Cryptocurrency finds itself in the sights of robust regulation

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Depending upon who you talk to, cryptocurrency is all the rage, a Ponzi scheme or yet another energy-consuming scourge on the environment. (See tweets by Elon Musk from mid-May 2021, citing the environmental impact of bitcoin transactions for Tesla's decision to suspend bitcoin for purchasing vehicles.)

Perhaps it is all three, but given the potential promise of its underlying technology, it is not going anywhere soon and will remain an emerging and even volatile commodity.

The question is whether it will become something more. Whether it ever becomes a true currency is open for debate. Traditional fiat currency finds its worth in its issuer. Currencies are generally controlled by governments backing their worth. Governments also manipulate the currency to suit their needs and influence domestic and international policy. Bitcoin, created in 2008 as part of the cypherpunk movement of the early 1990s by the pseudonymous Satoshi Nakamoto, was intended to be the opposite. Thus, the advent of cryptocurrency, as it begins to gain hold, is often viewed as a threat to government power and control worldwide.

Because of that, and other reasons discussed below, most governments will move to ensure that cryptocurrency does not become anything more than an investor's dalliance. And that may not be a bad thing. Imagine a world currency as volatile as a market driven by rumor and manipulation, where those with the loudest voices, or most-followed social media platforms, have the most influence. Imagine a world where Reddit bulletin boards have a major impact on the worth of our system of currency, where the currency of chaos abounds.

For examples, one need look no further than the GameStop and meme stock frenzy that permeated headlines and certain sectors of the financial world in 2021. Interesting to some, but not to those who crave predictability and stability, which, we suspect, is the vast majority. Of course, on Sept. 7, 2021, El Salvador bucked this notion, becoming the first country to adopt bitcoin as official legal tender, a decision received with great skepticism by more traditional global financial establishments.

Governments, too, are worried, not only about losing power to cryptocurrencies in the long term, but in the short term as well. This is especially true in areas such as tax avoidance, money laundering and other illicit transactions, and the skirting of regulatory requirements. Passage of the "Infrastructure Investment and Jobs Act," HR 3684 (https://bit.ly/3fDWuIP), on Nov. 15, 2021, introduced new reporting requirements for certain cryptocurrency transactions, which are wholly unrelated to "infrastructure."

Among other things, the Infrastructure Bill amends the anti-money-laundering "cash reporting" requirements to include "digital assets," extending reporting obligations for certain transactions in excess of $10,000 in cash to encompass digital asset transactions exceeding $10,000, starting Jan. 1, 2023. The Infrastructure Bill broadly defines digital asset to mean "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the [Treasury] Secretary." We do not anticipate government involvement in the crypto space stopping there.

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In certain circles, there is a push to do away with cash transactions and move entirely to a virtual currency. Indeed, on Nov. 30, 2021, Federal Reserve Chair Jerome Powell, testifying before the U.S. Senate Committee on Banking, Housing and Urban Affairs, made clear that, "You wouldn't need stablecoins; you wouldn't need cryptocurrencies if you had a digital U.S. currency. I think that's one of the stronger arguments in its favor." This movement was hastened during the pandemic as more people were forced to buy virtually and others became increasingly averse to hand-to-hand currency transactions.

A crypto-wallet could not only solve these types of problems, but could make government distribution of monies much more seamless. Lael Brainard, a member of the Federal Reserve Board of Governors, noted that this trend "has intensified calls for CBDCs [Central Bank Digital Currencies] to maintain the sovereign currency as the anchor of the nation's payment systems." *See* Lael Brainard, Speech at the Federal Reserve Board and Federal Reserve Bank of San Francisco's Innovation Office Hours, San Francisco, Calif.:

"An Update on Digital Currencies"; (Aug. 13, 2020); https://bit.ly/3ImRhBv.

China and Switzerland have taken a leading role in looking into the CBDC arena. According to the CBDC Tracker (https://bit.ly/3GLJs8f) maintained by the Atlantic Council, there are currently 79 countries in various phases of researching and developing their own digital currency.

In the absence of a United States-issued digital currency, private industry cryptocurrencies have been filling the void. As of November 2021, it was estimated that there were more than 10,000 different cryptocurrencies in existence, and the crypto asset market surpassed $3 trillion globally.

On April 17, 2021, Gary Gensler became the chair of the Securities and Exchange Commission. Gensler joined the SEC acutely aware of the crypto space, having taught courses in cryptocurrency at the Massachusetts Institute of Technology and having previously served as chair of the U.S. Commodity Futures Trading Commission in the Obama administration. Gensler has led with a focus on more regulation and an expressed desire for more robust measures to improve investor protection in the crypto space. During a recent interview with The Wall Street Journal, Gensler reaffirmed his view that the crypto market "needs more investor protection" and that digital assets fit within the "broad remit" at the SEC. "SEC Chairman on New Regulations on Cryptocurrencies and Climate Risk," The Wall Street Journal, Dec. 12, 2021.

While maintaining that the SEC's powers are already broad, Gensler has nonetheless asked Congress to pass legislation giving the agency the authority to monitor crypto exchanges. Recognizing that not all crypto tokens can be classified as securities under the test established in *SEC v. W.J. Howey Co.* (U.S. Sup. Ct. 1946), Gensler has maintained that because cryptocurrency platforms typically offer trading in multiple tokens, it is likely that at least some will be securities, and has repeatedly invited crypto trading platforms to work with the SEC and "come in" and "get registered."

Notwithstanding this offer, some platforms have not received the clarity or cooperation that this invitation implies. For example, in the fall of 2021, after months of effort by Coinbase to engage the SEC about its planned Coinbase LEND program, the agency advised the company of its intent to sue. And Ripple Labs has been defending itself in the Southern District of New York since December 2020, despite its earlier attempts to settle with the SEC.

Similarly, Gurbir Grewal, director of the SEC's Division of Enforcement, who was New Jersey's attorney general and a federal prosecutor, has emphasized restoring public trust in financial markets as an overarching goal. Grewal has pointed to robust enforcement, controls and procedures for ensuring compliance, and accountability through stricter penalties for misconduct.

Grewal has made clear that the SEC will engage in proactive enforcement while applying securities definitions in existing rules to emerging technologies, including cryptocurrency specifically and decentralized finance (DeFi) more generally (read to include non-fungible tokens (NFTs) and decentralized autonomous organizations (DAOs)). He claims he will require admissions of guilt in certain circumstances, a substantive change in agency operations.

In October 2020, the Department of Justice released its Cryptocurrency Enforcement Framework, stressing prosecution of illegal conduct that touches on financial data or computers in the United States, even if the criminal actors reside outside the country. In January 2021, federal authorities announced criminal charges against an individual who solicited monies for various cryptocurrency funds he operated. In February 2021, the U.S. Attorney for the Southern District of New York announced that the operator of two cryptocurrency hedge funds pleaded guilty to securities fraud.

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That same month, the SEC charged three individuals with defrauding hundreds of retail investors out of more than $11 million through two fraudulent and unregistered digital asset securities offerings. On Feb. 26, 2021, foreshadowing what Gensler's focuses might be, the SEC's Division of Examinations issued a Risk Alert (https://bit.ly/3tHrjEE) emphasizing an intention to focus on activities of investment advisers, broker-dealers, exchanges and transfer agents related to the offer, sale and trading of digital assets.

Under Gensler's tenure, the SEC has stepped up its work in the cryptocurrency market. On May 29, just a month after Gensler assumed the helm, the Wall Street Journal reported that the SEC sued five individuals who helped raise more than $2 billion from investors in one of the then-largest digital asset cases brought by that agency. Between Aug. 4 and 9, 2021, the SEC commenced three separate enforcement actions relating to digital assets.

On Sept. 1, 2021, the SEC Office of Investor Education and Advocacy and Division of Enforcement's Retail Strategy Task Force issued an investor alert (https://bit.ly/33zmzGH) to "remind investors to watch out for investment schemes involving digital assets and 'crypto.'" On Dec. 2, 2021, the SEC charged a Latvian citizen with defrauding hundreds of retail investors out of at least $7 million through two separate fraudulent digital asset securities offerings.

On Aug. 3, 2021, during remarks before the Aspen Security forum, Gensler noted his agreement with former SEC Chairman John Clayton's 2018 statement that "every ICO [initial coin offering] I have seen is a security — we have jurisdiction, and our federal securities laws apply."

Thus, the bottom line for someone contemplating entry into this arena is to proceed with caution. As governments confront the many threats, perceived or otherwise, that cryptocurrency poses to their power and ability to maintain fiscal control, more laws, regulations and stringent enforcement will follow. If you are in or thinking about entering the crypto space, do so with the knowledge that government scrutiny will become more and more invasive and enforcement more robust.

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