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PERSPECTIVE

GUEST COLUMN

Crypto turf battles await legislative resolution

By Benny Osorio

Cryptocurrencies are like the Wild West of finance. Each week new victims bite the proverbial dust while new gunslingers strap on their weapons. Two different marshals have been asserting authority over the battle, but it's unclear whether either or both of them have sufficient firepower to impose order. This turf war is unlikely to end until Congress steps in to establish an overarching crypto regulatory framework that everyone can understand and respect.

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The SEC

The Securities and Exchange Commission, charged with overseeing securities – including investment contracts – is the first marshal riding herd over the crypto landscape. More than seven decades ago, the Supreme Court established a test for investment contracts in *SEC v. W.J. Howey* 328 U.S. 293 (1946). In that case, the court held that an "investment contract" exists whenever (i) there is the investment of money; (ii) in a common enterprise; (iii) with a reasonable expectation of profits to be derived; (iv) from the efforts of others. The determination of whether an investment contract exists lies in the circumstances surrounding the contract and the manner in which it is offered, sold or resold.

SEC Chair Gary Gensler has urged legislators to grant the SEC more oversight authority over crypto, maintaining that "[crypto] products are subject to the securities laws and must work within our securities regime." "It doesn't matter whether it's a stock token, a stable value token backed by securities, or any other virtual product that provides synthetic exposure to underlying securities. These products are subject to the securities laws and must work within our securities regime…" The agency recently almost doubled the size of its Division of Enforcement's Crypto Assets and Cyber Unit.

The SEC has been aggressive against cryptocurrency players who straddle the securities line. In 2020, it went after Ripple Labs Inc., which provides block chain-based networks facilitating low-cost payments between financial institutions using a digital token called XRP. (Sec. *Exch. Comm'n v. Ripple Labs, Inc.*, No. 20 Civ. 10832 (S.D.N.Y. filed Dec. 22, 2020)) The sale of the tokens, the SEC alleged, was an unregistered securities offering, and Ripple had distributed billions of dollars' worth of tokens as employee compensation, in lieu of cash, to finance its business. The case is awaiting trial, but it could ultimately provide clarity on when a digital asset is considered a "security" subject to more onerous regulation by the SEC.

This year, the SEC charged BlockFi Lending LLC with failing to register offers and sales of BlockFi Interest Accounts (BIAs) under the Securities Act of 1933. (In Re BlockFi Lending LLC, Securities Act Release No. 11029(Feb. 14, 2022)). It found that BlockFi met the definition of "investment company" in the Investment Company Act of 1940 because it issued and acquired securities but had failed to register with the SEC as required by law.

The SEC said that BIAs were securities under the Howey test because (i) BlockFi promised investors a variable interest rate in exchange for crypto assets loaned by investors, (ii) BIA investors had a reasonable expectation of future profit from BlockFi's efforts, and (iii) they reasonably expected that BlockFi would use the invested assets in its lending and investing and that they would share profits resulting from those efforts.

In a sign that the SEC case had merit, BlockFi agreed to pay a $50 million penalty and to cease its unregistered offers and sales of BIAs. Its parent company promised to register the offer and sale of any new lending product under the Securities Act of 1933. Other SEC actions are now pending against Celsius Network LLC, Gemini Trust, and Voyager Digital.

The CFTC

The other marshal in town is the Commodities and Futures Trading Commission, which regulates derivatives transactions including swaps, futures, and options. The CFTC also has limited authority to regulate fraud and manipulation in commodities markets. The CFTC first asserted jurisdiction over digital assets in 2015. A year later the commission stated that "bitcoin and other virtual currencies are encompassed in the definition [of commodity] and properly defined as commodities, and are subject as a commodity to the applicable provisions of the [Commodity Exchange] Act…" In 2019, then-CFTC Chair Heath Tarbert went further, saying, "it is my view as Chairman of the CFTC that Ether is a commodity." More recently, the Southern District of New York found that "Bitcoin, Ether, Litecoin, and Tether tokens, along with other digital assets, are encompassed within the broad definition of "commodity" under Section 1a(9) of the [Commodity Exchange] Act" (*In Re Ifinex Inc.*, CFTC Docket No. 22-05 (Oct. 15, 2021)).

Just as the SEC has been wrangling securities rough riders, the CFTC has been actively rounding up commodities violators. In October 2020, it charged BitMEX, the owners of five trading platforms with illegally operating a cryptocurrency derivatives trading platform and with anti-money laundering violations (CFTC Release No. 8412-21). Under a consent order announced in August 2021, BitMEX paid a $100 million civil monetary penalty and agreed to stop offering futures or other related crypto commodity contracts in the United States without appropriate licensure from the CFTC. (*In re Payward Ventures, Inc.* d/b/a Kraken, CFTC Docket No. 21-20 (Sept. 28, 2021))

Other CFTC trophies include a settlement with the company known as Kraken for illegally offering margined retail commodity transactions in digital currencies such as Bitcoin and failing to register as a futures commission merchant. In March 2021, Coinbase agreed to a $6.5 million settlement with the CFTC, neither admitting nor denying wrongdoing, for alleged reckless, false, misleading, or inaccurate reporting as well as wash trading by a former employee.

The commission has defined the Tether stablecoin as a "commodity," reaffirming that it has enforcement jurisdiction over this type of cryptocurrency, and it has initiated enforcement actions related to tokens, ordering Tether to pay a fine of $41 million for making misrepresentations to customers about its financial position.

Build the Corral

If the foregoing discussion has reinforced the Wild West analogy, it's because these two commissions have seemingly been making their crypto rules up on the fly. Who can really say what constitutes a security and what falls into the commodities bucket? It's no wonder that the crypto industry appears to be like a dead man walking: It has no idea what's going to come at it, from which direction, and for what reason.

The first order of business, therefore, is clarifying what each class of digital assets is: a commodity, subject to CFTC authority, or a security, subject to SEC jurisdiction? Even with that clarity, will the SEC and CFTC be able to effectively regulate the market?

This is where Congress must act. It must reach bipartisan consensus on building a strong corral that will actually hold the various strains of crypto livestock and empowering the two government lawmen to properly oversee it. It must establish a new regulatory cryptocurrency regime and invest both agencies with sufficient authority to work together to tame and contain the Wild Crypto West.

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