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INSIGHT

SEC Jurisdiction and Perceived Crypto-Asset Regulatory Gap: An FTX Case Study

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FTX Trading, a crypto company once valued at $32 billion, filed for Chapter 11 bankruptcy proceedings in November 2022. Some of FTX's largest investors immediately wrote their FTX investments down to $0. More than a million creditors (including individuals and institutions) are caught up in this FTX insolvency. This Insight uses the FTX event as a case study to illustrate the Securities and Exchange Commission's (SEC's) regulatory jurisdiction, how it applies to crypto-assets, and perceived weaknesses in the application of the current regulatory framework.

SEC Investigation of FTX

The SEC and dozens of other federal, state, and international regulatory agencies and prosecutors have engaged with FTX to obtain more information. The SEC generally does not publicly disclose information regarding ongoing investigations. But multiple news sources have reported that the SEC has been investigating FTX.US, FTX's U.S. subsidiary, for months. While FTX is based overseas and reportedly seeks to block U.S. customers to potentially avoid U.S. jurisdiction, FTX.US provides narrower product offers and is tailored for the U.S. market, and it maintains several U.S. regulatory licenses.

Since the FTX crash, the SEC has reportedly expanded its investigation toward FTX and Alameda Research, an FTX-affiliated investment management firm. At issue is whether FTX and its affiliates are involved in certain securities-related activities, which should have been registered with the SEC (or received an exemption) before being sold to investors. To the extent that these are securities transactions that implicate U.S. jurisdiction, a crypto exchange may be subject to the SEC's regulation, including the Customer Protection Rule, which requires securities broker-dealers to segregate client assets from their proprietary business activities. That rule may have mitigated some of the issues that reportedly led to FTX's bankruptcy, as the firm is alleged to have loaned client funds to Alameda Research.

More importantly, even if the SEC could prove that FTX and its affiliates violated securities regulations, the SEC's capability to go after FTX is limited to *securities* activities, which generally do not include commodities and other non-securities instruments that make up the bulk (or even all, depending on whom you ask) of FTX's business. Some observers believe that the SEC may face difficulty pursuing FTX mainly because of the firm's offshore status and how existing regulatory frameworks are currently applied

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to crypto-assets—certain crypto-asset market segments are generally not subject to federal securities marketplace regulation commonly seen in traditional investments.

SEC Jurisdiction

The current regulatory landscape for crypto-assets is fragmented. Multiple agencies apply different regulatory approaches to crypto-assets at the federal and state levels. The SEC is the primary regulator overseeing securities offers, sales, and investment activities, including those involving crypto-assets. In general, a security is "the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others." When a crypto-asset meets this criterion, it is subject to the SEC's jurisdiction.

SEC Chair Gary Gensler has repeatedly stated that he believes the vast majority of crypto tokens are securities (while recognizing some crypto-assets are not). Other stakeholders, including the crypto industry, disagree with that assertion. In cases where they are not securities, crypto-assets may be commodities under the Commodity Exchange Act (CEA). In such cases, they would be subject to the Commodity Futures Trading Commission's (CFTC's) jurisdiction, which generally extends to commodities and derivatives. For example, under this framework as currently applied, most initial coin offerings are considered securities, but Bitcoin is considered a commodity, not a security. Securities regulations could also apply if the crypto market intermediaries (e.g., investment advisers, trading platforms, and custodians) are directly engaged in the security-based crypto-asset transactions.

In cases where the crypto-assets are securities, the SEC has both (1) *enforcement* authority that allows the SEC to bring civil enforcement actions, such as anti-fraud and anti-manipulation actions, for securities laws violations *after the fact* and (2) *regulatory* authority, including over digital asset securities, which could include registration requirements, oversight, and principles-based regulation. Also, the CEA provides the CFTC with certain enforcement and regulatory authority when it comes to digital asset derivatives. However, the CFTC has enforcement authority, but not regulatory authority, over the spot market of digital asset *commodities*.

Perceived Crypto-Asset Regulatory Gap

Because crypto-asset commodities spot market activities receive CFTC oversight that generally pertains to enforcement (but not regulatory) authority, activities in these non-security crypto-asset markets are not subject to the same safeguards as those established in securities markets. Examples of such safeguards include certain rules and regulations that encourage market transparency, conflict-of-interest mitigation, investor protection, and orderly market operations.

In the case of FTX, if FTX and its affiliates are involved in the crypto commodities spot market (e.g., the trading of Bitcoin), neither the SEC nor the CFTC would normally regulate these activities.

Certain observers, including the Financial Stability Oversight Council (FSOC), characterize this framework as having a regulatory gap. FSOC has encouraged Congress to provide explicit rulemaking regulatory authority for federal financial regulators over the spot market for crypto-assets that are not securities. FSOC states that this new rulemaking authority "should not interfere with or weaken market regulators' current jurisdictional remits."

Policy Questions

Some Members of Congress have proposed to redesign SEC and CFTC jurisdiction, and Congress will likely continue to propose changes and explore alternatives. When designing a new regulatory landscape, policymakers face challenging questions about how (or if) to make crypto-asset securities and commodities regulation more alike. Financial regulators have traditionally followed the "same activity, same risk, same regulation" principle to mitigate the potential risks of regulatory arbitrage. Related questions include: To what extent should the design of the crypto-asset regulation framework align with the existing securities trading and investment regulation? Should different sets of rules be based on the regulatory jurisdiction or the nature of risk exposure and risk mitigation needs? What are the operational costs to the platforms under different alternatives? Should Congress appoint a primary regulator for crypto-asset markets, or should actions such as rulemaking be evenly coordinated across financial agencies that are governing the same or similar entities?

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