Regulating Blockchain and Crypto via Novel Legislation or Rulemaking

By: Henry Hirsch & Zhoudan Xie | June 18, 2024

In brief…

The second panel of the event "Regulation by Enforcement: Blockchain and Crypto" focused on the topic of regulating crypto and blockchain via novel legislation or rulemaking. The discussion delved into the current state of crypto regulation, as well as its gaps and challenges, and reflected various perspectives on recent legislative and regulatory developments.

On June 5, 2024, the GW Regulatory Studies Center and GW Law hosted an event titled Regulation by Enforcement: Blockchain and Crypto. Leading experts in the industry, scholars, and policy professionals gathered to explore the complex landscape of cryptocurrency (crypto) regulation. The second panel of the day, moderated by Regulatory Studies Center founder and senior scholar, Susan Dudley, focused on the topic of regulating crypto and blockchain via novel legislation or rulemaking. The discussion delved into the current state of crypto regulation, as well as its gaps and challenges, and reflected various perspectives on recent legislative and regulatory developments.

Current Crypto Regulation

The panel began with a discussion of current regulations governing cryptocurrencies. Maude Wilson, Policy Counsel of Uniswap Labs, dispelled the common notion that the crypto industry is anarchic and entirely unregulated. She noted that there are financial laws and regulations that apply to all Americans, including crypto companies, such as money transmission rules. However, panelists agreed that there are gaps in the coverage of current regulations on the emerging crypto ecosystem due to jurisdictional ambiguity. Landon Zinda, Policy Counsel of Coin Center, and Lee Reiners, Lecturing Fellow at Duke University's Financial Economics Center, explained that much of this jurisdictional ambiguity can be attributed to uncertainty about how to classify crypto as a financial asset.

Crypto can be classified–and regulated–as either money, a commodity, or a security. To illustrate, if a crypto transaction is treated as a money transfer, then it is subject to the money transmission regulations of state governments. If crypto is treated as a security, then it falls under the jurisdiction of the Securities and Exchange Commission (SEC). And if crypto is defined as a commodity, then it falls under the purview of the Commodity Futures Trading Commission (CFTC). Reiners expressed concern that commodity spot markets are not well-regulated at the federal level, leaving a gap that is prone to abuse.

Jonathan Jachym, Global Head of Policy at Kraken Digital Asset Exchange, brought an international perspective to this discussion, highlighting the varied stages of regulatory development across countries in areas such as financial crimes, tax, market regulation, banking, and consumer protection. For example, the UK moved first and fast in the area of consumer protection by establishing financial promotions rules, which drives how crypto is advertised, marketed, and communicated to retail consumers.

Core Problems of Crypto Markets

The discussion then shifted to the core problems that crypto poses, whether they are unique, and how regulation can help to address them. The panelists touched on various problems associated with crypto, including cyber risks, terrorist financing, and environmental damage. Wilson and Jachym both noted that cyber risks in crypto transactions tend to be higher due to the open-source nature of the underlying technology. Reiners added that there are also concerns about the tremendous electricity consumption required for crypto mining.

The panelists concurred that the current legislative debate is mostly centered on the question of how to regulate centralized intermediaries in crypto markets. Although crypto transactions do not necessitate the involuntary relinquishment of assets to an intermediary, most users access crypto through centralized exchanges. Zinda argued that is where the government should intervene, as there is a legitimate consumer protection risk in those exchanges (as opposed to decentralized exchanges in which users trade directly with each other). Reiners posited that centralized crypto intermediaries are significantly less regulated than their traditional financial counterparts, pointing again to the spot market gap. Consequently, fraud, hacks, and bad actors abound.

Recent Legislative and Regulatory Developments

The panelists discussed several recent legislative and regulatory developments, specifically the SEC's approval of ether exchange-traded funds (ETFs), the House's passage of the Financial Innovation and Technology for the 21st Century Act (FIT21), and President Biden's veto of a joint resolution that would have struck down SEC Staff Accounting Bulletin 121 (SAB 121)–which directs banks to keep customers' crypto on their balance sheets and maintain capital against them.

Several panelists expressed surprise that the SEC approved the listing of ether ETFs. Reiners suggested that the action signifies an implicit acknowledgment that ether is a commodity, which may further widen the gap in spot markets regulation. Wilson argued that this development highlights the need for legislation that explicitly delineates the distinction between securities and commodities as applied to crypto. The panelists agreed that the current ambiguity surrounding the commodity/security classification, which in turn affects the regulatory regime governing crypto, makes it difficult for companies to plan for the future.

The panelists hoped that FIT21, which passed the House last month with bipartisan support, could begin to resolve this ambiguity. This bill could mark the beginning of the end of regulation by enforcement and the adoption of market structure legislation as an alternative approach. Zinda explained that the bill lays out procedures for issuing tokens and facilitating their trade in a regulated manner: tokens could initially be issued and traded on exchanges under the oversight of the SEC, but once the tokens become sufficiently distributed and the blockchain on which they are based is considered "decentralized," they would be regulated by the CFTC under the new spot market authority granted to it by FIT21. Jachym further clarified that the bill makes a preliminary attempt to distinguish between securities and commodities with regard to crypto, elucidates their respective risks, and brings clarity to firms and consumers.

Reiners added that FIT21 also aims to address the previously highlighted problems associated with the crypto industry's unregulated centralized intermediaries. Jachym agreed that getting a bill through Congress that establishes a comprehensive framework for clear market regulation is the best starting point for consumer protection. He reported that Kraken, as a centralized intermediary, is encouraged to see the recent progress toward that goal.

However, Reiners did note his disappointment that FIT21 would ultimately give the CFTC exclusive oversight over most crypto markets and warned that this choice could create the conditions for a crypto financial crisis. In his opinion, the SEC is better suited to regulate crypto than the CFTC, due to the latter's budgetary and staffing deficiencies. Furthermore, he believes that crypto spot market oversight aligns with the SEC's original mission of providing investor protection and averting financial crises. On the other hand, Wilson was concerned that it is difficult for crypto companies to comply with the SEC framework.

While the Biden administration has signaled opposition to FIT21, its recent statement of administration policy (SAP) did not go so far as to threaten a veto, which some panelists took as a signal that it was open to negotiation.

Panelists were not surprised by President Biden's recent veto of the joint resolution introduced under the Congressional Review Act that would have repealed the SEC's SAB 121. However, they agreed that his veto message was conciliatory and marked a change from the administration's previously negative stance on digital assets, which had dismissed their inherent value. This change may be driven by political reasons, especially with the upcoming election in November. Zinda argued that the tone of the veto message and other developments during the past few weeks suggest the administration's willingness to take a constructive position and seek some compromise on crypto-related issues.

The panel concluded that recent events signaled change, and that there might be more movement in the federal government's approach to crypto after the election. They generally believe that crypto is not a partisan issue and hope that a constructive bipartisan approach to legislation is possible.