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# The Developing Universe of Cryptocurrency Regulation: A Quick Survey on Expanding Regulatory Authority Over Cryptocurrency

*by Matt Criswell*

From Bitcoin to Dogecoin and Ethereum to Stellar, we've seen the popularity of cryptocurrencies skyrocket and their prices fluctuate over the past decade. Especially this past year, cryptocurrencies have been near the forefront of many financial discussions. As of July 2021, there are more than 6,000 cryptocurrencies in existence—though their popularity varies immensely.<sup>1</sup>

Despite the rise in the popularity of cryptocurrencies, the current law surrounding crypto-assets varies greatly. Some countries have interpreted existing laws and regulations in connection with cryptocurrency or crypto-assets, while others have enacted specific laws or regulations with the purpose of incorporating cryptocurrency into financial oversight.<sup>2</sup> The U.S. has pursued somewhat of a combination of both approaches.<sup>3</sup> While there are existing regulations, new developments have occurred and are occurring in connection with crypto-related laws. Many of these new developments stem from concerns with the potential illegal uses of crypto-assets.

In May of this year, the U.S. Department of the Treasury announced in its American Families Plan Tax Compliance Agenda that it will implement stricter compliance requirements for cryptocurrency markets and transactions.<sup>4</sup> The Treasury Department noted that “cryptocurrency already poses a significant detection problem by facilitating illegal activity broadly including tax evasion.”<sup>5</sup>

Two months later, Senator Elizabeth Warren, in an open letter, urged Securities and Exchange Commission (the “SEC”) Chair Gary Gensler to outline possible ways through which cryptocurrency exchanges may undermine the SEC’s mission to ensure that markets are operating in a “fair, orderly and efficient manner,” whether additional protections are necessary, and if international regulatory coordination is appropriate.<sup>6</sup> Warren also informed Gensler that the SEC had until July 28th to determine the SEC’s role in regulating cryptocurrency.<sup>7</sup>

This article will serve as an overview of some existing crypto regulations in the U.S. Cryptocurrency, crypto markets and exchanges, related transactions and transaction intermediaries are regulated under several federal and state regulatory regimes—a few of which are discussed here. As you will see, crypto regulation often depends on how each regime classifies and/or defines crypto-assets. For example, if a crypto-asset is considered a “security,” then securities laws, rules, and regulations will govern any offers or sales of such crypto. The Internal Revenue Service (the “IRS”) has provided guidance on the tax treatment of virtual currency.<sup>8</sup> The Financial Crimes Enforcement Network (“FinCEN”), under the regulatory umbrella of the Treasury Department, regulates any potentially criminal transactions involving convertible virtual currency.<sup>9</sup> The Commodity Futures Trading Commission (the “CFTC”) regulates commodities and futures markets, and the CFTC

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may regulate virtual currency as commodities in certain circumstances.<sup>10</sup> Whether a crypto-asset is regulated by one regulatory regime does not necessarily prevent it from also being regulated by another federal or state regime.<sup>11</sup>

## SEC Regulation

Similar to other concerns with cryptocurrency, the SEC staff expressed its opinion on Bitcoin in a May 2021 staff statement, in which it wrote, “investors should consider the volatility of Bitcoin and the Bitcoin futures market, as well as the lack of regulation and potential for fraud or manipulation in the underlying Bitcoin market.”<sup>12</sup>

Generally, securities laws can be used to prosecute potentially fraudulent initial coin offerings (“ICOs”) of virtual currency, dependent on certain circumstances.<sup>13</sup> Courts have also established precedent that the Securities Act of 1933 (the “Act”) “should be construed flexibly, not technically and restrictively” to effectuate the Act’s remedial purposes.<sup>14</sup>

Currently, if a crypto-asset is considered a security, it falls under the purview of the SEC and is subject current securities laws and regulations.<sup>15</sup> In such circumstances, any offering or sale of that crypto-asset must be registered under Section 5 of the Act unless there is an applicable exemption to registration.<sup>16</sup> State Blue Sky laws may also apply dependent on where any offering or sale is made and if any applicable exemptions are available. Consequently, this leads to the necessary question—what exactly is a security?

The Act defines a “security” with a long exhaustive list of items such as any note, stock, bond, debenture, etc.<sup>17</sup> Included in that definition is the term “investment contract.”<sup>18</sup> This broad category of securities was later defined in 1946 by the *U.S. Supreme Court in SEC v. W.J. Howey Co.*<sup>19</sup> The Court developed a three-pronged test (the Howey test) to determine when an investment contract exists.<sup>20</sup> An investment contract exists when there is (1) an investment of money, (2) in a common enterprise, (3) with a reasonable expectation of profits to be derived from the efforts of others.<sup>21</sup> Therefore, tokens issued in an ICO, securities token offering, or other similar offering may be securities depending on the particular facts and circumstances surrounding the issuance of such tokens.

As recently as September 2020, in *US SEC v. Kik Interactive Inc.*, the Howey test was used to analyze whether an ICO was, in fact, an offering of securities.<sup>22</sup> In 2017, Kik Interactive publicly announced its intention to raise money through the sale of “Kin,” a cryptocurrency stored, transferred and recorded on a digital ledger called a blockchain.<sup>23</sup> Kik Interactive later completed a two-step \$100 million ICO without filing a registration statement or otherwise relying on an exemption from registration.<sup>24</sup> The SEC then brought an action against Kik

Interactive, alleging that Kik’s unregistered offering of cryptocurrency violated the Act.<sup>25</sup>

The U.S. District Court for the Southern District of New York held that Kik’s public offer and sale of cryptocurrency without a registration statement constituted a violation of Section 5 of the Act.<sup>26</sup> The court determined that the cryptocurrencies offered were investment contracts because (1) there was an investment of money in Kik, (2) Kik established a common enterprise (inferred from Kik’s pooling the investment funds into one bank account for business operations), and (3) Kik continually applauded the cryptocurrency’s profit-making potential, which was dependent on Kik’s “entrepreneurial and managerial efforts.”<sup>27</sup>

Similar to the allegations from the SEC in *Kik*, the SEC also brought an action against Ripple Labs Inc. for the unregistered and ongoing sale of digital asset securities (i.e., Ripple’s XRP digital asset).<sup>28</sup> The SEC’s complaint claims that Ripple violated the registration provisions of the Act and seeks injunctive relief and disgorgement.<sup>29</sup> The SEC alleges that XRP’s only utility is to be an investment contract in Ripple, and investors’ return will be derived from Ripple’s efforts.<sup>30</sup> This case is ongoing and is something to monitor, but we could see a similar outcome to the ruling in *Kik*.

Accordingly, Kik’s “Kin” cryptocurrency is a security (and maybe XRP is too). But, what about Bitcoin? In 2018, former SEC Chairman Jay Clayton said that Bitcoin is not a security, but a type of currency instead.<sup>31</sup> Clayton believes that cryptocurrencies are simply replacements for sovereign currencies.<sup>32</sup> However, Clayton did make the distinction that if a token or digital asset is used in a fundraising transaction (e.g., in an ICO), then those tokens or digital assets are securities.<sup>33</sup> Clayton, in March of 2018, said “if it’s a security, we’re regulating it,” furthering his point that the underlying tokens in ICOs constitute securities.<sup>34</sup>

Earlier this year, current SEC Chairman, Gary Gensler, reiterated Clayton’s point.<sup>35</sup> Gensler said, “To the extent that somebody is offering an investment contract or security that’s under the SEC’s remit, and they have exchanges that operate there, then we have to make sure there’s investor protection.”<sup>36</sup> Gensler went on to say that if the token or digital asset is not an investment contract and is otherwise a commodity “as Bitcoin has been deemed to be,” then it may be a question for Congress or the CFTC.<sup>37</sup> Thus, Bitcoin’s status may be subject to change.

Nonetheless, in addition to regulating securities themselves, securities laws also regulate those intermediaries engaged in securities transactions.<sup>38</sup> The Securities Exchange Act of 1934 established certain laws that govern securities transactions on exchange markets and require stricter compliance with regard to transparency between companies and investors.<sup>39</sup> This

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suggests that cryptocurrency exchanges and any other transaction intermediaries may be required to register as securities exchanges or as broker-dealers if such underlying crypto-assets are considered securities. State Blue Sky laws may also apply in this context.

### IRS Regulation

As with every asset, there are tax implications. The IRS has defined virtual currency as a “digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.”<sup>40</sup> Further, “in some environments, it operates like ‘real’ currency, but it does not have legal tender status in any jurisdiction.”<sup>41</sup> The IRS also states that cryptocurrency is classified as property for federal tax purposes.<sup>42</sup> Therefore, the general tax principles associated with property apply to crypto-assets. Not only that, but taxpayers who receive crypto as payment for goods or services must include the fair market value of the crypto-asset in computing such taxpayer’s gross income.<sup>43</sup> This also includes cryptocurrency as a wage when paid by an employer to an employee as remuneration for services.<sup>44</sup> In fact, even taxpayers who “mine” cryptocurrency realize gross income upon receipt of “mined” crypto.<sup>45</sup>

The IRS has also noted that virtual currency may be considered a capital asset in the hands of taxpayers, through which the taxpayers may recognize capital gain or loss on the sale or exchange of such asset.<sup>46</sup> Securities are capital assets for purposes of a capital gain and loss analysis and, as discussed previously, crypto-assets can be considered securities.<sup>47</sup> Therefore, if the virtual asset falls under securities regulation, owners should be aware of capital asset tax implications.

### FinCEN Regulation

In FinCEN’s 2019 advisory to financial institutions, FinCEN stated that convertible virtual currencies are increasingly used as alternatives to traditional payment and money transmission systems.<sup>48</sup> In the sharing of current fears of unregulated virtual currency, the advisory was intended to assist

financial institutions in identifying and reporting suspicious activity in connection with bad actor exploitation of convertible virtual currency.<sup>49</sup>

FinCEN administers the Bank Secrecy Act (the “BSA”), which provides for various anti-money laundering restrictions.<sup>50</sup> The BSA requires certain reports or records that are highly useful in (1) criminal, tax, or regulatory investigations, risk assessments, or proceedings; or (2) intelligence or counterintelligence activities, including analysis, to protect against terrorism.<sup>51</sup> BSA requirements are also in place to “prevent the laundering of money and the financing of terrorism through the establishment by financial institutions.”<sup>52</sup>

Certain business entities involved in currency are subject to the BSA requirements and FinCEN regulations, which leads to the connection that if a virtual currency is considered “real” currency under FinCEN regulations, then it may also be subject to BSA requirements.<sup>53</sup> FinCEN’s regulations define “currency” as “the coin and paper money of the United States or of any other country that [1] is designated as legal tender and that [2] circulates and [3] is customarily used and accepted as a medium of exchange in the country of issuance.”<sup>54</sup>

Money service businesses (“MSBs”) are regulated and subject to BSA regulation.<sup>55</sup> Generally, whether a person qualifies as an MSB subject to BSA regulation depends on the person’s activities and not a formal business status.<sup>56</sup> MSBs include any person doing business, whether or not on a regular basis or as an organized business concern, in one or more of the following capacities: (1) currency dealers or exchangers; (2) check cashers; (3) issuers of traveler’s checks, money orders, or stored value; (4) sellers or redeemers of traveler’s checks, money orders, or stored value; (5) money transmitters; and (6) the U.S. Postal Service.<sup>57</sup> However, users of virtual currency are not considered MSBs.<sup>58</sup>

There are certain BSA regulatory requirements that money transmitters must comply with, including registration with FinCEN as an MSB and compliance with anti-money laundering, recordkeeping, monitoring, and reporting require-



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ments.<sup>59</sup> Accepting and transmitting anything of value that substitutes for currency makes a person a money transmitter under the regulations implementing the BSA.<sup>60</sup> Specifically, an administrator or exchanger that (1) accepts and transmits a convertible virtual currency or (2) buys or sells convertible virtual currency for any reason is a money transmitter under FinCEN's regulations, thus subject to FinCEN regulations and anti-money laundering restrictions unless a limitation or exemption applies.<sup>61</sup>

The bureau defines virtual currency as a medium of exchange that operates as if a currency in certain circumstances but does not share all attributes with real currency.<sup>62</sup> Convertible virtual currency, according to FinCEN, has an equivalent value to real currency or can substitute real currency.<sup>63</sup> Additionally, an "exchanger" is a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency.<sup>64</sup> An "administrator" is a person engaged as a business in issuing a virtual currency and who has authority to redeem the virtual currency.<sup>65</sup>

In its 2019 guidance, FinCEN provided that convertible virtual currency is subject to FinCEN regulation regardless of: (1) whether a convertible virtual currency is represented by a physical or digital token, (2) whether a centralized or distributed ledger is used to record the transactions, or (3) the type of technology utilized for the transmission of value.<sup>66</sup>

At the heart of the matter, if entities involve themselves as an exchanger or administrator of convertible virtual currency, they are subject to FinCEN regulations as money transmitters under the BSA.<sup>67</sup> Further, FinCEN may require that any trading platform engaged in the purchase or sale of convertible virtual currency as a customer business, provides services involving the receipt and transmission of virtual currency, and/or provides customers with a crypto wallet register with FinCEN as money transmitter under the BSA and comply with any applicable rules.<sup>68</sup> However, a trading platform that only provides information to and/or the opportunity for customers to execute their own trades, then it may not be considered a money transmitter.<sup>69</sup> This does not include any laws that states may have in connection with money transmissions, so review of any required state licensures for money transmitters should be done.

In light of FinCEN's presence in the crypto-regulatory universe, it may interest some to note that FinCEN appointed its first ever Chief Digital Currency Advisor, Michele Korver, on July 6, 2021.<sup>70</sup> As with the ongoing theme of crypto regulation, FinCEN appointed Ms. Korver to "advance FinCEN's leadership role in the digital currency space by working across internal and external partners toward strategic and innovative solutions to prevent and mitigate illicit financial practices and exploitation."<sup>71</sup>

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## CFTC Regulation

The CFTC regulates commodity futures and options markets and strives to promote the competition and efficiency of futures markets, while also protecting investors from manipulation as well as abusive and fraudulent tactics. In *Commodity Futures Trading Comm'n v. McDonnell*, the U.S. District Court of Eastern District of New York noted that virtual currency may be regulated by the CFTC as a commodity.<sup>72</sup> The court said that the CFTC is given this broad statutory authority in 7 U.S.C. § 9(1) and the regulatory authority in 17 C.F.R. § 180.1.<sup>73</sup> Subsequently, the court said that the misappropriation of customer funds in connection with a virtual currency scheme constitutes fraud that violates the Commodity Exchange Act (the “CEA”).<sup>74</sup>

Notably, the *McDonnell* court established the following relevant crypto/commodity precedent:


- That 7 U.S.C. § 1(a)(9) says “a ‘commodity’ encompasses virtual currency both in economic function and in the language of the statute.”<sup>75</sup>
- That the CEA “gives the CFTC authority to regulate contracts for the sale of a commodity for future delivery and authority to regulate US commodities futures markets and their participants.”<sup>76</sup>
- That according to 7 U.S.C. § 9(1), “the CFTC has broad authority that extends to fraud or manipulation in derivatives markets and underlying spot markets.”<sup>77</sup>
- That under 17 C.F.R. § 180.1, the CFTC is permitted to “exercise its enforcement powers over fraud related to virtual currencies sold in interstate commerce.”<sup>78</sup>

The same year the foregoing precedent was established, the CFTC also published a customer advisory (the “Advisory”) on virtual currencies to serve as a warning of the potential risks for investors purchasing virtual coins or tokens.<sup>79</sup> The Advisory lists important and impactful factors potential crypto investors should consider when purchasing digital coins or tokens.<sup>80</sup>

In the Advisory, the CFTC summarized the concept behind this entire article—that crypto-assets can be many things—by stating that, depending on the circumstances, cryptocurrency may be considered securities, derivatives, and/or commodities.<sup>81</sup> The Advisory specifically says “if initial buyers are told that the developers or promoters will bring them a return on their investments, or if the buyers are promised a share of future returns of the project, the digital coins may be securities and the offer and sale would be subject to federal securities laws.”<sup>82</sup> Conversely, it also says digital tokens and coins can be “derivatives or commodities, depending on how they are structured.”<sup>83</sup>

## Conclusion

By all accounts, we appear to be only scratching the surface on cryptocurrency regulation. Federal and state regulatory regimes are continuing their pursuit of an exact crypto regulatory methodology. These various agencies and other regimes will continue to determine exactly how to regulate crypto-assets.

While innovative cryptocurrency and virtual asset businesses aren’t likely to cease either, clients contemplating offers, sales or purchases of crypto-assets should be aware of regulations that can affect such transactions. Certain crypto-related business models may be more appropriate than others. As such, it’s crucial for attorneys to stay apprised of the ever-changing regulatory framework of crypto transactions. 

## Endnotes

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- <sup>3</sup> *Id.*
- <sup>4</sup> U.S. Department of the Treasury, The American Families Plan Tax Compliance Agenda (2021).
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- <sup>6</sup> Elizabeth Warren Asks SEC About Crypto Regulation in Open Letter, NASDAQ (July 14, 2021, 9:56 AM), <https://www.nasdaq.com/articles/elizabeth-warren-asks-sec-about-crypto-regulation-in-open-letter-2021-07-14>.
- <sup>7</sup> *Id.*
- <sup>8</sup> “IRS Virtual Currency Guidance” Notice, 2014-16 I.R.B. 938 (2014).
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- <sup>10</sup> *Commodity Futures Trading Comm’n v. McDonnell*, 332 F. Supp. 3d 641 (E.D.N.Y. 2018).
- <sup>11</sup> *Fintech 2020 | 2 Crypto-Asset Trading Platforms: Another Regulatory Trip Around the World*, (2020).
- <sup>12</sup> SEC Staff Statement on Funds Registered Under the Investment Company Act Investing in the Bitcoin Futures Market (May 11, 2021).
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- <sup>14</sup> *S.E.C. v. Zandford*, 535 U.S. 813 (2002).
- <sup>15</sup> *Fintech 2020 | 2 Crypto-Asset Trading Platforms: Another Regulatory Trip Around the World*, (2020).
- <sup>16</sup> 15 U.S.C.A. § 77e.
- <sup>17</sup> 15 U.S.C.A. § 77b.
- <sup>18</sup> *Id.*
- <sup>19</sup> *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946).
- <sup>20</sup> *W.J. Howey Co.*, 328 U.S. 293 (1946)
- <sup>21</sup> *Id.*
- <sup>22</sup> *U.S. Sec. & Exch. Comm’n v. Kik Interactive Inc.*, 492 F. Supp. 3d 169, 177 (S.D.N.Y. 2020).
- <sup>23</sup> *Kik Interactive Inc.*, 492 F. Supp. 3d 169 at 173.

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- <sup>25</sup> *Id.*
- <sup>26</sup> *Id.* at 182.
- <sup>27</sup> *Id.* at 178 and 179.
- <sup>28</sup> SEC Release, 2020-338, “SEC Charges Ripple and Two Executives with Conducting \$1.3 Billion Unregistered Securities Offering,” December 22, 2020.
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- <sup>41</sup> *Id.*
- <sup>42</sup> *Id.*
- <sup>43</sup> *Id.*
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- <sup>58</sup> FinCEN Guidance, FIN-2013-G001.
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- <sup>60</sup> FinCEN Guidance, FIN-2013-G001 and 31 C.F.R. § 1010.100(ff)(5)(i)(A).
- <sup>61</sup> FinCEN Guidance, FIN-2013-G001.
- <sup>62</sup> *Id.*
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- <sup>64</sup> *Id.*
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- <sup>66</sup> *Id.*
- <sup>67</sup> *Id.*
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