

No clarity on US crypto regulation

Sadakazu Osaki
11 September 2023

lakyara vol.376

Executive Summary



Sadakazu Osaki

Head of Research

Center for Strategic Management
& Innovation

The US SEC has launched a regulatory clampdown on the crypto industry in response to the FTX collapse, but the outlook for US crypto regulation is clouded by an adverse ruling in the SEC's ongoing suit against Ripple Labs.

SEC's crypto clampdown

US Securities and Exchange Commission (SEC) has launched a controversial regulatory clampdown on the crypto industry. The proximate catalyst behind the move was last November's collapse of FTX, a major crypto exchange.

Founded in 2019, FTX achieved rapid growth fueled largely by advertising campaigns featuring famous athletes, including MLB superstar Shohei Otani. Its success, however, proved illusory when its wunderkind founder and CEO, Sam Bankman-Fried, was arrested on fraud and money laundering charges. Its FTX Token nose-dived in response, shaking investor confidence in the entire cryptoasset complex.

Alarmed by the FTX debacle, the SEC has brought a series of enforcement actions against major crypto exchanges, beginning with Kraken in February 2023. It alleged that Kraken's staking-as-a-service program was an illegal securities offering, prompting Kraken to discontinue the service. Staking is the act of depositing cryptoassets with a crypto platform in exchange for a share of cryptoasset income earned by verifying new transaction blocks added to the blockchain. Staking has become popular among investors as an easy way to grow cryptoasset holdings.

In June 2023, the SEC charged Coinbase and Binance with securities law violations. It also sought to freeze some of Binance's assets on the grounds of improper custody of customer assets. Crypto industry insiders have criticized the SEC's enforcement actions against leading crypto exchanges as a crackdown intended to stifle the industry.

Enforcement based on Howey test

The SEC asserted in its complaints against the crypto exchanges that many of the tokens traded on the exchanges are securities subject to regulation under securities law. It argued that crypto exchanges are analogous to securities exchanges but they have failed to register as required as exchanges, securities brokers and/or securities clearinghouses.

The SEC's position is based on a 1946 US Supreme Court case, *SEC v. W.J. Howey Co.* The case established a four-pronged test, dubbed the Howey test, to determine what constitutes an investment contract, a type of security. Specifically, the Supreme Court defined an investment contract as any scheme involving (1) investment of money (2) in a common enterprise (3) expected to generate profits (4) solely from the efforts of others. Although the defendant in the Howey case was selling ownership units in a citrus grove, the SEC has taken the position that many token offerings of recent years were sales of securities requiring SEC registration under the Howey test. In response, the crypto industry has criticized the SEC's enforcement actions as unfair and capricious "regulation by enforcement" as opposed to regulation based on explicit statutory rules.

The debate over how to regulate the crypto industry is partly political. SEC Chairman Gary Gensler, a Democrat, is an advocate of aggressive enforcement. SEC decisions are often party-line votes, with Republican appointees unanimously dissenting. Support for new legislation to rein in the SEC has been growing in the Republican-controlled House of Representatives.

SEC setback in Ripple case

Against such a backdrop, the US District Court for the Southern District of New York in July 2023 issued a potentially landmark ruling in a suit the SEC filed in December 2020 against Ripple Labs. The suit alleges that Ripple's XRP token is an illegal unregistered security under the Howey test. The SEC is seeking civil fines from Ripple and two of its senior executives. In applying the Howey test, the court disaggregated the defendants' XRP sales into several categories. It ruled that XRP sales to institutional investors were illegal sales of investment contracts that should have been registered as securities. Contrary to the SEC's charges, however, the court found that XRP sales to retail investors via exchanges and XRP payments to employees and vendors did not constitute investment contracts.

This ruling was hailed as a major victory by the crypto industry, with XRP's market price nearly doubling within hours of the ruling's release. Major crypto exchanges that had delisted XRP in response to the SEC's charges resumed XRP trading in rapid succession.

In media interviews, SEC Chair Gensler commended the court for agreeing that the XRP sales to institutional investors were illegal, but he expressed disappointment over the rest of the ruling. Given the possibility of the SEC appealing the ruling to a federal appellate court, the Ripple case's outcome is still uncertain. Whether the adverse ruling will put a damper on SEC's regulation by enforcement remains to be seen. US regulation of cryptoassets is a big question mark at the moment.

Japan's placid regulatory environment

In the US, private businesses have a strong tendency to assume they are permitted to do anything not expressly prohibited by law. This attitude emboldens US companies to roll out products and services that leverage the latest technologies. While such an attitude is conducive to innovation, it also tends to provoke belated, reactive regulation by government authorities, a textbook example of which is the SEC's regulation of cryptoassets today.

In Japan, by contrast, the crypto industry appears to enjoy a placid regulatory environment. Japan has codified the legality of cryptoassets, including stablecoins, by amending its Payment Services Act and Financial Instruments and Exchange Act. Additionally, it requires crypto exchanges to segregate customer assets in their custody. Private businesses in Japan assume that any acts not expressly permitted by law are prohibited. The Japanese model of cooperative public-private rulemaking has proven fruitful.

That said, with crypto technologies and business models constantly advancing, waiting for a consensus on optimal rules to coalesce poses substantial risk of lost business opportunities. How cryptoasset regulation evolves in Japan will be a key focal point going forward.

about NRI

Founded in 1965, Nomura Research Institute (NRI) is a leading global provider of system solutions and consulting services with annual sales above \$5.1 billion. NRI offers clients holistic support of all aspects of operations from back- to front-office, with NRI's research expertise and innovative solutions as well as understanding of operational challenges faced by financial services firms. The clients include broker-dealers, asset managers, banks and insurance providers. NRI has its offices globally including New York, London, Tokyo, Hong Kong and Singapore, and over 16,500 employees.

For more information, visit <https://www.nri.com/en>

.....

The entire content of this report is subject to copyright with all rights reserved.
The report is provided solely for informational purposes for our UK and USA readers and is not to be construed as providing advice, recommendations, endorsements, representations or warranties of any kind whatsoever.
Whilst every effort has been taken to ensure the accuracy of the information, NRI shall have no liability for any loss or damage arising directly or indirectly from the use of the information contained in this report.
Reproduction in whole or in part use for any public purpose is permitted only with the prior written approval of Nomura Research Institute, Ltd.

Inquiries to : Financial Market & Digital Business Research Department
Nomura Research Institute, Ltd.
Otemachi Financial City Grand Cube,
1-9-2 Otemachi, Chiyoda-ku, Tokyo 100-0004, Japan
E-mail : kyara@nri.co.jp

<https://www.nri.com/en/knowledge/publication/fis/lakyara/>

.....