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U.S. Senate Hearing Takes Cautious, Optimistic Tone on Cryptocurrencies

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On Tuesday, February 6, 2018, the Chairman of the Securities and Exchange Commission (SEC) and the Chairman of the Commodity Futures Trading Commission (CFTC), met before the U.S. Senate Committee on Banking, Housing & Urban Affairs to discuss the future of regulation of cryptocurrencies.

In his written testimony, Chairman J. Christopher Giancarlo of the CFTC struck a cautious but positive tone on the burgeoning industry. While noting that cryptocurrencies present a novel challenge for regulators, the growth and development of distributed ledger technology - or blockchain technology - is likely to have a broad and lasting impact on global financial markets in payments, banking, securities settlement, title recording, cyber security and trade reporting and analysis. He remarked that if the financial market regulators had access to the real-time trading ledgers of large Wall Street banks during the 2008 financial crisis, while it may not have saved Lehman Brothers, it would have allowed for better-informed intervention, instead of the disorganized response that ensued.

Chairman Jay Clayton of the SEC, in his own written testimony, was optimistic about the technology's potential to help facilitate capital formation, providing promising investment opportunities for both institutional and retail investors. However, Clayton warned that fraudsters and bad actors see the "fear of missing out" enthusiasm as an opportunity, which highlights the need for investor protections such as those provided by existing securities laws. Clayton also had harsh words for companies that have raised funds through initial coin offerings (ICO), noting that despite the best efforts of these companies, "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. [...] Those who engage in semantic gymnastics or elaborate structuring exercises in an effort to avoid having a coin be a security are squarely within the crosshairs of our enforcement division."

Existing Regulatory Framework

Both, Giancarlo and Clayton set out the current authority of the CFTC and SEC, respectively, with respect to authority and oversight over cryptocurrencies. The current state of the law in the United States does not provide the CFTC with oversight over spot transactions of cryptocurrencies or other commodities, which includes cash transactions and exchanges that form the basis of the existing cryptocurrency market. However, the CFTC does have the enforcement jurisdiction to investigate through subpoena and conduct civil enforcement action against fraud and manipulation in cryptocurrency derivatives markets and in underlying cryptocurrency spot markets.

The SEC regulates securities transactions and certain individuals and firms that participate in the U.S. securities markets. In his comments, Clayton found that most cryptocurrency trading platforms have elected to be regulated as money-transmission services, and similar to the comments made by the CFTC, money-transmission services are predominantly state-regulated. For Clayton, calling a cryptocurrency a “currency” is choosing form over substance, especially given how many cryptocurrencies are being promoted as investment opportunities.

Recommendations of the CFTC and SEC

The CFTC, through the statements of Chairman Giancarlo, did not appear to be seeking an expanded mandate with respect to regulatory authority of cryptocurrency spot markets, noting that “such an extension of regulatory authority would be a dramatic expansion of the CFTC’s regulatory mission”.

Giancarlo analogized the development of distributed ledger technology to the growth of the internet, where the Republican Congress of the Clinton administration took a “do no harm” approach. That was the right approach to foster the development of the internet, and Giancarlo believes that “do no harm” is the right overarching approach for distributed ledger technology. Giancarlo noted that US federal oversight may include: data reporting, capital requirements, cyber security standards, measures to prevent fraud and price manipulation and anti-money laundering and “know your customer” protections.

The SEC appears to be taking a slightly stronger stance, noting that many, if not all, ICOs should be regulated by federal securities laws. In line with his recent warning statement, Chairman Clayton urged market professionals, including securities lawyers, accountants and consultants to act responsibly in advising parties in this new market. Clayton claims that certain market professionals have attempted to highlight the utility feature of proposed coins in an effort to claim they are not securities, an analysis he generally disagreed with.

Conclusions

In their concluding statements, both Giancarlo and Clayton emphasized that this new technology will offer great opportunities as it continues to develop. While Clayton acknowledges the benefits of distributed ledger technology, it should not come at the expense of the principles of investor and market protection.

Giancarlo, to the collective joy of the cryptocurrency community, gave a more headline-worthy conclusion. In it, he stated that, like the internet, “we cannot put the technology genie back in the bottle. Virtual currencies mark a paradigm shift in how we think about payments, traditional financial processes, and engaging in economic activity.”

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