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BLOCKCHAIN 2020
A Sidley Austin LLP Educational Series

Blockchain 2020: Cross-Border Regulatory Hot Topics

Tuesday, May 19, 2020

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Region: United States

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FinCEN Funds Travel Rule

At the federal level, virtual currency companies are regulated by the Financial Crimes Enforcement Network (FinCEN) under its existing regulatory structure applicable to Money Services Businesses (MSBs).

- Principal focus: Anti-money laundering and prevention of terrorist financing

In 2013, FinCEN released initial guidance on the application of the MSB regulatory structure to virtual currency businesses.

In May 2019, FinCEN issued more compressive guidance on FinCEN's regulatory expectations, including how the regulatory structure applied to different virtual currency business models.

In the 2019 Guidance, FinCEN clarified its expectation that entities that engage in the transmission of virtual currency comply with the **Funds Travel Rule**.

FinCEN Funds Travel Rule

Funds Travel Rule

- Applies to transmittals of the equivalent of $3,000 or more.
- Requires all transmitting institutions (including intermediaries) to include certain information either before or with the transmittal, including about the sender, the recipient and the transaction.
- Applies regardless of how the transmitter sets up their system for clearing and settling transactions.
- No exceptions or diminished responsibility if the transmitter sets up their system in a manner that makes it difficult to comply.

This becomes very expensive, time consuming and challenging, if there is not an international universal messaging standard for transmission.

Promptly following FinCEN's 2019 guidance, the Financial Action Task Force (FATF), an intergovernmental organization focused on developing policies to combat money laundering and terrorist financing, began to attempt to implement the Funds Travel Rule's application to virtual currency worldwide.

FinCEN Funds Travel Rule

Efforts by the Financial Action Task Force (FATF)

- In June 2019, FATF updated their guidance to indicate virtual currency service providers (VASPs) must share sender and recipient information for transactions over a certain threshold and urged VASPs and countries to understand the money laundering and terrorist financial risks associated with virtual currency transactions and to address those risks, including by implanting a Funds Travel Rule solution.
- FATC indicated it would review progress of the Funds Travel Rule solution at its June 2020 plenary meeting.

While industry groups worked diligently to implement a standard, FinCEN took an unwavering position.

- In November 2019, FinCEN Director, Kenneth Blanco made a speech that virtual currency transmitters are expected to comply, including with respect to Anonymity-Enhanced Cryptocurrencies (AECs).
- Funds Travel Rule is the most commonly cited violation during exams.
- Virtual currency transmitters should expect their compliance with Funds Travel Rule and other reporting and recordkeeping requirements, including for AECs, to be part of their examinations.

FinCEN Funds Travel Rule

On May 7, 2020, the Joint Working Group for InterVASP Messaging Standards released a standard that defined a uniform model for data sharing with virtual currency transmissions.

- InterVASP Messaging Standard 101 (IVMS101)
- Allow firms to pass forward information without reconfiguring incoming and outgoing messages

As intended, the standard was released prior to the FATF 2020 plenary meeting, which FATF announced it would use to evaluate progress towards worldwide compliance with the Funds Travel Rule.

Treatment of Stablecoins – FinCEN and U.S. State Approaches

FinCEN's existing 2013 and 2019 Guidance does not explicitly address stablecoins.

- Should all stablecoins be viewed the same way:
  - What is the stablecoin backed by: Sovereign-currency, commodity, or another assets, including other cryptocurrencies?
  - Does the issuer have obligation to redeem for the backed value?

In November 2019, Director of FinCEN, Kenneth Blanco gave remarks at Blockchain Symposium:

- "[T]ransactions in stablecoins, like any other value that substitutes for currency, are covered by our definition of 'money transmission services.'
- "It does not matter if the stablecoin is backed by a currency, a commodity, or even an algorithm — the rules are the same. To that point, administrators of stablecoins have to register as MSBs with FinCEN."

U.S. States have released very limited guidance on treatment of stablecoins.

- In January 2019, Texas provided that a sovereign currency-backed stablecoin that an issuer must redeem for fiat currency would fall within its money transmission statute. Treatment would be different for other types of stablecoins.

Cryptocurrency Exchange Lending Activity

Two categories of lending related to virtual currency exchange activities:

- Margin lending of fiat currency (with fiat currency or virtual currency collateral)
- Margin lending of virtual currency

Margin lending of fiat currency:

- State-by-state licensing regime, with many states requiring a license for consumer lending
  - Material compliance burden and some remaining usury requirements
- Alternatively, virtual currency exchanges can partner with a bank to engage in lending
  - May include the bank selling receivables to the virtual currency company
  - Reduced compliance burden, but some state licensing requirement may remain
  - Reduced economics
  - Banks may be more conservative regarding crypto-collateral requirements

Cryptocurrency Exchange Lending Activity

Margin lending of virtual currency:

- Many market players are taking the position that this activity does not require state licensing because it does not involve the lending of “money.”
- However, there will likely remain some risk in this area. While many states have taken formal positions on the application of money transmission laws to virtual currency activity, states are further behind on application of their lending laws.
    - As we saw with money transmission laws, certain states could indeed take the position that virtual currency constitutes “money” for purposes of their lending law.
    - Other states may decide to implement new lending regimes specifically focused on the risks of cryptocurrency lending.

Digital Asset Securities

The SEC regulates primary issuance and secondary trading of securities as defined in the Securities Act of 1933 (33 Act) and the Securities Exchange Act of 1934 (34 Act)

Under the 33 and 34 Acts, "the term 'security' means any note, stock, treasury stock, security future, security-based swap, bond…**investment contract**…."

Pursuant to the *Howey* test, an instrument is an investment contract if:

- (1) it is an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) derived from the efforts of a third party
- SEC's The DAO Report (July 27, 2017)
- SEC FinHub's Framework for "Investment Contract" Analysis of Digital Assets (April 3, 2019)

SEC staff have stated Bitcoin and Ethereum, as currently distributed, would likely not be treated as securities

SEC Commissioner Peirce Proposed Digital Asset Safe Harbor

On February 6, 2020, SEC Commissioner Hester M. Peirce proposed a safe harbor exempting certain digital assets from the registration requirements under the 33 Act and 34 Act.

Commissioner Peirce is soliciting feedback on the proposal; the proposal is not yet on the Commission's rulemaking agenda.

- While well-received overall, a number of commenters have provided suggestions for improvement.

The safe harbor provides a three-year grace period from the date of first token sale, effectively shifting the application of the *Howey* Test from the initial token sale to a future date.

- The grace period is intended to provide the blockchain network sufficient time to become functional or decentralized (defined in the proposal as "network maturity") such that the *Howey* test would not be met at the end of the grace period.

Persons that would otherwise meet the definition of a broker-dealer or exchange for activities with respect to digital assets issued pursuant to the safe harbor would also be exempt from registration under the 34 Act.

SEC v. Telegram decision

SEC v. Telegram illustrates need for clarity in the industry.

- On March 24, 2020, SDNY granted the SEC a preliminary injunction preventing the launch of the TON network.
- Telegram argued the launch of the TON network and delivery of tokens (Grams) should be distinct from the fundraising transaction conducted pursuant to SAFT-like agreement.
- Telegram attempted to comply with the 34 Act by relying on Regulation D for the offer and sale of Grams to initial purchasers, with Grams to be delivered at the future launch of the TON network.
- The court ruled the security at issue was neither the SAFT nor the Grams, but "the *entire scheme*"
  - The entire scheme "comprised the Gram Purchase Agreements and the accompanying understandings and undertakings made by Telegram, including the expectation and intention that the Initial Purchasers would distribute Grams into a secondary public market."
- The court found the economic reality based on the facts presented was that initial purchasers intended to act as statutory underwriters in distributing Grams to the public, notwithstanding contractual agreements to the contrary.

Subsequent to the SDNY's decision, a number of class action suits have been filed against token issuers and exchanges

Digital Asset Commodities

The CFTC has long taken the position that certain digital assets fall within the definition of “commodities” under the Commodity Exchange Act (CEA).

- CFTC letter in *SEC v. Telegram:* digital currencies are commodities, but that does not resolve the question of whether a digital currency is a security. Many commodities are subject to U.S. securities laws.

Under the CEA, retail commodities transactions are treated under as futures contracts and generally must be traded on a regulated futures exchange.

- A retail commodities transaction is:
  - the offer or sale of any agreement, contract, or transaction in any commodity on a leveraged, margined or financed basis
  - with a retail customer (i.e., a person who is not an Eligible Contract Participant or Eligible Commercial Entity, as those terms are defined by the CEA)

An exception exists where the transaction results in “actual delivery” of the commodity within 28 days.

CFTC's Guidance on Actual Delivery of Digital Assets

On March 24, 2020, the CFTC released final interpretative guidance regarding "actual delivery" of digital assets for purposes of the CEA's "retail commodity transactions" provision.

The guidance clarifies actual delivery occurs if:

- The entire amount of digital asset purchased is transferred to the purchaser's blockchain address (over which the purchaser has **sole** possession and control); and
- The offeror/counterparty seller does not retain *any* interest in the digital asset purchased at the expiration of 28 days from the date of the transaction.
- Actual delivery may also occur if the digital asset is delivered a third-party depository on behalf of the purchaser, however additional conditions must be met if the depository is affiliated with the offeror/counterparty.

Actual delivery does **not** occur if:

- the purchased commodity is not transferred away from a digital account or ledger system owned or operated by the offeror/counterparty seller (or their respective execution venues), or the transfer is made by book entry, or rolled, offset against, netted out, or settled in cash or a digital asset (other than the purchased digital asset).

Region: Europe

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UK/EU – General Remarks

- EU Fifth Money Laundering Directive applies to cryptoasset exchanges and to custodial wallet providers
- Otherwise, no harmonised EU regime for the regulation of cryptoassets – firms should consider the existing financial services framework (e.g., MiFID, E-Money Directive) to determine whether they fall within the regulatory perimeter
- No EU equivalent of the Howey test – securities analysis should apply categories of financial instruments under MiFID
- Brexit could create an opportunity for the UK to develop a regime for the regulation of cryptoassets independently of the EU

European Commission Consultation Paper

- **December 2019, European Commission consultation paper: *An EU Framework for markets in crypto-assets***

- **Section 1 – Questions for the general public.** The consultation seeks feedback from the general public about their use or potential use of cryptoassets.

- **Section 2 – Classification of cryptoassets.** Should, and if so, how should, cryptoassets be classified at an EU level? For example, by economic function (i.e., dividing between payment tokens, security tokens, utility tokens and hybrid tokens)?

- **Section 3 – Unregulated Tokens.** The consultation seeks views which will inform whether and how the regulatory perimeter could be extended to include certain currently unregulated cryptoassets.

- **Section 4 – Regulated Tokens Section.** The consultation seeks views as to the application of the existing regulatory framework to cryptoassets which fall within the existing regulatory perimeter. The consultation seeks feedback as to any existing regulatory impediments in relation to the use of DLT.

FCA Policy Statement (PS19/22)

- FCA Policy Statement (PS19/22): *Guidance on cryptoassets* (July 2019)

- FCA applies existing regulatory regime – the same analysis will still apply to financial services activities provided using cryptoassets and/or blockchain/DLT

- The FCA sets out a regulatory taxonomy:
  - **Regulated Tokens**
    - *Securities Tokens* – cryptoassets providing rights and obligations akin to what are called "specified investments" in the UK Regulated Activities Order
    - *E-Money Tokens* – cryptoassets meeting the definition of e-money under the Electronic Money Regulations
  - **Unregulated Tokens**
    - *Exchange Tokens* – decentralised and used primarily as a means of exchange, e.g., Bitcoin
    - *Utility Tokens* – provide access to a current or prospective product or service; grant rights similar to pre-payment vouchers

Libra

- December 2019, European Commission/European Council joint statement:
  - "…*no global 'stablecoin' arrangement should begin operation in the European Union until the legal, regulatory and oversight challenges and risks have been adequately identified and addressed."*
- April 2020, Libra Whitepaper v2.0
  - Single currency stablecoins: ≋ EUR; ≋ USD; ≋ GBP
  - Forgoing a planned move to a permissionless system
  - Increased due diligence by Libra Association and introduction of a Financial Intelligence Function
- May 2020, European Central Bank study – *A regulatory and financial stability perspective on global stablecoins*
  - Concerns regarding global stablecoins' (particularly Libra's) impact on availability of high quality collateral
- Summer 2020, Stuart Levey to become Libra Association's first CEO
- Q4 2020 (delayed) target launch date

CLE Code

Region Asia

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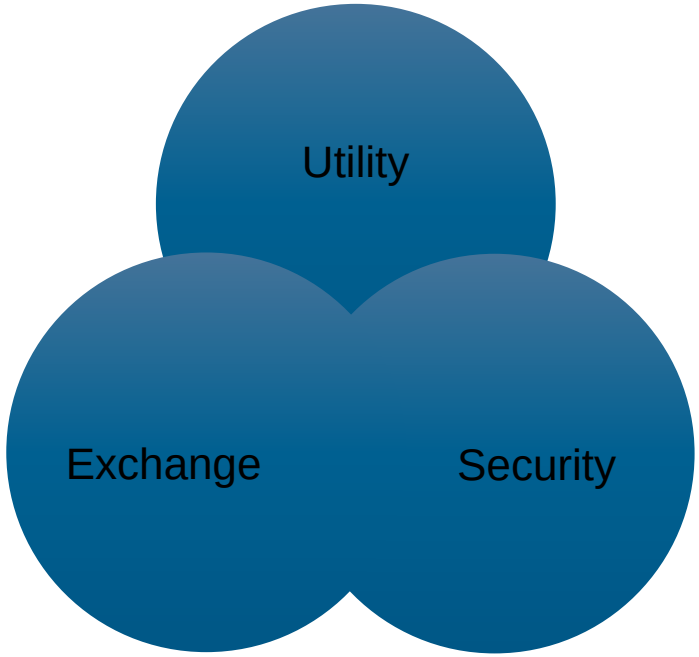
Digital Assets Regulatory Framework Overview

- Securities and Futures Commission (**SFC**) and Securities and Futures Ordinance (**SFO**)
- Focused on “securities” and “futures”
- No separate regime for digital assets, but other regulatory regimes could be triggered
- Legal characterization of digital asset is paramount
- Title is not determinative
- “Securities” is defined broadly under SFO
- Issue, marketing, distribution and secondary trading subject to the existing securities framework

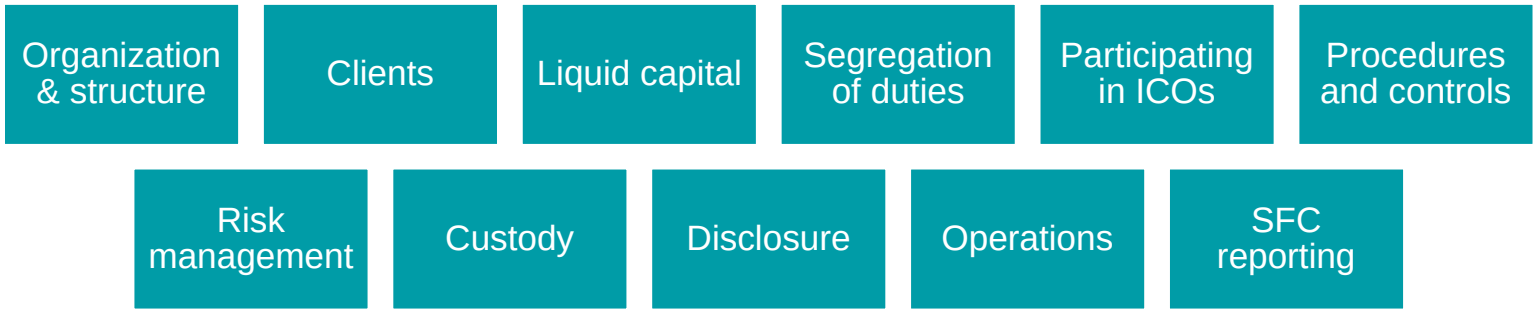


Managing Investments in Digital Asset

Proforma Terms and Conditions for Licensed Corporations Managing Portfolios in Virtual Assets (Oct 2019)

- Who does it apply to?
  - SFC-licensed managers with stated investment objective to invest in virtual assets or intention to invest more than 10% GAV in virtual assets
  - Similar requirements for managers of discretionary accounts investing in virtual assets

- What are the requirements?
  - Similar to Fund Manager Code of Conduct, but with variations to address differences in the nature of virtual assets and business models of virtual asset managers



- Several licensed managers currently authorized to manage portfolios that invest in digital assets. Expect more to be authorized as institutional interest increases

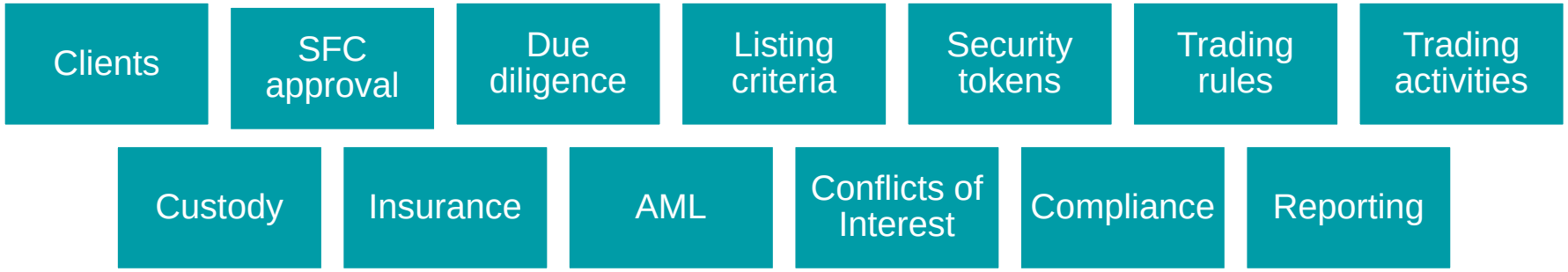
Virtual Asset Trading Platforms

Position paper – Regulation of Virtual Asset Trading Platforms (Nov 2019)

- Licenses for type 1 (dealing in securities) and type 7 (providing automated trading services) regulated activities

- Who is eligible?
  - Opt-in basis – must offer at least one token that is a "security"
  - Centralized platforms only

- What are the requirements?



- Several license applications have been submitted, expect approval Q4

Where to from here?

Three key thoughts to take away from today.

1. The SFC is working to create a safe and robust market in Hong Kong.

2. The infrastructure required for a vibrant digital assets ecosystem is on the way.

3. Hong Kong is positioned to be a hub and market leader for virtual assets.

Singapore – Introduction

Extract from website of the Monetary Authority of Singapore **(MAS):**

Key Facts

50+

Innovation labs

1,100+

FinTech firms

S$1B+

Record-high FinTech investment in 2019

US$12B

Capital for ASEAN enterprises

Singapore – Categorization of Digital Tokens

Broadly, digital tokens can be categorized as (i) security tokens, (ii) payment tokens or (iii) utility tokens

- **Security tokens** generally refer to tokens which constitute capital markets products under the Securities and Futures Act **(SFA),** e.g., security (share or debenture), unit in a collective investment scheme **(CIS),** derivative contract, etc.
- **Payment tokens** generally refer to digital payment tokens or e-money as defined under the Payment Services Act **(PSA)**
- **Utility tokens** generally refer to tokens that neither fall within the security nor digital payment token categorizations

Factual analysis on a case-by-case basis is required to determine the legal categorization of tokens

Substance over form: Notwithstanding what a token is called, its features and characteristics will determine its legal categorization and how it will be treated under Singapore law

Singapore – Security Tokens

MAS has published "A Guide to Digital Token Offerings" **(Guide)** which provides guidance on determining whether a digital token constitutes a capital markets product, e.g., security (share, debenture), unit in a CIS**,** derivative contract, etc., including 11 case studies

Where a digital token is deemed to constitute a capital markets product, the requirements under the SFA and Financial Advisers Act **(FAA)** become relevant when offering or dealing in or advising on such digital token, e.g.:

- the offer of security tokens will be subject to SFA prospectus registration requirements, unless offered pursuant to an applicable "safe harbor"
- the marketing of security tokens will require a capital markets services **(CMS)** license for dealing in capital markets products under the SFA, unless there is an applicable licensing exemption
- the management of a client's portfolio of security tokens will require a CMS license for fund management, unless there is an applicable licensing exemption
- providing advice on investing in security tokens will require a financial adviser's license under the FAA, unless there is an applicable licensing exemption

Singapore – Security Token Platforms

An operator of a platform on which issuers may make primary offers of security tokens will be required to hold a CMS license for dealing in capital markets products

An operator of an exchange or trading platform for secondary trading of security tokens will be required to be either:

- approved by MAS as an approved exchange (for retail trading) or
- recognized by MAS as a recognized market operator **(RMO)** (generally trading by institutional and accredited investors only)

The SFA and the FAA have extra-territorial jurisdiction, offshore platforms carrying out cross-border activities targeting persons in Singapore may trigger the offering/licensing requirements under the SFA and the FAA

Singapore – Payment Tokens

The new PSA commenced operation on January 28, 2020 and sets out:

- Licensing regime for seven payment services:
  - Account issuance service
  - Domestic money transfer
  - Cross-border money transfer
  - Merchant acquisition
  - **E-money issuance**
  - **Digital payment token service**
  - Money-changing service

- Designation regime for payment systems
  - "**Payment system**" is defined under the PSA as a funds transfer system or other system that facilitates the circulation of money, and includes any instruments and procedures that relate to the system

Singapore – E-Money Versus Digital Payment Tokens

"**E-money**" is defined under the PSA as any electronically stored monetary value that:

- Is denominated in any currency, or pegged by its issuer to any currency
- Has been paid for in advance to enable the making of payment transactions through the use of a payment account
- Is accepted by a person other than its issuer
- Represents a claim on its issuer

"**Digital payment token**" is defined under the PSA as any digital representation of value that:

- Is expressed as a unit
- Is not denominated in any currency, and is not pegged by its issuer to any currency
- Is, or is intended to be, a medium of exchange accepted by the public, or a section of the public, as payment for goods or services or for the discharge of a debt
- Can be transferred, stored or traded electronically

Bitcoin and Ethereum would be considered digital payment tokens

Singapore – License for E-Money Issuance and Digital Payment Token Service

E-money

Issuers of e-money or e-money digital wallets will require a license under the PSA

- Providers of e-money-based services that are licensed under the PSA will be subject to anti-money laundering/countering the financing of terrorism (AML/CFT) requirements unless such services meet certain "low-risk" criteria

Digital payment tokens

"**Digital payment token service"** is defined under the PSA to mean any of the following services:

- Any service of dealing in digital payment tokens
- Any service of facilitating the exchange of digital payment tokens

Cryptocurrency dealers and exchanges will require a license under the PSA

- All digital payment token service providers licensed under the PSA are subject to AML/CFT requirements

Singapore – Future Changes for Digital Payment Tokens

In December 2019, MAS issued two public consultations relating to digital payment tokens, including proposals to:

- Expand the scope of regulated digital payment token services under the PSA to include:
  - **Transfer** of digital payment tokens
  - Provision of digital payment token **custodial wallets** for and on behalf of customers
  - **Brokering** of digital payment token transactions (without possession of money or digital payment tokens by the service provider)
- Introduce in separate legislation, a new class of financial institution being entities that are created in Singapore, which provide virtual asset services outside of Singapore
- Request for comments on whether the existing definitions of e-money and digital payment tokens remain relevant today in light of new innovations in payment instruments, e.g., stablecoins

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Questions & Answers

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JOY LAM focuses primarily on investment funds and covers a wide range of investment fund formation transactions, including real estate funds, tokenized funds, private equity funds and hedge funds. Joy also focuses on advising clients within the virtual assets ecosystem in relation to tokenized funds, other tokenized offerings and on the complex and rapidly evolving regulatory requirements for managing virtual assets and operating secondary exchanges for virtual assets.

Joy also has significant experience in mergers and acquisitions and corporate finance transactions, and advises investment funds in relation to downstream acquisitions and disposals, upstream management and seeding arrangements and other corporate matters.

Joy was named a "Rising Star" by *Law360* in its 2018 annual report that recognizes the "top legal talent under 40" who are practicing at a level "usually seen from veteran attorneys." Joy is also recognized by *IFLR1000* 2019 as a notable practitioner in the Hong Kong investment funds area.

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LEONARD NG is co-head of the EU Financial Services Regulatory group and a member of the firm's Executive Committee. Based in the firm's London office, Leonard advises a wide range of global financial institutions on UK and EU financial services regulatory issues and has particular experience in advising investment managers and other clients on operating under the post-financial crisis regulatory framework. Leonard is a past member of the Board of the Managed Funds Association (MFA), the global trade association for hedge funds, and he is a frequent speaker at industry conferences.

In addition to UK and EU regulatory matters, Leonard has extensive experience in advising international clients on the Basel regulatory capital framework, as well as assisting EU-based clients assess the implications of U.S. legislation such as the Dodd Frank Act, in conjunction with colleagues in Sidley's U.S. offices.

In February 2019, Leonard was honored with the "Outstanding Contribution Award" which was presented at *The Hedge Fund Journal* Awards.

Leonard has also been interviewed widely for his thought leadership, including in such national publications as the *Financial Times, Reuters, Wall Street Journal* and *New York Times' Dealbook*. He has also been featured in numerous industry outlets, including *Bloomberg Briefs*, *HFMWeek, Financial News, Risk, Private Equity News, Asian Investor, Law360, Institutional Investor Magazine* and *Global Risk Regulator*.

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LILYA TESSLER is a partner and the New York head of Sidley's FinTech and Blockchain group, which is recognized as a Band 2 practice in the 2020 *Chambers Fintech* guide. She focuses her practice on representing digital asset trading platforms, blockchain technology companies, U.S. and non-U.S. broker-dealers, financial services firms and cryptocurrency funds. Lilya is ranked in the 2020 *Chambers Fintech* guide in the USA Legal: Blockchain & Cryptocurrencies category and was named a "Rising Star" in Fintech by *Law360* (2019).

Lilya advises technology companies on blockchain token offerings, including so-called ICOs. She also counsels financial institutions and digital asset exchanges with day-to-day securities issues, private placement agent requirements, custody rule requirements, cross-border regulatory issues, money services business registration requirements, as well as FINRA and SEC regulatory inquiries. She advises several U.S. and non-U.S. FinTech companies, including robo-advisors and high-frequency trading firms in evaluating the broker-dealer and investment adviser registration requirements.

Lilya works with transactional lawyers on structuring deals involving financial services and technology companies, digital asset exchanges and blockchain token offerings. She regularly assists both financial services firms and their vendors in negotiating U.S. and cross-border technology agreements for all types of services and considering the U.S. securities laws and broker-dealer regulatory issues associated with such technologies.

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JOSEPHINE LAW focuses her practice in both registered fund transactions and financial services regulatory advice. Josephine regularly advises on global payment and fintech regulatory matters representing both international corporations and start-up companies. She also has significant experience in establishing domestic funds, listing exchange traded funds on the Singapore Exchange, registering both domestic and offshore funds for retail distribution, and registering funds for restricted offers to accredited investors.

Josephine frequently advises on the establishment and licensing of fund management clients, as well as handling license applications with the Monetary Authority of Singapore. She also regularly advises on financial services regulatory issues relating to payment systems, stored value facilities, remittance business, credit cards and merchant acquiring, as well as regulated products and services under the Securities and Futures Act and Financial Advisers Act. Her experience includes advising both offshore and onshore financial institutions, including fund management companies, trustees, banks, broker-dealers, financial advisers, and payment service providers on Singapore licensing and regulatory compliance issues, such as advising on licensing requirements and exemptions, regulatory approvals for restructuring and change in control, cross-border marketing of regulated services and products and offering safe harbor exemptions, advertising rules, outsourcing requirements, derivatives reporting issues, anti-money laundering and disclosure of interests in listed securities.

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MATT FEEHILY'S primary focus is advising UK, EU and U.S. asset managers in relation to UK and EU financial services regulatory issues, including AIFMD, MiFID II, and MAR. Matt also advises the firm's FinTech clients, particularly companies that are actively engaged in the cryptocurrency and digital assets space.

More generally, Matt covers UK and EU financial services legislation affecting a variety of financial institutions, including banks, insurance companies and payment institutions. Matt is experienced in dealing with issues arising under the Financial Services and Markets Act 2000, the rules of the UK Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), transactional regulatory matters, compliance issues and anti-money laundering rules.

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KRISTIN S. TEAGER is an associate in the Banking & Financial Services group and represents a range of depository institutions, their holding companies, payment processors, technology providers, prepaid program managers, virtual currency businesses, money transmitters and retailers in connection with the provision of payments products and other financial services. Kristin advises on a range of federal and state regulatory issues and assists banks, retailers and fintech organizations in structuring their products to advance their business goals and meet their regulatory obligations. Kristin's practice includes negotiating and drafting complex commercial agreements, with a focus on the provision of financial services through strategic partnerships and joint venture arrangements, including private label and co-brand credit card program agreements, servicing agreements, and payment processing agreements.

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