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SPOTLIGHT REPORT

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Crypto’s Existential Moment

What’s Happening: Crypto is entering a make or break period with lawsuits from the Securities and Exchange Commission (SEC) that could force restructuring of the industry in the US and Congress starting to (again) seriously debate legislation.

Why It Matters: SEC Chair Gary Gensler has not been shy about his assertion that crypto exchanges have been in violation of federal securities laws and has now delivered on this with cases filed against Binance and **Coinbase (COIN)**. Winning these actions could lead to a total reshaping of the digital asset industry and potentially cement the SEC’s position as its lead regulator given its allegation that many of the tokens on these exchanges are securities that require the businesses to register with the agency. Reaching this point will likely take years given the time resolving these cases will require, but in the interim we expect Gensler and his fellow regulators to continue pursuing regulation by enforcement. **What could force a change to this approach would be legislation from Congress with House Republicans eyeing bills on market structure and stablecoins.** These proposals would reduce the SEC’s role to some extent and elevate the Commodity Futures Trading Commission (CFTC) and force the agencies to write crypto-specific regulations in order to implement the laws. As currently drafted, this would seem like a win for the industry, but the proposals remain by no means sure things to pass Congress at this point.

What’s Next: In a hearing yesterday, House Financial Services Committee Chair Patrick McHenry (R-NC) indicated that he intends to hold a markup next month to vote on the market structure bill and likely the stablecoin legislation as well. The latter already has a compromise draft that circulated prior to the hearing; a sign that there are efforts to create bipartisan support for the proposal and give it its best chance at passage. Getting through the committee level should not be too difficult with the Republican majority, but what will be key to watch is what, if any, Democratic support the measures attract, which could offer an indication on what

> chances they have to pass the Senate.

Gensler Swings for the Fences

The regulatory onslaught for crypto has been in full swing for much of last year, and accelerated after FTX's collapse last fall. This has now reached a full crescendo that makes all prior actions seem like merely prologue given the potentially transformative cases filed by the Securities and Exchange Commission (SEC) last week. With lawsuits against Binance and **Coinbase (COIN)**, SEC Chair Gary Gensler has put his money where his mouth is and is putting to test his allegations that the operations of these exchanges are illegal under existing securities laws. **The core charges effectively amount to listing tokens that the agency contends are securities, which then would require the platforms to register with the SEC, and operating as exchanges, broker-dealers, and clearing agencies without registering any of those businesses.** The court's rulings on these allegations will be most determinative for the future of the crypto industry in the US as some have argued this is an attempt to eliminate digital assets, at least as we know it today, in America.

The time frame for these cases to play out is likely years, especially if Coinbase makes good on its intent to appeal all the way to the Supreme Court if necessary. This also means it is possible that Gensler will no longer be the chair by the time that this case makes it that far. At the SEC, however, this means less than some other agencies given the historical tendency to avoid having it perceived as a political agency. For these cases then, the agency would likely continue to work to win them whether Gensler was in charge, another Democrat, or even a Republican. It is worth mentioning too that crypto's first regulatory run-in during the initial coin offering hype was with a Republican-led SEC. In addition, there are jurisdictional implications that will likely make future SEC chairs want to continue these cases as wins for the agency would grant it significant authority over the crypto industry.

While these cases proceed through the judicial system, do not expect Gensler to let the rest of his crypto work go quiet as there are several other issues that he will likely look to address in the interim. **This includes staking, which is a part of the SEC's case against Coinbase, and was a focus in the agency's $30 million settlement with Kraken earlier this year.** This crackdown seems to be an extension of Gensler's attention on lending and other interest-bearing products in 2022. It would not be surprising if there were more staking-related enforcement actions in the coming months. **It is worth noting that the agency's actions seemed most focused on the role that these central figures play in the staking ecosystem and their staking-as-a-service product rather than the actual**

act of staking. Based on what we have seen from the SEC so far, it seems that individuals are safe to continue pursuing staking on their own, but this is obviously not as accessible as being able to do it through an exchange and could mean fewer tokens are being used for staking.

In addition to staking, look for Gensler to wade more into the regulation of stablecoins. This was a part of the agency's case against Binance with the SEC alleging that the exchange's associated BUSD token is a security. This was not too shocking as the agency had previously sent a Wells notice to Paxos in February alleging that the company had been violating investor protection laws and that the BUSD token it issued was an unregistered security. Paxos has not been the subject of an enforcement action yet from the SEC, but it appears to be a potential prime target if Gensler is looking to bolster his track record on stablecoins and assert more jurisdictional control.

Beyond staking and stablecoins, it is probable that the SEC will continue filing enforcement actions against token issuers alleging that their tokens are securities. **How many of these will be against large assets is unclear given that the agency may feel its lawsuits against the exchanges are a better way to regulate the thousands of tokens instead of filing cases against them individually.** Also implied in this effort, to no one's surprise at this point, is that Gensler is going to stick with his regulation by enforcement approach rather than looking to provide crypto-specific regulations or guidance. Despite this strategy's unpopularity in Congress, the chair has signaled no intent to change courses. Crypto companies may continue to be caught in proposed regulations by the SEC, such as its proposal to redefine what is a qualified custodian, but rules explicitly for just the digital asset industry are not coming from Gensler's SEC.

Could Congress Pass Crypto Legislation?

As House Financial Services Committee Chair Patrick McHenry (R-NC) promised, he and House Agriculture Committee Chair G.T. Thompson (R-PA) jointly released a legislative framework to rework the market structure regulation of crypto. **The main question the bill aims to address is which tokens are considered commodities and which are securities. The proposal is written in a manner that would likely lead to most digital assets being commodities and those that are labeled as securities would be able to appeal this designation.** Key to being considered a commodity is the degree of decentralization of a particular token, which is measured in part on whether any specific individual owned 20 percent or more of the digital assets on the network within a year or marketed the network within the past three months. In addition, for crypto exchanges, the SEC would be barred from blocking registration as an alternative trading system and there would be a new registration category at the Commodity Futures Trading Commission (CFTC): digital commodity exchange. Absent in the legislation is any attempt to meaningfully regulate decentralized finance (DeFi) or non-fungible tokens (NFTs), instead simply calling for studies of the two topics to inform future regulation.

This bill was released as a draft and was done without Democratic input so if it were to have any real chance at passage, it is doubtful that it would be in its current form. **In House Agriculture Committee and House Financial Services Committee hearings over the last two weeks, it is clear that Democrats have some concerns, but they are not dismissing the bill entirely.** A common worry across the two hearings was about the safe harbor that would be created for provisionally-registered firms while the SEC and CFTC work to finalize regulations. Some other issues include the lack of a provision to clearly prohibit commingling of customer funds and crypto assets as well as a possible need to increase funding for the CFTC given its expected larger role. Republican committee members did not make clear if making these changes would cross any red lines.

What's uncertain is how much negotiation time the GOP will allow with McHenry eyeing a committee markup next month. Sitting in the majority, it is very possible that any alterations are minimal to be able to claim a compromise while ensuring that there is no loss in GOP votes that alone can carry the measure to the House floor. McHenry acknowledged in the hearing yesterday that there is a need for Democratic input, however, if there is any hope for the bill to get through the Senate. **Key members in the upper chamber, such as Senate Banking, Housing, and Urban Affairs Committee Chair Sherrod Brown (D-OH), have been relatively quiet on their view of what is happening in the House, making it unclear what changes would be needed to pass the Senate.** Others, like Senators Cynthia Lummis (R-WY) and Kirsten Gillibrand (D-NY), have previously proposed their own crypto legislation and are waiting to see what comes from the House before re-releasing drafts of their bills. At the moment, it seems that all eyes are on the House to act and many senators are holding their cards close to their chest, but without a bill that has genuine bipartisan backing, it is hard to envision anything passing the Senate.

On stablecoins, Democrats have already offered their own version and before yesterday's House Financial Services Committee hearing, McHenry released what he intended to be a new compromise draft. The legislation aimed to bridge some of the partisan divide as well as some of the Republican feedback the chair had received since releasing the original draft. No longer in the latest draft is a provision that would have called for a study of a US central bank digital currency (CBDC), given GOP pushback on that measure. **One of the biggest sticking points for Democrats previously was on**

the role of state regulators. In this new draft, the Fed would be able to write the requirements for issuing stablecoins, but state regulators would still be allowed to oversee the companies issuing the tokens. The Fed would also have an enlarged role relative to the previous Republican draft, including the ability to intervene against state-regulated issuers in emergency situations and being able to supervise firms if a state regulator chooses to pass the duty along. **These changes are intended to remedy some of the Democratic concerns without minimizing state regulators entirely.** Both parties agree on the core of the bill so these changes on the edges are what will be necessary to find a consensus bipartisan draft.

What this compromise draft does suggest is that McHenry wants to craft legislation that can have bipartisan support and is not looking to simply pass messaging bills along party lines. This measure was less of a focus in yesterday's hearing than the market structure proposal so how Democrats feel about the new compromise is still not entirely clear. **McHenry will likely look to have a committee vote on both measures at the same time, and at the moment it would appear that the stablecoin draft has the greater potential to attract Democratic votes.** Stablecoin regulation was an area that McHenry and House Financial Services Committee Ranking Member Maxine Waters (D-CA) had an agreement on last year and was the one issue that we believed had the highest chance for seeing something move in Congress this session. As with the market structure legislation, it is unknown where members of the Senate stand on this stablecoin proposal. Increasingly, it appears that there will not be any clarity on this front until the members of the upper chamber have their hands forced by the House passing something.

The Other Market Regulator

Since filing its own case against Binance, the CFTC has been relatively quiet with respect to the digital assets industry. In spite of this short lull, the future could be much busier for the agency. This is in part thanks to the Binance case, but also that the CFTC remains the industry and Republicans' preferred primary regulator.

As important as the Coinbase and Binance cases are to the SEC, the CFTC's lawsuit against Binance could prove equally significant to more fully develop the legal limits of the jurisdiction for both agencies. **If there are tokens that are both commodities and securities, which seems to be a common belief, it is possible that both agencies win their challenges and secure legal validation to force exchanges to register with the SEC and CFTC.** What will be interesting to watch in the two cases though is how the judges assess which tokens are securities and which are commodities and how those two possible definitions are complementary or in conflict with each other. This could create a scenario where tokens are labeled as being both securities and commodities as they meet the characteristics of each.

The Republican and industry support for the CFTC serving as the primary regulator for digital assets has been a constant in discussions over the last few years and shows no signs of waning. This would likely mean an increase in the agency's budget in the coming years and would put it into a bigger spotlight. **Although there is a perception that the CFTC may be friendlier than the SEC, at least under current CFTC Chair Rostin Behnam it has followed a fairly similar regulation by enforcement approach.** There have been some recent calls for revisions of rules to better consider crypto, but like the SEC, there has been little interest in crypto-specific regulations. This could eventually leave industry members disappointed in their choice, but if the other option is the SEC it is doubtful that there will be any changes of heart.

Caution First for Prudential Regulators

Though less prominent than at the start of the year, the cautious feeling toward crypto activities from President Biden's prudential regulators has shown little sign of fading. **There remains a fairly united front among this group that minimizing exposure for banks to digital assets until proper risk management controls can be put in place is the best path forward.** This is not an approach that is exclusive to the US as in Europe, as part of new banking capital regulations, institutions holding certain cryptocurrencies, including Bitcoin and ether, will be required to hold capital at a 1:1 ratio. This caution though and the turmoil among prominent crypto banks has not meant banks are avoiding the industry entirely and new institutions have risen to take the place of Silvergate Bank and Signature Bank. One of the most popular has been Pennsylvania-based Customers Bank but the industry has seen greater fragmentation with more reliance on regional and overseas institutions, a trend that could expand with continued warnings from Biden's prudential regulators.

While little has changed from a policy perspective about the regulators' stance toward a CBDC, there has been a notable uptick in Republican criticism of the potential token. This has been led by Florida Governor and GOP presidential candidate Ron DeSantis who has alleged that the token would be used as another means for the government to monitor citizens' activity. DeSantis has even gone so far as to sign a law that would ban its use in Florida if one were to be created. These problems are hypothetical at best as no formal design plans have been released by the Federal Reserve nor has legislation been advanced by Congress to authorize the creation of a retail CBDC. It is unlikely that this will be a defining issue for 2024, but it gives some window into how candidates may look to use examples from crypto to support larger policies that they are advocating for, such as in DeSantis' case minimizing government oversight of private lives.

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