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Analysis

The Current State of Play on Crypto

BY SAM SUTTON, ROSMERY IZAGUIRRE | 08/26/2022 05:00 AM EDT

PRO POINTS

- The collapse of several high-flying crypto startups has put pressure on Washington to impose new rules and regulations for digital asset markets. Lawmakers are preparing bills that would force digital exchanges and brokerages to register and establish guardrails for dollar-pegged tokens known as stablecoins.
- Leaders at the Securities and Exchange Commission and the Commodity Futures Trading Commission are both angling to step up oversight of digital asset businesses, including platforms where popular cryptocurrencies like Bitcoin and Ether are transacted.
- Banking regulators are cracking down on digital asset businesses that claim to offer similar customer safeguards to traditional banking services. They're also warning commercial banks to proceed with caution before partnering with crypto companies.

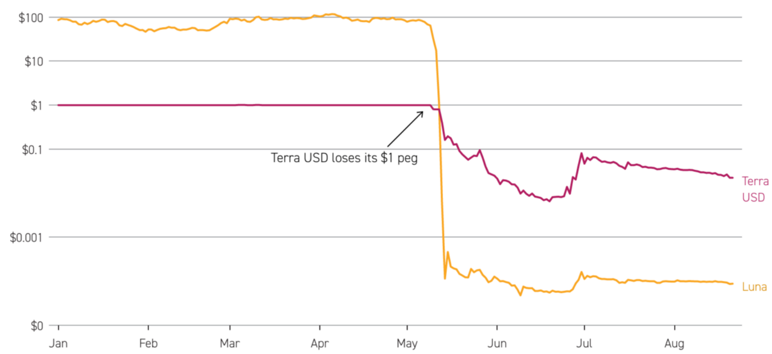
How We Got Here

Since May, the crypto industry has been hit by a series of crises and scandals that will shape how policymakers craft new rules to govern digital marketplaces in the coming months.

A market downturn — coupled with the implosion of the popular stablecoin TerraUSD and a second crypto token that had been used to maintain its peg to the U.S. dollar — led to the collapse of a key crypto hedge fund whose liquidation has reverberated across the digital asset ecosystem.

Stablecoin Terra USD and accompanying token Luna collapsed in May

Price of Terra USD and Luna in dollars



Note: Data for each cryptocurrency show the earliest price point for that day.
Source: CoinMarketCap
Rosmery Izaguirre / POLITICO

Three Arrows Capital was a major financial backer of projects like Terraform Labs — which was behind the TerraUSD fiasco — as well as several decentralized finance platforms and crypto lending businesses that attracted billions of dollars of investments during crypto's bull run.

In the process, the hedge fund also took out loans worth roughly $3.5 billion from a broad range of creditors that included prominent investment firms and broker-dealers like BlockFi, Celsius Network, Voyager Digital and Genesis. Three Arrows quickly began to rack up default notices once its bets went under, sparking a contagion that forced several retail-facing crypto lending platforms — most notably Voyager and Celsius — to freeze their customers' accounts and eventually declare bankruptcy.

SEC Chair Gary Gensler and crypto-skeptic Democrats like Sens. Sherrod Brown (D-Ohio) and Elizabeth Warren (D-Mass.) — along with countless financial watchdogs and consumer advocates — have warned for years that digital exchanges and brokerages lacked basic investor and consumer safeguards. Those warnings appeared prescient after millions of account holders at Celsius, Voyager and other platforms lost access to their digital asset deposits.

So far, crypto markets have not recovered.

While interest in Ether — the second-most widely traded crypto token — has climbed in anticipation of a software update that will change how crypto miners validate transactions, investor interest cooled amid rising interest rates and slowing economic growth.

Venture capital investment in new crypto projects began cooling during the second quarter, according to data compiled by PitchBook. Coinbase, a U.S.-based crypto exchange whose shares are traded on the Nasdaq exchange, reported earlier this month that its number of regular users had fallen by almost 20 percent between the end of last year and June 30.

Congress and top regulators are surveying the wreckage as they craft new rules for the industry.

“When the tide goes out, that's when you start to see entities that have been engaged in fraud,” CFTC Commissioner Christy Goldsmith Romero, a former federal official tasked with investigating fraud connected to the Troubled Asset Relief Program, said in an interview earlier this year. “There's nothing really to pad it or cover it.”

The crypto market has struggled to recover since it crashed following last year's peak

Value of crypto market cap in dollars, as of Aug. 22

Source: CoinMarketCap
Rosmery Izaguirre / POLITICO

What's Next

The next several months could be critical for crypto industry regulation.

Shortly before breaking for the summer recess, Senate Agriculture Chair Debbie Stabenow (D-Mich.) and top Republican Sen. John Boozman of Arkansas introduced legislation that would require digital asset exchanges to register with the CFTC.

While other crypto bills — including a wide-ranging measure sponsored by Sens. Cynthia Lummis (R-Wyo.) and Kirsten Gillibrand (D-N.Y.), also proposed putting digital marketplaces under the CFTC's oversight — the arrival of a bill backed by Senate leaders has given the concept more momentum.

That isn't the only major crypto bill in the works. House Financial Services Chair Maxine Waters (D-Calif.) and ranking GOP Rep. Patrick McHenry are negotiating legislation that would create new rules for stablecoins and direct the study of a central bank digital currency — a crypto-friendly version of the U.S. dollar issued by the Federal Reserve.

Meanwhile, federal agencies have started to announce new guidance, enforcement actions and regulatory efforts to curb industry practices that burned customers during the recent downturn.

The SEC in July filed a civil case alleging that a former Coinbase employee had leaked inside information on unregistered securities that were poised to list on the company's trading platform. While the SEC didn't allege any wrongdoing by Coinbase, many in the industry viewed the identification of individual crypto securities as a warning shot to trading platforms — including Coinbase — that have not registered as national securities exchanges.

Gensler has repeatedly said that most digital assets are securities and that crypto trading platforms should register with his agency to assure there are adequate protections for investors. Coinbase, for its part, has petitioned the SEC to create new rules that would allow digital exchanges to list securities.

Banking regulators have also started to crack down. In early August, the FDIC issued a cease-and-desist warning to Voyager slamming the bankrupt firm for making false and misleading statements about its customer deposits being insured. The regulator followed up with similar letters to other crypto businesses — including the U.S. arm of FTX, a major exchange led by political megadonor Sam Bankman-Fried.

The Federal Reserve has also warned commercial banks to avoid doing business with crypto startups without giving a heads-up to regulators.

“Banking organizations engaging in crypto-asset-related activities face potential legal and consumer compliance risks,” the central bank said in a supervisory letter earlier this month. “Prior to engaging in new activities of any kind, a supervised banking organization must ensure that such activities are legally permissible."

POWER PLAYERS

- **Rep. Patrick McHenry:** With Republicans widely expected to take control of the House, McHenry is poised to become chair of a committee that will play a key role in crypto regulations moving forward. The North Carolina Republican has already identified stablecoin regulation as a top priority for his caucus.
- **CFTC Chair Rostin Behnam:** As Congress works on legislation that would give the CFTC a top role in overseeing digital asset markets, Behnam — a former Stabenow staffer — will be a big player in crypto policy moving forward.
- **Jeremy Allaire,** co-founder, chair and CEO, Circle: Circle is the second-largest stablecoin issuer globally and one of the most visible crypto industry businesses in Washington. Members of Allaire's firm have been making the rounds as lawmakers chart a course on stablecoin legislation — particularly in the aftermath of TerraUSD's collapse.