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The SEC's Approach to Digital Asset Regulation Harms Investors

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In the U.S., no federal regulation specifically addresses digital assets—the vaguely defined, trillion-dollar-plus collection of tokens that includes bitcoin and thousands of other cryptocurrencies.

The recent wave of high-profile bankruptcies such as that of digital asset exchange FTX Trading Ltd. and associated market turbulence highlight the need for sensible regulation in this area. But instead of a coordinated federal response, an intra-governmental turf war is being waged to fill the regulatory void.

The main combatants are the Securities and Exchange Commission and the Commodity Futures Trading Commission, which both seek the lead role in regulating this novel and rapidly expanding sector.

SEC Activity

The SEC has been the most forceful regulator in this space, nearly doubling the size of its Crypto Assets and Cyber Unit last year. Rather than wait for Congress to sort out rules and regulatory responsibilities, the agency is forging ahead, firing off scores of lawsuits and enforcement actions against a diverse array of individuals and businesses—from Kim Kardashian to technology companies. These actions are all based on the SEC's position that existing federal securities laws apply to virtually any transaction involving digital assets.

That position is misguided as a legal matter and threatens a cavalcade of collateral consequences that will directly harm the people the Commission is trying to protect—individual investors—as well as other market participants and innovation more broadly.

Take, for example, SEC v. Wahi , an insider trading lawsuit brought against a former employee of Coinbase Global Inc. —the largest digital asset exchange in the U.S.—who allegedly tipped his brother and friend that digital assets were scheduled to be listed for sale on the platform. Understandably, few are quick to defend the actions of the former Coinbase insider, who pleaded guilty to criminal charges for wire fraud brought by the Department of Justice. But in piling on with allegations of securities fraud, the SEC is creating more problems than it's solving.

To win in Wahi and cases like it, the SEC must establish that the digital assets involved are “investment contracts” and therefore “securities” under U.S. law. Otherwise, the SEC would have no right to bring the action.

But the allocators who created the tokens—the digital asset exchanges that facilitate their purchase and sale—and the many other entities and individuals that own, trade, advise on, or use those tokens to do business, don’t consider them to be securities, and there’s no federal law stating that they are.

Problematic Approach

This backdoor approach to regulation is problematic for a host of reasons. The idea that secondary market transactions in digital assets like those underlying the fraudulent trades in Wahi are “securities transactions” is ungrounded in law or history.

Traditionally, for a given asset to constitute an investment contract, it must be accompanied by some sort of promise or obligation accompanying that asset. Decentralized digital assets sold by anonymous counterparties with no stake in their creation or original allocation traditionally would not qualify.

Neither the creators of the digital assets, nor the many digital asset exchanges that sold them, are parties to the lawsuit. This creates significant due process concerns, because many parties whose rights and economic interests could be greatly impacted by the decision have no voice in the proceeding.

It leaves their fates in the hands of alleged wrongdoers who may lack the incentives, resources, and knowledge to make the argument that these digital assets aren’t securities at all.

Actions such as Wahi threaten profound economic harm to virtually everyone involved. Creators of digital assets targeted by the SEC face damage to goodwill and reputation, and the exchanges that sell the assets could be regarded as unlicensed securities brokers and face severe regulatory consequences of their own—as well as class action lawsuits brought by private parties.

Even more troublingly, purchasers of the assets in question face an unexpected and rapid loss in value of their holdings. As SEC Commissioner Hester Peirce recently stated, the agency’s “imprecise application of the law has created arbitrary and destructive results,” with “secondary purchasers of the token often … left holding a bag of tokens that they cannot trade or use.” But the SEC’s core mandate is to protect the investing public, not cause it harm.

Outlook

Finally, the SEC’s regulation-by-enforcement approach diminishes the U.S. role as a global leader in blockchain adoption and financial services regulation. Regulatory clarity is necessary to create an environment where responsible innovation thrives.

Its sustained absence will continue to drive innovators away from the U.S. and to offshore havens, reducing U.S. competitiveness in an important new area and its ability to safeguard the interests of its digital assets investors.

While these consequences are predictable, they’re not inevitable; the SEC should wait for Congress to act. In the meantime, other federal regulators and law enforcement agencies are patrolling the space for the most egregious issues—as evidenced by the guilty pleas in Wahi, for instance.

Fundamental questions remain unsettled, such as which regulator or regulators will take primary responsibility for oversight of digital asset businesses.

Multiple legislative proposals are pending before Congress that aim to sort out the regulatory morass, including the bipartisan Lummis-Gillibrand Responsible Financial Innovation Act. Sensible and balanced congressional action is the best approach to bring much-needed clarity to an uncertain regulatory environment.

The case is Securities and Exchange Commission v. Wahi et al, Docket No. 2:22-cv-01009 (W.D. Wash. Jul 21, 2022).
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