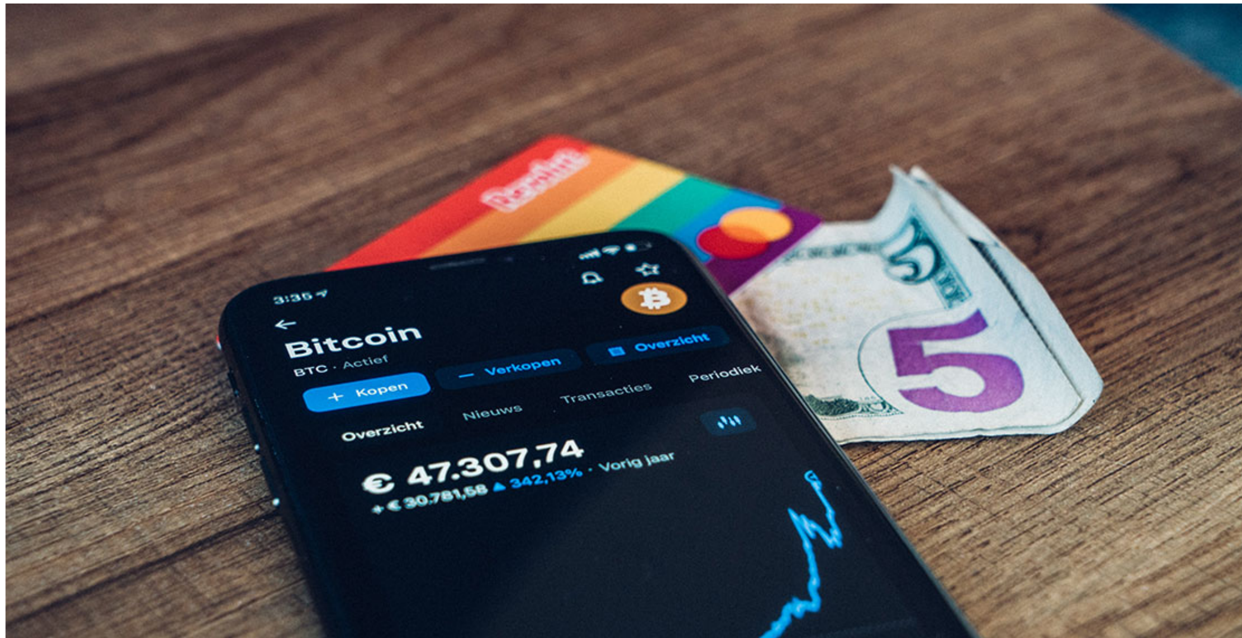
Biden May Tame the Crypto Wild West. Why That's Good for Investors.

03/18/21



(Excerpts from this article written by Caitlin Halligan, Oscar Shine and Mitchell Nobel were originally published in Barron's)

Investors have watched crypto assets like Bitcoin, Ethereum, and Ripple hit both dizzying highs and extreme lows over the past few years. Despite the volatility, some investors may feel they've missed out: Bitcoin alone appreciated over 1,000% in the last twelve months and over 11,000% in the last five years. The possibility of such returns explains why, today, one in four U.S. investors has exposure to crypto assets, according to a recent survey.

One concern for investors has been the lack of regulatory oversight. To remedy that, regulators must answer key questions: How should crypto assets be classified, and which government actors can best provide supervision? As regulators have puzzled through these issues, many in the crypto community showed active hostility to oversight, fearing it would undermine the decentralized ethos that attracted early crypto investors.

Now, the era of unregulated crypto appears to be ending. Regulators are focused on the crypto markets, and investors should expect increasing oversight. This is good news: Regulators appear to recognize the unique characteristics of crypto assets and the need to balance innovation and investor protection.

The Securities and Exchange Commission began to regulate crypto securities with a 2019 Framework for "Investment Contract" Analysis of Digital Assets, which provided guidance on which crypto assets are securities. The SEC has not been shy about acting on this guidance, bringing enforcement actions against allegedly unregistered crypto securities like XRP, Kik, and Gram.

Signs are good that the SEC's relationship with crypto will include some collaboration going forward. SEC Commissioner Hester Pierce's openness to blockchain-based investments has earned her the nickname "Crypto-Mom." Whether her initial proposal of a three-year safe harbor before crypto securities are registered is ultimately implemented, Pierce is a model for regulators concerned about squelching innovation. She has criticized the SEC's focus on enforcement, comparing them to the invention of roller skates. "Rather than provide useful guidance on safety standards and functional braking technology, we simply sue skaters for breaking mirrors," she said.

President Joe Biden's nominee for SEC chair, Gary Gensler, appears similarly open-minded. Gensler has taught courses at MIT on blockchain technology, calling it a "change catalyst." In a previous term as chair of the Commodity Futures Trading Commission, Gensler reformed the over-the-counter derivatives market without undermining its vitality. He is now similarly positioned to shepherd a more mature blockchain industry.

Other federal agencies have sought to protect investors by going after bad actors. The CFTC, which has regulatory authority over crypto commodities such as Bitcoin and Ethereum, has brought crypto enforcement actions under the Commodities Exchange Act. In its recent complaint against tech entrepreneur John McAfee and his bodyguard Jimmy Gale Watson Jr., the CFTC alleged a pump-and-dump scheme that exploited McAfee's fame to inflate the value of crypto assets like dogecoin. This enforcement action would not be groundbreaking in a traditional market. But in the crypto world, it signals that the CFTC is prepared to take action against those it believes are engaging in market manipulation.

Federal prosecutors have also unveiled enforcement actions in the crypto sphere. The CFTC and the United States Attorney for the Southern District of New York recently brought coordinated actions against BitMEX. The CFTC filed a complaint alleging that BitMEX had executed futures transactions without appropriately registering and ignored know-your-customer obligations. At the same time, federal prosecutors indicted BitMEX executives for alleged violations of the Bank Secrecy Act. Days after initiating this prosecution, the Department of Justice published "Cryptocurrency: An Enforcement Framework," emphasizing more than a dozen different statutes that the DOJ could use to prosecute crypto-related crimes. The DOJ made clear it intends to police the digital asset space, and there is no reason to believe the new administration will abandon this push.

Investors should regard these enforcement actions as positive steps. Enforcement disincentivizes manipulation, which benefits the manipulator at the expense of honest traders; more enforcement should therefore bolster investor confidence. Crucially, neither the CFTC nor the DOJ has attacked crypto itself. Instead, each has focused on allegedly illegal actions that threaten the integrity of crypto markets.

As the federal government continues to expand its crypto profile, state regulators and prosecutors will need to sort out their place in the emerging paradigm. State prosecutors have used existing enforcement authority to address suspected illegality in the crypto space. The New York attorney general's investigation of Tether and Bitfinex was resolved in a $18.5 million fine. Beyond enforcement, there are opportunities for state governments to create their own crypto-friendly regulatory regimes to encourage investment in this growing area. Wyoming, for example, passed a bill clarifying the appropriate treatment of digital assets and allowing businesses to hold digital assets safely and legally. Efforts to establish friendly environments for specialized industries is nothing new. Recall Delaware's promotion of corporate law, South Dakota's focus on credit-card operators, and recent steps in several states to embrace legalized marijuana.

New developments in crypto will continue to challenge state and federal regulators. The last year has seen adoption of the nonfungible token, which enables blockchain-based transfers of real-world goods like land, art, or traditional securities. And the rise of "decentralized finance" has led to new exchanges that provide even less centralization than traditional crypto exchanges, transferring assets directly between users. These technologies will demand a response from regulators, but the form this response might take is not yet clear.

Although investors may ask questions about how these new guardrails will impact the previously unregulated space that crypto has occupied, these developments signify maturity. They invoke a similar pattern from nearly 90 years ago, when Congress passed the Securities Act. Opponents of the law argued it would stifle the creation of new securities. But in hindsight, registration requirements did not inhibit growth but instead helped foster liquid and honest public markets that today are the envy of the financial world. Similarly, providing ground rules for crypto markets should attract, not discourage, investment in new crypto assets. And the targeting of bad actors should reassure investors concerned about potential manipulation. While crypto may lose something of its Wild West reputation, it should gain substantially in its legitimacy and appeal to traditional investors.

Attorneys

- Caitlin Halligan
- Oscar Shine
- Mitchell Nobel

Practices

- Complex Commercial Disputes
- Securities & Structured Finance