

Section 3: Opening the Door to Cryptocurrency Innovation by Eliminating Unnecessary Regulatory Barriers

While cryptocurrencies may no longer be brand new, they have increasingly caught the attention of policymakers, regulators, and the public over the past several years. The global market capitalization of crypto investments has grown sharply (see Figure 3), even when factoring in recent market declines, and by some estimates, upwards of 21 percent of Americans have made crypto investments.¹

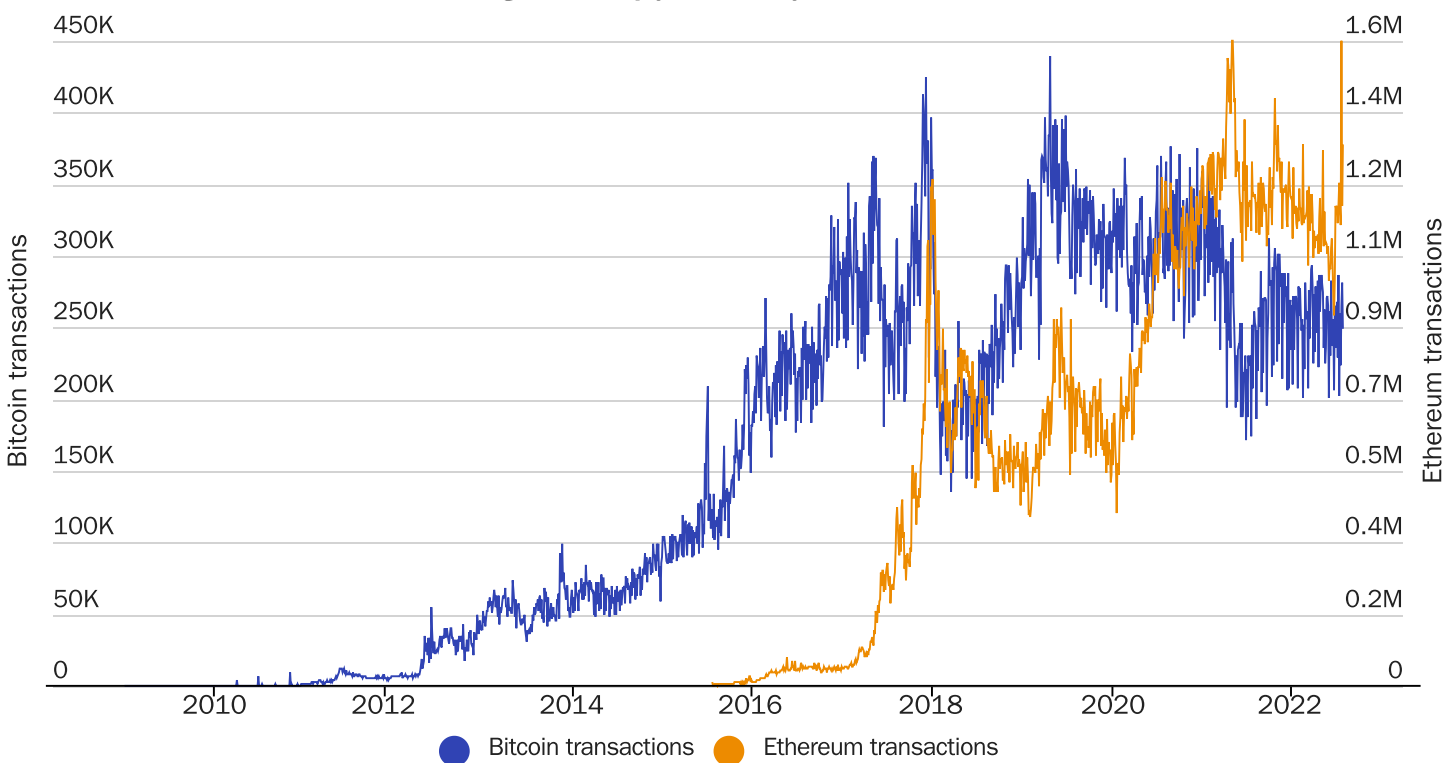
Yet, cryptocurrencies remain subject to regulatory uncertainties that may hamper their development along with innovation more broadly, potentially pushing entrepreneurs

outside of the United States and limiting Americans' ability to take advantage of these advances. Because the technology underlying cryptocurrencies also is foundational to additional innovations, including smart contracts, decentralized autonomous organizations (DAOs), and Web3, an inhospitable regulatory environment for cryptocurrencies could have far-reaching consequences.

Cryptocurrencies hold promise for liberty, providing individuals with choice in their currency, the potential to protect financial privacy and property rights, and the ability to engage in quick, cheap, and borderless transactions.

Figure 3

Bitcoin and Ethereum transactions have grown sharply in recent years



Sources: "Confirmed Transactions Per Day," Blockchain.com; and "Ethereum Daily Transactions Chart," Etherscan.

Whether these promises are realized depends in part on providing a regulatory environment for cryptocurrencies that does not unduly burden their abilities to innovate, transform, and grow.

Congress can take action to support cryptocurrencies, removing challenges to their use and development in the laws governing coins and currency, affording them sensible treatment under tax laws, and providing a clear regulatory framework for projects that are subject to securities laws.

THE PROBLEM

Cryptocurrencies can bring the benefits of competition to currencies, which have long been subject to a government monopoly. Competition not only has the potential to provide currency that better suits individuals' needs, but lessons learned from competition could also strengthen the dollar and preserve its status as the world's reserve currency.

Unfortunately, several laws place barriers in the way of such competition. First, laws governing coins and currency may deter both the development and use of cryptocurrencies. Both the Federal Reserve and Treasury Department recognize that "there is no federal statute mandating that a private business, a person, or an organization must accept currency or coins as payment for goods or services,"² but legal tender laws remain a center of confusion. These laws denote the acceptability of U.S. coins and currency for the payment of taxes, fines, and contracts, but many believe that they mandate the use of U.S. dollars and prohibit private businesses from refusing to accept them.³ This misunderstanding, which arises from the statute's failure to define what it does and does not mean in practice, may stand in the way of widespread use of cryptocurrency in commercial transactions.

Coinage laws, written largely to prohibit the counterfeiting of U.S. coins, may also limit cryptocurrencies. The statute vaguely prohibits coins that have a "resemblance or similitude" to U.S. coins and coins of original design from being used as money. While these statutes apply to physical coins made of metal, the risk—alluded to during a congressional hearing with the U.S. Senate Committee on Banking, Housing, and Urban Affairs⁴—that they could be amended

to include digital coins could deter both development and use of cryptocurrencies.

Second, subjecting cryptocurrencies to capital gains taxes impedes cryptocurrency's use as money. Because capital gains tax rates are structured to incentivize long-term holding, capital gains taxes penalize people for using cryptocurrencies as money for everyday purchases. Moreover, capital gains taxes impose a heavy—and at times impossible—administrative burden both on those who attempt to use cryptocurrencies as money and on those newly tasked with reporting cryptocurrency transactions to the Internal Revenue Service.

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Taken together, these issues put a thumb on the scale against the use of cryptocurrencies as money and limit their potential competitive benefits.

More broadly, regulatory uncertainty hinders cryptocurrency development. Because a crypto token can alternatively be seen as a commodity, a security, a currency, or perhaps something else entirely, the application of existing laws and regulations to crypto projects is not always clear. A legal landscape characterized by this uncertainty, or that prioritizes legacy regulatory formalities regardless of their practical relevance to cryptocurrencies, risks becoming inhospitable for both entrepreneurs and users. Such a landscape would be detrimental to technological innovation, capital formation, and consumer welfare.

Resolving whether cryptocurrencies are regulated under securities laws or commodities laws is a prerequisite to addressing other questions about how to regulate the exchange of cryptocurrencies and their general interactions

with the financial system, including questions about custody and accounting.

Where crypto entrepreneurs sell tokens to the public to finance the development of their projects, it is reasonable to ask whether, when, and how securities laws apply to these sales. While several federal bills touching on these questions have been introduced—and the Securities and Exchange Commission has engaged with the issue in enforcement actions and informal guidance—no law or formal rule decisively clarifies the application of securities laws to cryptocurrencies.⁵

“Policymakers should provide a clear, practical test for determining whether a crypto project is decentralized.”

Securities laws evolved in no small part to address the risks posed by managerial bodies possessing information that investors do not and those bodies’ capacity to act at odds with investors’ best interests. The archetype of a covered entity under securities laws is a centralized enterprise with a corporate form, headquarters, and managerial hierarchy. But cryptocurrency projects aspire to upend this historical template, eschewing not only the physical plant of a 20th-century enterprise but also, more importantly, a managerial body exercising ongoing control over the project. Thus, a core innovation of decentralized cryptocurrencies is mitigating third-party risks through technology.

When a cryptocurrency project does not involve third-party management or control, applying legacy securities laws is both legally inappropriate and practically ineffective at addressing potential harm. But when a cryptocurrency project does involve third-party managerial control and when other criteria under securities case law are satisfied, applying safeguards designed to mitigate risks is appropriate.

Nonetheless, applying the existing securities registration and disclosure regime to crypto projects could create compliance costs that foreclose an important means of financing a cryptocurrency’s development and thereby

achieving decentralization. Accordingly, even where securities laws are appropriately applied to centralized cryptocurrency projects, the disclosure framework ought to be narrowly tailored to the specific risks of cryptocurrencies: fraud, deception, and manipulation by developers, sellers, and promoters who remain actively involved in the management of a cryptocurrency project.

SOLUTIONS

Congress can undertake several reforms to level the playing field for cryptocurrencies.

- **Amend the definition of securities to exclude decentralized crypto projects.** Policymakers should provide a clear, practical test for determining whether a crypto project is decentralized. The key question is whether the cryptocurrency purchaser is expecting profits solely from the efforts of others (i.e., relying on essential managerial or entrepreneurial efforts of third parties). The criterion is whether, in selling a cryptocurrency, the seller, promoter, or developer promises performance necessary to bring the crypto project and its stated benefits to fruition. If so, the cryptocurrency project at issue is centralized. If not, it is decentralized. Congress should amend securities statutes to clarify that securities laws do not apply to decentralized cryptocurrency projects.
- **Establish tailored disclosure for crypto projects on the path to decentralization.** Cryptocurrency projects can take time to achieve decentralization. Some projects may seek to sell their cryptocurrencies to finance their development, including via so-called initial coin offerings or token presales. Congress should legislate a tailored registration model that prioritizes disclosures related to the specific risks of cryptocurrencies and protections against fraud and misleading statements.
- **Clarify the meaning of legal tender.** Congress should clarify the meaning of legal tender in U.S.C. § 5103 to make clear that legal tender status does not require private businesses, persons, or

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organizations to accept U.S. coins or currency as payments for goods and services.

- **Clarify the prohibition on counterfeiting U.S. coins.** Congress should amend 18 U.S.C. §§ 485–497 to clearly state the necessary conditions for a coin to be considered a counterfeit, rather than rely on vague terms like being in “resemblance or similitude.”
- **Remove the prohibition on minting coins of original design.** Congress should amend 18 U.S.C. § 486 to remove the prohibition on coins of original design.
- **Remove capital gains taxes from alternative**

currency use. Congress should remove capital gains taxes, at the very least, where cryptocurrencies are used to purchase goods and services.

- **Remove the Infrastructure Investment and Jobs Act’s change to the broker definition.** As it stands, the law sets an impossible tax-reporting standard by including cryptocurrency miners and developers, among others, in its definition of brokers who must report cryptocurrency transactions. Congress should ensure that tax-reporting requirements apply only to those who perform traditional brokerage functions.

SUGGESTED READING

The Hard Thing about Crypto Purgatory by Jack Solowey, *Cato at Liberty* (blog), Cato Institute, September 12, 2022.

Practical Legislation to Support Cryptocurrency Innovation by Jack Solowey and Jennifer J. Schulp, Cato Institute Briefing Paper no. 140, August 2, 2022.

Congress Should Welcome Cryptocurrency Competition by Nicholas Anthony, Cato Institute Briefing Paper no. 138, May 2, 2022.

What Do Cryptocurrencies Mean for Liberty? by Nicholas Anthony, *Cato at Liberty* (blog), Cato Institute, January 7, 2022.

The Trap of the Trilemma of Cryptocurrency Regulation: Government Control Is Not the Default by Nicholas Anthony, *Cato at Liberty* (blog), Cato Institute, December 20, 2021.

The Infrastructure Investment and Jobs Act’s Attack on Crypto: Questioning the Rationale for the Cryptocurrency Provisions by Nicholas Anthony, Cato Institute Briefing Paper no. 129, November 15, 2021.