

Professional Perspective

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SEC Outlook on Digital Assets Questions

Contributed by [Sam Waldon](#), [Joshua Newville](#), and [Jeff Neuburger](#), Proskauer

In his lectures and congressional testimony, SEC Chairman Gary Gensler has stressed the necessity of [protecting investors](#), guarding against illicit activities, and promoting market integrity through the application of the securities laws to relevant cryptocurrencies. For that reason, we can likely look forward to more clarity on important questions regarding digital assets including when a digital token is no longer a security and how non-fungible tokens and other online holdings will be treated in the regulatory environment.

What We Know

While a great deal about digital assets remains uncertain, one thing has been clear. Since the [2017 DAO 21\(a\) Report](#), the SEC has consistently taken the view that ICOs, or initial coin offerings, are securities. As former Chairman Jay Clayton explained, "I believe every ICO I've seen is a security ... You can call it a coin but if it functions as a security, it is a security." The SEC brought [75 enforcement actions](#) against digital asset market participants from 2013 through December 2020, with over 70% of those actions alleging unregistered securities offerings (including 39 actions relating to Initial Coin Offerings—52% of the total), while 58% of the total included allegations of fraud.

Gensler has not given any indication that he will take a different approach to ICOs. In July 2018, he [testified](#) before Congress that, "[n]early every ICO token's economic realities—its risks, expectation of profits, monetary policies, manner of marketing, and capital formation—are attributes of investment schemes."

When Is a Digital Token No Longer a Security?

One of the most confounding and fundamental questions regarding cryptocurrencies is, when, exactly, does a digital token transition from being a security to a currency or something else outside the purview of the federal securities laws? William Hinman, former director of the SEC's Division of Corporation Finance, stated publicly that Bitcoin and Ether are not securities, and the SEC's FinHub has provided a [framework](#) for how to analyze whether a token is a security. That guidance, however, was provided by SEC staff, not through a formal rule-making by the Commission. While the guidance provided a number of factors for consideration, it is not clear how to apply those factors and whether they remain relevant under the current chairman.

Under Clayton, the SEC took the view that the well-established, longstanding regulatory framework around securities was sufficient to govern digital assets. In the DAO report, in settled actions and in litigation, the SEC consistently relied upon what is known as the Howey Test to determine whether a cryptocurrency was a security or not. *Howey* is a Supreme Court case from 1946, in which the court decided whether interests in a citrus farm were securities. The court held that the interests were investment contracts, and therefore securities, because investors were investing money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

One place to look for early hints as to how Gensler's SEC will approach this issue is the agency's ongoing litigation in the U.S District Court for the Southern District of New York against Ripple Labs Inc. and two of its executive officers.

In that case, which was filed late last year, the SEC alleged that Ripple's XRP token has been a security since its inception in 2013, and that Ripple raised over \$1.3 billion through a continuous unregistered digital asset securities [offering](#). The Ripple case highlights the question of when a token crosses the line from being a security to being something else: The SEC alleged that, even eight years after its creation, XRP has still not crossed that line and continues to be a security to this day.

One interesting development in the Ripple case is that U.S. Magistrate Judge Sarah Netburn, in a highly unusual order, [granted](#) a request from Ripple for discovery from the SEC concerning the SEC's internal discussions on whether XRP tokens are similar to other cryptocurrencies, such as Bitcoin, which are not considered securities. The discovery requested from the SEC includes internal minutes and memos "expressing the agency's interpretation or views" on cryptocurrencies. Depending on how the SEC responds to this order, we could gain insight into how the SEC has been grappling with this issue.

Other Players in the Cryptocurrency Eco-System

While the question of whether a cryptocurrency is a security is a fundamental question for purposes of the application of the securities laws, it can be just the first of many other questions regarding other participants in the cryptocurrency space. Just recently, Coinbase went public through a direct listing on the NASDAQ. Coinbase operates as an exchange for the purchase and sale of Bitcoin and Ether. While SEC officials have stated that Bitcoin and Ether are something other than securities, if that view changes or if Coinbase decides to offer other cryptocurrencies, Coinbase may need to register as a securities exchange. In recent congressional testimony, Gensler expressed concern that cryptocurrency exchanges are not regulated by the SEC or otherwise.

Separately, decentralized finance or “DeFi” – a term used to refer to a number of financial services offered on blockchain (think of banking in support of cryptocurrency transactions and investments) – has become a multi-billion dollar industry almost overnight. That rapid growth has been accompanied by increased volatility and risk. Yet, DeFi is largely unregulated.

Beyond that, investment advisers holding clients’ digital assets may end up coming under the purview of the Custody Rule of the [Investment Advisers Act](#) of 1940. In a [November 2020 staff statement](#), the Division of Investment Management Staff, in consultation with the SEC’s FinHub staff, encouraged interested parties to engage with the Commission staff regarding the applicability of the Custody Rule to digital assets. If the Custody Rule does apply to digital assets held by an investment adviser, that adviser will be subject to additional regulatory requirements.

NFTs and Other Online Holdings

Another recent development in the digital asset world is the sudden emergence of what are known as non-fungible tokens. NFTs garnered headlines regarding Twitter chief executive Jack Dorsey’s first [tweet](#) NFT selling for \$2.9 million, and in the ultimate sign that they have entered today’s zeitgeist, NFTs were the subject of a [Saturday Night Live](#) skit. NFTs are unique online images and content pieces built on a distributed ledger, such as blockchain, and authenticated through a decentralized system of nodes. Each NFT is unique and indivisible—unlike cryptocurrencies—and linked to a single token stored in a smart contract on the blockchain. The NFT blockchain establishes ownership, even when others have copies of the underlying work.

Although Saturday Night Live has expressed its views on NFTs, the SEC has not—although at least one private investor suit has [alleged](#) that a particular NFT is a security. NFTs raise a number of other questions such as what about a fractionalized NFT, where one investor holds the NFT and sells portions of it to third parties for profit, or what if NFT owners could be paid dividends on the underlying artwork’s profitability, or what if an NFT establishes ownership of a sustained and continuing portfolio of work?

While NFTs are quickly becoming a market phenomenon, various applications to create Bitcoin exchange traded funds (ETFs) are waiting for the SEC’s go-ahead. These applications include WisdomTree Bitcoin Trust, First Trust SkyBridge Bitcoin ETF Trust, Fidelity’s Wise Origin Bitcoin Trust, and VanEck Bitcoin Trust. While some view Gensler’s appointment as an indication that the SEC will [begin approving](#) these ETFs, it remains unclear how the SEC will evaluate these ETFs.

Also, the SEC [issued a staff statement](#) May 11, 2021 warning investors interested in investing in a mutual fund with exposure to the Bitcoin futures market to carefully consider the inherent risks, such as Bitcoin’s speculative nature and high volatility. Commission staff stated that they will continue to monitor and assess mutual funds’ and investment advisers’ ongoing compliance with the [Investment Company Act](#).

How Will These Questions Be Answered?

Former Chairman Clayton viewed the longstanding securities law framework as sufficient to regulate cryptocurrency transactions. It seems unlikely that Gensler will follow the same approach. During a hearing of the House Financial Services Committee, [Gensler said](#), “There’s a lot of authority that the SEC currently has in the securities space and there are a number of cryptocurrencies that fall within that jurisdiction, but there are some areas, particularly Bitcoin trading on large exchanges, that the public is not currently really protected.”

Looking forward, it appears that Gensler will advocate for an updated regulatory framework to address the legislative gaps regarding cryptocurrencies. Moreover, it appears that the SEC will likely issue further guidance and clarity regarding Bitcoin and other cryptocurrency transactions and ICOs, as Gensler stressed the importance of [at his nomination hearing](#) before the Senate Banking Committee on March 2, 2021.

Other Regulators?

Beyond the SEC, a number of other regulators have also exercised jurisdiction over digital assets. This includes the Commodities and Futures Trading Commission, the Department of Justice (DOJ), the Federal Trade Commission (FTC), and the Department of Treasury's Financial Crimes Enforcement Network. The CFTC, for example, has jurisdiction over futures, swaps, and options linked to cryptocurrencies, as well as authority to prosecute [fraud and manipulation](#) in cryptocurrency spot markets.

In the past couple of years, the DOJ [prosecuted and announced](#) the indictment of various criminals who relied on virtual currency to fund their illegal ventures. In addition, two separate actions have been announced by federal prosecutors and the CFTC against BitMEX, one of the world's biggest cryptocurrency trading exchanges. It is alleged that BitMEX [failed to limit](#) money laundering and other illegal activities of its customers, despite being aware of such activities.

Up until now, we have not seen the various regulators take conflicting approaches to digital assets, but we also have not seen a comprehensive, cross-agency approach to these issues. We will have to wait and see whether the agencies align in their policies.

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