Blockchain Law

The regulators rear their heads

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As FinTech innovation and products take more ambitious and creative forms, it seems regulators have become more ambitious and creative themselves, and no less determined to act. Robert A. Schwinger explores recent developments in this edition of his Blockchain Law column.

The days when there were just a few recurrent regulatory issues in the world of blockchain, cryptocurrency and decentralized finance (DeFi) may now be behind us. For the past few years, regulatory attention seemed to focus mainly on several recurrent issues such as whether a particular token or cryptocurrency was a "security" under federal law—with all the attendant legal requirements and restrictions such a designation carries with it for issuers, exchanges, and buyers and sellers—and the tax consequences of cryptocurrency transactions and payments, given the IRS position that for tax purposes cryptocurrency is property rather than currency. While those issues haven't gone away, recently regulators from a number of different federal, state and, indeed, international bodies have emerged forcefully to raise a host of new issues they find implicated by new developments. As FinTech innovation and products take more ambitious and creative forms, it seems regulators have become more ambitious and creative themselves, and no less determined to act.

Derivative instruments and the CTFC

On June 8, 2021, Commissioner Dan M. Berkovitz of the Commodity Futures Trading Commission (CFTC) gave a keynote address at the FIA and SIFMA-AMG, Asset Management Derivatives Forum 2021, in part to address his "concerns regarding the rise of decentralized financial markets." In his remarks, Commissioner Berkovitz argued that the financial system had "developed over the past two or three hundred years" to "rel[y] extensively on financial intermediaries … to reliably provide critical financial services to support the financial markets and the investing public." He pointed to intermediaries performing roles such as providing information to the public, being subject to "fiduciary or other legal duties to act in the best interests of their customers," providing liquidity and stability in times of stress, providing custody of assets, preventing money-laundering, operating through "established standards of conduct," and having legal responsibility and accountability when standards are not met or "things go wrong."

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By contrast, he cautioned:

> In a pure "peer-to-peer" DeFi system, none of these benefits or protections exist. There is no intermediary to monitor markets for fraud and manipulation, prevent money laundering, safeguard deposited funds, ensure counterparty performance, or make customers whole when processes fail. A system without intermediaries is a Hobbesian marketplace with each person looking out for themselves. Caveat emptor—"let the buyer beware."

He focused in particular on derivative instruments of various kinds that operate on blockchain-based systems or other DeFi platforms:

> Not only do I think that unlicensed DeFi markets for derivative instruments are a bad idea, I also do not see how they are legal under the [Commodity Exchange Act, 7 U.S.C. §7 et seq.]. The CEA requires futures contracts to be traded on a designated contract market (DCM) licensed and regulated by the CFTC [citing CEA §4(a), 7 U.S.C. §6]. The CEA also provides that it is unlawful for any person other than an eligible contract participant to enter into a swap unless the swap is entered into on, or subject to, the rules of a DCM [citing CEA §2(e), 7 U.S.C. §2(e)]. The CEA requires any facility that provides for the trading or processing of swaps to be registered as a DCM or a swap execution facility (SEF) [citing CEA §5h(a), 7 U.S.C. §7b-3].

The problem Commissioner Berkovitz identified is that "DeFi markets, platforms, or websites are not registered as DCMs or SEFs." He stated bluntly, "[t]he CEA does not contain any exception from registration for digital currencies, blockchains, or 'smart contracts.'" Moreover, he said, "[a]part from the legality issue, in my view it is untenable to allow an unregulated, unlicensed derivatives market to compete, side-by-side, with a fully regulated and licensed derivatives market."

He concluded that for these reasons, "we should not permit DeFi to become an unregulated shadow financial market in direct competition with regulated markets. The CFTC, together with other regulators, need to focus more attention to this growing area of concern and address regulatory violations appropriately."

Two months after Commissioner Berkovitz's speech, the CFTC took the very kind of action he had called for. In *CFTC v. HDR Global Trading Ltd*., No. 1:20-cv-08132 (S.D.N.Y. Aug. 10, 2021), the CFTC entered into a consent order with the companies operating the offshore cryptocurrency derivatives exchange BitMEX for permanent injunction, civil monetary penalty, and other equitable relief, relating to BitMEX's offering of leveraged trading of crypto-asset derivatives to U.S. customers allegedly without proper approval or registration.

The consent order described BitMEX as a "peer-to-peer 'crypto-products platform' that offers the trading of cryptocurrency derivatives, including derivatives on bitcoin, ether, and litecoin" and found that BitMEX "offered leveraged trading of cryptocurrency derivatives to retail … and institutional customers in the U.S. and throughout the world." These products included what was described as a "perpetual bitcoin U.S. dollar leveraged swap product" that the BitMEX website characterized as "a product similar to a traditional Futures Contract in how it trades." BitMEX, however, engaged in this trading "without registering with the CFTC as a designated contract market or a swap execution facility."

The Consent Order concluded that by this activity the defendants had committed numerous Commodity Exchange Act (CEA) violations. These included (1) engaging in "transactions involving commodities for future delivery on its platform that was not designated as a contract market" in violation of CEA §4(a), 7 U.S.C. §6(a); (2) engaging in "commodity option transaction[s] not in compliance with and subject to" the CEA and CFTC regulations thereunder, in violations of CEA §4c(b), 7 U.S.C. §6c(b), and Regulation 32.2, 17 C.F.R. §32.2; (3) failing to register as a futures commission merchant in violation of CEA §4d, 7 U.S.C. §6d; and (4) failing to register as a swap execution facility or designated contract market in violation of CEA §5h(a)(1), 7 U.S.C. §7b-3(1), and Regulation 37.3(a)(1), 17 C.F.R. §37.3(a)(1). The consent order imposed various permanent injunctions on the defendants as well as a civil monetary penalty of $100,000,000.

Derivative instruments, stablecoins and trading platforms at the SEC

On July 21, 2021, about six weeks after CFTC Commissioner Berkovitz's remarks, Securities and Exchange Commission (SEC) Chair Gary Gensler delivered prepared remarks before the American Bar Association Derivatives and Futures Law Committee Virtual Mid-Year Program. Right before the end of his remarks, he too lay down the gauntlet regarding tokens that act as a synthetic derivative asset by mimicking the value of some other asset (often by tracking the price of such assets using data oracles or some other automated methodology). SEC Chair Gensler stated:

> Before I conclude, I'd briefly like to discuss the intersection of security-based swaps and financial technology, including with respect to crypto assets. There are initiatives by a number of platforms to offer crypto tokens or other products that are priced off of the value of securities and operate like derivatives.
>
> Make no mistake: It doesn't matter whether it's a stock token, a stable value token backed by securities, or any other virtual product that provides synthetic exposure to underlying securities. These platforms—whether in the decentralized or centralized finance space—are implicated by the securities laws and must work within our securities regime.
>
> If these products are security-based swaps, the other rules I've mentioned earlier, such as the trade reporting rules, will apply to them. Then, any offer or sale to retail participants must be registered under the Securities Act of 1933 and effected on a national securities exchange.
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> We've brought some cases involving retail offerings of security-based swaps; unfortunately, there may be more.
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> We will continue to use all of the tools in our enforcement toolkit to ensure that investors are protected in cases like these.

SEC Chair Gensler spoke again a few weeks later on Aug. 3, 2021 at the Aspen Security Conference, and in his remarks reiterated his warning about crypto-based derivatives, stating:

> [T]here are initiatives by a number of platforms to offer crypto tokens or other products that are priced off of the value of securities and operate like derivatives.
>
> Make no mistake: It doesn't matter whether it's a stock token, a stable value token backed by securities, or any other virtual product that provides synthetic exposure to underlying securities. These products are subject to the securities laws and must work within our securities regime.

SEC Chair Gensler's remarks also addressed "stable value coins, which are crypto tokens pegged or linked to the value of fiat currencies." He noted that "stablecoins are embedded in crypto trading and lending platforms," asserting that in the prior month "nearly three-quarters of trading on all crypto trading platforms occurred between a stablecoin and some other token." He cautioned:

> Thus, the use of stablecoins on these platforms may facilitate those seeking to sidestep a host of public policy goals connected to our traditional banking and financial system: anti-money laundering, tax compliance, sanctions, and the like. This affects our national security, too.
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> Further, these stablecoins also may be securities and investment companies. To the extent they are, we will apply the full investor protections of the Investment Company Act and the other federal securities laws to these products.

Finally, SEC Chair Gensler sounded a note of warning about "crypto trading platforms, lending platforms, and other 'decentralized finance' (DeFi) platforms." Such platforms, he said "not only can implicate the securities laws; some platforms also can implicate the commodities laws and the banking laws."

He addressed some of the practical realities that such platforms present. Given the substantial number of tokens traded on most such platforms, "[w]hile each token's legal status depends on its own facts and circumstances, the probability is quite remote that, with 50 or 100 tokens, any given platform has zero securities." In addition, "while many overseas platforms state they don't allow U.S. investors, there are allegations that some unregulated foreign exchanges facilitate trading by U.S. traders who are using virtual private networks, or VPNs."

He thus warned:

> Make no mistake: To the extent that there are securities on these trading platforms, under our laws they have to register with the Commission unless they meet an exemption.
>
> Make no mistake: If a lending platform is offering securities, it also falls into SEC jurisdiction.

SEC Chair Gensler concluded his remarks with this clarion call:

> Right now, large parts of the field of crypto are sitting astride of—not operating within—regulatory frameworks that protect investors and consumers, guard against illicit activity, ensure for financial stability, and yes, protect national security.
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> Standing astride isn't a sustainable place to be. For those who want to encourage innovations in crypto, I'd like to note that financial innovations throughout history don't long thrive outside of our public policy frameworks.
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> … . If this field is going to continue, or reach any of its potential to be a catalyst for change, we better bring it into public policy frameworks.

International action on stock tokens sales

Stock token sales have attracted regulatory scrutiny in countries around the world, not just in the United States. A few days before SEC Chair Gensler's remarks about stock tokens at the ABA program, across the world the Hong Kong Securities and Futures Commission (SFC) made a similar pronouncement about trading in stock tokens. In its July 16, 2021 "Warning statement on unregulated virtual asset platforms," the SFC stated:

> Stock Tokens are virtual assets that are represented to be backed by different depository portfolios of underlying overseas listed stocks, with their prices closely tracking the performance of the respective stocks … .
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> In Hong Kong, Stock Tokens are likely to be "securities" under the Securities and Futures Ordinance (SFO) … . The SFC warns that where the Stock Tokens are "securities", marketing and/or distributing such tokens – whether in Hong Kong or targeting Hong Kong investors – constitute a "regulated activity" and require a licence from the SFC unless an applicable exemption applies.

Later that same day, according to the July 16, 2021 Wall Street Journal, "Binance Holdings Ltd., the world's largest cryptocurrency exchange operator, said it would stop offering digital tokens tied to stocks … after regulators in multiple countries raised concerns about the products."

Interest-earning crypto accounts

In contrast to selling complex synthetic derivative products or engaging in cross-jurisdictional lending in exotic DeFi applications, one might think that simply paying interest would not be enough to attract regulators' interest. But in orders from a series of state securities boards in July 2021, regulators took aim at cryptocurrency accounts that pay interest.

In late July 2021, the New Jersey Bureau of Securities issued a Summary Cease and Desist Order in *In re BlockFi* (July 20, 2021). The order found that BlockFi "generates revenue through cryptocurrency trading, lending, and borrowing, as well as engaging in propriety trading" and that it "has been, at least in part, funding its lending operations and proprietary trading through the sale of … cryptocurrency interest-earning accounts," which accounts it charged amounted to "unregistered securities." Specifically, the order recited that the company allows "investors" to deposit cryptocurrencies into accounts. The company then allegedly "pools these cryptocurrencies together to fund its lending operations and proprietary trading," in exchange for which "investors are promised an attractive interest rate that is paid monthly in cryptocurrency." The accounts, however, were not registered as securities or insured by the FDIC.

The order concluded that these accounts were "securities" as defined in N.J. Stat. Ann. §49:3-49(m) and thus "were and are required to be registered with the Bureau" pursuant to id. §49:3-60. The Bureau of Securities thus ordered the company to cease and desist from offering these accounts "to or from New Jersey unless the security is registered with the Bureau."

Two days later the Texas State Securities Board noticed a hearing for a similar cease-and-desist order against BlockFi, likewise claiming that BlockFi's cryptocurrency interest-earning accounts constituted the sale of unregistered securities. *Texas St. Sec. Bd. v. BlockFi*, Dkt. No. 312-21-2938 (Tex. St. Ofc. Admin. Hrgs. July 22, 2021).

Similar to the New Jersey proceeding, and hearkening to the elements of the "*Howey* test" for determining status of an investment as a "security", see *SEC v. Howey Co*., 328 U.S. 293, 298-301 (1946), the Texas Securities Board alleged that these accounts worked by having "[i]nvestors relinquish control over their cryptocurrencies," which are then "commingl[ed]" with "cryptocurrencies deposited by other investors," and that those cryptocurrencies were used for "investing … in the market, purchasing equities, and lending those cryptocurrencies to institutional and corporate borrowers," in return for promises "to pay lucrative interest rates in the future," including advertised returns that were "well in excess of the rates currently being offered for short-term, investment grade, fixed income securities or for bank savings accounts."

The Board thus alleged that these accounts constituted securities under the Texas Securities Act, Tex. Rev. Civ. Stat. Ann. arts. 581-1-581-45, but that the company was "not registered with the Texas State Securities Board to offer or sell securities in Texas, as required by Section 12 of the Securities Act, and the [accounts] are not registered or permitted for sale in Texas, as required by Section 7 of the Securities Act." The matter is now scheduled for a hearing in October 2021.

The Alabama Securities Commission issued a similar notice for a cease and desist hearing against BlockFi based on similar allegations in *In re BlockFi*, Admin. Order SC-2021-0006 (July 20, 2021).

The death of stablecoins?

This summer saw the publication of a provocative paper by a Yale School of Management professor and an attorney for the Board of Governors of the Federal Reserve System. Gorton, Gary B. and Zhang, Jeffery, Taming Wildcat Stablecoins (July 17, 2021), which argues that stablecoins need to be driven out of existence.

The authors of this paper argue that cryptocurrency is just a new version of an old phenomenon, "privately produced money." While the authors assert "[t]he goal of private money is to be accepted at par with no questions asked," they argue that "[t]his did not occur during the Free Banking Era in the United States—a period that most resembles the current world of stablecoins." They note that banks in that period "experienced panics, and their private monies made it very hard to transact because of fluctuating prices," and that banking reform (including the National Bank Act of 1863) and tax changes ultimately drove such private money out of existence.

"Based on lessons learned from history," the authors argue that "privately produced monies are not an effective medium of exchange because they are not always accepted at par and are subject to runs." In order to address what the authors assert are "systemic risks created by stablecoins," the authors advance various proposals "including regulating stablecoin issuers as banks," such as by "pass[ing] legislation that requires stablecoin issuers to become FDIC-insured banks or to run their business out of FDIC-insured banks," or by replacing private digital money with public digital money by issuing a central bank digital currency, and then "to tax competitors of that uniform national [digital] currency out of existence."

Hypothesizing that widespread use of stablecoins might bring a return of the problems of the Free Banking Era such as value fluctuation in private money, the authors conclude their paper with this caution: "If [stablecoins] succeed in differentiating themselves from fiat cryptocurrencies and become used as money, then they will likely trade at time-varying discounts as well. Policymakers have a couple of ways to address this development, and they better get going."

Conclusion

Regulators in their recent pronouncements have not disparaged the potential for benefits from innovations in financial technology. Nevertheless, they have taken the posture that the prospect of such benefits does not supersede the need, the existing legal authority or their official obligation to pursue the historic regulatory goals with which their offices have been charged. Regulators' recent pronouncements and actions show their determination to pursue policies such as investor protection, market stability, national security and the prevention and detection of financial crime, even if doing so may slow down or impede reaching new frontiers in cryptoassets, smart contracts, FinTech or DeFi applications that now exist or might be on the horizon.

It thus may be unrealistic for those who are enthusiastic about the potential for such financial innovation to think that regulators will be so captivated by the benefits such innovation might offer that they will put their various statutory mandates at risk in order to ease the way for such possible future benefits. Regulators surely cannot be expected to ignore the practical and political consequences of taking such an approach. Even if regulators face some criticism for how they have proceeded to date, it may well be that without clear legislative guidance directing them to proceed differently regulators will continue to prioritize their longstanding regulatory objectives over whatever potential future benefits it is claimed that greater FinTech innovation would unleash.