Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: December 13, 2021

On Wednesday, several major crypto companies told Congress that the best way to govern them – should this be needed at all – is to create a new federal regulator that knows its way around the blockchain. One trusts this proposal is a sincere effort at constructive engagement, but anyone who has run the financial-regulatory traps longer than a DLT minute knows that proposing a single regulator is the most effective way to look earnest and yet still roam free outside the regulatory perimeter. There is simply no way Congress will pull itself together to enact a single crypto regulator. And, even if Congress could do so, it shouldn't.

Congressional obdurace about regulatory-agency rationalization isn't because the financial-regulatory construct makes sense or even that Congress somehow thinks it does. Congress knew that the multiplicity of banking agencies created undue opportunities for arbitrage and captivity at least as early as the 1971 Hunt Commission report arguing for what the then head of the Senate Banking Committee, William Proxmire, called the "Federal Banking Commission" when he tried to create one throughout the 1970s and early 1980s. As banking blurred into financial services in the 1990s, the regulatory perimeter became even fuzzier and Congress tried to rationalize it in the 1999 Gramm-Leach-Bliley Act, ultimately having only minimal impact on the alphabet soup.

A new regulator – the Office of Federal Housing Enterprise Oversight – was created in 1992 for Fannie, Freddie, and the Home Loan Banks, but that was because the S&L crisis of the 1980s disgraced its predecessor along with Fannie Mae. Fannie and Freddie immediately captured OFHEO until a new regulator, the Federal Housing Finance Agency, was created after a still more cataclysmic disgrace in 2008.

Dodd-Frank did lead to the Bureau of Consumer Financial protection in 2010 when we were also belatedly put out of decades of the misery created by the Office of Thrift Supervision. However, these bits of rationalization were largely accomplished because the great financial crisis also disgraced the prior order. Even so, Congress couldn't create a new agency to handle the all-too obvious problem of systemic risk; instead, it created an almost-toothless, multi-agency council in the FSOC and gave the Fed – tarnished though it was – a still greater uber-supervisory role over the rest of the complex regulatory architecture.

Taking this down to the crypto level shows why this history lesson is more than pertinent. No one has fully fleshed out quite what's meant by a new crypto regulator other than that it wouldn't be the SEC and thus companies that don't like the SEC would get someone likely to be more amenable to their charms. But, would this crypto agency deal only with monoline crypto companies – i.e., those that are crypto at the parent level – and yet know how to manage the risks of bank-, securities-, or commodities-like activities and with complex consumer- and investor-protection

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considerations? To do this, it would have to build up a lot of institutional knowledge torn from banking, securities, commodities, and consumer regulators.

Will there be meaningful buffers akin to GSIB safeguards if subsidiaries are systemic? What if crypto form part of the nation's critical financial infrastructure? What if the parent company is a regulated bank, broker-dealer, or futures commission merchant? Do crypto activities or some aspects of the regulated entity itself move to the new regulator even though it's not the activity that's different so much as the currency or assets through which it's conducted?

This complexity of activities also creates complexity of risks. To be effective, the new agency would need not just safety-and-soundness, investor/consumer-protection, and systemic standards, but also the reach to go after the governance hazards already evident in many crypto companies. These demonstrate the need for inter-affiliate transaction restrictions and conflict-of-interest safeguards, but complex parentage and domiciles will challenge any regulator not given the scope sure to elicit hard-hitting political opposition.

Even if all these questions are quickly answered, could Congress conquer its inability to settle inter-jurisdictional and cross-industry battles by taking crypto powers from the federal agencies who now have them and creating something akin to the CFPB for crypto? The brief history lesson above suggests that only a crisis sparks simplification and of course by then it's too late.