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End of the 'Wild West?' The Future of Crypto Regulation and Enforcement

As crypto grows in popularity, federal and state enforcement agencies are trying to apply existing legal regimes to this new space, while lawmakers are drafting and proposing new legislation, according to Paul Weiss' Meredith Dearborn, Austin Pollet and Kristina Bunting.

By Meredith Dearborn, Austin Pollet and Kristina Bunting

Once on the fringe of the global financial system, cryptocurrency has entered the mainstream: Nearly 1 in 5 American adults has purchased cryptocurrency. As crypto grows in popularity, federal and state enforcement agencies are trying to apply existing legal regimes to this new space, while lawmakers are drafting and proposing new legislation. Regulatory interest has been sharpened by recent market downturns, including a widespread depreciation of crypto assets in May 2022, which wiped out nearly $2 trillion in value. Below, we offer a primer for market participants on how to understand crypto in the context of current legal frameworks and potential future regulation.

Courtesy photos

L-R: Austin Pollet, Meredith Dearborn, and Kristina Bunting of Paul, Weiss, Rifkind, Wharton & Garrison.

What Is Crypto?

Most cryptocurrencies are digital assets whose transactions are recorded on a blockchain, which is a shared, immutable ledger distributed across many computers. Cryptocurrencies can be traded for other assets, including traditional currencies; used as a medium of exchange, such as to purchase goods and services; or saved as a store of value. Cryptocurrencies are usually not issued by any central authority, and have gained popularity as a means for cheaper and faster money transfers and decentralized commerce. They have also been criticized as facilitating criminal activities and—for some assets, like bitcoin—requiring enormous energy expenditure to "mine," or create new coins.

Fitting Crypto Into Current Legal Regimes

Over the last few years, there has been much debate about where cryptocurrencies fit under existing law. As Commodity Futures Trading Commission (CFTC) Chair Rostin Behnam recently noted, "the digital asset industry in the U.S. does not fall under a single comprehensive regulatory regime."

The Securities & Exchange Commission has said that certain cryptocurrencies may be "securities" and therefore fall within its ambit. The term "security" is defined by statute as encompassing not only things like stocks, but also "investment contracts," which the Supreme Court defined in its 1946 decision, *SEC v. W.J. Howey Co.*, as 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." Since 2017, the SEC has brought more than 80 crypto enforcement actions, claiming that specific assets are investment contracts, and has nearly doubled the size of the Division of Enforcement's crypto assets and cyber unit.

In addition to the SEC, the CFTC has claimed "relevant, and in some cases, overlapping jurisdiction in the crypto markets," where it treats some digital assets as commodities and seeks to reduce fraud and manipulation in their sales and trading. CFTC Chair Behnam has urged lawmakers to "reconsider and consider expanding" the authority of the CFTC in this space. In early 2022, Chair Behnam explained to lawmakers that the CFTC is "well situated to play an increasingly central role in overseeing the cash digital asset commodity market."

Law enforcement agencies also retain the ability to prosecute fraud, no matter the medium. Recently, on June 30, the DOJ brought criminal charges against six defendants in four separate actions for their alleged involvement in cryptocurrency-related fraud.

These blurry jurisdictional lines have presented challenges for regulators and market participants alike. As CFTC Chair Behnam stated, "market regulation and financial supervision in the U.S. often relies on the development of cooperative arrangements between regulators," which is "a challenge given jurisdictional inexactitudes and sometimes imprecise or nonexistent statutory authority." This challenge is exacerbated in the digital asset market because of its rapid development and the fact it has "largely taken place on the outskirts of the traditional financial market structures."

New Regulatory Proposals

Treasury Secretary Janet Yellen has called on Congress to institute comprehensive regulations of digital assets. Several lawmakers and federal agencies have answered the call.

On Oct. 6, 2021, the DOJ established its National Crypto Enforcement Team (NCET), whose goal is to investigate and prosecute criminal misuse of cryptocurrency. President Joe Biden has also signed an executive order regarding digital assets, with the goal of instituting a whole-government approach to addressing the risks and potential benefits of digital assets and their underlying technology.

On April 6, U.S. Sen. Patrick Toomey of Pennsylvania introduced the Stablecoin Transparency of Reserves and Uniform Safe Transactions (TRUST) Act, which would create a regulatory framework for payment stablecoin issuers in the U.S. Stablecoins are types of cryptocurrency designed to have a relatively stable price due to being tied to another currency, commodity or financial instrument. The bill would create a licensure and requirement structure for payment stablecoin issuers, and distinguish stablecoins from securities (presumably stripping the SEC of authority to regulate them). The Office of the Comptroller of the Currency (OCC) would be responsible for implementing the bill's regulatory framework.

Also in April 2022, Reps. Ro Khanna (D-California), Glenn "GT" Thompson (R-Pennsylvania), Tom Emmer (R-Minnesota), and Darren Soto (D-Florida) introduced the Digital Commodity Exchange Act of 2022. The act authorizes the CFTC to register and regulate digital commodity exchanges and require registered exchanges to implement key policies, for example to prohibit abusive practices and avoid conflicts of interest. The act distinguishes coins that are commodities from those that are securities by the rights and obligations the digital assets convey.

On June 7, Sens. Cynthia Lummis (R-Wyoming) and Kristen Gillibrand (D-New York) introduced the Responsible Financial Innovation Act. Among other things, the bill would grant significant regulatory authority to the CFTC, classifying bitcoin and ether, which make up more than half of the digital asset market cap, as commodities. Like the DCEA, the bill clarifies the distinction between digital assets that are commodities and those that are securities by focusing on the purpose of the asset and the rights and powers it gives to consumers. It imposes disclosure requirements on digital asset service providers.

On Aug. 3, U.S. Sens. Debbie Stabenow (D-Michigan), John Boozman (R-Arkansas), Cory Booker (D-New Jersey), and John Thune (R-South Dakota) introduced the Digital Commodities Consumer Protection Act of 2022. It too, would grant the CFTC exclusive jurisdiction over the digital commodities market, allowing it to issue relevant rules, and identify acceptable business practices. The bill also outlines registration and disclosure requirements for digital commodity platforms and contains core principles under which trading facilities, brokers and dealers, and platforms must operate.

Transactional Considerations

From a transactional perspective, the uncertain regulatory environment creates an additional risk investors need to evaluate prior to making crypto and other digital asset investments. When paired with highly volatile markets, many traditional institutional investors are reluctant to allocate significant capital to digital assets. Despite these headwinds, institutional investors still represent much of the digital asset transactional activity; Chainanalysis estimates that more than half of decentralized finance, or DeFi, transactions involve large institutional investors.

Heightened regulatory oversight has the potential to further this trend toward widespread institutional adoption. Clear and effective regulation should reduce regulatory uncertainty and increase stability in the crypto marketplace. Transparent policies can clarify the legal nature of digital assets and codify compliance obligations, while protecting investors and consumers. Decreasing the risk of fraudulent activity and increasing consumer confidence could broaden the scope of the underlying markets and drive further investment in crypto-related transactions.

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