

Effective Regulation of the Crypto Industry

(Updated April 2023)

The crypto industry has largely not delivered on its promise of innovation.

- Crypto has been touted as a source of innovation for payments, banking services, wealth creation, and more. Yet, [14 years after the Satoshi paper](#) and the launch of Bitcoin, many of these claims have largely failed to materialize; crypto remains [primarily a means of risky, speculative investment](#).
- Meanwhile, many other technological innovations developed during the same time frame [have achieved widespread, sustainable use](#). Additionally, [many technologists say](#) there are existing information technology tools that solve tech challenges more effectively than blockchain with less risk and cost.
- Crypto advocates have long claimed that blockchain technology can replace the need for various aspects of regulatory oversight, relying on ‘code’ instead. The longstanding record of [hacks, scams, bugs found in the crypto sector](#) – not to mention the “[complete failure of corporate controls](#)” that have been present even in large crypto firms – should make lawmakers skeptical of these claims.

Meanwhile, there are widespread, systemic problems found throughout the crypto industry, which cannot be blamed on a few bad actors alone.

- More than [\\$1.8 trillion of crypto value](#) (more than one third of the market value in Nov. 2021) has been lost in the recent crash. According to some economists’ estimates, [three-quarters of people who have invested in Bitcoin between 2015-2022 lost money](#). An Aug. 2022 Pew Research poll found that [46% of people who say they’ve invested in crypto currency have done worse than they expected](#), with only 15% reporting their investments have done better.
- Crypto investment fraud reported to the FBI reached [\\$2.57 billion in 2022, up 183% from the previous year](#). Additionally, academic studies estimate illegal wash trading that distorts crypto value for private gain amounts to [almost three-quarters \(over 70%\) of average trading volume](#) on unregulated exchanges. And, Barclays estimates that crypto investors are collectively avoiding paying the IRS at [least half the taxes they owe, amounting to about \\$50 billion a year](#), or 10% of all unpaid taxes in the US.
- Many of the industry’s former flagship firms and executives are, one year after the height of the crypto bubble, facing extensive civil or criminal charges as result of their alleged misdeeds or mismanagement – such as [Sam Bankman-Fried](#) (FTX); [Do Kwon](#) (Terra/Luna); [Justin Sun](#) (Tron/Huobi); [Alex Mashinsky](#) (Celsius); [Kyle Davies and Su Zhu](#) (Three Arrows Capital), as well as many others.

Policy makers should regulate crypto using the same frameworks used for other financial actors and activities that prioritize consumer and investor protections - not pursue deregulatory carve-outs in favor of an industry that has not delivered on its promise of innovation.

- Securities regulations were crafted to allow for a wide range of products and services and actors. Regulators should apply the same rigorous financial regulatory standards meant to protect consumers, investors, and markets, regardless of which technological platforms are used to provide them. This is also true for banking regulatory standards, and consumer financial protections.
- Crafting new regulations for the crypto sector would likely not only reduce such protections and legitimize risky, predatory behavior but might also weaken the rules for traditional financial actors, putting more investors and markets at greater risk.
- Stablecoins - the fuel for much of the speculative and risky crypto investment activity we see - offer a prime example of this dubious pattern. Many bills being proposed to regulate stablecoins ultimately would create a more permissive regulatory approach, allowing stablecoin issuers access to the broader financial system without sufficient oversight and regulatory standards, that would guard against risk and contagion. Given the recent failures of SVB and other banks, policymakers should be wary of establishing any rules that would provide less scrutiny to these untested and not-so-stable assets.
- Policymakers should see these proposals for new regulations for crypto as part of a broader effort to promote deregulation, legitimize weaker standards for financial actors as a whole, and erode regulators' ability to provide oversight, accountability and robust protections for consumers and investors.

The SEC has made it consistently clear how existing securities laws can and should apply to the crypto industry and has acted effectively to protect investors and markets from the rampant unfair, deceptive, and abusive practices found there.

- Both former Chair Clayton and current Chair Gensler largely [share the view that most crypto assets are securities](#) that should be registered with the SEC. The SEC has used multiple methods to convey this view and offer guidance and clarity to investors and firms.
- In 2013, the SEC issued [an alert on Ponzi schemes](#) using virtual currencies. In 2014 they issued an [investor alert on bitcoin](#) and other virtual currency related investments. Additionally, in 2017 the agency released the [report of an investigation into the DAO](#), a 'decentralized autonomous platform' (which later collapsed due a high-profile hack), which advised firms using DAOs, distributed ledgers or blockchain enabled means of capital raising to take steps to comply with U.S. federal securities laws. And in 2019, the SEC released a "[Framework for 'Investment Contract' Analysis of Digital Assets](#)," which provides details on when a digital asset has the characteristics of an investment contract and/or is a sale of securities.
- More recently, in Feb. 2022, the SEC issued [guidance for investors on the risks of interest-bearing accounts](#) for crypto asset deposits. In April 2022, the SEC issued [Staff](#)

[Accounting Bulletin 121](#), advising trading platforms holding assets for their users on the unique risks and uncertainties of safeguarding crypto assets. And, in Dec. 2022 the SEC issued a sample letter offering [guidance in response to the crypto crash](#), identifying risks to public companies and giving examples of issues they should consider when drafting disclosures.

- As of Jan. 2023 (going back as far as 2013), the SEC has brought [127 crypto-related enforcement actions](#) (voted on by Commission members) without losing a single case, which means federal courts have repeatedly confirmed the SEC's jurisdiction over crypto in numerous cases. In most of these cases, the SEC has applied the *Howey* test to successfully argue that the cryptocurrency in question is an investment contract, and therefore a security subject to SEC registration and disclosure requirements.
- Recent court decisions such as the *Ripple* case that appear to vindicate crypto industry claims are arguably outlier decisions based on questionable legal theories which, if left to stand, could invalidate decades of established securities law.

Policymakers seeking to further regulate crypto should ask: shouldn't crypto investors receive the same protections that investors in traditional finance are currently provided?

- Traditional broker-dealers, exchanges, custodians or clearing houses [are obliged to meet a range of requirements](#) aimed at protecting investors and ensuring fair, transparent and competitive markets, including but not limited to:
 - Submitting initial registration documents and ongoing disclosures to regulators, SROs and investors;
 - Establishing systems and controls to protect customer assets, prevent theft, hacks, etc.
 - Eliminating and/or mitigating and disclosing conflicts of interest;
 - Maintaining and making available accurate financial books and records;
 - Implementing robust, effective management, risk, legal and compliance programs; and
 - Instituting margin, liquidity, capital, and related protections to meet obligations to clients and investors and prevent contagion in the event of losses and volatility.
- Crypto firms complain this framework is too onerous and incompatible with crypto platforms, but the reality is that many [crypto firms are rife with conflicts of interest](#), struggle with [governance and management issues](#), and have business models rooted in a form of [predatory financial inclusion](#).
- Given this, the reality may simply be that many crypto firms' business models are incompatible with sound consumer, investor and market protections. Yet some Members of Congress are pursuing crypto legislative proposals that would embrace these flawed business models, undermining investor protection not only for crypto investors, but for mainstream investors at large.
- Congress should enhance the SEC's ability to rein in the systemic flaws and abuses found within the crypto industry – and stop echoing industry efforts to redirect attention away from their failure and blame regulators for doing their jobs.

For more information on crypto regulation and oversight, please contact Mark Hays with Americans for Financial Reform/Demand Progress (markhays@ourfinancialsecurity.org)