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Cryptocurrency: The Consequences of a Regulatory Gap in a Rapidly Growing Industry

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November 2, 2021 marked the first time that a jury rendered a verdict as to whether cryptocurrency is a security.[1] In *Audet v. Fraser,* a landmark decision regarding the booming industry,[2] the jury's verdict determined that four cryptocurrency-related products, including GAW Miners' "Hashlets," were not securities and thus not subject to special requirements and regulations under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").[3] As a result, the plaintiff class was left with no remedy despite the jury finding that they were defrauded.[4] This decision comes in sharp contrast to the Securities and Exchange Commission ("SEC")'s prior classification of Hashlets as a security in an action it brought against GAW Miners LLC co-founder Homero Joshua Garza in 2015.[5] The SEC has brought enforcement

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[1] Paul Weiss, *Federal Jury Finds Cryptocurrency Products Not Securities in Landmark Verdict* (Nov. 18, 2021), https://www.paulweiss.com/practices/litigation/securities-litigation/publications/federal-jury-finds-cryptocurrency-products-not-securities-in-landmark-verdict?id=41746 [hereinafter *Cryptocurrency Products Not Securities*]. The verdict was rendered without a corresponding judicial opinion.

[2] Ryan Harr, *The Future of Cryptocurrency: 5 Experts' Predictions After a 'Breakthrough' 2021,* NEXTADVISOR IN P'SHIP WITH TIME (Jan. 3, 2022), https://time.com/nextadvisor/investing/cryptocurrency/future-of-cryptocurrency/ [hereinafter *The Future of Cryptocurrency*]. 2021 brought all-time high prices for both Bitcoin and Ethereum, two of the most popular forms of cryptocurrency.

[3] *Cryptocurrency Products Not Securities*, *supra* note 1; Securities Exchange Act of 1934, 15 U.S.C. § 78 (2018).

[4] *Cryptocurrency Products Not Securities*, *supra* note 1. The lack of remedy was due in part to three of the four defendants becoming judgment-proof while the case was in progress.

[5] Katherine Cooper et al., *Jury Diverges from SEC in Finding that Digital Assets Are Not Securities,* CLIENT ALERT (Nov. 8, 2021), https://www.mmlawus.com/newsitem/pdf/client_alert_jury_diverges_from_sec_in_finding_that_digital_assets_are_not_securities_1126.pdf (citing Complaint at ¶ 3, *SEC v. Garza*

actions against 84 companies for the unregistered sale of a wide variety of cryptocurrencies since 2014, seemingly in an attempt to categorize the entire field as falling under their regulatory purview.[6] The Commodity Futures Trading Commission ("CFTC") has also declared their own regulatory authority over digital assets at times. Thus far, however, neither agency has been able to establish a regulatory framework, leading to a massive regulatory gap and devastating effects on consumers.

The rapid growth and popularity of digital assets presents alarming and unique risks if not properly regulated.[7] The primary purpose of the Securities Act and Exchange Act is to protect investors and ensure that they are well-informed before making investment decisions, and cryptocurrency investors need this protection and information even more.[8] The heightened risks of investing in digital assets have been duly noted and relayed by governments and agencies on a global scale, citing concerns with its transparency, valuation, and trading on unregulated exchange platforms.[9] The European Securities and Markets Authority, for example, released a statement warning consumers that ICO investments specifically are "extremely risky and highly speculative" and that most of the businesses offering them carry "an inherently high risk of failure."[10] Some other countries such as China, South Korea, and Thailand have even

et al., No. 15-cv-01760 [D. Conn. Dec. 1, 2015], ECF No. 1) [hereinafter *Jury Diverges from SEC*].

[6] *SEC, CFTC Coordination May Be The Way Forward for Crypto Regulation*, PYMNTS (Jan. 21, 2022), https://www.pymnts.com/news/regulation/2022/sec-cftc-coordination-may-be-the-way-forward-for-crypto-regulation/.

[7] David Gura, *Why Wall Street's top cop thinks it's time to get tough,* NPR (Dec. 19, 2021, 7:01 AM), https://www.npr.org/2021/12/19/1063573184/wall-streets-sec-gary-gensler-cryptocurrencies-bitcoin-spac.

[8] *Id.*

[9] Paul Latimer & Michael Duffy, *Deconstructing digital currency and its risks: why ASIC must rise to the regulatory challenge,* 47 FED. L. REV. 121, 130 (2019). The authors here discuss a very similar regulatory gap in Australia and around the world and call on the Australian Securities and Investments Commission to close it.

[10] Eur. Sec. and Markets Auth., Statement, 'ESMA Alerts Investors to the High Risks of Initial Coin Offerings (ICOs)', 13 Nov. 2017; *see* Latimer & Duffy, *supra* note 9.

gone so far as to ban ICOs or digital currency as a whole.[11] These reactions may be extreme, but they are far from unwarranted.

First, most people do not understand even the basic structure of cryptocurrency, including those who invest in it or plan to.[12] Despite the fact that last year showed all-time highs for the most popular forms of cryptocurrency,[13] a study conducted by YouGov in late 2021 revealed that a whopping ninety-eight percent of the 1,000 respondents across the United States, Mexico, and Brazil failed a quiz covering basic concepts of Bitcoin, stablecoins, and non-fungible tokens (NFTs).[14] Although respondents who own cryptocurrency themselves were nearly twice as likely to answer the questions correctly, cryptocurrency owners made up between fourteen and seventeen percent of total responses; a much greater portion than the two percent who passed.[15] Despite the overwhelming lack of knowledge displayed by the respondents, 12% of Americans, 28% percent of Mexicans, and 30% of Brazilians indicated that they plan to purchase or sell some form of cryptocurrency within the following six months.[16] This combined lack of public knowledge and reporting requirements has makes it nearly impossible for consumers to make informed investment decisions in the digital assets market.

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[11] *Public Notice of the PBC, CAC, MIIT, SAIC, CBRC, CSRC, and CIRC on Preventing Risks of Fundraising through Coin Offering,* THE PEOPLE'S BANK OF CHINA (Aug. 9, 2017), http://www.pbc.gov.cn/english/130721/3377816/index.html; Cynthia Kim, *South Korea Bans Raising Money through Initial Coin Offerings,* REUTERS (Sep. 29, 2017), https://www.reuters.com/article/us-southkorea-bitcoin/south-korea-bans-all-forms-of-initial-coin-offerings-idUSKCN1C408N; Andrew Trotman, *Bitcoins Banned in Thailand,* THE TELEGRAPH (July 29, 2013).

[12] Ben Strack, *Survey Says Most People Still Don't Understand Crypto,* BLOCKWORKS (Nov. 1, 2021, 2:35 PM), https://blockworks.co/survey-says-most-people-still-dont-understand-crypto/.

[13] *The Future of Cryptocurrency*, *supra* note 2.

[14] *Strack*, *supra* note 12. The quiz given in the survey can be accessed at https://cryptoliteracy.org/quiz/.

[15] *Id.*

[16] *Id.*

Second, cryptocurrency brought in a wave of amateur investors who are less informed about the investment market and its associated risks as a whole.[17] It has even been said that "cryptocurrencies have drawn more interest in the world of finance and technology than any other tradable instrument."[18] The stock market was historically viewed as a rich man's game, but the global pandemic saw millions of amateur investors, also called "noise traders," engage in trading for the first time during the rise of "meme stocks."[19] Were cryptocurrency classified as a security, it would be subject to the registration and reporting requirements of the Securities Act, granting these lay investors a great deal more information on which to base their decisions. While more sophisticated investors tend to base their trading on informed market predictions and the fundamentals of the asset, amateur investors' decisions are primarily driven by the recent performance of the asset; if the price of a cryptocurrency increases, they believe it will continue to increase, and if it decreases, they believe it will continue to decrease.[20]

Unfortunately, this understanding of stock trends fails to hold up in practice more often than not and tends to produce a market phenomenon

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[17] *Gura, supra* note 7.

[18] Pedro Piccoli & Mo Chaudhury, *Dynamic Relationship of Cryptocurrency Prices and Investor Attention,* RESEARCHGATE (Jan. 31, 2019), https://www.researchgate.net/profile/Pedro-Piccoli/publication/331089741_Dynamic_Relationship_of_Cryptocurrency_Prices_and_Investor_Attention/links/5c65538992851c48a9d2c60a/Dynamic-Relationship-of-Cryptocurrency-Prices-and-Investor-Attention.pdf.

[19] *Gura, supra* note 7; Piccoli & Chaudhury, *supra* note 18; Avie Schneider, *GameStop Stock Mania: Why Everyone Is Talking About It And Many Are Worried,* NPR (Jan. 28, 2021), https://www.npr.org/2021/01/28/961349400/gamestop-how-reddit-traders-occupied-wall-streets-turf. The most notable impact of amateur investors' efforts with respect to meme stocks was the shocking short-swing returns reaped on shares of GameStop after Reddit users organized a mass purchase on the "r/wallstreetbets" forum to drive up the price. The forum can be accessed at www.reddit.com/r/wallstreetbets.

[20] Piccoli & Chaudhury, *supra* note 18; *but see* Lavinia Rognone et al., *News sentiment in the cryptocurrency market: an empirical comparison with Forex,* 69 INT'L REV. OF FIN. ANALYSIS 101462, at 2 (2020). This study noted a similar phenomenon but found that investor attention increased returns irrespective of whether the attention was positive or negative.

referred to as a "bubble," wherein the investment rapidly increases in value until the bubble "pops" and the price falls drastically.[21] Many Bitcoin investors experienced such a devastating loss in 2019.[22] The price of a single Bitcoin was only $768 in December of 2016, but just one year later it had risen by an astounding 2,383% to a cost of $19,065 per coin in December of 2017.[23] One study examining the correlation between online searches and cryptocurrency prices suggests that "appreciation of such magnitudes clearly resembles a speculative bubble" which is "principally driven by the noise traders [who] […] ignore the fundamentals and believe that the asset price will keep growing."[24] This essentially creates a self-fulfilling prophecy – when a currency increases in value, a great deal of lay investors purchase it, which increases the price and confirms their predictions. Conversely, when the currency experiences a drop-off, lay investors engage in a mass unload of the currency, causing its value to plummet as Bitcoin did by 84% in just six months following the bubble's peak.[25]

Third, the unpredictable nature of cryptocurrency makes investing in it riskier than many other kinds of more traditional investments.[26] Due to their prices' tendency to rise and fall in great amounts with extreme speed, digital assets have been described by many as "volatile" investments."[27] Even if investors get lucky and experience a large increase

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[21] *See e.g.*Piccoli & Chaudhury, *supra* note 18; Rognone et al., *supra* note 20.

[22] Piccoli & Chaudhury, *supra* note 18.

[23] *Id.*

[24] *Id.* at 2-4 (calling noise traders "naïve" and "less informed"); *see also* Yukun Liu & Aleh Tsyvinski, *Risks and Returns of Cryptocurrency,* NAT'L BUREAU OF ECON. RSCH. at 39 (Aug. 2018) (concluding that the returns of cryptocurrency are primarily driven by "momentum and investor attention").

[25] Piccoli & Chaudhury, *supra* note 18, at 2.

[26] *Id.*

[27] *See e.g.* Sam Cooling, *CFTC Reminds SEC "We regulative derivatives not digital assets"*, YAHOO! (Aug. 24, 2021), https://www.yahoo.com/video/cftc-reminds-sec-regulate-derivatives-123215809.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAHqC4S7snRgwv2W6xRkXmGZhXIx5gWKgH_30UuR1WQkHKbyluKef53Aop8YD9Rto7VAfuA9Usl-PXXJLY3y_QsuwfTbnM4JQFqQxWWkp-

in the value of their digital tokens, they often have limited exit options and are not always able to cash in their returns before the price falls again.[28] One study by Yale University's Department of Economics revealed that the risk-return tradeoff of three prominent forms of cryptocurrency is completely distinct from that of stocks, largely due to its lack of exposure to the traditional stock market and economic factors.[29] There are two factors which *can* predict greater cryptocurrency returns – high momentum and high investor attention – but these are the same two factors that often lead to the "bubble" effect and devastating losses for investors.[30] This essentially creates a phenomenon wherein even *if* amateur investors are able to accurately predict returns on digital assets, they may be unable to collect them and/or face an even greater risk of the bubble popping, which is far worse than experiencing moderate fluctuation and losses on the traditional stock market.[31]

The greatest unique risk of cryptocurrency is not just a result of ill-informed investment decisions, however; it is the increased potential for fraud and difficulty in recovering for it. Because they do not fall within any existing regulatory framework, many digital asset investments are not subject to reporting requirements or strong federal anti-fraud protections, leaving those who are defrauded with no means of relief. *Audet* is anything but an anomaly – this sort of fraudulent conduct has already proved to be pervasive in the digital assets market. Its uninformed investors, lack of reporting requirements, and unclear enforcement mechanism makes it ripe for scams. The SEC and CFTC have already become aware of several instances of Ponzi schemes, pump-and-dump

gEPBdMEK1BFLXWzU303t1G9wa1g_fWNsZXPedTczcj8YxPMVtuBwDiwAGMZe54W7Niq; Thomas Franck, *Senators demand cryptocurrency regulation guidance from SEC Chair Gary Gensler,* CNBC (Sep. 14, 2021, 4:52 PM), https://www.cnbc.com/2021/09/14/cryptocurrency-regulation-sec-chair-gary-gensler-grilled-by-senators.html; Eur. Sec. and Markets Auth., *supra* note 10.

[28] Eur. Sec. and Markets Auth., *supra* note 10.

[29] Yukun Liu & Aleh Tsyvinski, *Risks and Returns of Cryptocurrency,* NAT'L BUREAU OF ECON. RSCH. at 39 (Aug. 2018).

[30] *Id.* at 1; *see* Piccoli & Chaudhury, *supra* note 18, at 2–4 .

[31] *See* Piccoli & Chaudhury, *supra* note 18; *see also* Rognone et al., *supra* note 20, at 13.

schemes, and fee scams.[32] Finally, cryptocurrency trading platforms specifically present vast opportunities for fraudulent conduct. Some of the platforms misrepresent the market value of the currencies and sell them for far more than they are worth, some allow consumers to mine for the currency but then keep it for themselves, and some are entirely fake and simply collect purchasers' money without ever delivering the currency.[33]

The SEC, CFTC, and Congress have continued to point the finger at one another while consumers continue to suffer losses from uninformed and unprotected investments. As of today, no legislation has been passed on the matter and no comprehensive regulatory framework has been put into place. Some claim the SEC should take full responsibility, others place blame on the CFTC, and some have advocated for a joint effort between the two. Judicial resolution is also an option, but it is a long and painful road that is clearly not appropriate for such an urgent and pervasive regulatory gap. Further, these are not solutions – they are simply suggestions as to who should be responsible for creating and enforcing the solutions. Once this is done, the road towards closing the regulatory gap will have only just begun. The responsible parties will have to create an entirely new regulatory framework or, at the very least, expand significantly upon its existing one. This process is likely to consume a great deal of time, which is a resource that many defrauded investors do not have. One thing is certain – to start regulating cryptocurrency now would already be too late.

Edited by Alex Beezley

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[32] *Customer Advisories,* COMMODITY FUTURES TRADING COMM'N (Apr. 20, 2020), https://www.cftc.gov/digitalassets/index.htm.
[33] *Id.*