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THE CURRENT: What do the SEC's lawsuits signal for the future of cryptocurrency?

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PITA: You're listening to The Current, part of the Brookings Podcast Network. I'm your host, Adrianna Pita. Last week, the U.S. Securities and Exchange Commission filed suit against two of the largest cryptocurrency exchanges, Binance and Coinbase. 2022 saw increasing volatility in cryptocurrency markets, so with us to talk about this latest move from the SEC and what it potentially signals for the future of cryptocurrency is Aaron Klein, the Miriam K. Carliner chair and senior fellow with the Center on Regulation and Markets here at Brookings. Aaron, thanks for talking to us today.

KLEIN: Oh, thank you for having me.

PITA: So, what can you tell us about what these lawsuits are about? Why did the SEC act against Binance and Coinbase?

KLEIN: So the Securities and Exchange Commission, or SEC, is our America's largest regulator of capital markets. So they regulate exchanges, marketplaces, etc.. And the SEC has been sending warning signs for a very long time that it didn't believe crypto exchanges were following the rules. And in the wake of the failure of FTX, it has acted more aggressively, in this case, going after both Binance, who was a big player in the FTX saga, and then Coinbase, which is the, I think, the largest crypto exchange based in the U.S. and it's saying that these folks are not operating -- so it's very different. Binance, it's accusing of more serious fraudulent activity, potentially more similar to some of the things that went on with FTX, taking customers money, etc.. Coinbase, it's talking about whether or not it is properly registered and properly operating as an exchange. At a higher level, there's been a debate about what is crypto and what isn't it? Is it a security? Is it a commodity? Do they operate exchanges or spot markets? What type of structure is it? And the SEC is aggressively exerting its authority, saying, Oh no, you're an exchange. You're under our existing purview in law. We don't believe you're complying with it and we're going to sue you.

PITA: Is that -- the question of whether it's a security or a commodity -- I'm going to ask you a question about regulation in a moment in the U.S., but is that a question that's not happening just in the U.S., but internationally as well? And has, how have other countries been coming down on that question?

KLEIN: So it's not as important a question in other countries. America is unique in that we regulate securities and commodities differently. That is, if you're trading the price of Apple stock, that's very different than if you're trading the price of corn or gold. Why do we regulate commodities differently from securities? Long history. A lot of it has to do with the tension in America between agricultural interests and banking interests, money-centered interests. But we have two different capital markets regulators, the Commodities Futures Trading Commission or CFTC and the Securities and Exchange Commission, or SEC. The SEC is what most Americans know, because most Americans who invest, invest in things like stocks and bonds and and trade in mutual funds. And those are all governed by the SEC. It's rare for retail investors to trade in commodities. Do you know anybody who trade soybeans futures? Right. Or even or even metallic gold? Right. Some people trade gold stocks or gold index funds, but to actually own gold itself. And so the CFTC is the smaller of the two regulatory bodies, but has been exerting more jurisdiction in crypto under the argument that crypto is a commodity, not a security. So in the rest of the world it would be the

same regulator either place. Only in the U.S. do we differentiate between the two. And so those stakes are higher.

PITA: Okay. So what is the current state of regulation in the U.S.? It is seemed like the SEC or other bodies were a little more hands-off at the beginning. But now the last few years, there have been increasing real official guidelines, real official rules coming down. Where where are we at in that picture?

KLEIN: Well, look, I mean, crypto is still largely not that regulated, right? Does anybody really know what the crypto is? All these different exchanges, whether you have customer funds or commodity funds, look at what was going on with FTX. Right. On the other hand, by the way, things that are quote unquote regulated. Bernie Madoff wasn't just regulated, he was the head of the Nasdaq, you know, in the head of very prestigious groups of self-regulatory bodies and was running a giant Ponzi scheme, too. So there's a bit of an assumption that if you're regulated, then you have to be doing things aboveboard. And we have a long litany of regulated companies, regulated exchanges.

And the other thing people have to understand is, America regulates markets, stocks, exchanges, bonds very different than we regulate things like banks or insurance companies. Those things are subject to prudential regulation. The regulator goes into the firm and examines the entity. You know, on an exchange, you're kind of regulating the market, the conduct of the market. Are people getting the best price or are they getting the most fair, best execution, etc.? It's not that they're going in and saying, does E-Trade have your stock held aside for you? Right. That's a very that's a very different type of regulation. And we don't do what's called prudential regulation as it relates to crypto. Crypto has been in a bit of nowhere, right? It's been a little bit not regulated by a lot of different people. The bank regulators tried to focus on keeping crypto out of the banking system, by and large. Several banks have leaned in on crypto like Silvergate and Signature Bank recently failed. They've been doing more in crypto clearing and crypto exchanges. Other parts of the crypto world said that they weren't securities. The industry is coalesced around proposals to strengthen their oversight by the CFTC, saying they're more regulated like commodities. But largely the crypto world has not been heavily regulated in the United States.

PITA: I know that there are some bodies like the Financial Action Task Force and other some some other international bodies that are looking to try and coordinate, since financial markets, of course, don't only exist solely within the U.S., right, it's the global financial system. What sort of other coordination or thoughts on these matters are you seeing in that international realm outside of the U.S.?

KLEIN: Well, look, international realm loves to sit around and talk about how coordinated they are. And then every time there's a problem, it's, oh, well, we didn't know this because the other person didn't inform us, etc.. In addition, yes, we live in a global world. However, most commodities are traded in dollars and the dollarization of the world gives the United States an important and unique position as a global regulator, because the only place you can get dollars is the United States or -- hold aside eurodollars. But the point being, the United States has a unique role here in this. Some of these companies, like Binance, had separate U.S. affiliates that they said had been carved off from the rest of their organization. FTX had a different affiliate in the United States than in Bahamas, where they were headquartered. But what we've seen and what the SEC alleges to be true in Binance, what we saw to be more true in FTX was these things were not nearly as separate and segregated from the offshore parent company as people were led to believe.

PITA: As you've talked about, you know, FTX, which was the second largest cryptocurrency exchange, had collapsed, they're facing charges of fraud. Now, these recent charges against Binance and Coinbase; you also mentioned the failure of several firms that were sort of functioning as crypto banks. One of the cryptocurrencies, Terra, just completely collapsed last year and many of the others also saw, you know, a I don't know, a crash might be too strong a word, but a very strong devaluation in their amount. Do you think we're approaching like a moment of reckoning for

crypto? Is this the point at which either they're going to start getting wrestled into a legitimate, for lack of a better word, legitimate part of the global financial system, or are we going to keep seeing the sort of volatility for for a while? What do you think?

KLEIN: So, look, I have no idea what the price of crypto is going to be. If I did, I would be a multibillionaire already and not have been an academic who was studying these things when they were, you know, trading for hundreds of dollars. I have no idea what the future price of any of these things are going. In terms of legitimacy, I think there's still a raging debate as to whether crypto serves an ultimate purpose or not. And to the extent it does serve an ultimate purpose, how much of that purpose is what I would call core to the financial system? That is, we're going to be using these currencies for a truly kind of next-generation in innovative finance, Web 3.0 it's often called, programable money, other things like that. Or how much of it are ways around national restrictions, capital flight controls, ways to move money around? Right? If the goal of Bitcoin is to be digital gold, right. Gold goes up in value because it's a perceived hedge against inflation. A perceived there's a perceived that it's not necessarily because people are needing more gold for jewelry or scientific experiments. And so it's not clear what the future of any of these things are.

When you go to crypto conferences, I was at one last week, that's still filled with platitudes of, you know, when the Wright brothers' first plane went, it only went 90 feet, but the world was forever changed. And, you know, the a lot of people point out crypto was the number one advertiser in the Super Bowl at the beginning of 2022 and then kind of imploded in price. Well, if you go back to 2000, right, dot com. Pets.com, all the dot coms were right and there was a huge dot com collapse, yet the internet has remained being fundamentally transformed business, commerce, and everyday life. So the crypto enthusiasts say, look, you know, with any new technology there are ups and downs and initial use cases don't turn out, then other use cases turn out to be huge. And the skeptics point out this thing got really large, really fast. There was a bunch of fraud and malfeasance in it, and we're still waiting for a major legitimate use case where somebody can go, Ah, this is something that can only be achieved through cryptocurrency that our existing prior financial system couldn't make happen.

PITA: So it's still a wait and see, basically.

KLEIN: Yeah. I mean, you have your enthusiasts, right, who believe it's there. You have your skeptics who think it's not there at all. I kind of personally feel a little bit like Fox Mulder from my old X-Files days, right? I want to believe, but every time I go out into the field, there's an Agent Scully who kind of walks me through the actual proposal, and then I kind of go, huh, well, that didn't, that doesn't really make sense.

Now I want to caveat there's a distinction between crypto and blockchain, right, which is a different type of accounting settlement. It's used for currency, but you know, you could use it for land record duration, you could use it for car title management. Don't you think it's weird that if you get pulled over by a cop, you're supposed to show them a sheet of paper that says, the car's yours?

PITA: Okay, right.

KLEIN: Don't you think there's a little bit of a better way that we could all title our cars and we all pay, like, 300 bucks to the state or whatever, and a, you know, title fee thing, and then you get a sheet of paper mailed to you. Like, they're probably -- I have a digital driver's license. Maryland is an early adopter in that. I think there are three states that have digital driver's licenses. I think in five or ten years we're going to be using digital driver's licenses a lot more and they'll solve a lot of fundamental problems about identity. So there could be more solutions to be had there. But I've yet to see this case for a cryptocurrency where I go, Wow, this can only be accomplished by crypto and not by any of the other digital currencies that we use every day in our life. If I can give listeners one thought. You all have digital currency. It's called your credit or debit card.

PITA: Right. You can use it online. So there we go. All right. Well, Aaron, I really appreciate you taking the time to stop and explain this to us today. And I'm sure our listeners will thank you as well.

KLEIN: Thanks for having me on. Hope to be back.