

MONDAY, SEPTEMBER 27, 2021

PERSPECTIVE

# Are cryptocurrencies the kryptonite of the SEC?

By Hon. Benny Osorio (Ret.)

Cryptocurrencies may be the next great global revolution, but in the United States they're as predictable as Whack-a-Moles. While other countries (see, e.g., El Salvador, Paraguay, Panama, Brazil and Mexico) are moving to embrace digital currencies, this country is struggling mightily to understand how to manage the crypto beast.

Case in point: In early September, the U.S. Securities and Exchange Commission informed Coinbase, the largest U.S. cryptocurrency exchange, that it planned to take legal action against the company's proposed "Lend" offering, which would have allowed investors to earn four percent annually by lending out their USDC virtual tokens. Such tokens comprise stablecoins, a crypto offering designed to be less volatile than other cryptocurrencies by pegging their market value to an outside asset like the U.S. dollar. Stablecoins have become popular for generating yield in increasingly complex decentralized finance, or DeFi, activities.

The SEC's move was disclosed via a Tweet and blog post from Coinbase's CEO Brian Armstrong on September 7. Two weeks later, Coinbase announced that it would discontinue Lend and close its waitlist. Armstrong had taken issue with what he considered the SEC's heavy-handed response to a request about the legality of Lend: a Wells notice instead of guidance.

What would appear to be the object lesson from the above is that

in the world of cryptocurrency it's better to ask forgiveness than seek permission. But, in fact, SEC enforcement activities have a legitimate rationale and should come as no surprise to anyone who has followed the agency. Nonetheless, they can still have the unsettling effect of ex post facto laws.

The Coinbase matter comes on the heels of *SEC v. Ripple*, a case filed in December charging Ripple Labs and two of its executives with raising more than \$1.3 billion through an unregistered, ongoing digital asset securities offering. 20- CV-10832 (AT) (SN) (S.D.N.Y.

## The present system of crypto oversight will remain broken until the government stops regulating via court cases and one-off enforcement activities.

Apr. 9, 2021). The defendants, according to the SEC, failed to register their offers and sales of XRP tokens or satisfy any exemption from registration, in violation of the registration provisions of federal securities laws.

And there's the rub. Neither the SEC nor any other government entity has clearly established what constitutes a security in the context of digital currency. The entire regulatory structure for cryptocurrency relies on a 75-year-old Supreme Court decision that could never have envisioned the current financial landscape. According to *SEC v. Howey*, 328 U.S. 293 (1946), "The test of whether there is an 'investment contract' under [Section 2(1) of] the Secur-

ities Act is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others..."

The SEC's stated position is that almost anything that gives investors the expectation of profiting from the work of others can be labeled an investment contract; thus, most digital assets are investment contracts or securities based on the Howey test. This reasoning does not fly with the industry and even raises eyebrows among regulators.

SEC Commissioners Hester

laws; they also cannot get a clear answer, backed by a clear Commission-level statement, that something is a securities offering.

On its website, the SEC states that its job is "to be responsive and innovative in the face of significant market developments and trends." In response to technological advancements, the agency must therefore "continuously monitor the market environment and, as appropriate, adjust and modernize our expertise, rules, regulations, and oversight tools and activities."

For crypto industry insiders, these statements must ring hollow. They see an agency so far behind the eight-ball it may never catch up

**Hon. Benny Osorio (Ret.)** served 10 years on the bench of the Los Angeles Superior County Court and now serves as a mediator, arbitrator and discovery referee with Signature Resolution, where he handles a wide variety of business and civil disputes.



Pierce and Elan Roisman shared their concerns in a July 14 public statement. In the Matter of Coin-schedule:

There is a decided lack of clarity for market participants around the application of the securities laws to digital assets and their trading, as is evidenced by the requests each of us receives for clarity and the consistent outreach to the Commission staff for no-action and other relief. The test laid out in *Howey*, is helpful, but, often, including with respect to many digital assets, the application of the test is not crystal clear.... Market participants have difficulty getting a lawyer to sign off that something is not a securities offering or does not implicate the securities

with digital developments. They see investors harmed by the very agency whose charter is to protect them. Holders of Ripple's XRP tokens have watched their investments plummet in the wake of the lawsuit; other crypto holders are sensing incipient cracks on the foundation of their investments. Mark Cuban, a strong cryptocurrency advocate, tweeted, "The worst case is that the SEC gets a judgment [sic] that cripples Crypto/DeFi and moves it even further offshore, killing possibly trillions of \$\$\$ in economic benefit for the USA. We need exemptions like the internet got in the 90s."

In his September 14 testimony before the Senate Banking, Hous-

ing and Urban Affairs Committee, SEC Chairman Gary Gensler said that the agency will be seriously reviewing crypto-related assets to determine if they fall under securities laws, and he acknowledged that he intends to increase regulation of digital currency. In July, Gensler had referred to the crypto industry, including decentralized financial or DeFi platforms, as "the wild west of our financial system" that "desperately needs rules of the road."

Investors should absolutely be protected against bad actors, and a regulatory framework that mirrors the disclosure and other consumer protection requirements in traditional banking and financial

services is long overdue. The president's Working Group on Financial Markets, which includes Gensler, as well as Treasury Secretary Janet Yellen and Federal Reserve Chair Jerome Powell, has called for erecting stronger safeguards in crypto, but that process could take time, and the industry is running out of patience.

The present system of crypto oversight will remain broken until the government stops regulating via court cases and one-off enforcement activities. On September 21, business reporter Charles Gasparino posted on Twitter that Coinbase "will unveil proposals in the coming weeks to start a debate on the SEC's ad hoc regulation of

#cryptocurrency." He noted that Commission Peirce had disclosed plans to meet with "leading crypto industry players who are voicing their concern SECgov has not provided clear regulatory guidance stifling innovation."

The solution will not be simple. It could entail working with the industry to craft rules, deputizing those who know crypto best to educate lawmakers and regulators. The SEC faces a Hobson's choice: Does it breathe life into a monster that could end up destroying the dollar, or does it defer to a Congress that could let partisan politics kill a propitious baby? Maybe, just maybe, the SEC could for once think outside the box ■