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Crypto Contagion –

Managing Risk on Multiple Fronts

The Capital Commitment on **April 4, 2023**

Crypto firm bankruptcies and resulting disruption in the crypto ecosystem will continue to exacerbate liquidity and regulatory concerns in this space. Signs of contagion are evident as prices of almost every cryptocurrency type have halved in recent months. Since all participants supporting the crypto ecosystem are at risk, managing that risk is critical.

Fund managers should be prepared on multiple fronts, as the following examples illustrate:

- Regulators broadening scope: The SEC is not just targeting fraudulent offerings but is scrutinizing all participants, including investors, in crypto transactions. At last count, the SEC and CFTC have brought five times as many crypto enforcement actions as the rest of the regulators in the world combined.
- Exchanges under scrutiny: After well-publicized actions against decentralized finance (DeFi) platforms, the enforcement spotlight is moving to crypto exchanges. With recent collapses, regulators are under pressure to act.
- DOJ: While the DOJ will no doubt continue to focus on the low hanging fruit of outright frauds in the crypto space, expect to see more complicated money laundering prosecutions against exchanges and others that, whether knowingly or acting with willful blindness, facilitate crypto transactions that conceal or promote illegal activity.
- Trading issues: The CFTC and SEC will use templates traditionally applied in the securities/commodities space to most crypto and crypto-related assets. For example, anti-manipulation, anti-touting, insider trading, statutory underwriter, etc.
- DAOs and NFTs: These projects are fielding a variety of regulatory requests – the SEC views them as potentially under its jurisdiction, regardless of what they are called.
- Private claims by LPs: When an investment goes south, questions framed through the lens of hindsight will be raised, including as to the adequacy of diligence and whether the investment was appropriate for the fund.
- Private securities litigation: When crypto enterprises falter, venture capital firms that backed the enterprise are likely to be targeted by plaintiffs' firms looking for

deep pockets.

TerraForm Labs illustrates the challenges faced on multiple fronts by crypto ventures. When linked cryptocurrencies TerraUSD and Luna collapsed, their developer TerraForm Labs was already facing multiple regulatory investigations and had filed suit to contest the enforcement of an SEC subpoena. After the collapse, TerraForm Labs, along with its venture capital fund backers (known as the "Luna Foundation Guard"), were hit with multiple class action lawsuits in the United States. Each case included a slew of claims, including RICO and/or securities violations and alleged that the Luna Foundation Guard's investments caused artificial inflation of the Terra Tokens ultimately contributing to their collapse. Class actions by crypto investors against deep pocketed venture capital fund backers are the likely next step. The blast zone of such claims will potentially include limited partners who exercise control, through board representation, or involvement in operations.

The bottom line: the end is not yet in sight, rather this is just the end of the beginning. Regulators and plaintiffs' attorneys show no signs of backing down anytime soon. In the words of SEC Chairman Gary Gensler: "Until crypto platforms comply with time-tested securities laws, risks to investors will persist. It remains a priority of the SEC to use all of our available tools to bring the industry into compliance."

Read more of our Top Ten Regulatory and Litigation Risks for Private Funds in 2023.

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