Professional Perspective

Crypto: Every Regulator Wants a Piece of the Action

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Not long ago, only the tech-focused were interested in cryptocurrencies and the distributed ledger technologies that make them possible. That has changed. The wins and losses of crypto investors are now center stage, as are the potential benefits and harms of a decentralized trust architecture that can be used both to democratize access to financial products and to circumvent traditional policing of financial transactions.

Federal and state regulators have appeared on the crypto-focused stage. While they've been active in the space previously, they've taken increasingly aggressive action to regulate cryptocurrency and prosecute those who have abused this otherwise exciting innovation. This article will summarize the basics of cryptocurrency, as well as actions by state and federal regulators involving cryptocurrency based products and services.

Cryptocurrency in a Nutshell

As a digital currency, cryptocurrency does not exist in any physical form, cannot be placed in a leather wallet like cash, and is not held in a bank with four walls and a villain-proof vault. Built on blockchain technologies, the most popular cryptocurrencies employ cryptography to manage and record transactions on decentralized and distributed ledgers.

Because they employ decentralized and distributed ledgers, cryptocurrencies and cryptocurrency-based financial product are not tied to financial institutions nor directly controlled by many of the laws and regulations that govern financial institutions. This is a sore spot for some regulators concerned that a lack of regulation has already facilitated all sorts of abuse.

Although not yet used for most financial transactions, the value of cryptocurrencies—and the related potential for abuse—has grown enormously. As of April 2021, the total market value of the various publicly available cryptocurrencies went as high as $2 trillion. In a May 2021 post, the FTC noted that since October 2020, nearly 7,000 people have reported losses of more than $80 million in cryptocurrency-related scams.

To address these concerns, a number of state and federal regulators have taken steps to regulate cryptocurrencies. However, that's resulted in a patchwork of state and federal laws, rather than a comprehensive and coherent regulatory regime. As Treasury Secretary Janet Yellen noted in May 2021, "While there are several agencies that arguably have some ability to address [cryptocurrency] through regulation, I frankly don't think we have a framework in the United States that is quite up to the task."

That said, state and federal regulators are doing what they can—with some taking productive actions and others getting into the game for no good reason.

State Action

Some states have taken steps to encourage crypto-related innovation. In May 2021, Nebraska Governor Pete Ricketts signed legislation that created a state bank charter for digital asset depository institutions. This charter allows existing state-chartered banks in the state to open cryptocurrency banking divisions, which could spur growth in Nebraska for the cryptocurrency market. Yet, the more prominent trend is aggressive enforcement activity challenging crypto-related financial products and services.

For example, in September 2020, Massachusetts Attorney General Maura Healey sued Stripe, Inc. for inappropriately facilitating transactions by individuals engaged in an initial coin offering (ICO). Attorney General Healey alleged that these individuals fraudulently sold PlexCoin, resulting in the fraudulent and unregistered offer and sale of cryptocurrency. In addition to a $120,000 payment, Stripe agreed to improve its risk monitoring procedures, including enhancing duplicate screening procedures for accounts with shared bank accounts, improving merchants' websites monitoring, revising its procedures for handling law enforcement requests, and conducting employee training for risk monitoring.

In February 2021, New York Attorney General Letitia James entered into a settlement agreement with Tether, a cryptocurrency trading platform that purported to offer a stablecoin backed by the U.S. dollar. Attorney General James alleged that Tether made false statements about its cryptocurrency, which was not fully backed by U.S. dollars. In the settlement agreement, Tether agreed to pay $18.5 million in penalties, cease trading activity with New Yorkers, and provide more transparent disclosures about the backing of its stablecoin.

Also in February 2021, Attorney General James filed an action against Coinseed, Inc.and two of its top executives. Attorney General James alleged that the Coinseed defendants unlawfully traded cryptocurrencies without registering as broker-dealers, and that they failed to disclose certain fees connected with trading virtual currencies on their investors' behalf. In May 2021, Attorney General James filed a motion in the Coinseed lawsuit, asking the court for a temporary restraining order, a preliminary injunction, and the appointment of a receiver to immediately block the Coinseed defendants from making additional unauthorized trades.

Federal Action

At the federal regulatory level, the DOJ investigates and prosecutes crimes and threats to national security, including crimes and threats perpetuated using cryptocurrency.

Department of Justice

In July 2020, the DOJ announced a five-count indictment of the individuals who conspired to induce consumers to purchase PlexCoin. In October 2020, the DOJ issued its first cryptocurrency-related guidance report, Cryptocurrency: An Enforcement Framework. The report was intended to help cryptocurrency firms comply with existing legal obligations, as well as issuing a warning that cryptocurrency technology generates a serious national security threat. The DOJ has taken a strict approach to enforcing the existing regulatory framework against cryptocurrency firms suspected of concealing illegal transactions and perpetuating tax evasion. For example, the DOJ and IRS initiated a money laundering investigation into Binance Holdings Ltd., one of the largest cryptocurrency exchanges.

Federal Trade Commission

In May 2021, the FTC reported having received around 7,000 cryptocurrency scam reports in the last quarter of 2020 and first quarter of 2021, with consumers reportedly losing more than $80 million to these scams. The recent Supreme Court ruling in AMG Capital Management, LLC v. FTC revoking the FTC's ability to obtain restitution is expected to shift some of the enforcement burden on cryptocurrencies onto the states and incentivize the FTC to partner with state attorneys general to carry out enforcement actions.

Treasury Department

In July 2020, the OCC, led by Brian Brooks, gave banks the green light to hold and safeguard cryptocurrency for clients and to engage in stablecoin activity. In January 2021, the OCC enabled banks to use stablecoins to facilitate payment transactions for customers. Banks can now issue stablecoins, exchange stablecoins for money, as well as store and record payment transactions. However, then Acting Comptroller of the Currency, Michael Hsu, has made statements walking back these favorable cryptocurrency practices.

In March 2021, the IRS announced Operation Hidden Treasure, a new cryptocurrency enforcement initiative in which IRS Criminal Investigation professionals trained in cryptocurrency and virtual currency tracking focus on finding, tracing, and attributing cryptocurrency to taxpayers. The IRS has also initiated several enforcement actions to prevent tax evasion and trace cryptocurrency exchanges. On April 1, a federal court authorized the IRS to serve a John Doe summons on Circle Internet Financial Inc. to retrieve information about customers with at least $20,000 in cryptocurrency transactions 2016 and 2020.

In addition to increased enforcement initiatives, the IRS its reporting requirements for cryptocurrency. Indeed, in May 2021, President Biden announced a plan to bolster tax compliance by requiring businesses to report the receipt of cryptocurrency in excess of $10,000. This followed measures already taken by the IRS to track cryptocurrency exchanges and prevent tax evasion, such as IRS Notice 2014-21. Under IRS Notice 2014-21, the IRS treats cryptocurrencies as property, not money, for tax purposes. As a result, the IRS requires cryptocurrency investors to declare income from investments, which is treated as a capital asset, and subject to capital gains tax treatment.

Federal Deposit Insurance Cooperation

In May 2021, the FDIC, through Federal Reserve Vice Chair of Supervision Randal Quarles, announced that it is creating a joint framework for the supervision of cryptocurrency in cooperation with the OCC. As the federal agency that insures deposits in US banks, the FDIC is growing increasingly interested in cryptocurrency, particularly as banks invest in and deploy digital assets.

Securities and Exchange Commission

In 2018, the former SEC chairman stated that Bitcoin was not a security, yet the SEC also suggests that certain cryptocurrencies are securities if they are sold to investors through initial coin offerings. In line with this, the SEC has been active in its attempts to regulate cryptocurrency and is grappling over whether cryptocurrencies are securities and therefore subject to SEC jurisdiction.

For example, in 2019 the SEC filed an action and obtained a temporary restraining order against Telegram Group Inc. for conducting an unregistered digital token offering violating the Securities Act of 1933. In March 2020, the U.S. District Court for the Southern District of New York issued a preliminary injunction against Telegram Group barring the delivery of Grams, i.e., the digital asset, and found that the SEC proved a substantial likelihood that the digital asset was an offering of securities which SEC jurisdiction controls and to which no exemption applies. In June 2020, Telegram agreed to return the $1.2 billion it gained from the sale of Grams to investors, and pay a civil penalty of $18.5 million.

In December 2020, the SEC filed an action against Ripple Labs Inc. and two of its executives, alleging that the company raised $1.3 billion through an unregistered digital asset securities offering of XRP cryptocurrency. The final determination of this case hinges on whether XRP is a currency or a security, as the SEC only has jurisdiction to oversee securities.

In an attempt to dismiss the case, Ripple Labs argued that XRP is not in fact a security, but a medium of exchange, such as cash or other cryptocurrency, not subject to the SEC's regulatory requirements. In a March 2021 hearing, the SEC took a hit as the presiding judge indicated that XRP is more likely a currency than a security. Judge Sarah Netburn stated that her "understanding about XRP is that not only does it have a currency value but it has a utility, and that utility distinguishes it from bitcoin and ether." Judge Netburn was not convinced that XRP is a security subject to SEC regulations, and viewed XRP as a currency outside the SEC's reach. This case is significant, as the legal precedent will shape the classification of XRP and other cryptocurrencies.

Commodities Future Trading Commission

The CFTC regulates commodity futures and, since 2015, has claimed Bitcoin and other digital tokens are commodities under the Commodity Exchange Act. As a result, the CFTC requires entities that "offer leveraged retail transactions, futures, options or swaps for commodities," to register as a future commission merchant and comply with the Bank Secrecy Act by creating anti-money laundering and know your customer (KYC) programs.

Ever since the CFTC claimed cryptocurrency as a commodity, the federal agency has consistently exercised its authority to enforce laws and regulations against cryptocurrency firms. In 2018, the CFTC filed its first enforcement action involving cryptocurrency fraud against Gelfman Blueprint, and the court held that Bitcoin and other cryptocurrencies are commodities subject to CFTC jurisdiction. In October 2020, the CFTC filed a civil enforcement action against five entities and three individuals that own BitMex, alleging that the defendants operated an unregistered trading platform violating CFTC regulations, including failing to satisfy anti-money laundering procedures.

What's Next?

More regulatory scrutiny of crypto-based products and services should be expected. As their recent activity demonstrates, state and federal regulators are paying attention to this space—and are likely to be even more aggressive given in the future. For those offering a crypto-related product or service, it will be important to stay vigilant to these developments.