

Crypto Bills Show Consensus On Need For Federal Oversight

By **Jonathan Marcus and Stephanie Cannuli** (April 21, 2021, 5:46 PM EDT)

The advent of bitcoin over a decade ago spawned an explosion in decentralized, peer-to-peer financial structures using distributed ledger technology, such as blockchain, that are challenging the traditional financial regulatory landscape. U.S. regulators have sought to apply principles and rules from a different era to protect the financial markets for public investment without stifling innovation.



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Federal regulatory agencies like the U.S. Securities and Exchange Commission and the Commodity Futures Trading Commission have used their enforcement authority to combat fraud in the digital asset space, and the SEC has challenged what it has determined to be unregistered securities offerings.

Nevertheless, the absence of clear rules or regulatory authority to impose rules for the trading and transfer of digital assets has left regulators, market participants and the public exposed and frustrated. Some legislation has been proposed to address the mismatch between the current federal regulatory framework and the digital asset revolution, but none has yet come close to becoming law.

Leading regulators have recently voiced their concerns about this mismatch, with acting CFTC Chairman Rostin Behnam expressly calling for a new regulatory regime for digital assets, and newly confirmed SEC Chairman Gary Gensler using his confirmation hearing to highlight the importance of laws keeping pace with profound technological changes.

Given the recent volatility in digital asset prices and the burgeoning investor demand for access to digital asset products, the environment is ripe for regulatory reform.

The Patchwork Approach of Regulation in the U.S.

Digital asset innovation has put pressure on the fragmented nature of U.S. regulation of financial markets. Across the nation, individual states have adopted varying approaches to the new products and technology, while Congress to date has left the task to numerous federal agencies with a range of regulatory mandates designed for a 20th century financial system.

State Regulation

At the state level, two approaches have emerged. One is the approach taken by states such as California and New York, which have pursued robust enforcement.

For example, in February, the New York Attorney General's Office announced an **\$18.5 million fine** against the issuer of the tether stablecoin, Tether, and the owner of the Bitfinex Trading Platform, iFinex, which the attorney general had been investigating for false statements relating to the nature of the stablecoin and the alleged loss of customer funds.

The settlement came one month after the New York Attorney General's Office **sued another actor** in the cryptocurrency space, Coinseed Inc., alleging that its initial coin

offering should have been registered as securities and subject to broker-dealer registration requirements.[1]

In connection with the suit, Attorney General Letitia James warned that "[u]nregulated and fraudulent virtual currency entities, no matter how big or small, will no longer be tolerated in New York." [2]

The attorney general has since issued two public alerts in response to the "extreme risk" posed to New Yorkers investing in virtual or cryptocurrencies.[3]

Other states, such as Colorado and Wyoming, have enacted pro-cryptocurrency legislation to attract investment. Wyoming has been particularly welcoming to cryptocurrency businesses: It has issued charters for special purpose depository trust institutions, permitting companies focused on blockchain to provide banking services in the state.

Additionally, the state has enacted the Wyoming Utility Token Act, which defines cryptocurrency as an asset class separate from securities and commodities, and thus not subject to regulation as such.

Federal Regulation

U.S. federal regulation of digital assets exists in a type of jurisdictional netherworld. The applicable laws often depend on how the asset is categorized — either as a commodity, security, currency or property.

While the agencies endeavor to coordinate so that digital assets are effectively regulated, the lack of clear definitional boundaries and legal authority has created gaps in the regulatory framework that are difficult to overcome.

The two main regulatory players in this space are the SEC and CFTC, and each agency's approach to digital assets has largely involved enforcement actions. The SEC has sought to protect investors by requiring offerings of digital assets to be registered as securities where the agency has determined that the offering satisfies the elements of the test established by the U.S. Supreme Court's 1946 opinion in SEC v. W. J. Howey Co. for an investment contract.[4]

Application of the Howey test to digital assets has generated debate, however. In 2019, SEC staff published guidance for applying the Howey test to determine whether a given digital asset is a security.[5] Staff also published the first digital asset-related no-action letters, in which it determined that digital assets that functioned as stored-value cards would not be deemed securities.[6]

However, these issuances have only highlighted the challenges involved in applying a 75-year-old test that evaluated the status of orange groves to the digital world. SEC Commissioner Hester Peirce has criticized the agency's reliance on enforcement actions and urged that a safe harbor be created to avoid deterring innovation.[7]

The SEC has consistently declined to approve vehicles designed to invest in digital assets; to date, the SEC has rejected every application to offer a bitcoin exchange-traded fund.

The commission has expressed concern that cryptocurrency markets are prone to fraud and manipulation,[8] and has repeatedly tied that concern to the absence of regulation of the spot market in cryptocurrencies.

For example, in February 2020, the SEC disapproved a rule change by NYSE Arca Inc. to list and trade shares of the U.S. Bitcoin and Treasury Investment Trust. The SEC reasoned that, NYSE Arca failed to demonstrate that the portion of the spot market represented by the Bitcoin Reference Rate was "uniquely and inherently resistant to manipulation," and that it had a surveillance sharing agreement with a "regulated bitcoin market of significant size."

The SEC concluded that the five spot markets on which the Bitcoin Reference Rate would be based did not constitute a sufficiently supervised market. In the SEC's view, the combination of potential Financial Crimes Enforcement Network and state oversight of these markets or the CFTC's limited jurisdiction over commodities such as bitcoin did not match the level of oversight exercised over national securities exchanges.[9]

In light of this position, regulation of the spot market in cryptocurrencies could expand the array of cryptocurrency products available to investors.

Like the SEC, the CFTC has used its enforcement authority in the digital asset space. Under the Commodity Exchange Act, the definition of "commodity" is expansive, covering goods and articles and "all services rights and interests ... in which contracts for future delivery are presently or in the future dealt in." [10]

The CFTC has relied on this definitional flexibility, declaring in its first cryptocurrency enforcement action that "bitcoin and other [cryptocurrencies] are encompassed in the definition and properly defined as commodities." [11]

The U.S. District Court for the Eastern District of New York in 2018 upheld the CFTC's enforcement authority over cryptocurrencies was in *CFTC v. McDonnell*, which found that cryptocurrencies "are 'goods' exchanged in a market for a uniform quality and value" and, as such, "[t]hey fall well within the common definition of 'commodity' as well as the [Commodity Exchange Act's] definition of 'commodities.'" [12]

While the CFTC has obtained success in pursuing fraud cases involving cryptocurrency, its oversight of the spot market in cryptocurrencies is nevertheless limited to enforcement of Commodity Exchange Act violations. It has no statutory authority to establish rules or principles for trading of physical cryptocurrencies; the CFTC's mandate is to regulate the trading of derivatives.

In this capacity, the CFTC has allowed the listing and trading of derivatives using cryptocurrency, such as the Chicago Mercantile Exchange's bitcoin and ethereum futures contracts.

The CFTC's anti-fraud and anti-manipulation enforcement authority over the physical commodity markets is in service of that mandate. [13] The distinction is important, because the ability to prosecute bad actors after misconduct has occurred does not offer the same protections as do rules that can help guard against misconduct occurring in the first place.

The difficulties that digital asset innovators face in determining whether their products are securities and the related challenges other market participants encounter in deciding how to handle such products have spurred calls for clarity in regulation. Meanwhile, the absence of regulation of spot market transactions in digital assets has prompted proposals to subject them to federal oversight.

The urgency of these challenges has grown as the demand for cryptocurrency products has

dramatically increased. While some prominent cryptocurrency companies maintain headquarters in the U.S., without a clear legal framework, the U.S. risks hobbling their growth as well as deterring new entrepreneurs from entering the U.S. markets.

Congressional Response to Calls to Action

Recognizing that the lack of a clear and cohesive approach to regulation serves neither innovators nor investors, federal lawmakers have begun developing proposals to clarify the legal framework governing digital assets and cryptocurrencies.

On March 9, H.R. 1602, the Eliminate Barriers to Innovation Act of 2021, **was introduced**.^[14] The bill, which the U.S. House of Representatives passed on Tuesday, establishes a working group composed of industry experts and SEC and CFTC representatives to evaluate the U.S. legal and regulatory framework for digital assets.

The working group would produce a report of its analysis and recommendations on improving the U.S. regulatory framework, specifically in the primary and secondary markets for digital assets. In formally bringing together the SEC and the CFTC to work through key structural issues that have hindered legal clarity for digital assets, this bill would present an opportunity for stakeholders to address these impediments in a methodical and more coordinated manner.

The Token Taxonomy Act of 2021 was also introduced March 9.^[15] Seeking to clarify the categorization of digital assets, H.R. 1628 would exclude "digital token" from the definition of a security under the securities laws.

As noted above, SEC enforcement actions have alleged that digital asset-based offerings have constituted the unlawful sale of unregistered securities, based on the Howey test.

Yet, the Howey test faces challenges when applied to digital tokens, given their reliance on emerging technology and decentralized networks. The Token Taxonomy Act's proposed definition of "digital token" aims to provide digital token issuers with some clarity in this regard.

As proposed, a digital token would be defined as a token that is created pursuant to rules ensuring that the creation and supply of the token are not controlled by a central group or single person, among other requirements. The token's transaction history must be able to resist modification or tampering, and the token must be capable of being transferred between persons without an intermediate custodian.^[16]

The success of these two congressional measures remains to be seen. Successful or not, their introduction highlights the importance of digital market regulation and reflects the recognition among at least some lawmakers of the need to enhance the regulatory landscape.

The new administration also presents an opportunity for progress in this space. During his nomination hearing before the U.S. Senate Banking Committee, Gensler stated that "[b]itcoin and other cryptocurrencies have brought new thinking to payments and financial inclusion" and expressed his intention to "work with fellow commissioners to both promote the new innovation ... [and] ensure for investor protection."

Gensler, a former CFTC chairman, U.S. Department of the Treasury undersecretary, and MIT professor who focused on the intersection of technology and finance, is viewed by

stakeholders in the digital asset space as an expert who can bring his knowledge to bear on the challenges digital assets present to regulators and market participants under the outdated regulatory framework.

Like the SEC, the CFTC will become a majority-Democratic commission and may seek a new approach to digital asset regulation, though its ability to do so could turn on whether Congress will give the agency regulatory authority over digital asset spot markets.

The CFTC's inclination to seek new approaches could also turn on agency leadership, and the Biden administration has yet to nominate a new chair. Behnam has called for federal regulators to oversee spot cryptocurrency markets.[17]

Whatever ultimate form the regulation of digital assets takes, its importance cannot be overstated. The burgeoning interest in digital asset investment, rapid pace of innovation and volatility of the digital asset markets have provided an imperative to lawmakers and regulators to enhance the current regime to better protect investors and promote innovation.

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[1] See *New York v. Coinseed, Inc.* (Feb. 17, 2021). The SEC filed a parallel action against Coinseed and its CEO in federal court for the sale of unregistered securities in violation of Sections 5(a) and 5(c) of the Securities Act of 1933 (15 U.S.C. §§ 77e(a) and 77e(c)). *SEC v. Coinseed, Inc.*, No. 1:21-cv-01381, compl. A 2 (S.D.N.Y. Feb. 17, 2021).

[2] See Press Release, "Attorney General James Sues To Shut Down Illegal Cryptocurrency Trading Platform and Virtual Currency, Seeks To Recoup Defrauded Funds for Thousands of Investors," N.Y. State Office of the Att'y Gen. (Feb. 17, 2021).

[3] See "Investor Alert: Virtual Currency Risks," N.Y. State Office of the Att'y Gen.; "Industry Alert: Registration of Commodity Brokers-Dealers, Salespersons and Investment Advisors Doing Business Relating to Virtual or 'Crypto' Currency," N.Y. State Office of the Att'y Gen.

[4] See *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). See also "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO," Securities Act Release No. 81207, at 11, SEC (July 25, 2017) (stating the SEC's position that many virtual currencies fall within the definition of a security under the Howey test); In the Matter of CarrierEQ, Inc., d/b/a Airfox, Securities Act Release No. 10575 (Nov. 16, 2018) and In the Matter of Paragon Coin, Inc., Securities Act Release No. 10574 (Nov. 16, 2018) (applying the Howey test in entering cease-and-desist orders against ICO issuers). Courts, too, have applied Howey to digital assets. See, e.g., *SEC v. Kik Interactive, Inc.*, No. 1:19-cv-05244-AKH (S.D.N.Y. Sept. 30, 2020).

[5] "Framework for 'Investment Contract' Analysis of Digital Assets," SEC, Strategic Hub for

Innovation and Financial Technology (April 3, 2019).

[6] No-Action Letter on TurnKey Jet, Inc., SEC, Division of Corporation Finance (April 3, 2019); No-Action Letter on Pocketful of Quarters, Inc., SEC, Division of Corporation Finance (July 25, 2019).

[7] See Hester M. Peirce, Commissioner, "Running on Empty: A Proposal To Fill the Gap Between Regulation and Decentralization," SEC (Feb. 6, 2020); see also, Hester M. Peirce, Commissioner, "Token Safe Harbor Proposal 2.0," SEC (April 13, 2021).

[8] See, e.g., Staff Letter, "Engaging on Fund Innovation and Cryptocurrency-Related Holdings," SEC, Division of Investment Management (Jan. 18, 2018) (addressing issues arising from funds potentially focused on cryptocurrency-related products); see also, e.g., Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, To List and Trade Shares Issued by the Winklevoss Bitcoin Trust, Release No. 34-80206 (Mar. 10, 2017), at 2; Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, Relating to the Listing and Trading of Shares of the SolidX Bitcoin Trust Under NYSE Arca Equities Rule 8.201, Release No. 34-80319 (Mar. 28, 2017).

[9] See Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, To Amend NYSE Arca Rule 8.201-E (Commodity-Based Trust Shares) and To List and Trade Shares of the United States Bitcoin and Treasury Investment Trust Under NYSE Arca Rule 8.21-E (Bitcoin Trust Disapproval Order), Release No. 34-88284, at 23-24 (Feb. 26, 2020).

[10] 7 U.S.C. § 1a(9).

[11] In the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC No. 15-29, (Sept. 17, 2015).

[12] See CFTC v. McDonnell, 287 F. Supp. 3d 213, 220-22 (E.D.N.Y. 2018).

[13] See 7 U.S.C. §§ 6(b), 9, 13(a)(2).

[14] H.R. 1602 was introduced by Reps. Patrick McHenry (R-NC) and Stephen Lynch (D-MA).

[15] H.R. 1628 was introduced by Rep. Warren Davidson (R-OH), and co-sponsored by Reps. Ted Budd (R-NC), Darren Soto (D-FL), Scott Perry (R-PA) and Josh Gottheimer (D-NJ).

[16] Additionally, the bill would: (i) direct the SEC to enact certain regulatory changes regarding digital units secured through public key cryptography; (ii) adjust taxation of virtual currencies held in individual retirement accounts; and (iii) create certain tax exemptions related to transfers or sales of virtual currency.

[17] "The State of the Commodity and Futures Trading Commission: Hearing Before the Subcommittee on Commodity Exchanges, Energy and Credit," 116th Cong. (2020) (statement of Rostin Behnam).