

Blurred Lines – Navigating a Murky Regulatory Landscape in a Cryptocurrency Boom

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In the last 12 months, institutional- and retail-investor demand for cryptocurrency and digital assets has risen exponentially, resulting in a nearly 500% increase in the total market capitalization for over 7,000 forms of cryptocurrency. Included in this explosion of new crypto offerings are stablecoins—digital assets that are designed to maintain a stable value relative to a national currency or other reference assets—which surpassed \$100 billion in total market cap for the first time in the summer of 2021. Despite the momentum toward broad adoption of cryptocurrency among consumers, corporations, and asset-management firms, few cryptocurrencies are subject to front-end regulatory oversight.

While we wait for clarity and uniformity in the front-end regulatory landscape, state and federal regulatory bodies have been pursuing back-end enforcement actions against market participants. For example, state and federal regulators have been increasingly active on the back end creating task forces, issuing cease-and-desist and informational requests, and bringing enforcement actions to address allegations of consumer harm or violations of various state and federal laws to the extent the crypto-related conduct is covered by their jurisdictional reach. The following summarizes the last several months of 2021:

- In October 2021, DOJ Deputy Attorney General Lisa Monaco announced the creation of a National Cryptocurrency Enforcement Team, to tackle complex investigations and prosecutions of criminal misuses of cryptocurrency, particularly crimes committed by virtual currency exchanges, mixing and tumbling services, and money-laundering-infrastructure actors.^[1]
- In October 2021, the CFTC settled two enforcement actions with crypto businesses owned by the same parent company, for a total of \$41.5 million, based on allegations that (i) one of the businesses had made false statements to consumers about whether its stablecoin was backed entirely by U.S. dollars or also backed by other types of reserves and (ii) one of the businesses had inadequate controls to keep U.S.-based customers from engaging in retail commodity transactions (e.g., margin trading), which would be illegal because the business was not a registered futures commission merchant.^[2] The entities neither admitted nor denied the allegations.
- While SEC Chair Gary Gensler and other SEC commissioners have been vocal proponents of cryptocurrency generally—so long as it develops under a clear, albeit yet unidentified, regulatory framework^[3]—the SEC has also ramped up its cryptocurrency-enforcement activity. In September 2021, one major cryptocurrency exchange disclosed that it had received a “Wells Notice” from the SEC indicating that the SEC planned to sue the entity over

a crypto-lending program it intended to offer to its customers. The entity later scrapped the lending program, although it also expressed its opposition to the SEC's position by arguing publicly that crypto-lending products are not securities and, thus, are not subject to the SEC's jurisdiction.^[4]

- Also in October 2021, the New York Attorney General's Office issued cease-and-desist letters to two cryptocurrency-lending platforms allegedly operating without appropriate licenses within New York state and sent information-request letters to three other lending platforms, ostensibly to understand whether those entities must also halt operations within the state.^[5]

The lack of front-end regulatory requirements and uptick in back-end enforcement actions has, not surprisingly, spurred market participants and various regulatory bodies to be vocal about the need for clear rules on how and by whom various crypto products and services will be regulated. For example, one of the largest cryptocurrency exchanges in the world published a Digital Asset Policy Proposal (Proposal) in mid-October 2021.^[6] Among other topics, the Proposal calls for a new regulatory framework for the crypto sector, including a newly created U.S. regulator that will work with a self-regulatory organization of market participants to create rules and regulate the space together.

Studying this issue and providing clarity to regulators and market participants has been one focus of President Biden's administration, particularly as it relates to stablecoins. In November 2021, the President's Working Group on Financial Markets (PWG) released a report recommending that "Congress act promptly to enact legislation to ensure that payment stablecoins and payment stablecoin arrangements are subject to a federal prudential framework on a consistent and comprehensive basis."^[7] The PWG report paints a potentially dire picture of how a catastrophic change in the stablecoin market could—in a doomsday scenario—lead to turmoil in other financial markets. Days after the report's publication, OCC Acting Chief Michael Hsu echoed the concerns outlined in the PWG report, noting that a "leveling up" of regulation would be required to fill the gaps because "crypto firms today are regulated at most only partially and selectively, with no single regulator having a comprehensive view of the firm as a whole."^[8]

Accordingly, while some industry participants and most state and federal regulators agree that there is a need for clarity and uniformity of regulation—with respect to both roles and rules—for now, we wait to see how and when Capitol Hill will take action. Until then, we expect a continued rise in state- and federal-regulator investigations and enforcement actions related to crypto products and services.

^[4] Press Release, U.S. Dep't of Just., Deputy Attorney General Lisa O. Monaco Announces National Cryptocurrency Enforcement Team (Oct. 6, 2021), <https://www.justice.gov/opa/pr/deputy-attorney-general-lisa-o-monaco-announces-national-cryptocurrency-enforcement-team>.

^[5] Press Release, CFTC, CFTC Orders Tether and Bitfinex to Pay Fines Totaling \$42.5 Million, (Oct. 15, 2021), <https://www.cftc.gov/PressRoom/PressReleases/8450-21>. This was the second such CFTC settlement related to improper-retail-commodity-transaction claims in only three weeks. On September 28, 2021, the CFTC settled similar charges—which the business did not admit or deny—for \$1.5 million. *See* Press Release, CFTC, CFTC Imposes A \$1.25 Million Penalty against Kraken for Offering Illegal Off-Exchange Digital Asset Trading and Failing to Register as Required (Sept. 28, 2021), <https://www.cftc.gov/PressRoom/PressReleases/8433-21>.

^[6] Zack Guzman, *It's 'a real shame' the way the SEC is regulating crypto: SEC commissioner*, Yahoo! Finance (Oct. 5, 2021), <https://finance.yahoo.com/news/its-a-real-shame-the-way-the-sec-is-regulating-crypto-sec-commissioner-175955363.html>; *see also* Hester M. Pierce, Comm'r of U.S. Sec. & Exch. Comm'n, Statement in the Matter of Poloniex LLC (Aug. 9, 2021), <https://www.sec.gov/news/public-statement/pierce-statement-poloniex-080921> (in which SEC Commissioner Hester Pierce issued a public statement raising concerns about an SEC enforcement action against a crypto-trading platform in August 2021 and concluding that without further clarity in the regulatory landscape, market participants "may understandably be surprised to see us come onto the scene now with our enforcement guns blazing").

^[7] Paul Grewal, *The SEC has told us it wants to sue us over Lend. We don't know why.*, Coinbase (Sept. 7, 2021), <https://blog.coinbase.com/the-sec-has-told-us-it-wants-to-sue-us-over-lend-we-have-no-idea-why-a3a1b6507009>.

^[8] Press Release, N.Y. State Att'y Gen., Attorney General James Directs Unregistered Crypto Lending Platforms to Cease Operations In New York, Announces Additional Investigations (Oct. 18, 2021), <https://ag.ny.gov/press-release/2021/attorney-general-james-directs-unregistered-crypto-lending-platforms-cease>.

▣ Faryar Shirzad, *Digital Asset Policy Proposal: Safeguarding America's Financial Leadership*, Coinbase (Oct. 14, 2021), <https://blog.coinbase.com/digital-asset-policy-proposal-safeguarding-americas-financial-leadership-ce569c27d86c>.

▣ *Report on STABLECOINS*, President's Working Grp. on Fin. Markets, Fed. Deposit Ins. Corp. & Off. of Comptroller of Currency (Nov. 2021), https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf.

▣ Michael J. Hsu, Acting Comptroller, Remarks Before American Fintech Council Fintech Policy Summit 2021 (Nov. 3, 2021), <https://occ.gov/news-issuances/speeches/2021/pub-speech-2021-115.pdf>.

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