

**Hearing on  
Crypto Crash: Why the FTX Bubble Burst and the Harm to Consumers  
Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs**

**Wednesday, December 14, 2022**

**Prepared Statement**

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Chairman Brown, Ranking Member Toomey, and Members of the Committee:

Thank you for inviting me to testify at today’s hearing. My name is Hilary Allen, and I am a Professor of Law at the American University Washington College of Law. I teach courses in corporate law and financial regulation, and my research focuses on financial stability regulation. I have authored several articles for law reviews and the popular press about fintech and financial stability, and I have also written a book, *Driverless Finance: Fintech’s Impact on Financial Stability*, that explores the threats that crypto and other fintech innovations pose to our financial system. Prior to entering academia, I spent seven years working in the financial services groups of prominent law firms in London, Sydney, and New York. In 2010, I worked with the Financial Crisis Inquiry Commission, which was appointed by Congress to study the causes of the financial crisis of 2007-2008.

I note that on May 25, 2022, I participated as an invited commenter at the CFTC’s roundtable on FTX’s proposal to automate clearing of margined trades for retail customers. I also co-authored a comment letter opposing that proposal. I have had no other interactions with FTX or any related entities. I am not testifying on behalf of the Washington College of Law or any other institution; the views expressed here are entirely my own.

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## 1. Executive Summary

We are still trying to piece together the details of FTX's failure, but a number of things are already clear. We know that FTX's affiliated hedge fund Alameda Research made large bets that fared poorly, leaving Alameda with a dubious balance sheet (its largest asset was its holdings of FTT tokens). We know that assets belonging to FTX's customers were lent to Alameda, in exchange for FTT tokens. We know that FTX created these FTT tokens out of nothing, and when FTX was no longer able to convince the world of FTT's value, it could no longer convert FTT into the assets needed to satisfy its customers' withdrawal requests. From all of this, it seems clear that FTX's problems arose in large part because of crypto's unique ability to create assets out of nothing. When unlimited assets can be created, there are no limits on the creation of leverage, and when assets have no fundamentals and trade entirely on sentiment, traditional checks on fraud (like valuation methodologies and financial accounting) will inevitably break down.

The problems at FTX were not a one-off, but part of a cascade of interconnected failures in the highly leveraged crypto financial system. These failures have impacted both centralized and decentralized players in the crypto industry: the decentralized players are not immune from problematic behavior. Bad actors can easily establish economic control over technologically decentralized platforms, so decentralization cannot guarantee that future FTXs will be avoided. Simply providing regulatory clarity will also be insufficient to prevent future FTXs. Some have claimed that FTX.com operated abroad because of a lack of regulatory clarity in the US, and that with more clarity, the exchange would have operated under the watchful eye of US regulators. The reality is, however, that FTX.com wanted to do things that it was not authorized to do in the United States (FTX operated a separate FTX US exchange designed to comply with US laws). FTX went abroad for more lax regulation, not more certain regulation.

FTX also sought to have more lax regulation implemented in the United States, by lobbying for new CFTC-administered crypto regulation that would help the crypto industry prosper. Crypto has demonstrated little utility in terms of real-world capital formation or financial inclusion, though, and so the public doesn't need the industry to prosper. What the public actually needs is protection – individual investors need protection from crypto frauds, and our broader financial system also needs protection from crypto's booms and busts. FTX's collapse has only harmed those who invested in crypto, but allowing crypto to integrate with the rest of our financial system could cause a broader financial crisis that will hurt those who never even invested in crypto.

A ban on crypto would be the most straight-forward way of protecting both investors and the financial system: it would end the uncontrolled creation of cryptoassets and also ensure that cryptoassets never require a bail-out. If policymakers don't wish to proceed with a ban, then they will need to be careful to ensure that any laws they *do* adopt don't inadvertently encourage the proliferation of cryptoassets or bring those cryptoassets closer to the core of our financial system. Crypto should *not* be regulated like banking products (that would give crypto access to the government support that we afford to banking because banking is critical to broader economic growth). Banking regulation should, however, continue to keep banks away from crypto. Crypto should also *not* have the CFTC as its primary regulator. The CFTC has no statutory investor protection mandate, has limited experience regulating retail-dominated markets, and the application of the CFTC's self-certification regime to crypto would allow an unlimited supply of cryptoassets to proliferate. Energetic enforcement of the SEC's registration requirements, on the other hand, would limit the creation of cryptoassets. Securities regulation could also help address problematic affiliations and asset custody problems in the crypto industry. Although the SEC's jurisdiction has geographical limitations, if properly funded and supported, the SEC could make significant strides in protecting US investors – and it could do so without conveying the message that crypto is “too big to fail.”

## 2. FTX: Events and Narratives

### Events

The FTX group is a sprawling group of entities that, prior to filing for bankruptcy, was majority-owned and controlled by Sam Bankman-Fried. The FTX group operated multiple businesses, including the FTX.com crypto exchange and the Alameda Research hedge fund.<sup>1</sup> Alameda sought to profit through various arbitrage, market-making, yield farming, and volatility-related trading strategies.<sup>2</sup> While “FTX and Alameda portrayed themselves publicly as distinct entities to avoid the perception of conflicts of interest between the exchange...and Bankman-Fried’s proprietary trading firm,” in reality, “[t]he close links between the firms and the large amount of borrowing by Alameda from FTX played a key role in the spectacular collapse of the exchange.”<sup>3</sup>

There are conflicts of interest inherent in having any hedge fund affiliated with an exchange.<sup>4</sup> Alameda provided liquidity to FTX.com’s other customers, but in doing so, it found a reliable source of trades to bet against. Alameda presumably also paid lower or no fees for trading on the exchange, and FTX.com also afforded preferential treatment to Alameda by delaying its margin calls (a benefit not extended to regular customers, who would have their positions liquidated for failing to meet margin calls).<sup>5</sup> The conflicts of interest become even more problematic, though, if the exchange starts lending out customer assets to the hedge fund, as FTX.com did with Alameda.<sup>6</sup>

Unlike stock exchanges, many crypto exchanges also integrate brokerage services into their offerings. As a result, exchanges like FTX.com not only facilitate the trading of their customers’ assets, they also hold them in custody.<sup>7</sup> Instead of keeping its customers’ assets safe in segregated accounts, it appears that FTX.com lent out its customers’ assets to Alameda.<sup>8</sup> Presumably, the exchange benefitted from the interest paid by Alameda for the loans – although some have suggested that the loans were made for free.<sup>9</sup> Alameda could then use the customer assets as cheap collateral for margined trades with other parties (obtaining collateral from other sources would have been much more expensive).<sup>10</sup> It appears that Alameda did post collateral to secure the loans of FTX customer assets that it received, and that that collateral took the form of FTT tokens.<sup>11</sup> FTT tokens were the so-called “native token” of the FTX exchange:<sup>12</sup> FTX created FTT and issued it to both institutional and retail

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<sup>1</sup> Declaration of John J. Ray III in Support of Chapter 11 Petitions & First Day Pleadings at 30, *In re FTX Trading Ltd.*, No. 22-11068 (Bankr. D. Del. Nov. 17, 2022).

<sup>2</sup> *Id.* at 8.

<sup>3</sup> Joshua Oliver, *Sam Bankman-Fried’s trading shop was given special treatment on FTX for years*, FIN. TIMES (Dec. 3, 2022).

<sup>4</sup> For a discussion of the conflicts of interest that were likely at work in the context of FTX/Alameda, see Frances Coppola, *The FTX-Alameda Nexus*, COPPOLA COMMENT (Nov. 10, 2022), available at <https://www.coppolacomment.com/2022/11/the-ftx-alameda-nexus.html>.

<sup>5</sup> Oliver, *supra* Note 3.

<sup>6</sup> Angus Berwick, Anirban Sen, Elizabeth Howcroft and Lawrence Delevigne, *Special Report: FTX’s Bankman-Fried begged for a rescue even as he revealed huge holes in firm’s books*, REUTERS (Nov. 16, 2022).

<sup>7</sup> Adam J. Levitin, *Not Your Keys, Not Your Coins: Unpriced Credit Risk in Cryptocurrency*, forthcoming 101 TEX. L. REV. (2022)

<sup>8</sup> Paige Tortorelli and Kate Davidson, *Sam Bankman-Fried’s Alameda quietly used FTX customer funds for trading, say sources*, CNBC.COM (Nov. 13, 2022).

<sup>9</sup> *Id.*

<sup>10</sup> Coppola, *supra* Note 4.

<sup>11</sup> Berwick *et al.*, *supra* Note 6.

<sup>12</sup> *Id.*

investors without registering with any regulator or undergoing any audit or other external due diligence. FTX could create unlimited amounts of FTT if it wished.

In short, there appear to have been two sets of leveraged transactions involved. First, Alameda borrowed assets from FTX's customers, providing FTT tokens as collateral for those loans. Second, Alameda engaged in margin trading, essentially borrowing money to execute risky trading strategies. Leverage makes trades potentially more lucrative, but also makes them more vulnerable to adverse market movements. At some point (perhaps during 2022's "crypto winter") Alameda seems to have lost a lot of money on its trades.<sup>13</sup> In an Alameda balance sheet made available to CoinDesk in early November, Alameda's largest asset holdings were listed as being FTT tokens<sup>14</sup> (it is possible that it received these in a kind of bailout from FTX). Other assets listed on that balance sheet included SOL tokens (issued by the Solana blockchain, in which Bankman-Fried was an early investor) and SRM tokens (issued by the Serum exchange that Bankman-Fried co-founded).<sup>15</sup> It appears that Alameda had few assets that hadn't been created out of thin air by FTX or FTX-related entities.

After the CoinDesk report came out on November 2, the CEO of FTX's rival exchange Binance Changpeng Zhao tweeted on November 6 that Binance was planning to sell off its holdings of FTT.<sup>16</sup> While FTX could control the supply of FTT and therefore could control its price to some degree, FTX did not have complete control over FTT's price because purchases and sales by existing holders would also impact that price. The large sale proposed by Binance would have put significant downward pressure on the price of FTT, and so when other FTT holders learned of it, they were incentivized to sell their FTT as quickly as possible and its price fell dramatically.<sup>17</sup> There was significant conjecture about liquidity problems, if not insolvency, at FTX and Alameda.<sup>18</sup>

Bankman-Fried negotiated a deal with Zhao (who is typically referred to as "CZ") for Binance to acquire FTX.com: the deal was announced on November 8, but was expressed to be non-binding.<sup>19</sup> All of this shook the confidence of FTX's exchange customers, many of whom sought to pull their assets off of the exchange. Presumably, exchange customers had assumed that their assets were being held in segregated accounts for them all along; in reality, they had been loaned to Alameda in exchange for FTT. This had gone unnoticed for some time: when customers had made withdrawals in the past, FTX seems to have been able to exchange FTT for any other assets that needed to be returned to a withdrawing customer.<sup>20</sup> However as the price of FTT fell, it would have become increasingly expensive for FTX to convert FTT into the assets that matched customers' expectations of their portfolio holdings – especially as so many FTX customers were seeking to pull their cryptoassets out of the exchange at the same time.

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<sup>13</sup> Molly White, *The FTX collapse: the latest revelations (part three)*, MOLLY WHITE (Nov. 18), available at <https://newsletter.mollywhite.net/p/the-ftx-collapse-the-latest-revelations>.

<sup>14</sup> Ian Allison, *Divisions in Sam Bankman-Fried's Crypto Empire Blur on His Trading Titan Alameda's Balance Sheet*, COINDESK (Nov. 2, 2022).

<sup>15</sup> *Id.*

<sup>16</sup> For a good timeline of the tweets and other events that immediately precipitated FTX's failure, see Dalia Ramirez, *FTX Crash: Timeline, Fallout and What Investors Should Know*, NERDWALLET (Nov. 28, 2022), available at <https://www.nerdwallet.com/article/investing/ftx-crash>.

<sup>17</sup> MacKenzie Sigalos, *FTX's token plunges 80% on liquidity concerns, wiping out over \$2 billion in value*, CNBC.COM (Nov. 8, 2022).

<sup>18</sup> *Id.*

<sup>19</sup> Ramirez, *supra* Note 16.

<sup>20</sup> Coppola, *supra* Note 4.

It became clear that the FTX exchange had insufficient assets to make its customers whole, and on November 11, Sam Bankman-Fried resigned his position with FTX and John Ray III was appointed as CEO.<sup>21</sup> Ray immediately cause FTX Trading Ltd., together with multiple related entities (including Alameda- and FTX US-related entities), to file a Chapter 11 bankruptcy petition with the Delaware Bankruptcy Court.<sup>22</sup> Shortly after the bankruptcy filing, roughly \$515 million was drained from FTX's accounts in a series of unauthorized transactions.<sup>23</sup>

### Narratives

The foregoing reflects my present understanding of what transpired at FTX, but this account comes with the caveats that some of it has not yet been substantiated, that we are being inundated with emerging revelations, and that there remain many things we simply do not know about what happened. Law enforcement authorities, courts, and journalists continue to probe the events surrounding FTX's failure, but narratives are already being formed about what transpired. This part of my testimony will describe some of the theories of what contributed to FTX collapse. To be clear from the outset, not all of these theories are plausible, for reasons I will explain.

One version of the events that has been proffered by Coinbase CEO Brian Armstrong and echoed by some others is that “[t]he problem is that the SEC failed to create regulatory clarity here in the US, so many American investors (and 95% of trading activity) went offshore,” where there was insufficient oversight.<sup>24</sup> This interpretation of events seems somewhat disingenuous, however. If we accepted this narrative, we would also have to blame the New York Department of Financial Services for FTX's failure, because the NYDFS never agreed to approve FTX's application for a BitLicense, and so they were not able to supervise FTX.<sup>25</sup> In reality, the NYDFS applied New York law to protect New Yorkers, just as the SEC applies the federal securities laws where it has jurisdiction. Geographical arbitrage of regulation is a longstanding problem, but it generally occurs because firms go abroad in search of more lax regulation – not more certain regulation. As SEC Chair Gary Gensler previously noted in response to criticism that the SEC has failed to provide regulatory clarity around crypto:

*For the past five years, though, the Commission has spoken with a pretty clear voice here: through the DAO Report, the Munchee Order, and dozens of Enforcement actions, all voted on by the Commission. Chairman Clayton often spoke to the applicability of the securities laws in the crypto space. Not liking the message isn't the same thing as not receiving it.*<sup>26</sup>

Indeed, the “lack of regulatory clarity” argument was recently rejected by Judge Peter Barbadoro of the United States District Court for the District of New Hampshire, who concluded that crypto issuer

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<sup>21</sup> Declaration of John J. Ray III in Support of Chapter 11 Petitions & First Day Pleadings at 16, *In re FTX Trading Ltd.*, No. 22-11068 (Bankr. D. Del. Nov. 17, 2022).

<sup>22</sup> *Id.* at 1.

<sup>23</sup> David Yaffe-Bellamy, *FTX Investigating Possible Hack Hours After Bankruptcy Filing*, N.Y. TIMES (Nov. 12, 2022).

<sup>24</sup> Jason Abbruzzese and Daniel Arkin, *FTX is in freefall. Where was the oversight?*, NBC NEWS (Nov. 15, 2022).

<sup>25</sup> Jordan Atkins, *In wake of FTX collapse, New York financial regulator wants its digital asset licensing regime adopted nationally*, COINGEEK (Nov. 17, 2022), available at <https://coingeek.com/in-wake-of-ftx-collapse-new-york-financial-regulator-wants-its-digital-asset-licensing-regime-adopted-nationally/>.

<sup>26</sup> Gary Gensler, *Kennedy and Crypto*, Remarks at SEC Speaks (Sept. 8, 2022), available at <https://www.sec.gov/news/speech/gensler-sec-speaks-090822>

LBRY “did not have a defense that it lacked fair notice of the application of [the securities] laws to its offer and sale.”<sup>27</sup>

Others have ascribed FTX’s failure to its centralization, suggesting that decentralized finance or “DeFi” lacks the kinds of conflicts of interest and profit motives that drove FTX to siphon off customer assets.<sup>28</sup> This narrative, however, overstates DeFi’s decentralization. Even where technology has been designed to be decentralized, that does not guarantee economic decentralization, and in DeFi, centralization has indeed occurred because of economic incentives.<sup>29</sup> As tech veteran David Rosenthal put it “economics forces successful permissionless blockchains to centralize”: the reality is that wealth and power in DeFi are more concentrated than in traditional finance, and this centralization creates conflicts of interest and affords opportunities for exploitation.<sup>30</sup> For example, individuals holding the majority of the governance tokens controlling a decentralized exchange could potentially change the exchange’s protocol to allow the transfer of customers’ assets somewhere they shouldn’t go. Although DeFi proponents may claim that it has a clean record, it’s important to remember that Terra/Luna was considered DeFi until it failed<sup>31</sup> (Do Kwon’s central economic role in managing Terra/Luna is now generally recognized).

Another narrative circulating about the FTX failure suggests that the whole crypto industry shouldn’t be judged by the actions of “one bad apple,” and that Sam Bankman-Fried perpetuated a “garden variety fraud” that could have happened in traditional finance. Although there is much more to learn about FTX’s failure, it is already clear that this narrative is false and should be rejected. Most obviously, the “one bad apple” narrative does not hold up well when we have already seen multiple crypto failures happen during this year’s “crypto winter.” Following the failures of Terra/Luna, Celsius, Voyager, Three Arrows Capital, and others, it is hard to describe FTX as an outlier. The crypto industry (both the nominally decentralized and the centralized parts of it) is very interconnected, and failures in one part inevitably have reverberations for the rest of the industry. It is likely that Alameda incurred many of its losses during the “crypto winter,” for example,<sup>32</sup> and FTX’s failure was followed almost immediately by the failure of BlockFi.<sup>33</sup> It is highly likely that the industry will see more dominoes fall in the coming months.

Another key flaw in the “this wasn’t about crypto” narrative is that many of the problems at FTX arose because of a feature that is unique to the crypto industry: cryptoassets (like the FTT token)

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<sup>27</sup> SEC Granted Summary Judgment Against New Hampshire Issuer of Crypto Asset Securities for Registration Violations, Litigation Release No. 25573 (Nov. 7, 2022), available at <https://www.sec.gov/litigation/litreleases/2022/lr25573.htm> (referring to the case of *SEC v. LBRY, Inc.*, No. 1:21-cv-00260-PB (D.N.H. filed Mar. 29, 2021)).

<sup>28</sup> See, for example, Giorgi Khazaradze, *FTX showed the value of using DeFi platforms instead of gatekeepers*, COINTELEGRAPH (Nov. 21, 2022), available at <https://cointelegraph.com/news/ftx-showed-the-value-of-rejecting-gatekeepers-in-favor-of-defi>.

<sup>29</sup> Sirio Aramonte, Wenqian Huang and Andreas Schrimpf, *DeFi Risks and the Decentralization Illusion*, BIS QUARTERLY REVIEW, 29-30 (Dec. 2021).

<sup>30</sup> David Rosenthal, *EE380 Talk*, (Feb. 9, 2022), <https://blog.dshr.org/2022/02/ee380-talk.html>.

<sup>31</sup> “LUNA was a growing powerhouse within the DeFi space before the collapse of the Terra ecosystem. In December 2021, Terra overtook the BNB Smart Chain to become the second-largest DeFi protocol with more than \$20 billion locked into the network across its applications.” *What is Terra (LUNA)? A beginner's guide* COINTELEGRAPH, available at <https://cointelegraph.com/blockchain-for-beginners/terra-luna-beginners-guide-to-the-blockchain-for-stablecoins>.

<sup>32</sup> White, *supra* Note 13.

<sup>33</sup> Lauren Hirsch, David Yaffe-Bellany and Ephrat Livni, *Crypto Lender BlockFi Files for Bankruptcy as FTX Fallout Spreads*, N.Y. TIMES (Nov. 28, 2022)

can be created out of nothing by anyone with computer programming abilities. I have previously explained that this unlimited supply of cryptoassets allows for significant leverage, making the crypto ecosystem very fragile.<sup>34</sup> The unlimited supply of cryptoassets also ensures that frauds are particularly easy to perpetuate: when an entire industry is built on an asset type that can be manufactured at zero cost, has no fundamentals, and trades entirely on sentiment, traditional checks on fraud (like valuation methodologies and financial accounting) will inevitably break down.

For example, concepts like “market capitalization” don’t have the same meaning for crypto as they do for traditional finance, and that can be exploited to inflate the value of cryptoassets. If a token is created and then sold, either to a willing third party or in a wash trade, the price paid for that token can then be multiplied by the entire supply of that particular token (even those that have never been sold) to create a large market capitalization number.<sup>35</sup> As Matt Levine put it in his description of the Serum tokens listed on FTX’s balance sheet:

*So if for instance some company creates a token, and says that there can be 10 billion of the token, and reserves them all for itself, and then sells 1 million of them to outside investors for \$1 each, then the market cap of that token is \$1 million (\$1 times 1 million circulating tokens), while the fully diluted market cap is \$10 billion (\$1 times 10 billion total tokens), and the issuer’s 9,999,000,000 remaining tokens have a value, on this math, of \$9.999 billion.<sup>36</sup>*

These types of valuations have a high propensity to mislead potential investors, and they are possible because an unlimited supply of tokens can be minted out of thin air.

Audits of financial accounts performed by reputable accounting firms are also key to detecting frauds. However, when crypto firms provide financial disclosures, they often take the form of “attestations” or “proof of reserves” that have not undergone the scrutiny of audited financials.<sup>37</sup> On occasions when audits *are* conducted, their reliability is not assured (for example, in FTX’s bankruptcy filing, Ray expressed concerns about the reliability of the FTX financial statements audited by Armanino LLP and Prager Metis).<sup>38</sup> Requiring audits by reputable accounting firms would certainly introduce some rigor and oversight that could help detect fraud at crypto firms, but there remains the concern that auditing practices will simply reflect the flawed valuation metrics I just discussed. There is presently a lack of clarity as to how accounting standards should apply to crypto, but FASB has indicated that it will shift to fair market accounting for cryptoassets (this shift has reportedly been

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<sup>34</sup> “There is no legal constraint on the quality of the tokens accepted as collateral for loans, or the amount that can be borrowed against that collateral – amounts borrowed can then be used to acquire yet more assets. An unconstrained supply of financial assets to serve as collateral therefore means more opportunities for asset bubbles to grow, and more assets to be dumped during fire sales.” Hilary J. Allen, *DeFi: Shadow Banking 2.0?*, forthcoming WM. & MARY L. REV. (2022).

<sup>35</sup> Molly White, *Cryptocurrency “market caps” and notional value*, MOLLY WHITE (Jul. 17, 2022), available at <https://blog.mollywhite.net/cryptocurrency-market-caps-and-notional-value/>.

<sup>36</sup> Matt Levine, *FTX’s Balance Sheet Was Bad*, BLOOMBERG (Nov. 14, 2022).

<sup>37</sup> Jonathan Weil, *Binance Is Trying to Calm Investors, but Its Finances Remain a Mystery*, WALL ST. JOURNAL (Dec. 10, 2022).

<sup>38</sup> “As a practical matter, I do not believe it appropriate for stakeholders or the Court to rely on the audited financial statements as a reliable indication of the financial circumstances of [the relevant entities].” Declaration of John J. Ray III in Support of Chapter 11 Petitions & First Day Pleadings at 20-21, *In re FTX Trading Ltd.*, No. 22-11068 (Bankr. D. Del. Nov. 17, 2022).

welcomed by the crypto industry).<sup>39</sup> This shift will lead to the current market value of cryptoassets increasingly being reflected on balance sheets – presumably recognizing and legitimizing the pliable market valuations discussed above. Where accounting standards accept market valuations of an asset class that can be synthesized out of nothing, it is easy to see how people could continue to be swindled.

The integration of crypto exchanges with other crypto businesses is another feature of the crypto industry that can encourage problematic behavior. Although the FTX exchange and the Alameda hedge fund were nominally separate legal entities, it seems that they were by and large operated as one enterprise.<sup>40</sup> FTX.com also consolidated brokerage, exchange, and clearing services in one platform. Consolidation of brokerage, exchange, clearing, and proprietary trading activities is endemic to the crypto industry,<sup>41</sup> and inevitably creates conflicts of interest – particularly the temptation for the exchange to use client assets and bet against its own clients. Presently, there is a lack of transparency about these and other potential conflicts of interest in the crypto industry. For example, all of the major stablecoins (Tether, USDC, and BUSD) have some kind of affiliation with a crypto exchange (Bitfinex, Coinbase, and Binance, respectively). Stablecoin reserves are meant to be comprised of safe assets which generate little return, so it is unclear how stablecoin issuers make profits. It may be that stablecoin issuers are financially supported by their related exchanges, in which case there would be conflicts of interest involved in the business model. We simply do not know, though (we might have had some transparency had USDC’s operator Circle proceeded with its SPAC and become a publicly-traded company, but that was recently abandoned).<sup>42</sup>

Not only could the FTX.com exchange affiliate with Alameda and manufacture assets, it was also able to take advantage of the mystique of crypto to help disguise what was going on behind the scenes. As with Bernie Madoff, Sam Bankman-Fried seems to have utilized his cult of personality to discourage investigation of his activities,<sup>43</sup> but Bankman-Fried was also able to exploit crypto’s technological complexity to his advantage as well – something that Madoff was unable to do. As I have written previously, “finance is so complicated that casual observers are discouraged from trying to figure out what finance actually is or does, and so the financial industry often escapes public scrutiny:” this can be, and long has been, exploited by those seeking to perpetuate frauds. “We are now in a moment, though, when traditional financial complexity is being overlaid with new kinds of technological complexity, making new fintech innovations doubly hard to understand.”<sup>44</sup> The result was that FTX was able to persist for a prolonged period with “such a complete failure of corporate controls and such a complete absence of trustworthy financial information” (this statement was made

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<sup>39</sup> Robert Graham, *FASB Recommends New Cryptocurrency Accounting Method with Significant Impact on Corporate Reporting*, MARCUM (Oct. 20, 2022), available at <https://www.marcumllp.com/insights/fasb-recommends-new-cryptocurrency-accounting-method-with-significant-impact-on-corporate-reporting>.

<sup>40</sup> Oliver, *supra* Note 3.

<sup>41</sup> “The terminology of “exchange” in the cryptocurrency context is confusing because some of the functions performed by a cryptocurrency exchange are more akin to those of a broker in securities or commodities markets. To understand the particular role of a cryptocurrency exchange, it is necessary to understand the relationship of three different functions in financial market places: exchanges, clearinghouses, and brokerages.” Levitin, *supra* Note 7 at 14.

<sup>42</sup> Scott Chipolina, *Crypto group Circle ends \$9bn deal to go public through Bob Diamond’s SPAC*, FIN. TIMES (Dec. 5, 2022).

<sup>43</sup> David Jeans and Sarah Emerson, *‘The Devil in Nerd’s Clothes’: How Sam Bankman-Fried’s Cult of Genius Fooled Everyone*, FORBES (Nov. 12, 2022).

<sup>44</sup> Hilary J. Allen, DRIVERLESS FINANCE: FINTECH’S IMPACT ON FINANCIAL STABILITY, 2 (2022).



by incoming FTX CEO John Ray III in FTX’s bankruptcy filing, who said that he had never seen such a failure – despite presiding over Enron’s bankruptcy).”<sup>45</sup>

### 3. Different kinds of financial regulation

Following FTX’s failure, there have been many questions about “where were the regulators?” and “what regulation do we need in response?” A difficulty with these types of questions is that there are many different types of regulation, and people are often talking about very different things when they talk about regulating crypto. This Section will address this by disaggregating different kinds of financial regulation and explaining that some kinds of financial regulation have worked very well with regards to crypto, that others need to be enforced more fully, and that some proposals for bespoke crypto regulation would be dangerous for the stability of our financial system.

#### A ban

The most effective way to protect both the stability of our financial system and individual investors would be to ban cryptoassets. It is sometimes said that such a ban would be impossible to enforce because of the decentralized nature of crypto. However, crypto is not actually decentralized,<sup>46</sup> and so there are many people against whom such a ban could be enforced. Most obviously, centralized exchanges (like FTX) serve as important gateways to the crypto markets. If they were banned from listing cryptoassets, then the market for cryptoassets would most likely diminish significantly.

In addition to centralized exchanges, there are also what are known as “decentralized exchanges”, like Uniswap. These are typically operated by a “decentralized autonomous organization” or “DAO.” Holders of the DAO’s governance tokens can vote on any proposals to change the way the exchange operates (Uniswap’s governance tokens are known as “UNI”).<sup>47</sup> While it might be hard to regulate a decentralized exchange or DAO directly, ultimately, their governance tokens are held by real people who could be prohibited from holding governance tokens in a DAO operating a prohibited business. Practically speaking, ownership of governance tokens tends to be reasonably concentrated with the founders, venture capitalist funders, and crypto whales,<sup>48</sup> so enforcement efforts would only have to target a limited number of holders to be effective (the ownership of UNI tokens, for example, is highly concentrated).<sup>49</sup> It is theoretically possible for a DAO to have more dispersed ownership of its governance tokens, but as I have argued previously, “if DeFi were forced to live up to its claims of decentralization by operating without any centralized intermediaries it would be very difficult for users to access DeFi or for DeFi services to scale up, and this would limit the real-world fallout from any DeFi failures.”<sup>50</sup> It is therefore feasible to implement a reasonably effective ban on crypto. Even if the ban is not 100% effective in practice, it can still be good public policy – bans on other illicit

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<sup>45</sup> Declaration of John J. Ray III in Support of Chapter 11 Petitions & First Day Pleadings at 2, *In re FTX Trading Ltd.*, No. 22-11068 (Bankr. D. Del. Nov. 17, 2022).

<sup>46</sup> See Aramonte *et al.*, *supra* Note 29.

<sup>47</sup> Andrey Sergeenkov, *A Deep Dive Into How the Top 10 DAOs Work*, COINMARKETCAP available at <https://coinmarketcap.com/alexandria/article/a-deep-dive-into-how-the-top-daos-work>.

<sup>48</sup> Chainanalysis Team, *Dissecting the DAO: Web3 Ownership is Surprisingly Concentrated*, CHAINANALYSIS BLOG (Jun. 27, 2022), available at <https://blog.chainanalysis.com/reports/web3-daos-2022/>.

<sup>49</sup> The FSOC Report on Digital Asset Financial Stability Risks and Regulation uses the UNI governance token to illustrate the point that “the top 1 percent of addresses of certain governance tokens hold over 90 percent of the total supply.” FSOC, REPORT ON DIGITAL ASSET FINANCIAL STABILITY RISKS AND REGULATION, 73 (2022), available at <https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf>.

<sup>50</sup> Allen, *supra* Note 34.

activities aim to reduce harm by discouraging the activities in question, even if eliminating those activities entirely is infeasible.

Because the crypto markets are largely speculative and self-referential, such a ban would not shut down any meaningful flows of capital to real-world productive capacity. Some might be concerned that such a ban would limit efforts to promote financial inclusion, but in a piece entitled “Debunking the narratives about cryptocurrency and financial inclusion,” Brookings’ Tonantzin Carmona concluded that:

*When examined closely, crypto’s current capabilities do not match the needs of the groups it purports to serve, and it carries a host of risks and drawbacks that undermine its benefits. More alarming, we can observe parallels between crypto and other predatory products, which highlights crypto’s potential to exacerbate unequal financial services to historically excluded groups.*<sup>51</sup>

Narratives about the ability of blockchain technology to improve the efficiency of financial services are similarly flawed. Any technology that aims to be decentralized will need some way of validating transactions that is more cumbersome and expensive than validation by a centralized intermediary, otherwise it will be too easy for a nefarious actor to subvert the blockchain. Permissionless blockchains are therefore inherently less efficient than centralized alternatives. While attempts are being made to remedy these inefficiencies, for example, by processing transactions off-chain in so-called “second layer” solutions, off-chain processing entails increasing dependency on intermediaries.<sup>52</sup> As Professor Edmund Schuster put it:

*Although it is possible to minimise or even eradicate the waste and computational overhead of blockchain solutions by, essentially, re-centralising the ledger, resulting systems so closely resemble traditional, widely available databases that there is little reason to expect significant benefits from their adoption compared to the status quo.*<sup>53</sup>

Ultimately, we have much to gain and little to lose from a ban on crypto (and the gains would go beyond investor protection – they would also include limiting environmental damage and preventing ransomware attacks).<sup>54</sup> If policymakers do not wish to enact such a ban, though, then they will need to be careful to ensure that any regulatory measures that they *do* adopt don’t inadvertently compromise the stability of our financial system.

### Banking regulation

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<sup>51</sup> Tonantzin Carmona, *Debunking the narratives about cryptocurrency and financial inclusion*, BROOKINGS (Oct 26, 2022), available at <https://www.brookings.edu/research/debunking-the-narratives-about-cryptocurrency-and-financial-inclusion/>.

<sup>52</sup> See, for example, Alyssa Hertig, *Bitcoin's Lightning Network Is Growing 'Increasingly Centralized,' Researchers Find*, COINDESK (Feb. 20, 2020), <https://www.coindesk.com/tech/2020/02/20/bitcoins-lightning-network-is-growing-increasingly-centralized-researchers-find/>.

<sup>53</sup> Edmund Schuster, *Cloud Crypto Land*, 84 MODERN L. REV. 974, 975 (2020).

<sup>54</sup> “If [crypto cannot deliver on its promises] or is even unlikely to, deliver, there must be strong regulation to rein in the negative consequences of crypto experimentation. Among its negative impacts, the rise of crypto has spurred ransomware attacks and consumed excessive energy. Bitcoin’s blockchain relies on a proof-of-work validation mechanism that uses about as much energy as Belgium or the Philippines.” Hilary J. Allen, *The Superficial Allure of Crypto*, IMF Finance & Development (F&D) (Sept. 2022). See also, Lee Reiners, *Ban Cryptocurrency to Fight Ransomware*, WALL ST. JOURNAL (May 25, 2021).

Banking regulation is designed to promote the safety and soundness of individual banks and the financial system as a whole. It aims to do so by managing the risks that banks take on *ex ante* and providing *ex post* support should things go poorly, in the form of emergency lending from the central bank, deposit insurance, and special resolution mechanisms.

Last year, I testified before this Committee regarding the dangers of regulating stablecoin issuers as banks.<sup>55</sup> The essence of that testimony was that in the normal order of things, financial investments should be allowed to fail. Banking regulation, however, seeks to prevent the failure of certain kinds of investments – including through *ex post* measures like emergency lending from the central bank, deposit insurance, and special resolution mechanisms. The availability of these *ex post* measures creates moral hazard (i.e. it gives banks incentives to engage in riskier behavior in order to multiply their profits in good times, knowing that there is a government safety net that will absorb the losses in bad times), but this moral hazard is deemed worthwhile because the economy depends on keeping banks stable to facilitate broad-based growth. Ultimately, banking regulation entails a kind of *quid pro quo* relationship, but as I said in my testimony:

*The moral hazard associated with deposit insurance was ultimately deemed a price worth paying to keep banks stable and funds flowing through them to the broader economy. But the value proposition for stablecoins is much less clear: what economic growth do they propel? And what moral hazard would government backing for stablecoins create?*

If we ask the same questions of crypto writ large, we should conclude that cryptoassets – which can be created out of whole cloth and are primarily used for speculation rather than investment – should not be the subject of government guarantees or otherwise be made “too big to fail.” Policymakers should be mindful of how fragile the crypto system is – as a result of its leverage, interconnectedness, and underlying technological complexity – which means that it may need rescuing regularly. Policymakers should be particularly mindful of the possibility that if banking regulation were applied to cryptoassets, people could potentially fabricate cryptoassets out of thin air and then have them bailed out by the Federal Reserve.

Because cryptoassets should be allowed to fail, banking regulation should not be applied to cryptoassets. Banking regulation should, however, continue to be applied to banks themselves to prevent them from being exposed to crypto. At present, banking regulation is reasonably strong on this issue. For example, OCC guidance provides that nationally chartered banks should not engage in the few crypto-related activities it has deemed permissible “until it receives written notification of the supervisory office’s non-objection” and that “a proposed activity cannot be part of the “business of banking” if the bank lacks the capacity to conduct the activity in a safe and sound manner.”<sup>56</sup> The Federal Reserve and FDIC have adopted similar approaches.<sup>57</sup>

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<sup>55</sup> Hilary J. Allen, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Hearing on *Stablecoins: How Do They Work, How Are They Used, and What Are Their Risks?* (Dec. 14, 2021).

<sup>56</sup> Office of the Comptroller of the Currency, *Chief Counsel’s Interpretation Clarifying: (1) Authority of a Bank to Engage in Certain Cryptocurrency Activities; and (2) Authority of the OCC to Charter a National Trust Bank*, INTERPRETIVE LETTER #1179, 1 (Nov. 18, 2021), available at <https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf>.

<sup>57</sup> Acting Comptroller of the Currency Michael J. Hsu, *Remarks to the Harvard Law School and Program on International Financial Systems Roundtable on Institutional Investors and Crypto Assets “Don’t Chase”*, 6 (Oct. 11, 2022), available at <https://www.occ.treas.gov/news-issuances/speeches/2022/pub-speech-2022-126.pdf>.

There is general agreement that this kind of banking regulation has performed well during this “crypto winter.” Despite turmoil in the crypto industry, the banking system (and our broader economy, which relies on that banking system for loans and transaction processing) have remained largely unshaken. Some have attributed this to the size of the crypto markets, saying that they are too small to have a systemic impact (at its high point, the notional value of the global crypto market was thought to be about \$3 trillion, now that notional value is hovering below \$1 trillion).<sup>58</sup> However, for context, the value of subprime mortgages in the United States in March 2007 was estimated by one source to be \$1.3 trillion,<sup>59</sup> and yet the subprime mortgage market was so intertwined with the banking industry that its failure led to a financial crisis and ensuing recession that harmed people who had never obtained a subprime mortgage, or even a mortgage at all.<sup>60</sup> In other words, even a relatively small market can cause systemic problems if the banking industry is significantly exposed to that market. So far, strong banking regulation has helped prevent failures in the crypto industry from harming those who have never invested in crypto: banking regulation has kept crypto away from the core of our financial system, crypto has not become “too big to fail,” and policymakers and central bankers have felt no public pressure to bail out the crypto industry.

If new banking legislation is implemented in the wake of FTX’s failure, it should formally recognize this separation of banking and crypto in a type of “Glass-Steagall 2.0.” Such legislation should prohibit banks from investing in any cryptoassets, or accepting them as collateral for loans. Banks should also be prohibited from holding stablecoin reserves in a deposit account, as those funds could disappear in the event of the run on the stablecoin, exposing the bank to the risk of a run itself. Congress may also wish to reconsider the wisdom of allowing banks to custody cryptoassets,<sup>61</sup> or to perform trades on permissionless blockchains.<sup>62</sup> There are reputational concerns to be considered when banks work with crypto in any way: Silvergate Bank held deposits for FTX and Alameda, and is now being targeted by short sellers and scrutinized by members of Congress.<sup>63</sup>

Insured depository institutions should also be prohibited from issuing their own stablecoins. Stablecoins are not a good payments solution, because, as I’ve said elsewhere:

*Blockchain technology needs to involve wasteful computations in order to discourage attacks, so it does not scale well. In addition, blockchains can have data added but not deleted from them, which prevents the reversal of mistaken or fraudulent transactions. It’s hard to see how blockchain payments could ever be faster or more efficient than more centralised alternatives.*<sup>64</sup>

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<sup>58</sup> <https://www.statista.com/statistics/730876/cryptocurrency-maket-value/>

<sup>59</sup> *Will subprime mess ripple through economy?*, NBCNEWS (Mar. 12, 2007), available at <https://www.nbcnews.com/id/wbna17584725>. The Financial Crisis Inquiry Commission also provided information about subprime mortgage originations in the years leading up to 2008, showing that “In 2006, \$600 billion of subprime loans were originated,” with slightly more being originated in 2005 and somewhat fewer in 2004. FCIC Report Financial Crisis Inquiry Commission, THE FINANCIAL CRISIS INQUIRY REPORT, 70 (2011).

<sup>60</sup> “We conclude collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis.” *Id.* at xxiii.

<sup>61</sup> Stephen Alpher, *BNY Mellon Starts Crypto Custody Service*, COINDESK (Oct. 11, 2022).

<sup>62</sup> Brayden Lindrea, *JPMorgan executes first DeFi trade on public blockchain*, COINTELEGRAPH (Nov. 2, 2022). There are significant operational risks associated with operating trades on a public blockchain. See Angela Walch, *The Bitcoin Blockchain as Financial Market Infrastructure: A Consideration of Operational Risk*, 18 NYU J. LEGISLATION & PUB. POL’Y 837 (2015).

<sup>63</sup> Max Reyes, *An Obscure Bank Found Its Key to Success. Then FTX Collapsed*, WASHINGTON POST (Dec. 11, 2022).

<sup>64</sup> Hilary J. Allen, *We’re asking the wrong questions about stablecoins*, FIN. TIMES (May 25, 2022).

Instead, stablecoins are primarily used as an on-ramp for crypto speculation.<sup>65</sup>

Unfortunately, the proposed Stablecoin TRUST Act (introduced by Senator Toomey), the proposed Lummis-Gillibrand Responsible Financial Innovation Act, and the proposed House Financial Services Committee bill on stablecoins all seek to *integrate* banking and crypto. For example,

- Section 601 of the Lummis-Gillibrand Responsible Financial Innovation Act proposes a new 12 USC S 4810(k)(1)(F) that require the development of “tailored recovery and resolution standards relating to payment stablecoins.” If the resolution process for stablecoin issuers happens outside of bankruptcy, it will likely require government funding to allow for speedy resolution in the same way that the deposit insurance fund is used to facilitate bank resolution. Section 702 would require the Federal Reserve to provide all stablecoin issuers (banks, and special purpose stablecoin banks) with master accounts, which would include “Fed guarantees for payments made on Fedwire, [and] daylight overdraft privileges.”<sup>66</sup>
- Section 6 of the proposed Stablecoin TRUST Act similarly proposes to require the Federal Reserve to provide all stablecoin issuers (banks and non-banks) with master accounts.
- The HFSC bill is rumored to extend discount window access to all stablecoin issuers (both banks and non-banks), allowing them to borrow from the Federal Reserve in times of crisis.

If any of these bills were enacted, they would authorize banks to issue stablecoins, making it highly probable that the Federal Reserve would feel compelled to bail out a failing stablecoin (which would operate as an indirect bailout of the crypto speculation the stablecoins are used for). Even more problematic, those bills would also authorize non-banks to issue stablecoins, yet be subject to lighter-touch regulation *ex ante* than traditional banks.<sup>67</sup> Furthermore, none of these bills propose charging the crypto industry a fee for access to this government safety net (contrast with banks, who must pay a premium for deposit insurance).

In sum, each of these legislative proposals would extend stablecoins some form of government safety net, bringing crypto closer to the core of our financial system. As I stated in my testimony before this Committee last year:

*Regulating stablecoins like bank deposits will lend them implicit government backing – and with it, confidence and legitimacy far beyond what stablecoin issuers could generate on their own. Inspiring this type of confidence in the stability of stablecoins may counterproductively make runs more likely. Furthermore, legitimized stablecoins will turbocharge the growth of*

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<sup>65</sup> “Gensler has previously compared the crypto industry to the Wild West, an analogy he expanded on during Tuesday’s interview. “We’ve got a lot of casinos here in the Wild West,” Gensler said. “And the poker chip is these stablecoins.”” Cheyenne Ligon, *SEC’s Gensler Calls Stablecoins ‘Poker Chips’ at the Wild West Crypto Casino*, COINDESK (Sept. 22, 2021).

<sup>66</sup> Arthur E. Wilmarth Jr., *Gillibrand-Lummis crypto bill ignores the lessons of history*, AM. BANKER (Jun. 17, 2022).

<sup>67</sup> See Section 6 of the Stablecoin TRUST Act, proposing a new Section 5244(i); Section 601 of the Lummis-Gillibrand bill, proposing new Sections 4810(k) and (l). The HFSC bill is rumored to include “tailored” capital, liquidity, and risk management standards for stablecoin issuers.

*the DeFi (which relies upon stablecoins to facilitate “fund transfers across platforms and between users”).*<sup>68</sup>

### Investor protection regulation

With banking regulation, the path forward is clear – keep banking and crypto separate. The more challenging question is what to do about investor protection regulation. In the wake of FTX’s collapse, a number of proposals have been made to exclude crypto from investor protection regulation entirely: either to “let it burn” as an entirely unregulated business,<sup>69</sup> or to regulate it as online gambling.<sup>70</sup> These proposals have much to recommend them: they recognize that crypto funds no productive investment, and so avoid communicating any legitimacy to would-be investors. They also avoid providing any government backing or support to crypto.

However, under these proposals, anyone who purchases crypto would have no *ex ante* protections – it would truly be *caveat emptor*. While some might say that crypto investors know what they were getting into, letters from those affected by the Celsius bankruptcy suggest that many investors were duped into believing that certain crypto services were safe and reliable places to earn a return.<sup>71</sup> Multiple celebrities touted FTX to their fans as good investments.<sup>72</sup> Investors who are misled can sue for fraud after the fact, but that assumes they have the resources to commence litigation in the first place, and in any event does not guarantee them timely relief. It can be difficult (both morally and politically) to stand back and let these investors be harmed, but by the same token, even more people will be hurt (including people who never even invested in crypto) if regulation legitimizes and encourages the intertwining of crypto and traditional finance and it all blows up. The key question policymakers must therefore ask themselves is: is it possible to afford some protections to crypto investors, while still keeping crypto away from the core of our financial system?

I believe that it is possible to thread this needle by enforcing the existing securities laws against the crypto industry. Securities laws have long been applied to an odd array of investments – ranging from orange groves to payphones<sup>73</sup> – without bringing them into the core of the financial system or making them too big to fail. The securities laws have always eschewed merit regulation, and so are designed to limit the legitimacy they confer on the securities themselves:<sup>74</sup> people generally understand that corporate stock, for example, can lose a lot of value and even become worthless. While it is true that if a security is registered with the SEC, that will likely lend it *some* legitimacy in the eyes of the public (even in the absence of merit regulation), few cryptoassets are likely to be able to satisfy the SEC’s registration requirements. The proper enforcement of the securities laws could therefore drastically reduce the supply of cryptoassets, and limits on supply will help curtail any threat that cryptoassets pose for financial stability.

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<sup>68</sup> Allen, *supra* Note 55 at 6.

<sup>69</sup> Stephen Cecchetti and Kim Schoenholtz, *Let Crypto Burn*, FIN. TIMES (Nov. 17, 2022).

<sup>70</sup> Todd H. Baker, *Let’s Stop Treating Crypto Trading as If It Were Finance*, THE CLS BLUE SKY BLOG (Nov. 29, 2022), available at <https://clsbluesky.law.columbia.edu/2022/11/29/lets-stop-treating-crypto-as-if-it-were-finance/>.

<sup>71</sup> Molly White, *Excerpts from letters to the judge in the Celsius Network bankruptcy case*, MOLLY WHITE (Jul. 22, 2022), available at <https://blog.mollywhite.net/celsius-letters/>.

<sup>72</sup> Winston Cho, *FTX Investors Sue Celebrity Endorsers*, THE HOLLYWOOD REPORTER (Nov. 16, 2022).

<sup>73</sup> Securities and Exchange Commission v. W.J. Howey Co., 328 U.S. 293 (1946); Securities and Exchange Commission v. Edwards, 540 U.S. 389 (2004).

<sup>74</sup> Daniel J. Morrissey, *The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review*, 44 U. Rich. L. Rev. 647, 679 (2010).

To take a step back for a moment, the SEC administers regulation that pertains to anything that satisfies the definition of a “security.” The SEC does so in accordance with its statutory mandates: to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. Not only does the SEC regulate the offer and sale of the securities themselves, it also oversees a number of key participants in the securities markets, including broker/dealers and securities exchanges. Several aspects of the securities laws would be particularly helpful in preventing another FTX-like failure. First, as just mentioned, the enforcement of the SEC’s registration requirements is likely to drastically curtail the ability of the crypto industry to create assets out of thin air. Second, the enforcement of securities broker/dealer regulations would increase oversight of crypto exchanges, help protect customer assets, and expose conflicts of interest. These will be elaborated upon in Section 4 of this testimony.

SEC Chair Gary Gensler has made clear that the SEC considers the vast majority of all cryptoassets to be securities, and therefore subject to this regulatory framework.<sup>75</sup> One might ask: if the solution to regulating crypto has been there all along, why didn’t it stop FTX and other crypto failures? Partly, this is due to inevitable geographical limitations on what the SEC can do: FTX.com operated beyond the jurisdiction of US regulators. The reality is, though, that when it comes to crypto, the securities laws have so far been underenforced even within the United States. This is partially attributable to the SEC’s limited resources: members of Congress seeking to strengthen investor protections should therefore ensure that the SEC is adequately funded through the appropriations process. This is not just a resource issue, though. The extent of the SEC’s jurisdiction over cryptoassets in the US has often been called into question, and the SEC has faced political pressure in the past to refrain from cracking down on the crypto industry (including, notably, FTX).<sup>76</sup> Given that the crypto industry offers little by way of financial inclusion or efficiency to counterbalance the increased potential for frauds, it is time for Congress to throw its support behind the SEC’s enforcement efforts. If new crypto legislation is adopted, it should reaffirm the SEC’s jurisdiction over cryptoassets. Legislation that categorically provides that all cryptoassets are securities would provide certainty to the crypto industry: they would know that the securities laws apply to them, and that the SEC is their regulator.

Unfortunately, both the proposed Lummis-Gillibrand Responsible Financial Innovation Act and the Digital Commodities Consumer Protection Act (“DCCPA”) proposed by Senators Stabenow, Boozman, Booker, and Thune would move in the opposite direction. Both create regimes for cryptoassets to be regulated by the CFTC. The CFTC is widely regarded to be the crypto industry’s preferred regulator (FTX endorsed the DCCPA).<sup>77</sup> The CFTC is a much smaller agency with a much smaller budget than the SEC, it has no statutory investor protection mandate, and it has limited experience regulating retail-dominated markets.<sup>78</sup> Section 4 of the DCCPA would also implement a new Section 5i(d) of the Commodity Exchange Act that expressly authorizes the CFTC to allow self-certification for cryptoassets (in a self-certification regime, the exchange is permitted to certify to the

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<sup>75</sup> “Of the nearly 10,000 tokens in the crypto market, I believe the vast majority are securities. Offers and sales of these thousands of crypto security tokens are covered under the securities laws.” Gensler, *supra* Note 26.

<sup>76</sup> David Dayen, *Congressmembers Tried to Stop the SEC’s Inquiry into FTX*, THE AMERICAN PROSPECT (Nov. 23, 2022), available at <https://prospect.org/power/congressmembers-tried-to-stop-secs-inquiry-into-ftx/>.

<sup>77</sup> Dennis M. Kelleher, *10 Key Questions that Must Be Answered Regarding the Senate Agriculture Committee’s Crypto Legislation that FTX Endorsed*, BETTERMARKETS (Nov. 30, 2022), available at [https://bettermarkets.org/wp-content/uploads/2022/11/Better\\_Markets\\_Fact\\_Sheet\\_10\\_Questions\\_FTX\\_Hearing.pdf](https://bettermarkets.org/wp-content/uploads/2022/11/Better_Markets_Fact_Sheet_10_Questions_FTX_Hearing.pdf).

<sup>78</sup> *Id.*

CFTC that an asset complies with the Commodity Exchange Act, rather than putting the onus on the CFTC to ensure compliance).<sup>79</sup> Recall that the FTT token was integral to the arrangements between FTX and Alameda, and that there were no constraints on FTX creating unlimited supplies of those FTT tokens. While SEC registration would effectively limit the number of tokens that could be issued, the CFTC’s self-certification process would allow issuers to bless their own unlimited supplies of self-minted assets.

In short, neither the DCCPA nor the Lummis-Gillibrand bill would create the needed investor protections. These bills are designed to offer fewer investor protections than the existing securities laws, and they were intentionally designed in this way in order to facilitate crypto innovation. As Acting Comptroller of the Currency Michael Hsu stated in a recent speech:

*Regulators often talk about “bringing crypto into the regulatory perimeter.” I have said as much on several occasions. There are two ways to interpret this statement. One is that crypto should be regulated and thus forced to change and conform to regulatory standards. The other is that regulation should adjust to crypto and accept the new technology and possibilities for what they are. The former is about taming, the latter about accommodation.<sup>80</sup>*

The Lummis-Gillibrand bill and the proposed DCCPA fall into the latter category: both can be viewed as an attempt to accommodate the crypto industry’s concerns that it will not be able to thrive in compliance with the securities laws. However, as already discussed, there are no compelling justifications for accommodating or legitimizing crypto with a lighter-touch, bespoke regulatory regime – taming regulation is needed instead. Neither the Lummis-Gillibrand nor the DCCPA bills should be passed as a response to the FTX failure. If crypto cannot comply with existing securities laws, then it shouldn’t exist.

There is also another, less obvious reason to avoid enacting bespoke, light-touch crypto legislation. As I explained in a recent op-ed:

*Any legislation that creates a bespoke crypto regulatory framework will create opportunities for traditional financial assets to migrate into the new regime and so sidestep existing financial regulation. This problem is unavoidable because it’s impossible to define “crypto asset” (or “digital asset” or “digital commodity”) in a way that excludes traditional financial assets. Ultimately, there’s nothing particularly special about crypto assets. They are just computer files, whose ownership is recorded on a blockchain (a type of database). Pretty much any financial asset could be represented as a computer file, and the ownership of any such computer file could be recorded on a blockchain. If the bespoke crypto regulatory regime is “lighter touch” than those for other financial assets, it’s going to be tempting for financial asset providers to put those assets on the blockchain (something that JPMorgan is already experimenting with).<sup>81</sup>*

### Consumer protection regulation

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<sup>79</sup> For more on the CFTC and self-certification, see Lee Reiners, *Bitcoin Futures: From Self-Certification to Systemic Risk*, 23 N.C. BANKING INST. 61 (2019).

<sup>80</sup> Hsu, *supra* Note 57.

<sup>81</sup> Hilary J. Allen, *Beware the proposed US crypto regulation — it may be a Trojan horse*, FIN. TIMES (Nov. 17, 2022).



If there are crypto-related products and services that are not otherwise covered by the securities laws, then the Consumer Financial Protection Bureau may have a role to play. The CFPB has authority to regulate a broad variety of consumer financial products and services, including authority to make rules and bring enforcement actions relating to unfair, deceptive, or abusive acts or practices.<sup>82</sup> As with investor protection regulation, what is critical is that the CFPB use its authority to bring the crypto industry in line with existing regulatory standards, rather than lowering standards to accommodate the industry.

#### **4. How securities regulation could be applied to the crypto industry going forward**

The previous Section argued that if the SEC is supported in its efforts to apply the securities laws to crypto, those laws can protect investors and limit crypto's growth while keeping crypto away from the core of the financial system. This Section will sketch out how some key provisions of the securities laws might achieve these outcomes.

To be sure, there are some interpretative issues here that courts will certainly weigh in on. There are also limits to the jurisdiction of the US securities laws: FTX.com was organized outside of the US and was not authorized to provide services to US persons, and the SEC and the US courts cannot be securities policemen for the entire world.<sup>83</sup> Furthermore, the securities laws will not succeed in protecting US persons who actively seek to avoid regulations designed to protect them (presumably, some US residents used VPN networks to disguise their location and access the FTX.com exchange). But there is still much to be gained by robustly enforcing US securities laws to protect US persons. To highlight the benefits of such an approach, we can observe that customers of the FTX.Japan exchange will be able to retrieve their assets, because Japanese regulations implemented following the failure of the MTGOX exchange require crypto exchanges to segregate client assets.<sup>84</sup>

This Section will therefore explore how existing provisions of the securities laws pertaining to securities registration, as well as existing regulation of securities broker/dealers, could be robustly enforced to protect US investors.

##### Registration Requirements

If enforced robustly, the registration requirements in the existing US securities laws will both limit the supply of cryptoassets and apply scrutiny to those cryptoassets that are issued. This will help limit fraud in furtherance of the SEC's investor protection mandate; an incidental benefit is that the reduced supply of cryptoassets will also reduce the amount of leverage in the crypto ecosystem. While some might worry that limiting the supply of cryptoassets might be inconsistent with the SEC's mandate to promote capital formation, the reality is that the crypto markets are largely speculative and self-referential, and do not contribute significantly to capital formation.<sup>85</sup> It's also important to note

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<sup>82</sup> Dodd-Frank Act, Title X, Subtitle C, Secs. 1031; 1036 (July 21, 2010).

<sup>83</sup> This sentiment informs the judgment of Justice Scalia in *Morrison v National Australia Bank Ltd.*, 561 U.S. 247 (2010).

<sup>84</sup> Luke Huigsloot, *FTX Japan drafts plan to return client funds*, COINTELEGRAPH (Dec. 2, 2022).

<sup>85</sup> "Crypto trading is wholly unconnected to the productive purpose that defines finance: helping businesses, individuals, and governments raise, save, transmit, and use money for socially and economically useful ends." Baker, *supra* Note 70.

that under this approach, any cryptoasset that can meet the same registration requirements as other securities would be allowed into the market.

Under Section 5 of the Securities Act of 1933, it is prohibited to offer or sell a security without first registering with the SEC, unless an exemption from registration is available. The most widely-used exemptions in the Securities Act include restrictions on who is eligible to purchase the securities in question, and restrict resales of those securities.<sup>86</sup> However, cryptoassets (which aren't backed by any real-world productive capacity) need significant amounts of demand and liquidity to support their value. Restricting the pool of eligible investors, as well as limiting the liquidity of the cryptoassets through resale restrictions, is therefore unlikely to be an appealing avenue for crypto issuers. Issuers of cryptoassets who wish to access the public markets will therefore need to contemplate registration under Section 5. The securities registration process requires a significant amount of disclosure on the part of the issuer, including the provision of audited financial statements. It takes time and money to prepare these disclosures, which changes the cost-benefit calculus for issuers of cryptoassets. Right now, there are virtually no costs to creating a cryptoasset out of thin air. If the registration requirement is enforced, it will discourage the creation of cryptoassets unless they have some long-term value creation potential. The required audit of financial statements and review of the registration statement by the SEC will also help weed out any fraud.

The application of Section 5's registration requirement can also encourage better private sector due diligence. Details emerging from the FTX collapse suggest that the venture capitalists who helped fund the expansion of FTX did not engage in even basic due diligence or insist on basic principles of good governance at FTX<sup>87</sup> (FTX's bankruptcy filing described FTX's "unprecedented" "concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals,"<sup>88</sup> and noted that many entities had never even held board meetings).<sup>89</sup> Given that venture capitalists lend reputational capital to the projects they fund, they serve a kind of gatekeeper function that seems to have been abdicated with respect to FTX.<sup>90</sup> It is therefore worth considering how the securities laws, if properly enforced with respect to crypto, might impact venture capital firms and improve the performance of their gatekeeping function.

First, venture capitalists who fund crypto projects are often able to "exit" their investments much more quickly than if they had made a traditional equity investment in a start-up. Venture capitalist firms typically receive tokens in connection with their crypto investments, and they often sell these tokens to the public as soon as their contractual lock-up expires.<sup>91</sup> However, this practice is

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<sup>86</sup> Rule 506, for example, restricts investor eligibility and resales. The Regulation A exemptions have fewer such restrictions, but require the filing of an Offering Statement with the SEC. The crowdfunding exemption also requires an initial filing with the SEC (as well as ongoing annual disclosure requirements), and resales are restricted for the first year.

<sup>87</sup> Erin Griffith and David Yaffe-Bellany, *Investors Who Put \$2 Billion Into FTX Face Scrutiny, Too*, N.Y. TIMES (Nov. 11, 2022).

<sup>88</sup> Declaration of John J. Ray III in Support of Chapter 11 Petitions & First Day Pleadings at 2, *In re FTX Trading Ltd.*, No. 22-11068 (Bankr. D. Del. Nov. 17, 2022).

<sup>89</sup> *Id.* at 16.

<sup>90</sup> Parallels can be drawn here with the Terra/Luna collapse. As one reporter details, "One very senior risk analyst at a crypto VC fund told me he held grave reservations regarding the "algorithm stablecoin." But his team was assuaged by the cap table having some big names in crypto capital...." Max Parasol, *The risks and benefits of VCs for crypto communities*, COINTELEGRAPH (Jul. 8, 2022).

<sup>91</sup> "VCs often buy a huge chunk of tokens at an early stage at a very low price, and these tokens are often time-locked, so they can't be sold for one or two years. When the time is up, VCs face the dilemma of dumping their

predicated on the assumption that the tokens are not securities: if the tokens *are* securities, then any token sales to the broader public will first need to be registered with the SEC. Venture capital firms will not be able to exit so quickly. In short, enforcing Section 5 against venture capital firms will likely result in their holding their crypto investments longer, reorienting their incentives to perform diligence because they will have “skin in the game” longer.

Second, individuals who have purchased a security that was offered or sold in violation of Section 5 have a remedy under Section 12(a)(1) that is essentially a put right: so long as the statute of limitations has not expired, investors can demand their money back. This remedy under Section 12(a)(1) is not just available against the issuer of the security; it is also available against any “statutory seller” that “successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner.”<sup>92</sup> Depending on how the relationship between a venture capital firm and a crypto founder is structured, the venture capital firm may satisfy the definition of statutory seller and therefore be liable to refund purchasers of unregistered securities. The threat of such a possibility should encourage venture capital firms to both perform due diligence and ensure that the crypto projects they fund meticulously comply with the securities laws.

### Broker/Dealer Regulation

As discussed earlier in this testimony, FTX.com (like many other crypto exchanges) performed brokerage, exchange, and clearing services for its customers (it also transferred customer assets to its affiliated hedge fund Alameda Research, marrying its brokerage, exchange, and clearing services with proprietary trading activities). Crypto exchanges providing similar services may need to register as exchanges, market-makers, and broker/dealers.<sup>93</sup> This testimony will focus on the application of broker/dealer regulation. Securities broker/dealers are subject to registration requirements under the securities laws, and registered broker/dealers are subject to a multitude of regulatory requirements. Relevantly, these include requirements relating to affiliations and to the custody of customer assets. Robust enforcement of these laws against crypto exchanges would confer protections on US investors.

More specifically, many crypto exchanges are likely to satisfy the definition of a “broker” in Section 3(a)(4)(A) of the Securities Exchange Act of 1934,<sup>94</sup> and as such be required to comply with

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tokens — which makes them a fortune but tanks the price of the community’s holdings — or hanging on. Typically, VCs are perceived to choose the former.” *Id.*

<sup>92</sup> Pinter v Dahl, 498 U.S. 622 (1988).

<sup>93</sup> John Reed Stark, *A New Crypto Regulatory Framework? No Thanks*, LINKEDIN (Dec. 10, 2022), available at [https://www.linkedin.com/pulse/new-crypto-regulatory-framework-thanks-john-reed-stark?trk=public\\_profile\\_article\\_view](https://www.linkedin.com/pulse/new-crypto-regulatory-framework-thanks-john-reed-stark?trk=public_profile_article_view).

<sup>94</sup> The definition identifies “any person engaged in the business of effecting transactions in securities for the account of others” as a broker; the SEC has provided the following guidance on interpreting this definition:

“Here are some of the questions that you should ask to determine whether you are acting as a broker:

- Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?
- Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal? Do you receive trailing commissions, such as 12b-1 fees? Do you receive any other transaction-related compensation?
- Are you otherwise engaged in the business of effecting or facilitating securities transactions?
- Do you handle the securities or funds of others in connection with securities transactions?

A “yes” answer to any of these questions indicates that you may need to register as a broker.”

the broker registration requirements in Section 15(a)(1) of that Act. Once registered, a broker is required to comply with many rules, including Rule 15c3-3 (which “prevents a broker-dealer from using customer funds to finance its business”).<sup>95</sup> A broker/dealer is also subject to a duty of fair dealing which requires full disclosure of any conflicts of interest,<sup>96</sup> and when dealing with retail customers, to Regulation Best Interest. Regulation Best Interest not only requires disclosure of any potential conflicts of interest, it also includes an affirmative obligation to “[i]dentify and mitigate any conflicts of interest associated with such recommendations that create an incentive for the broker-dealer’s associated persons to place their interest or the interest of the broker-dealer ahead of the retail customer’s interest.”<sup>97</sup>

As with securities registration requirements, robust enforcement of broker/dealer registration requirements against crypto exchanges will keep some of those exchanges out of the markets. For those exchanges that do register, investors will have more information about conflicts of interest, and their assets will be more secure.

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Securities and Exchange Commission, *Guide to Broker/Dealer Registration* (Apr. 2008), available at <https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html>.

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> Securities and Exchange Commission, *Regulation Best Interest: A Small Entity Compliance Guide* (last updated Sept. 23, 2019), available at <https://www.sec.gov/info/smallbus/secg/regulation-best-interest#Introduction>.