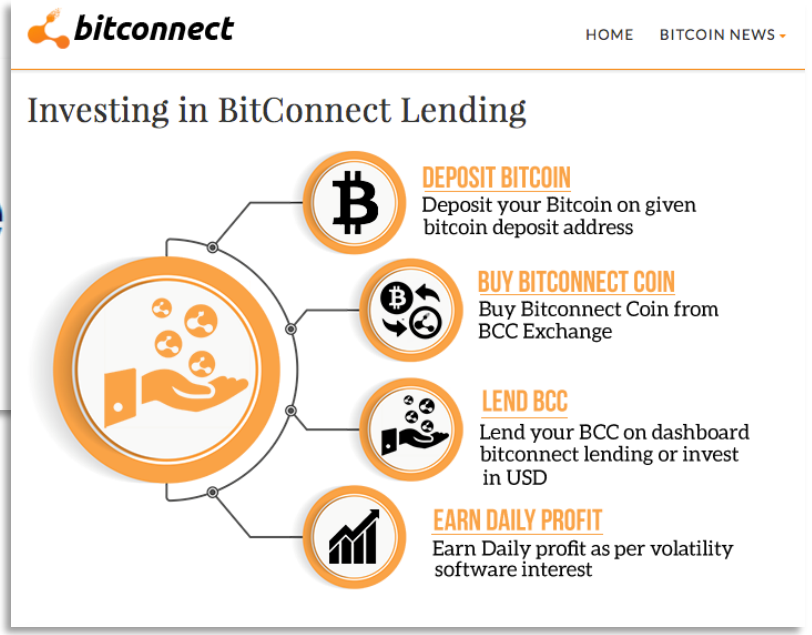
BitConnect founder charged with orchestrating $2 billion Ponzi scheme

By Ramishah Maruf, CNN

Published 1:45 PM EST, Sun February 27, 2022

BitConnect Promoter Gets 38 Months in $2.4 Billion Ponzi Scam

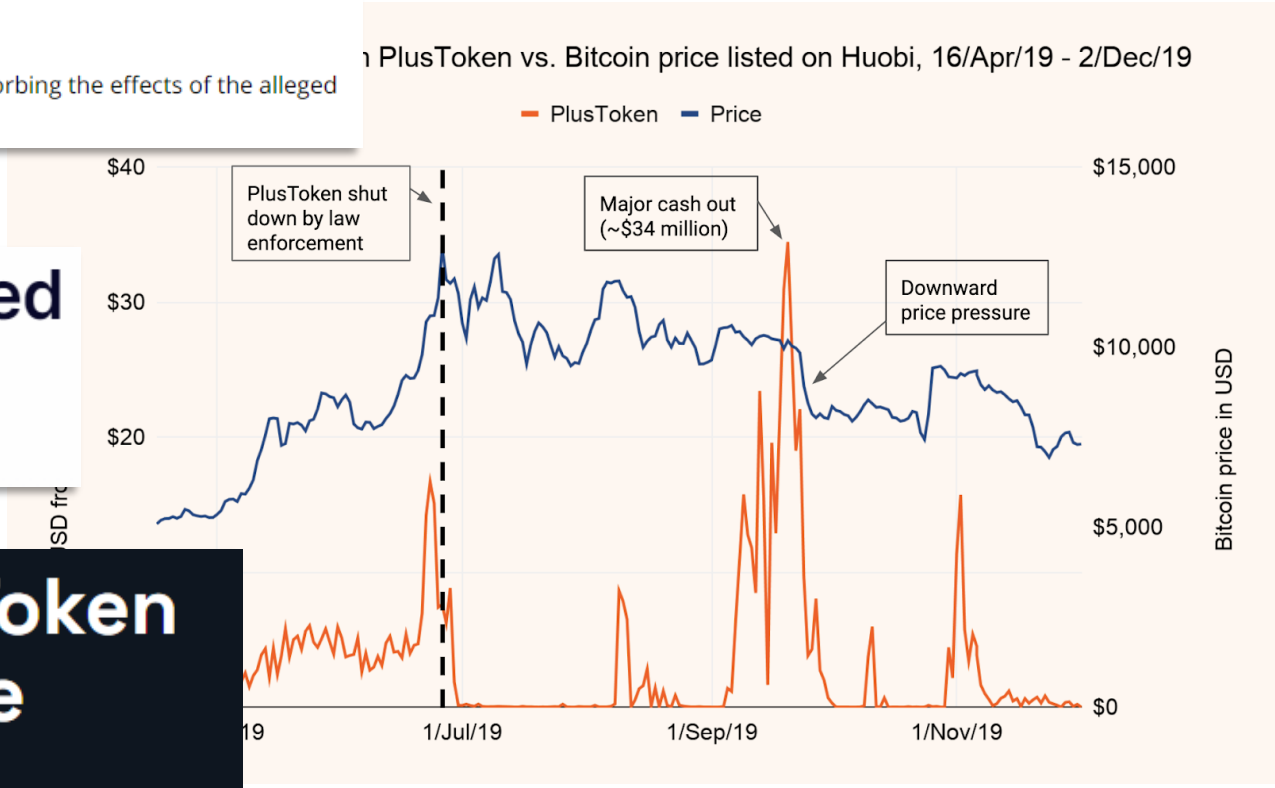
- Glenn Arcaro pleaded guilty to fraud on 4,500 people worldwide
- Founder Satish Kumbhani vanished from native India, SEC says



Victims of BitConnect scheme to receive more than $17 million to compensate for losses

PlusToken Effect: Alleged Asian Exit Scam to Blame for Market Decline?

New research suggests that the Bitcoin price could be still absorbing the effects of the alleged PlusToken exit scam.



Ringleaders of PlusToken Scam Jailed for Up to 11 Years

December 01, 2020 — 08:15 am EST

Bitcoin Worth $3B from PlusToken Ponzi Scam Seized by Chinese Authorities

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- FTX scandal is an old-school Wall Street garden variety scheme.
- FTX was centralized in SBF and a few others
- Likewise, Terra/Luna fraud was the result of a centralization and garden variety fraud: transactions were done on an app called “Chai” – which purported to settle transactions on the blockchain but actually did not.

120. As one Terraform employee stated in a chat with another employee on September 1, 2021, "working at terra has reinforced my belief in conspiracy theories . . . just the white lies to prop up anchor and mirror and the illusion of decentralization and true extent of chai adoption . . . all from the armchair of a single man sipping whisky" – the reference to a man sipping whisky being Kwon.

Multiple US state regulators allege AI trading DApp is a Ponzi scheme

The scheme allegedly claimed it could generate returns of up to 2.2% a day by leveraging AI to trade more often and with higher profits than a person could.

Regulators File the First State Securities Case Targeting AI Promos

- Texas, Montana and Alabama file cease-and-desist orders
- YieldTrust promised investors returns of 2.6% per day using AI

3 States Say 'Quantum AI' Crypto Trading App Is Ponzi Scheme

Centralization

- On April 4, 2023, regulators in Texas, Alabama, and Montana sued YieldTrust, an app-based crypto trading platform, claiming it has been running a Ponzi scheme tied to AI.
- YieldTrust purports to use YieldBot, an AI that interacts with the digital asset market, purportedly capable of executing 70x more trades with 25x more profits than any human trader could.
- YieldTrust promised 2.2% daily profits for investors.
- But YieldTrust does not provide blockchain data or other info allowing investors to verify trades, and investors are told to wait 15-30 days before withdrawing initial deposits.

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