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Carol R. Goforth

REGULATION BY ENFORCEMENT: PROBLEMS WITH THE SEC'S APPROACH TO CRYPTOASSET REGULATION

CAROL R. GOFORTH*

INTRODUCTION

On August 3, 2021, Securities and Exchange Commission ("SEC") Chairman Gary Gensler specifically told a global conference on crypto that Congress needed to "give the agency more authority to better police cryptocurrency trading, lending and platforms, a 'Wild West' he said is

* Carol R. Goforth is a University Professor and the Clayton N. Little Professor of Law at the University of Arkansas, in Fayetteville. She has decades of experience with corporate, securities, and business law issues in the United States, and has recently published a number of articles and blog posts dealing with the regulation of cryptotransactions. She is also the co-author of *Regulation of Cryptoassets* (2d ed. West Academic, 2022) and serves as an advisor to Honeycomb Digital Investments. Special thanks to Yuliya Guseva, the co-author of *Regulation of Cryptoassets* (2d ed.), for her insights and observations as this Article was being written.

riddled with fraud and investor risk."[1] He has repeated these themes multiple times, including in testimony at hearings before the House Financial Services and House Appropriations Committees.[2] In addition, on September 14, 2021, when he testified before the Senate Banking Committee, he reported that "clarity is needed from Congress on how the federal regulatory agencies can work together on crypto issues."[3] Gensler has repeatedly been quoted as having complained that crypto lending is so underregulated that it is still like the "Wild West."[4]

The desire for congressional clarification, particularly with regard to the scope of the SEC's authority, but also how that authority relates to power that has been delegated to other regulators, has long been shared by others in the crypto ecosystem.[5] Timothy Massad, former chairman of the Commodity Futures Trading Commission ("CFTC") and former Assistant Secretary for Financial Stability at the Treasury, explained in 2019 that "[t]here is a gap in

1. Katanga Johnson, *U.S. SEC Chair Gensler Calls on Congress to Help Rein in Crypto 'Wild West,'* REUTERS (Aug. 3, 2021, 6:43 PM), https://www.reuters.com/technology/us-sec-chair-gensler-calls-congress-help-rein-crypto-wild-west-2021-08-03/.

2. Katelynn Bradley, Annmarie Conboy-DePasquale & Travis Norton, *SEC Chair Gensler Signals Greater Regulation of Cryptocurrency Under Existing Authorities*, BROWNSTEIN (Sept. 21, 2021), https://www.bhfs.com/insights/alerts-articles/2021/sec-chair-gensler-signals-greater-regulation-of-cryptocurrency-under-existing-authorities [https://perma.cc/LLA6-C9GB]. Gary Gensler's testimony from a May 6, 2021, hearing before the House Committee on Financial Services included the fact that he had already affirmatively asked his staff "to consider whether expanded enforcement mechanisms are necessary" to deal with rapid changes in financial markets. *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part III Before the H. Comm. on Fin. Servs.*, 117th Cong. 1 (2021) (testimony of Gary Gensler, Chairman, SEC), https://financialservices.house.gov/uploadedfiles/hhrg-117-ba00-wstate-genslerg-20210506.pdf [https://perma.cc/P6GG-YQ4V]. On May 26, 2021, in his opening statement before a House subcommittee, Chairman Gensler not only made the case for expanded resources for the SEC but specifically called our regulatory gaps applicable to crypto exchanges, commenting that was "just one of many regulatory gaps in these crypto asset markets." *Securities and Exchange Commission Oversight Hearing Before the Subcomm. on Fin. Servs. & Gen. Gov't U.S. House Appropriations Comm.*, 117th Cong. 8 (2021) (testimony of Gary Gensler, Chairman, SEC), https://docs.house.gov/meetings/AP/AP23/20210526/112692/HHRG-117-AP23-Bio-GenslerG-20210526.pdf [https://perma.cc/XVS4-W585]. With regard to crypto regulation in particular, he also noted that he looked forward to working "with Congress to fill in the gaps of investor protection in these crypto markets." *Id.* at 9.

3. Ted Knutson, *SEC Chair Gensler: Crypto Assets Are Catalyst for Change but Need Greater Oversight*, FORBES (Sept. 14, 2021, 1:36 PM), https://www.forbes.com/sites/tedknutson/2021/09/14/sec-chair-gensler-crypto-assets-are-catalyst-for-change-but-need-greater-oversight/?sh=28af4c462f74 [https://perma.cc/H8DQ-95FF].

4. *Regulators Face 'Wild West' as Crypto Traders Compete with Traditional Banks*, NEWS24 (Sept. 17, 2021), https://www.news24.com/fin24/companies/regulators-face-wild-west-as-crypto-traders-compete-with-traditional-banks-20210917 [https://perma.cc/6P6H-D78X].

5. Tomio Geron, *Washington Is Rushing to Regulate Crypto. It's a Mess*, PROTOCOL (May 20, 2021), https://www.protocol.com/fintech/bitcoin-cryptocurrency-regulations [https://perma.cc/6NK5-7934] (noting that "a substantial number of players in the crypto industry have been seeking more regulatory clarity").

the regulation of crypto-assets that Congress needs to fix."[6] His report concluded that cryptoassets cut across jurisdictional boundaries of the SEC and CFTC, and that neither agency has sufficient jurisdiction to address the risks that they present.[7]

Other observers have also bemoaned the lack of congressional action to clarify how these new assets should be regulated. As one commentator has noted: "Over the last decade, digital assets and blockchain technology have developed from a fringe interest to a top concern of central banks and other financial institutions. But cryptocurrency remains underutilized and poorly understood. In the United States, this failure is symptomatic of congressional neglect."[8]

Notwithstanding apparent widespread agreement that existing laws and regulatory structures are unclear, SEC Chair Gensler has recently pivoted from this position, apparently deciding that the SEC can use a "broad" definition of what constitutes a security, giving the agency a "great deal of authority" while simultaneously providing "a great deal of clarity."[9] A review of SEC enforcement actions, however, reveals a number of times when this approach seems to have lacked the regulatory clarity necessary for proper functioning of the capital markets.[10]

In order to explain how the SEC has, in effect, been regulating by enforcement and to illustrate the problems with this approach while advocating for a legislative response, this Article is divided into five Parts and a conclusion. Part I of this Article offers a brief and high-level overview of the development of cryptoassets and their functions, as well as associated products that the SEC is claiming are securities. Part II offers an equally high-level explanation of how such interests have generally been regulated in the United States, with an emphasis on the test most often used by the SEC to

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6. Timothy G. Massad, *It's Time to Strengthen the Regulation of Crypto-assets*, BROOKINGS (Mar. 18, 2019), https://www.brookings.edu/research/its-time-to-strengthen-the-regulation-of-crypto-assets/ [https://perma.cc/3XV7-8WXH].

7. *Id.*

8. Craig Stevens, *Congress Should Deliver Crypto Clarity and Reassert Its Authority*, ROLL CALL (Aug. 18, 2021, 6:00 AM), https://rollcall.com/2021/08/18/congress-should-deliver-crypto-clarity-and-reassert-its-authority/ [https://perma.cc/8US3-MJWN].

9. Bradley et al., *supra* note 2.

10. Consider this complaint about the current situation:

> [R]ecent SEC guidance is primarily focused on how the agency will punish crypto entities for violations, but it provides few tangible rules of the road for crypto players to follow moving forward. This has a chilling effect on industry growth, as innovators may be hesitant to operate in the United States for fear of unwittingly falling into the SEC's crosshairs.

Kristin Smith, *Regulatory Clarity Will Ensure American Crypto Leadership*, MORNING CONSULT (Sept. 15, 2021, 5:00 AM), https://morningconsult.com/opinions/regulatory-clarity-will-ensure-american-crypto-leadership/ [https://perma.cc/DZV5-SRN4].

determine how the securities laws apply. Part III examines four distinct instances that illustrate how the SEC's approach to crypto has evolved and some of the open questions causing confusion in the crypto ecosystem. Part IV considers what it means for the SEC to be "regulating by enforcement" and why that approach is suboptimal. Part V offers some suggestions of how Congress might address the question of how cryptoassets should be regulated. This Article concludes by determining that regulation by enforcement is an inefficient and ineffective way to proceed, and that congressional intervention is likely to be necessary to resolve the problems that now exist in the crypto ecosystem.

I. THE EVOLUTION OF CRYPTOASSETS

As has been discussed in considerably more detail elsewhere,[11] the so-called blockchain era[12] was launched in late 2008 when a person or persons using the pseudonym "Satosohi Nakamoto" published a paper entitled *Bitcoin: A Peer-to-Peer Electronic Cash System* in an online discussion of cryptography.[13] The initial or genesis transaction on the Bitcoin blockchain occurred on January 3, 2009, when the first set of fifty Bitcoin ("BTC") was "mined."[14]

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11. There are a number of articles that do an admirable job of explaining the development and operation of Bitcoin and other cryptoassets. *See generally* Georgios Dimitropoulos, *The Law of Blockchain*, 95 WASH. L. REV. 1117 (2020); Shaanan Cohney et al., *Coin-Operated Capitalism*, 119 COLUM. L. REV. 591 (2019); Carol Goforth, *Securities Treatment of Tokenized Offerings Under U.S. Law*, 46 PEPP. L. REV. 405 (2019); Christopher Burks, Note, *Bitcoin: Breaking Bad or Breaking Barriers?*, 18 N.C. J.L. & TECH. 244, 244–50 (2017). See also Mark Popielarski, *Blockchain Research: Bitcoins, Cryptocurrency, and Distributed Ledgers*, 47 COLO. LAW., June 2018, at 10, for a list of additional resources describing the development and functioning of cryptoassets. For persons wishing to gain a familiarity with some of the terminology in the crypto space, see Carol Goforth, *The Lawyer's Cryptionary: A Resource for Talking to Clients About Crypto-Transactions*, 41 CAMPBELL L. REV. 47 (2019).

For a brief description of the development of crypto from a non-academic perspective, see Anshu Siripurapu, *Cryptocurrencies, Digital Dollars, and the Future of Money*, COUNCIL ON FOREIGN RELS. (Sept. 24, 2021, 12:55 PM), https://www.cfr.org/backgrounder/cryptocurrencies-digital-dollars-and-future-money [https://perma.cc/3YC2-NQUK]. An excellent explanation can also be found at Andrey Sergeenkov, *What Is Bitcoin?*, COINDESK (Aug. 5, 2022, 1:39 PM), https://www.coindesk.com/learn/what-is-bitcoin/ [https://perma.cc/DEA6-SMZE].

12. Although Bitcoin was the first to popularize the blockchain concept, blockchain technology was first mentioned in 1991 by two mathematicians who were considering a system in which document time stamps could not be tampered with. Adam Hayes, *What Is a Blockchain?*, INVESTOPEDIA (June 24, 2022), https://www.investopedia.com/terms/b/blockchain.asp.

13. Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, SATOSHI NAKAMOTO INST. (Oct. 31, 2008), https://nakamotoinstitute.org/bitcoin/.

14. "Mining" refers to the process by which cryptoassets using the proof of work consensus protocol, such as Bitcoin, are created. In a proof of work system, before a block of proposed transactions is added to the ledger, a computationally difficult problem must be solved. Computer nodes wishing to serve as "miners" compete to be the first to solve the problem that is appended to the block that they are verifying. The successful computer is rewarded with the automatic issuance

Bitcoin has no centralized bank, nation state, or regulatory authority backing it.[15] Bitcoins have no tangible existence,[16] and ownership is demonstrated through complex cryptographic processes[17] memorialized on a distributed digital ledger. Bitcoins are issued and transferred according to protocols established by an open-source computer program[18] running simultaneously on multiple computers. The program controls how the record of transactions (including the issuance and all subsequent transfers) of each Bitcoin or fraction thereof[19] is maintained, with each computer (called

of new cryptoassets, which are said to be mined. For a more detailed explanation of crypto mining, see Arya Taghdiri, *The Cost of Innovation: Why Bitcoin Mining Requires International Regulation*, 50 TEX. ENV'T L.J. 181, 183–84 (2020). For a more detailed explanation of the proof of work consensus mechanism, see Lyle Daly, *What Is Proof of Work (PoW) in Crypto?*, MOTLEY FOOL (June 28, 2022, 3:35 PM), https://www.fool.com/investing/stock-market/market-sectors/financials/cryptocurrency-stocks/proof-of-work/ [https://perma.cc/7KYJ-8GWS].

15. Another way of saying this would be to explain that Bitcoin is decentralized. For an explanation of the decentralization of blockchain technology, see Mally Anderson, *Exploring Decentralization: Blockchain Technology and Complex Coordination*, J. OF DESIGN & SCI. (Feb. 18, 2019, 10:39 PM), https://jods.mitpress.mit.edu/pub/7vxemtm3/release/2.

16. As is the case for all cryptoassets, Bitcoins are really nothing more than a digitized alphanumeric code memorialized on a blockchain. *What Is a Cryptocurrency Token?*, CRYPTOCURRENCY FACTS, https://cryptocurrencyfacts.com/what-is-a-cryptocurrency-token/ [https://perma.cc/4CS8-R3QH] (last visited Aug. 5, 2022) ("[A] token is just string of numbers and letters used in types of cryptography . . . .").

17. Cryptography is used to ensure the security of the transactions, the privacy and ownership rights of transaction participants, and the independence of operations from involvement of a centralized intermediary. A very general introduction to the topic of cryptography as it relates to cryptoassets can be found in Shobhit Seth, *Explaining the Crypto in Cryptocurrency*, INVESTOPEDIA (May 15, 2022), https://www.investopedia.com/tech/explaining-crypto-cryptocurrency/. In the context of cryptoassets, the most prevalent method of encryption involves an asymmetric encryption cryptograph, which relies on public and private keys. The topic of how public key cryptography functions to protect control over cryptoassets is far outside the scope of this Article. For those interested in learning more about the topic, explanations can be found at Kirsty Moreland, *What Are Public Keys and Private Keys?*, LEDGER ACAD. (Sept. 23, 2022), https://www.ledger.com/academy/blockchain/what-are-public-keys-and-private-keys, and *What Are Public and Private Keys?*, CRYPTOPEDIA (June 28, 2022), https://www.gemini.com/cryptopedia/public-private-keys-cryptography [https://perma.cc/7AJZ-XVJ7].

18. While the Bitcoin programming is open-source, not all cryptoassets operate in this way. Some blockchains are proprietary, and access requires permission from the owners. Shobhit Seth, *Public, Private, Permissioned Blockchains Compared*, INVESTOPEDIA (July 28, 2022), https://www.investopedia.com/news/public-private-permissioned-blockchains-compared/.

19. Bitcoins can be divided into fragments, with the smallest unit being called a "satoshi," after the name used by the creator of the asset. Jake Frankenfield, *Satoshi*, INVESTOPEDIA (July 14, 2022), https://www.investopedia.com/terms/s/satoshi.asp. One satoshi is equal to a 100 millionth of a Bitcoin. *Id.*

nodes)[20] in the peer-to-peer network[21] having full access to the digital ledger of transactions (known as the blockchain). The record of transactions is called a blockchain because transactions are aggregated together in "blocks" of data before they are approved and added to the ledger in a "chain."[22]

Crypto has evolved rapidly, increasing from a single such asset (Bitcoin) in 2009 to more than 20,000 different cryptoassets as of August 5, 2022, although many of those are inactive or have no appreciable value.[23] Collectively, these assets are worth approximately one trillion dollars.[24] Cryptoassets have also diversified in functionality, so that many of them are no longer designed simply as a substitute for fiat currencies.[25]

Bitcoin was originally conceived of as a potential substitute for conventional or "fiat" currency.[26] Subsequent developments have permitted

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20. For an explanation of nodes, see *What Is a Blockchain Node and How Is It Used in Cryptocurrency?*, GADGETS 360 (Aug. 21, 2021, 10:23 AM), https://gadgets360.com/cryptocurrency/features/what-is-a-blockchain-node-how-does-cryptocurrency-work-2515427 [https://perma.cc/T5DM-YL8D].

21. Bitcoin was founded, in part, on notions of democracy and equality, and therefore all computers in the network are given equal access to each other, without the need for any centralized authority or intermediary. Jake Frankenfield, *Peer-to-Peer (Virtual Currency)*, INVESTOPEDIA (Sept. 23, 2021), https://www.investopedia.com/terms/p/ptop.asp (explicitly noting that a peer-to-peer exchange was a primary goal for Bitcoin). Not all cryptoassets operate on a peer-to-peer basis. *Id.*

22. *What Is Blockchain Technology?*, IBM, https://www.ibm.com/topics/what-is-blockchain [https://perma.cc/E9W9-S95Y] (last visited Aug. 9, 2022) (noting that "[a]s each transaction occurs, it is recorded as a 'block' of data . . . . Each block is connected to the ones before and after it[.] These blocks form a chain of data . . . .").

23. *Today's Cryptocurrency Prices by Market Cap*, COINMARKETCAP, https://coinmarketcap.com/ [https://perma.cc/83GB-RQEM] (last visited Aug. 5, 2022) (the number of cryptoassets is listed at 20,460 in the upper left-hand corner of the page).

24. *Id.* (listing the total value of all cryptoassets as of August 5, 2022, at $1,088,319,737,603.93). This is substantially lower than the $3 trillion market capitalization that was reached in November 2021. *Crypto World Hits $3 Trillion Market Cap as Ether, Bitcoin Gain in Trade*, BUSINESS STANDARD (Nov. 9, 2021, 12:53 AM), https://www.business-standard.com/article/international/crypto-world-hits-3-trillion-market-cap-as-ether-bitcoin-gain-in-trade-121110900065_1.html.

25. Although Bitcoin was designed as a substitute for government-issued currency, cryptoassets that are often called utility tokens now serve a variety of functions, providing access to a whole range of services or goods within specific blockchain systems. Brian Nibley, *What is a Utility Token?*, SOFI LEARN (Dec. 22, 2021), https://www.sofi.com/learn/content/what-is-a-utility-token/ [https://perma.cc/L6B4-Y3C7]; *see also* Bernard Marr, *A Very Brief History of Blockchain Technology Everyone Should Read*, FORBES (Feb. 16, 2018, 12:28 AM), https://www.forbes.com/sites/bernardmarr/2018/02/16/a-very-brief-history-of-blockchain-technology-everyone-should-read/?sh=6aa885477bc4.

26. "The first generation of cryptocurrencies were designed as digital Stores of Value. Their purpose was to replace fiat currency as the medium for transactions. . . . Bitcoin is the classic example . . . ." *Is Your Crypto Digital Gold, Gas, or Something Else?*, STEEMIT (Aug. 12, 2017, 1:43 AM), https://steemit.com/cryptocurrency/@basiccrypto/is-your-crypto-digital-gold-gas-or-something-else [https://perma.cc/483A-4BJ5]. For a further explanation of Bitcoin's role as a currency substitute, see *Making Sense of Bitcoin, Cryptocurrency and Blockchain*, PWC,

new cryptoassets to utilize smart contract technology that gives some cryptoassets additional functions.[27] These new cryptoassets were often called "utility tokens" to differentiate them from cryptoassets that served only as a store of value, medium of exchange, or unit of account (the traditional functions of money).[28]

Given that none of these cryptoassets were in existence prior to 2009, it is not surprising that they were not in the contemplation of legislators and regulators who enacted laws designed to protect financial markets and systems, and members of the public who participate in or rely upon them.[29]

https://www.pwc.com/us/en/industries/financial-services/fintech/bitcoin-blockchain-cryptocurrency.html [https://perma.cc/LC2T-7Z6U] (last visited Aug. 9, 2022). Bitcoin and other cryptocurrencies can be contrasted with fiat currency because they are not issued or backed by any government or central bank and generally have no status as legal tender. Inyoung Hwang, *Fiat Currencies: Defined, Explained, Compared to Cryptocurrencies*, SOFI (June 1, 2022), https://www.sofi.com/learn/content/fiat-currency/ [https://perma.cc/V4AN-B9HN].

27. The primary development facilitating such cryptoassets was the launch of the Ethereum blockchain, although the idea of smart contracts predates even Bitcoin. *What Are Smart Contracts in Blockchain and How Do They Work?*, COINTELEGRAPH, https://cointelegraph.com/ethereum-for-beginners/what-are-smart-contracts-a-beginners-guide-to-automated-agreements [https://perma.cc/H5AL-B64Z] (last visited Aug. 9, 2022).

28. For an explanation of the distinction between cryptoassets based on whether they serve only as a currency substitute or whether they have additional utility, see Cryptopedia Staff, *Digital Assets: Cryptocurrencies vs. Tokens*, CRYPTOPEDIA (June 28, 2022), https://www.gemini.com/cryptopedia/cryptocurrencies-vs-tokens-difference [https://perma.cc/KN43-923X]. The attributes of money are discussed in Swati Goyal, *The Difference Between Fiat Money and Cryptocurrencies*, FX EMPIRE (Dec. 8, 2020, 7:44 AM), https://www.fxempire.com/education/article/the-difference-between-fiat-money-and-cryptocurrencies-520616 [https://perma.cc/R7L7-QWLP] ("[Price stability] allows fiat money to act as a means of storing value and facilitating exchange. It can also be used to provide a numerical account."). It is also worth noting that utility tokens can be further divided, so that, for example, it is possible to classify some of them as securities tokens either because they function as tokenized versions of conventional securities or because they are marketed as speculative investments. For an explanation of what security tokens are, see Cryptopedia Staff, *What Are Security Tokens?*, CRYPTOPEDIA (June 21, 2021), https://www.gemini.com/cryptopedia/security-token-offering-vs-initial-coin-offering-stos [https://perma.cc/E689-26SS].

29. The primary federal securities laws, for example, were written in the 1930s, including the Securities Act of 1933 (codified at 15 U.S.C. § 77) and the Securities Exchange Act of 1934 (codified at 15 U.S.C. § 78). *See The Laws That Govern the Securities Industry*, SEC, https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry [https://perma.cc/PMD2-NWNF] (last visited Nov. 3, 2021). The most recent federal legislation listed by the SEC as significantly changing the scope of the federal securities laws is the Jumpstart Our Business Startups Act of 2012, enacted on April 5, 2012. *Id.* This legislation minimized regulatory requirements and did not address cryptoassets at all. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

The Commodities Exchange Act ("CEA") was amended to create the Commodity Futures Trading Commission ("CFTC") in 1974. The history of the CFTC is set out in a series of links that can be accessed from the agency's webpage at *The Commission*, CFTC, https://www.cftc.gov/About/AboutTheCommission (last visited Oct. 4, 2022). The most recent legislative action affecting the CFTC's jurisdiction occurred on July 21, 2010, when President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Title VII of the Dodd-Frank Act amended the CEA to establish a comprehensive new regulatory

In addition, both because of the speed with which the crypto ecosystem has developed as well as the sheer bureaucracy and time required to promulgate official regulations (much less major legislation), it is not surprising that for the most part regulatory agencies have been forced to react to cryptoassets by fitting them into existing laws and regulations.[30] This has not resulted in an ideal situation, either for regulators or for those trying to comply with legal requirements.

II. CRYPTO REGULATION IN THE UNITED STATES

Notwithstanding recently expressed opinions from some that crypto is still the "Wild West,"[31] that is not really an accurate assessment of the crypto ecosystem. Cryptoassets may have operated under the legal radar for the first few years of Bitcoin's existence, but various aspects of the system have now been regulated for more than a decade. For example, cryptocurrency exchanges operating in the United States are required to operate under requirements imposed by the Financial Crimes Enforcement Network ("FinCEN"), pursuant to which they must adopt risk-based monitoring plans and report a range of transactions that raise suspicions that the participants are involved in money laundering or funding of illicit activities.[32] Depending on where they operate, such exchanges may also be required to comply with state laws regulating money transmission[33] and, in some cases, imposing special requirements on virtual currency operations.[34] The CFTC has also

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framework for swaps and security-based swaps but did not touch on cryptoassets, which had not yet risen to any level of prominence. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

30. To understand the problems faced by regulators in keeping up with rapid technological innovation, see Dan Awrey, *Complexity, Innovation, and the Regulation of Modern Financial Markets*, 2 HARV. BUS. L. REV. 235 (2012); *see also* Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1312 (1991).

31. *See supra* notes 1, 4 and accompanying text.

32. *See generally* U.S. DEP'T OF THE TREASURY, FIN. CRIMES ENF'T NETWORK, GUIDANCE ON THE APPLICATION OF FINCEN'S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES (Mar. 18, 2013) [hereinafter FinCEN 2013 Guidance], https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf [https://perma.cc/G4GF-6MMD].

33. While money transmitters are subject to FinCEN's requirements at the federal level, "individual states have the authority to administer and license money transmitters." Susan Alkadri, *Defining and Regulating Cryptocurrency: Fake Internet Money or Legitimate Medium of Exchange?*, 17 DUKE L. & TECH. REV. 71, 82 (2018). By 2015, it appeared that "[m]ost states . . . [had] taken positions on virtual currencies." Sarah Jane Hughes & Stephen T. Middlebrook, *Advancing a Framework for Regulating Cryptocurrency Payments Intermediaries*, 32 YALE J. ON REG. 495, 511 (2015).

34. The most onerous of those is probably the New York BitLicense requirement. N.Y. COMP. CODES R. & REGS. tit. 23, § 200 (2022). Among other things, an applicant for a BitLicense must provide extensive documentation, meet minimum capital and financial integrity standards, and

claimed jurisdiction over crypto derivatives and their trading,[35] as well as any fraud occurring in the crypto "spot markets."[36] And the SEC itself has pursued multiple enforcement actions against crypto issuers, promoters, and others associated with various crypto transactions.[37]

To explain when they intend to regulate, these federal agencies, along with the Internal Revenue Service ("IRS"), have issued reports and guidance

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comply with marketing and advertising restrictions. *See generally The New York BitLicense: What Is It and Who Needs to Have One?*, CAPITAL FUND L. BLOG, https://www.capitalfundlaw.com/blog/newyorkbitlicense [https://perma.cc/8TXV-U7DW] (last visited Oct. 4, 2022). The requirements associated with obtaining a BitLicense (needed for any virtual currency business) are so stringent that the adoption of the requirement led to an exodus of crypto businesses from the state. Daniel Roberts, *Behind the "Exodus" of Bitcoin Startups from New York*, FORTUNE (Aug. 14, 2015, 11:19 AM), https://fortune.com/2015/08/14/bitcoin-startups-leave-new-york-bitlicense/ [https://perma.cc/75DE-T6C2]. Rhode Island also has an intensive regulatory regime in place, having adopted the Uniform Law Commission's Uniform Regulation of Virtual-Currency Businesses Act. UNIF. REG. OF VIRTUAL-CURRENCY BUS. ACT (UNIF. L. COMM'N 2017), https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=ca527d52-9bcf-15b0-b1c1-279b55b53fa4&forceDialog=0 [https://perma.cc/Q6Q9-SC47]; *see also* Alan S. Kaplinsky & Dee Spagnuolo, *Uniform Act to Regulate Virtual Currency Businesses Ready for State Adoption*, BALLARD SPAHR LLP (Jan. 9, 2018), https://www.ballardspahr.com/insights/alerts-and-articles/2018/01/uniform-act-to-regulate-virtual-currency-businesses-ready-for-state-adoption (describing the requirements of the Uniform Regulation of Virtual-Currency Businesses Act, including the proposed tier system for regulation). Rhode Island adopted the Act in 2019. As of August 4, 2022, no other state had enacted the Act, and California was the only state in which it had been introduced, and it was vetoed by the California Governor on September 23. *Regulation of Virtual-Currency Businesses Act*, ULC, https://www.uniformlaws.org/committees/community-home?CommunityKey=e104aaa8-c10f-45a7-a34a-0423c2106778 (last visited Oct. 4, 2022).

35. The first order from the CFTC imposing sanctions against a crypto-based business came in 2015. *In re* Coinflip, Inc., CFTC No. 15-29 (Sept. 17, 2015), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprorder09172015.pdf [https://perma.cc/YQ2N-8CHH]; *accord In re* BFXNA Inc., CFTC No. 16-19 (June 2, 2016), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfbfxnaorder060216.pdf [https://perma.cc/LD3K-3DDS].

36. For the first judicial opinion affirming the CFTC's claims that cryptoassets should be regulated as commodities, see CFTC v. McDonnell, 287 F. Supp. 3d 213 (E.D.N.Y. 2018) (involving fraud in the spot or trading crypto markets), *adhered to on denial of reconsideration*, 321 F. Supp. 3d 366 (E.D.N.Y. 2018). "Spot market" is a term frequently encountered in connection with commodities regulation, and it refers to trades in the commodities themselves rather than trading in futures or other derivatives. For more information about spot markets, see CFI Team, *Spot Market*, CORP. FIN. INST. (Feb. 12, 2022), https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/spot-market/ [https://perma.cc/WG8A-V6C7].

37. A list of CFTC enforcement actions can be found at *Enforcement Actions*, CFTC, https://www.cftc.gov/LawRegulation/EnforcementActions/index.htm?year=all [https://perma.cc/K3BW-JRZH] (last visited Oct. 4, 2022). While this list includes actions that do not involve crypto or digital assets, it shows that, for example, fourteen crypto-based entities were charged with failing to register or falsely claiming to be registered on September 29, 2021. *Id.* At least ten other CFTC enforcement actions from 2021 alone involved cryptoasset operations of some sort. *Id.*

on how they interpret their authority and how they assert jurisdiction over cryptoassets and crypto-based businesses. FinCEN issued its initial explanation of how it intended to treat cryptoassets in 2013[38] and provided additional details in 2019;[39] the IRS issued an initial determination of how cryptoassets should be treated for tax purposes in 2014;[40] the CFTC issued a primer in 2017, concluding that virtual currencies were commodities, followed by a backgrounder issued in 2018, in turn followed by a second primer in 2020;[41] and the SEC explained the test it intended to use in determining when crypto is a security in 2017,[42] with numerous additional details being set out in a "framework" issued by the SEC in 2019.[43] These authorities have laid the groundwork for cryptoassets to be regulated simultaneously as a currency substitute (by FinCEN), as property (by the IRS), as commodities (by the CFTC), and as securities (by the SEC).[44] It is beyond obvious that this state of affairs makes for an incredibly complex regulatory situation,[45] which does not equal an unregulated "Wild West."

38. FinCEN 2013 Guidance, *supra* note 32.

39. *See* U.S. DEP'T OF THE TREASURY, FIN. CRIMES ENF'T NETWORK, FIN-2019-G001, GUIDANCE ON THE APPLICATION OF FINCEN'S REGULATIONS TO CERTAIN BUSINESS MODELS INVOLVING CONVERTIBLE VIRTUAL CURRENCIES (2019), https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf [https://perma.cc/K5JT-ZSBJ].

40. *See* I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, https://www.irs.gov/pub/irs-irbs/irb14-16.pdf [https://perma.cc/W5DL-XBLB].

41. *See* LABCFTC, A CFTC PRIMER ON VIRTUAL CURRENCIES (2017), https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf [https://perma.cc/F65B-Z7LT]; CFTC, CFTC BACKGROUNDER ON OVERSIGHT OF AND APPROACH TO VIRTUAL CURRENCY FUTURES MARKETS (2018), https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf [https://perma.cc/3WBH-89ZL]; CFTC, DIGITAL ASSETS PRIMER (2020), https://www.cftc.gov/media/5476/DigitalAssetsPrimer/download.

42. *See* SEC, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934: THE DAO (2017) [hereinafter DAO REPORT], https://www.sec.gov/litigation/investreport/34-81207.pdf [https://perma.cc/F862-YS5V].

43. SEC, FRAMEWORK FOR "INVESTMENT CONTRACT" ANALYSIS OF DIGITAL ASSETS (2019) [hereinafter FRAMEWORK], https://www.sec.gov/files/dlt-framework.pdf [https://perma.cc/J4KQ-HW52].

44. *See* Carol R. Goforth, *U.S. Law: Crypto Is Money, Property, a Commodity, and a Security, All at the Same Time*, 49 CAPCO INST. J. FIN. TRANSFORMATION, Apr. 2019, at 102.

45. As one group of lawyers recently observed: "The structure of the regulatory regime for financial products and services in the United States is arguably the most complex of any jurisdiction . . . ." Annette L. Nazareth, Mark A Sater & Zachary J. Zweihorn, *Snapshot: The Regulatory Framework for Financial Services Compliance in USA*, LEXOLOGY (Mar. 19, 2021), https://www.lexology.com/library/detail.aspx?g=1d36c283-222f-42d4-a9da-39b96ea19371&utm_source=Lexology+Daily+Newsfeed&utm_medium=HTML+email+-+Body+-+General+section&utm_campaign=Arkbar+subscriber+daily+feed&utm_content=Lexology+Daily+Newsfeed+2021-11-03&utm_term= [https://perma.cc/FH4T-X6Q6].

It is also quite clear that a decision by one agency to treat particular cryptoassets as falling under its jurisdiction does not preclude other agencies from also claiming regulatory authority. For example, FinCEN made headlines in May 2015 by fining Ripple Labs $700,000 for selling its XRP token and acting as a money-services business without registering with FinCEN.[46] In making this determination, FinCEN clearly characterized XRP as a virtual currency.[47] More than five and one-half years later, on December 22, 2020, the SEC initiated legal proceedings against the same company on the grounds that the tokens in question were securities.[48] CFTC Commissioner Dawn Stump has also carefully explained that characterization of crypto as a commodity does not mean it cannot also be a security.[49]

The SEC's approach to determining when cryptoassets are securities has evolved over time, and it has been anything but long established and clear. However, the test which the SEC (usually) relies upon has indeed been around for decades. Because the federal securities laws were not designed to apply to cryptoassets, they do not specifically enumerate anything like crypto as being within the ambit of the securities statutes.[50] The only option for the SEC has been to treat crypto as falling into one or more of the general categories included in the statutory definition of "security."[51]

On July 25, 2017, the SEC released its "DAO Report."[52] This marked the first time that the SEC articulated the official position that it intended to evaluate whether cryptoassets were investment contracts, and therefore securities, under the *Howey* investment contract test developed by the United

46. U.S. DEP'T OF THE TREASURY, FIN. CRIMES ENF'T NETWORK, FINCEN FINES RIPPLE LABS INC. IN FIRST CIVIL ENFORCEMENT ACTION AGAINST A VIRTUAL CURRENCY EXCHANGER (2015), https://www.fincen.gov/sites/default/files/shared/20150505.pdf [https://perma.cc/DQ3H-3LDE].

47. *Id.*

48. Complaint at 1, SEC v. Ripple Labs, Inc., No. 20 Civ. 10832, 2021 WL 1814771 (S.D.N.Y. May 6, 2021) [hereinafter Ripple Initial Complaint].

49. DAWN D. STUMP, COMMODITY FUTURES TRADING COMM'N, DIGITAL ASSETS: CLARIFYING CFTC REGULATORY AUTHORITY & THE FALLACY OF THE QUESTION, "IS IT A COMMODITY OR A SECURITY?", (2021), https://www.cftc.gov/media/6306/DigitalAssetsAuthorityInfographic_CommStump082321/download [https://perma.cc/YDE2-MA9R].

50. *See, e.g.*, Securities Act of 1933, 15 U.S.C. § 77b (providing definitions for the '33 Act and tasking the SEC with promulgating rules that "promote efficiency, competition, and capital formation"); Securities Exchange Act of 1934, 15 U.S.C. § 78c (providing definitions for the '34 Act).

51. For example, both the definitions sections of the '33 Act (15 U.S.C. § 77b) and the '34 Act (15 U.S.C. § 78c) include investment contracts and notes within the definition of securities, along with other assets such as stock, bonds, debentures, etc.

52. DAO REPORT, *supra* note 42.

States Supreme Court in 1946.[53] The *Howey* test says that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ."[54]

Subsequent cases have made it clear that investments need not be in money,[55] and that minor participation by the investor will not prevent the last part of the test from being satisfied.[56] Thus, relying on more recent clarifications, the *Howey* test could be rephrased today as requiring the following elements:

(i) an investment of money (or something else of value);[57]

(ii) a common enterprise;[58]

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53. *See* SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

54. *Id.* at 298–99.

55. While the *Howey* test originally spoke only of "money," subsequent opinions have made it clear that "cash is not the only form of contribution or investment that will create an investment contract. Instead, the 'investment' may take the form of 'goods and services,' or 'some other exchange of value.'" Uselton v. Com. Lovelace Motor Freight, Inc., 940 F.2d 564, 574 (10th Cir. 1991) (citations omitted) (first quoting Int'l Brotherhood of Teamsters v. Daniel, 439 U.S. 551, 560 n.12 (1979); and then quoting Hocking v. Dubois, 885 F.2d 1449, 1471 (9th Cir. 1989)), *cert. denied*, 502 U.S. 983 (1991).

56. Although the Court in *Howey* said the expectation of profits needed to be based "solely" on the efforts of others, this rule has also been modified and clarified over time. *See* SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973) (finding that the appropriate inquiry is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise"); *see also* Hocking v. Dubois, 885 F.2d 1449, 1455 (9th Cir. 1989), *cert. denied*, 494 U.S. 1078 (1990) (holding that the test should be whose efforts are "significant" and "essential").

57. *See supra* note 55.

58. *Howey*, 328 U.S. at 299. The requirement of a "common enterprise" is the element of the *Howey* test that appears to have received the most comment over the years, in part because there is a divergence among the federal circuits. Some courts appear to require "horizontal commonality," some will accept "strict vertical commonality," and some accept "broad vertical commonality." *See* Maura K. Monaghan, Note, *An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis*, 63 FORDHAM L. REV. 2135, 2152–63 (1995) (discussing the various judicial applications of the *Howey* "common enterprise" element). Horizontal commonality requires that investors' contributions be pooled together so their fortunes rise and fall together; strict commonality requires the investor and promoter or investment manager to have interests that are tied together; and broad commonality generally looks to whether the investor is depending heavily on the promoter in deciding whether to invest. *Id.*; *see also* Benjamin Akins, Jennifer L. Chapman & Jason Gordon, *The Case for the Regulation of Bitcoin Mining as a Security*, 19 VA. J.L. & TECH. 669, 688–91 (2015).

On the other hand, while cases and academic commentators alike have relied on these elements for decades, officials at the SEC have taken issue with the "common enterprise" requirement, suggesting in recent documents that the SEC does not "view a 'common enterprise' as a distinct element of the term 'investment contract.'" FRAMEWORK, *supra* note 43, at 13 n.10. Ironically, the text to which footnote 10 is appended and the note itself specifically recognize that courts do treat the *Howey* test as requiring a common enterprise as a distinct element.

(iii) the purchaser expects to receive profits;[59] and

(iv) the expectation of profits is from the essential entrepreneurial efforts of others.[60]

Even outside the context of cryptoassets, application of these elements is neither simple nor straightforward.[61] For example, there are multiple approaches as to what constitutes proof of a common enterprise under this test, with the federal circuit courts in considerable disagreement.[62]

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59. *Howey*, 328 U.S. at 299. The "expectation of profits" element has also been addressed numerous times. The United States Supreme Court held in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), that in order for this element to be met, "the primary motivation for investing must be to achieve a return on the value invested." Akins et al., *supra* note 58, at 691.

60. *See supra* note 56.

61. *See generally* Marc I. Steinberg, *The Supreme Court and the Definition of "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489 (1987); Theresa A. Gabaldon, *A Sense of a Security: An Empirical Study*, 25 J. CORP. L. 307 (2000); Miriam R. Albert, *The* Howey *Test Turns 64: Are the Courts Grading This Test on a Curve?*, 2 WM. & MARY BUS. L. REV. 1 (2011).

62. Horizontal commonality appears to be the preferred test in the Second Circuit, although strict vertical commonality may also suffice. In *Revak v. SEC Realty Corp.*, 18 F.3d 81, 88 (2d Cir. 1994), the Second Circuit explained that "[i]f a common enterprise can be established by the mere showing that the fortunes of investors are tied to the efforts of the promoter, two separate questions posed by *Howey* . . . are effectively merged into a single inquiry . . . ." *Accord* Copeland v. Hill, 680 F. Supp. 466, 468 (D. Mass. 1988).

Courts in the Fourth Circuit also accept horizontal commonality, with the status of the vertical commonality approach being unclear. In *Teague v. Bakker*, 35 F.3d 978, 986 n.8 (4th Cir. 1994), the Fourth Circuit found that horizontal commonality existed, and noted that the district court was therefore not required to have determined whether vertical commonality was present. In *SEC v. Pinckney*, 923 F. Supp. 76, 81–82 (E.D.N.C. 1996), a district court surveyed Fourth Circuit cases on commonality and concluded that vertical commonality would be sufficient.

The Fifth Circuit appears to accept a showing of broad vertical commonality. *See* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478 (5th Cir. 1974) (holding that "[t]he critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts"); SEC v. Cont'l Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974) (holding a pooling ingredient is not necessary for establishing a common enterprise). On the other hand, a more recent decision casts some doubt on how broadly the Fifth Circuit will be willing to define the requirement of commonality. In *Long v. Shultz Cattle Co.*, 896 F.2d 85, 86, 88 (5th Cir. 1990), the Fifth Circuit declined to reconsider its standard under the facts of that case, but also recognized that its approach was "at odds with the stricter approaches taken in other circuits."

Courts in the Eighth Circuit have not been entirely consistent in their approaches. For example, in *Sias v. Herzog*, No. 04-3832, 2006 WL 2418950, at *8 (D. Minn. Aug. 21, 2006), one district court acknowledged the split among the courts and analyzed the schemes in question for horizontal commonality and strict vertical commonality, but not broad vertical commonality. *Id*. at *13 n.8. On the other hand, in *Top of Iowa Coop. v. Schewe*, 6 F. Supp. 2d 843, 852–53 (N.D. Iowa 1998), a different district court looked at horizontal commonality and both of the vertical commonality approaches.

The Ninth Circuit permits the "common enterprise" element to be shown either by strict vertical commonality or horizontal commonality. SEC v. R.G. Reynolds Enters., Inc., 952 F.2d 1125, 1130–31 (9th Cir. 1991) (requiring proof of either strict vertical commonality or horizontal commonality).

While the Tenth Circuit will accept horizontal commonality, it has also indicated that this is not a rigid requirement. *See* McGill v. Am. Land & Expl. Co., 776 F.2d 923, 925 (10th Cir. 1985)

In the context of new and evolving cryptoassets, the proper application of the *Howey* test is even more difficult to ascertain.

At first, it appeared that the SEC was going to conclude that every cryptoasset was a security under the *Howey* test. In early 2018, SEC Chairman Jay Clayton was widely quoted as saying that he had "never" seen an initial coin offering ("ICO")[63] that did not involve the sale of securities.[64] However, a few months later, SEC Director Bill Hinman was quoted as hinting and then saying explicitly that Bitcoin and Ethereum (undoubtedly referring to Ether and not the Ethereum platform) are probably "no longer" securities.[65] This view was then repeated by others at the SEC, including Chairman Clayton.[66]

Even more recently, the SEC released a public framework (the "Framework") with a convoluted, thirty-eight-factor analysis to "help" explain when crypto will be an investment contract.[67] Most of the

(rejecting the notion that horizontal commonality is required by *Howey*). Narrow vertical commonality was relied upon in *Walsh v. Int'l Precious Metals Corp*., 510 F. Supp. 867, 871 (D. Utah 1981), although the Tenth Circuit does not appear to have formally accepted this approach.

The Eleventh Circuit has adopted the broad vertical approach. *See* SEC v. ETS Payphones, Inc., 300 F.3d 1281, 1284 (11th Cir. 2002) (affirming the circuit's adoption of the "broad vertical commonality" approach, which "only requires a movant to show that the investors are dependent upon the expertise or efforts of the investment promoter for their returns"), *rev'd on other grounds sub nom.* SEC v. Edwards, 540 U.S. 389 (2004).

63. "ICO," named in reference to initial public offerings of conventional securities, refers to the initial sale of a new cryptoasset to the public. Originally these ICOs were assumed to be outside the reach of regulators, and they typically allowed companies to raise funds with which to finish the creation and launch of the promised cryptoasset. *See* Jake Frankenfield, *Initial Coin Offering (ICO): Coin Launch Defined with Examples*, INVESTOPEDIA (Aug. 18, 2022), https://www.investopedia.com/news/what-ico/.

64. On February 6, 2018, the Senate heard testimony from SEC Chairman Jay Clayton that "every ICO token the SEC has seen so far is considered a security" and "that if a crypto-asset issued by a company increases in value over time depending on the performance of the company, it is considered a security." Joseph Young, *SEC Hints at Tighter Regulation for ICOs, Smart Policies for "True Cryptocurrencies"*, COINTELEGRAPH (Feb. 9, 2018), https://cointelegraph.com/news/sec-hints-at-tighter-regulation-for-icos-smart-policies-for-true-cryptocurrencies [https://perma.cc/Z5KF-BXG9].

65. Andrew Ancheta, *SEC Says Bitcoin and Ethereum Are Not Securities*, CRYPTO BRIEFING (June 14, 2018), https://cryptobriefing.com/sec-says-bitcoin-and-ethereum-are-not-securities/ [https://perma.cc/M6VL-QPZX] (discussing comments from Director William Hinman).

66. Nikhilesh De, *SEC Chair Clayton Affirms Agency's Stance Ether Is No Longer a Security*, COINDESK (Sept. 13, 2021, 4:58 AM), https://www.coindesk.com/markets/2019/03/12/sec-chair-clayton-affirms-agencys-stance-ether-is-no-longer-a-security/ [https://perma.cc/XWU7-NXS3]. In his April 2018 testimony before the House Appropriations Committee, Chairman Clayton appeared to acquiesce in the view that Bitcoin, at least, would not be a security. He explained that "there are different types of cryptoassets. . . . A pure medium of exchange, the one that's most often cited, is Bitcoin. As a replacement for currency, that has been determined by most people to not be a security." Neeraj Agrawal, *SEC Chairman Clayton: Bitcoin Is Not a Security*, COIN CTR. (Apr. 27, 2018), https://www.coincenter.org/sec-chairman-clayton-bitcoin-is-not-a-security/ [https://perma.cc/S8MF-7AKH].

67. FRAMEWORK, *supra* note 43.

Framework's numerous factors focus on the question of whether purchasers have a reasonable expectation of profits derived from the efforts of others.[68] Although some of the elements are described as "especially relevant,"[69] the Framework notes that no single part of the test is "necessarily determinative."[70] With regard to whether there is a reasonable expectation of profits, the Framework indicates that the greater number of listed factors present, the more likely the asset in question is to be a security.[71] The Framework does not, however, give any indication of how many of the described characteristics are necessary or sufficient and does not explain how to weigh any of the listed items.[72]

Not surprisingly, others have recognized that the Framework is so complicated that it is not easy to understand or apply. Shortly after publication of the Framework, SEC Commissioner Hester Peirce gave a speech raising her concerns about the new explanation.[73] She observed that the document could "raise more questions and concerns than it answers."[74] Commissioner Peirce continued:

> While *Howey* has four factors to consider, the framework lists 38 separate considerations, many of which include several sub-points. A seasoned securities lawyer *might* be able to infer which of these considerations will likely be controlling and might therefore be able to provide the appropriate weight to each. . . . [N]on-lawyers and lawyers not steeped in securities law and its attendant lore will not know what to make of the guidance. Pages worth of factors, many of which seemingly apply to all decentralized networks, might contribute to the feeling that navigating the securities laws in this area is perilous business.[75]

As noted at the outset of this Article, the current Chair of the SEC, Gary Gensler, began 2021 by repeatedly suggesting that congressional action was needed in order to provide clarity and fill gaps in the regulation of cryptoassets.[76] However, when no such guidance was immediately

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68. *Id.* at 2–11.

69. *Id.* at 3, § II.C.1.

70. *Id.*

71. *Id.* at 6, § II.C.2.

72. FRAMEWORK, *supra* note 43.

73. Hester M. Peirce, Comm'r, SEC, Speech at the Securities Enforcement Forum: How We Howey (May 9, 2019), https://www.sec.gov/news/speech/peirce-how-we-howey-050919 [https://perma.cc/729A-CG6C].

74. *Id.*

75. *Id.*

76. *See supra* notes 1–4 and accompanying text. To illustrate this starting point, in remarks during an August 2021 conference, Gensler specifically suggested that "[r]egulators would benefit from additional plenary authority to write rules for and attach guardrails to crypto trading and lending." Gary Gensler, Chair, SEC, Remarks Before the Aspen Security Forum (Aug. 3, 2021)

forthcoming, he shifted to suggesting that the SEC's authority is clear under a "broad" interpretation of the securities laws.[77] The assertion that the law is "clear" was relatively quickly followed by a plea from Gensler to attorneys not to help their clients avoid application of the securities laws.[78]

Complaints about the uncertainty of crypto enforcement and confusion about how the securities laws apply to the new asset class have been so common that on November 8, 2021, the SEC's Enforcement Director, Gurbir Grewal, admitted that he often heard that the SEC is "regulating by enforcement" when it comes to crypto.[79] His response was to deny the charge, explaining that the SEC's actions have been based on "long-standing, well-known and understood regulations and standards that govern the securities industry."[80]

Most people outside of the SEC appear to disagree. A range of crypto-entrepreneurs have complained about the difficulties of dealing with the confusing and complex U.S. securities laws.[81] Similarly, business leaders[82]

[hereinafter Gensler Remarks], https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03 [https://perma.cc/E4UU-E7RJ].

77. *See supra* note 9 and accompanying text.

78. Gary Gensler, Chair, SEC, Prepared Remarks at the Securities Enforcement Forum (Nov. 4, 2021) [hereinafter Gensler, Enforcement], https://www.sec.gov/news/speech/gensler-securities-enforcement-forum-20211104 [https://perma.cc/79FV-69H8]. In these remarks, Gensler also noted the frequent complaint that the SEC regulates by enforcement. His response was that "[s]ome market participants may call this 'regulation by enforcement.' I just call it 'enforcement.'" *Id.*

79. Gurbir S. Grewal, Dir., Div. of Enf't, SEC, 2021 SEC Regulation Outside the United States—Scott Friestad Memorial Keynote Address (Nov. 8, 2021), https://www.sec.gov/news/speech/grewal-regulation-outside-united-states-110821 [https://perma.cc/92N6-DYZV] ("In my three months in this role, I have heard more than three times the refrain that we are 'regulating by enforcement.'").

80. *Id.*

81. William Mougayar, entrepreneur and executive chairman of the Kin Foundation, pointed to regulatory uncertainty and political fear-mongering as major obstacles to innovation and success in the crypto ecosystem within the United States. William Mougayar, *It's Official: Political Fear-Mongering and Regulatory Uncertainty in Cryptocurrency Are Hurting US Blockchain Companie*s, MEDIUM (July 21, 2019), https://medium.com/@wmougayar/its-official-political-fear-mongering-added-to-regulatory-uncertainty-in-cryptocurrency-are-5e831eee219e.

Marco Santori, now chief legal officer at Kraken Digital Asset Exchange and former head of Cooley LLP's fintech group, helped develop the SAFT Whitepaper. *See infra* note 87. He has concluded that "the present regulatory environment has spawned 'mostly a state of confusion among entrepreneurs . . . [t]hat is not a good place for American innovation.'" Jeff Kauflin, *Crypto Startups Are Fleeing the U.S.—This Bill Is Trying to Stop Them*, FORBES (Jan. 10, 2019, 12:25 PM), https://www.forbes.com/sites/jeffkauflin/2019/01/10/crypto-startups-are-fleeing-the-usthis-bill-is-trying-to-stop-them/?sh=5dc509152267. Caitlin Long, founder and CEO of Avanti Group and crypto advocate, has complained that "[t]he SEC's stance has caused a massive flight of startups to offshore jurisdictions . . . Lawyers right and left were telling clients, 'Don't issue tokens to U.S. investors and don't domicile in the U.S.'" *Id.*

82. J.D. Seraphine, who produced the Discovery Science series *Open Source Money*, complained in mid-2020 that "[t]he U.S. government has had an overall uneven approach to regulating digital currencies and blockchain." Charles Bovaird, *Regulatory Uncertainty Greatest*

and academics[83] have also expressed the opinion that it is difficult to understand how the SEC intends to apply the U.S. securities laws to cryptoassets. As one commentator noted, "[l]awmakers, regulators, and financial services industry participants all are seeking more regulatory certainty surrounding cryptos, which means new rules, guidance, or interpretations."[84]

A review of some of the most closely followed reactions to recent developments sheds light on why crypto industry participants (and their attorneys) are right to feel confused.

III. REGULATING BY ENFORCEMENT: THE SEC IN ACTION

This Part of the Article evaluates some of the most significant recent decisions by the SEC with regard to enforcing the securities laws in the context of cryptoassets. It first describes three enforcement actions initiated by the SEC against issuers of cryptoassets, including one that involves sales that took place over a span of more than seven years. None of these actions were predicated on fraud or misconduct by the issuers, other than their failure to register the sales as involving securities. It then considers the SEC's failure to act in the case of "stablecoins," a particular category of cryptoassets. The purpose of these examples is to show how the SEC is relying upon enforcement actions to explain its rules rather than offering clear guidance for those in the crypto industry to follow.

Problem for Blockchain Entrepreneurs, Says Producer, FORBES (July 31, 2020, 9:00 AM), https://www.forbes.com/sites/cbovaird/2020/07/31/regulatory-uncertainty-greatest-problem-for-blockchain-entrepreneurs-says-producer/?sh=7b040d62481f. His take was that "this gray area of uncertainty is the worst thing for entrepreneurs and companies attempting to operate here, and it has led to other countries moving ahead of the U.S. in pioneering what many are calling the most important technology since the creation of the internet." *Id.*

The Digital Chamber of Commerce, a blockchain advocacy group, asked "federal policymakers to address the 'lack of a predictable legal environment' it says is hindering blockchain experimentation and innovation." Mike Orcutt, *Blockchain Boosters Warn that Regulatory Uncertainty Is Harming Innovation*, MIT TECH. REV. (Mar. 8. 2019), https://www.technologyreview.com/2019/03/08/136720/blockchain-boosters-warn-that-regulatory-uncertainty-is-harming-innovation/ [https://perma.cc/2D7R-UXZV].

83. "More than a decade after the launch of Bitcoin, regulatory ambiguity surrounding the peer-to-peer virtual currency continues to discourage entrepreneurial activity by increasing risk and the costs of compliance, according to a newly published paper by faculty at Florida Atlantic University's College of Business." *FAU Research Explores How Regulatory Ambiguity Has Discouraged Entrepreneurial Activity in Bitcoin Market*, AP NEWS (Feb. 20, 2020), https://apnews.com/press-release/globe-newswire/technology-business-florida-bitcoin-florida-atlantic-university-5c86ff9eebf3a771ff2ed40a2894ccb9 [https://perma.cc/G69B-AL3J] (pointing to a lack of guidance and unpredictable selective enforcement as two obstacles to understanding).

84. Todd Ehret, *INSIGHT: U.S. Cryptocurrency Regulatory Path Appears Long and Complex*, REUTERS (Apr. 6, 2021, 1:25 PM), https://www.reuters.com/article/bc-finreg-cryptocurrency-regulatory-path/insight-u-s-cryptocurrency-regulatory-path-appears-long-and-complex-idUSKBN2BT211 [https://perma.cc/ZJM7-2HZR].

A. *Kik Interactive Inc.*

On June 6, 2019, the SEC filed a lengthy complaint in the United States District Court for the Southern District of New York, alleging that a Canadian social media company, Kik Interactive Inc. ("Kik"), had violated the federal securities law by selling a trillion unregistered "Kin" tokens.[85] In their complaint, the SEC asserted that the sales in question satisfied the *Howey* test.[86]

Kik had used the "SAFT" process[87] to launch its Kin crypto token in September 2017 in a token distribution event ("TDE").[88] In its complaint, the SEC claimed that Kik's 2017 offering of SAFTs relating to Kin tokens was an unregistered, non-exempt sale of securities, involving a single plan of

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85. Complaint ¶¶ 84–85, SEC v. Kik Interactive Inc., 492 F. Supp. 3d 169 (S.D.N.Y. 2020) (No. 19-cv-5244) [hereinafter Kik Complaint]. The complaint essentially alleged that Kik had violated Section 5 of the '33 Act (15 U.S.C. § 77e) by selling unregistered securities. *Id.*

86. For example, in paragraph 197 of the Kik Complaint, the SEC alleges that persons who bought the Kin tokens from Kik "made an investment of money in a common enterprise with Kik and with each other, and reasonably would have been led to expect profits derived from the entrepreneurial and managerial efforts of Kik and its agents." *Id.* ¶ 197.

87. The SAFT, which stands for "simple agreement for future tokens," was a project designed to provide simple documentation that could be used to assist companies in raising funds to develop functional cryptotokens with an anticipated functionality beyond serving as an alternative to fiat currency. By 2015, it was already becoming increasingly clear that U.S. regulators, and particularly the SEC, were not going to take a hands-off approach to crypto. The SAFT was therefore designed to promote the funding and development of these new assets in a manner that was intended to comply with the federal securities laws. Supporting documentation in the form of a whitepaper set out a framework that the drafters clearly hoped would convince securities regulators to treat functional utility tokens as being outside the scope of the federal securities laws. JUAN BATIZ-BENET, JESSE CLAYBURGH & MARCO SANTORI, THE SAFT PROJECT: TOWARD A COMPLIANT TOKEN SALE FRAMEWORK (2017) [hereinafter SAFT WHITEPAPER], https://www.cooley.com/~/media/cooley/pdf/reprints/saft-project-whitepaper.ashx [https://perma.cc/XDP4-MQU5].

The essential idea was that an issuer seeking to develop and sell a new cryptoasset designed to have functionality other than being a cryptocurrency (a "utility token") could raise funds for the development of the asset by selling contractual rights to acquire the tokens on a when-issued basis. This stage of the offering was assumed to involve the sale of investment contracts and would therefore be conducted pursuant to the terms of Rule 506(c) of Regulation D, an exemption from registration under the Securities Act of 1933. *Id.* at 16 (citing 17 C.F.R. § 230.506(c)). The subsequent sale of fully functional utility tokens was intended to be outside the scope of the securities laws. *Id.* at 6–12 (considering in detail how the SEC might apply the *Howey* test to functional utility tokens and concluding it was likely that such assets would not be securities).

88. The TDE was to be the start of the second half of the SAFT process, and since the Kin tokens were designed to have utility and were functional at the time of this issuance, Kik proceeded on the understanding that its tokens would not be securities. *See generally Kik Announces Highly Anticipated Token Distribution Event*, CISION PR NEWSWIRE (Aug. 29, 2017, 4:00 PM), https://www.prnewswire.com/news-releases/kik-announces-highly-anticipated-token-distribution-event-300511074.html [https://perma.cc/MKC4-V99H].

distribution that needed to be viewed as part of the eventual unregistered and non-compliant token sale.[89]

Kik answered the SEC's allegations on August 6, 2019, denying that Kik had engaged in any unlawful activity, based in part on its position that the Kin tokens it sold were not investment contracts.[90] In particular, Kik argued that it had engaged in two separate transactions: First, the "pre-sale" of contractual rights which was conceded to involve the sale of securities, and second, the sale of Kin tokens, which were characterized by the company as something other than securities.[91] Kik also asserted in its answer that the SEC's approach to defining when cryptoassets were investment contracts was unconstitutionally vague.[92]

On September 30, 2020, Judge Hellerstein ruled in favor of the SEC on its motion for summary judgment, concluding that the "two phases" of the Kik offering were intertwined so that the sale of contractual rights and the eventual public offering of Kin tokens were part of a single plan of financing with a single purpose.[93] As a result, the pre-sale and TDE, which together had raised $100 million for Kik, "constituted an unregistered offering of securities that did not qualify for exemption."[94]

As the SEC requested, the court relied on the *Howey* investment contract test in determining that the offering involved the distribution of securities.[95] The judge treated the entire plan as a single offering meeting the elements of

89. Kik Complaint, *supra* note 85, ¶ 189 (noting, for example, that "the fortunes of each Kin investor were tied to one another and to the success of the overall venture, including the development of a Kin Ecosystem, integration with Kik Messenger, creation of the Rewards Engine, and implementation of a new transaction service and/or bespoke blockchain. Investors' profits were also tied to Kik's profits based on Kik's significant holdings of Kin").

90. Kik's answer was "fairly combative." Stephen A. Rutenberg, Thomas H. Wagner & Jason A. Nagi, *BitBlog Weekly Summary: Kik Kicks Back and the SEC Continues Its Enforcement Campaign Against ICOs*, NAT'L L. REV. (Aug. 19, 2019), https://www.natlawreview.com/article/bitblog-weekly-summary-kik-kicks-back-and-sec-continues-its-enforcement-campaign#google_vignette [https://perma.cc/3ZAY-QSRL]. *See* Answer to Complaint, SEC v. Kik Interactive Inc., 492 F. Supp. 3d 169 (S.D.N.Y. 2020) (No. 19-cv-5244) [hereinafter Kik Answer], https://www.courtlistener.com/docket/15722539/22/us-securities-and-exchange-commission-v-kik-interactive-inc/ [https://perma.cc/8GG9-REXJ].

91. "The Commission is wrong that Kik sold Kin in a single 'offer and sale.' In reality, the distribution of Kin involved two entirely separate transactions: (1) a pre-sale of contractual rights, pursuant to SAFTs . . . and (2) the sale of Kin to the public (the 'TDE') . . . ." Kik Answer, *supra* note 90, at 4 (response to paragraph 1 of Kik Complaint).

92. Kik Answer, *supra* note 90. One of the problems raised by Kik was that the SEC had not even explained its approach to crypto regulation until after the Kik offering was underway. Kik had announced its plans to create and distribute Kin tokens on May 25, 2017, and the company began its pre-sale in June of that year. It was not until July 25, 2017, that the SEC released its DAO Report. *See supra* note 42. The SEC did not initiate legal action against Kik for another two years, filing its complaint on June 4, 2019. *See* Kik Complaint, *supra* note 85.

93. SEC v. Kik Interactive Inc., 492 F. Supp. 3d 169, 174, 181 (S.D.N.Y. 2020).

94. *Id.* at 182.

95. *Id.* at 177.

Howey. He seemed particularly influenced by Kik's promotional efforts extolling the profit-potential of Kin, the lack of consumptive uses available for the token on the date of its original launch, and references to the range of activities that Kik anticipated would support the growth of the Kin ecosystem and token value.[96] He was not convinced by the prominent representations from purchasers during the first stage that they were not buying with an intent to redistribute the tokens.[97]

In determining that the pre-sale was part of an integrated offering along with the eventual tokens (thus destroying the claimed exemption for the sale of the contractual rights as well as tainting subsequent sales), the judge looked to conventional integration doctrine analysis.[98] He found that "most notably, the Pre-Sale and TDE sale were part of a single plan of financing and made for the same general purpose. Proceeds from both sales went toward funding Kik's operations and building the ecosystem for Kin."[99] The offerings also occurred at about the same time.[100] Oddly, despite noting that the rights of purchasers in the two stages of the offering differed, he also concluded that the pre-sale of contractual rights involved the same class of securities as the eventual sales of the functional token.[101] The only fact that, in the judge's mind, weighed against integration was that there were different forms of consideration paid in the two phases of the offering.[102]

The ultimate impact of this decision is unclear.[103] First, the final order was entered as a result of a settlement agreement so there was no appeal,

96. Judge Hellerstein opined that "none of [the contemplated] 'consumptive use' was available at the time of the distribution." *Id.* at 180.

97. Kik's SAFT documentation included a specific representation that the SAFTs were being purchased for investment and not with a view towards distribution. *Id.* at 174–75. The private placement memorandum also warned of the purchasers' obligations in this regard. *Id.*

98. No doubt because Kik relied upon Regulation D for its claimed exemption for the sale of SAFTs, Judge Hellerstein cited the integration rule included in that exemption. *Id.* at 181 (citing 17 C.F.R. § 230.502(a)).

99. *Id.*

100. The Kin offering began one day after the SAFT sale was complete. *Id.* at 174.

101. The order states, somewhat misleadingly, that "[p]urchasers in the two sales received the same class of securities, fungible Kin that were equal in value." *Id.* at 182. Although Judge Hellerstein concluded that the end result of the process was the "distribution of identical assets," he did acknowledge that the two groups (the original accredited investors who purchased contractual rights and the eventual owners) "received them via different instruments with different rights." *Id.*

102. "The only factor weighing against a finding of integration is that Kik received different forms of consideration from the two sales. For the Pre-Sale, Kik received consideration in the form of U.S. dollars. For the TDE, Kik received consideration in the form of Ether." *Id.*

103. Kik's General Counsel, Eileen Lyon, reacted to the eventual decision of the court with considerable disappointment and some confusion. She is quoted as having said:

> The ruling may raise more questions than it answers, since it applies only to our original token distribution. The SEC should engage in proper rulemaking, including the opportunity for public commentary, rather than force our industry to hunt for regulatory

meaning that this is a ruling from a single federal court judge.[104] Second, the Kin offering does not necessarily mirror other SAFT-type offerings, which may involve more time between the phases of the offering or may include a more extensive set of applications for the token when issued.[105] But the most significant problem in trying to rely on *Kik* to predict future outcomes stems from the SEC's decision in November 2020 to substantially revise the integration doctrine[106] that Judge Hellerstein used.[107]

As worded now, if multiple offerings are integrated (i.e., treated as being part of the same distribution for purposes of registration or qualifying for an exemption), the issuer must have a reasonable belief that each offering complies with the registration requirements or applicable exemption from registration.[108] For offers prohibiting general solicitation, the issuer is required to reasonably believe, "based on the facts and circumstances," that the issuer either did not solicit the purchaser through any general solicitation or that, prior to the offering, the issuer had established a "substantive relationship" with the purchaser.[109] However, the rule now also includes four non-exclusive "safe harbors" against integration.[110]

> clues among the SEC's conflicting statements, Commissioner and staff speeches, no-action letters, closed-door meetings with the SEC, and nonprecedential settlements.

Kik Responds to Court Ruling in Favor of SEC, CISION PR NEWSWIRE (Sept. 30, 2020, 6:45 PM), https://www.prnewswire.com/news-releases/kik-responds-to-court-ruling-in-favor-of-sec-301142420.html [https://perma.cc/GK3R-VTUY]. Since this is a trial court decision rendered by a single judge, it is not a binding precedent for cases brought in other courts, and it will be up to other judges to determine whether to regard the opinion as persuasive.

104. The final order in the lawsuit was entered into by agreement between the parties. *The Good News on Kik's Settlement with the SEC*, MEDIUM (Dec. 1, 2020), https://blockchainassoc.medium.com/the-good-news-on-kiks-settlement-with-the-sec-cc8a8eed7a35.

105. In commenting on the final order in *SEC v. Kik*, the Blockchain Association specifically commented on the fact that "Kik's token offering was unique," therefore limiting its importance in determining how future deals will be assessed. *Id.*

106. *SEC Harmonizes and Improves "Patchwork" Exempt Offering Framework*, SEC (Nov. 2, 2020), https://www.sec.gov/news/press-release/2020-273 [https://perma.cc/6PRF-KA5S]. For the final rule itself, see Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3496 (Jan. 14, 2021) (to be codified at 17 C.F.R. pts. 227, 229, 230, 239, 240, 249, 270, 274).

107. In fact, Heading III in the order is entitled "The Pre-Sale Was Part of an Integrated Offering." SEC v. Kik Interactive Inc., 492 F. Supp. 3d 169, 181 (S.D.N.Y. 2020).

108. 17 C.F.R. § 230.152(a).

109. *Id.* § 230.152(a)(1), (a)(1)(ii). In the event that the two offerings take place concurrently, additional requirements are also imposed. *Id.* § 230.152(a)(2).

110. The new integration provision states: "No integration analysis under paragraph (a) of this section is required, if any of the following non-exclusive safe harbors apply . . . ." *Id.* § 230.152(b). Prior to the amendments, Rule 152 read: "The phrase *transactions by an issuer not involving any public offering* in section 4(a)(2) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement." *Id.* § 230.152 (2013) (repealed 2021) (citations omitted).

The first listed safe harbor against application of these general principles would seem to be the most significant for crypto entrepreneurs. It gives a safe harbor against integration for "[a]ny offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering."[111] If, however, the initial sales involve general solicitation or advertising and the latter sales are made pursuant to an exemption that does not allow such communication,[112] the issuer must have a reasonable belief that the original purchasers were not solicited with general advertisements, or if there was a general solicitation, it was done to establish a substantive relationship between the purchaser and the issuer.[113]

There are three other listed safe harbors, but they are all narrower than the one that was just described. One applies to distributions of securities in compliance with a bona fide compensation plan under Rule 701;[114] the next applies if the second offering is registered with the SEC;[115] and the last applies if the second offering is made pursuant to an exemption that allows general solicitation.[116] The last option could prove useful in some situations, but the typical approach of most crypto deals, and certainly those conducted via the SAFT process, is to structure the final sales as being outside the scope of securities laws, rather than being made pursuant to a specific exemption that allows or disallows general solicitation.

Having described the new rules, the question remains as to how they should be applied to two-phase crypto distributions, such as those contemplated by the SAFT whitepaper[117] and the process employed by Kik in its distribution of contractual rights and tokens.[118] Should the initial sale of contractual rights to acquire tokens when issued be treated as part of a single scheme to distribute the planned cryptoassets, or are the two phases really distinct transactions that should be eligible for the safe harbors in these new rules? Unfortunately, the answer to this is not clear.

For example, the introductory language to new Rule 152 creates ambiguity by stating that "the provisions of this section will not have the effect of avoiding integration for any transaction or series of transactions that, although in technical compliance with the section, is part of a plan or scheme

111. *Id.* § 230.152(b)(1).
112. *Id.*
113. *Id.* (cross-referencing the requirements of *id.* § 230.152(a)(1)).
114. *Id.* § 230.152(b)(2).
115. *Id.* § 230.152(b)(3).
116. *Id.* § 230.152(b)(4).
117. See *supra* note 87 for a description of the SAFT process.
118. See *supra* notes 87–91 and accompanying text for a review of the Kik offering.

to evade the registration requirements of the Act."[119] Because the entire purpose of an exemption is to avoid the registration requirements, it is difficult to understand exactly what this language will cover.

In the discussion of the comments received on the proposed rule, the SEC noted some concern about the possibility that "an issuer could identify investors through a general solicitation and then sell to such investors in a subsequent private offering."[120] In explaining its decision to adopt the anti-evasion introductory language, the SEC said the function of the language is "to describe what is provided in the rule and caution issuers that Rule 152 may not be used as part of a plan or scheme to evade the registration requirements of the Securities Act."[121]

Consider this "explanation" in the context of a typical crypto offering structured with an initial phase where contractual rights such as SAFTs are sold and a later token distribution occurs once the cryptoasset has been developed. In the first phase, the issuer sells contractual rights to acquire the token at a future date. These sales are generally conducted so as to comply with Rule 506(c) of Regulation D,[122] although other exemptions from registration could work. The general consensus has always been that these sales would involve the distribution of an investment contract that qualifies as a security.[123] At some point, ideally at least thirty days after the sale of SAFTs has ended, the programming for the token would be completed and it would be launched.[124]

In *SEC v. Kik*, the token sales were collapsed by the court into the initial sale of contractual rights under the traditional integration doctrine.[125] If there had been a built-in thirty-day delay between the end of the SAFT sales and the token issuance (and assuming there was a thirty-day period in which resales were not allowed), would the new safe harbors against integration have come into play? We simply do not know.

The very fact that SEC officials are urging attorneys not to help crypto-based clients avoid application of the securities laws,[126] and to "voluntarily"

119. 17 C.F.R. § 230.152.

120. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3496, 3503 (Jan. 14, 2021).

121. *Id.* at 3503–04.

122. *See supra* note 87 and accompanying text.

123. *See* SAFT WHITEPAPER, *supra* note 87.

124. The thirty-day safe harbor did not exist at the time of the Kin TDE. Therefore, Kik had set up the TDE to start a single day after conclusion of the SAFT offering. SEC v. Kik Interactive Inc., 492 F. Supp. 3d 169, 174 (S.D.N.Y. 2020).

125. *Id.* at 181–82.

126. *See* Gensler, Enforcement, *supra* note 78 (in which Gensler pointedly asked attorneys not to aid clients "paper over the cracks" in regard to the securities laws). The warning did not go unremarked. *See* John Reed Stark, *SEC Warning to Crypto Attys Harkens to Prior Crackdowns*, LAW360 (Nov. 23, 2021, 5:50 PM), https://www.law360.com/articles/1441969/sec-warning-to-

comply with disclosure requirements,[127] suggests that there is considerable uncertainty in this area.[128]

B. Telegram

Similar facts were present in another recent highly publicized action by the SEC against a planned token distribution, this time by Telegram Group Inc. and Ton Issuer, Inc. (jointly, "Telegram").[129] Telegram, which according

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crypto-attys-harkens-to-prior-crackdowns (noting that Gensler "seized the opportunity to admonish the rising crop of self-anointed fintech lawyers . . . to stop trying to help their clients cover up securities regulation failures and compliance deficiencies"); *see also* Chris Matthews, *SEC's Gensler Warns Securities Lawyers: Don't 'Help Paper Over the Cracks' of Client Misconduct*, MARKETWATCH (Nov. 4, 2021, 1:40 PM), https://www.marketwatch.com/story/secs-gensler-warns-securities-lawyers-dont-help-paper-over-the-cracks-of-client-misconduct-11636047621 [https://perma.cc/ECQ6-QLJF] (quoting Gensler telling lawyers to "be the first lines of defense," particularly "when a client is getting close to crossing the line").

Nor is Gensler the only SEC official warning attorneys of their need to assist in increasing compliance. Gurbir Grewal, Director of Enforcement for the SEC, warned in 2021 that when gatekeepers such as attorneys "are living up to their obligations, they serve as the first lines of defense against misconduct. But when they don't, investors, market integrity, and public trust all suffer. Encouraging your clients to play in the grey areas or walk right up to the line creates significant risk." Gurbir S. Grewal, Dir., Div. of Enf't, SEC, Remarks at SEC Speaks 2021 (Oct. 13, 2021), https://www.sec.gov/news/speech/grewal-sec-speaks-101321. In 2018, then-Chairman Jay Clayton issued similar warnings:

> Market professionals, especially gatekeepers, need to act responsibly and hold themselves to high standards. To be blunt, from what I have seen recently, particularly in the initial coin offering ("ICO") space, they can do better. Our securities laws—and 80 plus years of practice—assume that securities lawyers, accountants, underwriters, and dealers will act responsibly. It is expected that they will bring expertise, judgment, and a healthy dose of skepticism to their work. Said another way, even when the issue presented is narrow, market professionals are relied upon to bring knowledge of the broad legal framework, accounting rules, and the markets to bear.

Jay Clayton, Chairman, SEC, Opening Remarks at the Securities Regulation Institute (Jan. 22, 2018), https://www.sec.gov/news/speech/speech-clayton-012218.

127. On November 9, 2021, in an article posted to the SEC webpage, Commissioner Caroline Crenshaw urged DeFi (decentralized finance) participants to "voluntarily comply" with disclosure requirements under the federal securities laws. Caroline A. Crenshaw, *Statement on DeFi Risks, Regulations, and Opportunities* (Nov. 9, 2021), https://www.sec.gov/news/statement/crenshaw-defi-20211109 [https://perma.cc/FFY8-WL8K] (originally published in Caroline Crenshaw, *DeFi Risks, Regulations, and Opportunities*, 1 INT'L J. OF BLOCKCHAIN L., Nov. 2021, at 4, 8).

128. As one commentator noted, "[t]he S.E.C. has yet to set clear rules on cryptocurrencies, leaving the industry guessing. Maybe that's just how the agency wants it." Sheelah Kolhatkar, *The Challenges of Regulating Cryptocurrency*, NEW YORKER (Oct. 6, 2021), https://www.newyorker.com/business/currency/the-challenges-of-regulating-cryptocurrency [https://perma.cc/S86C-5GX5].

129. For popular commentary using this short-hand reference, see David I. Miller & Charlie Berk, *SEC v. Telegram: A Groundbreaking Decision in Cryptocurrency Enforcement?*, 10 NAT'L L. REV. (Apr. 1, 2020), https://www.natlawreview.com/article/sec-v-telegram-groundbreaking-decision-cryptocurrency-enforcement; Anna Baydakova, *Making Sense of the SEC's Case Against Telegram*, COINDESK (Sept. 14, 2021, 4:28 AM), https://www.coindesk.com/markets/2020/04/12/making-sense-of-the-secs-case-against-telegram/ [https://perma.cc/3Z3K-X5WM]; *SEC v. Telegram: Key Takeaways and Implications*, COOLEY

to its webpage is currently headquartered in Dubai,[130] began raising capital in January 2018 in a SAFT offering.[131] In the initial phase of fundraising, which lasted from January to March of 2018, Telegram raised approximately $1.7 billion by selling contractual rights to acquire 2.9 billion digital tokens (called "Grams") to 171 initial purchasers worldwide in a SAFT[132] offering limited to accredited investors.[133] As Kik had done, Telegram designed the first phase to comply with the requirements of Rule 506(c) of Regulation D.[134]

The Grams were to be delivered upon the launch of the TON Blockchain, which was scheduled to occur no later than October 31, 2019.[135] Following the token launch, the plan was that both the initial investors and Telegram would be able to sell Grams to additional purchasers. Because the plan was to have a fully functional blockchain and tokens before this occurred, Telegram expected that at that time, the Grams would not be securities and instead would be treated as a currency or commodity.[136]

Shortly before the Grams were to be delivered in the fall of 2019, the SEC filed an emergency action alleging that Telegram had violated the federal securities laws by conducting an unregistered digital token

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(May 7, 2020) [hereinafter COOLEY ALERT], https://www.cooley.com/news/insight/2020/2020-05-07-sec-v-telegram-key-takeaways-implications [https://perma.cc/EXN5-Z9NG].

130. *Telegram FAQ*, TELEGRAM, https://telegram.org/faq#q-how-old-is-telegram [https://perma.cc/FT8N-9P7C] (last visited Nov. 10, 2021).

131. Complaint at 2, SEC v. Telegram Grp. Inc., 448 F. Supp. 3d 352 (S.D.N.Y. 2020) (No. 19 Civ. 9439) [hereinafter Telegram Complaint], https://www.sec.gov/litigation/complaints/2019/comp-pr2019-212.pdf. Technically speaking, Telegram did not utilize the SAFT documentation. Particularly in the face of the SEC's resistance to the SAFT process, many other labels have been applied to these kinds of arrangements; in the case of Telegram, the label used was "Gram Purchase Agreement." "[C]omparable agreements by other issuers come under a myriad of titles, [but] the Gram Purchase Agreements and their relatives are commonly known as Simple Agreements for Future Tokens (SAFTs), even though many practitioners, cognizant of the SEC's long-held suspicions, avoid using the term." Courtney Rogers Perrin & J. Gray Sasser, *SAFTs May Survive Telegram's Garbled Message*, FROST BROWN TODD LLC (Nov. 19, 2019), https://frostbrowntodd.com/safts-may-survive-telegrams-garbled-message/#page=1. This Article refers to the Telegram process as involving SAFTs.

132. The SAFT process is described *supra* at note 87.

133. Telegram Complaint, *supra* note 131, at 2. "Accredited investors" are defined in Rule 501(a) of Regulation D. 17 C.F.R. § 230.501(a). Most investors gain accredited status by virtue of wealth, but sophistication and knowledge are also now allowed as the basis for accredited status. *SEC Modernizes the Accredited Investor Definition*, SEC (Aug. 26, 2020), https://www.sec.gov/news/press-release/2020-191 [https://perma.cc/Y34H-7QJ3].

134. In the *Telegram* litigation, both parties stipulated that Telegram had relied on 506(c) of Regulation D to exempt the sale of contractual rights. *See* SEC v. Telegram Grp. Inc., 448 F. Supp. 3d 352, 361 (S.D.N.Y. 2020) (referring to Joint Stipulation of Undisputed Facts ¶¶ 48, 52, 55, *Telegram*, 448 F. Supp. 3d 352 (No. 19 Civ. 9439) [https://perma.cc/4WFC-XSQR]).

135. Telegram Complaint, *supra* note 131, at 2.

136. *See* Defendants' Answer, Defenses and Affirmative Defenses to Plaintiff's Complaint at 2, *Telegram*, 448 F. Supp. 3d 352 (No. 19 Civ. 9439) [hereinafter Telegram Answer] [https://perma.cc/9D9W-ZTM2].

offering.[137] As part of its complaint, the SEC requested (and received) an ex parte temporary restraining order "to prevent Telegram from flooding the U.S. markets with digital tokens that . . . were [allegedly] unlawfully sold."[138] Telegram responded promptly,[139] with a brief claiming that there was no need for an emergency order[140] and requesting the court deny the SEC's request for a preliminary injunction.[141] Part of Telegram's reasoning was that the SEC had failed to provide notice of how it intended to interpret or apply the securities laws, despite Telegram engaging in eighteen months of dialogue with the SEC about its plans.[142]

On November 12, 2019, Telegram filed its answer to the SEC's complaint denying the SEC's allegations and claiming that the SEC was engaging in "regulation by enforcement."[143] Two amici curiae briefs were submitted in support of Telegram, both taking the position that the Grams should not be presumed to be securities.[144] In opposition to those arguments, three experts for the SEC opined that the TON network was not sufficiently mature and decentralized to function without additional input from Telegram

137. Telegram Complaint, *supra* note 131, at 3, 29.

138. *SEC Halts Alleged $1.7 Billion Unregistered Digital Token Offering*, SEC (Oct. 11, 2019), https://www.sec.gov/news/press-release/2019-212 [https://perma.cc/759K-97DH].

139. The initial response to the SEC's emergency request for a preliminary injunction in the Defendants' Response in Opposition to Plaintiff's Emergency Application for Preliminary Injunction, *Telegram*, 448 F. Supp. 3d 352 (No. 19 Civ. 9439) [hereinafter Telegram Response], https://storage.courtlistener.com/recap/gov.uscourts.nysd.524448/gov.uscourts.nysd.524448.7.0.pdf [https://perma.cc/LH9H-QAKZ], was filed October 16, 2019.

140. This initial response specifically alleged that Telegram had spent the preceding eighteen months in voluntary talks with, and soliciting feedback from, the SEC, "consistent with the SEC's publicly stated desire to engage with developers of digital asset technologies." *Id.* at 1 (citing *Strategic Hub for Innovation and Financial Technology (FinHub)*, SEC (June 14, 2022), a copy of which has been archived at https://perma.cc/4WFH-6HKA). FinHub currently "encourages anyone working with RegTech solutions or implementations to engage with FinHub as part of this initiative." *FinHub to Host Virtual Meet-Ups*, SEC (June 11, 2020), https://www.sec.gov/news/press-release/2020-130 [https://perma.cc/F52V-Z52X].

141. Telegram Response, *supra* note 139, at 4.

142. For example, the Telegram response claimed that despite being fully aware of the terms of the proposed offering, "the SEC (i) never requested that Telegram delay the launch of the TON Blockchain; [and] (ii) never advised Telegram of its intention to seek injunctive relief . . . ." Telegram Response, *supra* note 139, at 2.

143. Telegram Answer, *supra* note 136, at 1.

144. Anna Baydakova, *Blockchain Association Sides with Telegram Against SEC, Says Grams Are Not Securities*, YAHOO (Jan. 22, 2020), https://finance.yahoo.com/news/blockchain-association-sides-telegram-against-121713959.html. The Blockchain Association's amicus brief is described at Blockchain Association, *Blockchain Association Stands Up for Crypto Industry in Amicus Brief for Telegram Case*, MEDIUM (Jan. 21, 2020), https://medium.com/@BlockchainAssoc/blockchain-association-stands-up-for-crypto-industry-in-amicus-brief-for-telegram-case-2a0d92a3803b [https://perma.cc/2MSG-L6SD]. A copy of the amicus brief filed by the Chamber of Digital Commerce is archived at https://perma.cc/27CR-P6VS. Both the Digital Chamber of Commerce and the Blockchain Association are not-for-profit organizations seeking to promote blockchain-based technologies.

and that a reasonable investor would have purchased the tokens with an expectation of profit.[145] The CFTC also filed a brief, stating its position that the Grams were commodities but concluding that should not preclude them from also being regulated as securities.[146]

On February 19, 2020, the SEC and Telegram presented arguments on the "economic realities" of the planned Grams. The SEC argued that the entire plan of distribution should be treated as a single transaction, while Telegram argued that the SAFT sales and eventual launch of the Gram tokens should be viewed as two distinct events, with only the first involving the sale of investment contracts. It took the judge more than a month to conclude that the SEC had shown a substantial likelihood of success on the merits, and on March 24, 2020—before the Kik litigation was decided—the court granted the preliminary injunction, halting the planned issuance of Grams with the following explanation:

> The Court finds that the SEC has shown a substantial likelihood of success in proving that the contracts and understandings at issue, including the sale of 2.9 billion Grams to 175 purchasers in exchange for $1.7 billion, are part of a larger scheme to distribute those Grams into a secondary public market, which would be supported by Telegram's ongoing efforts. Considering the economic realities under the *Howey* test, the Court finds that, in the context of that scheme, the resale of Grams into the secondary public market would be an integral part of the sale of securities without a required registration statement.[147]

Telegram promptly appealed this ruling to the U.S. Court of Appeals for the Second Circuit,[148] but dropped the appeal in early May 2020, agreeing to return $1.2 billion to investors worldwide and to pay a fine of $18.5 million to the SEC.[149]

Although initiated after the enforcement action against Kik, *Telegram* was the first of the cases discussed here to be decided. Its precedential value

145. Stefan Stankovic, *SEC Taps 3 Experts on Why Telegram's Token Is a Security*, CRYPTOBRIEFING (Jan. 30, 2020), https://cryptobriefing.com/sec-taps-experts-gram-token-security/ [https://perma.cc/B3GR-PY5N].

146. Shiraz Jagati, *CFTC Joins the Telegram vs. SEC Case, Shedding Light on Likely Verdict*, COINTELEGRAPH (Feb. 21, 2020), https://cointelegraph.com/news/cftc-joins-the-telegram-vs-sec-case-shedding-light-on-likely-verdict [https://perma.cc/K2YB-RGH4].

147. SEC v. Telegram Grp., Inc., 448 F. Supp. 3d 352, 358 (S.D.N.Y 2020).

148. Richard B. Levin & Stephen A. Rutenberg, *Hanging on the Telephone: Judge Enters Order Blocking Telegram ICO*, 10 NAT'L L. REV. (Apr. 14, 2020), https://www.natlawreview.com/article/hanging-telephone-judge-enters-order-blocking-telegram-ico [https://perma.cc/LS54-B94M].

149. *Telegram to Return $1.2 Billion to Investors and Pay $18.5 Million Penalty to Settle SEC Charges*, SEC (June 26, 2020), https://www.sec.gov/news/press-release/2020-146.

is perhaps even less clear than that of the *Kik* opinion.[150] First, it is not only the opinion of a single trial judge, but it is also a decision involving a preliminary injunction, not rendered after a trial or hearing on the merits.[151] Second, as happened in *Kik*, the appeal was dropped without giving the Second Circuit a chance to agree or disagree with the trial court's reasoning. And, as was the case with *Kik*, the new integration rules were not yet in effect when the offering occurred[152] or when the decision was announced.[153] Thus, there is no way to predict whether a built-in thirty-day gap between the end of trading in the contractual rights and the issuance of the ultimate tokens will matter in future transactions.

The facts of the case are also quite significant, especially given the SEC's repeated reminders that application of *Howey* depends on the specific facts and circumstances of each offering.[154] It is quite possible that a relatively minor change in the facts could have led to a different outcome. As reported elsewhere:

> [S]hortly after the SEC brought its action to enjoin the Telegram launch in October 2019, a SEC staff member noted expressly that the SAFT model should and could still work so long as resale was tied not just to a set period of time but rather linked to a point in

150. The Kik order's potential impact is considered *supra* at notes 103–107 and accompanying text.

151. As one case analysis notes, "[t]he *Telegram* opinion comes out of the influential Southern District of New York, but it is the opinion of a single trial court, rendered on a preliminary injunction standard." COOLEY ALERT, *supra* note 129.

152. As noted *supra* at notes 130–137 and accompanying text, the offering of contractual rights in the *Telegram* case occurred in 2018, and the Grams themselves were set to launch in 2019.

153. The court's order was published on March 24, 2020, several months before the November adoption of the new integration rules. See *supra* notes 106–116 and accompanying text for a description of the adoption of the current integration rules.

154. The DAO Report emphasized the importance of considering the specific facts of the situation in ascertaining when cryptoassets should be treated as securities:

> This definition embodies a "flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." [SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946)] . . . The test "permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" *Id.* In analyzing whether something is a security, "form should be disregarded for substance," Tcherepnin v. Knight, 389 U.S. 332, 336 (1967), "and the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto." [United Housing Found. v. Forman, 421 U.S. 837, 849 (1975)].

DAO REPORT, *supra* note 42, at 11 (emphasis omitted). This was confirmed in the SEC's Framework on digital assets, which noted that "[w]hether a particular digital asset at the time of its offer or sale satisfies the *Howey* test depends on the specific facts and circumstances." FRAMEWORK, *supra* note 43, at 2.

> time in which the resale of the underlying token would no longer be a securities transaction.[155]

The staff member, of course, gave no clear indication of what point in time would convert an underlying token to something other than a security.

C. Ripple

An even more recent enforcement action by the SEC further illustrates how its actions can catch companies unaware of how broadly the securities laws can apply. As mentioned in the introduction to this Article, in May 2015, FinCEN made a determination that Ripple Labs was subject to its jurisdiction because Ripple's XRP token was a currency substitute.[156] Despite numerous opportunities in the coming years to announce that the SEC believed Ripple was issuing securities when it sold XRP, the SEC was apparently silent on the topic until late 2020. On December 22, 2020, the SEC initiated an enforcement action based on allegations that Ripple had been selling XRP tokens, which the SEC declared to be securities, without registration or an exemption for the past several years.[157]

This case is somewhat different from the Kik and Telegram distributions. First, Ripple did not issue the XRP tokens pursuant to anything like the SAFT. The XRP ledger was completed in December of 2012, and at that time the computer code set a fixed supply of 100 billion tokens.[158] When launched, 80 billion XRP were transferred to Ripple and the remaining twenty billion tokens went to a group of founders.[159]

According to the SEC's complaint, what followed was a very long unregistered offering of XRP tokens.[160] As described by the SEC, Ripple eventually issued approximately 14.6 billion XRP in a combination of

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155. COOLEY ALERT, *supra* note 129.

156. *See supra* notes 46–47 and accompanying text.

157. Ripple Initial Complaint, *supra* note 48. On February 18, 2021, the complaint was amended, and most references in the text will be to this version. First Amended Complaint, SEC v. Ripple Labs, Inc., No. 20 Civ. 10832, 2021 WL 1814771 (S.D.N.Y. May 6, 2021) [hereinafter Ripple Amended Complaint] [https://perma.cc/XEG3-ANQV].

158. Ripple Amended Complaint, *supra* note 157, ¶ 45.

159. *Id.* ¶ 46. There is actually some debate about the original transactions. The first 32,569 ledger entries were accidentally lost due to a bug in the program. Anton Lucian & Kyle Baird, *XRP's Genesis Block Still Has No Record*, BEINCRYPTO (Dec. 15, 2019, 5:20 PM), https://beincrypto.com/xrps-genesis-block-still-has-no-record/ [https://perma.cc/CPE9-F9WF]. While the SEC claims that the initial issuance of XRP was to the company, other versions of the genesis transactions suggest that the initial distribution was to the founders, who in turn contributed or gifted (depending on the source) eighty billion XRP to the company. *See Provide a Better Alternative to Bitcoin*, XRP, https://xrpl.org/history.html [https://perma.cc/9Y9Q-856G] (last visited Aug. 8, 2022).

160. The amended complaint states that "Ripple engaged in this illegal securities offering from 2013 to the present . . . ." Ripple Amended Complaint, *supra* note 157, ¶ 3.

distributions via bounty programs, as compensation to programmers and developers, and to institutional and other market participants.[161] These sales raised approximately $1.38 billion to fund Ripple's operations.[162]

Most of these sales occurred before the SEC had issued its DAO Report in 2017, and according to Ripple's answer to the SEC complaint,[163] they also took place up to five years after XRP was determined to be a virtual currency by FinCEN and after more than two and a half years of investigation, during which time the SEC permitted Ripple to distribute its token and expand its network, allowing millions of purchasers to rely on the free and efficient functioning of the market.[164] Ripple's answer begins with the company's position that its XRP token is not an investment contract,[165] and then alleges that the SEC's complaint "is a sprawling and convoluted effort to allege that Ripple's distributions of XRP (through numerous and varied methods) over a nearly eight-year period constitute a single, unbroken distribution" that should have been registered.[166]

The most common reactions to the lawsuit appear to have been surprise and frustration.[167] On January 1, 2021, a group of XRP holders, led by attorney John Deaton, filed a petition for a writ of mandamus in the United States District Court for the District of Rhode Island asking the court to force the SEC to exclude their XRP tokens from its pending litigation against

161. *Id.* ¶ 1.

162. *Id.*

163. Answer of Defendant Ripple Labs, Inc. to Plaintiff's First Amended Complaint, *Ripple Labs, Inc.*, 2021 WL 1814771 [hereinafter Ripple Answer] [https://perma.cc/8R25-X4PR].

164. *Id.* ¶ 4.

165. *Id.* ¶ 1.

166. *Id.* ¶ 12.

167. *See* Jeff John Roberts, *SEC Is 'Dead Wrong': Former Chair Mary Jo White Defends Ripple in Pivotal Crypto Case*, FORTUNE (Feb. 19, 2021, 10:00 AM), https://fortune.com/2021/02/19/ripple-sec-lawsuit-mary-jo-white-crypto-unlicensed-securities-xrp/ [https://perma.cc/QAB3-Y9KT] (commenting that "the broader crypto-industry reacted with surprise and alarm"). Similarly, Roslyn Layton, a senior contributor to Forbes, characterized the action as a "bombshell lawsuit" that has become a "cause célèbre in the cryptocurrency community . . . [with] sweeping implications about regulatory overreach . . . ." Roslyn Layton, *SEC Assault on Ripple Provokes Wider Debate*, FORBES (June 30, 2021, 4:56 PM) [hereinafter Layton, *Debate*], https://www.forbes.com/sites/roslynlayton/2021/06/30/sec-assault-on-ripple-provokes-wider-debate/?sh=51e39c5c29e1. Another commentator suggested that case was a "time bomb" going off, with the case being:

> [E]mblematic of the murky regulation enveloping digital currency, reflecting the mismatch between laws largely developed during the Great Depression and today's burgeoning fintech ecosystem. While opinions differ on whether the SEC has a strong case against Ripple, almost everyone agrees that the underlying problem is a lack of clarity over how cryptocurrency can be regulated . . . .

David H. Freedman, *Why Ripple's SEC Lawsuit Could Have a Lasting Impact on Crypto*, FORTUNE (July 29, 2021, 5:20 AM), https://fortune.com/2021/07/29/ripple-xrp-sec-lawsuit-impact-on-crypto-industry/ [https://perma.cc/6TLB-5CA8].

Ripple on the grounds that the plaintiffs had not purchased investment contracts.[168] Deaton's petition argues that the SEC, under the leadership of then-chairman Jay Clayton, "caused multi-billion-dollar losses to innocent investors who have purchased, exchanged, received and/or acquired the Digital Asset XRP."[169] In the memorandum submitted in support of the petition for a writ of mandamus, the plaintiffs make it clear that they did not invest in XRP in order to make a profit based on efforts of Ripple.[170]

While there is no statute of limitations on the SEC's ability to bring enforcement actions for conducting an unregistered offering, the public backlash against this particular lawsuit has been notable.[171] Commentators not only point to decisions from regulators in other jurisdictions that XRP is a currency rather than a security,[172] but the unpredictability and unfairness of the SEC waiting so long to act if, indeed, the rules are as "clear" as the SEC claims.[173]

D. Stablecoins: Regulation by Inaction

The response of the SEC described in this Section of the Article is different from that described in the preceding three sections in that there has been no specific enforcement action initiated by the SEC. Rather, it is the lack of intervention despite significant evidence of fraud and misconduct that is particularly problematic if, as the SEC claims, its authority in the space is extensive and clear.[174]

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168. Petition for Writ of Mandamus at 26, Deaton v. Roisman (*In re* Deaton), No. 21-cv-00001 (D.R.I. Jan. 1, 2021), https://www.tbstat.com/wp/uploads/2021/01/xrp_investors_sec.pdf [https://perma.cc/9QMM-NEF4].

169. *Id.* ¶ 2.

170. Memorandum in Support of Writ of Mandamus ¶ 163, *In re Deaton*, No. 21-cv-00001 [https://perma.cc/9QMM-NEF4] ("The Petitioners and all others similarly situated are unaware of efforts or statements by Ripple leading the Petitioners to expect profits for their purchase or acquisition of XRP. To the contrary, some named Petitioners are aware that Ripple executives and former executives have publicly stated that XRP was not designed for retail investors.").

171. "No one expected the tsunami of legal, political and social media action from retail cryptocurrency investors, outraged by the betrayal from an agency claiming to protect their interests." Roslyn Layton, *The Crypto Uprising the SEC Didn't See Coming*, FORBES (Aug. 30, 2021, 11:24 AM), https://www.forbes.com/sites/roslynlayton/2021/08/30/the-crypto-uprising-the-sec-didnt-see-coming/?sh=275e26a7143e [https://perma.cc/NF5L-4ZM5].

172. Layton, *Debate*, *supra* note 167 ("Financial regulatory authorities in Japan, Singapore, the U.K., Switzerland, and the UAE have already declared that XRP is a currency, not a security.").

173. Former SEC Chair Mary Jo White, who admittedly lacks impartiality as she is serving as counsel to Ripple, reacted to the lawsuit by commenting on the fact that the SEC waited until December 2020 to bring the lawsuit: "As a former U.S. attorney and SEC chair, you know that when it takes that long to figure out a case you probably shouldn't be bringing it." Roberts, *supra* note 167.

174. As one commentator complained, the SEC "is playing a ridiculous game with the blockchain and cryptocurrency industry and the millions of investors it claims it's trying to protect. The agency insists there is 'clarity' on the rules it applies to digital assets, but will only communicate

Stablecoins are a form of crypto designed to have stable pricing as compared to the extreme volatility associated with most cryptoassets.[175] The value of a stablecoin is generally pegged to an external asset class such as a single fiat currency (with the U.S. dollar being the most popular), a basket of fiat currencies, or a tangible commodity (such as gold). A stablecoin may be collateralized off-chain, meaning that the issuer or a related entity holds sufficient amounts of the relevant fiat or commodity to ensure price stability. Alternatively, the stablecoin may be collateralized on-chain, by holding other cryptoassets. The preferred form of on-chain collateral has been Ethereum. It is also possible for a stablecoin to be uncollateralized, depending instead on algorithms and smart contracts governing the buying and selling of the asset to keep a stable price. While early stablecoins such as NuBits experimented with this option, this is no longer prevalent, although algorithmic stablecoins do exist.[176]

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them through lawsuits." Jared Whitley, *Gensler's Crypto Mess: It's Time For Congress To Teach The SEC What "Clarity" Means*, CRYPTO LAW (Sept. 16, 2021), https://www.crypto-law.us/genslers-crypto-mess-its-time-for-congress-to-teach-the-sec-what-clarity-means/ [https://perma.cc/WT6S-ULRC].

In September 2021, in testimony before the Senate Banking Committee, SEC Chair Gensler "pushed back on senators' criticism that the SEC has been vague on when a crypto token is and isn't a security. 'I think that there's a fair amount of clarity over the years.'" Tomio Geron, *Gary Gensler Had a Lot to Say About Crypto in 2021*, PROTOCOL (Dec. 26, 2021), https://www.protocol.com/fintech/gary-gensler-crypto-wall-street [https://perma.cc/9JFW-7TNY]. The SEC's Director of Enforcement has also characterized the SEC's actions in the crypto space as being based on "long-standing, well-known and understood regulations and standards that govern the securities industry." *See supra* note 79 and accompanying text.

175. James Burton, *Bitcoin Is 'More Volatile than Volatility Itself*,*'* WEALTH PRO. (May 20, 2021), https://www.wealthprofessional.ca/investments/alternative-investments/bitcoin-is-more-volatile-than-volatility-itself/356352 [https://perma.cc/SH3V-A5AD] (quoting the CEO of Horizons ETFs, Steve Hawkins, as having said that "Bitcoin is now the most volatile asset class in the world"). For a further explanation of pricing volatility in crypto, see Cryptopedia Staff, *Healthy Volatility and Its Implications for Crypto Markets*, CRYPTOPEDIA (June 28, 2022), https://www.gemini.com/cryptopedia/volatility-index-crypto-market-price [https://perma.cc/QHB8-HX45].

176. *Stablecoins: The Complete Guide, Part I—Past & Present (2014–2019)*, COOLWALLET (Sept. 22, 2019) [hereinafter CoolWallet Blog], https://www.coolwallet.io/the-complete-guide-to-stablecoins-part-i-2014-2019/ [https://perma.cc/3XA9-8KJG]. In early May 2022, an algorithmic stablecoin, UST or TerraUSD, imploded spectacularly, resulting in a spate of headlines and new questions about the need to regulate this asset class. "Before May 10, TerraUSD was in the top 10 most valuable cryptocurrencies with an estimated market value of more than $40 billion. However, a huge market crash sent the value tumbling (understatement) to $500 million, a drop of nearly 99 percent." Oliver Povey, *Cryptocurrency Prices: What Is the Correlation Between UST and Luna that Explains Its Big Drop?*, AS USA (May 16, 2022, 7:51 PM) (emphasis omitted), https://en.as.com/latest_news/cryptocurrency-prices-what-is-the-correlation-between-ust-and-luna-that-explains-its-big-drop-n/ [https://perma.cc/63BE-WC7K]. It appears that the "network as it once was can't be salvaged." Daniel Kuhn, *UST Won't Be the End of Algorithmic Stablecoins*, COINDESK (May 16, 2022, 2:14 PM), https://www.coindesk.com/layer2/2022/05/16/ust-wont-be-the-end-of-algorithmic-stablecoins/ [https://perma.cc/UFK5-P6LR]; *see also* Matt Phillips, *Broken Stablecoin Could Intensify Crypto Regulation Push*, AXIOS (May 12, 2022),

The first successful stablecoin, USDT (colloquially known as "Tether," which is also the name of the company that created it), was launched in 2014. Originally called RealCoin, it was renamed USD Tether ("USDT") in November 2014, and it began trading on exchanges in early 2015.[177] The original concept was that each USDT would be backed by one U.S. dollar, although Tether Limited has also maintained that it is not contractually obligated to guarantee that USDT can be redeemed or exchanged for dollars or other fiat.[178] In the absence of external audits, and with rumors circulating that Tether was not maintaining sufficient reserves, USDT dropped below $1 in October 2018,[179] although the price recovered relatively quickly and has stayed close to $1 since that time.

Subsequent investigations have demonstrated that Tether falsely claimed that USDT was fully backed by U.S. dollars, and for years denied any connection to Bitfinex, when in fact both companies are owned by iFinex.[180] Later developments indicated that each USDT was at best backed at 74% of its stated value, and not primarily by U.S. dollars.[181] In addition, the parent company, iFinex, secretly used some of its reserves to cover an $850 million loss that Tether did not disclose to the public.[182]

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https://www.axios.com/2022/05/12/broken-stablecoin-could-intensify-crypto-regulation-push [https://perma.cc/AC5M-43JW].

177. David Hamilton, *What Is Tether? Everything You Need to Know*, SECURITIES.IO (Mar. 20, 2022), https://www.securities.io/what-is-tether-a-look-at-the-worlds-most-popular-stablecoin/ [https://perma.cc/5KVQ-AKAD].

178. David Dinkins, *The Strange Story of Tether, the Digital Money That Claims it Isn't Money*, COINTELEGRAPH (Aug. 17, 2017), https://cointelegraph.com/news/the-strange-story-of-tether-the-digital-money-that-claims-it-isnt-money [https://perma.cc/F7U4-YDJB].

179. Gareth Jenkinson, *Untethered: The History of Stablecoin Tether and How It Has Lost Its $1 Peg*, COINTELEGRAPH (Oct. 17, 2018), https://cointelegraph.com/news/untethered-the-history-of-stablecoin-tether-and-how-it-has-lost-its-1-peg [https://perma.cc/2PMP-8L4S]. Historical pricing information about USDT can be obtained at *Historical Data for Tether*, COINMARKETCAP, https://coinmarketcap.com/currencies/tether/historical-data/ (last visited Oct. 4, 2022). While USDT did drop to $0.9771 on October 17, 2018, it was again trading at $1.00 in early December of that year. *Id.*

180. Jordan Atkins, *Crypto Crime Cartel: The End Is Nigh for Tether*, COINGEEK (Jan. 15, 2021), https://coingeek.com/crypto-crime-cartel-the-end-is-nigh-for-tether/ [https://perma.cc/YGP7-XRN7]. Bitfinex had previously been the subject of CFTC enforcement actions for illegal off-exchange commodity transactions and failure to register as a futures commission merchant. *CFTC Orders Bitcoin Exchange Bitfinex to Pay $75,000 for Offering Illegal Off-Exchange Financed Retail Commodity Transactions and Failing to Register as a Futures Commission Merchant*, CFTC, https://www.cftc.gov/PressRoom/PressReleases/7380-16 [https://perma.cc/2MPT-RDCS] (last visited Sept. 30, 2022).

181. *Id.*

182. Paul Vigna, *Bitfinex Used Tether Reserves to Mask Missing $850 Million, Probe Says*, WALL ST. J. (Apr. 25, 2019, 11:21 PM), https://www.wsj.com/articles/bitfinex-used-tether-reserves-to-mask-missing-850-million-probe-finds-11556227031. As described in this story, the New York Attorney General's office leveled these accusations as part of its investigation against Bitfinex and its parent, iFinex. *Id.*

These actions led to an enforcement action not by the SEC, but by the New York Attorney General's office which was finally settled in February 2021, with iFinex agreeing to pay an $18.5 million fine without admitting wrongdoing.[183] In addition, on May 13, 2021, Tether complied with other requirements of the New York settlement order by releasing the asset breakdown for its reserves, indicating that cash accounted for only 2.9% of the reserves, while the company relied on commercial paper and fiduciary deposits that may be illiquid or insecure for the bulk of its backing.[184]

While there have been hints that the SEC might be investigating Tether,[185] in the absence of any actual action, in October 2021, the CFTC announced an order that both initiated and settled "charges against Tether Holdings Limited, Tether Limited, Tether Operations Limited, and Tether International Limited (d/b/a Tether)" for lying about the USDT (Tether) stablecoin.[186] The most important allegations against Tether involved a pattern of deceit about the way in which the stablecoin was supposed to be backed. The order included the following findings:

> Tether misrepresented to customers and the market that Tether maintained sufficient U.S. dollar reserves to back every USDT in circulation with the "equivalent amount of corresponding fiat currency" held by Tether and "safely deposited" in Tether's bank accounts. In fact Tether reserves were not "fully-backed" the majority of the time. The order further finds that Tether failed to disclose that it included unsecured receivables and non-fiat assets in its reserves, and that Tether falsely represented that it would undergo routine, professional audits . . . .[187]

Even in the face of these legal actions, USDT continues to be very actively traded. According to *CoinMarketCap*, the circulating supply of

183. Duncan Riley, *iFinex Agrees to Pay $18.5M to Settle New York Tether Lawsuit*, SILICONANGLE (Feb. 23, 2021, 9:45 PM), https://siliconangle.com/2021/02/23/ifinex-agrees-pay-18-5m-settle-new-york-tether-lawsuit/ [https://perma.cc/48D3-3RUC].

184. ValExplorer, *Should We Worry About Tether?*, MEDIUM (May 19, 2021), https://medium.com/coinmonks/should-we-worry-about-tether-1fc1727ebe4c [https://perma.cc/Q4DG-MXKM].

185. Nikhilesh De, *SEC Hints at Tether Probe in Records Request Denial*, COINDESK (Sept. 24, 2021, 2:42 PM), https://www.coindesk.com/policy/2021/09/24/sec-hints-at-tether-probe-in-records-request-denial/ [https://perma.cc/54DW-H3B5]. The SEC declined to release records about Tether in response to a FOIA request from Jacob Silverman, a staff writer at The New Republic, on the grounds that they were collected for enforcement purposes. A copy of the SEC's letter denying the request can be accessed at *Tether Stablecoin Company (Securities and Exchange Commission)*, MUCKROCK, https://www.muckrock.com/foi/united-states-of-america-10/tether-stablecoin-company-securities-and-exchange-commission-118568/#file-972087 (last visited Oct. 4, 2022).

186. *CFTC Orders Tether and Bitfinex to Pay Fines Totaling $42.5 Million*, CFTC (Oct. 15, 2021) (emphasis omitted), https://www.cftc.gov/PressRoom/PressReleases/8450-21 [https://perma.cc/YL9E-BC2H]. At the same time, Bitfinex was ordered to pay $1.5 million for illegal transactions while it operated the Bitfinex crypto exchange. *Id.*

187. *Id.*

USDT as of August 7, 2022, exceeded sixty-six billion tokens.[188] The same source listed a twenty-four-hour trading volume on that day of almost thirty-two billion USDT.[189]

The real question is what it means for the SEC to have abstained from any action against a repeated pattern of apparently deceptive behavior by the companies responsible for the most heavily traded stablecoin.[190] If the SEC is being truthful in its claim that it has clear and broad authority, does this inactivity mean that stablecoins are outside the purview of the SEC? We do not really know.

On November 1, 2021, the President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency jointly issued a report on stablecoins.[191] This report unhelpfully notes that "stablecoin arrangements and activities may implicate the jurisdiction of the SEC and/or CFTC."[192] While concluding that there are gaps in existing regulations that suggest the need for congressional action, the report neither explains the extent of the SEC's jurisdiction nor the extent to which gaps exist with regard to issues of investor protection or market integrity, instead focusing on prudential regulation of stablecoin issuers.[193]

SEC Chair Gensler has also been less than clear in his assessment of stablecoins. In July 2021, he said in remarks to the American Bar Association

188. *Today's Cryptocurrency Prices by Market Cap*, COINMARKETCAP, https://coinmarketcap.com/currencies/tether (last visited Aug. 7, 2022) (reporting that Tether's market capitalization as of that day was $66.48 billion).

189. *Id.* (listing a 24-hour trading volume of 31.82 billion USDT on August 7, 2022). While some sources recently questioned the accuracy of reported high trading volumes of cryptoassets, data aggregators such as CoinMarketCap have responded by improving their analytic processes. Anupam Varshney, *Telling the Truth? How Crypto Data Aggregators Fight Fake Exchange Volumes*, COINTELEGRAPH (Jan. 5, 2021), https://cointelegraph.com/news/telling-the-truth-how-crypto-data-aggregators-fight-fake-exchange-volumes (explaining some of the improvements made by crypto data aggregators). CoinGecko, another aggregator using different metrics, reported a twenty-four-hour trading volume as of August 7, 2022, of 34.21 billion USDT, which is even higher than the volume reported by CoinMarketCap. *Cryptocurrency Prices by Market Cap*, COINGECKO, https://www.coingecko.com/ [https://perma.cc/6L5C-24UD] (last visited Aug. 7, 2022).

190. USDT has become so important to the crypto ecosystem that a number of observers have expressed concern that it poses a possible systemic risk to the entire crypto market. Elizabeth Lopatto, *The Tether Controversy Explained*, VERGE (Aug. 16, 2021, 8:00 AM), https://www.theverge.com/22620464/tether-backing-cryptocurrency-stablecoin.

191. PRESIDENT'S WORKING GRP. ON FIN. MKTS. ET AL., INTERAGENCY REPORT ON STABLECOINS (2021) [hereinafter STABLECOIN REPORT], https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf [https://perma.cc/8WG3-PA5T].

192. *Id.* at 11.

193. "This report focuses on analyzing prudential risks posed by stablecoins used as a means of payment and provides recommendations for addressing these gaps." *Id.* at 2. Footnote 2, which follows this statement, confirms that the "report does not provide recommendations regarding issues or risks under the federal securities laws." *Id.* at 2 n.2.

that stablecoins whose value was pegged to securities "might" themselves be securities.[194] He did not include stablecoins pegged to a fiat currency such as the U.S. dollar in this analysis. In remarks before the Aspen Security Forum in August 2021, he suggested that "stablecoins also may be securities."[195] In testimony before a Senate hearing in September 2021, in response to a question from Pennsylvania Senator Patrick Toomey about whether stablecoins were securities, he said only that "they may well be."[196] During a Washington Post interview, also in September 2021, when it came to stablecoins, Gensler said "the agency still needs to coordinate with other financial regulators to ensure they aren't letting any matters fall through the cracks, while also working with Congress 'to sort through that.'"[197] These statements do not sound as if the SEC's authority to regulate stablecoins is clear.

The lack of clarity over how the SEC views stablecoins is particularly important given the market capitalization of stablecoins that are widely available in the United States and pegged to the U.S. dollar. Tether is hugely important in the crypto space.[198] In addition, the United States Dollar Coin ("USDC"), originally launched in September 2016 by Coinbase and Circle,[199] had 11.5 billion coins in circulation as of April 8, 2021.[200] Other fiat-backed stablecoins with a value tied to the U.S. dollar include TrueUSD, Paxos Standard, and Gemini Dollar.[201] The DAI stablecoin, an Ethereum-based

194. Nikhilesh De, *SEC Chair Hints Some Stablecoins Are Securities*, NASDAQ (July 21, 2021, 12:17 PM), https://www.nasdaq.com/articles/sec-chair-hints-some-stablecoins-are-securities-2021-07-21.

195. Gensler Remarks, *supra* note 76.

196. Daren Fonda, *The SEC May Be Coming for Stablecoins, While Congress Aims to Treat Cryptos More Like Stocks*, BARRON'S (Sept. 15, 2021, 12:57 PM), https://www.barrons.com/articles/cryptocurrencies-bitcoin-stablecoins-regulation-51631724992 [https://perma.cc/3AG7-74KE]. Representative Toomey suggested that to him "a stablecoin doesn't meet the second prong of the Howey Test, that there has to be an expectation of profits from the investment . . . [i]f it doesn't meet the Howey Test, it looks . . . like it's not a security." Michael Bacina & Jade McGlynn, *Blockchain Bites: Stablecoins as Securities?*, LEXOLOGY (Sept. 27, 2021) (first and second alterations in original), https://www.lexology.com/library/detail.aspx?g=1143fe94-7912-4ccc-bf64-8935859d8b6c. Gensler did not address the reasoning in Toomey's inquiry.

197. Tory Newmyer, *SEC's Gensler Likens Stablecoins to 'Poker Chips' Amid Call for Tougher Crypto Regulation*, WASH. POST (Sept. 21, 2021, 3:17 PM), https://www.washingtonpost.com/business/2021/09/21/sec-gensler-crypto-stablecoins/ [https://perma.cc/H3TP-PAR2].

198. "As the dominant stablecoin used in Bitcoin and cryptocurrency trading, Tether has become hugely important." Jasper Lawler, *What Is Tether? | Using Stablecoins | Is USDT a Bitcoin Scam?*, FLOWBANK (June 9, 2021), https://www.flowbank.com/en/learning-center/what-is-tether-using-stablecoins-is-usdt-a-bitcoin-scam [https://perma.cc/P6BZ-NBRY].

199. *USD Coin*, CIRCLE, https://www.circle.com/en/usdc (last visited August 7, 2022).

200. *Id.*

201. Becky, *What Is a Fiat-Backed Stablecoin?*, COIN INSIDER (July 9, 2021), https://www.coininsider.com/what-is-a-fiat-backed-stablecoin/ [https://perma.cc/VGT2-WPG9].

decentralized stablecoin,[202] "maintains its peg by users who provide an over-collateralization in Ethereum (more than $1 in value) which they can redeem later."[203] BitShares is another decentralized stablecoin pegged to but not directly backed by the U.S. dollar.[204]

In the absence of any regulations or even official guidance on the issue of how stablecoins should be classified under the securities laws, entrepreneurs working with stablecoins are left to wait for the SEC to initiate enforcement actions in order to ascertain how the securities might be applied to their operations. This is the essence of regulation by enforcement, and the damage that it is doing to an emerging technology of significant potential is significant.

IV. THE PROBLEMS WITH REGULATION BY ENFORCEMENT

One of the problems that regulation by enforcement can encourage is a tendency to over-regulate. The federal Administrative Procedures Act of 1946[205] ("APA") was specifically designed to operate as a check on the power of administrative agencies, to ensure not only uniformity in procedures but also to limit the power of administrative agencies that might otherwise act in excess of their statutory authority.[206] Administrative actions that are arbitrary or capricious can be set aside,[207] and failing to observe notice and comment requirements that give the public an opportunity to provide input to a proposed action is grounds for overturning such an action.[208] While the scope

202. *The Maker Protocol: MakerDAO's Multi-Collateral Dai (MCD) System*, MAKERDAO, https://makerdao.com/en/whitepaper/#abstract [https://perma.cc/PZ2F-B8BG] (last visited Aug. 9, 2022).

203. CoolWallet Blog, *supra* note 176.

204. Aaron Mangal, *What Is Bitshares? The Ultimate Guide for Beginners*, COINCENTRAL (Nov. 12, 2017), https://coincentral.com/what-is-bitshares/ [https://perma.cc/YMG2-3C4X].

205. *See* 5 U.S.C. §§ 551–559, 701–706, 1305, 3105, 3344, 4301, 5335, 5372, 7521 (governing agency rulemaking and adjudication).

206. United States v. Morton Salt Co., 338 U.S. 632, 644 (1950) ("The Administrative Procedure Act was framed against a background of rapid expansion of the administrative process as a check upon administrators whose zeal might otherwise have carried them to excesses not contemplated in legislation creating their offices."); *see also* Chrysler Corp. v. Brown, 441 U.S. 281, 303 (1979) ("[A]gency discretion is limited not only by substantive, statutory grants of authority, but also by the procedural requirements which 'assure fairness and mature consideration of rules of general application.'" (quoting Nat'l Lab. Rels. Bd. v. Wyman-Gordon Co., 394 U.S. 759, 764 (1969))).

207. 2 CIV. ACTIONS AGAINST THE U.S., ITS AGENCIES, OFFICERS & EMPS. *Action arbitrary, capricious, abuse of discretion, or not in accordance with law* § 6:40, Westlaw (database updated Mar. 2022).

208. The Supreme Court has found that an agency's failure to explain its failure to comply with notice and comment requires a rule to be vacated. Azar v. Allina Health Servs., 139 S. Ct. 1804, 1809, 1810 (2019) (although the case involved a "statement of policy," the Court found that the announcement in question should have followed notice and comment).

and application of the APA is far outside the scope of this Article,[209] the underlying values that it is based upon are useful for evaluating why congressional action is so important for the future of the crypto ecosystem.

The SEC has so far declined to initiate formal rulemaking in regard to cryptoassets, instead relying on non-binding statements by individual officials[210] and complicated frameworks[211] that may or may not apply in any given situation. This has meant that the SEC has not needed to observe the normal notice and comment procedures required of formal rulemaking.[212]

The lack of opportunity for input or comment on potential administrative decisions increases the likelihood that important information might be overlooked or the cost of a particular interpretation underestimated.[213] Others have noted the tendency of SEC officials to make generalizations, falsely suggesting that crypto is increasingly rife with fraud.[214] According to some sources, such assumptions "fly in the face of

209. For example, one could look at the SEC DAO Report and subsequent Framework and ask whether those documents are intended by the SEC to be so substantively binding that they should have been subject to notice and comment under the "practically binding" doctrine. For a discussion of the parameters of that rule, see Cass R. Sunstein, *"Practically Binding": General Policy Statements and Notice-and-Comment Rulemaking*, 68 ADMIN. L. REV. 491, 496 (2016). *See also* Nicholas R. Parrillo, *Should the Public Get to Participate Before Federal Agencies Issue Guidance? An Empirical Study*, 71 ADMIN. L. REV. 57, 61 (2019) (noting widespread calls to make the process by which agencies issue guidance more participatory).

210. For some of the recent statements by Chair Gensler, see *supra* notes 1–9 and accompanying text.

211. *See* FRAMEWORK, *supra* note 43.

212. Interpretive rules and guidance are exempt from the notice and comment requirement under 5 U.S.C. § 553(b)(A). Because the SEC so far has claimed to be limiting its remarks and guidance to interpreting pre-existing rules, the existing pronouncements have been made with no opportunity for advance comment.

213. Deserai A. Crow, Elizabeth A. Albright & Elizabeth Koebele, *Evaluating Informational Inputs in Rulemaking Processes: A Cross-Case Analysis*, ADMIN. & SOC'Y ONLINE 1, 4 (2015) https://sciencepolicy.colorado.edu/admin/publication_files/2015.22.pdf ("[P]rocesses that sit outside the notice and comment period may diminish inclusiveness, transparency, and standardization of the overarching rulemaking process . . . .").

214. In response to August 3, 2021, comments from SEC Chair Gensler claiming that crypto markets are "rife with fraud," Kristin Smith of the Blockchain Association in Washington explained, "Where we differ with Chair Gensler is his characterization of the growing crypto economy as the 'Wild West' . . . . The crypto industry is far from unregulated." Katanga Johnson, *U.S. SEC Chair Gensler Calls on Congress to Help Rein in Crypto 'Wild West'*, REUTERS (Aug. 3, 2021, 6:43 PM), https://www.reuters.com/technology/us-sec-chair-gensler-calls-congress-help-rein-crypto-wild-west-2021-08-03/.

Analytic data suggests that the amount of fraud in the crypto space is not as great as Gensler and others have suggested. The blockchain data platform Chainalysis prepares annual reports evaluating the rates of crypto-related crime since 2019. *Reports*, CHAINALYSIS, https://blog.chainalysis.com/reports/ [https://perma.cc/2ZG9-E2DC] (last visited Oct. 4, 2022) (containing a list of the company's reports). Its 2021 report found that, as a percent of all cryptocurrency activity, scams and other illicit activity accounted for 0.34% by value, as compared to 2.1% of transactions in 2019. CHAINALYSIS, THE 2021 CRYPTO CRIME REPORT 5 (2021), https://go.chainalysis.com/rs/503-FAP-074/images/Chainalysis-Crypto-Crime-2021.pdf established investigative and forensics analysis of cryptocurrency transactions, showing only a minute proportion of the overall volume being linked to illicit activities. Also, crypto is used far less with criminal intent when compared with traditional financial methods."[215]

The risk that the SEC might choose a particularly aggressive enforcement strategy seems borne out by recent actions, including the lawsuits brought against Kik, Telegram, and Ripple.[216] Crypto entrepreneurs must operate in the face of uncertainty and with the knowledge that their actions may be challenged by the SEC years after the fact.[217] Crypto entrepreneurs must either risk that they or their businesses may later face substantial penalties[218] or forego operating in the United States.

There is some evidence that crypto entrepreneurs are succumbing to the pressure to do business elsewhere, with the corresponding reality that U.S. investors who would like to participate in some market initiatives are precluded from doing so. For example, in the first quarter of 2019, eighty-six public sales of new cryptoassets were specifically structured to exclude American purchasers, making the United States the single country most likely to be excluded from crypto offerings, followed by North Korea, Iran, and Syria.[219] Major crypto exchanges exclude U.S. customers, to the confusion and disappointment of many.[220] In the fall of 2021, after receiving

[https://perma.cc/V5LM-LDKS]. The downward trend for illicit activity as a percent of overall transactions has continued, as documented in the company's 2022 report. CHAINALYSIS, THE 2022 CRYPTO CRIME REPORT 3 (2022), https://go.chainalysis.com/rs/503-FAP-074/images/Crypto-Crime-Report-2022.pdf [https://perma.cc/5W9J-4TL9].

215. Osato Avan-Nomayo, *Regulatory and Privacy Concerns Trail SEC's Threat to Coinbase*, COINTELEGRAPH (Sept. 12, 2021), https://cointelegraph.com/news/regulatory-and-privacy-concerns-trail-sec-s-threat-to-coinbase [https://perma.cc/2STC-WXM8].

216. *See supra* Sections III.A–C.

217. The Ripple enforcement action, for example, was brought about seven years after the XRP token was first issued. *See supra* Section III.C.

218. The SEC's activity in the crypto enforcement sphere has been demonstrably more aggressive than that taken in any other jurisdiction. For a comparative analysis of how the SEC's enforcement actions stack up against enforcement in other countries, see Douglas S. Eakeley & Yuliya Guseva, *Crypto-Enforcement Around the World*, 94 S. CAL. L. REV. POSTSCRIPT 99 (2021). These researchers conclude their "data unequivocally demonstrate that the U.S. regulators, the SEC and the CFTC, have been singularly active in commencing enforcement actions against a variety of crypto-firms." *Id.* at 127. Of particular note is the $18.5 million fine assessed against Telegram, alongside the requirement that it disgorge $1.224 billion in proceeds from the first stage of its offering. *Id.* at 119, 125.

219. Lukas Hofer, *Why Token Issuers Exclude U.S. Investors*, ICO.LI (Apr. 26, 2019), https://ico.li/us-investors/ [https://perma.cc/JUB8-MCTF].

220. "The U.S. remains a challenging environment for centralized cryptocurrency exchanges, with major players significantly scaling back their operations and others heading for the door." Kai Sedgwick, *As Crypto Exchanges Exit the US, Which Trading Platforms Will Enter the Breach?*, BITCOIN.COM (Oct. 24, 2019), https://news.bitcoin.com/as-crypto-exchanges-exit-the-us-which-trading-platforms-will-enter-the-breach/ [https://perma.cc/N6S6-TZH3]; *see also* Benjamin Pirus, *Crypto Exchanges Barring US Citizens Is Heartbreaking and Frustrating*, FORBES (Sept. 30, 2020,

a Wells Notice[221] from the SEC, Coinbase shut down a planned crypto lending program that would have offered U.S. participants interest on their deposits of USDC at rates substantially higher than those offered for cash deposited with conventional financial institutions.[222] Coinbase subsequently chose to pursue a substitute lending program that will exclude U.S. participants.[223] On February 14, 2022, the SEC also shut down the BlockFi lending program for U.S. participants.[224] There are additional lending programs that also exclude U.S. participants.[225]

Unfortunately, there is no indication that the SEC intends to back away from its recent approach to cryptoasset regulation. It made no public announcements regarding planned rulemaking relating to cryptoassets prior to the end of 2021 and continued to initiate new enforcement actions throughout the last months of that year.[226] The SEC has considerable

8:03 AM) https://www.forbes.com/sites/benjaminpirus/2020/09/30/crypto-exchanges-barring-us-citizens-is-heartbreaking-and-frustrating/?sh=18e3f7527c97 ("Part of the difficulty lies in the uncertainty. I am not a legal professional, so I do not know exactly why I am banned from using the top exchanges in the industry. Other average folks likely feel the same.").

221. A Wells Notice is "a notification from a regulator that it intends to recommend that enforcement proceedings be commenced against the prospective respondent. The notice references, in broad-strokes, the violation that the Staff believes has occurred." Mark Astarita, *The Wells Notice SEC/FINRA Investigations*, SECLAW.COM, https://www.seclaw.com/wells-notice-sec-finra-investigations/ [https://perma.cc/B72K-S9GV] (last visited June 26, 2022).

222. Paul Grewal, *The SEC Has Told Us It Wants to Sue Us over Lend. We Don't Know Why.*, COINBASE (Sept. 7, 2021), https://blog.coinbase.com/the-sec-has-told-us-it-wants-to-sue-us-over-lend-we-have-no-idea-why-a3a1b6507009 [https://perma.cc/TTC5-6ELJ].

223. On December 9, 2021, Coinbase announced on its blog that it would enable "eligible customers in more than 70 countries to access the attractive yields of DeFi from their Dai with no fees, lockups, or set-up hassle." Rhea Kaw, *Coinbase Makes It Easy to Earn Yield with DeFi*, COINBASE (Dec. 9, 2021), https://blog.coinbase.com/coinbase-makes-it-easy-to-earn-yield-with-defi-bd38156e2715 [https://perma.cc/J5RR-S2N3].

224. *BlockFi Agrees to Pay $100 Million in Penalties and Pursue Registration of Its Crypto Lending Product*, SEC (Feb. 14, 2022), https://www.sec.gov/news/press-release/2022-26 [https://perma.cc/28XX-889E]. Despite shutting down the program for U.S. participants, BlockFi's program continues to be available to other customers. *See Update to BlockFi Interest Account (BIA) Rates*, BLOCKFI (Feb. 25, 2022), https://blockfi.com/march-update-to-blockfi-interest-account-bia-rates [https://perma.cc/LY5U-EHPB].

225. For a discussion of crypto lending programs that exclude U.S. participants, see *Crypto Lending in the United States*, SELFKEY (June 12, 2020), https://selfkey.org/crypto-lending-in-the-united-states/ [https://perma.cc/ZY6S-T6K8].

226. *See SEC Charges Issuers and CEO for $18 Million Illegal Securities Offering*, SEC (Sept. 8, 2021), https://www.sec.gov/litigation/litreleases/2021/lr25198.htm [https://perma.cc/XGG9-69PZ] (relating to Complaint, SEC v. Rivetz Corp., No. 3:21-cv-30092 (D. Mass. Sept. 8, 2021)); *SEC Charges Three Media Companies with Illegal Offerings of Stock and Digital Assets*, SEC (Sept. 13, 2021), https://www.sec.gov/news/press-release/2021-175 [https://perma.cc/GGF7-8P8U] (relating to GTV Media Group, Inc., Admin. Proc. File No. 3-20537 (SEC Sept. 13, 2021), and requiring defendants to pay more than $539 million to settle the charges); *SEC Charges Promoter with Conducting Cryptocurrency Investment Scams*, SEC (Nov. 18, 2021), https://www.sec.gov/news/press-release/2021-237 [https://perma.cc/5LJ5-V9NS] (relating to Complaint, SEC v. Ginster, No. 5:21-cv-01957 (C.D. Cal. Nov. 18, 2021)); *SEC Charges Latvian*

resources at its disposal,[227] which are likely to far exceed the amounts that most defendants who are likely to be targeted will have available to expend on responding to any administrative or court actions. This disparity means that the strategy of initiating actions or even threatening them can be very effective while never resulting in binding appellate precedents.[228]

The fact that the SEC has substantial resources at its disposal does not mean that it can initiate unlimited actions. As recognized in the Division of Enforcement's Manual, the SEC must make choices about how to allocate its resources.[229] This reality, especially combined with confusion about what the law means, is certain to reduce the value and efficacy of the agency in seeking to advance its mission.

When neither entrepreneurs nor the public understand the law, the risk is that everyone's behavior will be directed in non-optimal ways that do a poor job of protecting investors, do not increase trust in the financial markets, and actually impede capital formation in the burgeoning crypto ecosystem. When the law is uncertain and the risk of an enforcement action is low or uncertain, the potential for deterrence is also impacted negatively.[230] As articulated in groundbreaking work back in the 1980s, legal uncertainty creates conflicting incentives for over- and under-deterrence.[231] Both results can be seen in the crypto ecosystem, as persons acting in bad faith continue to operate, perhaps assuming (or hoping) that they will escape detection or

Citizen With Digital Asset Fraud, SEC (Dec. 2, 2021), https://www.sec.gov/news/press-release/2021-248 [https://perma.cc/98SR-ME6V] (relating to Complaint, SEC v. Auzins, No. 1:21-cv-06693 (E.D.N.Y. Dec. 2, 2021)).

227. The SEC's 2022 budget request sought funding for 1,330 positions in the Division of Enforcement, with a budget of nearly $640 million. SEC, FISCAL YEAR 2022 CONGRESSIONAL BUDGET JUSTIFICATION ANNUAL PERFORMANCE PLAN 23 (2020), https://www.sec.gov/files/fy-2022-congressional-budget-justification-annual-performance-plan_final.pdf [https://perma.cc/GX8X-XNSE]. The SEC's total budget request was for $1.993 billion to support the equivalent of 4,658 full-time positions. *Id.* at 2.

228. *See supra* note 104 (settlement in the Kik action that resulted in decision not to appeal) and 149 (settlement in the Telegram action that resulted in dismissal of the appeal).

229. DIV. ENF'T, SEC, ENFORCEMENT MANUAL 4 (2017), https://www.sec.gov/divisions/enforce/enforcementmanual.pdf [https://perma.cc/UPK9-6NUL] (discussing the need to devote "appropriate resources to investigations that are more significant").

230. A full discussion of deterrence and the voluminous academic discourse on the topic is far outside the scope of this Article. However, there seems to be general agreement that "[t]he potential efficacy of deterrence policies is further hampered by the low risk of punishment." PAUL H. ROBINSON & MICHAEL T. CAHILL, LAW WITHOUT JUSTICE: WHY CRIMINAL LAW DOESN'T GIVE PEOPLE WHAT THEY DESERVE 128 (2006).

231. Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. ECON. & ORG. 279 (1986). These scholars' key conclusion was that legal uncertainty creates conflicting incentives for both over- and under-deterrence. *Id.* at 279–80; *accord* STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 93–97 (1987) (reaching a similar conclusion with respect to the level of due care exercised by market participants when the law is uncertain).

censure, and persons acting in good faith remove themselves from the United States, depriving interested participants of potentially valuable opportunities.

V. A CALL FOR CONGRESSIONAL INTERVENTION

The preceding discussion demonstrates that the existing response by the SEC to the rapid growth in cryptoassets has been primarily through enforcement, rather than by establishing new, clearer rules to govern what appears to be a novel asset class with unique characteristics.[232] The problems with this approach have also been described. Because the SEC shows every indication of continuing along the same path for the foreseeable future, it seems clear that congressional action is needed. Even SEC Chair Gensler has, at times, called for additional clarification from Congress.[233]

Obviously, Congress might choose to act in ways that are themselves suboptimal. Just as SEC Chair Gensler has repeatedly warned about the risk of fraud,[234] others have also expressed strong reservations about crypto generally. Senator Elizabeth Warren (D-Massachusetts) has been particularly vocal in expressing her opinions about cryptoassets. In a prepared statement from July 2021, she claimed that "[w]hile demand for cryptocurrencies and the use of cryptocurrency exchanges have sky-rocketed, the lack of common-sense regulations has left ordinary investors at the mercy of manipulators and fraudsters. These regulatory gaps endanger consumers and investors and undermine the safety of our financial markets."[235]

On the other side of the issue, there are also clear crypto supporters. Senator Cynthia Lummis (R-Wyoming) is reportedly in favor of what she calls "light-touch regulation."[236] Lummis also says that "[w]e want the innovators to innovate. We want to create a space where the United States is the leader in opportunity for the creation and use of digital assets."[237] Senator Patrick Toomey (R-Pennsylvania) has characterized distributed ledger

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232. *See, e.g.*, Carol R. Goforth, *Cinderella's Slipper: A Better Approach to Regulating Cryptoassets as Securities*, 17 HASTINGS BUS. L.J. 271, 305–06 (2021) (explaining how the novelty of cryptoassets makes the current regulatory approach and disclosures overly burdensome and less than helpful to potential purchasers).

233. For example, in August 2021, he was quoted as having asked for "additional congressional authorities to prevent transactions, products, and platforms from falling between regulatory cracks." David Gura, *A Big Fight Is Brewing over Cryptocurrencies. These Are Some Key Players to Watch*, NPR (Nov. 6, 2021, 5:00 AM), https://www.npr.org/2021/11/06/1050430801/cryptocurrencies-bitcoin-elizabeth-warren-gary-gensler [https://perma.cc/UJM3-22JH].

234. *See supra* note 1 and accompanying text.

235. Ajibola Akamo, *US Senator Elizabeth Warren Gives SEC Ultimatum to Regulate Cryptocurrency Trading*, NAIRAMETRICS (July 9, 2021), https://nairametrics.com/2021/07/09/us-senator-elizabeth-warren-gives-sec-ultimatum-to-regulate-cryptocurrency-trading/.

236. Gura, *supra* note 233.

237. *Id.*

technology behind cryptoassets as a "powerful technological innovation."[238] In the House, Representative Warren Davidson (R-Ohio) has expressed concern that Congress is moving too slowly in providing guidance to the crypto entrepreneurs. One source quotes Davidson as saying: "Industry is basically pleading, 'Give us some regulatory clarity.'"[239]

Despite these clear differences of opinion among congressional leaders, there is some indication that sentiment may be increasingly shifting towards a lighter regulatory response. A December 8, 2021, hearing before the House Financial Services Committee specifically considered how the U.S. government should improve crypto regulations:

> The general sentiment of the hearing was positive towards the cryptocurrency industry, a dramatic shift from past years. This disposition surprised some, but it reflects an evolving view of the benefits of cryptocurrency technology and the fear that the US is falling behind other countries such as China that have made noticeable progress towards launching a sovereign digital currency.[240]

Not surprisingly, most of the six witnesses (all of whom were chief executive officers of successful crypto operations) called for greater clarity in the way the industry is being regulated, particularly by the SEC.[241]

Potentially adding to the impetus for action, on March 9, 2022, President Biden signed an executive order setting national priorities for the development and regulation of cryptoassets (called digital assets in the order).[242] The document is described by the White House as "outlining the first ever, whole-of-government approach to addressing the risks and harnessing the potential benefits of digital assets and their underlying technology."[243] The order itself lists a number of national objectives for cryptoassets, including both protection of consumers and investors and for financial stability, as well as promotion of "responsible development and use

238. Daniel Moore, *Sen. Toomey Buys into Crypto Craze, Praising Potential of Technology Driving Digital Currency*, PITTSBURGH POST-GAZETTE (July 27, 2021, 5:48 PM), https://www.post-gazette.com/news/politics-nation/2021/07/27/Pat-Toomey-cryptocurrency-bitcoin-memestock-banking-committee/stories/202107270021 [https://perma.cc/A7ZR-8N32].

239. Gura, *supra* note 233.

240. Hailey Lennon, *Capitol Hill Warms Up to Crypto*, FORBES (Dec. 9, 2021, 10:15 PM), https://www.forbes.com/sites/haileylennon/2021/12/09/capitol-hill-warms-up-to-crypto/?sh=5921d535790c [https://perma.cc/4ESR-TBRA].

241. *Id.*

242. Exec. Order No. 14067, 87 Fed. Reg. 14,143 (Mar. 14, 2022).

243. *Fact Sheet: President Biden to Sign Executive Order on Ensuring Responsible Development of Digital Assets*, WHITE HOUSE (Mar. 9, 2022), https://www.whitehouse.gov/briefing-room/statements-releases/2022/03/09/fact-sheet-president-biden-to-sign-executive-order-on-ensuring-responsible-innovation-in-digital-assets/ [https://perma.cc/SP2L-AFHG].

of digital assets."[244] Rather than calling for congressional action, however, the order focuses on interagency coordination involving an extensive number of participants with reports being required from many of them, acting in a coordinated fashion.[245]

While the executive order certainly acknowledges that the current state of regulation is inadequate, it stops short of recognizing the need for congressional action.[246] Some commentators have suggested that this means that "[t]he executive order is unlikely to result in significant legislation that can pass both houses of Congress and be signed into law."[247] Others, however, suggest that the result may be exactly the kind of comprehensive legislation that the industry has been seeking.[248] In fact, some members of Congress are working on such initiatives.[249]

The possibility of congressional action that clarifies the regulatory treatment of cryptoassets in a balanced way is therefore realistic, although by no means certain. While there are many options that would be an improvement over the current system, here are some suggestions for clarification moving forward. The remainder of this Part discusses potential solutions to cryptoasset regulation that would clarify agency authority and offer crypto businesses more certainty in their ongoing operations.

244. Exec. Order No. 14,067, 87 Fed. Reg. 14,145 (Mar. 14, 2022).

245. *Id.* at 14,147–49.

246. "In an executive order signed on Wednesday, the White House called on agencies across the government to coordinate what's thus far been a scatter-shot approach to the asset class. However, it falls short of providing clear direction on regulation." Allyson Versprille, *Biden Pushes for Coordinated Approach to Crypto Oversight*, BLOOMBERG (Mar. 9, 2022, 12:31 PM), https://www.bloomberg.com/news/articles/2022-03-09/biden-pushes-for-more-coordinated-approach-to-crypto-oversight [https://perma.cc/K554-8LHQ].

247. *Biden Executive Order on Cryptocurrencies and Other Digital Assets Emphasizes Innovation and Regulation*, COOLEY (Mar. 16, 2022), https://www.cooley.com/news/insight/2022/2022-03-16-biden-executive-order-on-cryptocurrencies [https://perma.cc/FVV7-MEPX].

248. Caitlin Mullen, *Biden's Digital Asset Order May Prompt Legislation*, PAYMENTS DIVE (Mar. 11, 2022), https://www.paymentsdive.com/news/bidens-digital-asset-order-may-prompt-legislation/620219/ [https://perma.cc/X3VK-TM23].

249. For example, Senators Cynthia Lummis (R-Wyoming) and Kirsten Gillibrand (D-New York) introduced a bipartisan bill covering a wide range of topics relating to crypto regulation on June 7, 2022. "Lummis-Gillibrand Responsible Financial Innovation Act," S. 4356, 117th Cong. (2022), https://www.congress.gov/117/bills/s4356/BILLS-117s4356is.pdf. On August 3, 2022, another bipartisan bill was introduced by U.S. Senators Debbie Stabenow (D-Michigan) and John Boozman (R-Arkansas), along with Senators Cory Booker (D-New Jersey) and John Thune (R-South Dakota). Their bill would give the CFTC authority to regulate spot markets in cryptoassets that are not securities. Digital Commodities Consumer Protection Act of 2022, S. 4760, 117th Cong. (2022), https://republicans-agriculture.house.gov/uploadedfiles/digital_commodity_exchange_act_of_2022.pdf.

A. A Coherent Classification Scheme

First, it would be helpful to have an idea of how the law classifies tokens. An important study by the Cambridge Centre for Alternative Finance concluded that "[a] major impediment to the analysis and the formulation of clear policies for the emerging cryptoasset and blockchain industry is the lack of clear and common terminology. A variety of terms are used, often interchangeably and without a clear definition."[250]

An excellent first step would be to divide tokens into something like the following general categories: (1) currency or payment tokens; (2) securities tokens; and (3) utility tokens.[251] While slightly different nomenclature is used, this is similar to the classification scheme applied in Wyoming, which classifies a "digital asset" as either digital consumer assets (rather like utility tokens),[252] digital securities,[253] or "virtual currency" (which is a form of crypto that is "a medium of exchange, unit of account or store of value" but not legal tender in the United States).[254]

While uniformity in how cryptoassets are classified would be ideal, it should be noted that this approach would not be identical to the approach currently being advocated for the European Union. The European Union's Regulation on Markets in Financial Instruments, known as MiFID II,[255] governs some types of financial instruments including cryptoassets that have that function, while a new proposal, Markets in Crypto Assets ("MiCA"), discusses regulation of utility tokens, asset-referenced tokens, and e-money tokens.[256] The E.U. Council presidency and the European Parliament announced a provisional agreement on the MiCA proposal on June 30, 2022,

250. APOLLINE BLANDIN ET AL., GLOBAL CRYPTOASSET REGULATORY LANDSCAPE STUDY, CAMBRIDGE CTR. FOR ALT. FIN. 15, https://www.jbs.cam.ac.uk/wp-content/uploads/2020/08/2019-04-ccaf-global-cryptoasset-regulatory-landscape-study.pdf [https://perma.cc/N8BH-ML7V].

251. This is not a novel categorization. *See, e.g.*, *What Is the Difference Between Utility, Security and Payment Tokens?*, PLANET COMPLIANCE, https://www.planetcompliance.com/what-is-the-difference-between-utility-security-and-payment-tokens/ [https://perma.cc/2KXW-ZAFN] (last visited Aug. 9, 2022).

252. Under Wyoming law, "'[d]igital consumer asset' means a digital asset that is used or bought primarily for consumptive, personal or household purposes," although this is also the catch-all category for assets that are not digital securities or virtual currency. WYO. STAT. ANN. § 34-29-101(a)(ii) (2021).

253. "'Digital security' means a digital asset which constitutes a security . . . but shall exclude digital consumer assets and virtual currency . . . ." *Id.* § 34-29-101(a)(iii).

254. *Id.* § 34-29-101(a)(iv).

255. *MiFID II*, EUR. SEC. & MKTS. AUTH., https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir [https://perma.cc/798T-3WLL] (last visited Aug. 9, 2022). This Regulation, which went into effect in January 2018, regulates cryptoassets that serve as financial instruments.

256. *See* Werner Vermaak, *MiCA (Updated July 2022): A Guide to the EU's Proposed Markets in Crypto-Assets Regulation*, SYGNA BLOG (July 2022), https://www.sygna.io/blog/what-is-mica-markets-in-crypto-assets-eu-regulation-guide/ [https://perma.cc/9AFJ-R6HM]. MiCA specifically excludes those cryptoassets that are regulated as financial instruments under MiFID II. *Id.*

but there is a multi-year phase-in, and it has been noted that in the "absence of an agreed upon, comprehensive taxonomy of crypto-assets, European financial authorities follow a widely-accepted classification that distinguishes tokens in three main classes: payment, utility and investment tokens—based on the different functions that tokens can perform."[257] Thus, the classification scheme outlined here would be a reasonable approximation of a broad-based approach to understanding different kinds of cryptoassets and the next inquiry would be how to regulate interests that fall into each of these categories.

B. *Relying on the SEC to Police Crypto Fraud*

This Article suggests that all tokens, however classified, should to some extent be regulated as securities. This approach avoids the lack of clarity inherent in the current system. However, to avoid the perils of over-regulation and concomitant stifling of innovation, the securities laws should be amended to provide an exemption from registration (but not the anti-fraud provisions) of federal law for cryptoassets other than those classified as securities tokens.[258] This would allow the SEC, the federal agency with the most resources[259] and the most extensive enforcement experience to date,[260] to continue its role in protecting consumers and investors. As proposed in this Article, fraudulent, deceptive, or manipulative misconduct in connection with the issuance and sale of cryptoassets, whether classified as currency

257. The announcement on the preliminary agreement can be found at Digital Finance: Agreement Reached on European Crypto-Assets Regulation (MiCA), COUNCIL OF THE EUR. UNION (June 30, 2022. 10:30 PM), https://www.consilium.europa.eu/en/press/press-releases/2022/06/30/digital-finance-agreement-reached-on-european-crypto-assets-regulation-mica/ [https://perma.cc/GA2B-C9AQ]. Valeria Ferrari, *The Regulation of Crypto-Assets in the EU—Investment and Payment Tokens Under the Radar*, 27 MAASTRICHT J. EUR. & COMPAR. L. 325, 329 (2020), https://journals.sagepub.com/doi/pdf/10.1177/1023263X20911538 [https://perma.cc/G9HG-RUJ6].

258. This approach is consistent with the exempted transactions provision of the '33 Act. *See* Securities Act of 1933 § 4, 15 U.S.C. § 77d (exempting specified transactions from the requirements of Section 77e).

259. *See* SEC. & EXCH. COMM'N, *supra* note 227, at 2 (noting that the SEC requested a total budget of nearly $2 billion for 2022). In contrast to this, the CFTC requested less than $400 million for 2022. COMMODITY FUTURES TRADING COMM'N, PRESIDENT'S BUDGET FISCAL YEAR 2022 8 (2021), https://www.cftc.gov/sites/default/files/2021-05/CFTC_FY_2022_President_s_Budget_Final_Signed_05212021.pdf [https://perma.cc/26YE-T729]. FinCEN requested a total of just over $225.5 million for 2022. U.S. DEP'T OF THE TREASURY FIN. CRIMES ENF'T NETWORK, CONGRESSIONAL BUDGET JUSTIFICATION AND ANNUAL PERFORMANCE PLAN AND REPORT 3 (2022), https://home.treasury.gov/system/files/266/13.-FinCEN-FY-2022-CJ.pdf [https://perma.cc/US48-4DDS].

260. "We find that the United States Securities and Exchange Commission ('SEC' or 'Commission') brings more enforcement actions against digital-asset issuers, broker-dealers, exchanges, and other crypto-market participants than any other major crypto-jurisdiction." Eakeley et al., *supra* note 218, at 99–100.

tokens, security tokens, utility tokens, or otherwise, would still be subject to SEC enforcement initiatives focused on fraudulent or manipulative conduct.[261]

This approach would give the SEC clearer authority over all cryptoassets, so that the agency would no longer have to argue about whether a particular cryptoasset is or is not a security under the *Howey* test. It does not, however, explain how other aspects of cryptoassets should be regulated. As proposed here, that would depend on the kind of token being regulated.

C. Possible Approaches to Currency Tokens

Consider, for example, currency (or payment) tokens. This category would presumably be defined to include cryptoassets whose only primary functions are those associated with fiat currency (serving as a unit of account, medium of exchange, or store of value).[262] As financial instruments, at the federal level, businesses involved in the transmission or exchange of such assets would continue to be subject to the Bank Secrecy Act requirements as administered by FinCEN.[263]

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261. An exemption from registration would mean that an issuer need not comply with the registration requirements of Section 5 of the '33 Act. Securities Act of 1933 § 5, 15 U.S.C. § 77e. The anti-fraud provisions appear in other provisions including the '34 Act § 10(b). *See* Securities Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (providing that it is illegal for any person to "use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe"). There is no statute of limitations for actions brought by the SEC, even though Section 84 of the Sarbanes-Oxley Act of 2002 limits the right of private plaintiffs to bring claims more than two years after discovery of the facts constituting fraud or more than five years after fraud. Sarbanes-Oxley Act of 2002 § 84, 28 U.S.C. § 1658(b).

262. *See* Michael Jünemann & Johannes Wirtz, *Zeitschrift für das Gesamte Kreditwesen* 1117–21, 1222–26 (2018), *translated in ICO: Legal Classification of Tokens: Part 3—Currency Token*, BIRD & BIRD 21–23 (June 2, 2019), https://www.twobirds.com/en/insights/2019/global/ico-legal-classification-of-tokens-3 [https://perma.cc/QQW2-DJL9] (explaining an early consideration of what kinds of assets could be classified as currency (or payment) tokens).

263. FinCEN asserted authority over businesses engaged in the transmission of digital assets in 2013. FINCEN, FIN-2019-G001, APPLICATION OF FINCEN'S REGULATIONS TO CERTAIN BUSINESS MODELS INVOLVING CONVERTIBLE VIRTUAL CURRENCIES 1, 12 (2019), https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf [https://perma.cc/4BSY-4YPS]. FinCEN's oversight is important to protect against money laundering and the funding of criminal activities as well as to ensure compliance with international standards. International anti-money laundering ("AML") standards are set out by the Financial Action Task Force ("FATF"). The FATF revised its standards to include Virtual Assets and Virtual Asset Service Providers (the "Standards") in 2019. FATF, GUIDANCE FOR A RISK-BASED APPROACH: VIRTUAL ASSETS AND VIRTUAL ASSET SERVICE PROVIDERS 4 (2019), https://www.fatf-gafi.org/media/fatf/documents/recommendations/RBA-VA-VASPs.pdf [https://perma.cc/P7UG-TDBS]. It then published a second annual review of the implementation of the Standards in July 2021. FATF, SECOND 12-MONTH REVIEW OF THE REVISED FATF STANDARDS ON VIRTUAL ASSETS AND VIRTUAL ASSET SERVICE PROVIDERS 2 (2021), https://www.fatf-

However, because there have been no exchanges focused on currencies in the way that some crypto exchanges currently operate, either a new agency would need to be created to regulate exchanges focused on transactions in currency tokens, or an existing agency would need to be tasked with this responsibility. The CFTC has a reasonable approach to markets in which futures are traded (which is the scope of its current power), requiring any such exchanges (called designated contract markets) to operate in compliance with overarching principles designed to adequately protect market participants.[264]

The Chair of the CFTC has recently asked for expanded authority,[265] and while this would necessarily expand the agency's traditional role, the CFTC has already demonstrated a measured but firm response to exchanges trading in crypto derivatives.[266] For example, the CFTC has been overseeing trading in Bitcoin (and other crypto) futures since 2017.[267] The first Bitcoin Futures Exchange Traded Fund ("ETF") was not approved by the SEC until October 2021, but the fact that the SEC allowed listing of that ETF on a

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gafi.org/media/fatf/documents/recommendations/Second-12-Month-Review-Revised-FATF-Standards-Virtual-Assets-VASPS.pdf. Most recently, FATF issued an updated guidance report. FATF, UPDATED GUIDANCE FOR A RISK-BASED APPROACH: VIRTUAL ASSETS AND VIRTUAL ASSET SERVICE PROVIDERS (2021), https://www.fatf-gafi.org/publications/fatfrecommendations/documents/guidance-rba-virtual-assets-2021.html.

264. The CFTC has twenty-three core principles. Core Principles and Other Requirements for Designated Contract Markets, 77 Fed. Reg. 36,612 (June 19, 2012) (to be codified at 17 C.F.R. pts. 1, 16, 38), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2012-12746a.pdf [https://perma.cc/WHC3-DQ67].

265. Rostin Behnam, the acting head of the CFTC, called on Congress to expand the authority of the CFTC over cryptoassets in October 2021. *See, e.g.*, Paul Kiernan, *CFTC Chief Says Recent Crypto Cases Are 'Tip of the Iceberg'*, WALL ST. J. (Oct. 27, 2021, 5:32 PM), https://www.wsj.com/articles/cftc-chief-says-recent-crypto-cases-are-tip-of-the-iceberg-11635370374; *see also* Gura, *supra* note 233 (noting that during Behnam's confirmation hearing before the Senate Agriculture Committee, he suggested the CFTC "should have a bigger role in regulation, even as he acknowledged it would 'be a departure from our historical role as a derivatives regulator'").

266. The self-certification process followed by designated contract markets under the CFTC's jurisdiction allows for crypto products to be offered without unreasonable delays. *See* CFTC, CFTC BACKGROUNDER ON SELF-CERTIFIED CONTRACTS FOR BITCOIN PRODUCTS, https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/bitcoin_factsheet120117.pdf [https://perma.cc/QP23-M4R5] (noting that on "December 1, 2017, the Chicago Mercantile Exchange Inc. (CME) and the CBOE Futures Exchange (CFE) self-certified new contracts for bitcoin futures products and the Cantor Exchange self-certified a new contract for bitcoin binary options").

267. "In 2018, [CFTC Chairman Chris] Giancarlo did the unthinkable and approved bitcoin futures trading. More specifically, he allowed CME Group and C[BOE] Global Markets to 'self-certify' these products. In 2019, then-Chairman Heath Tarbert declared that ETH is a commodity. A year later ErisX, a cryptocurrency derivatives platform, launched the first ether futures contract." Daniel Kuhn, *The CFTC Was Proved Right on Bitcoin Futures. What's Next for the Agency?*, COINDESK (Oct. 22, 2021, 3:00 PM), https://www.coindesk.com/policy/2021/10/19/the-cftc-was-proved-right-on-bitcoin-futures-whats-next-for-the-agency/.

regulated securities exchange indicates that the SEC has a reasonable level of confidence in the CFTC's regulatory approach.[268] Giving the CFTC authority (and the necessary resources to appropriately oversee implementation of, and compliance with, applicable standards) could close a potential loophole in existing regulations and remove an apparent explanation for part of the SEC's continual overreaching to regulate virtually all cryptoassets as securities. This could also help create a framework within which stablecoins could be regulated, which seems to be a priority for regulators and legislators at this time.[269]

D. Security Tokens

Securities tokens would be another potential category of cryptoassets.[270] As suggested here, this group of cryptoassets would not only include anything issued as a tokenized version of a conventional security,[271] marketed as a speculative investment,[272] or denominated as a securities token,[273] but also cryptoassets sold where there is a reasonable likelihood that a substantial majority of purchasers are acquiring them in the hopes of appreciation based

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268. Hassan Maishera, *US SEC Finally Approves a Crypto ETF. But It Is a Bitcoin Futures ETF*, YAHOO (Oct. 18, 2021), https://www.yahoo.com/now/us-sec-finally-approves-crypto-105924679.html [https://perma.cc/C44M-KX2W]. If the SEC did not agree that the CFTC's approach to regulating futures exchanges meant that they are sufficiently free of manipulation and abuse, it could not have approved trading of the Bitcoin Futures ETF on a securities exchange.

269. *See, e.g.*, STABLECOIN REPORT, *supra* note 191, at 2–3 (demonstrating government agencies' commitment to regulating stablecoins).

270. *See* Michael Jünemann & Johannes Wirtz, *Zeitschrift für das Gesamte Kreditwesen* 1117–21, 1222–26 (2018), *translated in ICO: Legal Classification of Tokens: Part 2—Security Token*, BIRD & BIRD 21–23 (May 27, 2019), https://www.twobirds.com/en/insights/2019/global/ico-legal-classification-of-tokens-2 [https://perma.cc/34XW-DR9A] (explaining an early consideration of what kinds of assets could be classified as security tokens).

271. As used here, a tokenized security is a conventional debt or equity interest that would be recognized as a security absent any consideration of blockchain technology, where ownership of the interest is registered through distributed ledger technology. As explained elsewhere, "[a] tokenized security can be equity, a bond or an investment fund." *Tokenized Securities*, COINMARKETCAP, https://coinmarketcap.com/alexandria/glossary/tokenized-securities [https://perma.cc/AE3Z-E4BL] (last visited Aug. 8, 2022).

272. This categorization is also consistent with Wyoming law, although it is formulated differently. Wyoming law excludes digital consumer assets and virtual currency from the definition of digital security. WYO. STAT. ANN. § 34-29-101(a)(iii) (2021). In a different section of the law, adopted later, the statutes define open blockchain tokens as those that: have a predominant consumptive purpose; are not marketed to the initial buyer as a financial investment; and are either reasonably expected to have been sold for consumption, or could have been sold for consumption, or cannot be resold until the consumptive purpose is available, or there are other reasonable precautions to prevent purchasers from buying as a financial investment. WYO. STAT. ANN. § 34-29-106(b) (2019) (including a comment in the codified version that that section should probably cross-reference to § 34-29-101(a)).

273. This would track one of the current categories of items included as a security under the federal securities laws. Section 2 of the '33 Act specifically includes as a security "any interest or instrument commonly known as a 'security.'" Securities Act of 1933 § 2, 15 U.S.C. § 77b(a)(1).

on something other than market forces (including any implicit promises or expectation of efforts from the issuer or others associated with it). The concept of a securities token would therefore include any pre-functional token where funding is being sought, at least in part, to develop a network, the token itself, or the token's functionality,[274] because purchasers of the pre-functional interest would be relying on the issuer to finish developing the anticipated functionality.

Securities tokens would need to be sold in compliance with an existing exemption[275] or pursuant to a registration statement under the federal securities laws.[276] Ideally, as has been explored in more detail elsewhere, the disclosures required for deals involving cryptoassets could (and should) be tailored to those kinds of interests.[277]

In addition, in order to rein in overly-aggressive enforcement by the SEC, Congress should also consider a statute of limitations on enforcement actions based on a failure to register a security token.[278] A two-year statute of limitations after the SEC becomes aware of the facts that would justify bringing such an enforcement action would parallel the statute of limitations for private claims,[279] and the period could be tolled for pending administrative actions, which would still give issuers reasonable notice of the SEC's position.

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274. Because, in this case, there is no functional token being sold, traditional investment contract analysis should work well, as described in the SAFT documentation. *See* SAFT Whitepaper, *supra* note 87, at 1. Regardless of whether the purchasers are buying contractual rights to acquire tokens when issued or incomplete items, because there is no ambiguity about application of the securities laws in this particular context, there is no need to abandon the conclusions called for by the traditional *Howey* test here. *Id.* at 4–5 (pre-functional tokens), 16 (contractual rights) (explaining why the sale of such interests involves securities).

275. Most current exemptions from registration (as opposed to transactional exemptions) are found in Section 4 of the '33 Act. Securities Act of 1933 § 4, 15 U.S.C. § 77d.

276. The registration requirement is found in Section 5 of the '33 Act. Securities Act of 1933 § 5, 15 U.S.C. § 77e.

277. *E.g.*, Carol R. Goforth, *Using Cybersecurity Failures to Critique the SEC's Approach to Crypto Regulation,* 65 S.D. L. REV. 433, 447 (2020).

278. *SEC v. Ripple*, which was brought more than seven years after Ripple first began selling the XRP token, is a case in point illustrating the need for a limitation on the SEC's power to initiate actions long after the complained-of behavior has occurred. *See supra* Section III.C. (discussing the *Ripple* case). The perceived unfairness of an enforcement action brought so many years after the conduct began has been highlighted by numerous commentators. *See, e.g.*, Layton, *supra* note 171. It has also led to ongoing litigation seeking to curb the SEC's activity. *See supra* notes 167–169.

279. This suggestion has also been made by the author of this paper before. *See* Roslyn Layton, *Toward a Ripple Test at the SEC*, FORBES (July 22, 2021, 6:35 AM), https://www.forbes.com/sites/roslynlayton/2021/07/22/toward-a-ripple-test-at-the-sec/?sh=503334b92e67 ("Goforth notes the following conditions which would exempt the asset from registration . . . a 2 year statute of limitations on litigation over a company's failure to register . . . .").

If Congress does decide to move forward, it would also be useful to minimize duplicative regulation by preempting inconsistent state regulation.[280] The SEC might also be encouraged to clarify its rules on integration of offerings.[281]

The SEC would thus have regulatory authority over securities tokens (including pre-functional utility tokens), as well as enforcement authority over fraudulent or manipulative behavior in connection with the sale of any type of token, as described earlier.[282] This leaves the question of who should have regulatory authority over functional utility tokens.

E. Utility Tokens

As used in this Article, the term "utility tokens" refers to fully functional cryptoassets that would not be classified as securities tokens, but which possess one or more significant functions other than those associated with fiat currency.[283] Certainly, the original SAFT proponents hoped that these utility tokens would be beyond the purview of federal regulations such as those enforced by the SEC.[284] Given the SEC's insistence that utility tokens are within its authority and need to be regulated, a reasonable compromise might be to allow the SEC to use its enforcement power over fraud to protect purchasers who acquire utility tokens, without triggering the full panoply of registration requirements when these assets are sold by their creators.

280. Preemption of state securities laws has also been discussed before. *See* Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT'L L. 495, 499 (2003) (noting that "Congress has frequently preempted state law, particularly in the area of financial regulation"). One of Karmel's conclusions is that "much state securities regulation over the years has been duplicative, unnecessarily burdensome, and expensive for the securities industry, without adding sufficient value in terms of investor protection. Also, state securities regulation is uneven from state to state and even from administration to administration within a particular state." *Id.* at 544.

281. *See supra* notes 117–125 and accompanying text (describing some of the open questions left by the most recent amendments to the integration rules).

282. *See supra* Section V.B.

283. *See* Michael Jünemann & Johannes Wirtz, *Zeitschrift für das Gesamte Kreditwesen* 1117–21, 1222–26 (2018), *translated in ICO: Legal Classification of Tokens: Part 4—Utility Token* 21–23 BIRD & BIRD (June 2, 2019), https://www.twobirds.com/en/insights/2019/global/ico-legal-classification-of-tokens-utility-token [https://perma.cc/4B32-XTJQ] (explaining an early consideration of what kinds of assets could be classified as utility tokens). Their suggestion was that utility tokens "are a type of digital voucher for goods or services," where the issuer pledges to provide goods or services when the token is redeemed. *Id.* Note that not all functionality outside the kinds of utility provided by conventional currency would place a token into this category. A token could be designed to replace a traditional equity or debt security, and thus be different than a traditional cryptocurrency. However, that functionality would result in the creation of a securities token, not a utility token. See *supra* notes 270–273 and accompanying text for an explanation of security tokens.

284. SAFT WHITEPAPER, *supra* note 87, at 1.

Alternatively, regulatory authority over utility tokens could be passed to the CFTC. This would require a change in the CFTC's general authority, as otherwise it would be limited to handling fraud in the spot markets,[285] which is already within the SEC's jurisdiction. If the Commodity Futures Trading Commission was to become the Commodity *and* Futures Trading Commission, it could be given explicit regulatory authority over exchanges on which utility tokens might be traded.

There are benefits to this approach. This would mean that utility tokens could be traded on exchanges operating under the CFTC's jurisdiction, so long as the interests are traded in a way consistent with the CFTC's principles. As described earlier in connection with the discussion of currency tokens,[286] this means that exchanges are likely to be able to expeditiously proceed with the listing of utility tokens so long as they make sure that their exchanges are organized in compliance with CFTC standards. There are no built-in delays like those that would be imposed before a trading exchange could be approved by the SEC.[287]

CONCLUSION

This Article sets out to demonstrate that the SEC is currently on a path that amounts to regulation by enforcement. Despite protestations to the contrary arguing that the definition of a security in the context of cryptoassets is clear,[288] the reality suggests a great deal of confusion and uncertainty.[289] Inconsistent and uncertain enforcement of the securities laws in the context of cryptoassets, coupled with a lack of definitive, precedential case law backing up the SEC's interpretation of its jurisdiction, has led to a situation where crypto entrepreneurs are not certain about when the securities laws apply or what they require. As a result, some crypto entrepreneurs have moved away from the United States, not only diminishing the pool of talent operating here, but also depriving Americans of the opportunity to participate

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285. Most of the CFTC's enforcement activities in the crypto space have involved combatting fraud in the crypto ecosystem. Kuhn, *supra* note 267 (noting that historically the CFTC's crypto "[i]nvestigations were limited to pretty clear, identifiable, fraudulent schemes; businesses that failed to register with the CFTC; illegal off-exchange transactions; gatekeepers and price manipulators").

286. *See supra* Section V.C.

287. *See* Hester M. Peirce, Comm'r, SEC, Statement, *In the Matter of Poloniex, LLC* (Aug. 9, 2021), https://www.sec.gov/news/public-statement/pierce-statement-poloniex-080921 [https://perma.cc/295P-TM2Q] (expressing concern about such delays and noting that "the Commission was moving very cautiously with respect to regulated entities' engagement with crypto assets," and that if Poloniex had tried to register its exchange "it likely would have waited . . . and waited . . . and waited some more" (ellipses in original)).

288. *See* Bradley, *supra* note 2, quoting SEC Chairman Gensler as having claimed that the "broad" definition of "security" gave the SEC "great deal of authority . . . a great deal of clarity" over the crypto markets; *see also supra* note 174.

289. *See, e.g.*, *supra* notes 73–74, 80–82, 126–127 and accompanying text.

in potentially valuable opportunities that are available to others.[290] Finally, because the SEC is now asserting that it has clear and broad authority in the crypto system, it is unclear how apparent holes in the existing regulatory structure are going to be filled.

Given that there is no indication that the SEC has any intention of changing its direction, the best chance to resolve the existing issues is through congressional intervention. This Article suggests that there is a great need for consistent terminology and classification of cryptoassets,[291] and that clearer areas of primary responsibility for federal agencies would be desirable.[292] The suggestions offered here provide some possible options that might result in a change of direction in line with these objectives.

290. *See supra* notes 219–225 and accompanying text.

291. *See supra* Part V.B.

292. The need for consistent approaches to different kinds of cryptoassets is discussed throughout *supra* Part V.