

VIRGINIA JOURNAL OF LAW & TECHNOLOGY

SPRING 2022

UNIVERSITY OF VIRGINIA

VOL. 25, No. 4

Beyond the Hype: A Practical Approach to CryptoReg

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ABSTRACT

Most regulatory action related to cryptocurrencies is primarily aimed at preventing scams, illicit uses, and market manipulation. Although the technology that underlies cryptocurrencies is groundbreaking, these regulatory concerns are not. Nonetheless, regulators have struggled to fit cryptocurrencies into their preexisting legal frameworks. For a time, it seemed that cryptocurrencies would be classified by the Commodity Futures Trading Commission (CFTC) as a commodity, by the Financial Crimes Enforcement Network (FinCEN) as a form of money, and by the Internal Revenue Services (IRS) as property. Meanwhile, the Securities and Exchange Commission (SEC) had determined that the two most well-known cryptocurrencies, Bitcoin and Ether, were not securities. In December of 2020, however, the SEC filed an enforcement action against Ripple Labs for issuing XRP, a cryptocurrency that the SEC deemed a security. Although the future of the Ripple lawsuit is uncertain, the SEC's unexpected action reveals the need for regulatory clarity for cryptocurrency markets. The time has come to develop a regulatory plan for cryptocurrencies that will not only provide clarity and address legitimate concerns but also allow for the continued development of cryptocurrencies. This Article proposes to minimize the SEC's oversight of cryptocurrencies and suggests statutory amendments that would 1) strengthen the authority of the CFTC and FinCEN to effectively oversee cryptocurrency markets and 2) modernize tax policy to enable the development of cryptocurrencies as a viable payment method.

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INTRODUCTION

When the Securities and Exchange Commission (SEC) filed an action in December of 2020 alleging that Ripple Labs had sold \$1.38 billion of unregistered securities, it cited concerns that the company had not provided investors with material information, thereby creating an “information vacuum.”¹ The purported unregistered security that Ripple had sold was XRP, the native cryptocurrency that operates on Ripple’s distributed ledger.² To reach the conclusion that XRP was a security and thus subject to registration requirements, the SEC applied the 75-year-old *Howey* test.³

Applying this test, the SEC alleged that the purchase of XRP is an investment in a common enterprise and that purchasers of XRP reasonably expect to profit from their investment based on Ripple’s efforts.⁴ Ripple has mounted a defense to these claims.⁵ According to Ripple, the XRP ledger is decentralized, and XRP’s price is not determined by Ripple’s activities.⁶ Ripple further argues that XRP performs a number of functions, including serving as a medium of exchange and facilitating transactions, that are distinct from the functions of securities.⁷

Setting aside the determination of whether XRP meets all the elements of the *Howey* test, this Article argues that the test is problematic for cryptocurrencies generally. If the test is applied consistently, all cryptocurrencies would initially qualify as securities under the test. A cryptocurrency cannot exist without a “common enterprise” or central figure to initially

¹ Complaint at 1-2, Sec. & Exch. Comm’n v. Ripple Labs, Inc., No. 1:20-cv-10832 (S.D.N.Y. Dec. 22, 2020).

² *Id.* at 9.

³ *Id.* at 34-56; Sec. & Exch. Comm’n v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (establishing the test under which a transaction counts as an “investment contract,” thus falling under the definition of “security” under the Securities Act of 1933).

⁴ Complaint, *supra* note 1, at 34-56.

⁵ Answer at 1-2, Sec. & Exch. Comm’n v. Ripple Labs, Inc., No. 1:20-cv-10832 (S.D.N.Y. Jan. 29, 2021).

⁶ *Id.* at 6.

⁷ *Id.* at 2.

develop and issue the currency. Further, based on recent market trends,⁸ a purchaser of cryptocurrency could reasonably expect that the value of the asset might rise without any effort on the investor's part.

The consequences of a cryptocurrency being deemed a security by the SEC are significant. Unless the developers have qualified for an exemption, the asset must be registered with the SEC, which requires extensive documentation in the form of a registration statement.⁹ If the developers proceed on the assumption that a particular asset is not a security, as Ripple did, then they could be subject to an *ex post facto* enforcement action by the SEC. Further, only exchanges that are registered with the SEC as a national securities exchange (NSE) or an alternative trading system (ATS) can list securities for sale.¹⁰ Given that only one cryptocurrency exchange has registered with the SEC,¹¹ the label severely restricts secondary trading.

In the words of SEC Commissioner Hester Peirce, the application of the *Howey* test to cryptocurrencies has created “a regulatory Catch 22.”¹² Potential developers cannot surmount the enormous burdens imposed by securities regulations in order to initially distribute the assets.¹³ Yet a network cannot mature into a decentralized network until the assets are distributed to

⁸ Justin Lahart, *If Crypto Crashes Tomorrow, It's No Big Deal. In Five Years, It Might Be*, WALL ST. J. (May 7, 2021, 4:27 PM), <https://www.wsj.com/articles/cryptocurrency-crash-no-big-deal-bitcoin-ether-dogecoin-11620332378> (reporting the 290% and 23,000% increases in the price of Bitcoin and dogecoin, respectively, in the prior six months).

⁹ 15 U.S.C. § 77f(a).

¹⁰ *Statement on Potentially Unlawful Online Platforms for Trading Digital Assets*, SEC. & EXCH. COMM'N (Mar. 7, 2018), <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading> [hereinafter *SEC Statement on Potentially Unlawful Online Platforms*].

¹¹ *See Alternative Trading System (“ATS”) List*, SEC. & EXCH. COMM'N (May 2021), <https://www.sec.gov/foia/docs/atlist.htm> [hereinafter *ATS List*] (listing Coinbase as an alternative trading system).

¹² Hester M. Peirce, Commissioner, Sec. & Exch. Comm'n, *Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization* (Feb. 6, 2020), https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06#_ftnref5.

¹³ *Id.*

and transferable among potential users, developers, and participants of the network.¹⁴

Further complicating matters, the SEC has inconsistently applied the *Howey* test to cryptocurrencies. When William Hinman of the SEC described Bitcoin's network as decentralized,¹⁵ he overlooked the fact that Bitcoin was centrally launched by Satoshi Nakamoto.¹⁶ Hinman also put "aside the fundraising that accompanied the creation of Ether" to describe the Ethereum network as decentralized.¹⁷ As the disparity in the treatment of XRP and other cryptocurrencies exemplifies, the subjective nature of the *Howey* test leads to inconsistent enforcement and a lack of clarity for market participants.¹⁸ In the words of Ripple, the SEC's application of the test allows the SEC to choose "virtual currency winners and losers."¹⁹

While the future of the lawsuit is unclear, the SEC's action reveals the need for regulatory clarity with respect to

¹⁴ *Id.*

¹⁵ William Hinman, Dir. of Div. of Corp. Fin., Sec. & Exch. Comm'n, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), <https://www.sec.gov/news/speech/speech-hinman-061418>.

¹⁶ In 2008, using the pseudonym Satoshi Nakamoto, an individual or group published a white paper to an online cryptography newsletter that introduced bitcoin as a digital currency that would allow secure, peer-to-peer transactions without intermediaries. See Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (Jan. 2009), <https://bitcoin.org/bitcoin.pdf> (introducing bitcoin and the bitcoin blockchain protocol). In 2009, Nakamoto mined the first bitcoin block known as the "genesis block." That same year, Nakamoto sent 10 bitcoins to computer scientist in the world's first peer-to-peer transaction. Andrew Lisa, *Here's a Bitcoin Timeline for Everything You Need To Know About the Cryptocurrency*, YAHOO! (May 2, 2021), <https://www.yahoo.com/now/bitcoin-timeline-everything-know-cryptocurrency-120003591.html>.

¹⁷ Hinman, *supra* note 15.

¹⁸ The SEC staff issued a framework to assist issuers with conducting a *Howey* analysis that included 38 separate considerations. But, it did not provide information as to which factors would control in the determination of whether a token or cryptocurrency is a security. DIV. OF CORP. FIN., SEC. & EXCH. COMM'N, FRAMEWORK FOR 'INVESTMENT CONTRACT' ANALYSIS OF DIGITAL ASSETS (Apr. 3, 2019), <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>.

¹⁹ Answer, *supra* note 5, at 3.

cryptocurrencies generally. Market participants complain of the continued regulatory uncertainty and argue that, without clarity, they may face costly liability *ex post*.²⁰ With Gary Gensler now at the helm of the SEC, the Commission has yet to propose clear rules for determining which networks are sufficiently decentralized so as not to be deemed a security.²¹ In the meantime, issuers and exchanges remain exposed to liability and uncertainty about the application of securities regulations.²²

Financial regulation in the U.S. is far from simple, however, and cryptocurrencies have been viewed through an assortment of lenses by regulators. While the SEC has recognized that some cryptocurrencies are securities, the Commodities Futures Trading Commission (CFTC) labels them as commodities, the Financial Crimes Enforcement Network (FinCEN) regulates them like a form of money, and the Internal Revenue Service (IRS) treats them as property for tax purposes. Each framework notably impacts the development, use, and exchange of cryptocurrencies.

While the SEC has only recently stepped into the cryptoregulatory mix, the CFTC has been actively regulating cryptocurrency-derivative products since 2015. Relative to the SEC, the CFTC appears to be more strongly positioned to oversee cryptocurrency markets.²³ Unlike the SEC, which has

²⁰ See The Editorial Board, *The SEC's Cryptocurrency Confusion*, WALL ST. J. (Apr. 18, 2021, 10:22 AM), https://www.wsj.com/articles/the-secs-cryptocurrency-confusion-11618611723?mod=opinion_major_pos1 (“U.S. participants in the \$2 trillion cryptocurrency market are seeking clarity that the agency has declined to provide, preferring to announce its positions through individual enforcement actions.”).

²¹ Kristin N. Johnson, *Regulating Cryptocurrency Secondary Market Trading Platforms*, U. CHI. L. REV. ONLINE (Jan. 20, 2020), <https://lawreviewblog.uchicago.edu/2020/01/07/298/>.

²² *Id.* (proposing that the SEC reduce regulatory uncertainty and enhance liquidity by making a modification to enable a secondary market trading platform to register as an ATS).

²³ It should be noted that the CFTC operates with a much smaller budget than the SEC. *Compare* COMMODITIES FUTURE TRADING COMM’N, FY 2022 PRESIDENT’S BUDGET (May 19, 2021), https://www.cftc.gov/sites/default/files/2021-05/CFTC_FY_2022_President_s_Budget_Final_Signed_05212021.pdf (requesting \$332 million operating budget for 2022), *with* SEC. & EXCH.

adopted an *ad hoc* approach in determining that *some* cryptocurrencies are securities, the CFTC determined that *all* cryptocurrencies were commodities at the outset.²⁴ This approach provides the CFTC with an opportunity to oversee the entire market as opposed to just select participants.

One problem, however, is that while the Commodity Exchange Act (CEA) gives the CFTC full regulatory authority to oversee transactions involving “commodity interests,” which include futures contracts, swaps, leveraged retail foreign exchange contracts, and leveraged retail commodity transactions,²⁵ the CFTC has limited authority with respect to the underlying commodity spot markets.²⁶ In the spot markets, the CFTC only has authority to take enforcement action against fraud and manipulation.²⁷ As proposed in this Article, the CFTC’s ability to *prevent* fraud and manipulation in cryptocurrency markets could be improved if the Commission had full regulatory authority over the spot markets in addition to the derivatives thereof.

Despite their prominence in the discourse, fraud and manipulation are not the only concerns related to the use of

COMM’N, CONGRESSIONAL BUDGET JUSTIFICATION ANNUAL PERFORMANCE PLAN (May 28, 2021),

https://www.sec.gov/files/FY%202022%20Congressional%20Budget%20Justification%20Annual%20Performance%20Plan_FINAL.pdf#page=17 (requesting \$1.993 billion for 2022). If the CFTC is to be the primary supervisor of cryptocurrency markets, a reallocation of budgetary funds from the SEC to the CFTC to allow the CFTC to expand its staff may be necessary.

²⁴ *In re Coinflip, Inc.*, CFTC No. 15-29, at 3 (Sept. 17, 2015).

²⁵ 7 U.S.C. §§ 1-27f; 17 C.F.R. § 1.3.

²⁶ 7 U.S.C. § 6c(1); *Hearing Before S. Comm. on Banking, Hous., and Urb. Affs.*, 115th Cong. 4 (2018) (testimony of J. Christopher Giancarlo, Chairman, Commodity Futures Trading Comm’n) [hereinafter Testimony of J. Christopher Giancarlo, Chairman, Commodity Futures Trading Comm’n], <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo37>. The spot markets exchange the “actual commodity as distinguished from a futures contract.” *CFTC Glossary*, COMMODITIES FUTURE TRADING COMM’N, https://www.cftc.gov/LearnAndProtect/EducationCenter/CFTCGlossary/glossary_s.html (last visited June 28, 2021).

²⁷ Testimony of J. Christopher Giancarlo, Chairman, Commodity Futures Trading Comm’n, *supra* note 26.

cryptocurrencies. Since the early days of Bitcoin, criminals have been attracted by the reputed anonymity of cryptocurrencies.²⁸ Further, crypto-mixing exchanges offer a new means for criminals to easily launder their proceeds.²⁹ FinCEN, the primary administrator of anti-money laundering laws in the U.S., has recently taken enforcement action against such services and now requires them to register with the agency.³⁰ Still, not all cryptocurrency exchanges are subject to FinCEN's reporting requirements, and thus, significant money laundering activity remains undetected.³¹ If all cryptocurrency exchanges were required to register with FinCEN, as proposed in this Article, the agency would be better able to prevent and detect money laundering.

While FinCEN views cryptocurrencies as money, the IRS treats cryptocurrencies as property. Thus, every exchange or sale is considered a taxable event.³² This approach might be reasonable with respect to cryptocurrencies that are purchased as investments, but it also makes their use as a payment method impracticable. A more sensible classification of cryptocurrencies would allow for different treatment depending upon use.³³ When a taxpayer acquires cryptocurrency in the same manner and with the same intent as investment property, the IRS should continue to classify the cryptocurrency as a

²⁸ Corinne E. Keel, *Crime and Cryptocurrency*, 83 BENCH & BAR 18, 19 (Sept./Oct. 2018).

²⁹ FIN. CRIMES ENF'T NETWORK, U.S. DEP'T OF THE TREASURY, FIN-2019-G001, APPLICATION OF FINCEN'S REGULATIONS TO CERTAIN BUSINESS MODELS INVOLVING CONVERTIBLE VIRTUAL CURRENCIES (May 9, 2019) [hereinafter 2019 FinCEN Guidance] ("Providers of anonymizing services, commonly referred to as 'mixers,' or 'tumblers,' are either persons who accept [virtual currencies] and retransmit them in a manner designed to prevent others from tracing the transmission back to its source (anonymizing services provider), or suppliers of software that a transmitter would use for the same purpose (anonymizing software provider)."); *see also id.* at 19.

³⁰ *See infra* text accompanying notes 244-48.

³¹ *See infra* text accompanying notes 249-51.

³² *See infra* text accompanying notes 254-58.

³³ Elizabeth Nevle, *Tales from the Crypt: Global Trends in the Taxation of Cryptocurrency*, 24 CURRENTS: INT'L TRADE L.J. *116, *121 (2021).

property transaction.³⁴ However, if the cryptocurrency is exchanged, like money, in a sale of goods or services, then the cryptocurrency should be treated as money at the moment that the transaction occurred.³⁵ Without this change, cryptocurrencies cannot develop as a viable payment method.

This Article is the first to comprehensively review the legal frameworks that are applied to cryptocurrencies in order to ascertain and propose the reforms necessary to create a regulatory environment that sufficiently polices bad actors while allowing for the continued maturation of cryptocurrencies. This Article proceeds in three primary parts. Part I provides a brief overview of cryptocurrencies, then explores the valid regulatory concerns relating to these novel digital assets. In Part II, the regulatory frameworks that are currently applied to cryptocurrencies are examined, and gaps in each framework are identified. Part III then proposes to strengthen the enforcement of the CFTC and FinCEN regarding cryptocurrencies to address regulatory gaps and to eliminate the SEC's oversight and, further, offers changes to current tax policy that will allow cryptocurrencies to be used as a payment method.

I. PRIMER ON CRYPTOCURRENCIES

For purposes of this Article, the distinction between cryptocurrencies and coins offered during an initial coin offering (ICO) is important. This Article focuses on cryptocurrencies, which are digital assets issued or transferred on a distributed ledger that are intended to be used as a decentralized form of payment.³⁶ Tokens or coins issued during an ICO, by contrast, are sold to raise funds for a particular project or organization.³⁷

³⁴ *Id.*

³⁵ *Id.*

³⁶ See DAVID W. PERKINS, CONG. RSCH. SERV., RL 45427, CRYPTOCURRENCY: THE ECONOMICS OF MONEY AND SELECTED POLICY ISSUES (2020).

³⁷ See Erin F. Fonté & Ferdose al-Taie, *Cryptocurrency vs. Initial Coin Offerings (ICO): Different Animals, Different Regulatory Concern*, Lexology (July 23, 2018), <https://www.lexology.com/library/detail.aspx?g=e4138ef4-e12e-48ff-97d8-e8e2afe6ac37> for a description of ICOs (“As such, ICOs have a defined beginning and end date for their fundraising, and funds are designated for a

ICOs are often viewed as alternatives to initial public offerings (IPOs) and have been subject to close scrutiny by the SEC.³⁸ Part III of this Article offers a framework for regulators to distinguish true cryptocurrencies from ICOs.³⁹

The breakthrough technology that underlies cryptocurrencies is the distributed ledger.⁴⁰ A distributed ledger is a peer-to-peer database spread across a network of computers that records all transactions.⁴¹ Potential benefits of distributed ledger technology include improved end-to-end settlement speed, data auditability, resilience, and cost efficiency.⁴² Some cryptocurrencies exist as “native tokens” to a particular ledger—meaning that they are represented on their own ledger, while other digital assets may also be represented on that ledger.⁴³

The history of cryptocurrency is relatively short. In 2008, an unknown computer programmer using the pseudonym

specific project to be completed by an identifiable team of people.”); *see also* Nathaniel Popper, *An Explanation of Initial Coin Offerings*, N.Y. TIMES (Oct. 27, 2017), <https://www.nytimes.com/2017/10/27/technology/what-is-an-initial-coin-offering.html>.

³⁸ Fonté & al-Taie, *supra* note 37; *see also* Moran Ofir & Ida Sadeh, *ICO vs. IPO: Empirical Findings, Information Asymmetry, and the Appropriate Regulatory Framework*, CLS BLUE SKY BLOG (Aug. 5, 2019), <https://clsbluesky.law.columbia.edu/2019/08/05/ico-vs-ipo-empirical-findings-information-asymmetry-and-the-appropriate-regulatory-framework/> (discussing the differences between ICOs and IPOs).

³⁹ *See infra* Part III.B.

⁴⁰ *See* Kristin N. Johnson, *Decentralized Finance: Regulating Cryptocurrency Exchanges*, 62 WILLIAM & MARY L. REV. 1911, 1918, n. 23 (2021) for a discussion of how the terms “distributed ledger technology” and “blockchain” are not synonymous but often used interchangeably.

⁴¹ David Mills et al., *Distributed Ledger Technology in Payments, Clearing, and Settlement*, BD. OF GOVERNORS OF THE FED. RES. SYS., FIN. AND ECON. DISCUSSION SERIES 2016-095 3 (2016), at <https://www.federalreserve.gov/econresdata/feds/2016/files/2016095pap.pdf>; *see also* Carla L. Reyes, *If Rockefeller Were a Coder*, 87 GEO. WASH. L. REV. 373, 379-82 (citing Carla L. Reyes, *Conceptualizing Cryptolaw*, 96 NEB. L. REV. 384, 390-91 (2017)), (describing digital ledger technology as “computer software that is distributed, runs on peer-to-peer networks, and offers a transparent, verifiable, tamper-resistant transaction management system maintained through a consensus mechanism rather than by a trusted third-party intermediary that guarantees execution.”).

⁴² Mills et al., *supra* note 41, at 3.

⁴³ Complaint, *supra* note 1, at 7.

Satoshi Nakamoto proposed a new platform that would allow users to make transfers of digital representations of value to be recorded on a public ledger called a blockchain.⁴⁴ Nakamoto created the first block of the chain in January of 2009, known as the genesis block.⁴⁵ The native currency on this blockchain, dubbed Bitcoin, is the first known cryptocurrency.⁴⁶ Since the early beginnings, Bitcoin has progressed from relative obscurity to a mainstream investment, with a peak total market capitalization of over \$1 trillion.⁴⁷

After Bitcoin, Ether is the second-largest cryptocurrency by market capitalization.⁴⁸ Ether is the native currency on the Ethereum blockchain, which was proposed by programmer Vitalik Buterin in 2013 with the goal of allowing developers to build and operate decentralized applications on the platform.⁴⁹ After its development was crowdfunded, the network went live with a supply of 72 million coins in 2015.⁵⁰ Since its launch, Ethereum has undergone several protocol upgrades, some of which were planned and others unplanned.⁵¹

⁴⁴ Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (Jan. 2009), <https://bitcoin.org/bitcoin.pdf>.

⁴⁵ Benjamin Wallace, *The Rise and Fall of Bitcoin*, WIRED (Nov. 23, 2011), <https://www.wired.com/2011/11/mf-bitcoin/>.

⁴⁶ PERKINS, CONG. RSCH. SERV., *supra* note 36, at 1.

⁴⁷ Gertrude Chavez-Dreyfuss & Tom Wilson, *Bitcoin Hits \$1 Trillion Market Cap, Surges to Fresh All-Time Peak*, REUTERS (Feb. 19, 2020, 1:01 AM), <https://www.reuters.com/article/us-crypto-currency-bitcoin/bitcoin-hits-1-trillion-market-cap-surges-to-fresh-all-time-peak-idUSKBN2AJ0GC>.

⁴⁸ *Today's Cryptocurrency Prices by Market Cap*, COINMARKETCAP, <https://coinmarketcap.com/> (last visited June 4, 2021); Arjun Kharpal, *Cryptocurrency Market Value Tops \$2 Trillion for the First Time as Ethereum Hits Record High*, CNBC (Apr. 6, 2021, 3:40 AM), <https://www.cnbc.com/2021/04/06/cryptocurrency-market-cap-tops-2-trillion-for-the-first-time.html>.

⁴⁹ *Ethereum Whitepaper*, ETHEREUM (Feb. 9, 2021), <https://ethereum.org/en/whitepaper/>.

⁵⁰ Luit Hollander, *History of Ethereum Hard Forks*, MEDIUM (May 4, 2020), <https://medium.com/mycrypto/the-history-of-ethereum-hard-forks-6a6dae76d56f>.

⁵¹ *The History of Ethereum*, ETHEREUM (May 10, 2021), <https://ethereum.org/en/history/>; Paul Vigna, *Ethereum Gets Its Hard Fork, and the 'Truth' Gets Tested*, WALL ST. J. (July 20, 2016, 10:56 AM), <https://www.wsj.com/articles/BL-MBB-51666>.

Since their 2008 invention, cryptocurrencies have rapidly proliferated.⁵² As of June 4, 2021, one industry group purported to track 5,524 cryptocurrencies trading at prices that suggest an aggregate value in circulation of more than \$1.66 trillion.⁵³ The classes of cryptocurrencies now include, among others, alt-coins and stablecoins.⁵⁴ The universe of issuers has expanded as well—from solo developers to multinational businesses,⁵⁵ central banks,⁵⁶ and governments.⁵⁷

Although Satoshi Nakamoto envisioned Bitcoin being sent directly from user to user, more trades have been facilitated by exchanges or platforms in recent years.⁵⁸ These exchanges may be best understood as falling along a continuum with centralized, custodial platforms at one end of the continuum and

⁵² PERKINS, CONG. RSCH. SERV., *supra* note 36, at 1, 8.

⁵³ *Today's Cryptocurrency Prices by Market Cap*, *supra* note 48.

⁵⁴ *Types of Cryptocurrencies: Explaining the Major Types of Cryptos*, CAPITAL (Nov. 1, 2019), <https://capital.com/types-of-cryptocurrencies> (explaining that “alt-coin” refers to cryptocurrencies that are not Bitcoin, while stable coins are digital assets that are linked to underlying assets such as a national currency or a precious metal such as gold); Paulina Likos, *What Are Stablecoins and How Can I Invest in Them?*, U.S. NEWS (May 21, 2021), <https://money.usnews.com/investing/cryptocurrency/articles/what-are-stablecoins-and-how-can-i-invest-in-them>. Of note, Stablecoin issuers face particular regulatory challenges that, while outside the scope of this piece, I plan to address in future work.

⁵⁵ See John Adams, *Inside Facebook's Plans for a Banking Super App*, AMER. BANKER (Aug. 26, 2021, 8:00 AM), <https://www.americanbanker.com/news/inside-facebooks-plans-for-a-banking-super-app> (describing Facebook's plans to launch its stable coin Diem).

⁵⁶ See Vivien Lee & David Wessel, *Digital Currencies: Five Big Implications for Central Banks*, BROOKINGS INST. (May 21, 2018), <https://www.brookings.edu/blog/up-front/2018/05/21/digital-currencies-five-big-implications-for-central-banks/> (discussing that Tunisia and Ecuador's central banks have issued their own digital currencies).

⁵⁷ See James T. Areddy, *China Creates Its Own Digital Currency*, WALL ST. J. (Apr. 5, 2021), <https://www.wsj.com/articles/china-creates-its-own-digital-currency-a-first-for-major-economy-11617634118> (reporting on China's creation of the cyber yuan).

⁵⁸ Eva Szalay, *Crypto Exchanges are Booming, For Now*, FIN. TIMES (Aug. 24, 2021); Paul Vigna, *Bitcoin: What to Know Before Investing*, WALL ST. J. (Feb. 16, 2021, 12:54 PM), <https://www.wsj.com/articles/bitcoin-what-to-know-before-investing-11613498045>. This Article will refer to trading platforms as “exchanges” throughout.

decentralized, noncustodial platforms at the other end.⁵⁹ Centralized, custodial exchanges place users' deposits into a pooled wallet that is controlled by the exchange.⁶⁰ The exchange also acts as an intermediary by directly matching buy and sell orders.⁶¹ In contrast, on decentralized, noncustodial exchanges, users execute transactions and store their cryptocurrencies in their own wallets.⁶² Other exchanges fall between these two ends of the spectrum.

A. *Potential Benefits of Cryptocurrencies*

Many supporters believe that cryptocurrencies and their underlying distributed ledger technology have the potential to transform financial services.⁶³ Cryptocurrencies are already providing the means to make faster payments without an intermediary and have broadened financial opportunities for certain people in less developed economies. This Section explores the potential benefits of cryptocurrencies that justify a regulatory scheme that will allow for their continued development.

1. Potential Cost Savings

Cryptocurrencies may hold the potential to provide a cost advantage over traditional payment systems.⁶⁴ This potential is most likely to be realized in international money transfers. Compared to domestic transfers, international transfers

⁵⁹ Johnson, *supra* note 21.

⁶⁰ *Id.*

⁶¹ *Id.* (citing Coinbase, Gemini, Bittrex, and Binance as examples of centralized exchanges).

⁶² *Id.*

⁶³ See, e.g., Paul Schrodt, *Cryptocurrency Will Replace National Currencies By 2030 According to This Futurist*, MONEY (Mar. 1, 2018), <http://money.com/the-future-of-cryptocurrency/>.

⁶⁴ PERKINS, CONG. RSCH. SERV., *supra* note 36, at 11; see also David S. Evans, *Economic Aspects of Bitcoin and Other Decentralized Public-Ledger Currency Platforms* 19 (Coase-Sandor Inst. for Law & Econ., Working Paper No. 685, 2014). (“[PayPal] does not charge senders or receivers for transferring funds between accounts in the case in which both sender and receiver have PayPal accounts. For overseas transfers [PayPal] charges the sender between 0.5 percent and 2 percent depending on the country for transactions that are fully funded from a bank account.”).

traditionally involve more intermediaries, requiring transfers between banks and other transmitters in different countries and exchanges of one national currency for another.⁶⁵ Proponents assert that cryptocurrencies could avoid these particular costs because cryptocurrency transactions take place over the Internet—which is already global—and are not backed by government-fiat currencies.⁶⁶

The truth, for now, is more complicated. While it is possible to send cryptocurrencies from one digital wallet to another without a fee, more cryptocurrency transactions have occurred through an exchange in recent years.⁶⁷ Coinbase, as an example, operates the largest cryptocurrency exchange.⁶⁸ To initially acquire the cryptocurrency, Coinbase has been known to charge a spread of approximately 0.5 percent plus a fee ranging from \$0.99 to \$2.99.⁶⁹ Once the cryptocurrency is acquired, it is then possible for a user to send it internationally relatively inexpensively if 1) the funds are sent in XRP or USD Coin (USDC), 2) the recipient has a Coinbase account, and 3) the recipient is able to convert the XRP or USDC to her local currency.⁷⁰ If conversion is possible, the recipient will still incur fees to convert to a fiat currency.⁷¹

⁶⁵ PERKINS, CONG. RSCH. SERV., *supra* note 36, at 11.

⁶⁶ Ben Schiller, *The Fight for the \$400 Billion Business of Immigrants Sending Money Home*, FAST CO. (Apr. 28, 2017), <https://www.fastcompany.com/3067778/the-blockchain-is-going-to-save-immigrants-millions-inremittance-fees>.

⁶⁷ See Szalay, *supra* note 58; see also Eimantas Žemaitis, *DEX & CEX Trading Volume Exploded in May Surpassing USD 2 Trillion*, CRYPTONEWS (June 1, 2021, 8:24 AM), <https://cryptonews.com/news/dex-cex-trading-volume-exploded-in-may-surpassing-usd-2-tril-10528.htm> (reporting combined trading volume on centralized and so-called decentralized platforms at over \$2.48 trillion in May 2021).

⁶⁸ PERKINS, CONG. RSCH. SERV., *supra* note 36, at 18.

⁶⁹ *Coinbase Pricing and Fees Disclosures*, COINBASE, <https://web.archive.org/web/20210519150055/https://help.coinbase.com/en/coinbase/trading-and-funding/pricing-and-fees/fees> (last visited May 17, 2021); Taylor Tepper & John Schmidt, *Coinbase Review 2021*, FORBES, (updated May 27, 2021, 7:22 PM).

⁷⁰ *How to Send Money Internationally with Coinbase*, COINBASE, <https://www.coinbase.com/international> (last visited June 28, 2021).

⁷¹ *Coinbase Pricing and Fees Disclosures*, *supra* note 69 (describing fees to sell crypto).

Using cryptocurrency to purchase goods and services also typically requires an intermediary and thus the payment of fees.⁷² Again, there is an initial charge to acquire the cryptocurrency on an exchange. Upon the consumer making a purchase using a hosted wallet, a processor also charges the merchant a fee.⁷³ For example, BitPay charges merchants 1 percent of the transaction amount.⁷⁴ Thus, the roundtrip cost of a transaction that begins with the user buying cryptocurrency is approximately 1.5 percent plus the fee. Depending upon the fee and the amount of the transaction, this could still be less than the average credit card network fees that merchants pay.⁷⁵

Any discussion of the costs of cryptocurrencies would be incomplete without a discussion of energy consumption. To operate a decentralized network, massive computational resources are required to mine—or validate—transactions.⁷⁶ The operation and cooling of the computers that mine cryptocurrencies consume massive amounts of energy.⁷⁷ The daily energy consumption to maintain the Bitcoin network, for

⁷² In April of 2021, PayPal announced that it would begin to allow users in the U.S. to make purchases online with cryptocurrency. Anna Irrera, *Exclusive: PayPal Launches Crypto Checkout Service*, REUTERS (Mar. 30, 2021, 5:34 AM), <https://www.reuters.com/article/us-cryptocurrency-paypal-exclusive/exclusive-paypal-launches-crypto-checkout-service-idUSKBN2BM10N>.

⁷³ Sean Ludwig, *How to Accept Bitcoin Payments*, CO—, U.S. CHAMBER OF COM. (Apr. 5, 2021), <https://www.uschamber.com/co/run/technology/how-to-accept-bitcoin-payments>.

⁷⁴ *Id.*; *What Fees Will I Pay to Use BitPay for Payment Processing?*, BITPAY, <https://support.bitpay.com/hc/en-us/articles/203324073-What-fees-will-i-pay-to-use-BitPay-for-payment-processing-> (last visited Oct. 8, 2021).

⁷⁵ AnnaMaria Andriotis & Harriet Torry, *The Credit-Card Fees Merchants Hate, Banks Love and Consumers Pay*, WALL ST. J. (June 21, 2020, 5:30 AM), <https://www.wsj.com/articles/the-credit-card-fees-merchants-hate-banks-love-and-consumers-pay-11592731800>; OPTIMIZED PAYMENTS CONSULTING, UNDERSTANDING THE COST OF PROCESSING CARD PAYMENTS 7 (2017), https://www.nacha.org/system/files/resources/Understanding_Card_Processing_Costs_WP.pdf (estimating the spread of credit card payments' effect cost as ranging between a low of 1.8% or less and a high of 2.51% or more).

⁷⁶ PERKINS, CONG. RSCH. SERV., *supra* note 36, at 14.

⁷⁷ *Id.*

example, are comparable to that of Ireland.⁷⁸ Thus, the price per transaction does not accurately reflect the total societal costs.⁷⁹

2. Potential for Broader Financial Inclusion

Cryptocurrencies initially developed during a time of growing distrust in financial intermediaries in the aftermath of the 2007-2009 financial crisis. While faith in the U.S. financial system waned during this time, mistrust of financial systems in the U.S. is generally less prevalent than it is in less developed economies.⁸⁰ This mistrust often grows from the lack of stability of financial institutions that may become insolvent without warning, wiping out depositors' life savings.⁸¹ Additionally, individuals may not be confident in the currency of their home country.⁸²

Venezuela, for example, has experienced extremely high inflation of its own currency, the bolivar.⁸³ According to some estimates, inflation in Venezuela reach 6500% last year alone.⁸⁴ As inflation has surged in the country, so too has cryptocurrency trading.⁸⁵ In fact, Venezuelan cryptotraders rank close to those in the U.S. in peer-to-peer dollar-based trading.⁸⁶ Given the

⁷⁸ *Id.*

⁷⁹ Ann Sraders, *A New Cryptocurrency Claims to Be an Eco-Friendly Bitcoin Alternative. Is Chia Worth a Look?*, FORTUNE (May 9, 2021, 7:00 PM), <https://fortune.com/2021/05/09/chia-green-eco-friendly-cryptocurrency-farming-Bitcoin-mining/> (reporting on eco-friendly cryptocurrency as a response to other currencies' energy- and carbon-intensity). For more information on Ethereum moving from a proof-of-work to a proof-of-stake consensus mechanism, which will reduce energy consumption, see *Proof-of-Stake*, ETHEREUM (Sept. 29, 2021), <https://ethereum.org/en/developers/docs/consensus-mechanisms/pos/>.

⁸⁰ PERKINS, CONG. RSCH. SERV., *supra* note 36, at 12.

⁸¹ *Id.*

⁸² *Id.*

⁸³ Nicholas Martin, *Venezuelans Try to Beat Hyperinflation with Cryptocurrency Revolution*, DEUTSCHE WELLE (Apr. 16, 2021), <https://p.dw.com/p/3s5IR>.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.*

troubles with the bolivar, cryptocurrencies are more widely accepted in Venezuela than they are in the U.S.⁸⁷

A few services have had some initial success in expanding access to financial services through cryptocurrencies as well. In Tunisia, the national postal service has collaborated with Monetas and DigitUS to launch a smartphone application that provides a new payment infrastructure using cryptocurrencies.⁸⁸ The service allows Tunisians to pay their bills and manage their government identification documents.⁸⁹ Coin.ph, which operates out of the Philippines, converts remittances into cryptocurrencies that can be withdrawn in the form of fiat currency by the recipient.⁹⁰ This service eliminates the need for a third party.⁹¹

Cryptocurrencies are still not entirely accessible, however. In Venezuela and other countries that struggle with hyperinflation, it is primarily the wealthy and the upper middle class who are able to utilize cryptocurrencies as a substitute for their home country's currency.⁹² In areas with poor Internet access or connectivity, using cryptocurrency is not a viable solution to hyperinflation.⁹³ Thus, cryptocurrencies cannot solve financial access issues without the necessary investment fundamentals, such as high-speed Internet.⁹⁴

⁸⁷ *Id.* (quoting a Venezuelan journalist as saying, “[w]hether it’s furniture, clothing or groceries — virtually everything can be purchased with cryptocurrencies.”).

⁸⁸ Marco Lichtfous, Vivek Yadav & Valentina Fratino, *Can Blockchain Accelerate Financial Inclusion Globally?*, 19 *INSIDE MAGAZINE*, Oct. 2018, at 68, 73.

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² Martin, *supra* note 83.

⁹³ *Id.*

⁹⁴ See TERRI FRIEDLINE, *BANKING ON A REVOLUTION: WHY FINANCIAL TECHNOLOGY WON’T SAVE A BROKEN SYSTEM* 131-48 (2021), for a description of digital redlining, which exacerbates the inequality of access to financial services.

3. Potential for Smart Contracting

Distributed ledgers, the technology that underlies cryptocurrencies, have the potential to revolutionize contractual relationships. While current settlement processes are closed, distributed ledgers utilize protocols that are open, decentralized, and consensus based.⁹⁵ Open ledgers may facilitate “smart” contracts, including securities and derivatives that can “value themselves in real time, automatically calculate and perform margin payments and even terminate themselves in the event of a counterparty default.”⁹⁶

The Ethereum blockchain was designed with smart contract functionality in mind.⁹⁷ Whereas traditional contracts simply define rules amongst the parties thereto, smart contracts have the ability to enforce the rules by controlling the transfer of assets.⁹⁸ As Vitalik Buterin, the initial programmer of Ethereum, has explained, in a smart contract approach, an asset or currency is transferred into a program “and the program runs this code and at some point it automatically validates a condition and it automatically determines whether the asset should go to one person or back to the other person, or whether it should be immediately refunded to the person who sent it or some combination thereof.”⁹⁹

⁹⁵ J. Christopher Giancarlo, Commissioner, Commodity Futures Trading Comm’n, Fidelity Guest Lecture Series on International Finance at Harvard Law School (Dec. 1, 2015).

⁹⁶ *Id.*; see also Nick Szabo, *Smart Contracts*, PHONETIC SCI. AMSTERDAM (1994), <http://www.fon.hum.uva.nl/rob/Courses/InformationInSpeech/CDROM/Literature/LOTwinterschool2006/szabo.best.vwh.net/smart.contracts.html> (describing a smart contract as “a computerized transaction protocol that executes the terms of a contract.”).

⁹⁷ *Ethereum Whitepaper*, *supra* note 49.

⁹⁸ Sue Troy, *What is a Smart Contract and What’s It Good For?*, TECHTARGET (Apr. 25, 2016), <https://searchcio.techtarget.com/feature/What-is-a-smart-contract-and-whats-it-good-for>; see Kevin Werbach & Nicholas Cornell, *Contracts Ex Machina*, 67 DUKE L. J. 313, 318 (2017), for an argument that “smart contracts are contracts.”

⁹⁹ Troy, *supra* note 98.

While use of smart contracts is not yet widespread, certain industries are meaningfully implementing the technology. Smart contracts are currently employed in insurance, exchanges of goods, energy trading and demand management, social credit systems, and mobile payment systems.¹⁰⁰ As a specific example, the insurance industry streamlines claims processing, accuracy, and fraud prevention by using smart contracts to automate claims verification and payment.¹⁰¹ Others have proposed flight insurance smart contracts that would issue automatic refunds upon flight delays.¹⁰²

*B. Regulatory Concerns Relating to
Cryptocurrencies*

*For the love of money is the root of all evil.*¹⁰³

Cryptocurrencies, as a new form of money, are well loved by their most devoted users but also offer an attractive channel for nefarious uses. Scammers lure unwitting investors, social media influencers coordinate to affect market prices, and criminals fund their operations and launder their proceeds through cryptocurrency exchanges. This Section explores the illicit uses of cryptocurrencies that justify modifying the applicable legal frameworks to empower regulators to detect and prevent the most harmful activities.

1. Fraud

Cryptocurrencies are almost a perfect vehicle for scams. The combination of credulous buyers and low barriers for scammers were bound to lead to a high level of fraud, if and when the money involved got large. The fact that the money got huge almost overnight, before there

¹⁰⁰ S.N. Khan, F. Loukil & C. Ghedira-Guegan, *Blockchain Smart Contracts: Applications, Challenges, And Future Trends*, PEER-TO-PEER NETW. APPL. 16, Apr. 2021, at 2901, 2915-16.

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ 1 *Timothy* 6:10 (King James).

*were good regulatory or even self-regulatory models in place, made the problem acute.*¹⁰⁴

With the rise in values, fraudsters have been busy utilizing cryptocurrencies as the “perfect vehicle for scams.”¹⁰⁵ A recent study by Bolster, a company specializing in fraud prevention, found that over 400,000 cryptocurrency scams were created in 2020 for a 40% increase in such scams over 2019.¹⁰⁶ Further, Bolster projects a 75% increase in scams in 2021, which is highly correlated with the rise in the price of Bitcoin and other cryptocurrencies over the past year.¹⁰⁷

Although scams occur using every form of payment, cryptocurrencies have certain attributes that make their use particularly advantageous for the execution of fraudulent schemes. First, cryptocurrencies do not carry the same legal protections as other forms of payment, such as credit or debit cards.¹⁰⁸ If an unauthorized transfer occurs, for example, there is no intermediary to cover the loss. Second, cryptocurrency payments are irreversible.¹⁰⁹ Once the funds have been sent to a scammer, a user cannot reverse the transaction.¹¹⁰ Third,

¹⁰⁴ See Nathaniel Popper, *As Bitcoin Bubble Loses Air, Frauds and Flaws Rise to Surface*, N.Y. TIMES (Feb. 5, 2018), <https://www.nytimes.com/2018/02/05/technology/virtual-currency-regulation.html> (quoting Professor Kevin Werbach).

¹⁰⁵ *Id.*

¹⁰⁶ BOLSTER, CRYPTOCURRENCY SCAM REPORT 4 (2021), <http://boost.bolster.ai/rs/540-RFH-299/images/Bolster-Cryptocurrency-WP-103-web.pdf>.

¹⁰⁷ *Id.* at 5, 7.

¹⁰⁸ *What to Know About Cryptocurrency and Scams*, FED. TRADE COMM’N, <https://www.consumer.ftc.gov/articles/what-know-about-cryptocurrency-and-scams> (last visited May 5, 2021); see also 15 U.S.C. §§ 1643, 1666 (providing credit cardholders with limits to their liability for unauthorized use and the ability to withhold payment for billing disputes or for merchant non-performance); 15 U.S.C. § 1693g (providing debit cardholders with limits to their liability for unauthorized charges).

¹⁰⁹ See *Some Things You Need to Know*, BITCOIN, <https://Bitcoin.org/en/you-need-to-know> (last visited June 18, 2021) (“A Bitcoin transaction cannot be reversed, it can only be refunded by the person receiving the funds.”).

¹¹⁰ *Id.* Researchers at Aalto University and NEC Laboratories have considered one possible solution by identifying and comparing payment-for-receipt protocols to leverage functionality from the blockchain and

cryptocurrencies are not well understood by the public.¹¹¹ Scammers take advantage of this information asymmetry by offering too-good-to-be-true investment opportunities in cryptocurrencies.

Fraudulent cryptocurrency schemes take several forms. One of the most common cryptocurrency scams presents itself in the form of an investment or business opportunity.¹¹² The scammers often promise investors high returns within a short time frame.¹¹³ Ultimately, the investors transfer their cryptocurrency assets to these so-called investment managers, who either abscond with the funds or require payment of fees before the investors can withdraw their assets.¹¹⁴ Other scams involve emails that blackmail victims by threatening to expose compromising photos or personal information unless a payment is made in a particular cryptocurrency.¹¹⁵

2. Manipulation

Cryptocurrency prices are also particularly susceptible to manipulation.¹¹⁶ Cryptocurrencies are relatively thinly traded and generate enough market excitement that a single statement on social media can cause a flurry of market activity that results

increase fairness in cryptocurrency payments. Jian Liu, Wenting Li, Ghassan O. Karame & N. Asokan, *Toward Fairness of Cryptocurrency Payments*, 16 IEEE SECURITY & PRIVACY 81, at 81-89 (2018).

¹¹¹ Nicolas Vega, *More Than 1 in 3 Cryptocurrency Investors Know Little to Nothing About It, Survey Finds*, CNBC (Mar. 4, 2021, 3:35 PM), <https://www.cnbc.com/2021/03/04/survey-finds-one-third-of-crypto-buyers-dont-know-what-theyre-doing.html> (reporting that 33.5% of cryptocurrency investors have little to no knowledge about cryptocurrencies).

¹¹² *What to Know About Cryptocurrency and Scams*, FED. TRADE COMM'N, *supra* note 108; see Rebecca M. Bratspies, *Cryptocurrency and the Myth of the Trustless Transaction*, 25 MICH. TECH. L. REV. 1, 6 (2018), for an interrogation of the claim that cryptocurrency transactions do not require trust.

¹¹³ *What to Know About Cryptocurrency and Scams*, FED. TRADE COMM'N, *supra* note 108.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ Joshua D. Franklin, *McAfee Cryptocurrency Team Members Indicted for Pump and Dump Schemes*, XI NAT'L L. REV. (Mar. 13, 2021), <https://www.natlawreview.com/article/mcafee-cryptocurrency-team-members-indicted-pump-and-dump-schemes>.

in rapid price changes.¹¹⁷ Unfortunately, schemes to take advantage of these characteristics are pervasive.¹¹⁸

The most common manipulation scheme is referred to as the “pump-and-dump.” A pump-and-dump scheme involves artificially inflating the price of a cryptocurrency before selling at a higher price.¹¹⁹ For cryptocurrency-related schemes, this pumping generally takes place on social media.¹²⁰ Once the assets are “dumped,” the price falls, and the newest investors lose money.¹²¹ In the cryptocurrency markets, traders coordinate “to target a specific currency on a certain exchange at a set time in a bid to drive the price higher for a quick payday.”¹²² Such groups “generated more than \$825 million in trading activity in 2018 alone, all of it coming from small, individual traders across hundreds of different groups.”¹²³

In addition to the pump-and-dump scheme, cryptocurrency manipulation takes other, more complex forms. A forensic study on Bitcoin’s 2017 boom found that the majority of the rise in value of the digital currency was attributable to one main market manipulator.¹²⁴ This manipulator used Tether, a stablecoin tied to the U.S. dollar, to purchase large amounts of

¹¹⁷ *Id.*

¹¹⁸ Shane Shifflet & Paul Vigna, *Traders are Talking Up Cryptocurrencies, then Dumping Them, Costing Others Millions*, WALL ST. J., (Aug. 5, 2018, 9:00 AM), <https://www.wsj.com/graphics/cryptocurrency-schemes-generate-big-coin/>.

¹¹⁹ *See id.* (reporting \$825 million in trading activity linked to cryptocurrency pump-and-dump schemes).

¹²⁰ Jiahua Xu & Benjamin Livshits, *The Anatomy of a Cryptocurrency Pump-and-Dump Scheme*, PROCEEDINGS OF THE 28TH USENIX SECURITY SYMPOSIUM 1609 (2019) (“Due to their end-to-end encryption, programmability, and relative anonymity, new social media tools such as Telegram and Discord have become cryptocurrency enthusiasts’ preferred communication vehicles.”).

¹²¹ Shifflet & Vigna, *supra* note 118.

¹²² Paul Vigna, *GameStop Frenzy Echoes Sharp Moves Long Seen in Cryptocurrency Markets*, WALL ST. J. (Feb. 10, 2021, 9:00 AM), <https://www.wsj.com/articles/gamestop-frenzy-echoes-sharp-moves-long-seen-in-cryptocurrency-markets-11612965608?page=1>; see Xu & Livshits, *supra* note 120, for a precise description of the practice.

¹²³ Vigna, *supra* note 122.

¹²⁴ John M. Griffin & Amin Shams, *Is Bitcoin Really Untethered?*, 75 J. OF FIN. 1913, 1917 (Aug. 2020).

Bitcoin following the printing of new Tether.¹²⁵ The results of the study indicated that the price of cryptocurrency had been distorted by manipulation.¹²⁶ That study came after a separate analysis found that 95% of Bitcoin spot trading is faked.¹²⁷ The survey, created by cryptocurrency asset manager Bitwise for the SEC, also found that only \$273 million of approximately \$6 billion in daily Bitcoin volume over the course of four days was legitimate.¹²⁸

3. Illicit Uses

While cash has been the preferred currency for criminal enterprises, cryptocurrencies have now also gained a reputation for use in illegal activity.¹²⁹ Cryptocurrencies combine two characteristics that traditional currencies lack and criminal organizations seek: they provide relative anonymity to users, and they are relatively easy to transfer worldwide almost instantaneously.¹³⁰ Criminal activity relating to cryptocurrencies generally takes two forms: crime resulting from the use of cryptocurrencies to finance illegal activities and crime affecting

¹²⁵ *Id.*; see also Matt Robinson & Tom Schoenberg, *Bitcoin-Rigging Criminal Probe Focused on Tie to Tether*, BLOOMBERG (Nov. 20, 2018), <https://www.bloomberg.com/news/articles/2018-11-20/Bitcoin-rigging-criminal-probe-is-said-to-focus-on-tie-to-tether> (reporting that the U.S. Department of Justice was investigating Tether and Bitfinex for possible market manipulation in 2018).

¹²⁶ Griffin & Shams, *supra* note 124, at 1961.

¹²⁷ Paul Vigna, *Most Bitcoin Trading Faked by Unregulated Exchanges, Study Finds*, WALL ST. J. (Mar. 22, 2019, 9:00 AM), https://www.wsj.com/articles/most-bitcoin-trading-faked-by-unregulated-exchanges-study-finds-11553259600?mod=hp_lead_pos7 (reporting on an analysis showing that most trades were artificially created by unregulated exchanges).

¹²⁸ *Id.*

¹²⁹ Keel, *supra* note 28, at 19; see also Sondes Mbarek, Donia Trabelsi & Michel Berne, *Are Virtual Currencies Virtuous? Ethical and Environment Issues*, in CRYPTOFINANCE AND MECHANISMS OF EXCHANGE: THE MAKING OF VIRTUAL CURRENCY 29, 38 (Stéphane Goutte, Khaled Guesmi & Samir Saadi eds., 2019) for an explanation that cryptocurrencies offer potentially low detection and the reduction of many of the risks associated with real-world money laundering and criminal financing activities.

¹³⁰ Mbarek et al., *supra* note 129, at 39.

the structures of the cryptocurrencies themselves via cyber-attacks.¹³¹

Studies have shown that cryptocurrencies are used extensively to fund and facilitate criminal activity.¹³² Specifically, the use of cryptocurrencies combined with encryption activated by the hidden web (*e.g.*, Tor) has advanced the use of the Internet for illegal activities.¹³³ Online marketplaces, fueled by cryptocurrency, facilitate transactions for the purchase of drugs, weapons, child pornography, stolen data, malware, ransomware, assassinations, hacking services, terrorism, and human trafficking.¹³⁴

The best-known example of an online marketplace that facilitated crime is Silk Road.¹³⁵ Before the Silk Road was shut down in 2013, an estimated \$300,000 worth of Bitcoin circulated through the site daily for the purchase of drugs and other illegal goods.¹³⁶ Although less widely known, AlphaBay grew larger than Silk Road before being shut down in 2017, hosting \$600,000 to \$800,000 in cryptocurrency transactions

¹³¹ Shaen Corbet, Brian Lucey, Andrew Urquhart & Larisa Yarovaya, *Cryptocurrencies as a Financial Asset: A Systematic Analysis*, 62 INT'L REV. FIN. ANALYSIS 182, 192 (2019).

¹³² See, *e.g.*, Sean Foley, Jonathan R. Karlsen & Talis J. Putnins, *Sex, Drugs, and Bitcoin: How Much Illegal Activity Is Financed Through Cryptocurrencies*, 32 REV. OF FIN. STUDIES 1798, 1800 (2019) (estimating that up to 44 percent of all Bitcoin transactions may be related to criminal activity in some way); Sessa Kethineni & Ying Cao, *The Rise in Popularity of Cryptocurrency and Associated Criminal Activity*, 30 INT'L CRIM. JUSTICE REV. 325, 335 (2020) (finding that cryptocurrencies are used to facilitate property crimes as well as theft, drug transactions, extortion, ransom, and hacking).

¹³³ Mbarek et al., *supra* note 129, at 38.

¹³⁴ Foley et al., *supra* note 132, at 1799, 1807; see also Sasha Aslanian, *For Sex Industry, Bitcoin Steps in Where Credit Cards Fear to Tread*, NPR (Dec. 15, 2015, 4:15 PM), <https://www.npr.org/sections/alltechconsidered/2015/12/15/456786212/for-sex-industry-bitcoin-steps-in-where-credit-cards-fear-to-tread> (discussing how sex traffickers have used cryptocurrencies as a workaround when credit cards took affirmative steps not to facilitate such transactions).

¹³⁵ Keel, *supra* note 28, at 19.

¹³⁶ *Id.*

daily for drug, credit card data, and other illicit sales.¹³⁷ Despite the shutdown of Silk Road and AlphaBay and numerous seizures by law enforcement agencies, the number of illegal activities involving cryptocurrencies remains staggering.¹³⁸

A separate yet related illicit use of cryptocurrencies is tax evasion. As Professor Omri Marian has written, cryptocurrencies are attractive for avoiding taxes in that they possess traditional characteristics of tax havens.¹³⁹ First, they allow for the parties to remain somewhat (but not completely) anonymous.¹⁴⁰ Second, since blockchain technology operates in a decentralized manner, there is no centralized government or other institution that may impose taxes.¹⁴¹ Significantly, cryptocurrencies offer one additional major advantage to tax evaders that traditional tax havens do not: the transfer of cryptocurrencies is not necessarily dependent on the existence of financial intermediaries such as banks.¹⁴²

¹³⁷ Kyle Swenson, *Suspected AlphaBay Founder Dies in Bangkok Jail After Shutdown of Online Black Market*, WASH. POST (July 18, 2017), <https://www.washingtonpost.com/news/morning-mix/wp/2017/07/18/suspected-alphabay-founder-dies-in-bangkok-jail-while-online-black-market-remains-closed/>.

¹³⁸ Mbarek et al., *supra* note 129, at 40; see also Foley et al., *supra* note 133, at 1800, for an estimate that in April 2017, 24 million Bitcoin users were primarily using Bitcoin for illegal purposes and annually conducting “around 36 million transactions, with a value of around \$76 billion, and collectively held around \$7 billion worth of Bitcoin.”

¹³⁹ Omri Marian, *Are Cryptocurrencies Super Tax Havens?*, 112 MICH. L. REV. FIRST IMPRESSIONS 38, 39 (2013) [hereinafter *Are Cryptocurrencies Super Tax Havens?*] (“Cryptocurrencies possess the traditional characteristics of tax havens: earnings are not subject to taxation and taxpayers’ anonymity is maintained.”).

¹⁴⁰ Omri Marian, *A Conceptual Framework for the Regulation of Cryptocurrencies*, 82 U. CHI. L. REV. DIALOGUE 53, 57 (2015) (“It should be noted, however, that most cryptocurrencies are not completely anonymous, but rather are pseudonymous.”).

¹⁴¹ Omri Marian, *Blockchain Havens and the Need for Their Internationally-Coordinated Regulation*, 23 FLA. TAX REV. 770, 775, 806 (2020) (arguing that coordinated international regulatory policies are needed to prevent a race to the bottom with respect to taxation of cryptocurrencies and blockchain-based ventures).

¹⁴² *Are Cryptocurrencies Super Tax Havens?*, *supra* note 139, at 42. Given these features, it is not surprising that the IRS has increased its focus on cryptocurrencies as part of its renewed efforts to close a nearly \$600 billion tax gap that is projected to grow into a \$7 trillion gap within the

As noted above, cryptocurrencies have also been linked to terrorism.¹⁴³ With better access to the Internet to promote propaganda, terrorists use cryptocurrencies as a means for foreign donors to support them financially without detection from their home countries.¹⁴⁴ Supporters of ISIS and other terrorist organizations have been identified in forums asking supporters to finance attacks with Bitcoin.¹⁴⁵ In August of 2020, the Justice Department seized millions of dollars' worth of cryptocurrency and uncovered several websites that solicited donations in Bitcoin to fund terrorism.¹⁴⁶ A common method of exchanging Bitcoin utilized by terrorists is through the use of a two-way ATM, which can be purchased by the organization itself and is used only to transfer money between its units in an international, anonymous, and almost instantaneous manner.¹⁴⁷

Cryptocurrencies can both fund and be impacted by cyberattacks.¹⁴⁸ Using cryptocurrency, online marketplaces facilitate purchases of easy-to-use phishing scams and ransomware.¹⁴⁹ After making these purchases, these hackers can then hold entire computer systems hostage by demanding payment in the form of Bitcoin or another cryptocurrency.¹⁵⁰

decade. David Lawder, *U.S. Treasury Seeks Reporting of Cryptocurrency Transfers, Doubling of IRS Workforce*, REUTERS (May 20, 2021, 3:04 PM), <https://www.reuters.com/business/finance/us-treasury-says-can-shrink-7-trillion-tax-gap-by-10-over-next-decade-2021-05-20/>. It is worth noting that lawmakers intend to impose tax-reporting requirements on cryptocurrency brokers to raise \$28 billion over 10 years for new infrastructure plans. Marcy Gordon, *Explainer: How Cryptocurrency Fits into Infrastructure Bill*, ASSOC. PRESS (Aug. 10, 2021), <https://apnews.com/article/technology-joe-biden-business-bills-cryptocurrency-92628a41124230448f65fdeb89ffad7d>.

¹⁴³ Mbarek et al., *supra* note 129, at 40.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ Press Release, Dept. of Justice, Global Disruption of Three Terror Finance Cyber-Enabled Campaigns (Aug. 13, 2020), <https://www.justice.gov/opa/pr/global-disruption-three-terror-finance-cyber-enabled-campaigns>.

¹⁴⁷ Mbarek et al., *supra* note 129, at 41.

¹⁴⁸ *Id.*

¹⁴⁹ Keel, *supra* note 28, at 19.

¹⁵⁰ L.S. Howard, *Business Interruption, Recovery Costs Drive Financial Losses from Cyber Attacks: Report*, INSURANCE J. (Nov. 1, 2021), <https://www.insurancejournal.com/magazines/mag->

Cryptocurrencies are vulnerable to the types of attacks that they finance. For example, Bitfinex, a cryptocurrency exchange platform, reached the top of the trading market before collapsing due to a massive hack in 2014 that resulted in the theft of more than 700,000 Bitcoins.¹⁵¹

4. Money Laundering

Money laundering is the term used to describe the process by which the proceeds of illegal activities, such as drug sales or gun running, are used in legitimate transactions with the goal of concealing the funds' unlawful origin.¹⁵² Cryptocurrencies are laundered when they are moved from an address associated with illicit activity to a new address or cashed out to a fiat currency in a way that obscures the original source of funds.¹⁵³ Many criminal enterprises choose cryptocurrencies because they are less cumbersome than cash, allow for instant payments, may be exchanged without an intermediary, and provide some perceived level of anonymity.¹⁵⁴

Cryptocurrency laundering mostly occurs on exchanges, mixers, and gambling sites.¹⁵⁵ A recent study found that Bitcoin exchanges accounted for the highest volume of illicit cryptocurrency.¹⁵⁶ While many cryptocurrency exchanges comply with anti-money laundering laws, some operate as black

features/2021/11/01/639581.htm (noting that 98% of ransomware payments are made in bitcoin).

¹⁵¹ Corbet et al., *supra* note 131, at 192.

¹⁵² *Frequently asked questions – Money Laundering*, FIN. ACTION TASK FORCE, <https://www.fatf-gafi.org/faq/moneylaundering/> (last visited May 12, 2021).

¹⁵³ *Id.*; see also Yaya J. Fanusie & Tom Robinson, *Bitcoin Laundering: An Analysis of Illicit Flows into Digital Currency Services*, CENTER ON SANCTIONS & ILLICIT FIN., FOUNDATION FOR THE DEFENSE OF DEMOCRACIES, at 3 (Jan. 12, 2018), https://www.fdd.org/wp-content/uploads/2018/01/MEMO_Bitcoin_Laundering.pdf.

¹⁵⁴ Fanusie & Robinson, *supra* note 153, at 1-3 (noting, however, that transactions are not entirely anonymous in that a “person-to-person payment using Bitcoin will leave a record of that transaction and the addresses involved ... in the blockchain.”).

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 7 (Table 7).

market banks that are structured to facilitate criminal activity.¹⁵⁷ Liberty Reserve, a Costa Rican exchange, offered such services prior to being forcibly shut down in 2013.¹⁵⁸ The service had traded in virtual currency and provided an anonymous and accessible banking infrastructure.¹⁵⁹ Richard Weber, former chief of the IRS's criminal investigation division, stated that "[i]f Al Capone were alive today, this is how he would be hiding his money."¹⁶⁰

Although exchanges have the highest crypto-laundering volume overall, mixers and online gambling services have a higher proportion of laundering within their platforms.¹⁶¹ According to FinCEN, mixers accept virtual currencies and retransmit them in a manner designed to prevent others from tracing the transmission back to its source.¹⁶² Mixers (alternatively called "tumblers") accomplish this by mixing identifiable cryptocurrency funds with other funds for a fee while other alternatives' blockchains include "built-in" mixing services.¹⁶³ Online gambling services, by contrast, offer wagers and payouts in cryptocurrency.¹⁶⁴ Such services can be used anonymously without limits, providing an avenue for laundering funds.¹⁶⁵

¹⁵⁷ Jack Cloherty, 'Black Market Bank' Accused of Laundering \$6B in Criminal Proceeds, ABC NEWS (May 28, 2013, 7:08 PM), <https://abcnews.go.com/US/black-market-bank-accused-laundering-6b-criminal-proceeds/story?id=19275887>.

¹⁵⁸ Mbarek et al., *supra* note 129, at 42-43.

¹⁵⁹ *Id.*

¹⁶⁰ Marc Santora et al., *Online Currency Exchange Accused of Laundering \$6 Billion*, N.Y. TIMES (May 28, 2013), <https://www.nytimes.com/2013/05/29/nyregion/liberty-reserve-operators-accused-of-money-laundering.html>.

¹⁶¹ Fanusie & Robinson, *supra* note 153, at 10.

¹⁶² See 2019 FinCEN Guidance, *supra* note 29, at 19.

¹⁶³ Usman W. Chohan, *The Cryptocurrency Tumblers: Risks, Legality and Oversight*, DISCUSSION PAPER SERIES: NOTES ON THE 21ST CENTURY, at 2-3 (Nov. 30, 2017).

¹⁶⁴ Fanusie & Robinson, *supra* note 153, at 15.

¹⁶⁵ *Id.*

II. REGULATORY FRAMEWORKS APPLIED TO CRYPTOCURRENCIES

Although slow to start, financial regulators have begun addressing the fraud, manipulation, illicit uses, and money laundering practices described in Part I. Nevertheless, with cryptocurrencies' groundbreaking technological features, smorgasbord of protocols, and characteristics of both money and property, regulators have struggled to fit them into their preexisting legal frameworks. This Part examines the current application of these frameworks and identifies gaps in each framework that must be filled to effectively regulate cryptocurrencies going forward.

A. *As Securities*

The purpose of securities regulation is to ensure that investors are protected from market participants who would take advantage of information asymmetries.¹⁶⁶ Thus, securities regulation is based on the assumption that investors are incapable of fully protecting their own interests.¹⁶⁷ The principal pieces of legislation regarding securities, the Securities Act of 1933 and the Securities and Exchange Act of 1934, mandate disclosures to narrow the knowledge gap between issuers of securities and investors.¹⁶⁸

Securities laws and regulations apply to “securities,” which are statutorily defined as “any note, stock ... [or] investment contract.”¹⁶⁹ “Investment contract” has been used as a catchall term for transactions that do not neatly fit into a specific category under the definition of securities. In 1946, the Supreme Court adopted a four-pronged test to determine which transactions are investment contracts in the seminal case *SEC v. Howey*.¹⁷⁰ The Court held that an instrument is an investment

¹⁶⁶ Anne M. Tucker, *The Outside Investor: Citizen Shareholders & Corporate Alienation*, 11 U. ST. THOMAS L. J. 99, 114 (2013).

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* at 113-14.

¹⁶⁹ 15 U.S.C. § 77b(a)(1).

¹⁷⁰ *Sec. & Exch. Comm'n v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

contract, and therefore a security, when it is 1) an investment of money 2) in a common enterprise 3) with the expectation of profit 4) that is derived solely from the efforts of others.¹⁷¹

The SEC, the agency charged with enforcing securities laws, has applied the *Howey* test in the context of cryptocurrencies. For example, the SEC has formally and informally acknowledged that Bitcoin is not a security. In a 2019 letter to Cipher Technologies Management, the SEC stated that it “disagreed with [the] conclusion that Bitcoin is a security” because the SEC did not “believe that current purchasers of Bitcoin are relying on the essential managerial and entrepreneurial efforts of others to produce a profit.”¹⁷² In eyes of the SEC, Bitcoin failed to meet the last prong of the *Howey* test. In a 2018 speech, the director of the SEC’s corporate finance division, William Hinman, focused on the common enterprise element of the *Howey* test and described Bitcoin’s network as having been “decentralized for some time.”¹⁷³

In the same speech, Hinman also acknowledged that Ether, the cryptocurrency supported by the Ethereum network, is not a security by stating that “the *current* offers and sales of Ether” are not securities transactions.¹⁷⁴ The director notably focused on the present, “putting aside the fundraising that accompanied the *creation* of Ether.”¹⁷⁵ This analysis represents a departure from previous applications of the *Howey* test that have focused on the initial offerings.¹⁷⁶ In a March 2019 letter, Chairman Jay Clayton confirmed this analysis by stating that the “designation may change over time if the digital asset is offered

¹⁷¹ *Id.*

¹⁷² Cipher Tech. Mgmt., SEC Interpretive Letter, File No. 811-23443, (Oct. 1, 2019), <https://www.sec.gov/Archives/edgar/data/1776589/999999999719007180/filename1.pdf>.

¹⁷³ Hinman, *supra* note 15.

¹⁷⁴ *Id.* (emphasis added).

¹⁷⁵ *Id.* (emphasis added).

¹⁷⁶ See CHRIS BRUMMER, FINTECH LAW IN A NUTSHELL 141-43 (2020) (“Under the Securities Act of 1933, if a financial product is offered as a security, it needs to be registered. It does not become over time a non-security because of changes as to how it is offered.”).

in such a way that it will no longer meet” the definition of a security.¹⁷⁷

Despite the letter professing that the SEC had been “transparent with the criteria used to determine whether a digital asset is offered or sold as investment contract,”¹⁷⁸ the financial world was shocked by the news that the SEC had charged Ripple and two of its executives with conducting a \$1.38 billion unregistered securities offering by issuing XRP.¹⁷⁹ In the complaint, the SEC applied the *Howey* test and concluded that “XRP was an investment contract and therefore a security subject to the registration requirements of the federal securities laws.”¹⁸⁰ The SEC alleged that purchasers of XRP had invested in a common enterprise and that Ripple had led these investors to reasonably expect a profit based on their efforts.¹⁸¹

With respect to the common enterprise element, the SEC cited the fact that Ripple had used the funds from the sale of XRP to fund its operations.¹⁸² The complaint then focused on Ripple’s statements regarding its efforts to increase demand, assurances that Ripple would protect the XRP market, and assertions that tied XRP’s price with Ripple’s efforts.¹⁸³ According to the SEC, these statements led investors to reasonably expect a profit based on Ripple’s efforts.¹⁸⁴

In its complaint, the SEC also alleged that Ripple had ignored warnings that XRP could be a security and cited its warning for “those who would use . . . distributed ledger or blockchain-enabled means for capital raising to take appropriate

¹⁷⁷ Letter from Jay Clayton, Chairman, Sec. & Exch. Comm’n, to Rep. Ted Budd (Mar. 7, 2019) (on file with author).

¹⁷⁸ *Id.*

¹⁷⁹ Complaint, *supra* note 1, at 1-2; Paul Vigna & Dave Michaels, *SEC Sues Ripple Over XRP Cryptocurrency*, WALL ST. J. (Dec. 22, 2020, 6:36 PM), https://www.wsj.com/articles/ripple-to-face-sec-suit-over-xrp-cryptocurrency-11608598800?mod=searchresults_pos9&page=1 (describing the lawsuit and reactions thereto).

¹⁸⁰ Complaint, *supra* note 1, at 34.

¹⁸¹ *Id.* at 36-55.

¹⁸² *Id.* at 46.

¹⁸³ *Id.*

¹⁸⁴ *Id.*

steps to ensure compliance with the U.S. federal securities laws.”¹⁸⁵ This warning was issued when the SEC published an investigative report offering guidance on the application of securities laws to ICOs issued by decentralized, autonomous organizations.¹⁸⁶ In its response, Ripple distinguished its distributions of XRP from an ICO. According to Ripple, the company did not offer or contract to sell future tokens to build an ecosystem, made no promise of profits to XRP holders, and had no relationship with the majority of XRP holders.¹⁸⁷

This distinction is important. As Ripple pointed out, up until the lawsuit, the SEC had only determined that digital assets offered during an ICO were investment contracts.¹⁸⁸ Compared to its view of cryptocurrencies like Bitcoin and Ether, the SEC had taken a clearer position on ICOs. In 2018, former SEC Chairman Jay Clayton said, “I believe every ICO I’ve seen is a security,” bluntly stating that “ICOs that are securities offerings, we should regulate them like we regulate securities offerings. End of story.”¹⁸⁹ Further, although a framework to distinguish a cryptocurrency launch from an ICO has yet to be produced, testimony and guidance produced by the SEC had indicated the position that the two events were to be treated differently.¹⁹⁰

Once the SEC determines that a particular cryptocurrency is a security, it becomes subject to a host of requirements including registration of the asset.¹⁹¹ Another

¹⁸⁵ *Id.* at 8.

¹⁸⁶ Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207 (July 25, 2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

¹⁸⁷ Answer, *supra* note 5, at 4-5.

¹⁸⁸ *Id.* at 6.

¹⁸⁹ *Hearing Before S. Comm. on Banking, Hous., and Urb. Affs.*, 115th Cong. 4 (2018) (testimony of Jim Clayton, Chairman, Sec. Exchange Comm’n), at 32:10, 1:32:35 [hereinafter Testimony of Jim Clayton, Chairman, Sec. Exchange Comm’n] <https://www.banking.senate.gov/hearings/virtual-currencies-the-oversight-role-of-the-us-securities-and-exchange-commission-and-the-us-commodity-futures-trading-commission>.

¹⁹⁰ See, e.g., *id.* at 6-10; Hinman, *supra* note 15 (comparing ICOs to Bitcoin and Ether).

¹⁹¹ See, e.g., Carriereq, Inc., Securities Act Release No. 10575, 2018 WL 6017664 (Nov. 16, 2018),

implication is that the exchanges that list and trade cryptocurrencies determined to be securities must register with the SEC or qualify for an exemption to facilitate trading of these securities.¹⁹² An exchange may choose to register as a national security exchange (NSE) or qualify to operate as an exempt Alternative Trading System (ATS).¹⁹³ An NSE is subject to significant regulatory obligations but operates with relative autonomy.¹⁹⁴ An ATS, by contrast, must register as a broker-dealer and join a self-regulatory organization, such as the Financial Industry Regulatory Authority (FINRA), which subjects an ATS to a host of regulatory requirements.¹⁹⁵

In recent years, the SEC has stepped up its enforcement efforts with respect to unregistered exchanges.¹⁹⁶ For example, in 2018, the SEC accused Zachary Coburn of operating an unregistered securities exchange, EtherDelta.¹⁹⁷ EtherDelta served as a marketplace, enabling buyers and sellers to trade Ethereum-based tokens, some of which the SEC had labeled as securities.¹⁹⁸ During the 18-month period immediately leading up to the SEC's cease-and-desist order, the platform executed more than 3.6 million orders for such tokens.¹⁹⁹ EtherDelta does

<https://www.sec.gov/litigation/admin/2018/33-10575.pdf> (finding that tokens sold to raise capital were securities and were thus required to be registered).

¹⁹² 15 U.S.C. § 78(e).

¹⁹³ *SEC Statement on Potentially Unlawful Online Platforms for Trading Digital Assets*, *supra* note 10.

¹⁹⁴ BRUMMER, *supra* note 176, at 164-65.

¹⁹⁵ *SEC Statement on Potentially Unlawful Online Platforms for Trading Digital Assets*, *supra* note 10 (including “reasonable policies and procedures to prevent the misuse of material non-public information, books and records requirements, and financial responsibility rules, including, as applicable, requirements concerning the safeguarding and custody of customer funds and securities.”).

¹⁹⁶ Johnson, *supra* note 21.

¹⁹⁷ In the Matter of Zachary Coburn, Exchange Act Release No. 84553 (Nov. 8, 2018), <https://www.sec.gov/litigation/admin/2018/34-84553.pdf>; see also Johnson, *supra* note 21, noting that it was unclear specifically which tokens Coburn “should have assumed were securities that triggered liability.”

¹⁹⁸ Johnson, *supra* note 21.

¹⁹⁹ In the Matter of Zachary Coburn, Exchange Act Release No. 84553, at 2 (Nov. 8, 2018), <https://www.sec.gov/litigation/admin/2018/34-84553.pdf>

continue to operate but now with much more limited trading activity, as it must refrain from listing securities.²⁰⁰

Immediately following the SEC's lawsuit against Ripple, the price of XRP dropped precipitously as many exchanges began delisting the cryptocurrency.²⁰¹ Although some exchanges continue to list and facilitate trading of XRP despite the lawsuit, Coinbase is the only cryptocurrency exchange authorized to do so, as it is qualified with the SEC as an ATS.²⁰² Given that the new SEC Chairman Gary Gensler has expressed that lack of oversight of cryptocurrency exchanges is the most pressing issue before the Commission, it is likely that the exchanges are subjecting themselves to future liability.²⁰³

B. *As Commodities*

Regulation of commodities in the U.S. began in the agricultural realm. The Commodity Exchange Act of 1936 (CEA), the statute that still governs futures and options trading, amended and renamed the earlier Grain Futures Act.²⁰⁴ The CEA also broadened the application of the act from grains to a broadly defined "commodity."²⁰⁵ At its heart, the CEA's purpose is to

²⁰⁰ Johnson, *supra* note 21.

²⁰¹ Olga Kharif, *Cryptocurrency XRP Is in Free Fall with Exchanges Delisting Coin*, BLOOMBERG (Dec. 29, 2020), <https://www.bloomberg.com/news/articles/2020-12-29/cryptocurrency-xrp-is-in-freefall-with-exchanges-delisting-coin>.

²⁰² *ATS List*, *supra* note 11.

²⁰³ Chris Matthews, *SEC Chairman Says Americans Need A 'Cop on The Beat' to Protect Investors from Crypto Fraud*, MARKETWATCH (May 26, 2021), <https://www.marketwatch.com/story/sec-chairman-says-americans-need-a-cop-on-the-beat-to-protect-investors-from-crypto-fraud-11622055519>.

²⁰⁴ John H. Stassen, *The Commodity Exchange Act in Perspective a Short and Not-So-Reverent History of Futures Trading Legislation in The United States*, 39 WASH. & LEE L. REV. 825, 832 (1982).

²⁰⁵ The definition of commodity has been amended several times and currently includes "wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions and motion picture box office receipts (or any index,

deter and prevent market manipulation, protect investors from fraud, and promote fair competition among market participants, among other things.²⁰⁶ To carry out this purpose in the context of the rapidly expanding commodities futures markets of the 1970s, Congress established the Commodity Futures Trading Commission (CFTC) in 1974 to enforce the CEA.²⁰⁷

While it is difficult to fathom that a regulatory framework could be sufficiently broad so as to apply to both lard and cryptocurrencies, the CEA's application is exactly that broad. In a 2015 enforcement action, the CFTC determined that "Bitcoin and other virtual currencies" are commodities.²⁰⁸ The CFTC's analysis was simple on this point. The definition of commodity includes "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."²⁰⁹ According to the CFTC, since Bitcoin and other virtual currencies²¹⁰ serve as underlying assets for futures contracts, they are "encompassed in the definition and properly defined as commodities."²¹¹

Having summarily settled that virtual currencies are commodities, the CFTC began overseeing cryptocurrency transactions involving "commodity interests," which include futures contracts, swaps, leveraged retail foreign exchange contracts, and leveraged retail commodity transactions.²¹² In

measure, value, or data related to such receipts), and all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1a(9); 17 C.F.R. § 1.3 (2021).

²⁰⁶ 79A C.J.S. *Securities Regulation* § 598 (2021).

²⁰⁷ 7 U.S.C. § 2.

²⁰⁸ *In re Coinflip, Inc.*, CFTC No. 15-29, at 3 (Sept. 17, 2015).

²⁰⁹ *Id.*

²¹⁰ *Id.* at 2 (defining a 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, but does not have legal tender status in any jurisdiction.").

²¹¹ *Id.* at 3.

²¹² 17 C.F.R. § 1.3 (2021). The CEA provides for an exception of leveraged retail commodity transactions when the actual delivery of the digital asset occurs within 28 days. 7 U.S.C. § 2 (2021). The CFTC has provided interpretation establishing "two primary factors necessary to demonstrate 'actual delivery' of retail commodity transactions in virtual

2015, the CFTC ruled that Derivabit was illegally offering options and futures contracts on Bitcoin by not registering as a Designated Contract Market (DCM) or a Swap Execution Facility (SEF).²¹³ Similarly, in 2016, the CFTC filed charges against Bitfinex, an online digital assets trading platform that facilitated financed acquisitions of Bitcoin, for offering off-exchange financed retail commodity transactions and for failing to register as a Futures Commission Merchant.²¹⁴

The CFTC also enjoys considerable authority to take action to limit fraud and manipulation in the markets that it oversees. The Dodd-Frank Act of 2010 expressly extended the CFTC's anti-fraud and anti-manipulation enforcement authority to the commodity spot markets²¹⁵ as opposed to only the derivatives markets.²¹⁶ Until recently, it was not clear whether CEA § 6(c)(1) and 7 U.S.C. § 9(1) granted the CFTC anti-fraud authority in the spot markets “in the absence of [an] actual or

currency.” Press Release, Commodity Futures Trading Comm’n, CFTC Issues Proposed Interpretation on Virtual Currency “Actual Delivery” in Retail Transactions (Dec. 15, 2017), <https://www.cftc.gov/PressRoom/PressReleases/7664-17>. First, for delivery to have occurred, a customer must have the ability to (i) take possession and control of the entire quantity of the commodity, whether it was purchased on margin, or using leverage, or any other financing arrangement, and (ii) use it freely in commerce no later than twenty-eight days from the date of the transaction. Second, the offeror and counterparty seller must not retain any interest in or control over any of the commodity. Press Release, Commodity Futures Trading Comm’n, *supra*.

²¹³ *In re Coinflip, Inc.*, CFTC No. 15-29, at 3 (Sept. 17, 2015).

²¹⁴ *In re BFXNA Inc.*, CFTC No.16-19, at 6-7 (June 2, 2016).

²¹⁵ The term “spot market” denotes markets in which commodities themselves are traded in real time. BRUMMER, *supra* note 176, at 179.

²¹⁶ 7 U.S.C. § 9(1) (“It shall be unlawful for any person . . . to use or employ, in connection with any swap, or a *contract of sale of any commodity* in interstate commerce, or for future delivery on or subject to the rules of any registered entity, *any manipulative or deceptive device or contrivance. . .*”) (emphasis added).

potential market manipulation.”²¹⁷ The 9th and 11th Circuits have since held in the affirmative.²¹⁸

The CFTC has shown that it is willing to assert this new authority in spot markets specifically for digital assets. For example, in 2017, the Commission took an enforcement action against Gelfman Blueprint, Inc. and its CEO for operating a “Bitcoin Ponzi scheme.”²¹⁹ According to the CFTC, the defendants had solicited \$600,000 from more than 80 customers by agreeing to place the money in a pooled commodity fund.²²⁰ In fact, the defendant had provided false reports to its customer that showed Bitcoin trading gains, paid out some returns from funds collected from customers, and then later faked a computer hack that they claimed had caused the loss of the customers’ funds.²²¹

²¹⁷ *Commodity Futures Trading Comm’n v. Monex Credit*, 311 F. Supp. 3d 1173, 1189 (C.D. Cal. 2018), *rev’d*, 931 F.3d 966, 976 (9th Cir. 2019), *cert. denied sub nom.*, 141 S. Ct. 158 (2020) (holding that 7 U.S.C. § 9 (1) covers “stand-alone fraud claims” even in the absence of “fraud-based manipulation.”).

²¹⁸ *Commodity Futures Trading Comm’n v. Monex Credit*, 931 F.3d 966, 976 (9th Cir. 2019); *Commodity Futures Trading Comm’n v. S. Tr. Metals, Inc.*, 894 F.3d 1313, 1334-35 (11th Cir. 2018) (holding that the District Court did not err in concluding that defendants committed fraud under 7 U.S.C. § 9(1) despite the absence of allegations of price manipulation); *see also* *Commodity Futures Trading Comm’n v. McDonnell*, 321 F.Supp.3d 366, 368 (E.D.N.Y. 2018) (holding that the CFTC has anti-fraud enforcement power even when manipulation is not present); *Commodity Futures Trading Comm’n v. My Big Coin Pay, Inc.*, 334 F. Supp. 3d 492, 499 (D. Mass. 2018) (holding that the CFTC’s anti-fraud enforcement authority under CEA § 6(c)(1) extends to transactions in virtual currency even absent allegations of manipulation).

²¹⁹ Complaint at 1, *Commodity Futures Trading Comm’n v. Gelfman Blueprint, Inc.*, 2018 U.S. Dist. LEXIS 205706 (S.D.N.Y. 2018); *see also* Complaint, *Commodity Futures Trading Comm’n v. Dean*, 2018 U.S. Dist. LEXIS 165861 (E.D.N.Y. 2018) (alleging a fraudulent scheme to solicit Bitcoin from the public by misrepresenting that the funds would be pooled and invested in products including binary options); Complaint, *Commodity Futures Trading Comm’n v. McDonnell et al.*, 332 F. Supp. 3d 641 (E.D.N.Y. 2018) (charging the defendants with operating a deceptive and fraudulent virtual currency scheme).

²²⁰ Complaint, *Gelfman Blueprint, Inc.*, *supra* note 219, at 1.

²²¹ *Id.* at 1-2.

Similarly, the CFTC brought a case against My Big Coin Pay, alleging that the defendants were operating a fraudulent virtual currency scheme in violation of the CEA.²²² The defendants had enticed customers to buy the virtual currency, My Big Coin, by falsely claiming that the currency was “backed by gold,” could be used anywhere Mastercard was accepted, and was being actively traded on several currency exchanges.²²³ Although the defendants argued, in part, that My Big Coin was not a “commodity” as defined by the CEA because no futures contracts existed for the coins, a federal court held that the virtual currency fell within the Act’s definition of a commodity even though no futures existed for that particular currency.²²⁴

Then, in March of 2021, the CFTC filed a complaint alleging a manipulative scheme involving a digital asset for the first time.²²⁵ The complaint alleged that antivirus software creator John McAfee had secretly acquired cryptocurrencies, such as Dogecoin, ReddCoin, and Verge, and then used his prominence to promote these assets on social media.²²⁶ According to the CFTC, after the prices had sufficiently risen because of his efforts, McAfee and his associate sold the cryptocurrencies for a \$2 million profit. The CFTC is seeking civil monetary penalties and other relief, including trading bans, restitution, disgorgement, rescission, and pre- and post-judgment interest.²²⁷

While the CFTC’s anti-fraud and anti-manipulation authority over virtual currency markets has been affirmed, it is not without limits. As compared to derivatives markets, the CFTC does not have authority to conduct regulatory oversight over spot virtual currency platforms or other cash commodities, including imposing registration requirements, surveillance and monitoring, transaction reporting, compliance with personnel conduct standards, customer education, capital adequacy,

²²² *My Big Coin Pay, Inc.*, 334 F. Supp. 3d at 494.

²²³ *Id.*

²²⁴ *Id.* at 498.

²²⁵ Complaint at 1, *Commodity Futures Trading Comm’n v. McAfee*, No. 21-CV-1919 (S.D.N.Y. Mar. 5, 2021).

²²⁶ *Id.* at 1-2.

²²⁷ *Id.* at 2.

trading system safeguards, cybersecurity examinations, or other requirements.²²⁸

C. *As Money*

To deter money laundering, cryptocurrencies are treated as money.²²⁹ The Bank Secrecy Act of 1970 (BSA) is the main body of law that deters money laundering by requiring financial institutions to maintain appropriate records, file reports on certain type of transactions, and verify customer identities.²³⁰ Thus, the law places the burden of preventing money laundering on financial institutions. FinCEN has been granted the primary authority to administer and interpret the BSA.²³¹ In addition to banks, the BSA applies to Money Services Businesses (MSBs), which include money transmitters.²³² Per FinCEN, the transmission of money includes the acceptance and transmission of “substitutes for currency” and “convertible virtual currencies” that act as a substitute for real currency.²³³ Cryptocurrencies are considered a type of convertible virtual currency.²³⁴ Thus, a person or entity transmitting cryptocurrencies will be subject to the BSA.²³⁵

²²⁸ Testimony of J. Christopher Giancarlo, Chairman, Commodity Futures Trading Comm’n, *supra* note 26.

<https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo37>.

²²⁹ See 2019 FinCEN Guidance, *supra* note 29, at 3-4 (explaining that the BSA applies to “money services businesses,” money services businesses include “money transmitters,” money transmitters “provide money transmission services,” and money transmission services include the “acceptance of other value that substitutes for currency.”).

²³⁰ Bank Secrecy Act of 1970, 31 U.S.C. § 5311-5332 (2021).

²³¹ BRUMMER, *supra* note 176, at 417.

²³² 31 C.F.R. § 1010.100(ff)(5) (2014).

²³³ FIN. CRIMES ENF’T NETWORK, U.S. DEP’T OF THE TREASURY, FIN-2013-G001, Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies 3 (Mar. 18, 2013) [hereinafter 2013 FinCEN Guidance], <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>.

²³⁴ 2019 FinCEN Guidance, *supra* note 29, at 7 (referring to “digital currency,” “cryptocurrency,” “cryptoasset,” and “digital asset” as subtypes of convertible virtual currencies).

²³⁵ 2013 FinCEN Guidance, *supra* note 233, at 1; Brian Hayes et al., *Key Provisions of the Anti-Money Laundering Act of 2020*, HOLLAND & KNIGHT (Jan. 13, 2020), <https://www.hklaw.com/en/insights/publications/2021/01/key-provisions->

More specifically, FinCEN treats exchanges and administrators of cryptocurrencies as money transmitters and thus as MSBs under the BSA.²³⁶ As MSBs, exchanges and administrators have an obligation to register with FinCEN, to develop, implement, and maintain anti-money laundering compliance programs, and to meet all applicable recordkeeping and reporting requirements.²³⁷ FinCEN has begun taking enforcement action against unregistered exchanges. For example, in April of 2019, FinCEN assessed a civil money penalty against Eric Powers, an operator of a peer-to-peer cryptocurrency exchange.²³⁸ FinCEN alleged that Powers had

of-the-anti-money-laundering-act-of-2020 (explaining that the Anti-Money Laundering Act of 2020 (AMLA) amended the BSA to expressly affirm FinCEN's long-held position that those who exchange or transmit value that substitutes for currency (e.g., cryptocurrency) are subject to BSA registration and compliance requirements).

²³⁶ 2013 FinCEN Guidance, *supra* note 233, at 1-2 (defining an exchanger as “a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency” and an administrator as a “person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency.”).

²³⁷ Press Release, Fin. Crimes Enf't Network, U.S. Dep't of the Treasury, First Bitcoin “Mixer” Penalized by FinCEN for Violating Anti-Money Laundering Laws (Oct. 19, 2020) [hereinafter Oct. 2020 FinCEN Press Release] <https://www.fincen.gov/news/news-releases/first-bitcoin-mixer-penalized-fincen-violating-anti-money-laundering-laws>. FinCEN's 2019 guidance expanded the application of some of its rules to cryptocurrencies. 2019 FinCEN Guidance, *supra* note 29, at 11. For example, the regulations known as the Funds Travel Rule and Recordkeeping Rule require a money transmitter to store and transmit information on transfers of \$3,000 or more. Press Release, Fin. Crimes Enf't Network, U.S. Dep't of the Treasury, The Financial Crimes Enforcement Network Proposes Rule Aimed at Closing Anti-Money Laundering Regulatory Gaps for Certain Convertible Virtual Currency and Digital Asset Transactions (Dec. 18, 2020), <https://home.treasury.gov/news/press-releases/sm1216>. In December of 2020, FinCEN proposed new rules that would reduce the threshold from \$3,000 to \$250 for both virtual and fiat currencies. Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets, 85 Fed. Reg. 83840 (proposed Dec. 3, 2020).

²³⁸ In the Matter of Eric Powers, No. 2019-01, FIN. CRIMES ENF'T NETWORK, U.S. DEP'T OF THE TREASURY, at *7 (2019) https://www.fincen.gov/sites/default/files/enforcement_action/2019-04-18/Assessment%20Eric%20Powers%20Final%20for%20Posting%2004.18.19_1.pdf.

never registered as an MSB, filed the required reports, or implemented an anti-money laundering program as required by the BSA.²³⁹

While the BSA is primarily administered by FinCEN, the Department of Justice (DOJ) is authorized to pursue civil and criminal violations of the BSA, including prosecutions of both firms and individuals who fail to register or to report suspicious activities.²⁴⁰ In October of 2020, the DOJ brought criminal charges against four executives of BitMEX, a well-known platform for trading cryptocurrency derivatives, for violating and conspiring to violate the BSA.²⁴¹ The unsealed indictment specifically charges the defendants with failure to maintain an adequate anti-money laundering program, as required by the BSA.²⁴² Such indictments are rare, and this also appears to be the first indictment to combine allegations involving the BSA, digital assets, and alleged futures commissions merchants.²⁴³

FinCEN's 2019 guidance clarified that mixers and tumblers of cryptocurrencies will also be treated as MSBs.²⁴⁴ In 2020, FinCEN took an enforcement action against Larry Dean Harmon, the founder of mixers Helix and Coin Ninja, resulting in a \$60 million civil penalty.²⁴⁵ FinCEN alleged that Harmon violated the BSA by failing to register his companies as MSBs, to implement and maintain an anti-money laundering program,

²³⁹ *Id.* at 2, 4, 7-8.

²⁴⁰ BRUMMER, *supra* note 176, at 418.

²⁴¹ *Founders and Executives of Off-Shore Cryptocurrency Derivatives Exchange Charged with Violation of The Bank Secrecy Act*, U.S. DEP'T OF JUSTICE (Oct. 1, 2020), <https://www.justice.gov/usao-sdny/pr/founders-and-executives-shore-cryptocurrency-derivatives-exchange-charged-violation>.

²⁴² Indictment at 8, *U.S. v. Arthur Hayes et al.*, No. 20 Cr. 500 (S.D.N.Y. Oct. 1, 2020), <https://www.justice.gov/usao-sdny/press-release/file/1323316/download>.

²⁴³ Peter Hardy et al., *CFTC and DOJ Charge BitMEX and Executives with Illegally Trading in Digital Assets and Ignoring BSA/AML Requirements*, JDSUPRA (Oct. 13, 2020), <https://www.jdsupra.com/legalnews/cftc-and-doj-charge-bitmex-and-58197/><https://www.jdsupra.com/legalnews/cftc-and-doj-charge-bitmex-and-58197/>.

²⁴⁴ 2019 FinCEN Guidance, *supra* note 29, at 16, 19.

²⁴⁵ Oct. 2020 FinCEN Press Release, *supra* note 237.

and to report suspicious activities.²⁴⁶ According to FinCEN, Harmon advertised Helix and Coin Ninja's services in the darkest spaces of the Internet as a way for customers to anonymously pay for things like drugs, guns, and child pornography.²⁴⁷ In addition, Harmon failed to collect and verify customer names, addresses, and other identifiers on over 1.2 million transactions.²⁴⁸

The application of the BSA to cryptocurrencies is not without gaps, however. While exchanges, administrators, mixers, and tumblers are treated as MSBs, users are not.²⁴⁹ Further, certain types of trading platforms and wallets also do not qualify as MSBs. If a trading platform provides a forum where buyers and sellers simply post their bids and offers, and the parties settle any matched transactions through an outside venue, the platform does not qualify as a MSB under FinCEN regulations.²⁵⁰ With respect to wallets, as long as a transaction through an unhosted wallet is for the purpose of purchasing goods or services for one's self, the wallet is not treated as an MSB.²⁵¹ Therefore, it is possible to conduct transactions through cryptocurrencies entirely outside the purview of FinCEN.

D. *As Property*

While the discontinuous history of the IRS goes as far back as Abraham Lincoln's presidency, the current form of the IRS states that its mission is to "[p]rovide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and

²⁴⁶ *Id.*

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ 2013 FinCEN Guidance, *supra* note 233, at 1-2 (defining a user as "a person that obtains virtual currency to purchase goods or services" on the user's own behalf).

²⁵⁰ 2019 FinCEN Guidance, *supra* note 29, at 24.

²⁵¹ *Id.* at 16 (defining unhosted wallets as "software hosted on a person's computer, phone, or other device that allow the person to store and conduct transactions" in a virtual currency without the participation of an additional third party).

fairness to all.”²⁵² As part of its enforcement duties, the IRS is responsible for the investigation of alleged violations of federal tax laws including tax fraud and evasion.²⁵³

In 2014, the IRS announced that it would treat virtual currencies as property under federal tax law.²⁵⁴ Thus, if an investor sells a cryptocurrency unit after holding it longer than a year, the profit is taxed at the long-term capital gain rate, which is lower than the tax rate on ordinary income.²⁵⁵ If the holding period is for a year or less, however, the profit is treated as a short-term capital gain and taxed at the same rate as ordinary income.²⁵⁶ According to the IRS, all sales and exchanges of cryptocurrencies are taxable transactions.²⁵⁷ These rules make using cryptocurrencies for payments burdensome for users and merchants.²⁵⁸

²⁵² *Brief History of the IRS*, INTERNAL REVENUE SERV., <https://www.jobs.irs.gov/about-us/who-irs#:~:text=Origin,was%20repealed%2010%20years%20later> (last visited Apr. 22, 2021).

²⁵³ *Law Enforcement and Investigations*, INTERNAL REVENUE SERV., <https://www.jobs.irs.gov/resources/job-descriptions/law-enforcement-and-investigation> (last visited Apr. 22, 2021).

²⁵⁴ I.R.S. Notice 2014-21, 2014-16 I.R.B 938 at 2 (Apr. 14, 2014), <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

²⁵⁵ *Topic No. 409 Capital Gains and Losses*, INTERNAL REVENUE SERV., <https://www.irs.gov/taxtopics/tc409> (last visited Apr. 22, 2021) (clarifying that an investor’s profits from selling virtual currency after holding it for more than one year are typically treated as long-term capital gains while profits from sale of virtual currency held for less than a year are short-term capitals gains taxable at higher ordinary income tax rates).

²⁵⁶ *Id.*

²⁵⁷ *See Frequently Asked Questions on Virtual Currencies*, INTERNAL REVENUE SERV., <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions> (last visited Oct. 10, 2021) (responding affirmatively that transactions involving sales of virtual currencies, paying for services with virtual currencies, or exchanging virtual currencies for goods or other property, including other virtual currencies, are subject to capital gains taxes).

²⁵⁸ Laura Saunders, *The IRS Is Coming for Crypto Investors Who Haven’t Paid Their Taxes*, WALL ST. J. (May 14, 2021, 5:30 AM), https://www.wsj.com/articles/Bitcoin-irs-comes-for-crypto-investors-who-havent-paid-their-taxes-11620937095?mod=hp_lead_pos13.

After the 2014 announcement, the IRS began launching cryptocurrency tax fraud investigations.²⁵⁹ In 2016, the IRS served a summons on Coinbase, the largest U.S.-based cryptocurrency exchange, seeking all records relating to transactions in virtual currency between 2013 and 2015.²⁶⁰ When Coinbase failed to comply, the IRS filed a petition to enforce the summons, to which Coinbase responded with a motion to quash the summons.²⁶¹ Ultimately, the district court ordered Coinbase to disclose information pertaining to accounts with at least \$20,000 in any one transaction (buy, sell, send, or receive) in any one year between 2013 and 2015.²⁶² Coinbase thereafter provided the IRS with information about more than 13,000 of its customers that is potentially useful for civil and criminal investigations.²⁶³ As a result, the IRS has reported that it has received “more than 1,000 amended tax returns and collected \$13 million from cryptocurrency holders.”²⁶⁴

The IRS’s concern is that cryptocurrencies are being used to shield both legal and illegal income from federal taxes.²⁶⁵ The agency recently estimated that unreported cryptocurrency tax liabilities total more than \$11 billion.²⁶⁶ In an attempt to close this gap, the IRS has undertaken a Virtual Currency Compliance Campaign.²⁶⁷ As part of this campaign, the IRS sent over 10,000 letters to taxpayers whom the IRS

²⁵⁹ Benjamin Tompkins, *United States v. Coinbase: Three Years Later*, AMER. BAR ASSOC. (Dec. 11, 2020), <https://www.americanbar.org/groups/litigation/committees/criminal/articles/2020/winter2021-united-states-v-coinbase-three-years-later/>.

²⁶⁰ *United States v. Coinbase, Inc.*, No. 17-cv-01431-JSC, 2017 WL 5890052, at *1 (N.D. Cal. Nov. 28, 2017).

²⁶¹ *Ex Parte* Petition for Leave to Serve “John Doe” Summons at 2, *United States v. Coinbase, Inc., et al.*, No. 3:16-cv-06658-JSC, Dkt. No. 2-4 (N.D. Cal. Nov. 17, 2016); *Coinbase, Inc.*, 2017 WL 5890052 at *1.

²⁶² *Coinbase, Inc.*, 2017 WL 5890052 at *8-*9.

²⁶³ Tompkins, *supra* note 259.

²⁶⁴ Saunders, *supra* note 258.

²⁶⁵ *Coinbase, Inc.*, 2017 WL 5890052 at *8.

²⁶⁶ INTERNAL REVENUE SERV., INFORMATION REPORTING ADVISORY COMMITTEE PUBLIC REPORT (Oct. 2018), <https://www.irs.gov/pub/irs-pdf/p5315.pdf>.

²⁶⁷ *IRS Announces the Identification and Selection of Five Large Business and International Compliance Campaigns*, INTERNAL REVENUE SERV. (July 2, 2018), <https://www.irs.gov/businesses/irs-lbi-compliance-campaigns-july-2-2018>.

suspected had not reported and paid taxes resulting from cryptocurrency transactions in 2019.²⁶⁸ The IRS also issued additional taxpayer guidance on the subject²⁶⁹ and added a question to the 2020 Form 1040 regarding cryptocurrencies.²⁷⁰ On August of 2020, the IRS sent out a new set of warning letters to taxpayers.²⁷¹

In 2021, the IRS has continued its pursuit to find tax evasion by targeting companies that facilitate movements of cryptocurrencies. In April, a federal court approved an IRS summons, which required Circle and its affiliates, including Poloniex, to submit their customer records to the agency.²⁷² The following month, another federal court approved an IRS summons for records to one of the largest cryptocurrency exchanges, Kraken.²⁷³ Like the Coinbase summons, the turnover applied to transactions greater than \$20,000 in any one year between 2016 and 2020.²⁷⁴ With this flurry of activity, the IRS seems poised to begin taking enforcement actions against

²⁶⁸ Press Release, Internal Revenue Serv., IRS Has Begun Sending Letters to Virtual Currency Owners Advising Them to Pay Back Taxes, File Amended Returns; Part of Agency's Larger Efforts, IR-2019-132 (July 26, 2019), <https://www.irs.gov/newsroom/irs-has-begun-sending-letters-to-virtual-currency-owners-advising-them-to-pay-back-taxes-file-amended-returns-part-of-agencys-larger-efforts>.

²⁶⁹ See Rev. Rul. 2019-24, 2019-44 I.R.B. 1004 (Oct. 19, 2020), <https://www.irs.gov/pub/irs-drop/rr-19-24.pdf> (reaffirming that virtual currencies are to be treated as property and clarifying as to when hard forks in virtual currencies result in taxable income).

²⁷⁰ Tompkins, *supra* note 259; but see *Frequently Asked Questions on Virtual Currency Transactions*, INTERNAL REVENUE SERV., <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions> (last visited Apr. 23, 2021) (clarifying that there is no need to answer that question affirmatively if a taxpayer merely bought cryptocurrency with fiat).

²⁷¹ Shehan Chandrasekera, *Crypto Users Are Receiving IRS Tax Warning Letters, Again*, FORBES (Aug. 25, 2020, 5:22 PM), <https://www.forbes.com/sites/shehanchandrasekera/2020/08/25/crypto-tax-warning-letters-2020/#142adf1517f7>.

²⁷² Saunders, *supra* note 258.

²⁷³ *Id.*

²⁷⁴ *Id.*

taxpayers who have failed to properly report their virtual currency transactions.²⁷⁵

III. THE PROPOSAL: GIVING *HOWEY* THE BOOT + ADDRESSING REGULATORY GAPS

Although tycoons and economists alike have railed against them,²⁷⁶ cryptocurrencies are likely to remain a key part of the financial ecosystem for the foreseeable future.²⁷⁷ As such, market participants need clear legal frameworks to guide their interactions with cryptocurrencies, and regulators need adequate authority to protect investors and prevent illicit uses. This Part suggests statutory amendments that would allow for the continued evolution of cryptocurrencies and would fill current regulatory gaps in order to address the legitimate concerns relating to cryptocurrencies identified in this Article.²⁷⁸

Admittedly, key components of the foregoing proposal involve tightening the regulation of cryptocurrency markets

²⁷⁵ John Carney et al., *DOJ and IRS May Soon Begin Enforcement Actions Against Virtual Currency Tax Fraudsters*, JD SUPRA (Oct. 23, 2020), <https://www.jdsupra.com/legalnews/doj-and-irs-may-soon-begin-enforcement-51885/>.

²⁷⁶ See, e.g., Tae Kim, *Warren Buffett Says Bitcoin Is 'Probably Rat Poison Squared'*, CNBC (updated May 6, 2018, 10:48 AM), <https://www.cnbc.com/2018/05/05/warren-buffett-says-Bitcoin-is-probably-rat-poison-squared.html>; Fred Imbert, *JPMorgan CEO Jamie Dimon Says Bitcoin is a 'Fraud' that Will Eventually Blow Up*, CNBC (updated Sep. 12, 2017, 4:39 PM), <https://www.cnbc.com/2017/09/12/jpmorgan-ceo-jamie-dimon-raises-flag-on-trading-revenue-sees-20-percent-fall-for-the-third-quarter.html>; Kate Rooney, *Bitcoin Is the 'Mother of All Scams' and Blockchain Is Most Hyped Tech Ever, Roubini Tells Congress*, CNBC (updated Oct. 12, 2018, 3:09 PM), <https://www.cnbc.com/2018/10/11/roubini-Bitcoin-is-mother-of-all-scams.html>.

²⁷⁷ See generally ESWAR S. PRASAD, *THE FUTURE OF MONEY: HOW THE DIGITAL REVOLUTION IS TRANSFORMING CURRENCIES AND FINANCE* (Harvard Univ. Press 2021) (predicting the end of physical cash spurred by the emergence and continued evolution of cryptocurrencies).

²⁷⁸ Other scholars have argued that cryptocurrencies are sufficiently distinct so as to justify new, tailored regulation that is substantively different from general financial law. See, e.g., William Magnuson, *Financial Regulation in the Bitcoin Era*, 23 STAN. J. L. BUS. & FIN. 159, 188 (2018) (proposing guiding principles for a new “law of fintech.”).

where necessary. While some have raised concerns that such tightening could chill the market,²⁷⁹ a recent study by Professors Brian D. Feinstein and Kevin Werbach casts doubt on these concerns.²⁸⁰ The study examined the effects of major government actions across several jurisdictions on 56 cryptocurrency exchanges.²⁸¹ Perhaps counterintuitively, Feinstein and Werbach concluded that the recent increase in regulatory activity did not hamper market activity.²⁸² While the study did not foreclose the possibility that regulation could have some chilling effects, their findings suggest that such effects should not be the foremost concern when considering the regulation of cryptocurrency.²⁸³

A. *Expressly stating that cryptocurrencies are not securities and thus not subject to oversight by the SEC*

To discontinue the SEC's *ad hoc* approach to regulating cryptocurrencies, Congress should act to declare expressly that all cryptocurrencies, outside of the ICO context, are not securities. Currently, by applying the *Howey* test, the SEC determines whether a digital asset is an "investment contract" that thus falls under the definition of a "security" under the Securities Act of 1933.²⁸⁴ Under the test, an "investment

²⁷⁹ See, e.g., Andrew Griffin, *Bitcoin Price Recovers After Crash, but Threat of New Regulation Looms Over Cryptocurrencies*, THE INDEPENDENT (Jan. 18, 2018, 5:32 PM) (stating that several potential new international regulatory announcements could "shove the [bitcoin] price down even further"); Vincent Figueras, *Bitcoin Price Suffers Biggest Plunge in December: What Happened?*, INT'L BUS. TIMES (Dec. 22, 2020), <https://www.ibtimes.com/bitcoin-price-suffers-biggest-plunge-december-what-happened-3107423> (attributing a significant drop in the price of Bitcoin to the announcement of proposed rules requiring cryptocurrency service providers to obtain beneficial ownership information from unhosted software wallets).

²⁸⁰ Brian D. Feinstein & Kevin Werbach, *The Impact of Cryptocurrency Regulation on Trading Markets*, 7 J. FIN. REG. (2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3649475.

²⁸¹ *Id.*

²⁸² *Id.* at 56.

²⁸³ *Id.* at 59.

²⁸⁴ Sec. & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 298-299 (1946).

contract” is an investment of money in a common enterprise that an investor makes with a reasonable expectation of profit based on the efforts of others.²⁸⁵

Thus far, the SEC has applied the *Howey* test to established cryptocurrencies with mixed results.²⁸⁶ In December of 2020, SEC determined that the sale of XRP was an investment contract and thus a security subject to registration requirements and SEC oversight.²⁸⁷ In its lawsuit against Ripple Labs and two of its executives, the SEC sought injunctive relief, disgorgement, and civil penalties based on the allegation that Ripple Labs had sold \$1.38 billion of unregistered securities, XRP.²⁸⁸ This action surprised many market participants as it came after the SEC had acknowledged that neither Bitcoin nor Ether were securities under the *Howey* test.²⁸⁹

The *Howey* test is problematic in the context of cryptocurrencies. If the test is consistently applied, all cryptocurrencies would likely qualify as an investment contract in their early stages. When William Hinman of the SEC focused on the decentralized nature of Bitcoin’s network in determining that Bitcoin is not an investment contract,²⁹⁰ he overlooked the fact that Bitcoin was initially launched by the central figure Satoshi Nakamoto.²⁹¹ A cryptocurrency cannot exist without a “common enterprise” or central figure to initially develop and issue the currency.

If the SEC had applied the *Howey* test consistently, Ether would have been deemed a security as well. Hinman admitted that he was “putting aside the fundraising that accompanied the creation of Ether” when he determined that the “current offers and sales of Ether are not securities transactions.”²⁹² This is inconsistent with the approach the SEC took in its enforcement

²⁸⁵ *Id.*

²⁸⁶ *See supra* text accompanying notes 172-87.

²⁸⁷ Complaint, *supra* note 1, at 36-55.

²⁸⁸ *Id.* at 1-2.

²⁸⁹ Hinman, *supra* note 15.

²⁹⁰ *Id.*

²⁹¹ *See supra* note 16 and accompanying text (describing Satoshi Nakamoto’s role in the creation of bitcoin).

²⁹² Hinman, *supra* note 15.

action against Ripple. With Ripple, the SEC looked back to the initial launch of XRP to determine that XRP was a security.²⁹³ The SEC alleged that Ripple had begun making unregistered offers and sales of XRP for fiat and other cryptocurrencies in August of 2013.²⁹⁴

Professor Shlomit Azgad-Tromer has also questioned the fitness of applying key components of the *Howey* test to cryptocurrencies.²⁹⁵ She argues that hinging the determination on purchasers' motivation unnecessarily increases regulatory uncertainty looming over the industry, as purchaser motivation is rarely free of profit aspirations.²⁹⁶ Based on recent market trends,²⁹⁷ a purchaser of a cryptocurrency could reasonably expect that the value of the asset might rise without any effort on the investor's part. As Azgad-Tromer also notes, investors have no choice but to rely on a global community with respect to their cryptocurrency investments.²⁹⁸

As the disparity in the treatment of Bitcoin, Ether, and XRP exemplifies, the subjective nature of the *Howey* test leads to inconsistent enforcement for market participants. In the words of Ripple Labs, the SEC's application of the test to cryptocurrency allows the SEC to choose "virtual currency winners and losers."²⁹⁹ Some commentators have also noted the irony in the SEC's claim that Ripple should have known that XRP was a security when the agency itself did not reach this conclusion until December of 2020.³⁰⁰ Although Ripple has

²⁹³ Complaint, *supra* note 1, at 13.

²⁹⁴ *Id.*

²⁹⁵ Shlomit Azgad-Tromer, *Crypto Securities: On the Risks of Investments in Blockchain-Based Assets and the Dilemmas of Securities Regulation*, 68 AM. U. L. REV. 69, 74–75 (2018).

²⁹⁶ *Id.*

²⁹⁷ Lahart, *supra* note 8.

²⁹⁸ Azgad-Tromer, *supra* note 295, at 74–75.

²⁹⁹ Answer, *supra* note 5, at 3.

³⁰⁰ Roslyn Layton, *In the Ripple Case, The SEC Is Now on Trial – And Knows It*, FORBES (Apr. 8, 2021), <https://www.forbes.com/sites/roslynlayton/2021/04/08/in-the-ripple-case-the-sec-is-now-on-trial--and-knows-it/?sh=4c5fb6c44bd6>; *see also* Complaint, *supra* note 1, at 64 ("Garlinghouse knew or recklessly disregarded that Ripple's offers and sales of XRP were part of the offer and sale of an investment contract and thus a security.").

benefitted from some favorable rulings to date, the ultimate outcome of the litigation is uncertain.³⁰¹

While the markets have more than recovered from their initial reaction to the lawsuit, industry participants continue to seek clarity.³⁰² To that end, SEC Commissioner Hester Peirce has proposed a “safe harbor” that would allow digital currency issuers to avoid registering with the SEC during a three-year development period.³⁰³ Although her proposed approach represents an improvement to the current *ad hoc* approach taken by the SEC, it still leaves open the possibility that a cryptocurrency could be called a security should it fail to decentralize within the set timeframe. As discussed in the next section, a better approach would be for Congress to state expressly that cryptocurrencies are not securities and to establish a clear framework for determining which digital assets qualify as a cryptocurrency.

B. Including a clear framework to distinguish a cryptocurrency launch from an ICO

*I believe every ICO I’ve seen is a security.*³⁰⁴

An ICO is a form of financing in which an enterprise seeks to raise capital by selling a digital asset.³⁰⁵ Some companies have attempted to use the ICO structure as a means to raise capital without registering with the SEC.³⁰⁶ Cryptocurrencies, by contrast, are virtual currencies that are

³⁰¹ See *The SEC’s Cryptocurrency Confusion*, *supra* note 20 (reporting that the judge granted Ripple access to the SEC’s discussions regarding Bitcoin and Ether and has indicated that Ripple has “utility.”).

³⁰² *Id.*

³⁰³ Peirce, *supra* note 12; see Hester M. Peirce, Commissioner, Sec. Exch. & Comm’n, *Token Safe Harbor 2.0* (Apr. 13, 2021), https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06#_ftnref5 for an update of the proposal.

³⁰⁴ Testimony of Jim Clayton, Chairman, Sec. Exchange Comm’n, *supra* note 189, at 32:10.

³⁰⁵ See Fonté & al-Taie, *supra* note 37, for a description of ICOs.

³⁰⁶ Press Release, Sec. & Exch. Comm’n, *SEC Halts Alleged \$1.7 Billion Unregistered Digital Token Offering* (Oct. 11, 2019), <https://www.sec.gov/news/press-release/2019-212>.

intended to be used as a form of payment in place of a government-backed currency.³⁰⁷ To prevent businesses from funding their enterprise with the sale of digital assets under the guise of launching a new cryptocurrency, clear standards should be developed to separate true cryptocurrency launches from ICOs.

To qualify their product as a true cryptocurrency that is thus not subject to securities law, the developers' initial publicly available white paper should include 1) detailed plans for decentralizing the cryptocurrency within a predetermined timeframe, 2) a description of how the cryptocurrency is to be used for payments in general commerce, and 3) a description of how the funds from the initial sale are to be used. This information would establish that the purpose of the launch is not to fund the issuer's enterprise but rather to develop a currency for use outside of the launchers' ecosystem.

Periodically and at the end of the three-year period, the developers should be required to post public reports that demonstrate that the revenue generated from the issuance of the cryptocurrency was used solely to fund the development of the decentralized network. Aside from reasonable fees earned, the developers would not be able retain any of the cryptocurrency units but rather would have to create a process for mining future units. Following these steps would provide a safe harbor for developers who are looking to launch a truly decentralized currency. At the same time, those who seek to fund their enterprise by selling tokens could still do so but would still be subject to securities regulation.

As mentioned above, SEC Commissioner Hester Peirce has put forth a similar safe harbor proposal that would allow network developers a three-year grace period to develop a functional decentralized network exempted from the registration provisions of the federal securities laws.³⁰⁸ Although similar, this proposal differs in several key respects. First, Peirce's safe harbor is conditioned upon the developers undertaking "good

³⁰⁷ Fonté & al-Taie, *supra* note 37.

³⁰⁸ Peirce, *supra* note 12.

faith and reasonable efforts to create liquidity for users.”³⁰⁹ The problem with this condition is that it requires developers to focus on the secondary market as opposed to facilitating the use of the cryptocurrency for payments, which should distinguish a cryptocurrency from a speculative investment.

Lastly, and perhaps most importantly, Peirce’s safe harbor merely provides an exemption from registration. The developers would still be required to file reports with the SEC and would be subject to the SEC’s oversight regarding anti-fraud enforcement. This Article proposes that the primary oversight of the cryptocurrency markets should lie with the CFTC rather than the SEC for the reasons outlined in the next section.

C. *Extending the CFTC’s full regulatory authority to the cryptocurrency spot markets*

To adequately address the growing problems of fraud and manipulation discussed in Part I, the CFTC’s full regulatory oversight should be expanded to the cryptocurrency spot markets. Currently, the CFTC has jurisdiction over cryptocurrency-derivative markets, but it does not oversee the “spot” or cash markets, except with respect to *ex post facto* fraud or manipulation enforcement actions.³¹⁰ Such an extension of the CFTC’s regulatory authority to the cryptocurrency spot markets would require an amendment of the CEA.³¹¹

In 2015, the CFTC determined that cryptocurrencies, such as Bitcoin, are commodities.³¹² As written, the CEA gives the CFTC authority to regulate certain derivatives of commodities and leveraged transactions involving commodities.³¹³ For these transactions, the CFTC requires registration, surveillance and monitoring, transaction reporting, compliance with personnel conduct standards, customer

³⁰⁹ *Id.*

³¹⁰ Lee Reiners, *Bitcoin Futures: From Self-Certification to Systemic Risk*, 23 N.C. BANKING INST. 61, 61-62 (2019).

³¹¹ Testimony of J. Christopher Giancarlo, Chairman, Commodity Futures Trading Comm’n, *supra* note 26.

³¹² *In re Coinflip, Inc.*, CFTC No. 15-29, at 3 (Sept. 17, 2015).

³¹³ 7 U.S.C. § 2(a)(1)(A).

education, capital adequacy, trading system safeguards, cyber security examinations, and other requirements.³¹⁴

The CEA does not, however, provide the CFTC with the authority to regulate commodity spot markets in the same way.³¹⁵ The CFTC's authority over spot markets is limited to anti-fraud and anti-manipulation enforcement.³¹⁶ With this, the CFTC can investigate and, as appropriate, conduct civil enforcement action against fraud and manipulation in underlying commodity spot markets.³¹⁷ The problem is that such *ex post facto* enforcement is insufficient to address the expanding fraud and manipulation occurring in cryptocurrency markets.³¹⁸

To adequately prevent fraud and manipulation, the CFTC needs access to the data that would be provided by registered markets.³¹⁹ The CFTC requires any market that seeks to provide trading of futures, options, or swaps of commodities to register with the CFTC.³²⁰ By requiring all trading to be conducted on these registered venues, the CFTC can exercise critical authority over derivatives products.³²¹ If the CFTC was granted the same authority over cryptocurrency spot markets, then the markets that allow trading of cryptocurrencies would be required to register as well. Like other registered markets, they would have to comply with the Core Principles that require specified financial resources, surveillance, and operational and

³¹⁴ Testimony of J. Christopher Giancarlo, Chairman, Commodity Futures Trading Comm'n, *supra* note 26.

³¹⁵ *Id.*

³¹⁶ *Id.*

³¹⁷ *Id.*

³¹⁸ *See id.* (comparing the CFTC's full authority over virtual currency derivatives markets to its narrower enforcement authority over virtual currency spot markets).

³¹⁹ Reiners, *supra* note 310, at 75 (stating that the CFTC's visibility into spot markets is limited).

³²⁰ 7 U.S.C. §§ 7, 7b-3; *Designated Contract Markets (DCMs)*, COMMODITY FUTURES TRADING COMM'N, <https://www.cftc.gov/IndustryOversight/TradingOrganizations/DCMs/index.htm> (last visited Oct. 2, 2021); *Swaps Execution Facilities (SEFs)*, COMMODITY FUTURES TRADING COMM'N, <https://www.cftc.gov/IndustryOversight/TradingOrganizations/SEF2/index.htm> (last visited Oct. 2, 2021).

³²¹ BRUMMER, *supra* note 176, at 193.

system safeguards, as well as trading and product requirements.³²²

Further, relative to the SEC, the CFTC is better positioned to be the primary regulator of cryptocurrency markets. First, the CFTC determined early on that all cryptocurrencies are commodities.³²³ This clear-cut approach differs from the SEC's determination that some cryptocurrencies are securities (*e.g.*, XRP) and some are not (*e.g.*, Bitcoin and Ether). The CFTC's approach has provided market participants with much-needed clarity. This agency is thus better poised to regulate the entire cryptocurrency market as opposed to merely the portion of the market that is deemed a security.

Second, since the CFTC determined that cryptocurrencies were commodities, the agency has worked to gain expertise on the subject. It has formed an internal virtual currency enforcement task force to garner and deploy relevant expertise in this evolving asset class.³²⁴ The CFTC has been hiring to expand its knowledge of cryptocurrencies as well. In 2019, the CFTC hired Dorothy DeWitt as the Director of the Division of Market Oversight.³²⁵ DeWitt had previously been with Coinbase, where she had served as vice president and general counsel for the business lines and markets.³²⁶

Although President Biden's nominee for the chair of the CFTC has yet to be confirmed, the most recent chairman

³²² 7 U.S.C. § 7(d).

³²³ COMMODITY FUTURES TRADING COMM'N, CFTC BACKGROUNDER ON OVERSIGHT OF AND APPROACH TO VIRTUAL CURRENCY FUTURES MARKETS 4 (Jan. 4, 2018) [hereinafter CFTC BACKGROUNDER ON VIRTUAL CURRENCY OVERSIGHT], https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf.

³²⁴ *Id.*; see also *LabCFTC Overview*, COMMODITY FUTURES TRADING COMM'N, <https://www.cftc.gov/LabCFTC/Overview/index.htm> (last visited June 23, 2021) (overviewing the CFTC's recent launch of LabCFTC which was established to foster responsible innovation in financial markets and areas including financial technology, cryptocurrency, and blockchain).

³²⁵ *Dorothy D. DeWitt*, COMMODITY FUTURES TRADING COMM'N, <https://www.cftc.gov/About/ExecutiveLeadership/DorothyDDeWitt/index.htm> (last visited May 20, 2021).

³²⁶ *Id.*

advocated for a “do no harm” approach to crypto regulation.³²⁷ Chairman J. Christopher Giancarlo indicated that “U.S. and foreign regulators must coordinate ... [DLT oversight] ... to provide the flexibility, certainty and harmonization necessary for this technology to flourish.”³²⁸ While it remains to be seen how the CFTC will operate under its newly appointed chair, the agency could remain consistent by adopting this same “do no harm” viewpoint.³²⁹

One expectation is that the new chair will place a significant emphasis on climate change.³³⁰ The Market Risk Advisory Committee, an advisory group to the CFTC, predicted in 2020 that “climate related disasters... could have severe consequences for the markets they serve, including paralysis.”³³¹ In addition to other climate-related measures, the group called for regulators, including the CFTC, to establish labs or sandboxes to enhance financial products and services that directly integrate climate risk into new or existing instruments.³³² If the CFTC were to adopt the measures proposed by the advisory group as the primary regulator of

³²⁷ J. Christopher Giancarlo, Chairman, Commodity Futures Trading Comm’n, Special Address Before the Depository Trust & Clearing Corporation 2016 Blockchain Symposium (Mar. 29, 2016), <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-13>.

³²⁸ *Id.*

³²⁹ The CFTC’s recently confirmed Chairman, Rostin Behnam, might be expected to follow the “do no harm” approach. For example, he previously indicated that “regulators must approach FinTech with an open mind and a healthy respect for our role in the markets.” Rostin Behnam, Comm’r, Commodity Futures Trading Comm’n, Remarks at the 2018 ISDA Annual Japan Conference (Oct. 26, 2018), <https://www.cftc.gov/PressRoom/SpeechesTestimony/opabeznam11>.

³³⁰ Interview with Josh Sterling, Former Director, Market Participants Division, Commodity Futures Trading Comm’n, Jones Day Talks (March 2021), <https://www.jonesday.com/en/insights/2021/03/jones-day-talks-the-biden-administration-and-the-cftc-are-changes-coming>.

³³¹ COMMODITY FUTURES TRADING COMM’N, MANAGING CLIMATE RISKS IN THE U.S. FINANCIAL SYSTEM 30 (2020), <https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf>.

³³² *Id.* at ix.

cryptocurrency markets, it could influence the development of more eco-friendly cryptocurrencies.³³³

D. Eliminating self-certification as an option for cryptocurrency derivatives

The Commodity Futures Modernization Act of 2000 has been interpreted as granting futures exchanges the authority to self-certify new products as an extension of the exchanges' authority as self-regulatory organizations.³³⁴ An exchange is permitted to list new products one business day following self-certification.³³⁵ For a self-certified product, the CFTC has limited grounds for delaying a new contract listing and only has the ability to do so when the product presents "novel or complex issues that require additional time to analyze, an inadequate explanation by the submitting registered entity, or a potential inconsistency" with the CEA or CFTC regulation.³³⁶ The burden of proof rests with the CFTC if it chooses to prevent an exchange from self-certifying a new product.³³⁷

In December of 2017, the Chicago Mercantile Exchange Inc. (CME) and the CBOE Futures Exchange (CFE) self-certified the first contracts for Bitcoin futures products at the same time that the Cantor Exchange self-certified a new contract

³³³ See Jacob Huston, *The Energy Consumption of Bitcoin Mining and Potential for Regulation*, 11 GEO. WASH. J. ENERGY & ENV'T. L. 32, 34-35 (2020), for a discussion of the alarming amount of energy consumed by and carbon emitted from Bitcoin mining,

³³⁴ BRUMMER, *supra* note 176, at 194-95. Prior to listing the new contracts, these exchanges are required either to certify that the contract complied with the CEA and CFTC regulations or to submit the contracts for CFTC approval. COMMODITY FUTURES TRADING COMM'N, CFTC BACKGROUNDER ON SELF-CERTIFIED CONTRACTS FOR BITCOIN PRODUCTS 1 (Dec. 1, 2017) [hereinafter CFTC BACKGROUNDER ON SELF-CERTIFIED CONTRACTS], https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/bitcoin_factsheet120117.pdf.

³³⁵ CFTC BACKGROUNDER ON SELF-CERTIFIED CONTRACTS, *supra* note 334, at 1.

³³⁶ Reiners, *supra* note 310, at 71 (citing 7 U.S.C. § 7(a)(2)).

³³⁷ *Id.* at 89.

for Bitcoin binary options.³³⁸ In this instance, CME, CFE, and Cantor voluntarily provided the CFTC with advanced draft contract terms and conditions of their contracts.³³⁹ The CFTC engaged with both exchanges in the period leading up to the self-certifications in a process it later referred to as a “heightened review.”³⁴⁰ The heightened review required the exchanges to enter into information-sharing agreements with spot market platforms and to share the collected data with the CFTC.³⁴¹ The CFTC’s expectation was that by requiring the information-sharing agreements, the agency would have greater visibility into the Bitcoin spot market.³⁴²

One problem, however, is that the exchanges that share information with CME and CFE are a fraction of the overall trading of Bitcoin in the spot markets, and thus, the CFTC’s ability to review these markets remains limited.³⁴³ Another problem is that the “heightened review” may be entirely without a statutory basis.³⁴⁴ While the CFTC stated that it had reviewed the draft contracts, it also acknowledged that it had limited ability to require the exchanges to make changes to their contracts.³⁴⁵ The very day that the contracts were certified, the CFTC expressed concerns regarding “the relatively nascent

³³⁸ Press Release, Commodity Futures Trading Comm’n, CFTC Statement on Self-Certification of Bitcoin Products by CME, CFE and Cantor Exchange (Dec. 1, 2017) [hereinafter CFTC Statement on Self-Certification of Bitcoin Products], <https://www.cftc.gov/PressRoom/PressReleases/7654-17>.

³³⁹ CFTC BACKGROUNDER ON SELF-CERTIFIED CONTRACTS, *supra* note 334, at 1.

³⁴⁰ CFTC BACKGROUNDER ON VIRTUAL CURRENCY OVERSIGHT, *supra* note 323, at 1.

³⁴¹ *Id.* at 3.

³⁴² Reiners, *supra* note 310, at 75.

³⁴³ *Id.*

³⁴⁴ *Id.* at 74. *See also* Rostin Behnam, Comm’r, Commodity Futures Trading Comm’n, Opening Statement before the Market Risk Advisory Committee (Jan. 31, 2018), <https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement013118> (“the implementation of the ‘heightened review’ process is a new regulatory approach in and of itself. Such changes require a more formal process, subject to Commission deliberation and public notice and comment.”).

³⁴⁵ CFTC BACKGROUNDER ON SELF-CERTIFIED CONTRACTS, *supra* note 334, at 1.

underlying cash markets” for cryptocurrencies in that they “remain largely unregulated markets.”³⁴⁶ Further, CME, CFE, and Cantor could have simply self-certified the products and listed them the next day to avoid the heightened review.

A solution to some of these issues is to eliminate the self-certification option for new derivatives of cryptocurrencies by statute. Notably, the CFTC did have the ability to review, and disapprove of, contract market rules relating to “terms and conditions of sale” from 1968 to 2000.³⁴⁷ The self-certification process is flawed as it allows little opportunity for the CFTC to prevent a contract from listing even if it potentially violates one or more of the CFTC’s Core Principles.³⁴⁸ With such cases having a mere one-day waiting period, the CFTC has insufficient time to review the contracts. As part of the comprehensive cryptocurrency legislation proposed in this Article, Congress should grant the CFTC the right to review, and disapprove of, contract market rules relating to terms and conditions of sale with respect to cryptocurrency derivatives.

E. Expressly requiring all cryptocurrency exchange providers to register with FinCEN as MSBs and all MSBs to report transactions involving any wallet

With respect to cryptocurrency exchanges, the application of anti-money laundering laws and regulations currently depends upon two factors: 1) the degree to which the platform acts as an intermediary between buyers and seller and 2) whether the platform maintains custody of the users’ digital

³⁴⁶ CFTC Statement on Self-Certification of Bitcoin Products, *supra* note 338. “[E]arly experience indicates that Bitcoin futures serve primarily as a means to speculate on the price of Bitcoin and not as a true hedging instrument.” Further, Bitcoin futures contracts may incentivize manipulative behavior in a spot market that is already ripe with manipulation. Reiners, *supra* note 310, at 64, 75.

³⁴⁷ Reiners, *supra* note 310, at 70.

³⁴⁸ *Id.* at 76-77. As Reiners argues, CME and CFE should not have qualified for self-certification in part because the CFTC’s Core Principles only allow listing of contracts that are not readily susceptible to manipulation.

assets.³⁴⁹ Under FinCEN’s 2019 guidance, if an exchange provides a forum where buyers and sellers simply post their bids and offers and the parties settle any matched transactions through an outside venue, the platform generally does not have to register as an MSB.³⁵⁰

As noted above, FinCEN guidance also distinguishes between “hosted” and “unhosted” cryptocurrency wallets.³⁵¹ According to FinCEN, hosted wallet providers receive, store, and transfer cryptocurrencies on behalf of accountholders, while unhosted wallets simply serve as software that enables users to hold cryptocurrency.³⁵² A hosted wallet provider is generally treated as an MSB, whereas a provider limiting its role to the creation of unhosted wallets that require the addition of a second authorization key to the wallet owner’s private key to complete transactions is not.³⁵³ Despite the existence of this distinction, however, the determination of whether a particular business must register as an MSB still depends upon the specific “facts and circumstances.”³⁵⁴

To address the illicit uses discussed in Part I.B., this Article proposes a statute that would require all cryptocurrency exchanges to register as MSBs and all MSBs to report transactions involving both hosted and unhosted wallets.³⁵⁵ The

³⁴⁹ 2019 FinCEN Guidance, *supra* note 29, at 24.

³⁵⁰ *Id.* (“[I]f a [convertible virtual currency] trading platform only provides a forum where buyers and sellers of [convertible virtual currency] post their bids and offers (with or without automatic matching of counterparties), and the parties themselves settle any matched transactions through an outside venue (either through individual wallets or other wallets not hosted by the trading platform), the trading platform does not qualify as a money transmitter under FinCEN regulations.”).

³⁵¹ *Id.* at 15-16; *see also supra* text accompanying notes 250-51.

³⁵² 2019 FinCEN Guidance, *supra* note 29, at 15.

³⁵³ *Id.* at 17. Further, as long as a transaction through an unhosted wallet is for the purpose of purchasing goods or services, the wallet is not treated as an MSB. *Id.* at 16 (defining unhosted wallets as “software hosted on a person’s computer, phone, or other device that allow the person to store and conduct transactions” in a virtual currency without the participation of an additional third party).

³⁵⁴ *Id.* at 1.

³⁵⁵ Note that this proposal is in line with the guidance by the Financial Action Task Force, the intergovernmental agency watchdog that establishes

problems with the current guidance are twofold. First, FinCEN currently allows so-called decentralized exchanges and certain unhosted wallets to continue to serve as a haven for users who seek to avoid anti-money laundering processes. As discussed in Part I, cryptocurrencies are often used to fund human trafficking and terrorism, neither of which can occur efficiently without some form of financial intermediary.³⁵⁶ Without a change to this policy, anti-money laundering processes can still be circumvented by transferring funds on a decentralized exchange or from one institution to an unhosted wallet and then from the unhosted wallet to the second institution.

To address this issue, FinCEN proposed rules in late 2020 that would require all MSBs to submit reports, keep records, and verify customers in connection with specific transactions involving unhosted wallets and “otherwise covered wallets.”³⁵⁷ Notably, the proposed rule would require MSBs to collect identity data not only about their own customers but also about noncustomers who transact with their customers using their own cryptocurrency wallets.³⁵⁸ The rule would require

anti-money laundering requirements. The guidance requires all businesses that transfer funds in the form of cryptocurrencies, including decentralized exchanges, to implement know-your-customer procedures. FIN. ACTION TASK FORCE, DRAFT UPDATED GUIDANCE FOR A RISK-BASED APPROACH TO VIRTUAL ASSETS AND VASPS (March 2021), <https://www.fatf-gafi.org/media/fatf/documents/recommendations/March%202021%20-%20VA%20Guidance%20update%20-%20Sixth%20draft%20-%20Public%20consultation.pdf>.

This change would also be consistent with the European Union directive mandating that cryptocurrency exchanges and custodian cryptowallet providers follow the same regulatory requirements as banks and other financial institutions. Directive 2018/843, of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the Prevention of the Use of the Financial System for the Purposes of Money Laundering or Terrorist Financing, and Amending Directives 2009/138/EC and 2013/36/EU, 2018 O.J. (L 156) 43, 43-74.

³⁵⁶ See CYNTHIA DION-SCHWARZ, DAVID MANHEIM, & PATRICK B. JOHNSTON, *TERRORIST USE OF CRYPTOCURRENCIES* 14-21 (2019), for a discussion of the use of cryptocurrencies to fund terrorism.

³⁵⁷ Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets, 85 Fed. Reg. 83840 (proposed Dec. 20, 2020) (to be codified at 30 C.F.R. 1010, 1020, 1022).

³⁵⁸ Ana Badour et al., *U.S. Proposes New Anti-Money Laundering Rule in Respect of Unhosted Virtual Currency Wallets*, LEXOLOGY (Jan. 13,

MSBs to collect and maintain such data on transactions above \$3,000 USD and to report the data for transactions over \$10,000 USD.³⁵⁹ Implementing this rule along with regulating all cryptocurrency exchanges as MSBs would capture the remaining avenues for significant money laundering, slowing down money transfers for trafficking and terrorist operations and potentially disrupting such activities.³⁶⁰

The second issue with the current FinCEN guidance is that it does not provide adequate certainty for market participants. With civil and criminal enforcement against more centralized exchanges, commenters speculate that decentralized exchanges will be next.³⁶¹ Although treating all exchanges including decentralized exchanges as MSBs would likely be met with resistance from many cryptocurrency market participants,³⁶² it would also provide a clean bright-line rule. The 2019 guidance leaves open the possibility that a particular business model could be deemed an MSB based on the specific “facts and circumstances.”³⁶³ The guidance also revealed that there are countless ways for individuals to transact in cryptocurrencies, which makes determining FinCEN’s scope of regulatory activity difficult.³⁶⁴

2021), <https://www.lexology.com/library/detail.aspx?g=e5607347-0252-42e9-a403-8ba03bc723a8>.

³⁵⁹ *Id.*

³⁶⁰ In their forthcoming paper, Hadar Y. Jabotinsky & Michal Lavi propose to require all users to register so that their identity can be unmasked upon a showing of probable cause. Hadar Y. Jabotinsky & Michal Lavi, *Speak Out: Verifying and Unmasking Cryptocurrency User Identity*, 32 *FORDHAM INTELL. PROP. MEDIA & ENT. L. J.* 6 (forthcoming).

³⁶¹ William Foxley, *Should DEXs Be Worried After BitMEX? DeFi Founders Weigh In*, COINDESK (updated Sept. 14, 2021, 6:03 AM), <https://www.coindesk.com/should-dexs-be-worried-after-bitmex-defi-founders-weigh-in>.

³⁶² *See, e.g.*, Electronic Frontier Foundation, Comments to the Financial Crimes Enforcement Network (FinCEN) on Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets (Jan. 4, 2021), <https://www.eff.org/document/2021-01-04-eff-comments-fincen> (responding with strong opposition to FinCEN’s proposed rules).

³⁶³ 2019 FinCEN Guidance, *supra* note 29, at 1.

³⁶⁴ Terence M. Grugan, *New FinCEN Cryptocurrency Guidance Provides Comprehensive Overview of BSA Application to Crypto Businesses*, BALLARD SPAHR (May 30, 2019), <https://www.moneylaunderingnews.com/2019/05/new-fincen->

F. Directing the IRS to tax cryptocurrencies according to their use and to recognize a de minimis exception for nominal gains

As noted in Part II.D., the IRS treats cryptocurrencies as property, and thus, every exchange or sale is considered a taxable event.³⁶⁵ Notably, the IRS does not even make an exception for small cryptocurrency gains.³⁶⁶ While this treatment might be logical for cryptocurrencies purchased as investments, it also makes their use as a currency or payment method unduly cumbersome. As others have argued, a more reasonable tax scheme would tax cryptocurrencies based on their use.³⁶⁷ Specifically, when a taxpayer acquires cryptocurrency for investment purposes, then the IRS should continue to classify the cryptocurrency as a property transaction such that capital treatment is available to the taxpayer.³⁶⁸ If the taxpayer exchanges the cryptocurrency, like money, to purchase goods or services, however, then the cryptocurrency should be treated as currency when the transaction occurs.³⁶⁹

In 2020, Congresswoman Susan K. DelBene proposed a bill that would have exempted any gain of \$200 or less from taxation.³⁷⁰ This legislation would subject cryptocurrencies to similar treatment as foreign currency holdings, for which the tax code only requires reporting of personal gains of \$200 or more.³⁷¹ Although the legislation failed, recognizing such a *de*

cryptocurrency-guidance-provides-comprehensive-overview-of-bsa-application-to-crypto-businesses/.

³⁶⁵ See *supra* notes 254-58 and accompanying text.

³⁶⁶ John E. Elmore, *Virtual Currency, Real Tax: Taxation and Valuation Issues Related to Emerging Digital Payment Systems*, EMERGING TREND INSIGHTS 60, 68 (2015).

³⁶⁷ Nevle, *supra* note 33 at *121; see also Sami Ahmed, *Cryptocurrency & Robots: How to Tax and Pay Tax on Them*, 69 S.C. L. REV. 697, 725 (2018).

³⁶⁸ Nevle, *supra* note 33, at *121.

³⁶⁹ *Id.*; see also Adam Chodorow, *Rethinking Basis in the Age of Virtual Currencies*, 36 VA. TAX REV. 371 (2017) (examining the concept of basis in taxation and how it should change to a system of “basis pooling” because the current system otherwise allows users to manipulate their taxes).

³⁷⁰ H.R. 5635, 116th Cong. (2020).

³⁷¹ 26 U.S.C. § 988(e)(2)(A)-(B).

minimis exception for cryptocurrencies would reduce compliance burdens and has the potential to increase overall tax compliance with respect to cryptocurrencies.³⁷²

IV. CONCLUSION

The future of the SEC's lawsuit against Ripple is uncertain.³⁷³ Given that Ripple has the resources and determination to take their case to the highest court, some suggest that the Supreme Court may take the opportunity to overturn the SEC's application of the *Howey* test to cryptocurrencies.³⁷⁴ While such an opinion could provide some regulatory certainty for market participants, it would not solve the regulatory gaps discussed in this Article.³⁷⁵ Cryptocurrency

³⁷² See Jason Clark & Margaret Ryznar, *Improving Bitcoin Tax Compliance*, 2019 U. ILL. L. REV. ONLINE 70, 73 (2019) (discussing the effects of a potential *de minimis* exception for cryptocurrency transactions); Kelly J. Winstead, *The North Carolina State Tax Treatment of Virtual Currency: An Unanswered Question*, 21 N.C. BANKING INST. 501, 533 (2017) (contending that a *de minimis* exception could have the effect of encouraging compliance for larger gains); *Crypto Tax and ICO Regulations in the United Kingdom*, CRYPTO DAILY (Aug. 31, 2018), <https://cryptodaily.co.uk/2018/08/crypto-tax-and-ico-regulations-in-the-united-kingdom> (explaining that the United Kingdom has adopted a *de minimis* exception, although its threshold is much higher); but see Amy Lee Rosen, *De Minimis Exception Could Hinder Crypto Tax Administration*, LAW360 (Nov. 19, 2019), <https://www.crowell.com/files/20191119-De-Minimis-Exception-Could-Hinder-Crypto-Tax-Administration.pdf> (raising the possibility that a *de minimis* exception could encourage cryptocurrency users to game the system and add to the IRS's administrative burden).

³⁷³ See Roslyn Layton, *The Crypto Uprising the SEC Didn't See Coming*, FORBES (Aug. 30, 2021, 11:24 AM), <https://www.forbes.com/sites/roslynlayton/2021/08/30/the-crypto-uprising-the-sec-didnt-see-coming/?sh=6879e769143e> (reporting on the public's backlash to the SEC's lawsuit against Ripple and that the discovery phase of the lawsuit is currently winding down).

³⁷⁴ *Id.* (quoting Jason Gottlieb, a white collar and regulatory enforcement attorney, as saying "only the U.S. Supreme Court can consider overturning *Howey* with respect to digital assets. And for the first time in an SEC crypto case, we have defendants who can make good on a promise to take the case to the highest court. They have the legal firepower, and the resources to pay for their very fine attorneys. Any District Court ruling may only be the first step in a longer fight.").

³⁷⁵ While comprehensive legislation would provide clarity and fill the gaps identified in this Article, much of the proposal, though not all, could

markets need regulatory clarity in the form of comprehensive legislation. To that end, this Article proposes legislation that would 1) declare that cryptocurrencies are not securities, 2) establish a framework for determining which digital assets are genuine cryptocurrencies, 3) extend the CFTC's full regulatory authority to cryptocurrency spot markets, 4) prohibit self-certification of cryptocurrency derivative products, 5) require all cryptocurrency exchanges to register with FinCEN as MSBs, and 6) tax cryptocurrencies according to their use and provide for a *de minimis* exception. Such measures would not only address gaps in the regulation of cryptocurrencies but would also provide much-needed certainty to market participants and allow cryptocurrencies to develop as a viable payment option.

be accomplished pursuant to each administrative agency's rulemaking authority.