View from the Beltway

Well, Finally

By Owen Ullmann

Belated calls for crypto regulation.

In 1998, Brooksley Born, the chair of the Commodity Futures Trading Commission, had grown increasingly alarmed by the explosive growth of unregulated over-the-counter trading of derivative contracts, which had a mouth-dropping estimated value of $80 trillion. These often-complex, computer-generated trades were a mystery to federal regulators—and most investors, who only understood the promised high rate of return at a presumed low risk.

Born was not as complacent. She already had seen several derivative deals go south in recent years, triggering hundreds of millions in losses, lawsuits, and claims of fraud. A major hedge fund, Long-Term Capital Management, blew up that year over bad bets, forcing a government orchestrated bailout. So Born's agency proposed regulating over-the-counter trades. Other top federal regulators at the time—Treasury Secretary Robert Rubin and his deputy, Lawrence Summers, Federal Reserve Chairman Alan Greenspan, and Securities and Exchange Commission Chairman Arthur Levitt—squashed the proposal. They yelled at her and said the CFTC had no jurisdiction over the lucrative market, which would only move overseas if restrictive government oversight was in the offing. Congress was opposed to the idea as well, aided by intense financial industry lobbying, and President Clinton signed a bill in 2000 that barred any regulation of OTC derivatives.

FTX is the canary in the coal mine.

In December 2007, the very derivatives Born had wanted to regulate triggered a financial meltdown, a housing crisis, the collapse of Lehman Brothers less than a year later, a financial panic, and the Great Recession that lasted into 2009. Only then did Washington respond, enacting the Dodd-Frank Act, which tightened federal oversight of the financial industry.

Barely a decade later, history is repeating itself, only the risky bets this time involve not derivatives but crypto currency, an equally opaque, complex, computer-generated industry that has escaped regulation and gone splat. As recently as a year ago, the industry had a market cap of $3 trillion. Now it is worth less than $1 trillion in the wake of the collapse in November of the crypto exchange FTX. Bitcoin, which started it all, is worth less than a quarter of its peak value in 2021, and investors—ranging from sophisticated hedge funds to teenagers—have suffered huge losses.

FTX is the canary in the coal mine, just as Long-Term Capital Management was in 1998. Like the calls for government regulation following the derivatives crash, many in Congress and the Biden Administration are calling for new tools to supervise the crypto industry. And once again, it's a belated response—after the damage has been

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done with the prospect of even greater financial instability if congressional action stalls.

It's a familiar pattern. A new, little-understood industry promising great riches emerges and balloons in value overnight. A few voices in Washington raise concern but Congress, which must pass legislation to grant regulators new oversight powers, does nothing, mainly because lobbyists for the unregulated industry shower members with millions in campaign donations and appeals to remain unregulated. Their argument is

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that heavy-handed oversight will stifle innovation and shackle the entrepreneurial spirit behind the world's most successful economy.

Before FTX filed for bankruptcy, the exchange's founder, Sam Bankman-Fried, had amassed a fortune estimated at more than $26 billion and became one of the biggest donors to members of Congress. He gave $40 million prior to the midterm election, mostly to Democrats, according to records tracked by the non-partisan Center for Responsive Politics. Ryan Salame, a top official at FTX, donated an estimated $24 million to congressional Republicans. Little wonder, bills in Congress to regulate crypto have gone nowhere.

Treasury Secretary Janet L. Yellen, who has been pressing for regulation of the volatile industry since assuming office in 2021, recently renewed her concerns about the risks of crypto currency. The collapse of FTX is "a Lehman moment within crypto,"

U.S. Treasury Secretary **Janet Yellen** *has good reason to push for crypto regulation. She was chair of Clinton's Council of Economic Advisers when CFTC Chair Brooksley Born made her ill-fated effort to regulate derivatives. Yellen sided with the anti-regulation forces, a position she has regretted ever since. As president of the San Francisco Federal Reserve Bank from 2004 to 2010, she had seen the housing crisis grow on the horizon and favored tighter regulation of derivatives, but lacked authority at the time to do anything other than to raise an occasional alarm.*

Yellen said November 30 at an event sponsored by DealBook, a *New York Times* financial news service. "Crypto is big enough that we've had substantial harm of investors and particularly people who aren't very well informed about the risks that they're undertaking, and that's a very bad thing," she continued.

Yellen has good reason to push for crypto regulation. She was chair of Clinton's Council of Economic Advisers when CFTC Chair Born made her ill-fated effort to regulate derivatives. Yellen sided with the anti-regulation forces, a position she has regretted ever since. As president of the San Francisco Federal Reserve Bank from 2004 to 2010, she had seen the housing crisis grow on the horizon and favored tighter regulation of derivatives, but lacked authority at the time to do anything other than to raise an occasional alarm. The Fed Board in Washington also had its hands tied because the repeal of most of the Depression-era Glass-Steagall Act in 1999 allowed banks to once again trade securities through non-bank subsidiaries that avoided Fed oversight.

In her current post, Yellen has a large megaphone to prod for action in Congress. While acknowledging that the blockchain technology pioneered by crypto currencies could lead to more efficient financial transactions by eliminating third-party authentication, having such a large industry behave as if it's still the Wild West poses too great a risk to financial stability and investors.

As head of the Financial Stability Oversight Council, a group of top regulators created by Dodd-Frank, Yellen has been working with her colleagues to draft legislation that would provide enhanced oversight of crypto. In a prescient report issued five weeks before FTX collapsed, FSOC warned that the burgeoning industry posed ever-greater risks to the larger financial system. "The scale of crypto-asset

Two of the gaps in regulation are quite clear. One is the stablecoin market with its potential for wider financial instability. The other is when crypto is sold on the spot market like equities and commodities.

activities has increased significantly in recent years," the report said. "Although interconnections with the traditional financial system are currently relatively limited, they could potentially increase rapidly." FSOC urged Congress to provide the SEC and CFTC with more authority and resources to oversee crypto.

The report was particularly concerned about the systemic risks of stablecoins, crypto currencies tied to the

MIT Sloan School of Management Professor **Deborah Lucas** *predicts that all the regulators will play a role in accordance with their missions. Lucas sees the CFTC and SEC playing key roles, noting that the SEC recently clarified its definition of a security to include crypto.*

value of assets such as the dollar to reduce their volatility. Several ostensibly "safe" stablecoin companies collapsed in the spring of 2022.

It's understandable that companies resist government intervention that hurts both profitability and new business models that may benefit consumers. Yet there are always greedy players, those who take on too much risk and others who cheat, making it necessary for someone to maintain a level playing field with rules that curb all the excesses. Financial regulations that aren't too heavy-handed have served the economy well. They have prevented once-common bank runs, kept the financial markets from seizing up, largely stopped stock swindles and insider trading, and minimized the frequency and depth of financial crises.

The need for stronger crypto oversight was endorsed in November by panelists participating in a program on "Regulating Disruptive Innovation" held by MIT's Sloan School of Management. "What we've seen is, in the absence of regulation, abuses occur," said Dan Doney, CEO of Securrency Inc., a blockchain infrastructure company.

Doney, Sloan professor Deborah Lucas, director of the MIT Golub Center for Finance and Policy, and Edward Golding, the center's executive director, agreed regulation is essential to protect consumers from scams and other risks. But they also acknowledged that it is equally important to strike the right balance between regulation and innovation.

The unanswered question is who will take the lead in regulating crypto currency. The SEC? The CFTC? The Fed? Lucas predicts that all the regulators will play a role in accordance with their missions. Lucas sees the CFTC and SEC playing key roles, noting that the SEC recently clarified its definition of a security to include crypto.

With the regulatory future in the United States still hazy, Doney sees companies going overseas to do business in crypto where regulations are clearer. "Parties are going elsewhere with this amazing and powerful new technology," he said. "It's something that we should really seek to align on as a policy objective as a country." He argued that a clear set of rules by Washington will make it easier for companies to operate domestically and save them the cost of hiring teams of lawyers to protect their interests.

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"Regulatory uncertainty becomes a massive barrier to innovation," Doney said. "We have a responsibility to provide that regulatory certainty if we want to be an innovative leader in financial service technology."

Before FTX failed, founder Bankman-Fried worked closely with CFTC Chair Rostin Behnam to back a bill in Congress that would grant the CFTC the lead role in regulating crypto exchanges, the *Washington Post* reported on November 28. Why? Perhaps, as the *Post* noted, because the CFTC is smaller and less rigorous than the SEC in overseeing the industry, at least in the eyes of the bill's opponents. The bill, however, would provide the commission with more resources.

Even so, critics suspected FTX backed the bill because it figured the CFTC would be a lax regulator. SEC Chair Gary Gensler, who headed the CFTC during the Obama Administration, made that point in a speech in the immediate wake of FTX's collapse. "There's some legislation on the Hill I do not think meets the test. I think it undermines the securities laws," he said. "Just to note, some of that legislation was promoted by some of the same folks that failed in the last day or two. And you sort of wonder why. Because it was too light touch. So we're going to continue what we're doing."

A Belated Response

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A Familiar Pattern

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Bankman-Fried and Behnam also jointly supported a now-dead proposal that would have allowed clients to make complex cryptocurrency trades on margin directly through its exchange website, rather than through traditional brokers, according to the *Post.* Critics' warnings that such a move would create grave risks for customers and the larger market were proven on target when FTX collapsed.

Crypto companies have fended off regulation not only through generous campaign donations but another common corporate ploy: the revolving door. In 2021, FTX hired former CFTC Commissioner Mark Wetjen as "Head of Policy and Regulatory Strategy," a fancy title for chief lobbyist. Bankman-Fried also hired other former officials from the CFTC and SEC to add more lobbying muscle.

We can thank FTX's Sam Bankman-Fried for unintentionally kicking Congress in the butt, just like Lehman Brothers unwittingly did fourteen years ago.

And if packing its corporate offices with former regulators wasn't enough, companies like FTX often set up headquarters offshore—putting most operations out of the reach of U.S. agencies. FTX was based in the Bahamas, where Bankman-Fried was arrested on December 12 and subsequently charged by U.S. prosecutors with a series of financial crimes.

Senate Banking Committee Chair Sherrod Brown (D-OH) urged Yellen in a letter on November 30 to work with lawmakers and financial regulators to help write legislation to better oversee the cryptocurrency market.

Biden Administration officials advising Yellen on proposed regulation note that current laws dealing with traditional securities issues such as fraud protect crypto buyers, but there remain many gaps in regulation because cryptocurrency is neither a typical commodity that falls under the CFTC's purview nor a traditional equity covered by all SEC rules. Determining what those gaps are, setting priorities for closing them, and determining the best protections for consumers are being weighed.

The administration is looking at a variety of proposals that would produce the most pragmatic approach for closing the regulatory gaps, explained one administration official involved with the issue. "Both the SEC and CFTC likely will have a role to play," the official said. "We're trying to get as much as we can get ahead of the sources of risks before they become more significant." The Fed may also play a role since some crypto companies function much like traditional banks, as well as like brokerages and commodity exchanges.

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When will legislation finally pass? That's still an open question. Control of the House in 2023 by Republicans, among whom anti-regulatory feelings run high, may prove to be another barrier. Still, it's fair to say some new rules are likely to emerge and will happen sooner than before FTX went under. "There were some in Congress who felt that legislation may not have been necessary, that regulators had the authority," observed a second administration official assigned to helping draft a proposed bill. Since the collapse of FTX, however, added the official, "I think you are seeing a change toward a view that there is a real need now to address some of the issues through legislation."

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It's about time. And we can thank Sam Bankman-Fried for unintentionally kicking Congress in the butt, just like Lehman Brothers unwittingly did fourteen years ago.

As for Brooksley Born, the prescient former CFTC chair, she sees the current situation—to quote wordsmith Yogi Berra—as a case of "*déjà vu* all over again." ◆