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DIGITAL CURRENCY

As FTX Burned, Lawmakers Said to Be Dithering Over Regulator

The central debate about regulation of cryptocurrencies is whether they are securities or commodities.

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Congress opted to tread water on legislation that would clarify the agency in charge of the cryptocurrency industry, leaving lawmakers now without a regulator to blame for missing the signs of the FTX collapse this month and facing deep skepticism about some proposals.

Rejecting one House Republican leader's criticism of Securities and Exchange Chairman Gary Gensler, industry representatives and legal experts say Congress itself moved too slowly on legislation that would establish clear regulatory jurisdiction of the sector.

Joseph Hall, a partner at Davis Polk, said Congress failed to establish clear regulatory jurisdiction over cryptocurrency spot markets and trading platforms—jurisdiction that would have come with disclosures, inspections, treatment of customer funds, corporate governance and other rules.

“Congress really should have acted before now,” said Hall. “These assets have been around now for a decade. They briefly reached a \$3 trillion market capitalization, and it's crazy to think that we had that much wealth in a market that is basically not regulated. It just doesn't make any sense at all.”

Lawmakers may also be unable to revive several bills that have thus far stalled in committee, the experts say, adding that FTX founder Sam Bankman-Fried's prominence on Capitol Hill as a cryptocurrency voice has tainted bills that critics said were too favorable to the industry.

Bankman-Fried donated about \$40 million to political campaigns and PACs, mostly to benefit Democrats and a few strategically positioned Republicans, in the midterms. He also testified about his industry and the need for regulation before at least three congressional committees in the past 12 months: the House Financial Services and House and Senate Agriculture committees.

FTX, once valued at \$32 billion, filed for bankruptcy after a run on customer accounts prompted by reports that Alameda Research, its affiliated trading arm, stood on shaky financial ground. FTX reportedly lent Alameda billions of dollars.

FTX has headquarters in the Bahamas and is subject to that country's regulations, but it also has a branch, FTX US, serving U.S. customers. The company filed for bankruptcy in Delaware on Nov. 11 and announced Bankman-Fried's resignation as CEO the same day.

Basic market regulations could have given regulators some insight into its condition, at least through the U.S. affiliate, said Georgia Quinn, general counsel of Anchorage Digital, a federally chartered bank that provides custody for digital assets.

“This entity was slightly, if you want to call it, regulated offshore,” Quinn said in an interview. “I do not think that this outcome would have existed if they were being required to provide quarterly financial statements and capital reserve requirements and all of the things that are required of a U.S. financial institution.”

The collapse of the second biggest cryptocurrency exchange may even have soured lawmakers on the industry altogether.

“It’s going to be a lot harder to get any sort of coalition now on Capitol Hill,” Quinn said. “We’ve lost credibility as an industry as a whole, and we’re really going to have to work to get that back.”

One victim of the collapse may be a bill sponsored by Senate Agriculture Chairwoman Debbie Stabenow, D-Mich., and co-sponsored by ranking member John Boozman, R-Ark., because of Bankman-Fried’s support for the measure.

“The DCCPA [the Stabenow bill] is the SBF bill. He was the sole organization, sole person pushing to move that forward,” said Kristin Smith, executive director of the Blockchain Association, using Bankman-Fried’s initials. “If something like that were to move forward, it would have to look substantially different than it does now. Not only because the way it was written was overly broad, but it was also written in a way that very much favored the FTX business model.”

Smith added that others in the cryptocurrency sector already opposed the bill, seeing it as unfairly favoring FTX.

Lisa Gilbert, executive vice president of Public Citizen, also said Bankman-Fried’s association with the bill will make it unpalatable. “I think it will be a real challenge for the other crypto advocates who have been pushing for it, to divorce that influence and move the legislation, particularly because the lame duck is so crowded.”

Stabenow and Boozman said in statements they were committed to revising the legislation and putting it up for a committee vote. Boozman in an interview rejected the bill’s association with Bankman-Fried.

“We’ve really worked hard to ask everybody in the industry,” Boozman said. “We want to get everybody happy, but we also want to make sure that the safeguards are in place to prevent something like this happening to another group, but again this is all about consumer safety.”

SEC vs. CFTC

The central debate about regulation of cryptocurrencies is whether they are securities or commodities, and by extension whether their markets should be regulated by the Securities and Exchange Commission or the smaller Commodity Futures Trading Commission.

Without a resolution to that question, cryptocurrency markets lack the regulatory framework of traditional financial markets.

Consumer advocates favor the bigger, better-funded SEC as the main agency to oversee cryptocurrency spot markets. Cryptocurrency and blockchain advocates have pushed for the CFTC, which is seen by some as friendlier to the industry.

Hall, who specializes in capital markets for Davis Polk, said granting either agency clear jurisdiction over cryptocurrency markets and trading platforms would be an improvement over the status quo.

“A comprehensive market regulator, like the SEC or like the CFTC, could pretty quickly put in place a regulatory regime that would prevent trading market blow-ups like this,” he said in an interview. “It’s not going to be able to get rid of Ponzi schemes, rug pulls and garden-variety fraud in the market, but the SEC and the CFTC do a very good job of regulating basic market infrastructure. That’s what was missing here.”

Both agencies have staked claims to parts of the cryptocurrency ecosystem, though not without challenge. The CFTC says that bitcoin and ethereum, the two biggest cryptocurrencies, are commodities, but the agency lacks the jurisdiction to regulate the asset or its trading platforms directly because only derivatives markets and not the underlying commodities fall under its purview. The CFTC already oversees derivatives tied to the digital tokens.

Gensler has said that most cryptocurrencies are likely securities and urged trading platforms to register with his agency. His call has been met with resistance from the industry that says many rules that govern securities and their exchanges don’t make sense for digital assets or their intermediaries.

At least five bills before Congress would designate a primary regulator of cryptocurrency spot markets, typically the CFTC, and direct it to set rules. Several of those bills specifically address digital trading platforms. Two more bills would establish that digital tokens are not securities, but would not specify another regulator.

In addition to the Stabenow-Boozman bill, the most prominent measures include one introduced by Sen. Cynthia Lummis, R-Wyo., and co-sponsored by Sen. Kirsten Gillibrand, D-N.Y., and another introduced by House Agriculture ranking member Rep. Glenn “GT” Thompson, R-Pa., and backed by Reps. Tom Emmer, R-Minn., Darren Soto, D-Fla., and Ro Khanna, D-Calif.

None of the bills has advanced out of committee despite bipartisan support, and many face opposition from consumer advocates wary of any measure that could sideline the SEC. Disagreement over which regulator should oversee the industry, particularly among Democrats, seems to have slowed progress on legislation.

Democrats tend to fall into two camps. Some, like Stabenow, Gillibrand and Khanna, see a need for legislation to provide clarity for regulators to police the assets. Others, like Senate Banking Chairman Sherrod Brown, D-Ohio, fear legislation resulting from a closely divided Congress would be too industry-friendly.

“I know that because of the cryptocurrency lobbyists’ lobby here, we can’t pass any legislation that would protect the public,” Brown said after a hearing in May. “But we can work with the SEC, the Fed and FDIC. It doesn’t mean we’re not trying legislatively, but [we’ll] work with the Fed, the FDIC and the CFTC.”

In the wake of the FTX collapse, Brown said in a statement that he would work with regulators to hold wrongdoers accountable and find the best path forward to protect consumers.

With Republicans in the House majority in the next Congress, Thompson is expected to become House Agriculture chairman and Rep. Patrick T. McHenry, R-N.C., is expected to lead the House Financial Services Committee, where he is now ranking member.

“There’s no sugarcoating the FTX collapse. It’s been a dumpster fire. The digital asset ecosystem is in limbo. And add to the mix an SEC chair who is more interested in chasing headlines than bad actors,” McHenry said at a hearing this month.

“I have advocated for Congress to develop a clear regulatory framework for the digital asset ecosystem, including trading platforms,” he said in a separate statement. “The recent events show the necessity of Congressional action. It’s imperative that Congress establish a framework that ensures Americans have adequate protections while also allowing innovation to thrive here in the U.S.”

McHenry’s own bill passed by the House in 2021, didn’t involve such a framework. That bill would require the SEC and CFTC to form a joint working group to assess the state of cryptocurrency regulation and make recommendations.

A ‘cataclysmic’ event

Observers are split on whether FTX’s fall will result in legislation they say the industry needs. Some point to landmark financial legislation that followed the Enron and WorldCom accounting scandals and the 2008 financial crisis as positive signs that Congress will take action.

Christopher LaVigne, a partner at Withers law firm, said politicians will see calling for better regulation of cryptocurrencies as a “quick win,” especially given the bipartisan support for cryptocurrency measures in the past.

“We’re witnessing the exact way regulation has passed, like the exact sort of cataclysmic events that result in regulation,” he said in an interview. “There’s a reason that fire extinguishers exist in hotels, that there’s a requirement for it. Because at some point in time, a cataclysmic event happened and the laws changed.”

(Ellyn Ferguson contributed to this report.)

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