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SPOTLIGHT REPORT

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Is Gensler Just Losing Battles or the Whole War?

What's Happening: Securities and Exchange Commission (SEC) Chair Gary Gensler is seen by some recently as being in a weaker position after judicial pushback on his crypto policies and walking back some of his regulatory proposals in the face of industry criticism.

Why It Matters: Gensler came into the SEC with vast ambitions for what he could achieve at the agency. While all his plans may not come to fruition, he seems satisfied with following the principle that even if he shoots for the moon and misses, he will still land among the stars. **Gensler's willingness to accept imperfect victories is a critical lens through which to evaluate the agency's recent "losses."** Neither the Ripple nor Grayscale decisions are as clear defeats as the crypto industry has attempted to portray them. While they are inarguably blows to Gensler's agenda, neither will force immediate changes to the SEC's stance toward digital assets. Similarly, much of Gensler's softening of his regulatory proposals is intentional and mirrors a strategy he followed at the Commodity Futures Trading Commission (CFTC) during the Obama administration. By starting with an aggressive initial rule, Gensler can walk back the regulations in the final rule while still preserving the spirit of the reform and achieving a policy win. This strategy, at least back at the CFTC in the Obama era, made the final regulation look more legally defensible and less likely to face a court challenge. However, in the current environment, which is more conducive to challenging regulatory actions due to the more conservative Supreme Court being less willing to deference to regulators, most, if not all, of Gensler's controversial rulemakings will likely be unable to avoid judicial review.

What's Next: Several of Gensler's more ambitious reforms are expected to be finalized in the next six to nine months, including the agency's proposed regulations on climate disclosure and equities market structure. The final rules will likely be walked back from the initial proposals, but expect the chair to preserve the intent of the regulations even if some parts, like Scope 3 climate disclosures or the auctions for retail trades, are removed entirely. Despite this softening, it is almost certain that at least these two rules will face legal challenges, but we expect Gensler to craft the regulations to give them the best chance to survive this scrutiny.

Crypto: Setbacks, But Not Defeat for the SEC

Much has been said of Securities and Exchange Commission (SEC) Chair Gary Gensler's crypto agenda recently. The agency has suffered two high-profile court losses in the last two months: a partial loss in its case against Ripple Labs and a decision regarding Grayscale's attempt to convert its bitcoin trust into a spot Bitcoin exchange-traded fund (ETF). When announced, industry members celebrated both decisions as significant wins over the SEC. There was also a hope that the rebukes of Gensler's strategy would force him to reconsider his regulation-by-enforcement approach and change course to begin writing rules for the emerging sector instead.

While these decisions' potential significance should not be downplayed, it is also important to contextualize them and consider where they fit in Gensler's regulation-by-enforcement strategy. **In both lawsuits, neither gave the industry an immediate victory and are best viewed as setbacks for the SEC in individual battles rather than equivalent to losing the entire war.** The Ripple case is moving toward an appeal, and shortly after the decision, another judge in the same district issued an opinion on a separate case disagreeing with the decision. The Grayscale decision was initially portrayed as the court forcing the SEC to approve the conversion attempt and thus spot Bitcoin ETFs. The decision only requires the agency to re-evaluate Grayscale's proposal, and if the SEC were to deny it again, it could not do so with the same reasoning. The arguments used in its initial denial mirrored those used to deny other spot Bitcoin ETF applications, and the agency has not publicly argued against these proposals for different reasons. **Approval of a spot Bitcoin ETF may be a matter of when, not if, but the Grayscale decision is not a reason to think it could be imminent.** The SEC has taken the legal maximum amount of time to review all previous spot Bitcoin ETF applications, 270 days, and there is little reason to think that this cycle of attempts will be different, making it most likely that if these products were to be approved, it would not be until next year.

As for whether Gensler may change his approach to the crypto industry in light of these decisions, it is unlikely he will meaningfully deviate from his regulation-by-enforcement course. Overall, this strategy has been relatively successful, and continuing down this avenue is a faster way to claim regulatory jurisdiction than the cumbersome and time-consuming rulemaking process. A recent example was the agency's first-of-its-kind enforcement action against Impact Theory for its sale of non-fungible tokens (NFTs). While the settlement may not have the most widespread applicability, it signals another area in the industry that Gensler is watching. Pursuing these enforcement actions alleging that different aspects of the crypto industry are violating securities law has enabled Gensler to extend the SEC's crypto reach, and that, coupled with its largely successful outcomes, will be enough to have him stick with this approach.

As crucial as the Ripple and Grayscale decisions are, the lawsuits with the most potential to transform the crypto industry in the US as it exists today are still pending. At the top of this list are the SEC's cases against **Coinbase (COIN)** and Binance. Both could change how crypto exchanges are regulated in the US. With the lawsuit being considered "existential" for Coinbase, the company is expected to fight the case to the

legal maximum. Neither case is expected to be resolved quickly; thus, we will probably not have a conclusion to either process for several years. It is doubtful that Gensler will agree to settle either of these cases unless he can get an outcome that he deems a victory. This would likely entail the exchanges agreeing to register as a securities exchange and create more firewalls among their activities as market makers, brokers, and custodians.

Gensler's Rulemaking Philosophy

A common trend has emerged in recent months for the areas where Gensler is willing to write rules to regulate. **Often, the agency walks back its finalized rules from what was initially proposed, softening the most controversial aspects.** Gensler followed a similar tactic when he led the Commodity Futures Trading Commission (CFTC) under former President Obama, and we have expected him to follow suit in his current role. A recent example was the changes made to the agency's rules on private funds, where language on side letters was softened, and plans to prohibit fund managers from charging fees for unperformed services and limiting their liability for misconduct or negligence were dropped. Another instance was the changes made to the SEC's final revisions to Form PF, where reporting of major events was pushed back from happening within a day to 72 hours.

This approach of walking back the final rules from the initial proposal is an intentional tactic by Gensler. He hopes that by proposing effectively a worst-case scenario, there can be negotiations with the industry where it feels that it got some wins and staved off the worst part of the rules. Gensler is proposing the initial regulations, knowing they will likely be walked back, and is okay with reaching that point. **Another hope for Gensler is that allowing this input to soften the rules will lower the likelihood of a lawsuit challenging the regulations.** The SEC is conscious of potential legal threats to its rules and is actively working to craft its proposals to minimize the likelihood that they end up in court. This strategy has the added benefit that if the regulations are challenged, the chances that they are overturned have been minimized.

While this strategy has been reasonably successful in dodging most battles, even if some of the SEC's most controversial proposals have yet to be finalized, it has not been perfect, particularly in the present environment in which the conservative Supreme Court has shown interest in reducing the traditional deference provided to regulators. Earlier this month, industry groups representing private equity and hedge funds sued the SEC for its private fund rules despite the initial proposal being walked back. The case alleges that the agency went beyond its remit and violated administrative law. In addition, the lawsuit contends that while the bans were modified, the restrictions put in place amounted to effective prohibitions of the covered activities. The challenge was filed under the jurisdiction of the particularly conservative Fifth Circuit Court of Appeals. Gensler has publicly stated that he is confident in the agency's authority to propose the rules. The ensuing battle is expected to be consequential for the SEC as it pursues one of its most extensive overhauls for the private funds industry, a crucial part of Gensler's agenda. The outcome will be closely watched, and the case could take months, if not years, to be

resolved, at a minimum likely delaying the effective date for the new regulations from coming into force.

Implications for Pending Rules

For as much as Gensler has already done at the SEC, arguably, the most controversial rules that the agency has proposed under his watch are still unfinished. This list includes the regulations to standardize climate disclosure and reform the equities markets' structure. Per this June's semi-annual regulatory agenda issued by the Office of Management and Budget, the SEC estimated that these would not be completed sooner than October 2023 and April 2024, respectively. It would not be shocking if either of these rules slipped past these estimates and were not completed until early 2024 and summer 2024. **Gensler will push to advance these rules before next August to avoid them being subject to a Congressional Review Act (CRA) resolution if a unified Republican government takes power after the 2024 elections.** The date after which the CRA can be used will not be known until next year, but in 2020, the date was August 21st.

Part of the reason there may be delays to the finalization of these rules is the SEC is working to ensure that whatever version moves forward is as legally defensible as possible. This was a reason the climate rules were initially delayed in being proposed and could be why requiring disclosure of Scope 3 emissions is eventually dropped. **As has been the case with other regulations completed during Gensler's term, both proposals will likely be walked back in the final drafts.** In the case of market structure reform, this could mean dropping Gensler's proposed auctions for certain retail trades and moving forward with transparency requirements.

Regardless of how much the rules are walked back when the SEC votes on them, it is doubtful that the agency will be able to avoid a lawsuit contesting the regulations. These topics are simply too controversial and sensitive to prevent legal challenges. The climate regulations, in particular, will be carefully crafted in light of the Supreme Court's decision in *West Virginia v. EPA* last year and its implications for the major questions doctrine. It is unlikely that Gensler will pass on the chance to vote to finalize these climate disclosure requirements, but if one of these two rulemaking efforts were overturned in court, this appears to be the more vulnerable. **A potential challenge of these federal regulations could be previewed if a bill in California, which would go further than the SEC's proposal, is signed into law.** The amended legislation passed the state Assembly on Monday and will now go back to the state Senate for a vote before it can head to the governor's desk. If the bill went into effect, corporations would be required to start reporting certain greenhouse gas emissions data at some point in 2026, and then reporting on Scope 3 emissions would begin in 2027. California Governor Gavin Newsom (D) has not indicated whether he will sign the bill.

In addition to these two significant undertakings, another area to watch is the SEC's proposed regulations for investment advisers and broker-dealers' use of predictive

data analytics. This has been a focus for Gensler, who has decried these digital engagement practices as harmful to retail investors. Under the proposed regulations, what would constitute a "covered technology" is defined very broadly and would include any "analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes." Anytime a broker-dealer or investment adviser uses one of these technologies when engaging with or exercising investment discretion on behalf of an investor, the technology would have to be evaluated for conflicts of interest and, if any found, would have to be removed. **These proposed rules have seen growing opposition since they were released at the end of July, mainly thanks to the breadth of what would be covered under the proposal.** While this definition will likely be narrowed in the final version, it may not be enough for industry members to accept. The agency could still find itself in court defending the regulations. The rules are unlikely to be completed before 2024 but watch for Gensler also to try to get these done before the potential CRA deadline.