



FedFin Client Report

Wednesday, October 5, 2022

FSOC: Cryptoassets Demand Top-Down Standards, Securities Regulation, Banking-Agency Cooperation

Client Report: CRYPTO33

Executive Summary

In this report, we build on our [initial assessment](#) of FSOC's conclusion that cryptoassets now pose systemic risk and the Council's recommendations about what should be done to curtail it. Unsurprisingly, the FSOC report reiterates Treasury's conclusion that cryptoassets have few, if any, natural uses ([see Client Report CBDC14](#)), characterizing this asset class as largely speculative and/or focused on benefiting insiders. Specific recommendations are detailed in this FedFin report, with FSOC focusing as much on inter-agency cooperation – so far almost non-existent – and effective enforcement via the reach of traditional rules into cryptoassets as on new regulatory initiatives and legislation. The description of new laws governing spot markets side squarely with the SEC, urging Congress to limit the CFTC's jurisdiction to futures-related activities now subject to its jurisdiction and govern retail investors only to the extent needed with regard to CFTC-specific activities. Custody and similar crypto activities should only be conducted by banks or other regulated entities, with FSOC also seeking first data and then restrictions on inter-connections between crypto companies and regulated banks. The report is also opposed to special-purpose national charters along lines previously approved by the OCC ([see FSM Report CRYPTO31](#)) that Acting Comptroller Hsu has so far limited, but also allowed. Instead, FSOC – doubtless as Secretary Yellen and Chairman Powell prefer – strongly endorses integrated regulation that governs crypto companies as a whole, including with regard to subsidiaries and affiliates. The reach of these companies into global markets is also to be stopped at the water's edge to ensure effective regulation and AML/CFT enforcement.

Analysis

As noted, the Council unanimously agreed that cryptoassets now pose systemic risk, thus reversing years of reports urging only vigilance. This change results from a determination that cryptoassets may quickly become systemically intertwined with traditional finance and pose significant risk due to the absence of effective safeguards and internal controls at largely unregulated issuers and service providers. Specific systemic-risk nodes include:

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- stablecoin reserve assets;
- trading-platform activities and potential conflicts of interest without internal control;
- DLT vulnerabilities; and
- consumer use of crypto, especially in the payment system.

The paper strongly disputes crypto-industry assertions that it is regulated, noting numerous instances of fraud or, at best, misrepresentation along with stating that state regulations can be easily arbitrated and that, in any case, such regulation largely addresses limited payment-system or AML risks and in no event address systemic considerations. The paper also notes that OCC special-purpose charters lack consolidated regulation, implicitly opposing them. FSOC expressly recommends:

- prioritizing legally-binding settlement and timely, orderly transaction processing along with monitoring avenues of inter-connectedness and facilitating price discovery;
- continuing enforcement;
- regulating crypto spot markets for instruments that are not securities via new law that does not interfere with the jurisdictions of other regulators;
- ensuring effective custody via new regulation for nonbank custodial providers;
- ending regulatory arbitrage, in part by establishing a federal framework for payments that subsumes cryptoassets into a sound construct – the report does not make clear how this new framework is to be established but implies that new law is not necessary. The report also urges regulatory cooperation to fill gaps and supersede limited state standards;
- enacting new laws to give federal regulators authority over crypto firms as a whole, including all subsidiaries and affiliates, doing so regardless of decentralization representations and authorizing capital, liquidity, and similar prudential standards;
- immediate review by federal and state regulators of the services provided by crypto entities to banking organizations, also reviewing the extent to which these agencies have sufficient authority to address crypto-related risks;
- passing laws giving the FHFA, NCUA, and other agencies express authority over third-party service providers;
- addressing the cascading liquidity and systemic risk of automatic customer close-outs and limiting retail exposure to these protocols;
- more broadly, agencies should address crypto-firm vertical integration to identify risk to systemic stability, retail customers, and market integrity as well as conflicts of interest;
- greater use of existing data-collection powers to facilitate effective supervision and enforcement; and
- enacting the stablecoin legislation outlined in the prior PWG report ([see Client Report CRYPTO21](#)).