How Crypto Industry Can Fight Regulatory Overreach In Court

By **James Burnham** (December 6, 2021)

James Burnham

The digital asset industry is ascendant. It is valued at over $2.5 trillion and is quickly becoming a mainstay of the global financial system.[1]

Not sure whether cryptocurrency is worth your time? Seeing the Los Angeles Lakers play at the Crypto.com Arena should get your attention.[2] And as digital assets have become more popular, federal regulators have begun to pay attention. Almost every day, a new regulator makes public statements about the need to get digital assets under control.

At a Nov. 30 hearing featuring Treasury Secretary Janet Yellen, U.S. Senate banking committee Chairman Sherrod Brown, D-Ohio, compared decentralized finance and stablecoins to subprime mortgages and derivatives — intimating that failure to aggressively regulate digital assets would lead to another global financial collapse.[3] Yellen sounded similar notes, claiming that digital assets would pose significant risks without more federal oversight.

Senior officials at the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission have likewise criticized digital assets, singling out stablecoins and other digital assets as targets for enforcement.[4]

The SEC has pursued controversial enforcement actions against major digital asset players — like Ripple Labs Inc. and American CryptoFed DAO — alleging that their tokens amount to unlawfully offered securities. At the same time, the SEC has stonewalled applications by spot bitcoin exchange-traded funds to register with the agency.[5]

The CFTC, for its part, recently pronounced a prominent stablecoin a commodity in the context of a settlement with Bitfinex — a classification that was not tested in court.[6]

And the Biden administration has floated a possible executive order that pours more federal resources into digital asset enforcement.[7]

Intelligent regulation sometimes creates useful clarity, but a D.C. dogpile creates only confusion. Right now, at least seven regulatory entities — the SEC, CFTC, Financial Crimes Enforcement Network, Office of Foreign Assets Control, Office of the Comptroller of the Currency, U.S. Department of Justice and the IRS — claim some authority to regulate digital assets. And that comes on top of increasing enforcement at the state level, often with little coordination.

This is all a recipe for conflicting mandates and compliance chaos.

Some regulators have gotten the message. Just before Thanksgiving, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the OCC released a crypto asset road map designed "to provide greater clarity on whether certain activities related to crypto-assets conducted by banking organizations are legally permissible."

This is precisely the sort of regulatory collaboration that the industry needs and that the

public deserves.

But collaboration and transparency have not yet reached the rest of the regulatory landscape. Rather than collaborate to provide certainty, other regulators have charted a zigzag course of enforcement actions that leave everyone guessing about the rules.

This scattershot approach has drawn broad criticism — most recently from the ranking member on the Senate banking committee. As Sen. Pat Toomey, R-Pa., put it on Dec. 3:

> For investors to benefit from a fair and competitive marketplace, federal agencies should answer questions about whether — and if so, how — new and emerging technologies fit under existing regulations.[8]

Rather than provide clarity up front, regulators are rushing to fill statutory gaps and claim predominance in the digital-asset regulatory hierarchy. Such regulatory land grabs often lead to litigation against the government. And that litigation is often successful.

To understand the current dynamic, just consider the SEC — the specific target of Toomey's comments. Under Chair Gary Gensler, the SEC has taken a hard-charging approach to regulating digital assets. But the SEC's statutory authorities may not match its regulatory aspirations. The SEC has limited jurisdiction under the Securities Act to regulate the trading of securities, known in this context as investment contracts.

Whether an asset is an investment contract — and thus a security — depends on whether the asset is offered to the public to support a common enterprise, in which investors are "led to expect profits solely from the efforts of the promoter or a third party," as articulated by the U.S. Supreme Court in 1946 in SEC v. W. J. Howey Co.

This definition fits poorly with digital assets, which are offered in a decentralized fashion to owners who retain control over the assets' future. They are disparate enterprises — not common ones — and their value does not derive solely from the work of third parties.

Even today, the SEC has left standing its staff's view that the two tokens with the highest market capitalization, bitcoin and ether, don't count as securities, given their decentralized distribution.

Yet the SEC has increasingly sought to apply the securities laws to cryptocurrency, warning visitors to its website that initial coin offerings are sometimes securities offerings that must be undertaken in compliance with the securities laws.[9]

Few courts have considered whether ICOs are securities offerings, while the few that have considered it reach conflicting outcomes.[10]

For those who seek to offer new coins without fear of SEC interference or sanction, litigation might be the best option. And for those who trade other digital assets — stablecoins, tokens outside the context of an ICO, and so on — the SEC's regulatory power is even less apparent, and so litigation is potentially even more necessary.

The CFTC is another aspiring crypto cop. But that agency's statutory authority is likewise limited.

The CFTC's job is to regulate derivatives based on commodities — a broad term that includes almost everything tangible and intangible you can imagine.

To the CFTC's eyes, many digital assets look like commodities. If that's right, then the CFTC has the authority to regulate markets for crypto-related derivatives and the intermediaries that transact in them.

But the CFTC's jurisdiction over the underlying digital assets, such as bitcoin, doesn't go beyond preventing and punishing fraud and deception. Should the CFTC seek to do more — should it attempt to actually regulate trading in digital assets beyond preventing fraud and deception — pushback in court might be necessary.

Those inclined to resist regulatory overreach are not without options.

The Administrative Procedure Act provides a statutory basis to challenge the actions of many federal agencies as inconsistent with the agency's statutory authority, as arbitrary and capricious, or as otherwise contrary to law.

The Supreme Court has substantially curtailed the power of all federal agencies in recent years — with the justices indicating in an oral argument on Nov. 30 in American Hospital Association v. Becerra that further curtailment is likely coming[11] — and it might be time for the digital asset industry to capitalize on these broader legal developments.

Challenging regulatory actions pre-enforcement is relatively common when litigating with the government, and it could be an option here. Perhaps one could sue the SEC for a judicial declaration that a particular ICO won't be a securities offering, or that a particular proposed platform isn't a securities exchange.

The U.S. Constitution is another option. James Madison never mined the blockchain, but the principles of our founding charter remain as vital today as they were in 1787.

For example, the recently enacted infrastructure bill contains constitutionally dubious reporting requirements.[12] Congress may repeal these ill-conceived rules,[13] but if it doesn't, then a credible Fourth Amendment challenge is in the offing.

Other constitutional protections may prove relevant, too. For example, it could be a constitutional taking — necessitating just compensation — when a new regulation confiscates or diminishes the value of a digital asset.[14]

The digital asset industry has already scored one victory. On the eve of the transition between presidential administrations in December 2020, FinCEN attempted to promulgate a reporting and record-keeping requirement on digital asset sellers with a truncated 15-day notice and comment period.[15]

When the digital asset industry resisted what it described as "midnight rulemaking,"[16] FinCEN extended the comment period until the end of March.[17] The industry used this time to file thousands of comments advocating against the reporting rule and the burdens it would impose on the digital asset market.[18]

Almost a year later, FinCEN's new leadership has taken no action to implement the proposed rule, and the rule is absent from FinCEN's online list of pending rulemakings.[19] This experience showcases the importance of aggressively resisting regulatory high jinks.

Digital assets have the potential to change the world. And we can all hope that regulators will take a wise, measured, collaborative approach. But if history is any guide, regulatory

zeal will sometimes trump regulatory commonsense. Thankfully, when that happens, the courts will be waiting.

James Burnham is a partner at Jones Day. He previously served as a counselor to the attorney general, and a deputy assistant attorney general in the DOJ's Civil Division.

[1] CoinMarketCap, Today's Cryptocurrency Prices by Market Cap, https://coinmarketcap.com/ (last visited Nov. 23, 2021).

[2] Elise Hansen, Crypto.com To Pay $216M For Pair Of Derivatives Exchanges, Law360 (Dec.1, 2021), https://www.law360.com/articles/1444766/crypto-com-to-pay-216m-for-pair-of-derivatives-exchanges.

[3] Hearing on CARES Act Oversight, C-SPAN (Nov. 30, 2021), available at https://www.c-span.org/video/?516333-1/treasury-secretary-federal-reserve-chair-testify-cares-act-oversight&live.

[4] Nikhilesh De, SEC Chair Hints Some Stablecoins Are Securities, CoinDesk (July 21, 2021), https://www.coindesk.com/markets/2021/07/21/sec-chair-hints-some-stablecoins-are-securities/; David Gura, The push to regulate cryptocurrency could cause friction in Congress, NPR (Nov. 3, 2021), https://www.npr.org/2021/11/03/1052079396/the-push-to-regulate-cryptocurrency-could-cause-friction-in-congress.

[5] Bob Pisani, Decision time looms for the first spot bitcoin ETF. Here's why an actual launch could be years away, CNBC (Nov. 10, 2021), https://www.cnbc.com/2021/11/10/decision-time-looms-for-the-first-spot-bitcoin-etf.html.

[6] Press Release, CFTC, CFTC Orders Tether and Bitfinex to Pay Fines Totaling $42.5 Million (Oct. 15, 2021), https://www.cftc.gov/PressRoom/PressReleases/8450-21.

[7] Nikhilesh De, White House Considering Executive Order on Crypto Oversight: Report, CoinDesk (Oct. 8, 2021), https://www.coindesk.com/policy/2021/10/08/white-house-considering-executive-order-on-crypto-oversight-report/.

[8] Elise Hansen, GOP Senator Decries Gensler's Crypto Stance As Vague, Law360 (Dec. 3, 2021), https://www.law360.com/fintech/articles/1445569/gop-senator-decries-gensler-s-crypto-stance-as-vague?nl_pk=d7c35f83-6606-43f3-ab84-eb5ea85a18bc&utm_source=newsletter&utm_medium=email&utm_campaign=fintech.

[9] SEC, Spotlight on Initial Coin Offerings (ICOs), https://www.sec.gov/ICO (last updated July 14, 2021).

[10] Alison Frankel, Crypto precedent: N.Y. judge rules Kik's digital currency was a security, grants win to SEC, Reuters (Oct. 1, 2020), https://www.reuters.com/article/legal-us-otc-crypto/crypto-precedent-n-y-judge-rules-kiks-digital-currency-was-a-security-grants-win-

to-sec-idUSKBN26M7GF; Alison Frankel, In apparent first, Conn. class action jury finds crypto products are not securities, Reuters (Nov. 3, 2021), https://www.reuters.com/legal/transactional/apparent-first-conn-class-action-jury-finds-crypto-products-are-not-securities-2021-11-03/.

[11] Oral Argument Transcript, American Hospital Ass'n v. Becerra, Case No. 20-1114 (2021), available at https://www.supremecourt.gov/oral_arguments/argument_transcripts/2021/20-1114_3314.pdf.

[12] Peter Van Valkenburgh, An unworkable and arguably unconstitutional tax change tucked away in the infrastructure bill, Coin Center (Sept. 17, 2021), https://www.coincenter.org/an-unworkable-and-arguably-unconstitutional-tax-change-tucked-away-in-the-infrastructure-bill/.

[13] Kia Kokalitcheva, Lawmakers to introduce bill aimed at crypto reporting rules in infrastructure package, Axios (Nov. 18, 2021), https://www.axios.com/crypto-reporting-rules-infrastructure-bill-6c06412f-69ed-456f-945a-c2556c278ff4.html.

[14] Zachary Segal, Taking Back Bitcoin, 34 Touro L. Rev. 1375 (2018), https://digitalcommons.tourolaw.edu/cgi/viewcontent.cgi?article=2920&context=lawreview.

[15] Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets, 85 Fed. Reg. 83,840 (Dec. 23, 2020), https://www.regulations.gov/document/FINCEN-2020-0020-0001.

[16] Jerry Brito & Peter Van Valkenburgh, Join us in responding to an unfair and discriminatory midnight rulemaking, Coin Center (Dec. 22, 2020), https://www.coincenter.org/join-us-in-responding-to-an-unfair-and-discriminatory-midnight-rulemaking/.

[17] Jake Chervinsky, FinCEN decides against midnight rulemaking, Cryptolaw (Apr. 12, 2021), https://www.cryptolaw.one/fincen-decides-against-midnight-rulemaking/.

[18] Rulemaking Docket, Comments on Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets, https://www.regulations.gov/docket/FINCEN-2020-0020/comments (last visited Nov. 23, 2021).

[19] U.S. Treasury Financial Crimes Enforcement Network, Pending Rulemakings, https://www.fincen.gov/resources/statutes-regulations/federal-register-notices/pending-rulemakings (last visited Nov. 23, 2021).