SURVIVING REGULATION **BY ENFORCEMENT**

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SURVIVING REGULATION BY ENFORCEMENT

By Renato Mariotti & Maggie DePoy

In the 16 years since Satoshi Nakamoto published the original Bitcoin whitepaper, U.S. regulators have failed to promulgate regulations to provide a clear legal framework for the burgeoning digital asset space. Congress has not stepped up to fill the gap. The result has been what many dub "regulation by enforcement" – lawsuits filed by the SEC and CFTC against industry participants for engaging in activity that is not clearly unlawful, leading to inconsistent, inefficient, and interminable litigation that has resulted in conflicting and confusing rulings that have stifled the growth of crypto in the United States. Other countries have tried to seize upon this opportunity, providing the clear framework that the U.S. has thus far failed to provide. For example, the UK has taken a proactive approach to regulating crypto, vowing "to make the UK a global hub for cryptoasset technology and investment." While progress has been made in the U.S., with the House recently passing the Financial Innovation and Technology for the 21st Century Act, the bill is unlikely to become a law this year and the prospect of a legislative solution still appears to be at least two years away. In the meantime, industry participants have several means to mitigate the risks imposed by the U.S. "regulation by enforcement" approach until a regulatory framework is adopted. This article provides an analysis of the costs and risks imposed by "regulation by enforcement" and offers industry participants practical advice regarding how best to position themselves to reduce their risk in the short term.

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INTRODUCTION

Digital assets are both "new" and "not new" at the same time. Until the publication of Satoshi Nakamoto's original whitepaper, there was nothing quite like crypto. Fiat currency, created by nation states, lacks many of crypto's features. Crypto is really not like a stock that represents an ownership interest in an ongoing business concern. And, at the very least, it is not what people usually think of as a "commodity" and is not exactly like a futures contract, bond, or swap.

In that sense, digital assets are "new." They are not exactly like what came before them. But Satoshi's whitepaper was published in 2008. Regulators and lawmakers around the world have had 16 years to grapple with how best to regulate digital assets, and yet the result has been a patchwork of rules, with some nations adopting comprehensive frameworks for the regulation of digital assets, and others doing little more than shrugging their shoulders and waiting for someone else (like the courts) to figure it out.

Theoretically, companies and individuals who use crypto can move freely between jurisdictions, choosing the regulatory approach that works best for them. One could even imagine "competition" among jurisdictions to adopt regulations that encourage the growth of this space, just as nations, states, and municipalities compete to lure businesses to relocate within their borders.

To some extent, the real world has played out the way that a theoretical competitive market among jurisdictions would predict. For example, Brazil has created an industry-friendly regulatory system and actively recruits crypto businesses to incorporate within its shores. But the real world isn't a theoretical marketplace, and digital assets are not neatly confined to a specific jurisdiction.

In particular, the United States poses a challenge for the industry more broadly. It is extremely difficult, if not impossible, to create a business in this space without grappling with potential regulatory enforcement activity by the U.S. government. The United States is the world's largest economy, with revenue in the U.S. crypto market projected to reach over $23 billion in 2024.

Remarkably, the U.S. has maintained this position *despite* a regulatory approach to digital assets that is difficult to make sense of and impossible to pin down.

The United States has at least two regulators that could plausibly take the lead in regulating digital assets. The Securities and Exchange Commission ("SEC") regulates stocks and publicly traded companies, among other things. The Commodity Futures Trading Commission ("CFTC") regulates commodities, futures contracts, and swaps.

As noted earlier, digital assets do not neatly fit into any of these categories, but either of these agencies could have come forward and promulgated regulations that would have at least started a conversation and provided some amount of clarity for industry participants. They did not do so.

Instead, whether a particular digital asset is regulated by the SEC or CFTC is determined by a test created by Supreme Court justices back in 1946. The so-called "Howey" test is often discussed, rarely understood, and never definitive.

The factors are deceptively simple. To determine whether a digital asset is a "security," courts consider whether it is: 1) an investment of money; 2) in a common enterprise; 3) with the expectation of profit; 4) to be derived from the efforts of others. If you can look at this World War II-era test and conclusively determine for yourself whether any particular digital asset is a security, you're a step ahead of the rest of us.

It should surprise no one that courts across the United States have struggled to apply this test and have produced a patchwork of results that have been difficult to predict and failed to provide certainty going forward. A single trial judge in a particular jurisdiction does not bind other judges in other jurisdictions who grapple with the same or similar questions.

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HOW DOES THE U.S. REGULATE CRYPTO?

In the absence of a regulatory or legislative framework, these disparate (and sometimes inconsistent) judicial decisions and their underlying enforcement actions are the closest thing to a regulatory framework that the U.S. has. Some decisions have definitively placed particular digital assets (like Bitcoin and Ether, or even meme coins) firmly in the CFTC's orbit as "commodities." The SEC has taken a very expansive view of what is a security, and with rare exceptions (like Bitcoin), has not conceded many limits on that authority.

In fact, the SEC has even filed suit against large industry participants who reached out to the SEC asking for regulatory guidance. It didn't have to be this way. As noted above, the SEC could have promulgated regulations that set forth its expectations for industry participants, even if the legality

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and reach of those regulations was not fully determined. Or the SEC could have worked with industry participants to create processes or safe harbors that would provide guidance and allow those innovators to grow.

At times, the U.S. government has taken a careful and hands-off approach to innovative, new technologies. Most notably, the Clinton administration advocated that U.S. lawmakers and regulators follow the "do no harm" principle in their approach to Internet regulation, believing that self-regulation would allow the Internet to boom, while government regulation would stifle its growth.

In an important way, the U.S. approach to regulating digital assets is the worst possible outcome. While some regulatory frameworks will be better than others, clearly-defined rules are better than an absence of rules altogether. Court decisions provide some guidance, but the patchwork of differing (and sometimes conflicting) decisions bear little resemblance to a comprehensive legal framework. They also don't come until years of litigation have elapsed, ensuring that they answer yesterday's questions rather than the questions of today. The result has been uncertainty, frustration, and an inhibition of the growth of this industry.

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WHAT IS "REGULATION BY ENFORCEMENT" ANYWAY?

The use of court decisions as a substitute for a regulatory framework is often dubbed "regulation by enforcement." This approach is best understood as a tool that can be appropriately used by regulators, but is misused in this context.

The term "regulation by enforcement" is used, sometimes as an insult, by the regulated whenever a regulator files an enforcement action before detailed and explicit guidance has been given around a particular issue. But regulations are time consuming and resource intensive to create, and it is often impossible for regulators to anticipate problematic conduct and key developments in advance. For that reason, deeming every first-of-its-kind enforcement action to be "regulation by enforcement" is a misnomer.

I have some personal experience with this. When I prosecuted the first-ever spoofing case, it was met with some criticism, because the prosecution was initiated before the CFTC promulgated detailed regulations providing specific guidance regarding what the anti-spoofing provision of the Dodd-Frank Act meant. But the conduct I prosecuted was so egregious that I included fraud charges in the indictment and obtained a guilty verdict on those counts as well.

In that context, the first spoofing prosecution sent a statement to the industry that egregious market behavior that cheated others would face consequences. There is a place for "regulation by enforcement" of that type. Enforcers cannot always wait for perfect clarity before deterring the most serious wrongdoers.

This context is quite different. The anti-spoofing provision was one-sentence long, and the term spoofing was defined in the statute itself. By contrast, the regulations, rules, and laws that could plausibly regulate digital assets would fill volumes. More importantly, there is little clarity regarding which of these rules apply to specific assets and how they are to be applied, which makes enforcement a substitute for legislation or regulation, rather than a way for enforcers to stay on top of wrongful behavior while regulators catch up.

That is particularly true here, given that digital assets are distinct from anything that has come before them. It is difficult to argue, as the SEC has done, that someone marketing or trading crypto should have known all along that they were actually securities based on a test set forth in a 1946 court case. We should not try to pretend that crypto is just like a stock certificate.

Some defenders of the SEC's approach have likened "regulation by enforcement" to the common law, in which judicial decisions iterate over time, expanding legal doctrine to meet new factual scenarios. That approach works well once there is an ample body of existing precedent. There is none here.

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THE TIDE IS TURNING

The "regulation by enforcement" approach to regulating digital assets is particularly extreme given that prominent industry participants have asked regulators for guidance, but were subjected to an enforcement action rather than receiving an answer to their regulatory questions.

Perhaps the most prominent example of an industry participant seeking guidance but receiving a lawsuit is Coinbase, which publicly posted a remarkable statement laying out facts surrounding its communications with the SEC after it received a Wells notice indicating that the SEC intended to bring an enforcement action.

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Coinbase's statement noted that it received the notice after the SEC met with Coinbase 30 times over nine months, at the SEC's invitation, to discuss proposals regarding a potential registration of some portion of Coinbase's business with the SEC. According to Coinbase, the SEC was conflicted regarding the proposals that Coinbase came up with – at the SEC's request – and told Coinbase that they would pursue an enforcement action instead.

The striking nature of this statement, written by Coinbase Chief Legal Officer (and former federal magistrate judge) Paul Grewal, was underscored by the impressive in-house legal and compliance team that Coinbase assembled. Coinbase is an industry participant that *wants* to be regulated. They want to be compliant. But they don't know what the rules are.

The SEC's enforcement action has already faced some pushback from the courts. In late March of this year, Judge Katherine Failla of the Southern District of New York significantly limited the SEC's enforcement action, dismissing the SEC's claims against Coinbase's wallet product. While that was an important victory for Coinbase (and others with similar products), most of the SEC's enforcement action remains intact.

There are limits to even the SEC's seemingly boundless regulatory ambition. The SEC concedes that Bitcoin is not a security. Meme coins and non-yield generating, fully-reserved stablecoins aren't either. But that still leaves many tokens and related products that remain within the SEC's crosshairs. For now, at least, "regulation by enforcement" marches onward.

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IT AIN'T OVER 'TIL IT'S OVER

The SEC's (partial) victory over Coinbase hasn't stopped many in the industry from prematurely celebrating the demise of "regulation by enforcement." In particular, many celebrated the recent bi-partisan vote in the U.S. House passing the Financial Innovation and Technology for the 21st Century Act as the arrival of the long-awaited legislative framework the industry has lobbied for.

Unfortunately, as any middle schooler knows, a bill is not a law. It's just a bill. The President has already indicated that he will never sign the Fit21 bill, and it doesn't look like it will pass the U.S. Senate in any event. To be clear, achieving a bipartisan vote in the House is a significant step forward. But one should not spike the ball on the one-yard line – or in this case, the fifty-yard line.

Betting on Congress and the President to work together in an election year is never a good bet. By far the most likely outcome is that a legislative solution is another year, or two, or four – or more – years away.

Eventually, something is going to happen. A regulatory or legislative solution makes too much sense, and the current "regulation by enforcement" approach inhibits the growth of the crypto industry in the U.S. At some point, we believe that a law will be passed if regulators don't take matters into their own hands and promulgate regulations before lawmakers act. The real question is – what do we do in the meantime?

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YOU CAN'T ESCAPE THE INQUISITION

One common answer within the industry is that firms need to consider moving operations elsewhere. To be sure, one reason we are confident the U.S. will act is that it is effectively being outcompeted by other countries who have created regulatory frameworks in order to encourage crypto companies to move substantial assets within their borders.

For example, the UK has taken a proactive approach to regulating cryptocurrency, vowing to "make the UK a global hub for crypto asset technology and investment." It put those words into action when it passed the Financial Services and Markets Act of 2023, legislation that brings digital assets within the scope of the UK's existing regulatory regime. Many have touted this new law as providing the clarity industry participants needed to innovate responsibly.

The UK isn't the only country to pass laws meant to lure crypto dollars to their territory. Switzerland, Brazil, and Singapore have done the same, with many more actively grappling with how to establish crypto-friendly regulatory frameworks.

But while a company's location does matter, crypto companies ignore the United States and its regulators at their peril. Crypto is not confined by territorial boundaries, and efforts to wall off users from a particular jurisdiction are notoriously difficult to implement.

More importantly, U.S. regulators have an expansive view of their regulatory authority. For example, the scope of the anti-fraud authority of the DOJ, SEC, and CFTC reached

Sam Bankman-Fried in his home in the Bahamas, where he ran a Bahamian company. SBF's efforts to separate FTX's U.S. affiliate did not keep him out of federal prison.

But foreigners don't have to be fraudsters to find themselves subjected to a U.S. enforcement action. For example, Binance (and its founder and CEO, CZ) found itself sued by the CFTC and SEC for a number of alleged violations of U.S. law, none of which involved allegations of fraud. Binance and CZ also pleaded guilty to criminal charges for failing to implement an anti-money laundering program.

The bottom line is that locating your company overseas is not an easy or clean solution to avoiding the U.S. "regulation by enforcement" crusade. Any substantial company operating in this space has to consider how to position itself to reduce its risk in the short term, until a legislative or regulatory framework is put in place.

07

HOW TO RIDE OUT THE STORM

The easiest way to avoid an enforcement action is to stay off the radar screen of regulators. Regulators don't sue companies they've never heard of. It is much easier to avoid being targeted by regulators than it is to negotiate a resolution once you face an enforcement action.

So anyone operating within this space should consider public statements carefully, carefully vetting them and considering how they might be viewed by regulators. Internal communications are just as important. Talk that could be perceived as deceptive or questionable should be vetted by a lawyer or compliance professional.

If your business involves digital assets, you need a lawyer, even if you can't afford to hire one full time. You also need some sort of compliance professional who will provide training and guidance to employees on a regular basis. Obviously, the current legal and regulatory landscape is not completely clear, with as many as questions as there are answers. But having lawyers and compliance professionals on your side will make you a less attractive target.

To be sure, merely having lawyers is not enough. FTX hired a high-end New York law firm, along with a well-qualified lawyer, but that firm did not prevent the demise of FTX. In fact, that lawyer ultimately testified at the trial of SBF, pursuant to an immunity deal.

The lesson to be learned is that the mere presence of lawyers will not prevent a legal catastrophe. It is important to empower lawyers and compliance professionals within your organization and create what is often called a "culture of compliance." Regulators need to see, when they look at your company, that you are trying to do your best to comply with the law.

That won't necessarily prevent an enforcement action. But it will ensure that you are prepared for one, and will allow you to mitigate its impact. It will also give you the opportunity to mount an aggressive defense that will potentially limit or even end the enforcement action altogether.

Given that the days of "regulation by enforcement" are numbered, it is more important than ever to be able to mount a vigorous defense. If you do face an enforcement action, don't be in a hurry to achieve a resolution. The tide is turning against regulatory overreach. Given that a legislative or regulatory framework will likely arrive in the years to come, now is not the time to cut a deal. Now is the time to make yourself a less attractive target and be prepared to fight if the battle comes to you..

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