

## Who Will Be the Crypto Regulator and Why It Matters

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**B**lockchain-based digital assets have existed in an unregulated ecosystem since their inception—a rare financial sector with no comprehensive legislation or regulation, no dedicated regulator, and no clear guidance for those in the industry looking to play by the rules.

A number of federal agencies will ultimately play a role in regulating digital assets but only two are likely to lead the crypto regulatory regime: the Securities and Exchange Commission (SEC) or the Commodities Future Trading Commission (CFTC). But with comprehensive crypto legislation on the distant horizon, the SEC and CFTC are staking their claim to be *the* crypto regulator through aggressive enforcement actions. The recent crypto winter has provided the perfect opportunity for regulators to make their case, as crypto markets endure a deep freeze caused in part by several significant industry bankruptcies and growing concerns about the stability of crypto.

In this article, we will analyze the current state of crypto regulation, how regulators are vying to establish themselves as the primary crypto

regulator, and what this means for players in the digital asset space. The article will also examine a recent SEC enforcement action charging a former Coinbase employee with insider trading and discuss how this enforcement action foreshadows what will likely be an extended period of regulation by enforcement as the SEC and CFTC jockey to be the top crypto regulator as news of turmoil in the crypto industry seemingly escalates daily.

**The Current State of Crypto Regulation.** Regulatory uncertainty in crypto persists because there is no consensus over how to categorize digital assets. The same digital asset might look like taxable property to the IRS, currency to FinCEN, a commodity to the CFTC, or a security to the SEC. Until a lead regulator emerges, companies in the crypto industry will have to operate under a fragmented regulatory framework, driven by ad hoc enforcement actions.

As a first step to bringing cohesion to this fragmented regulatory framework, President Biden signed an Executive Order in March 2022 titled “Ensuring Responsible Development of Digital Assets,” which called for a “whole-of-government approach to addressing the risks and harnessing the potential benefits of digital as-



Falling cryptocurrencies (bitcoins, dogecoins, shiba coins, binance coins and other)

sets.” The Order directed government agencies to study crypto and produce reports and recommendations about how the United States should address this burgeoning and volatile industry. The Order did not appoint a primary regulator or establish policy. It did, however, encourage regulators to continue aggressively pursuing investigations and enforcement actions.

Six months later, in September 2022, after reviewing a number of the agency reports, the President released what was described as a “First-Ever Comprehensive Framework for Responsible Development of Digital Assets.” The results are more modest than the headline suggested. The White House outlined steps it was *considering* taking to build a comprehensive crypto framework, including pushing

Congress to amend laws like the Bank Secrecy Act to specifically account for digital assets. The White House reiterated its earlier call to regulators, specifically the SEC and CFTC, to aggressively pursue investigation and enforcement actions “consistent with their mandates.”

These Executive Branch public statements came as agencies and departments were already enhancing their enforcement capabilities. In October 2021, the DOJ created the National Cryptocurrency Enforcement Team (NCET), a group of federal prosecutors specializing in the investigation and prosecution of crimes involving digital assets. In September 2022, the DOJ expanded its crypto enforcement program, launching the Digital Asset Coordinator (DAC) Network, which designated 150 federal prosecutors for training as subject matter experts on digital assets. Similarly, in May 2022, the SEC announced that it was nearly doubling the size of its crypto enforcement team. Not to be outdone, in a September 2022 Senate hearing, CFTC Chairman Rostin Behnam testified that the CFTC was “the right regulator” for crypto, and his agency would continue bringing enforcement actions.

As the Executive branch mulls digital asset oversight and the regulatory arms race accelerates, Congressional crypto proposals are also percolating. Two of those bills propose naming the CFTC as the primary crypto regulator and define cryptocurrencies, including Bitcoin and Ether, as digital commodities, not securities. Although the SEC would still have a role to play, the proposed legislation would substantially shift the balance of regulatory power to the CFTC. Most agree that Congressional action is necessary to resolve

the regulatory uncertainty, but these proposals have only exacerbated this uncertainty and increased tensions between the SEC and the CFTC.

**Regulation by Enforcement.** While the CFTC may appear to be emerging as the potential winner of this regulatory tug of war, that has only fueled competition between the SEC and CFTC to assert jurisdiction over digital assets through enforcement actions—now the norm in the industry. The SEC has reportedly brought nearly 100 crypto-related enforcement actions involving everything from initial coin offerings (ICOs) to celebrities improperly touting crypto on social media.

Most recently, on Nov. 7, 2022, the SEC scored a victory when it convinced a New Hampshire federal judge that cryptocurrency tokens associated with a blockchain-based video sharing platform were securities because the tokens were “investment contracts.” In siding with the SEC, the court rejected the argument that because the tokens were consumptive “utility tokens,” they were not securities. The court also gave short shrift to the argument that the token issuer’s due process rights were violated because the SEC did not provide sufficient notice that the offerings were securities.

For its part, approximately 20% of the CFTC’s 2022 enforcement actions involved digital assets, which targeted digital asset exchanges and price manipulation schemes. The CFTC has also notched several court victories; in 2018, federal judges in Massachusetts and New York ruled that certain digital assets are commodities. Thus, the SEC and CFTC are clearly using enforcement actions, backed by court victories, to assert jurisdiction over regulating the digital asset ecosystem.

The problem with regulation by enforcement, of course, is that it is retroactive, rather than proscriptive. That is, it tells crypto players *after the fact* when they have supposedly misstepped, rather than giving them notice and guidance about how not to misstep in the first place. This dynamic raises obvious due process concerns.

If competing enforcement actions suggest jurisdictional tension between the two agencies, public statements from the SEC and CFTC heads emphasize that this spirited debate is only heating up.

On Sept. 15, 2022, SEC Chairman Gary Gensler testified before the Senate Banking Committee and laid out the SEC’s position that the “vast majority” of the 10,000 tokens in the crypto market are securities and that crypto exchanges must register with the SEC. Following the hearing, Chairman Gensler reportedly doubled down on his position, suggesting that native tokens on proof-of-stake blockchains, like Ethereum, could be securities. The SEC’s focus on Ether continued when it filed a complaint against a crypto token promoter connected with an ICO, alleging that because validators on the Ethereum blockchain are clustered more densely in the United States, transactions occurred in the United States and were thus within the SEC’s jurisdiction. The SEC clearly envisions itself as *the* crypto regulator, including the Ethereum blockchain.

For its part, the CFTC has not backed down. On Oct. 24, 2022, Chairman Behnam said, “Ether, I’ve suggested that it’s a commodity” but “Chairman Gensler thinks otherwise—or at least hasn’t certainly declared one or the other.”

This regulatory battle is now centering on a specific digital asset—Ether.

Unlike Bitcoin, the Ethereum blockchain allows for the development of smart contracts and decentralized applications (dApps), the development of which often involves creating and issuing an Ethereum-based cryptocurrency token. Because much of the development in this industry is taking place on the Ethereum blockchain, and others like it, the agency that successfully claims primary jurisdiction over it will likely become the lead crypto regulator.

**'SEC v. Wahi': The SEC Makes Its Case That Ethereum-Based Cryptocurrency Tokens Are Securities.** In late July 2022, the DOJ unsealed an indictment charging a former Coinbase employee with what was referred to as the "first ever cryptocurrency insider trader tipping scheme." See *Three Charged in First Ever Cryptocurrency Insider Trading Tipping Scheme*, DOJ (July 21, 2022); see *United States v. Wahi*, No. 22 Cr. 392 (S.D.N.Y. July 21, 2022). The alleged scheme involved the defendant supposedly funneling confidential information to his co-conspirators about when Coinbase was planning to list new cryptocurrencies on its exchange. Before the listings were announced, the defendants purchased the cryptocurrencies—25 in total—anticipating that prices would increase after the announcements. After the listings were announced, and prices surged, the defendants sold the tokens for a profit.

Despite the attention-grabbing "insider trading" headline, the indictment charged the defendants with wire fraud, not securities fraud, thus allowing the DOJ to prosecute the alleged crypto fraud without having to address whether the tokens were securities.

But the more groundbreaking news came later that day when the

SEC filed a Complaint alleging that the defendants committed insider trading in violation of federal securities laws. *SEC v. Wahi et al.*, No. 22 Cv. 1009 (W.D. Wash. July 21, 2022). Unlike the DOJ action, the SEC Complaint alleged that nine of the 25 tokens in the DOJ indictment were securities. Applying the age-old *Howey* test to determine whether the tokens at issue were "investment contracts," the SEC did a deep dive into each token and associated project to examine whether there was: (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profit, (4) derived from the efforts of others. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

In making its case that each token was a security, the SEC relied on several common factors. First, each token identified was an Ethereum-based token. This is significant because it demonstrates that the SEC is indeed staking its claim to regulate the Ethereum blockchain despite the CFTC's statements and the legislative proposals potentially naming the CFTC as the Ether regulator.

The SEC continued to contend that the tokens were securities because (1) they were sold to raise money to fund a centralized project or protocol, (2) the projects involved a core team of founders and developers who retained a tranche of the tokens issued, (3) the success of the project or application was based on the core team's work, and (4) the projects often issued statements on social media predicting that the price of their token would increase on crypto exchanges. According to the SEC, these attributes demonstrated that individuals purchased the tokens with the expectation of profit derived

from the efforts of the token creators.

The SEC's Complaint is a significant milestone in crypto regulation because it shows that, despite pending legislation giving the CFTC authority to regulate Ether, the SEC believes that Ether and Ethereum-based tokens are securities. We expect that the SEC will continue to argue that it has jurisdiction over almost all cryptocurrencies, including Ether, through enforcement actions, resulting in court rulings that cryptocurrencies are securities. The CFTC will likely respond by continuing to ramp up its enforcement efforts.

This back and forth strongly suggests that everyone in the digital asset space should anticipate a deluge of enforcement actions as the SEC and CFTC battle it out for crypto regulator supremacy. Accordingly, it is critical for all involved in this space to understand how these regulators view digital assets to best withstand regulatory scrutiny in what will be ongoing regulation by enforcement.

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