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WEALTH MANAGEMENT

INVESTMENT STRATEGY

Market Research & Strategy | November 14, 2022

US Policy Pulse

The State of Cryptocurrency Regulation

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Special thanks to Daniel Kohen for his contributions to this report.

In this report we discuss cryptocurrency regulatory and legislative actions and what they could mean for the industry and investors.

Key Findings:

- Cryptocurrencies were first regulated in the US in 2011, with scrutiny intensifying since 2017.
- The decade of regulatory and legal actions pertaining to the crypto industry serves as the foundation for future legislation and agency rule-making. While legislation introduced in 2022 is unlikely to pass this Congress, the proposals could signal congressional priorities in the near term.
- Proposed legislation could create regulatory obligations for brokers, dealers, crypto exchanges, custodians, nonbank-issued stablecoins and crypto trading facilities.
- The Biden administration recently released several reports detailing policy recommendations that could serve as a blueprint for future cryptocurrency oversight.
- These reports examine crypto-related consumer protections, central bank and crypto payment systems, climate change and cryptocurrency mining, financial risks and money laundering.
- Importantly, we expect increased crypto industry regulation to be constructive for the asset class, potentially encouraging greater institutional investor participation.

Since its inception, the cryptocurrency industry has been regulated by a patchwork of different bodies and frameworks. However, recent actions suggest that a more coordinated regulatory framework may be in the early stages of formation. The regulatory landscape around cryptocurrency and other digital assets has evolved over time, with the complexity of the asset class fostering uncertainty for regulators. The lack of clarity touches everything from market transparency to the development of a definition of cryptocurrency assets (featuring elements of currencies, commodities, property and securities), to a decision on which regulatory body should lead oversight. This uncertainty has created a speculative environment over whether or not anticipated government action will take place. While key questions persist, today all branches of government are debating and examining regulatory solutions. Primary areas of government action include legislative proposals, executive branch rule-making and federal and state legal enforcement.

In this report, we leave state and local actions aside and focus on federal activity, due to the breadth and reach of the federal government and the regulatory consequences that could shape the cryptocurrency industry at large. We review recent actions taken by the executive branch, legislation that could receive congressional consideration and significant legal actions—all of which could provide insights into both the future of cryptocurrencies and the investment landscape.

Short History of Crypto Regulations

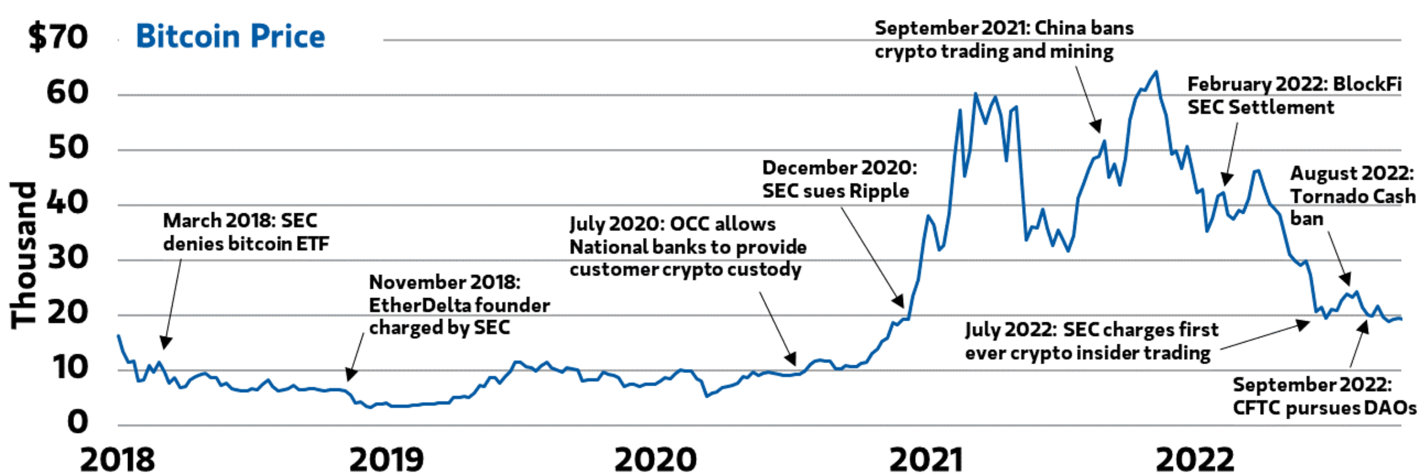
Digital currencies were created in the 1990s but did not become viable as currency options until bitcoin was designed in a decentralized way using proof-of-work consensus and a blockchain in 2008. Blockchain technology made it inexpensive for users to separate valid digital assets from worthless copies and facilitated decentralized digital scarcity for the first time. The relatively short history has resulted in a regulatory regime spanning just 11 years.

The first instance of regulatory action directed toward crypto occurred in 2011, when the Financial Crimes Enforcement Network (FinCEN), the US' top anti-money laundering agency, determined that virtual currencies fall under its regulatory scope. Since then, government scrutiny has increased steadily. Other federal bodies that have exercised oversight include the Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency (OCC), the Commodity Futures Trading Commission (CFTC) and the IRS.

The SEC brought its first enforcement actions—against cryptocurrency Ponzi schemes—in 2013, and the IRS defined digital assets as property in 2014. In 2015, the CFTC declared that bitcoin and some other virtual assets should be treated as commodities rather than currencies and that, as such, any fraud or manipulation involving cryptocurrencies in interstate commerce should come under its oversight. The industry has also experienced increased regulation in foreign markets, with China enacting sweeping laws tightly regulating trading in 2017, then moving to ban trading and mining all together in 2021 (see Exhibit 1). Congress has gradually taken more of an interest in crypto and successfully passed legislation addressing transaction- and tax-related issues in 2017 and 2021. More recently, a few bipartisan bills have emerged.

Reviewing this history dispels the theory that cryptocurrencies are completely without regulatory oversight. On the contrary, the industry has experienced a steady stream of legislative, regulatory and legal actions for more than a decade. Perceived regulatory uncertainty stems from a lack of guidance on how to handle several unique aspects of cryptocurrency. Many of the regulatory actions thus far have attempted to apply regulations and laws, some of which are nearly 100 years old, to a new asset class that is far different from what was assumed by the designers of the early regulations. We expect both Congress and the executive branch to increase oversight in the coming years. Due to the relatively nascent nature of cryptocurrencies, the US government is likely to grapple with many new regulatory concerns not discussed in this report as the emerging asset class matures.

Exhibit 1: Regulatory Actions at Home and Abroad Have Evolved Over Time



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Oct. 23, 2022.

Legal Overview

The executive branch has pursued regulation by legal enforcement. Claims, settlements and legal decisions have begun to clarify the governance of cryptocurrencies, with several actions that could set notable legal precedents expected to take place in upcoming months. The SEC, the Treasury Department, the CFTC and the Department of Justice (DOJ) have each engaged in important enforcement actions that may inform such precedents. The SEC, notably, has brought over 100 actions since 2013. The actions have addressed a variety of issues, such as prevention of fraud, illegal use of bitcoin and other cryptocurrencies to fund new organizations or trade existing securities, operation of illegal security exchanges and fundraising for new cryptocurrencies that have been determined to be securities. SEC actions have also pertained to the application of insider trading laws to cryptocurrency exchanges.

Defining Cryptocurrencies

Many of the laws that address security regulations depend on a legal definition of a security from a 1946 court case known as the "Howey Test", which established a four-pronged determination of what constitutes a security. The test requires 1) an investment of money 2) in a common enterprise 3) with a reasonable expectation of profit 4) solely through the efforts of others. The application of the Howey Test to cryptocurrencies has been a point of debate between the industry and the SEC, with few clear answers. Two important ongoing legal cases to monitor involve a cryptocurrency called Ripple and employees of a cryptocurrency exchange. The December 2020 claim involving Ripple, concerns recurring sales of a cryptocurrency and the alleged offering of an unregistered security. The claim against former exchange employees is directed at individuals alleged to have engaged in insider trading ahead of cryptocurrency listings deemed by the SEC to be securities using the Howey Test. As part of this claim, the SEC, employing the Howey Test, rendered a detailed analysis of why the seven cryptocurrencies in question qualify as securities.

Deterring Criminal Activity

Turning to the US Treasury, we have seen this agency pursue anti-money laundering initiatives. For example, the Treasury has disallowed cryptocurrency transactions that obfuscate assets and make them harder to trace. Treasury has targeted "mixers," which combine many cryptocurrency transactions so that the origin and destination of each transaction becomes difficult to determine. In addition, the Treasury's Office of Foreign Assets Control (OFAC) has the capacity to sanction currencies and make them legally uninvestable in the US if it is suspected they are being used to aid money laundering activities. A cryptocurrency trade organization recently filed a suit claiming that Treasury and OFAC improperly sanctioned "tornado cash"—a decentralized mixer software program.

The CFTC has also pursued legal measures to enforce rules against illicit commodity exchanges. In a recent complaint against Ooki Dao, the CFTC has sought to fine the decentralized autonomous organization (DAO) for offering leveraged and margined retail commodity transactions in digital assets and engaging in activities reserved for registered futures commission merchants (FCMs). While the full details of this case are beyond the scope of this report, it could set an important precedent for decentralized crypto exchange activity.

While we do not know what direction these cases will take, their resolutions might provide more clarity on cryptocurrency regulatory issues in the years ahead.

Legislative Overview

Cryptocurrencies are also top of mind for some legislators, with members of the 117th Congress introducing over 50 bills related to crypto and digital assets since January 2021. That said, we reviewed three recently proposed bipartisan bills that may have significant impacts on the regulation of digital assets: the Digital Commodities Consumer Protection Act of 2022 (DCCPA), the Responsible Financial Innovation Act (RFIA) and the Waters-McHenry Stablecoin draft legislation (Waters-McHenry). Importantly, each bill, in some way or other, focuses on protecting consumers, reducing digital asset market risk and defining a clear legal framework for handling cryptocurrencies and other digital assets (see Exhibit 2).

The Digital Commodities Consumer Protection Act (DCCPA), introduced by Democratic Senator Debbie Stabenow of Michigan and Republican Senator John Boozman of Arkansas, is intended to increase transparency and accountability of digital assets. Critically, the Stabenow-Boozman bill would be significant for the CFTC, as it provides the commission with exclusive jurisdiction over digital commodities, including a requirement for all digital commodity platforms to be CFTC-registered and pay user-fees to the commission. The bill was introduced in the Senate in August, with numerous committee hearings held in mid-September. It currently has six bipartisan cosponsors.

The Responsible Financial Innovation Act (RFIA) was introduced by Republican Senator Cynthia Lummis of Wyoming and Democratic Senator Kirsten Gillibrand of New York in early June but lost momentum after committee hearings in July and September. That said, the bill could be reintroduced in the next congressional session. It aims to 1) address the assets backing stablecoins (cryptocurrencies that are similar to money market accounts); 2) divide responsibility between the CFTC and the SEC, depending on whether digital assets are currencies, commodities or securities; 3) address tax treatment of digital assets; and 4) consider cybersecurity and environmental impacts.

Exhibit 2: Potential Legislation Assigns Cryptocurrency Oversight to Various Federal Agencies

Bill	Regulator	Regulated Asset	Impacted Parties	Main Goals	Main New Rules
DCCPA (Stabenow-Boozman)	CFTC	Digital commodity platforms; bitcoin, ethereum	Brokers, custodians, dealers, exchanges, trading facilities	• Provide CFTC exclusive jurisdiction over digital commodities • Protect consumers and market integrity	• All digital commodity platforms must be CFTC-registered • Imposes user fees on digital commodity platforms
RFIA (Lummis-Gillibrand)	CFTC, SEC	Jurisdiction over digital assets, including stablecoins, bitcoin, ethereum	Brokers, custodians, dealers, exchanges, trading facilities	• Stability and safety of digital assets, including stablecoins • Clear legal and regulatory lanes; responsible digital asset development	• Grants CFTC regulation of digital assets; SEC regulation of "ancillary assets" • Stablecoins to be 100% backed by high-quality liquid assets
Waters-McHenry*	Federal Reserve	Algorithmic and nonalgorithmic stablecoins	Nonbank stablecoin issuers; Treasury Department	• Increase understanding and oversight; reduce stablecoins risks • Prevent algorithmic stablecoin collapses	• Fed oversight of nonbank-issued stablecoins • Two-year algorithmic stablecoin moratorium • Stablecoins must be backed by cash/cash-related securities only • Directs Treasury Dept. to study stablecoins

*Draft Legislation

Source: Congress.gov, Morgan Stanley Wealth Management Global Investment Office as of Oct. 23, 2022

The Waters-McHenry draft legislation, sponsored by Democratic Rep. Maxine Waters of California and Republican Rep. Patrick McHenry of North Carolina, would take stablecoin regulation a step further. Specifically, the bill would grant the Federal Reserve oversight of nonbank-issued stablecoins and require digital assets to be backed by cash or cash-related securities. Importantly, the bill also imposes a two-year moratorium on "endogenously collateralized stablecoins", also known as algorithmic stablecoins. These experimental stablecoins are not backed by assets but by complex incentive systems and formulas. Stablecoin legislation could receive bipartisan support and serve as a first step in the congressional oversight of digital assets.

Bottom line, each of the three bills grants jurisdiction over digital assets to one or more regulatory bodies, highlighting debate among not only the regulators themselves, but also legislators. While the passage of one or more of these proposals could create greater guidance for the future governance of cryptocurrencies, they would not eliminate or resolve all outstanding regulatory questions and further debate is expected to continue. Nonetheless, a regulatory environment made more certain by legislation may drive further investment and innovation in digital assets.

Future of Crypto Oversight

While we expect continued regulatory, legal and legislative actions to take shape over the next few years, this year President Biden has called for several agencies to examine cryptocurrency regulation across the government. The resulting series of reports provides a sweeping review of policy issues that intersect with cryptocurrency and blockchain technologies. The reports examine consumer protections and financial literacy, central bank and crypto payment systems, climate change and cryptocurrency mining, financial risks and money laundering. We reviewed reports from the US Treasury, DOJ, Department of Commerce and White House Office of Science and Technology Policy (OSTP). Each entity has identified issues for future study and policy recommendations and has created a framework for the future of crypto legislation. Generally, the reports recommend increased industry monitoring along with more consumer and market protections. In the payments space, they examine central bank digital currencies and explore issues related to money laundering. Money laundering issues also appear in the administration's plans to prevent illicit financing and improve the detection, investigation and prosecution of crimes related to digital assets. In addition, an OSTP report reviews the environmental impact of high-energy data mining. Finally, the documents explore ways to improve US leadership and competitiveness in the space.

Although the administration's reports are not binding, they can serve not just as an indicator of the Biden administration's priorities, but as a blueprint for agency rule-making and congressional legislation. Furthermore, we expect the long-term impact of continued cryptocurrency regulatory oversight to be constructive for the market. Stronger rules around transparency, investor education and protection, accountability and climate impact could incentivize further government and institutional adoption.

While we expect to see the crypto-related regulatory environment mature, many risks remain. These include encryption breaks, flaws in coding/software, government bans, holdings concentration, competition and market volatility. Importantly, risks may vary depending on the type and structure of the cryptocurrency in question. For example, bitcoin and ethereum present different sets of risks for investors (see Exhibit 3).

Exhibit 3: Different Cryptocurrencies Carry Different Risks

Cryptocurrency Risks			Traditional Risks	
Encryption Breaks	Flaw in Code	Government Action	Concentration Risk	Volatility
Increased processing power and quantum computing techniques **could eventually crack encryption**, leading to cryptocurrency chaos, failed transactions, and hacking of some wallets. While the chances are low in any given year, over 100 years it is a risk that is likely to emerge.	Flaws in code occur frequently in a smart contract - the self-executing code that carries out the buyer-seller agreement in the Blockchain. Since 2010, bitcoin has had two large bugs that resulted in more coins printed. This could lead to **further price volatility.**	Government action could disrupt the global bitcoin network through a: • **Regulatory Action:** raised tax rate or through laws banning bitcoin's use. • **Direct Action:** governments limiting unwanted, unfavorable transactions.	Bitcoin's 95 largest addresses hold ~14% of total coins, many of which are institutions and crypto exchanges. Any movement in assets could impact price: • **Limited capacity:** transaction fees are typically used to allocate scarce capacity. • **Heavy usage:** High fees, slow transactions can lead to users exiting the network.	Despite low beta due to low (even sometimes negative) correlations with the broader economy, its historical realized **volatility is among the highest of all assets.** Bitcoin trailing 12-month volatility is 56% vs. S&P 500 (23%) vs. Nasdaq (31%).

Source: Chainanalysis, Computerworld.com, Coindesk, BitIngoCharts, Digital Currency Initiative, Morgan Stanley Wealth Management Global Investment Office as of Oct. 23, 2022.

Conclusion

Cryptocurrency regulation is still evolving, with several key governance and oversight questions yet to be addressed. This said, the federal government has been working to tackle some of the concerns facing the asset class, and we expect more regulatory clarity within the next few years. Although sweeping solutions may not be imminent, in the near term we expect agency level enforcement and legal action to effectively establish industry rules. Legislative activity is likely to be slower, depending on electoral outcomes, though it is too early to tell which bills will gain traction in 2023. Furthermore, electoral politics may play a critical role in shaping crypto-policy, as the 2024 general election cycle could either deprioritize the issue or create opportunities for pro-regulation lawmakers. Ultimately, the slower pace of the legislative process may cause regulators to address many nuances. To close, we expect the long-term trend of increased regulation to be constructive for cryptocurrencies, as stronger oversight could encourage institutional participation. We caution investors seeking exposure to the asset class, however, as cryptocurrencies may entail notable risks.

Disclosure Section

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For index, indicator and survey definitions referenced in this report please visit the following:

https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

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Buying, selling, and transacting in Bitcoin, Ethereum or other digital assets ("Digital Assets"), and related funds and products, is highly speculative and may result in a loss of the entire investment. Risks and considerations include but are not limited to:

- Digital Assets have only been in existence for a short period of time and historical trading prices for Digital Assets have been highly volatile. The price of Digital Assets could decline rapidly, and investors could lose their entire investment.
- Certain Digital Asset funds and products, allow investors to invest on a more frequent basis than investors may withdraw from the fund or product, and interests in such funds or products are generally not freely transferrable. This means that, particularly given the volatility of Digital Assets, an investor will have to bear any losses with respect to its investment for an extended period of time and will not be able to react to changes in the price of the Digital Asset once invested (for example, by seeking to withdraw) as quickly as when making the decision to invest. Such Digital Asset funds and products, are intended only for persons who are able to bear the economic risk of investment and who do not need liquidity with respect to their investments.
- Given the volatility in the price of Digital Assets, the net asset value of a fund or product that invests in such assets at the time an investor's subscription for interests in the fund or product is accepted may be significantly below or above the net asset value of the product or fund at the time the investor submitted subscription materials.
- Certain Digital Assets are not intended to function as currencies but are intended to have other use cases. These other Digital Assets may be subject to some or all of the risks and considerations set forth herein, as well as additional risks applicable to such Digital Assets. Buyers, sellers and users of such Digital Assets should thoroughly familiarize themselves with such risks and considerations before transacting in such Digital Assets.
- The value of Digital Assets may be negatively impacted by future legal and regulatory developments, including but not limited to increased regulation of such Digital Assets. Any such developments may make such Digital Assets less valuable, impose additional burdens and expenses on a fund or product investing in such assets or impact the ability of such a fund or product to continue to operate, which may materially decrease the value of an investment therein.
- Due to the new and evolving nature of digital currencies and the absence of comprehensive guidance, many significant aspects of the tax treatment of Digital Assets are uncertain. Prospective investors should consult their own tax advisors concerning the tax consequences to them of the purchase, ownership and disposition of Digital Assets, directly or indirectly through a fund or product, under U.S. federal income tax law, as well as the tax law of any relevant state, local or other jurisdiction.
- Over the past several years, certain Digital Asset exchanges have experienced failures or interruptions in service due to fraud, security breaches, operational problems or business failure. Such events in the future could impact any fund's or product's ability to transact in Digital Assets if the fund or product relies on an impacted exchange and may also materially decrease the price of Digital Assets, thereby impacting the value of your investment, regardless of whether the fund or product relies on such an impacted exchange.
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- Investors in funds or products investing or transacting in Digital Assets may not benefit to the same extent (or at all) from "airdrops" with respect to, or "forks" in, a Digital Asset's blockchain, compared to investors who hold Digital Assets directly instead of through a fund or product. Additionally, a "fork" in the Digital Asset blockchain could materially decrease the price of such Digital Asset.
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