With States' Crypto Regulation, Problems Multiply

By Jason P. Gottlieb

First published in *Law360*, May 24, 2018.

The last two years have brought a wave of cryptocurrency-related business, all set against a backdrop of regulatory uncertainty.

The Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) have staked out their territory. They believe the law clearly provides them concurrent or overlapping jurisdiction over coins or tokens, either as securities under the broad *Howey* test,[1] or as commodities in the case of fraud or manipulation in cryptocurrency spot trading.

Such a broad jurisdictional ambit would give the SEC and CFTC's enforcement staffs authority over every single ICO or other cryptocurrency offering that has occurred in the past two years. They either do not have the resources for such an endeavor, or are choosing to leave most cryptocurrency offerings alone in favor of targeting a select few. As a result, states are stepping into this breach. But the uncertainties and ambiguities in current cryptocurrency regulation mean that multi-state action – even if coordinated – will create a real risk of splintered authority, in turn increasing regulatory burdens for U.S. blockchain-based businesses.

Federal Regulators, Regulating Through the Courts

It appears that instead of seeking legislative approval or even passing new regulations through their own administrative processes, the SEC and CFTC have decided to regulate cryptocurrency through incremental judicial interpretations of their pre-existing authority. The CFTC has won a district court decision granting its jurisdictional authority for one particular cryptocurrency in one particular instance,[2] and more SEC and CFTC cases in the pipeline are approaching that decision point.

However, a "regulation by court decision" approach means that the regulatory landscape will not be settled for quite some time – not until several federal appellate courts, or even the Supreme Court, weigh in on the key questions of jurisdictional authority.

The uncertainty has led to two trends so far. The first is an increasing division in the cryptocurrency industry. On one hand, there are a few "pure" currencies (such as bitcoin, Litecoin, and Ethereum) that are not considered securities, and are traded on the larger, more sophisticated exchanges who are apparently moving toward becoming fully SEC-regulated exchanges for those particular currencies. On the other hand, there are a slew of alt-coins and exchanges operating in the regulatory shadows, many of which are moving offshore to avoid confusing and seemingly draconian U.S. regulations.

The second result is that the SEC and CFTC are quite busy. The decision to regulate through active litigations and a "street sweep" of subpoenas and information requests has stretched their cryptocurrency enforcement staffs thin. As talented and capable as their enforcement staffs are,

Copyright 2018, Morrison Cohen LLP. Provided for information purposes only. For legal advice, please contact us.

they may not have the capacity to review and address all of the ICOs and other cryptocurrency-related issuances of the last two years.

State regulators, Into the Breach

State regulators are increasingly picking up the slack, through administrative proceedings and summary cease and desist orders. In 2018 to date, there have been at least eight summary cease and desist orders or other regulatory actions from the Texas state securities regulatory authority; six from Massachusetts; four from New Jersey; four from Alabama; two from Colorado, North Carolina, and South Carolina; and one each from Maryland, Missouri and Ohio.[3]

On May 21, 2018, the North American Securities Administrators Association (NASAA), a group of U.S. state and Canadian provincial regulators, announced "Operation Cryptosweep," which to date "has resulted in nearly 70 inquiries and investigations and 35 pending or completed enforcement actions related to ICOs or cryptocurrencies since the beginning of May."[4]

Several of these regulatory actions have been filed against blatant frauds, and thus are not likely to worry anyone in the larger cryptocurrency community, which benefits from the removal of bad actors. However, there are deeper, more fundamental problems with this proliferation of regulators and activity: some of these actions have been against companies or individuals with little or no connection to the state, and who may not have appreciated that they ran any risk of state regulation in the first place.

Especially where the state regulator is issuing a summary cease and desist order, where is the due process? Where is the necessary showing of minimum contacts with the forum? Particularly where an offering is being conducted from abroad, and is not operating within the state in question, how can a state securities regulator decide to summarily close an entire foreign business operation on the assertion that the operation violated the securities law of a particular state?

Particularly after the U.S. Supreme Court's decision in *Daimler AG v. Bauman*[5] eviscerated the notion of general corporate jurisdiction outside that corporation's "nerve center," there needs to be a showing that the company or individual is doing business specifically in that state, sufficient to trigger the state's long-arm jurisdiction statutes, and in a way that does not offend Constitutional due process. And after the Supreme Court's decision in *Morrison v. National Australia Bank*,[6] it is unclear whether states have the right to apply their laws to extraterritorial securities trading in the first place, to the extent foreign cryptocurrency transactions are "extraterritorial" – another point that has not yet been decided by the courts.

The questions raised by these state actions go beyond the jurisdictional. They are substantive as well. No doubt, most states' securities laws are roughly-equivalent, and well-settled; misrepresentations or material omissions in connection with the purchase or sale of securities are universally a violation. But as "blue sky" lawyers know, state securities requirements may differ in important but subtle ways.

In the absence of solid federal guidance on cryptocurrency regulation, different states are regulating in different ways: Wyoming's movement toward blockchain-friendly laws, Arizona's "sandbox" initiative, and Delaware's consideration of corporate-records blockchains may not square with the stricter views taken by Texas and Massachusetts. Does a blockchain company need a blue sky review of every potential transaction? Even if that company is a foreign

Copyright 2018, Morrison Cohen LLP. Provided for information purposes only. For legal advice, please contact us.

company trying to avoid U.S. transactions in the first place? Are states like Texas undermining the efforts of states like Wyoming – or vice versa? Will Texas take steps that impede Wyoming's blockchain-friendly efforts?

Conclusion

The SEC/CFTC approach of regulation through the courts, rather than through actual regulation or even legislative authority, risks a regulatory lacuna. It is admirable that state securities authorities are helping to regulate the cryptocurrency space, particularly in light of the necessarily limited resources at the federal level. And everyone agrees that clear-cut frauds should be stopped in their tracks.

But state-by-state regulation in this area, even under the auspices of a nominally unifying group such as NASAA, risks creating a host of uniformity problems that the Securities Act and the Securities Exchange Act – and all the federal regulations promulgated thereunder – were designed to eliminate. Fifty different states may choose govern in fifty different ways, some at odds with each other, and all of them claiming jurisdiction over companies in other states – and even other countries.

Without a unified regulatory framework, a common understanding of who the proper regulator should be, or whether and how a state regulator can reach an out-of-state actor, the states are risking splintering blockchain law in a way that will exacerbate the current trend of blockchain-based businesses moving offshore to escape confusing and overly burdensome U.S. regulations.

Some cryptocurrency issuers have acted like cryptocurrency is a wild west, where rules and standards don't apply. But that doesn't mean that state securities regulators should behave like Lone Rangers as well. The SEC and CFTC should obtain more solid legislative or regulatory authority, and state regulators can then be guided by that authority. States should be careful not to get carried away with a "cryptosweep" that will act in disparate ways, sweep away due process rights, and risk pushing offshore blockchain-based business innovations.

Jason Gottlieb is a partner at Morrison Cohen LLP and the principal author of the MoCo Cryptocurrency Litigation Tracker, available here.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

Reprinted with permission from the May 24, 2018 edition of the Law360© 2018 Portfolio Media, Inc. All rights reserved.
Further duplication without permission is prohibited.

---

[1] *SEC v. W. J. Howey Co*., 328 U.S. 293 (1946).
[2] *CFTC v. McDonnell*, 18-cv-361 (E.D.N.Y.), Memorandum and Order dated March 6, 2018.
[3] These orders, and other cryptocurrency litigation, can be found on the MoCo Cryptocurrency Litigation Tracker, available at https://www.morrisoncohen.com/news-page?itemid=471.
[4] http://www.nasaa.org/45121/state-and-provincial-securities-regulators-conduct-coordinated-international-crypto-crackdown-2/.
[5] *Daimler AG v. Bauman*, 571 U.S. 117 (2014).
[6] *Morrison v. National Australia Bank*, 561 U.S. 247 (2010).

Copyright 2018, Morrison Cohen LLP. Provided for information purposes only. For legal advice, please contact us.