TechSpeak Alert

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SEC Ramp Up Means Increased Enforcement Coming to Crypto Platforms, DeFi Exchanges and NFTs

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On May 3, the Securities and Exchange Commission (SEC) announced that it was nearly doubling the size of the Enforcement Division's Crypto Assets and Cyber Unit in order to pursue cases involving crypto asset offerings, crypto asset exchanges, crypto asset lending and staking products, decentralized finance (DeFi) platforms, non-fungible tokens (NFTs) and stablecoins.[1] SEC Chair Gary Gensler stated that with this increase "the SEC will be better equipped to police wrongdoing" in cryptocurrency markets and from cyber-related threats. While Gensler did not specify the types of wrongdoing this expanded unit will pursue, his recent public statements provide helpful guidance.

Last month, in a sweeping speech at the University of Pennsylvania, Gensler ominously compared the crypto ads during the Super Bowl this year to Super Bowl ads run by subprime lenders in the lead-up to the financial crisis and dotcom companies in 2000, revealing a skepticism toward these markets and the potential harm they can cause investors and the economy. His comments indicate that he believes most cryptocurrency exchanges must register with the SEC, and that almost all crypto tokens are securities subject to SEC oversight.

As discussed below, while his recent comments are most directly applicable to cryptocurrency exchanges and tokens, they also likely apply to DeFi platforms and NFT markets and we should expect to see increased regulation in these areas as well, especially because Gensler highlighted these two areas as focal points for the expanded Crypto Assets and Cyber Unit.

Chair Gensler's Speech at the Penn Law Capital Markets Association Annual Conference

In his speech at the University of Pennsylvania on April 4, 2022, Chair Gensler addressed three areas that the SEC is focused on: (1) crypto trading and lending platforms; (2) stablecoins; and (3) crypto tokens. Below is a summary of some of his comments in each of these areas.

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Crypto Trading and Lending Platforms

Gensler has instructed SEC staff to work on a number of projects related to trading platforms. The first project Gensler mentioned is getting these platforms registered and regulated, just like stock exchanges. In Gensler's view, these platforms play roles similar to traditional regulated exchanges and investors should be protected in the same way. Gensler added that platforms that meet the "gold standard" of SEC regulations will promote investor confidence and help crypto markets function.

Second, Gensler has also directed the SEC to consider how best to register and regulate platforms that trade both crypto commodity tokens and crypto security tokens. Specifically, Gensler has asked SEC staff to work directly with the Commodities and Futures Trading Commission (CFTC), which has authority to regulate crypto commodity tokens, on how to jointly regulate platforms that trade both types of tokens.

Third, Gensler has asked SEC staff to work with platforms that take custody of cryptocurrency in order to register and regulate those platforms to ensure the protection of customers' assets.

Finally, because many platforms may also act as market makers trading for their own accounts on the other side of customers, Gensler has asked SEC staff to consider whether it would be appropriate to segregate out market making functions.

As an example of what the future will likely hold for crypto trading and lending platforms, Gensler highlighted the SEC's recent settlement with crypto lending platform BlockFi for allegedly failing to register its offering of its retail crypto lending product, as required by the federal securities laws, among other alleged federal violations. As part of the settlement, in addition to paying a large fine, BlockFi agreed to bring its business into compliance with federal securities laws. Gensler believes this settlement shows the Commission's willingness to work with platforms on their compliance efforts.

Stablecoins

During his speech, Gensler also took aim at stablecoins. As stablecoins are pegged to reserve assets such as the U.S. dollar, Gensler believes stablecoins raise public policy considerations around financial stability and monetary policy, including uncertainty over whether they have sufficient backing. He noted that "stablecoins are so integral to the crypto ecosystem that a loss of the peg or failure of the issuer could imperil one or more trading platforms, and may reverberate across the wider crypto ecosystem." Gensler also flagged that stablecoins potentially permit illicit activity, such as money laundering, tax evasion and sanction avoidance, because they provide users with a pathway to avoid the traditional banking system. Finally, Gensler suggested the need for additional oversight over stablecoins for investor protection. As the three largest stablecoins were created by trading or lending platforms themselves, he believes there are conflicts of interest and market integrity questions.

Tokens

Last of all, Gensler addressed crypto tokens, noting that "[w]hen new technology comes along, our existing laws don't just go away." Gensler rejected the notion that most of these tokens are like "digital gold" or that they operate like money. Instead, he contended that most crypto tokens are in fact securities under the federal

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securities laws from the 1930s, which have been amended many times with Congress painting with "an even wider brush." Gensler highlighted *SEC v. W.J. Howey Co*., 328 U.S. 293 (1946), in which the Supreme Court established what is now known as the "Howey Test." Under the Howey Test, an investment contract exists where there is the investment of money in a common enterprise with the reasonable expectation of profits to be derived from the efforts of others. Gensler believes the Howey Test applies to many crypto tokens because entrepreneurs are raising money from the public by selling crypto tokens, with the expectation that managers will build ecosystems where the tokens are useful, thereby drawing more users to the projects. And if these crypto tokens are securities, issuers of these tokens must comply with the SEC's rules around offerings.

Chair Gensler's *New York Times* Interview

In an interview published on April 17 in the *New York Times*, Gensler reiterated many of the same themes about regulating crypto markets. He stated that crypto exchanges are no different from the New York Stock Exchange or Nasdaq, where "people are meeting and buying and selling something that is most likely a security." On the question of whether cyrptocurrencies are securities, he was perhaps even more emphatic, stating "[t]hese crypto tokens are crypto security tokens because entrepreneurs are raising money from the public." He ended his interview with a familiar refrain—that old laws apply with just as much force today as to crypto, as the issues presented are "what F.D.R. and Congress addressed some 90 years ago."

Key Takeaways

Crypto Exchanges and Tokens

The announcement of the dramatic expansion of SEC Enforcement's Crypto Assets and Cyber Unit along with Gensler's recent comments mean we will see more activity from the SEC, in the form of regulations and/or enforcement actions, targeted at crypto platforms, stablecoins and tokens. Put simply, Gensler believes that crypto platforms are like traditional, regulated stock exchanges and that investors should be protected the same way when trading cryptocurrencies. Gurbir Grewal, the Director of the SEC's Division of Enforcement, echoed this belief in the announcement of the unit's expansion, noting that "[c]rypto markets have exploded in recent years, with retail investors bearing the brunt of abuses in this space. . . . The bolstered Crypto Assets and Cyber Unit will be at the forefront of protecting investors and ensuring fair and orderly markets in the face of these critical challenges." As such, we can expect to see more settlements, like the BlockFi settlement, in which platforms are charged with failing to register.

As to the tokens themselves, while Gensler noted that the SEC would evaluate each token on a case-by-case basis, he made clear that he believes most are investment contracts under *Howey* and must also be registered with the SEC. Stablecoins in particular will be subject to enhanced scrutiny because of concerns that they permit illicit activity and also concerns that they are not, in fact, pegged to value of the underlying currency.[2]

DeFi Exchanges

Although not the primary focus of his comments, Gensler also addressed DeFi platforms in his comments at UPenn. DeFi platforms are generally peer-to-peer marketplaces where financial transactions (often cryptocurrency trading and lending) occur between two parties, presumably without any kind of intermediary. While discussing crypto trading and lending platforms, Gensler quipped that he was addressing these platforms “whether they call themselves centralized of decentralized (DeFi).” Gensler also noted that, ironically, the DeFi platform market is actually quite centralized. This indicates that Gensler is suspicious that a number of DeFi platforms are decentralized in name only. Gensler has expressed skepticism of DeFi platforms in the past because “[t]here’s still a core group of folks that are not only writing the software, like the open source software, but they often have governance and fees[.] There’s some incentive structure for those promoters and sponsors in the middle of this.”

Taken together, Gensler’s comments indicate the SEC will probe whether these exchanges are decentralized and whether they are offering unregistered securities. The SEC brought its first action related to DeFi last year when it charged two individuals and their company for misleading investors about their operations and profitability of their DeFi business.[3] We can expect to see similar SEC actions in the future.

NFT Markets

Finally, while Gensler did not directly address NFTs, his remarks should serve as a warning to NFT markets, especially given recent reports that the SEC has been scrutinizing this space and the SEC listing NFTs as a priority for the expanded unit.[4] Gensler’s broad reading of the Howey Test seemingly brings a numbers of NFTs and NFT exchanges into the SEC’s purview. Importantly, in his UPenn speech, Gensler stated that “many entrepreneurs are raising money from the public by selling crypto tokens, with the expectation that the managers will build an ecosystem where the token is useful and which will draw more users to the project.” Under this broad definition of a security, it seems likely that many NFT projects that offer users more than just a basic JPEG image would be considered securities offerings. For example, one popular NFT provides owners of the NFT membership in an exclusive community with “perks.” These perks can include exclusive chat platforms, tokens, merchandise and games. If these additional perks add value to the NFTs due to the efforts of the project’s developers, especially in terms of resale value, it’s hard to see how they do not fall under Gensler’s definition. If these projects are selling securities, then it follows that the NFT exchanges that list these tokens are also selling securities and must register with the SEC.

Other NFT platforms arrangements may face a similar fate. A number of NFT platforms permit users to take out loans using their NFTs as collateral. This arrangement is quite similar to the arrangement BlockFi had with its users, which led to BlockFi’s recent settlement with the SEC for offering unregistered securities. In addition, one of the largest NFT markets recently delisted an NFT that entitled holders to share in the casino profits generated by the NFT’s developers, following cease and desist orders from the states of Texas and Alabama against the developers for offering unregistered securities.[5] From these reports, it appears that NFT platforms are already selling securities, which will likely attract attention from the SEC.

[1] *SEC Nearly Doubles Size of Enforcement’s Crypto Assets and Cyber Unit,* SEC (May 3, 2022), https://www.sec.gov/news/press-release/2022-78?utm_medium=email&utm_source=govdelivery.

[2] Recent media reports have questioned whether algorithmic stablecoins—meaning stablecoins backed by a computer code and not by fiat currency or other crypto—adequately protect investors from losing the peg.

[3] *SEC Charges Decentralized Finance Lender and Top Executives for Raising $30 Million Through Fraudulent Offerings,* SEC (Aug. 6, 2021), https://www.sec.gov/news/press-release/2021-145.

[4] Matt Robinson, *SEC Scrutinizes NFT Market Over Illegal Crypto Token Offerings,* BLOOMBERG (March 2, 2022), https://www.bloomberg.com/news/articles/2022-03-02/sec-scrutinizes-nft-market-over-illegal-crypto-token-offerings

[5] Bob Mason, *OpenSea Delists Sands Vegas Casino Club NFTs after Cease & Desist Orders*, FX Empire (Apr. 23, 2022), https://www.fxempire.com/news/article/opensea-delists-sands-vegas-casino-club-nfts-after-cease-desist-orders-977419.

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