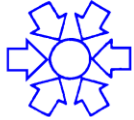

Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: November 21, 2022

The only question left unanswered about FTX is whether it was a purposeful scam as more than a few clients conclude or a case of implacable forces ending the era of easy money that just got the better of another wunderkind whose awesome skills turned out to be largely confined to costumery conveying inspired innovation to all too many vulnerable investors and gullible politicians. No matter which it is or even – as I think – if it's a bit of both, FTX is a debacle that will change U.S. financial policy for the better unless FTX drives still more crypto chaos that then spills over to core financial infrastructure and intermediation. I've gotten a lot of questions about crypto policy after my brief discussion in last week's talk on the midterm's policy impact. Here, more on both the legislative outlook and what regulators may finally bring themselves to do even if Congress can't get itself together any better next year than in so many before it.

First more on why stablecoins are the cryptoasset most likely to come under a new federal gun. This isn't because they deserve it more than any other cryptoasset – although they might – but because policy thinking about what to do with stablecoins is most advanced and, thus, bipartisan negotiations in the House are closest to the finish line.

That said, even stablecoin standards aren't going to be easy. The clearest articulation of how new law might work is S. 4356, the Lummis-Gillibrand bill. But, as our in-depth analysis made clear, this bill is a hodge-podge of the hopes of Bankman-Fried acolytes and an amazing array of internal contradictions about just what would be done to stablecoins, issuers and banks along with what would befall consumers, investors, and the financial system.

But regardless of whether there is new law, there will be new rules. So far, federal agencies have stayed in hidey-holes burrowed into their respective corners. FTX's collapse and others in its wake will force clear stands on critical questions and rapid action on anything that can be plausibly represented as possible under current law.

Given this, here's an overview of what we expect from key regulators over the next few months even as Congress reconvenes and talks on.

First, the SEC will be forced from its you-know-it-when-we enforce-it crypto stand to set clear guidance. FSOC politely called for this in its last report of oh-so-many on digital assets and there's also bipartisan agreement that the SEC should more clearly define when activities constitute a securities exchange or broker-dealer. I expect them to do so via statements rather than rulemakings given the near-term collapse of SEC staff from nervous exhaustion. This is a process sure to elicit vigorous GOP protest, but it's what the SEC will do and, after it does it, it's what will last unless or until there's new law or a different SEC chairman.

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The key to what banking agencies do is the extent to which they can agree or, if not, are willing to embark on their own. Messrs. Barr, Hsu, and Gruenberg told Congress that they would issue a tough version of the Basel crypto rules, although they didn't say when. Early next year is our forecast for a fast turn-around proposal.

We think the Fed and OCC will also agree on risk-management standards akin to those formally issued by the Fed and adopted by the OCC when it rolled back Brian Brooks' parade of crypto-friendly orders. We can't see why the FDIC wouldn't join in, but then we can't see why the agencies disagree on so much that seems both straightforward and urgent. A case in point: the long-delayed final version of way-overdue rules on third-party relationships and service providers. Treasury called for this in its latest fintech report from their lips and thus perhaps it's soon to come. When it does, it will make a major difference in the inter-connectedness between banks and cryptoasset entities, strangling them to the greatest extent the agencies think possible.

The CFPB has been strangely silent through FTX's demise despite obvious fodder for its consumer-protection campaign. In sharp contrast, the CFTC was on a roll before FTX blew, supporting the industry's approach to regulation endorsed at the time by bipartisan Senate Agriculture Committee leadership until conceding most crypto powers to the CFTC and its light-touch approach lost its bling appeal in FTX's wake. Now, the Commission is readying enforcement actions to show it's on the job when it comes at least to aspects of crypto exchanges it thinks fall under its authority. This too is an enforcement-oriented approach – one that, like the SEC's, will force some crypto executives to do a perp walk if they can be persuaded to come back from the Bahamas, Singapore, Korea, or wherever they are to be found.

To some degree, regulatory action can address at least some of the risks FTX epitomizes that would be far better resolved by federal law. For example, the OCC has so far refused to allow banks to provide crypto custody services because it says, with good reason, that asset ownership cannot often be ascertained. Banks holding a bag of assets everyone claims will end up owing everyone for at least most of them, a far cry from the riskless infrastructure role for which custody was intended. But, a rule which says that banks can provide custody services for assets with legal-ownership rights – many of which can be established under current law – would encourage crypto issuers to take the now- inconvenient step to increase market resilience at least for the institutional investors who should know that bank-provided custody is essential if they are to fulfill their fiduciary duties.

FTX also epitomizes the self-interest bonanza readily at hand without inter-affiliate transaction restrictions. The third-party standards noted above provide an avenue for banks to support crypto platforms and other vehicles if they can assure that appropriate firewalls are in place to protect the ultimate owners of the digital assets issued, traded, or otherwise touched by their customers. An imperfect solution, to be sure. But, it's also at least a start

And a start is what's urgently needed. One reason FTX and so many other crypto companies were able to take in so much money for so long from so many yield-seekers is because many assumed that crypto companies were bank-like – see our 2019 paper predicting this outcome to see why it isn't surprising. Maybe all these losses will sober folks up and surely the sudden absence of many seemingly-legendary crypto heroes will help. But unless or until rules contain crypto damage to investors who knowingly take speculative risk, crypto crises will continue and, in the not-too-distant future, metastasize.

For all the Fed's hikes, interest rates are still negative in real terms. Yield-chasing will thus drive investors into abysses unless the guardrails of which regulators talked much last week move from official states to actual edict.