Divergent Paths of Crypto Fraud Enforcement: How Three Major U.S. Agencies Police Fraud

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How far we've come from Howey's citrus groves. Today's cryptocurrency products would have almost assuredly left the drafters of the most utilized laws in the criminal and regulatory securities context utterly befuddled.

Because Congress has failed to enact modern legislation governing crypto assets, including cryptocurrency, the U.S. Department of Justice (DOJ), Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) have been compelled to shoehorn their crypto related fraud enforcement strategies into distinct enforcement schemes that are many decades old.

Predictably, the outdated and varied methodologies have returned mixed and at times contradictory results, not to mention some public, inter-agency disputes.

The Problem

Cryptocurrency, which made its debut in 2009, is a peer-to-peer digital medium of exchange existing on decentralized electronic networks. Cryptocurrency's design allows users to transact globally without using traditional currencies backed by a government, central bank or a tangible commodity, such as gold.

While trading in fiat or commodity-backed currency is certainly not novel, crypto assets, and more specifically cryptocurrencies like Bitcoin, Ethereum and Dogecoin, have seemingly drawn a tsunami of institutional and retail participants seeking to profit from cryptocurrency's extreme volatility and analyst predictions of ever-rising prices. Inevitably, this wave of investor interest has created a seemingly endless stream of bad actors hoping to gain an unfair advantage over other participants in this still relatively juvenile market.

Without congressional approval of legislation specifically addressing crypto assets and categorizing them as a security, commodity, currency, computer software token or some other asset, there remains significant uncertainty concerning whether crypto assets are regulated by the SEC, the CFTC or some other prudential regulator. This has led to great consternation and dissent about how to police a rapidly expanding global industry that is, in SEC Chairman Gary Gensler's words, "rife with noncompliance."

Chairman Gensler has stated that crypto assets are "investment contracts under the Supreme Court's Howey Test" and "must work within our securities regime." Former CFTC Commissioner Brian Quintenz expressed that "the SEC has no authority over pure commodities or their trading venues, whether those commodities are wheat, gold, oil...or crypto assets." Somewhat in opposition to the CFTC's position, the Treasury Department has advanced the position that issuers of stablecoin (a specific type of cryptocurrency that is usually pegged to a fiat currency) should be regulated as banks. Lastly, the DOJ has largely stayed above the fray, declining to take a position on who should regulate the crypto assets.

U.S. Attorney Damian Williams of the U.S. District Court of the Southern District of New York has argued the DOJ already possesses the tools it needs to enforce federal criminal law in the crypto space because while the asset class might be new, the "kind of corruption [seen in it] is as old as time." In other words, the DOJ can fulfill its objectives without worrying about how certain crypto assets are classified.

DOJ's Criminal Enforcement in the Crypto Space

Traditionally, because of the heightened standard of proof inherent in criminal law, the DOJ has a more arduous task than their regulatory partners when it comes to securing a judicial victory. However, because the DOJ, especially the Southern District of New York, has largely side-stepped the question of how exactly crypto assets are classified, the crypto space appears to be the rare exception where the DOJ has had an easier path to traverse than its sister regulatory agencies, the SEC and CFTC.

A prominent example of this strategy can be found in United States v. Wahi, a 2022 Southern District of New York case that concluded with the first ever custodial sentence for insider trading in a crypto case.

In Wahi, the government alleged that Ishan Wahi, a former Coinbase Global Inc. (Coinbase) product manager, provided his brother and another individual with material non-public information regarding Coinbase's plans to list new crypto assets on its platform. The decision to list a crypto asset, and the scheduling of any announcement, could be exceedingly valuable to an investor as the decision by a major platform to list a lesser-known crypto asset could dramatically increase the value of that asset.

Completely bypassing the difficult issue of cryptocurrency asset classification, the government chose not to charge Wahi with securities or commodities fraud, but instead only charged him and his confederates with wire fraud. After Wahi's guilty plea and sentencing, U.S. Attorney Williams proclaimed that Wahi "should send a strong signal to all participants in the cryptocurrency markets that the laws decidedly do apply to them. The [government] will hold those who engage in insider trading to full account, regarding of whether their illegal conduct occurs in the equity markets or in the market for crypto assets."

The SEC and the 'Howey' Problem

Because the SEC's jurisdiction is limited to policing securities and the securities markets, the SEC must show that the assets it seeks to regulate are in fact securities. The SEC maintains that cryptocurrency is a security, classifying it as an investment contract. SEC v. W.J. Howey (1946) has long been the seminal case on whether an asset is an investment contract. Under Howey, an asset is considered an investment contract only if there is: (i) an investment of money (ii) in a common enterprise (iii) with an expectation of profits (iv) to be derived solely from the efforts of others.

In the SEC's litigation against Wahi in SEC v. Wahi (W.D. Wash.), the Commission alleged that the defendants violated the antifraud provisions of the Securities Exchange Act of 1934, requiring the SEC to argue that the cryptocurrency assets that were the subject of the Wahi scheme were, by definition, investment contracts and thus securities under Howey.

Not only did the defendants in SEC v. Wahi file compelling motions arguing that the specific digital assets were not "investment contracts," as market participants did not necessarily have an expectation of profits to be derived solely from the efforts of others, and therefore not subject to the SEC's jurisdiction, but other prominent cryptocurrency industry participants appeared as amici, expressing significant apprehension about the SEC's stance regarding cryptocurrency.

Ultimately, after pleading guilty in the related criminal matter, the defendants in SEC v. Wahi agreed to a consent judgment, allowing the court to avoid ruling on the hotly contested issue of whether the SEC has jurisdiction over cryptocurrency assets.

Even within the Southern District of New York, the contours of the SEC's jurisdiction over cryptocurrency remains unsettled.

In July, U.S. District Judge Analisa Torres ruled in SEC v. Ripple Labs that XRP token, a crypto asset, was an investment contract subject to the SEC's jurisdiction only when sold to institutional purchasers when these institutional purchasers knew the identity of the sellers (the issuer). This disappointing decision for the SEC stands in contrast with the decision issued two weeks later by Judge Torres' colleague, U.S. District Judge Jed Rakoff, in SEC v. Terraform Labs.

In Terraform Labs, Judge Rakoff explicitly rejected the reasoning of Ripple Labs ruling that the identify of a transaction participant "has no impact" on whether a product qualifies as an investment contract, creating a relatively novel intra-district split on the important and high-profile issue of the extent of the SEC's jurisdiction over cryptocurrency assets.

In short, the SEC's path has been somewhat fraught, and its results mixed.

The CFTC

Since 2015, the CFTC has, with seemingly universal success, taken the position that where there is fraud or other manipulative conduct, Bitcoin, Ether and other widely decentralized virtual currencies are commodities under the Commodities Exchange Act. Given the cleaner path the CFTC has because of the broad language in its authorizing statute, the Commodities Exchange Act, it is rather unsurprising that in fiscal year 2023, just shy of 50% of the regulatory enforcement actions initiated by the CFTC involved conduct related to digital asset commodities.

Practical Tips for Handling a Crypto-Related Matter

Even though Congress has yet to provide appropriate legislation and courts remain split on fundamental threshold questions, the DOJ, SEC and CFTC have all made public pronouncements regarding continuing commitments to expend ever-increasing amounts of resources in the crypto enforcement space. Accordingly, it is becoming more likely that a regulatory defense lawyer may be asked to represent a client in the crypto space.

Given the territorial disagreements and distinctive enforcement strategies utilized by the relevant regulators, it is incumbent upon counsel to quickly identify which regulators may have jurisdiction in their matter. If more than one regulator may be in the fold, if handled correctly, a jurisdictional turf-war may present a unique opportunity for counsel to attempt to steer a matter towards a preferred regulator, especially if a client is considering cooperation or settlement.

Lastly, it is time for Congress to act and-after congressional hearings with input from crypto issuers, exchanges and all regulators-enact clear and thoughtful legislation to address these turf battles and provide the crypto industry with clear guidance instead of trying to understand how Howey's citrus grove applies to cutting edge electronic assets.

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