THE BROOKINGS INSTITUTION

A DEBATE:

SHOULD CRYPTO BE REGULATED BY THE FEDERAL GOVERNMENT?

WEBINAR

Tuesday, December 20, 2022

PARTICIPANTS:

KELLY EVANS (Moderator)
Anchor, CNBC's "The Exchange"

PETER CONTI-BROWN
Class of 1965 Associate Professor of Financial Regulation, Wharton School, University of Pennsylvania; Nonresident Fellow, Economic Studies, The Brookings Institution

STEPHEN G. CECCHETTI
Rosen Family Chair in International Finance, Brandeis International Business School

* * * * *

David Wessel [00:00:14] Good morning. I'm David Wessel, director of the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution. Bitcoin, Etherium, Tether, Central Bank Digital Currencies, Grayscale, Genesis, FTX, Binance. They've all been in the news almost every day for the past few months. Depending on who you listen to, crypto is either the greatest invention since paper money or the biggest bubble since tulips in the 17th century. As big a technological advance as the Internet or just a gigantic Ponzi scheme. But one thing is clear— or I should probably say one thing is not clear— which of the many federal financial regulatory agencies is responsible for regulating crypto and how should they do it? We've had several regulators on our stage so far this year, each offering his or her own approach.

Today, the Hutchins Center and the Center on Regulation and Markets at Brookings step back, and we ask a more fundamental question. Should the federal government regulate crypto to protect people in the financial system? Or should it let crypto wither and die because regulation might be misunderstood by the public as approval? Arguing for regulation today will be Peter Conti-Brown, a lawyer, a Ph.D. in financial and political history, he is the class of 1965 Associate Professor of financial regulation at the Wharton School at the University of Pennsylvania and a nonresident fellow here in Brookings. Arguing against regulation will be Steve Cecchetti, a Ph.D. economist, the Rosen family chair in international finance at Brandeis International Business School and a member of the Hutchins Center Advisory Committee. Moderating will be my friend Kelly Evans, anchor of CNBC's The Exchange.

Now, as you'll see, Peter and Steve don't disagree on everything— but I think or at least I hope—we'll have some lively disagreement in the next hour. If you want to pitch a question to us you can do it on Twitter or on Slido, Slido with the hashtag crypto debate, hashtag crypto debate. Or you could send an email to events at Brookings dot edu. We won't get to all your questions, but we do have a lot of time for Kelly to pose some of the questions that listeners or viewers offer. Now, the ground rules for today's discussion is essentially, Peter will get 5 minutes. Steve will get 5 minutes. Peter will get another 5 minutes. Steve will get another 5 minutes, and then Kelly will take over. So with that, I welcome Kelly Evans of CNBC to our virtual stage.

Kelly Evans [00:02:50] Let's try this again. Thanks, David. It's good to be back together. Thrilled to be here with Peter and Steven as well, because I admire them tremendously. And I haven't made up my own mind on this question yet, and I hope to by the end of this discussion. So with that in mind, Peter, let's start with you. You think crypto should be regulated even with the risks that people acknowledge that that could legitimize it unduly and introduce a host of new problems. So we'd love to hear why.

Peter Conti-Brown [00:03:18] You know, the word legitimacy has an important place. The concept of legitimacy is central, Steven, I agree, to questions about how the government interacts with the private sector in constituting a financial system that accomplishes the real economic goals and that a financial system must accomplish. The problem is, is that crypto has already been profoundly legitimized in the minds and eyes of many. There is no one, Steve included, who is anywhere close to the financial system professionally who has not found in social gatherings, at parties, in the dentist's chair, people asking questions about crypto. That's been true, not just as David said for the last few months, but over the last five years. And the question then becomes, what do we do about this fact? What do we do about the fact that that there has been such an increasing enthusiasm around crypto?

Now one view which Steve will elaborate is to just let it burn, let it be, let it percolate and let it die. It has nothing to show. And I think for a lot of different kinds of activities, that's exactly the right answer. But we are at a stage of crypto development where that's not sufficient. And let me give you three reasons why that is. The first is because crypto entrepreneurs, some delusional dreamers, some ambitious futurists, some hucksters and con artists have already introduced the idea that crypto is a not just money substitute, which we see throughout the financial system, but a money improvement. And so here we have institutions and entities, commodities and assets that masquerade as something different, but in fact are exactly what we have seen before. These are institutions that are bank like and offer bank like financial services. These are exchanges that offer securities which they call tokens or coins. And so the first principle that we have to acknowledge here is that a failure to regulate crypto is a declaration of a prosecutorial non-enforcement of existing laws.

So the first principle is regulators must regulate using existing authority. A failure to do so, to allow people to present bank like instruments or bank like institutions to, to hawk securities under the name of tokens is to invite lawlessness. It's to delegitimize the efforts of government. It's to put a governmental imprimatur by inaction on regulatory arbitrage. And we can't allow that to occur. We can't allow people to skirt the laws in the name of inventing the future.

The second, I'll say, is more optimistic about Crypto's future. If the first is to say that so much of crypto activity amounts to a regulatory dodge that we must not permit, the second is to acknowledge a little bit of epistemic humility, to say, we don't know where this is going. There is no doubt that our financial system is not what it could be. There are people who are excluded from it. The cost of of transferring money across national jurisdiction is, in some cases, prohibitive. I was, I was a visiting professor in Germany over the summer for a month, and unfortunately, I have a bit of a lead foot when I was driving, and I misunderstood that the Autobahn still has a speed limit in many places, and I got tickets. Can I tell you it's been four months, 20 hours, and I still can't figure out how to pay the thing.

The cross-border payment system is not an easy situation. There are so many other examples like this, and crypto enthusiasts see crypto as an answer to the future. I don't know if it will be. I don't know if it'll make these problems worse, but it might make them better. We don't know yet. The stage of of developed, technological development where we are with crypto is so early that simply saying let us let it be destroyed, let it burn is to, to say is to mark something too early in where we are.

Last point, I know my time is sped up. And that is to say, while I strongly stand for the proposition of this debate that we should regulate crypto, I'm very skeptical that we should legislate crypto. I think the kind of legitimacy that is granted to crypto through aggressive enforcement of existing regulations and calling the securities and banking regulators arms to pay closer attention to these assets and institutions is very important. But the time is not for Congress to create a technology specific regime for crypto. It's to acknowledge that through the crypto ecosystem, we have money launderers, we have fraudsters, we have technologists, we have futurists, and we need to have mechanisms to separate the goats from the sheep. And those mechanisms are regulatory, they aren't legislative. Thank you. And I'll pass it on to Steve.

Kelly Evans [00:08:26] Peter, thanks for that. And Steve, so if I could recap what Peter said and Peter, you'll have a chance to correct me in a moment for anything that I don't get quite right. The three reasons we can't just let it burn. Number one, we have to enforce existing laws and inaction kind of puts it imprimatur, an implicit sort of backing that this activity is okay. Number two, if there are legitimate purposes like for cross-border payments, we don't want to snuff that out. And number three, while saying we should regulate it, that doesn't necessarily mean we should legislate it. Steve, over to you.

Stephen Cecchetti [00:08:57] Thanks very much. And let me start by thanking David and the Hutchins Center and thanking Kelly for, for agreeing to moderate this. And, and it's great to be here with Peter. My comments are based on work that I've been doing with Kim Schoenholtz at Stern NYU for a number of years. I'm going to make a number of comments and some of them seem legal, but I'm obviously not a lawyer so I defer to Peter to, to correct me on those, some of those. So I have five main points.

First, in the strongest argument I think against regulation is about conferring legitimacy and legitimacy creates responsibility. I think of a lot of this stuff as being like a video game. And so if I look at an analogue, the World of Warcraft has 120 million players, and it has an economy inside of it. Fortunately, I think no federal financial regulator has responsibility for overseeing the World of Warcraft and, and while there's money involved, I don't think any of us would call on them to do us, to supervise online massive multiplayer games. Like the World of Warcraft, crypto, in my view, does nothing to support the real economy. So legitimizing it is simply going to drain creative resources from productive activities. In economic terms, this would be like subsidizing a dead weight loss. And I think we would all agree that that's a pretty bad idea.

Second, we already have a set of laws, as Peter has emphasized, and we have enforcement mechanisms to address fraud, theft and the facilitation of criminal activity. I think it's essential that prosecutors address the misbehavior that is, in my view, the defining feature of the crypto world. They should do this by enforcing existing laws aggressively, and where appropriate, I think going after the celebrities that are promoting this stuff. Importantly, also, we need policymakers to redouble their efforts to promote financial literacy and warn the public, especially those of limited means about get rich quick schemes of the sort that seem to be rampant in the crypto world.

Third— and this I think, is where, where Peter and I largely agree— new light touch rules for crypto would fuel the migration of financial activity from traditional finance to the less regulated but newly legitimized crypto world. Both crypto and traditional finance are simply combinations of a database and computer code. This is, I think, really important to understand at the technological level. It would be straightforward as a consequence for a group of technicians to convert one into the other. I don't think this would be even a challenge for most of them.

Fourth, some people argue that regulation of crypto is going to promote financial innovation. I don't see it. So long as regulators promote competition, there's nothing to prevent traditional intermediaries from investing in new technologies, which they do all the time. And these technologies are reducing costs and improving access. To Peter's point about paying his ticket, fintech, the fintech revolution has spurred the creation of many institutions that are innovating in order to help Peter pay his, pay his ticket. My guess is the problem is at the German end, not at our end. We've seen this then in payments, credit evaluation, insurance and stock trading. This stuff has nothing to do with crypto at all.

Fifth and last, legitimizing crypto is going to encourage banks to purchase crypto assets directly and to lend against them as collateral. Imagine where we would be if leveraged financial intermediaries had been holding crypto in November of 2021 before the plunge in value. So if we need any new rules, there are rules to prohibit exposure of traditional leveraged intermediaries, prohibit banks, dealers, insurers, pension funds from holding this stuff and from accepting it as collateral. If virtually all of the transactions in the crypto world remain inside of the crypto world without links to the real economy, it would be as if this stuff was going on on Mars and it would leave the financial traditional financial system unaffected. I think that should be our goal. So my conclusion is that creating a separate, federal, regulated financial regulatory regime from crypto would make the system less, not more safe. And it's a bad idea whose time is never going to come. Thank you.

Kelly Evans [00:13:51] Thank you, Steve and Peter, let's turn back to you and Peter in addressing those points, I also wonder if you could kind of answer one question on my mind as I think through your arguments for regulating crypto, which is has it the, would it be like closing the barn door after the horse has left? You know, the public who was burned by crypto has just learned from that experience. And so won't that experience itself put guardrails in place for the future as opposed to us now trying to impose a regulatory environment that in a weird way could end up looking like an endorsement of the very ecosystem that just failed people.

Peter Conti-Brown [00:14:33] Let me take your question first. I think that the history of financial innovation, financial crisis and scandal and financial regulation is littered with instances where market participants get burned and then announce that there's no need for regulation because they've already learned their hard lessons. And then they retire three years later, and a new generation comes along and says, this time is different, things are great. We certainly don't need regulation to solve the problems that we read about in the history books. And of course, then onward it goes on, ever, ever, ever, the cycle continues. So I don't think that the instance of scandal and crisis, the crypto winter is sufficient to discipline markets on anything like a medium or long term.

Let me quickly dispense with the place where Steve and I agree most profoundly, because it's not even the most interesting part of the debate, even though there's a momentum gathering on Capitol Hill. We are so far away from a place where we could cast in amber an institutional arrangement that isolated crypto separate the ways that we have done with securities brokers from banks. It took a hundred years for us to get a good sense of how we should regulate and supervise banks and 100 more before we developed any real skill in it in the United States. Hundred 50 years, really, before we had sophistication on the regulatory front for federal regulation of securities. So the last point that Steve makes, I agree with it's not time for us to have a crypto specific regulatory regime, but that's not the debate. Debate is whether we should regulate crypto. And I'm going to playfully suggest that Steve conceded the debate and I welcome you to the warmth of the side of the debate where people have the correct ideas. Because, Steve, you said that we should aggressively enforce existing laws.

The problem is, is that which laws do we enforce against crypto and there are legal definitional problems that are non-trivial. For example, it is not obvious, and I've consulted the leading banking lawyers in the country in preparation for this debate— I consider myself one of those lawyers— it is not obvious how we should clamp down on those crypto exchanges and institutions, the facilitating institutions that market themselves as banks offering bank like products. The best we can do, the obvious is what the FDIC has already done, which is issue cease and desist letters, but only when those institutions use the incorrectly the talismanic authority to say the FDIC eagle approves of your account. When they do everything but this, they are doing they're practicing banking without a license, they should be prohibited from doing so.

But the regulatory authority that exists on the books today is probably insufficient for this. They seem to for let's take the notorious FTT token issued by FTX and collateralized and used as the basis for loans from other institutions, that looks, smells, quacks like a security. And yet the SEC, under the aggressive anti crypto chair Gary Gensler, did not shut it down. And it's not because they didn't know about it and it's not because they didn't want to, it's because the existing regulatory authority to do so is ambiguous. And so to fill in those ambiguities requires more regulation. And for that regulation to give them the prohibitory authority to, to say you cannot do what other regulated entities are doing simply by slapping a new technologist, jargon-intensive label on your activities. To do that is non-trivial. It's a lever that requires more of a regulatory framework and yes, more of a crypto specific regulatory framework to say what's the difference between a Bitcoin, which probably isn't a security and or an XRP issued by Ripple or what have you, and a token issued by FTX that looks exactly like a security and that will require further regulation.

The last point I'll make here is I think that if we were talking about pure video game like dynamics, I would agree completely. Another analogy might be Chuckie Cheese tokens, nobody worries about the issuance of Chuckie Cheese tokens. But crypto has not been an internal ecosystem for many years. And there I think Kelly you're right, that horse is out of the barn. There are so many ways that people have mixed and mingled their crypto investments alongside other kinds of asset strategies where they have indeed brought into place the levered financial system within the banking perimeter. And the questions now are, what do we do with this thing that has already occurred? And that to me requires more regulatory clarity, not less. It's done. It's passed. And so we need to handle the problem as it has landed in our lives.

Kelly Evans [00:19:41] And Steve, as I turn it over to you, I wonder if you could use one example to illustrate your points, which is, to my memory, there were a number of institutions offering crypto for your retirement plans over the last couple of years. And can you just kind of address that, which seems unsound, especially in retrospect, and explain if crypto is not regulated, or maybe even if it is, who is the arbiter of whether that would be appropriate for individuals to put in something like a 401k? Or are we babying people if we try to protect them from the stuff, especially as we expect more financial innovation like this in the decades to come.

Stephen Cecchetti [00:20:30] So I guess, again, I'll start with your excellent, your excellent question. Fiduciaries have suitability requirements for their customers. And I would claim that any, any custodian of a, or the administrator of an, of a individual retirement account is violating those suitability requirements if it allows its customers to invest in crypto. I actually think those people are likely to be open to lawsuits over that. And so and so they're going to, they're going to face some, they're going to face some problems. I think they're going to, we're going to see, we're going to see a lot of lawsuits over people who were allowed who allowed unsuspecting just normal people to invest, particularly their savings and their retirement accounts in some of this, in some of this stuff. So I think, again, we have those requirements on the books, and the question is whether or not it's, whether or not it's sufficient.

So let me just, let me just emphasize again that Peter and I clearly agree on two points. One is about the parallel regulatory system, and the other one is about enforcement of current laws. And, and I think that the, you know, on the enforcement of current laws, I guess, you know, much of crypto looks like looks like fraud and pure gambling to me, prosecute what's illegal and applying existing regulations where it is it is legal if anywhere. I mean, I love the, the quote from Alex Mashinsky, the founder and former CEO of bankrupt Celsius Network that I'm sure many of you have heard, which is when a traditional bank offers zero interest rate and crypto lenders offer 18%, someone is lying. And I agree. And I want everyone to know who it is. And I think we all agree that we know who it is.

So where we clearly disagree, I think is, is on this point about whether or not there's going to be any evidence as to whether crypto is the future. And I don't think crypto's the future of anything. In my view, it passes the Supreme Court's obscenity test. It's utterly without redeeming social value. There's, this is not an issue of humility which, which Peter brought up. Crypto has made, has been around for more than a decade, it's demonstrated to demonstrate any meaningful benefits. And so far, it hasn't. You know, and I my, my former my former employer, the BIS, the general manager, Augustine Carstens, called it a fraud, a Ponzi scheme and an environmental disaster. I don't think that that's, that that's changed.

I think the other thing is that that I think we, we might want to separate crypto from the technology itself, but even the technology looks like it's extremely unlikely to bear fruit. This blockchain distributed ledger stuff, the trustless technology is does not look like it has, it has much of a of a future. Professor Eric Budish at the University of Chicago has shown, I think compellingly that that it's either going to be extremely expensive or vulnerable to attacks that slow it down. People are not flocking to this technology. They're abandoning it. So I really, I really don't, I don't see it. You know, it's not just crypto that's nonsense. I think the concept of decentralization, either a decentralized ledger or a decentralized finance more generally turn out to be a pipe dream. In every case, there's some form of decentralization, of centralization in all of this. And that means that there's a pressure point where, where authorities can actually, can actually go after these people for what they're doing.

It's, it surprises me again, you know, I have to defer to Peter on all of the legal, the legal details. So but it does surprise me that there's a need for additional legal, an additional legal framework to go after this stuff. We've had, we've had frauds and Ponzi schemes around for probably the history of mankind. And, and, and so in that sense, there's nothing, there's nothing really, there's nothing really new. So without I think, you know, with without any source of expansion, which is coming from the centralization, crypto is going to wither and die. Or perhaps I guess it could survive like World of Warcraft does. But, but I, but I hope not.

Kelly Evans [00:25:27] Steve. It'll, I'll morph into kind of the Q&A portion of this now. One, I want to pick one real world example of where I do think crypto shows that it has some societal value and it actually something that Peter mentioned. But on this question about cross-border payments. So there's a payment system, a wallet, if you want, called strike and it uses Bitcoin to convert your dollars into international currency, crypto, you name it, but it basically does that conversion using bitcoin and the blockchain in order to do it kind of instantaneously and without the existing financial intermediaries that the proponents of the system say basically prey upon those who then have to pay Western Union incredible amounts of money, deal with, you know, currency conversions and people who take a cut of that and all the rest of it. And that using the Bitcoin blockchain technology, it offers an elegant, immediate way around that problem. And there's been quite a bit of take up on this, they just launched in Africa.

This is what kind of got El Salvador involved in the first place was this need for its community to be able to more quickly interact with the international financial system without, and the the proprietor of this technology says it is basically a direct competition to the likes of Western Union and those kinds of stocks that some argue prey upon the more vulnerable parts of the global population.

So is that not an example where we might not have expected this to come out of something like Bitcoin and blockchain? It might not be what the, you know, the original inventors had in mind, but is that not a practical use? And if that ends up being a very practical and helpful use to, as the world becomes more intermingled to kind of allow for, for very quick cross-border payments, then what would happen in a version where there is no existing regulatory system for crypto? Do we need one? Would that interfere with it? Do you acknowledge that that could be a legitimate use of this technology?

Stephen Cecchetti [00:27:28] I guess that question's for me.

Kelly Evans [00:27:29] Yeah.

Stephen Cecchetti [00:27:31] The short answer is no. The, and what makes what makes cross-border payments expensive is, is identity verification, anti-money laundering, know your customer rules. I grant that Western Union's very expensive. But for those of us that have access to, to the banking system, to the traditional banking system, cross-border payments are actually not all that expensive. There are a lot of ways to do this through correspondent banking relationships, which are actually very low cost now, though, there has been a tremendous amount of innovation, FinTechs are out there offering people essentially what look like visa transactions that go from bank to bank, bank account to bank account across borders.

Central banks are also very much in the business of improving the, the improving cross-border transactions as a, as well as within border low paid, low value payment transactions. So I don't believe that Bitcoin necessarily or any, any blockchain technology necessarily has anything to do with this. I think that these, that these fintech companies that are using blockchain technology and Bitcoin and the like, as their payment rails are doing it as a more of a marketing gimmick than they are is something that's absolutely necessary. It's simply not, it's simply not necessary to use something like that. You can do it in the traditional system, and the traditional system is being forced to reduce its costs.

This was, payments is a place where there's been a tremendous amount of competition, both within and across borders, because it was so controlled by, by the banking system and by visa. And they were basically collecting huge rents off of big fees. This is being competed away. And, and I think that's an extremely good thing. But again, I don't see that it has anything to do with crypto and crypto is not necessary.

Kelly Evans [00:29:29] Peter, could you address that as well?

Peter Conti-Brown [00:29:31] Sure. I agree that the payment space is a really important one for any partisan in this debate. And the place where I agree with Steve is the vibrancy of the environment and even with the incumbents and major players who own networks facing everyday competition coming in from upstarts, from, you know, state-owned enterprises and payment rails. And it's, it is an extremely dynamic place.

Where I think Steve is wrong is that Bitcoin or blockchain has nothing to do with this. Every major payments player is extraordinarily close to following blockchain developments and thinking about where this might represent both opportunity and challenge. And I think the mindfulness of this does not mean, even if blockchain does not solve this problem, serving as an impetus for technological innovation that I think I agree at this stage anyway, in the medium term, is far likely to occur in, through fintech or even existing incumbents than it is through a crypto ecosystem, the very existence of crypto, the crypto ecosystem, making threats to that environment, having solutions that are, if inchoate, are not non sequiturs.

In other words, they I don't think that blockchain has solutions to these problems, but it's not coming up with orthogonal proposals. They're still visionary proposals. I can't tell, in, as 2022 comes to an end, whether we're dealing with those futurists in the 1960s who promised us artificial intelligence in the next 5 to 7 years, or if we're dealing with those futurists who in 1905 said the horse will no longer be a major presence on the streets of Manhattan. In either case, it looked preposterous. In the first it was. But note, 70 years later, we are getting closer to the idea of really active, vibrant artificial intelligence for good or ill. And in the case of the car, we were 5 to 7 years away from watching horses and stables and carriage houses essentially get eliminated from the streets of Manhattan and other large cities in the United States.

But blockchain offers here is a a technology that is responsive to a set of problems. I'm not a crypto booster, I am, I would probably put myself in more of a skeptical posture. But I'm not an existential prophet of doom about what crypto might be. And in fact, I've started to think that we should retire the term crypto as essentially incoherent and meaningless analytically. I think there are real opportunities using digital assets and digital databases whose, whose keys and, and networks look very different from incumbents, to radically change the way that money moves within and beyond nations. That's the hope and potential of what we call crypto. And if we, if we simply say this is a video game with nothing other than fraud to require regulatory attention, I think we miss what is dynamic and important about these frontiers.

Kelly Evans [00:33:05] But Peter, I wonder if letting it play out, in other words, we've gotten to this point without regulatory framework for crypto. We've gotten to the point of it being rails for payments, introducing a new experiment with Defi and all the rest of it. So it's not as if anything needs to happen now to foster that innovation. Probably the biggest headwind is just the reversal of Fed liquidity for the next five or ten years. That's not going to support a lot of new projects.

Here's my question, and it came up a lot in our audience questions, so I want to make sure that I ask it and get a really specific answer here. A lot of people said, if we regulate it, who is regulating it? Why is there, are there so many regulatory bodies as it is for the financial system? Is this an opportunity to kind of remake or reshape the regulatory framework? If not, where does crypto fall within it? And if yes, what would that look like?

Peter Conti-Brown [00:34:01] Should I begin that? Steve got an easy answer, which is just to let it all die. Let me give you the more nuanced answer. So in a book that will be coming out this coming year with Sean Vannata, we've written a history of bank supervision. So thinking, focusing on the bank, banking perimeter, and we tell the story of why we have federal fragmentation. It's a very important story. We count no fewer than 19 very serious legislative efforts to simplify this model, to consolidate the federal banking system. Every single one of them has failed and usually failed quite abysmally. So I don't think that that's going to happen, we're going to see that change. And we have these differences, including uniquely in the United States, the separation between commodities futures and securities futures for important historically contingent reasons. And so that's not, the crypto meltdown and a regulatory response to it provides no opportunity or platform for massive rethink. And we never get to clear the decks and wipe the slate clean, to mix my metaphors.

But the crypto meltdown might offer us is to look at where the existing regulatory frameworks are and ask ourselves what gaps does crypto produce? So in 2018, one gap it did not produce was the initial coin offerings. They did exactly what Steve predicted, which as the SEC said, oh yeah, these are just securities so you can do an ICO, you should go through what we call an IPO and, and many happy returns, but nobody did because it was a pure regulatory arbitrage. So the ICO's died. What about other kinds of crypto environments that are not fraudulent because the risks are fully disclosed? What are these? Not obvious that they're securities. I think they should be regulated as such, or at least as a securities light type instrument. And the comptroller of the currency, to its credit, wanted to do this thing starting in the Obama administration, continuing in the Trump administration to say not not with respect to crypto that would include it too, is to say, listen, these are bank like instruments and institutions, but they're not full bank like instruments and institutions.

So let's have a modified charter that allows them to continue. They will be regulated and supervised, but not exactly like banks. And so I think grafting on to the existing regulatory framework, we're talking about consumer protection, the CFPB, if we're talking about banking charters, talking about the comptroller, we're talking about general financial stability, we're probably talking about the Fed and for securities the SEC, let them do, and I think the SEC has done a really phenomenal job here, create specialized units. The SEC has a crypto unit that is devoted to understanding where crypto activity intersects with its policies, let the Fed do the same, let the comptroller do the same. Not to jump whole hog into this new world to validate it, but to say what you're doing looks and smells an awful lot like what has long been done.

Kelly Evans [00:36:50] Right. If, if that's the case, I don't mean to interrupt, but because obviously a lot of this is in the wake of the FTX collapse, then under the paradigm that you're describing, what should have happened or, or was there no way of preventing that institution from collapsing? You know, then should it have been the SEC? And what is it that they should have been doing? And at what point or if we're going to say, no, this was a simple case of theft, there was no way to regulate it ahead of time or, or should somebody have been more proactive on the FTT token? I'd be curious of your thoughts?

Peter Conti-Brown [00:37:24] Yeah, absolutely. Let me be brief because I'll be interested in Steve's thoughts here, too. I think the SEC is the real standout in in the crypto regulatory response. It could have done more. It should have done more. I think FTT should have been a really terrific test case for what's called the Howey test in terms of determining whether something that is new constitutes a security. I think the Fed had some failures here. The Fed approved, it looks like on a pro forma basis, a banking relationship within the FTX empire that should never have occurred, it should have certainly been subjected to much more scrutiny than it was.

I think any bank, to Steve's point earlier, that accepted as collateral FTT or other FTX created tokens or adjacent tokens for loans should have been subjected. They either should not have occurred, or they should have been subjected to an extraordinary discount in their lending relationships. There was so much more that existing regulators could have done. What we did see is the FDIC send a cease-and-desist letter, but only after FTX said this is deposit, these are insured by FDIC accounts. And I think that is the lowest hanging fruit. And there was a lot of fruit on the FTX poison tree that was ripe for regulatory picking. And I think I'll have more to say about what, what is, what is so deeply problematic about this and why this is not a problem that's simply resolving itself. But let me pause there for a moment.

Kelly Evans [00:38:57] Yes, Stephen, absolutely on all of these points, you know, what should, you know, if you would grant that maybe we are going to end up regulating crypto, who should do it? How should they do it? How might that have prevented, or would it have prevented the FTX debacle?

Stephen Cecchetti [00:39:12] So let me, let me just first of all, I want to make one comment that I think that I agree that some of what's going on in the, in, in the digital space has spurred a tremendous amount of innovation. Is it blockchain per se? I'm not so sure. But again, I want to, I want to come back, and I keep coming back to this, that that what we're talking about here is simply databases and code. And that's all it is, all the time. And so the question is, how do we, how do we deal with this map? Matt Levine describes tokens as magic numbers or magic beans. They are kind of, they are just numbers, right. But they're particular numbers. So I think we have to be a little bit careful with how we think about this.

And technology has always spurred innovation. And it's not always the case that the technology that spurs the innovation survives. And I think it's, it's important to keep that in mind. And I think, Peter, you basically said that a minute ago. Now on who should regulate this, if you're going to regulate it, on this, I think that that that some of this is going to be difficult. I mean, you know, I view what happened at FTX as being I mean, we don't know a lot of the details, but it looks to me from my casual vantage point of reading everything I can find is that it's the, is that it's the early days of Bernie Madoff, and they just weren't able to keep it going. And, and who, so they could have had a lot of regulators if they but they could have also managed to hide it all. They just weren't able to hide it for very long, partially because they were doing their accounting on post-it notes, which I find to be just amazing.

Kelly Evans [00:41:01] But what about the FTT's token, Steve? I'd be curious if that itself should have somehow been quote unquote regulated.

Stephen Cecchetti [00:41:07] Well, the FTT tokens were a scam, and so it's hard to regulate, it's hard to regulate something that is they were like, I guess, I don't know, I think the again, the best thing, they were a lot like frequent flier miles with a secondary market where the issuer was, was propping up the value with occasional, with occasional repurchases in order to establish prices.

Now, if United Airlines were to start buying back its frequent flier miles in order, and creating a, and somebody, let's say me, were to create a secondary market, where would the regulator be? I don't know. I don't know who would, who is supposed to regulate? Who's supposed to regulate that? I don't think we have a frequent flier mile regulator. Oh, maybe we, and I guess I'm just—.

Kelly Evans [00:41:59] Does Peter think we need one.

Peter Conti-Brown [00:42:01] I don't think we need one. I think we have one, SEC. If they are—.

Stephen Cecchetti [00:42:06] Oh, it does the. I see. So you're saying that if the, if they had done what I'm suggesting, the SEC would have then intervened with United Airlines?

Peter Conti-Brown [00:42:13] I think frequent flier miles would be just a classic instance of a security like instrument, no doubt, whose value would be the function of the, the economic activities of the company.

Stephen Cecchetti [00:42:27] Right. But so then then the answer is that in those cases and frequent flier miles are legal, I just want to be clear, and they're not a fraud. And so the point is that in the cases where things are legal, we have regulations in place, and we have regulators in place. I mean, my my my sense is that it's the, that it is the SEC that that is on the, on the front lines here.

Now, I mean, the problem and again, Peter knows this far better than I do is, you know, if you try to count the number of, the number of financial regulators in this country, you get over 100 very quickly. I'm not exactly sure whether we have, whether you get to 150, but you're going to get close. And, and, and so that's a problem in and of itself is the fragmented nature of the system.

But the problems that we're describing exist in the UK too, where there are only two regulators and, and there, but I think that they, that they, they are going to be able, I think, to, to do this again without, they are not, they are likely to do it without additional regulatory requirements.

Kelly Evans [00:43:30] So if both of you think that it's likely the SEC ends up maybe with a specialized crypto unit here defining what is allowable with tokens, what is not and all the rest of it, that that might be one issue. There's, there's two more things I want to get into with the time that we have and one of them is probably the most important from a systemic point of view. And it's the question about Stablecoins. And you know, Steve, if you could address this, if regulators, and it looks like we were maybe getting close, you know, how should Stablecoins be regulated? Are they just money market mutual funds? You know, is that going to end up putting them within the existing financial system? In other words, should we, should we try to segment them as far away from the existing financial system as possible or give them some kind of rules so that people don't get burned?

Stephen Cecchetti [00:44:18] So I think I had a lot of sympathy for Jeremy Allaire of Circle's view that they wanted to be a bank. They this is the issue of USD coin. If you look at the structure of of their balance sheet, which you can actually see, it, unlike tether, is it looks to me like a narrow bank. And so I think that regulating them, I think that they should be forced into having bank charters and they should be regulated as banks because that's what they're doing. The that they're just providing a particular kind of liability that has specific properties, that allows for transfers of, of value, which of course, you know, as I say that if you think about it in a broad sense, that's what my bank is doing too. My bank is giving me is giving me a demand deposit, a checking account that allows me to transfer value in a particular way. This is just a somewhat different technology for doing exactly the same thing. So if we're going to do activity-based regulation— which I think we should be moving towards as much as as quickly as we can— it's clear to me that that stablecoins should be banks.

Kelly Evans [00:45:32] Peter, can you also address this question of stablecoins? And the most remarkable thing about the collapse of crypto over the past 12 months is that it happened without really affecting the broader financial system. Unlike the financial crisis of '07, '08, a lot of the same characteristics brought down the entire economy. So are stablecoins going to end up being this kind of— I don't know if Trojan Horse is the right term— but, you know, if we start regulating them, it seems like a small, you know, sort of almost side issue, but it actually ends up introducing crypto into the financial system in a systemically unstable way.

Peter Conti-Brown [00:46:09] So I'm with you until that last, that last clause. So I think that there are three options for us from a regulatory perspective for Stablecoin. First, you've covered, these are banks regulated as banks that should be required to get a charter that's an extremely expensive enterprise. It's a multi-year process, as many so-called neobanks and some some fintechs and in the crypto space have encountered cost millions of dollars. And I think it's great. And I think that that, if that were the way that Stablecoin resolved, I would be thrilled. I think that they do they look very bank like to me and I think having all of the supervision, examination, regulation, liquidity and capital regulations, insurance and the like would be, would be very healthy. But I think for a lot of stablecoins, maybe not the biggest ones, but for a lot of them there's simply no value in it. And that suggests that this might be something more of the regulatory arbitrage.

But the second still attractive to me, you mentioned it, Kelly, and that is that these are money market mutual funds. And that is also attractive, they're not regulated as such now and I think that they should at least be that. And that's a very different regulatory regime, you're not subject to anything like the examination scrutiny. You don't have the same kind of insurance commitments. But there is a regulatory mechanism in place, the SEC is designated as the primary regulator. The key legislation is the 40 Act rather than the 33 or 34 Act. And I think that that's, that could be really beneficial.

The third is where we are today and that a lot of Stablecoin enthusiasts insist that where we belong, which is this is something completely different, it's neither the first nor the second. I'm most skeptical of this. And so the Stablecoin question for me, to prevent them from being a vector from a, of contagion in a future meltdown would be through door A or door B. So that wouldn't facilitate the failure, it would help prevent it because it puts us within a financial ecosystem that we understand very, very well.

Banks are doing novel and innovative things all the time, but we still call them banks. We don't say, oh, this is a fancy bank, and this is a less fancy bank. We just say, oh, these are banks, they have different, they different financial services. And that's where I would love to see Stablecoin really emerging to maturity, which is to say, oh, you're a money market mutual fund, you're a different kind of one, but you are that or you're a bank. You offer different kinds of services, but you're still a bank. I think that's the best solution.

Kelly Evans [00:48:23] And Steve, can you address this question of if European regulators are moving ahead in regulating crypto? The, you know, what, the US at some point would follow suit, you think?

Stephen Cecchetti [00:48:35] I think that they will. I mean, the EU is very pleased with the fact that they seem to be out in front of this. They also, of course, you know the details of the law, they're already trying to, it isn't going to be implemented until 2024. So we'll see what's left by 2024. They also, it's also quite complex what they're trying to do. They have a bunch of different categories that they're trying to define things and we'll see whether and I'm afraid they may be missing some of them, so we'll we'll see, we'll see what happens.

My view is actually that they're going to, is that they're going to live to regret this because they're going to try and draw in things that they think are the higher quality, more legitimate things. And in my view, there isn't a whole lot of that out there. So, so I'm, I'm, I'm skeptical that this is going to work for them. It may very well drive other people to do something similar, however.

Kelly Evans [00:49:34] Should we, Peter, let them try this experiment and then learn from what they get wrong about it, if Steve's right.

Peter Conti-Brown [00:49:42] I love the idea of, of regulatory and supervisory dynamism. And so I think learning from this is vital. What I like less is starting from baseline of no regulatory or supervisory oversight. Then that's when the dynamism can, can impose those asymmetric risks where the upsides are privatized, and the downsides are socialized. Better if the socialized downsides— as we do within the banking perimeter— better to make sure that we understand just everything that we can about the process on the ride up.

Kelly Evans [00:50:20] Well, we only have a few minutes left and I thought I had my mind made up and now I'm not sure all over again. So if you guys wouldn't mind providing a closing statement in which, Steve, if you could start, lay out what you think the red line should be, what should we absolutely not do? What do you acknowledge we probably will do in the years to come?

Stephen Cecchetti [00:50:44] Oh, dear. Well, I think that, I mean, I'm, I'm perfectly, I think I'm going to lose, I think I'm going to lose the battle, first of all, I think there is going to be some form of regulation. And so then the question is, what's the regulation to put in place that that is the least, that is going to be the, the least damaging. And here I think I would, I think that Peter and I actually agree that, that creating a separate regulatory structure for crypto that's a light touch regulatory structure is, is inviting, is inviting disaster. I think this is also the view of, of our friend Hillary Allen at American University, who has written a very nice book called Driverless Finance, where she, she essentially says this is, this is, this is the worst the worst possible thing, the thing that can happen.

I think the other thing that, the other thing that we do need to do is we need to, we need to deal urgently with the risk that traditional leveraged financial intermediaries could get involved in this system. Because as you pointed out, Kelly, there was an enormous collapse while there was a boom and a bust over a period of probably— you know, we can decide how long, whether it was 12 months or 15 months or 18 months—a boom and a bust of incredible size, roughly from 1 trillion to 3 trillion and then back to 1 trillion and below over, over that period. And it seems to not have made a ripple in the, in the traditional financial system. I think that that shows that there wasn't much of a connection.

And I think we have to be very wary of those connections. And, and so we have to be able to monitor those connections, and we have to be able to ensure that if something does collapse in the crypto world, which is, if I'm right, is going to happen, that it doesn't infect the rest of the financial system, it doesn't do, as you pointed out, what the subprime mortgage crisis ended up doing in 2008.

Kelly Evans [00:52:58] Okay, great. Peter.

Peter Conti-Brown [00:53:01] My, my answer— and to convince you, Kelly, to my side— I think I've already got Steve onto my side, I see him more as, as a fellow traveler here, by the end. We must enforce existing laws. But there are big blanks in them. The theory of regulation that we have for the financial system is very strong. It's appropriate for us to consider securities differently from banking activities. It's appropriately for us, appropriate for us to consider money market funds differently from the traditional deposit issuing banks. But where crypto fits within that financial ecosystem has too many ambiguities for us to simply lie back and relax and let existing regulation do what it needs to do. So there are blanks to fill. Regulators should fill them.

Steve is right, we do agree, I do not think legislators should fill them. I think regulators should do what they are doing already and should continue to do and FTX should be a kick in their pants to make sure that if you're going to act and smell and pack like a bank, you need to charter. And if you're going to hock securities, then you need to register. And if we do that, I would think that 90 to 95% of crypto activity goes away. But that 5 to 10%, that makes me think of where the automobile was in 1902 or artificial intelligence, maybe it was in 1960 or some sort of goofy jetpack that simply is not ever going to happen was today. I don't have an opinion on that future, but I do have an opinion that there is something here that we should let play out. And in order to do that, we need regulators to prune that tree.

Kelly Evans [00:54:46] All right, so I can't resist a last comment. Almost, Columbo-esque. But, Peter, I'll confess, I'm a little bit more sympathetic to Steve's point of view, and here's why. Because the current system, as we know it seems to be safe from damaging the broader financial system and economy. But I grant that a lot of people got really burned by the collapse of FTX and some of these other institutions.

So I'm concerned that in trying to protect the little guy, if that's what we're trying to do, we're actually going to put the entire financial system at risk. And so when I listen to your arguments, what I hear is a case for enforcing the existing laws, but I feel like that's the same case that Steve is making. So I don't understand where the step forward is in regulating crypto that is a clear break from just enforcing the rules that we already have on the books today.

Peter Conti-Brown [00:55:40] Because on the books today we can't answer questions like even whether FTT is a security. We can't answer the question even today that when Celsius says, here's a deposit which you can write checks out of digitally, that offers 18%, whether that's a bank, we can't do it. We should be able to do it and it's not enough to stand patents say the existing rules are good enough. We can't even say whether or not these money launderers who are using the crypto ecosystem to transfer real dirty money should go to jail. And that to me, that requires answers. And if you agree with that, if you agree that we have problems to which we don't have answers, then you agree that we need to regulate in ways that we haven't done before.

Kelly Evans [00:56:22] And Steve, it's hard for me to imagine you would have a problem with doing that, simply spelling out what these are and, you know, making sure that AML applies. Is that to you, would there be any issue with that?

Stephen Cecchetti [00:56:35] Oh, absolutely not. I'd put it on, I'd put it, put it on billboards and make sure that celebrities are advertising in the Super Bowl.

Kelly Evans [00:56:47] So state your state then your final conclusion here, Steve.

Stephen Cecchetti [00:56:51] Oh, I think I did.

Kelly Evans [00:56:54] It, in the, in the sense that just and I'll put a pin on it, I'll turn it back over to David here. But if, if all we need to do is spell out what these tokens or, what counts, as you know, do that, fill that gap, and then fill the gap in which we say, you know, AML, all of that applies to these activities. Then does that, does that to you, count as regulation?

Stephen Cecchetti [00:57:15] I think it's going to all, I actually think it's going to all go away. I mean, this is because I think that it's basically a regulatory, since I believe that the entire, that the entire space is is a form of regulatory arbitrage in a casino as opposed, and some portion of it is is also is also illicit activity. But on this, I think that that there's, there's a bigger question as to how much of it is illicit activity that that if we were to enforce existing laws, that it would just disappear.

Kelly Evans [00:57:51] Hmm hmm. Hmm.

Stephen Cecchetti [00:57:53] I don't see the 5% that Peter sees.

Kelly Evans [00:57:57] Well, you guys give great quotes, I will say that. Thank you very, very much. This has been wonderful. I'll turn it over to David.

David Wessel [00:58:05] Thank you very much, Steve Cecchetti and Peter Conti-Brown for a lively and I think informative conversation. I'm kind of impressed with both your ability to state your positions clearly, but to have disagreements in a civil way, which in Washington we don't know how to do anymore. But I also think this format helps illuminate some of the issues that people ask me about crypto in ways that other formats don't. But I particularly want to thank Kelly Evans for such a great job of moderating. You must have had a great training as a journalist, Kelly.

Kelly Evans [00:58:37] For those who don't know, David taught me everything I know, literally, that's not an exaggeration.

David Wessel [00:58:42] I was Kelly's first boss at the Wall Street Journal, and I take full credit for all of her success that followed that. So with that all, thank you all. Have a happy holiday season and I'm sure we'll be joining this conversation again in the future.

Kelly Evans [00:58:58] Thanks so much.