

# Cryptocurrency Regulations and How They May Impact Private Investment Funds

By: Bruce W. MacLennan and Michael A. Hill

*Corporate and Securities Alert*

7.6.22

## OVERVIEW

Over the last five years, decentralized finance (DeFi), especially cryptocurrencies and other digital assets are a space that continues to grow at an exponential rate, not only for retail investors but also for private investment funds. Given this rapid growth, investors find themselves with the opportunity to purchase non-traditional assets that have had staggering returns compared to their traditional counterparts. However, this also brings new risks associated with allowing digital assets to be a part of investment packages offered by private funds. The Securities and Exchange Commission (SEC) has had an increasingly difficult time regulating this new investment universe, with some calling it "The Next Frontier" of SEC enforcement. On May 3, 2022 the SEC stated that it would nearly double the size of its enforcement division, specifically for its cyber unit and crypto assets. Since 2017, the cyber unit has brought more than 80 enforcement actions against bad actors in the crypto markets with these actions being related to fraudulent and unregistered crypto asset offerings, resulting in monetary relief totaling more than \$2 billion.

On June 6, 2022 a bipartisan bill was introduced and proposed on the floor of Congress to address the cryptocurrency regulatory overhaul that would treat most digital assets as commodities under the Commodity Futures Trading Commission's (CFTC) oversight given their strong record of bringing enforcement actions against cryptocurrency trading platforms. While cryptocurrencies themselves are not under the jurisdiction of the Commission or CFTC currently, many government officials, specifically Republican Senator Cynthia Lummis, Democrat Senator Kirsten Gillibrand, CFTC Commissioner Brian D. Quintenz, and Chairman of the SEC Gary Gensler, continuously call for crypto exchanges along with the currencies to be more heavily regulated. The debate as to who should regulate cryptocurrency assets is still a controversial conversation with CFTC Commissioner Quintenz saying that "the SEC has no authority over pure commodities or their trading venues, whether those commodities are wheat, gold, oil...or crypto assets." While stricter regulations on cryptocurrencies may not be inherently dangerous to the crypto market, there is the potential that retail investors and private funds will change how they interact with cryptocurrencies if new regulations are put in place based on current enforcement actions being brought by both the SEC and the CFTC.

## SECURITIES AND EXCHANGE COMMISSION ENFORCEMENT: SEC v. RIPPLE LABS, INC.

Between 2013 and 2020, Ripple Labs, Inc. (Ripple) sold over 14.6 billion units of the cryptocurrency XRP in return for \$1.3 billion. The SEC brought an action against Ripple, and Ripple executives Bradley Garlinghouse and Christian Larsen in their individual capacities on December 22, 2020 alleging that Ripple undertook this distribution without registering their offers and sales of XRP and were in violation of federal securities laws. While Ripple argues that XRP is a cryptocurrency and therefore does not need to be registered, the SEC contends that XRP is a security and therefore no exemption from the registration requirement applies. The SEC has brought a claim under Section 5(a) of the Securities Act of 1933 (Securities Act) which generally prohibits any person, including broker-dealers, from using interstate means to sell, either directly or indirectly, any security unless a registration statement is in effect or an exemption from the registration requirements of Section 5 applies. Additionally, the SEC brought a claim under Section 5(c) which generally prohibits any person, including broker-dealers, from using interstate means to offer to sell or offer to buy, either directly or indirectly,

any security unless a registration statement has been filed or an exemption from the registration requirements of Section 5 applies.

For the SEC to successfully bring claims that Ripple violated Section 5(a) and 5(c) of the Securities Act, it will need to prove that XRP is an investment contract, and therefore a security, under the *Howey* test set out in the Supreme Court case *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Accordingly, the *Howey* three-prong test to determine whether a digital asset is a security, more specifically an investment contract, exists when there is: (1) an investment of money, (2) in a common enterprise, (3) with the reasonable expectation of profits to be derived from the efforts of others.

### 1) An Investment of Money

The first prong of the *Howey* test is typically satisfied in an offer and sale of a digital asset because the digital asset is purchased or otherwise acquired in exchange for value, whether in the form of real currency, another digital asset, or other type of consideration. Here, the SEC's argument makes clear that there was an investment of money into XRP satisfying the first prong.

### 2) In a Common Enterprise

The second prong of the *Howey* test is typically satisfied when evaluating digital assets because profits and losses are shared across all investors.

### 3) Reasonable Expectation of Profits Derived from Efforts of Others

The third prong of the *Howey* test is the most difficult for the SEC to prove given that Ripple markets XRP as a currency but is being bought and sold like a security by retail investors and private investment funds. When a promoter, sponsor, or other third party provides essential managerial efforts that affect the success of the enterprise, and investors reasonably expect to derive profit from those efforts, then this prong of the test is met. The SEC states that Ripple led investors to reasonably expect that Ripple's and its agents' entrepreneurial and managerial efforts would drive the success or failure of Ripple's XRP project. However, Ripple denies the SEC's allegations stating that "it never offered or sold XRP as an investment." Later it was noted by Ripple how "XRP holders do not acquire any claim to the assets of Ripple, hold any ownership interest in Ripple, or have any entitlement to share in Ripple's future profits."

The SEC alleged that XRP met the *Howey* test by claiming that "the principal reason for anyone to buy XRP was to speculate on it as an investment," that Ripple reflected a common enterprise, and that investors reasonably expected to profit from those efforts. It also claims that because Ripple did not provide a registration statement, it made material misstatements and omissions of information that is required of securities issuers when soliciting public investment. Ripple concluded that the SEC's "theory in the Complaint would read the word 'contract' out of 'investment contract,' and stretch beyond all sensible recognition the Supreme Court's test for determining investment contracts in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946)." Ripple never held an Initial Coin Offering, never offered future tokens to raise money, and has no contracts with the vast majority of XRP holders causing it to not fit neatly into *Howey*. While the case will not be decided for some time, and it is at the trial level meaning that whichever side loses will most likely appeal, the Ripple determination will have significant implications for the SEC's jurisdiction over cryptocurrencies.

## cftc eNFORCEMENT

The SEC is not alone in trying to bring stricter regulations to the cryptocurrency markets. The CFTC has also initiated a number of enforcement actions against cryptocurrencies, specifically focusing on cryptocurrency exchanges that offer crypto derivatives to U.S. persons and are not registered with the CFTC. Of the enforcement actions taken by the CFTC, some of the most notable are their actions against Coinbase, Inc. (Coinbase), BitMEX, Payward Ventures, Inc. d/b/a Kraken (Kraken), and BFXWW Inc. d/b/a Bitfinex

(Bitfinex).

#### **Coinbase, Inc.**

On March 19, 2021, the CFTC issued an order filing and settling charges against the digital asset exchange for "reckless false, misleading, or inaccurate reporting as well as wash trading by a former employee..." of Coinbase. The order required Coinbase to pay a civil monetary penalty of \$6.5 million and to cease and desist from any further violations of the CFTC. "Reporting false, misleading, or inaccurate transaction information undermines the integrity of digital asset pricing," said Acting Director of Enforcement Vincent McGonagle. "This enforcement action sends the message that the Commission (referring to the CFTC not the SEC) will act to safeguard the integrity and transparency of such information."

#### **BitMEX**

On August 21, 2021, the CFTC entered a consent order against five companies charged with operating the BitMEX cryptocurrency derivatives trading platform. The companies are HDR Global Trading Limited, 100x Holding Limited, ABS Global Trading Limited, Shine Effort Inc Limited, and HDR Global Services (Bermuda) Limited. The order requires the BitMEX entities to pay a \$100 million civil monetary penalty and provides that up to \$50 million of the penalty may be offset by payments the BitMEX entities make or are credited pursuant to a Consent to Assessment of Civil Monetary Penalty entered by the Financial Crimes Enforcement Network. The order also prohibits BitMEX from further violations of the Commodity Exchange Act and the CFTC's regulations.

The Chairman of the CFTC, Rostin Behnam stated, "This case reinforces the expectation that the digital assets industry, as it continues to touch a broader pool of market participants, takes seriously its responsibilities in the regulated financial industry and its duties to develop and adhere to a culture of compliance. The CFTC will take prompt action when activities impacting CFTC jurisdictional markets raise customer and consumer protection concerns."

#### **Kraken**

On September 28, 2021 the CFTC required Kraken to pay a \$1.25 million civil monetary penalty for illegally offering margined retail commodity transactions in digital assets, including Bitcoin, and failing to register as a futures commission merchant. Kraken, founded in 2011, is one of the largest digital asset exchanges in the U.S. "This action is part of the CFTC's broader effort to protect U.S. customers," said Acting Director of Enforcement Vincent McGonagle. "Margined, leveraged or financed digital asset trading offered to retail U.S. customers must occur on properly registered and regulated exchanges in accordance with all applicable laws and regulations."

#### **Bitfinex**

On October 15, 2021, the CFTC alleged that Bitfinex offered spot and leveraged Bitcoin, Ether, and Tether (all cryptocurrencies) trading to non-eligible U.S. Customers. The CFTC brought a civil monetary penalty of \$1.5 million plus they required that Bitfinex implement systems to prevent unlawful retail transactions. "This case highlights the expectation of honesty and transparency in the rapidly growing and developing digital assets marketplace," said Chairman Rostin Behnam. "The CFTC will continue to take decisive action to bring to light untrue or misleading statements that impact CFTC jurisdictional markets."

## CONCLUSION

As federal regulators, specifically the CFTC and the SEC, push to regulate cryptocurrencies and digital assets, it is clear that the days of little regulatory scrutiny for cryptocurrencies are in the past. Both the SEC and the CFTC are trying to prove they have jurisdiction

over crypto assets, but even then, with proper regulations from both regulatory authorities, is it enough to properly regulate the market, or will the U.S. government need to address the issue head on? Another question that should be asked by private investment funds is how much will the new regulatory system being developed affect the volatility of cryptocurrencies, and more importantly the stability of pricing?

Another interesting point to mention is that crypto markets have reached bear market territory affecting not only retail investors but crypto hedge funds, one specifically being the Dubai-based crypto fund Three Arrows Capital (3AC). When the crypto markets crash, the issue of paying lenders back becomes paramount for crypto funds. 3AC failed to pay back a loan to Voyager Digital, a crypto brokerage to the amount of roughly \$350 million in USD Coin, (a stablecoin correlated to the U.S. dollar) and over \$300 million in Bitcoin. A court in the British Virgin Islands ordered 3AC to liquidate due to their outstanding debts, but the firm has not yet publicly announced this order. The story of 3AC illustrates one of the many issues that arise when dealing with such a young and emerging market that's volatility is untested and relatively unknown.

As new regulations, cases, and court orders are being decided almost every month now, the future of cryptocurrencies and digital assets is extremely unclear and private investment funds should take time to conduct diligent research on this evolving investment space to decide whether crypto currency is right for their portfolio.

If you have any questions or would like further information, please contact Bruce W. MacLennan ([maclennanb@whiteandwilliams.com](mailto:maclennanb@whiteandwilliams.com); 212.714.3060) or Michael A. Hill ([hillm@whiteandwilliams.com](mailto:hillm@whiteandwilliams.com); 646.766.1356)

This correspondence should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only and you are urged to consult a lawyer concerning your own situation and legal questions.