

## **Exchanges at Goldman Sachs**

**What's next for crypto regulations?**

**Jay Clayton, Former Chairman,**

**Securities and Exchange Commission**

**Timothy Massad, Former Chairman,**

**Commodity Futures Trading Commission**

**Marcel Kasumovich, Head of Research,**

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**Allison Nathan:** Cryptocurrency exchange FTX, once considered one of the most reputable exchanges in the crypto business recently collapsed in stunning fashion. This comes on the heels of several other recent crises in crypto, including the crash of Terra's Luna stablecoin and the failure of Celsius, a crypto lending platform. Not surprisingly, this turmoil has raised questions about the regulatory landscape for digital assets.

I'm Allison Nathan and this is Exchanges at Goldman Sachs.

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On this special episode, we're breaking down our most recent Top of Mind report now available on GS.com. We dig into what the regulatory landscape for digital assets looks like today, what it may be lacking, and how that can be fixed. We first speak with Marcel Kasumovich, head of research for digital investment manager One River Asset Management. He believes that the problem with US crypto regulation isn't a lack of regulatory oversight, but a lack of regulatory clarity.

**Marcel Kasumovich:** The US crypto space is heavily regulated, right? You have OFAC, FinCEN, the SEC [PH], CFTC, they're all engaged. And the fourth largest creditor in the BlockFi bankruptcy filing is the SEC. They're still owed \$30 million of the \$100 million fine that they gave to BlockFi for violating what they thought was two forms of regulation. They had to \$50 million fines. 70 of that was paid. 30 is remaining. So, the SEC is the fourth largest creditor in that filing, which is very interesting.

So, they're regulated. It's not that there's an absence of

regulation. There's an absence of regulatory clarity. That absence of regulatory clarity pushed a lot of the risk taking offshore into non-US entities. So, that's why the Bahamas became home for FTX.

If you want to trade options markets in digital, you have to do that offshore. Deribit controls 95 percent of the open interest in options. So, that is the market. Onshore US persons cannot engage with that exchange by regulatory decree.

**Allison Nathan:** But Jay Clayton, former chairman of the Securities and Exchange Commission believes the argument that the US regulatory landscape lacks clarity is, in his words, garbage. At the center of the debate is whether digital assets are considered securities, and entities that trade them should therefore be regulated by the SEC or commodities which are regulated by the be Commodity Futures Trading Commission.

Commodities regulation is apparently considered less onerous because the CFTC only has oversight over commodity derivatives, not the spot markets that underlie them. And the vast majority of crypto trading today occurs

on a spot basis.

Clayton believes most crypto coins are securities. So, he thinks the regulations are clear. And he says, "calls for more clarity are in many cases just an attempt to avoid the high cost of regulatory compliance for securities."

People have made the point that the lack of regulatory clarity in the US has pushed a lot of the activity and risk taking abroad. Do you agree?

**Jay Clayton:** Let me just be very direct. It's garbage. These are not calls for regulatory clarity. The law is words. And then the law is enforcement. And the law is oversight.

There is no greater place of enforcement and oversight than in the US regulated financial markets. The regulations are very clear. People just don't like them.

We have an incredibly rigorous, very paternalistic regulatory regime for financial services in the US. The amount of time and money that financial intermediaries spend on compliance and ensuring that products are suitable or advisable for their clients is enormous. We've

decided that's how we're going to run the railroad in the US.

Crypto comes in and says, "You know what, that's a very inconvenient way to the railroad." It may be it reveals just how hard it is for retail investors to access private, unregulated investments. That's a choice that we have made. But it's not unclear.

Now, some people have said there are some digital assets that should not be regulated as securities, but rather should be regulated as commodities. And they look at the fact that bitcoin was designated as a commodity some years ago. And they try to argue that many digital assets should have commodity-like regulation, rather than securities-like regulation. And say, "Oh my gosh, there's this big uncertainty."

Two points. One, most of them are clearly securities. The SEC has won a number of cases demonstrating that. The second thing is, when you're trading things on platforms, that in itself is regulated. And commodities trading and futures trading is regulated. So, this claim of uncertainty is, in many cases, really a thinly veiled attempt to avoid

regulation. And it should be called out as that.

There's a lot of hype, there's a lot of craze around crypto. Which has also led to a lot of, I would say, confusing and baseless claims about lack of jurisdiction or lack of authority. In the United States, we have a multifaceted regulatory regime. You have the Fed, the CFTC, the OCC, the FDIC. There are not many gaps. There are many more overlaps than there are gaps.

**Allison Nathan:** Timothy Massad, former chairman of the CFTC agrees that the lack of clarity argument is overblown. But he argues that the US regulator framework for crypto is woefully inadequate to protect investors. That's because, he says, even regulated crypto exchanged in the US are only subject to antiquated state money service laws.

**Timothy Massad:** I think lack of regulatory clarity argument is overblown by some people in the crypto community. I think they're using it as a reason not to comply because costs of compliance can be significant. The basic challenge is that investor protection standards that we've developed through decades of experience in the securities and commodities derivatives markets aren't

being observed in the crypto market.

Most big trading platforms in the US are regulated only under state money service business laws. Those laws do trigger the application of federal anti-money laundering requirements. But otherwise, those laws are completely inadequate to setting investor protection standards. They are really very light touch kinds of laws that originated in the telegraph era. Literally. They were designed to regulate Western Union because it had offices in different places and it was wiring money from one to the other.

It's like saying the stock market was well regulated prior to 1929 under state blue sky laws. Not really.

**Allison Nathan:** I think asked Massad about the debate around the classification of digital assets and why commodity spot markets aren't regulated at the federal level.

**Timothy Massad:** The reason trading venues in crypto aren't observing standards that we've developed over the years that apply to the securities markets and the derivatives markets is because we argue over do the tokens

fall in the securities bucket? Or do they fall in the commodities bucket?

Exchanges have argued they're not trading securities. So, they haven't registered as securities exchanges. There are trading commodities, but then there's no federal regulator of the spot market for commodities. So, a lot of people in the crypto industry have avoided regulation.

**Allison Nathan:** Why is there no federal regulator for the commodity spot market?

**Timothy Massad:** You've got to understand historically why that is. We never saw a need for a federal regulator of spot commodity markets. Because when you think about the way these markets evolved, they were local. And they were physical. In other words, I often explain to people, look, the fact that the CFTC regulates commodity or crypto derivatives, but it doesn't regulate the buying and selling of crypto is similar to the fact that it regulates cattle futures, but it doesn't regulate the buying and selling of cows. No one would ever think that the CFTC should regulate the buying and selling of cows.



With crypto, this emerged as a financial instrument from the start. It was a global financial instrument. It was a retail financial instrument. But our framework of commodity regulation was always just federal regulation at the derivatives level. It was never federal regulation at the spot level.

**Allison Nathan:** What's the fix for some of these perceived issues? Kasumovich thinks more regulatory clarity will help bring risk taking back on shore within the reach of US regulators. He believes this regulatory clarity is coming. Here he is again.

**Marcel Kasumovich:** We have regulatory clarity around bitcoin. It's considered a commodity. We'll get regulatory clarity around stablecoin through both the Fed and stablecoin legislation next year. And I think in the context of forward regulation, we're going to have a lot of hearings tied to FTX. I think we'll see accelerated movement on regulatory legislation. And I suspect judging by the nature of the hearings, Senate agriculture is driving the process.

CFTC reports into the agriculture group. SEC reports into Senate banking. So, Senate ag is driving the hearings. So, I

think we're going to see regulatory clarity with the CFTC playing a much more prominent role.

And then we have existing legislation. Stabenow, who's the chair of Ag committee, she has a bill out. Lummis and Gillibrand have a bill. So, you have movement on that side that will bring clarity.

**Allison Nathan:** Why has it taken so long to get that clarity?

**Marcel Kasumovich:** It puzzles me a bit because if I think of something like custody, so, what's really important to an institution? The custodial relationship. They're not going to self custody the asset. So, you and I may. But there's no way a pension fund is going to self custody. So, they need a custodial intermediary. And we still don't have crystal clear guidance on that issue. It would have to come through the custody rule. Custody rule has not been revised to make it clear where digital assets sit inside of the custody rule. That's an SEC provision.

And then you take a step back, and you ask yourself, okay, why is it taking ten years for the custody rule to

incorporate digital? I suspect it's that the vast majority of people presumed that digital would just disappear.

So, why are we jumping through all of these hoops in terms of regulating an asset class that's not going to exist? Which is, by the way, the current position of many prominent economists and scholars. There was an FT article that says "let it burn" for crypto. So, it's just, enh, let's do nothing. So, I think it's been slow in large part because people really didn't believe the asset class was going to be here as long as it has.

**Allison Nathan:** But doesn't the "let it burn" camp have a point?

**Marcel Kasumovich:** Where I think the "let it burn" camp gets its spot on is be grateful that FTX is not a systemic risk. So, digital has not penetrated FIAT [PH] from a systemic risk standpoint. For sure. We want to make sure that's the case.

Now, if you take the "let it burn" view to the limit, do we want to have this thing completely unregulated? If we just want to make it buyer beware and SEC and OFAC and

everyone else disappears, this asset class will explode to the upside. And the innovation will be rampant. The untoward activities will be rampant. And you'll end up with a transformative technology that may not be used for good. I don't think they want that.

If the point of the piece is let's make sure digital and FIAT don't mix until we know what this is, you need regulation to do that. If there were no regulatory [UNINTEL], banks would have been involved by now. For sure. Look at BNY Mellon. They have a terrific custodial solution that the SEC basically shut down with SAB 121. Staff guidance 121 basically said digital custodial assets have to be held on balance sheet. That takes banks out of the business. Banks have capital charges against gross balances. So, you're out of the game. So, you've separated FIAT from digital very clearly. That makes sense to me. That is just bidding time until you get regulatory clarity.

So, if you want to take all that stuff away, then it's almost certain that FIAT and digital will bleed into one. And I don't think that's the point of the piece. So, I think on that side, they're just horrible misguided.

**Allison Nathan:** If there is more regulation onshore though, won't that actually be an added incentive for people to move offshore?

**Marcel Kasumovich:** Is it the million-dollar question. How do we regulator in a manner that encourages innovation but doesn't thwart risk taking? And I think we can find that balance. I really do.

You will definitely have an onshore and offshore market emerging. Stablecoin is a great example. Tether is the dollar unit of collateral for the Asia system. And it's probably going to stay that way. But it will never trade in the US. It's just never going to cross the regulatory threshold to be a dominant stablecoin in the US.

So, I think we'll end up with this delicate balance where you will have these offshore markets, but for the ecosystem to achieve what people hope for it to achieve, which is, let's say, institutional adoption, you're going to have to enter the regulatory mainstream.

**Allison Nathan:** Clayton, for his part, sees value in addressing the lack of federal regulation over commodity

spot markets. But he believes the primary focus of US regulators should be enforcing regulations already on the books.

**Jay Clayton:** To the extent that something is a commodity and is trading on a platform on a spot basis, which is an area where regulation is quite light today, we should consider adding regulation there. But I think that is a narrow fix.

The regulations that are on the books should be enforced. Trading platforms that are trading securities should come into compliance with the ATS and other [UNINTEL]. I'm very proud of the crack down that we did on ICOs, initial coin offerings, in 2017/2018.

The second area to focus is stablecoin because there are many, quote/unquote, "stablecoins" that have unstable features. And to the extent they have unstable features, it's usually because you're taking counterparty your credit risk. We regulate counterparty credit risk in the United States. We should go out and regulator counterparty and credit risk in stablecoins and also define where a, quote/unquote, "stablecoin" is truly stable. Like a bank

deposit or a one-to-one backing with cash.

So, those are the two areas where I think regulators should focus in the near term.

**Allison Nathan:** Clayton believes the SEC and CFTC should work together to achieve this as they've done several times in the past.

**Jay Clayton:** The SEC and CFTC absolutely have to work together. And they have overlapping jurisdiction. There are lots of things that overlap between the SEC and the CFTC's jurisdiction, as most financial institutions and long-time financial players know full well. In the swaps market that covers securities, there's a great deal of cooperation. A large swath of Dodd-Frank required joint [UNINTEL] because the CFTC and the SEC because their jurisdictions overlapped.

**Allison Nathan:** There's also this role for legislation.

**Jay Clayton:** One of the things about Washington is there are lots of proposed bills. There are lots of proposed talk. At the end of the day, the percentage that actually moves

through the system to become law is fairly low. So, waiting for Congress is sometimes waiting for Godot.

With that perspective, waiting for legislation is generally not a winning strategy. When you're running an administrative agency, your job is to try and enforce the law, bring discipline and rigor to the market as best you can.

That said, let's separate the legislation to a few categories. There is legislation that would encourage force incentivize cooperation across federal financial regulators. Okay, that's a good place to start. There's targeted legislation that deals with the integration of new technology into existing laws and regulation. So, for example, how do you custody a digital asset? Whether a stablecoin with particular characteristics should be considered a security like a mutual fund or should be considered a deposit like a banking product, those discreet fixes or clarifications around the accommodation of digital assets in our existing laws, those are part of legislation.

And then there are comprehensive bills around creating a new regulator or a new regulatory scheme for digital assets.



I think the first two have some significant chance of going through. I think the last, and you can always be surprised by Washington, is remote at best.

**Allison Nathan:** Massad also believes the SEC and CFTC should work together to strengthen investor protections in the crypto space. Here he is again.

**Timothy Massad:** Jay Clayton and I have proposed that the SEC and the CFTC could get together and set common standards for the crypto spot market. Agencies should just get together and say, "We want these standards followed while we sort out whether these are securities or commodities."

The standards are, in many ways, very similar in both the securities market and the derivatives market that we need followed here, right? They are the standards that are designed to protect customer assets, prevent fraud and manipulation, prohibit conflicts of interest, and ensure operational resilience. Things like that. Those are the standards we need followed. The SEC and the CFTC should develop these standards and basically tell the trading venues, "We won't shut you down. We won't come after you

if you implement these standards. And we may still later say you really are trading securities. You've got to register as securities." This would be a way to substantially improve investor protection in the near term.

The longer-term fix might be that Congress codifies this in some way. I've written a paper with a similar argument with Professor Howell Jackson at Harvard where we argue this could be done by setting up a joint self regulatory organization. People often misunderstand what self regulatory organizations are in this country. That does not mean the industry goes off and regulates itself. It means that you form an entity that is under the jurisdiction and supervision of a regulatory agency. But it brings in people from the industry to formulate rules that are then approved by the regulatory agency. And then the self regulatory body enforces those.

FINRA is the classic example. The National Futures Association is another. Those self regulatory organizations have been incredibly important in the development of our securities and derivatives markets. But they only work if they are tightly supervised by the government.

William O. Douglas, the former Supreme Court justice before he was on the Supreme Court was chair of the SEC. And it was really under his tenure that self regulatory organizations were developed. And he said, I'm not going to quote him exactly, but he said the only way this works is if the government has a shotgun, a well-oiled, cleaned, loaded shotgun in the room ready to use. Meaning you've got to exercise supervision over the self regulatory organizations. So, that's the method that Professor Jackson and I have talked about.

You're getting some industry expertise, which is good, particularly when it comes to challenges like how do you implement standards for decentralized finance platforms? You also make the industry pay for it this way. So, that's a benefit too. The SEC and the CFTC have the authority today to create a joint self regulatory organization that could do this.

And there are self regulatory organizations that are registered in both agencies today. So, there is precedent for this.

**Allison Nathan:** Massad believes that such an agency

would effectively protect crypto investors, despite the global nature of digital assets.

**Timothy Massad:** Regulation is always implemented through national authorities. And crypto is a global market. So, that's always going to be a challenge. And you need to have similar types of regulatory frameworks in other countries as well.

But we've faced this kind of problem before. We faced it with swaps [PH]. That's one of the main things I did at the CFTC. Over the counter swaps were unregulated. We developed some standards that the G20 leaders agreed to. Each nation then went and implemented those standards in its laws. And then we tried to harmonize all those laws and regulations. Took a long time. But we eventually got to a framework that's pretty harmonized. And I think most people agree it's pretty effective.

**Allison Nathan:** A lot of jurisdictions that crypto is trading on are not part of the G20.

**Timothy Massad:** People made the same argument about swaps. Oh, they'll move to jurisdictions that aren't going to

follow these principles. But there are ways that then you can deal with that. You can restrict access. You can restrict relationships with platforms based in those jurisdictions.

The same issue came up when the SEC went after coin offerings. Everybody said, oh, the coin offerings are just going to move offshore. And that didn't really happen either.

**Allison Nathan:** Despite these different views, our interviewees agree that the technology itself didn't fail during the recent turmoil. And the innovative potential of blockchain technology to improve our financial system and beyond remains significant and remarkable. Here's Kasumovich again.

**Marcel Kasumovich:** Think of what we're building on. We're building on base layers. So, we have two dominant base layers right now: Ethereum and bitcoin. They're being used for different things. Both operated 24/7 through the downfallen FTX. From a settlement's perspective, we're settling billions of dollars of transactions on those rails every day with no intermediation. Which is really quite incredible.

From a bitcoin perspective, that's all being done with the incentive structure through proof of work. The protocol math is on track to incentivize miners to the tune of \$10 billion this year. The technology has proven incredibly resilient.

**Allison Nathan:** And here's Clayton.

**Jay Clayton:** The promise of distributed ledger technology is remarkable. If you look at the transactions that are taking place around the globe 24/7 with very low friction in and out of financial products, it demonstrates that the opportunity to add efficiency to our traditional financial markets and others is vast. That's undeniable.

But we're not going to give up, what I would say, is a proven and widely accepted regulatory framework in order to achieve those efficiencies as quickly as possible.

**Allison Nathan:** Gary Gorton, professor at Yale University also sees the potential for blockchain technology to improve the efficiency of the financial system. But he worries that the technology could penetrate the real world before

regulators are ready and ultimately cause a future financial crisis.

**Gary Gorton:** The technology is such that it's not interoperable with the real world right now. Crypto platforms, you give them money and then they trade colored beads with each other. They can't create value other than taking people's money. But the technology will change and it will become interoperable.

Blockchain is going to effect the payment system, and particularly internationally, and that, I think, is an inevitability. So, then there's going to be a link between crypto and the real world. And that's where the value of blockchain really lies, right? We don't really care if they're off there trading with themselves. That's a game. But we do want the technology to be useful.

So, I'll give you an example. Many global supply chains now use blockchain to keep track of things. And the correspondent banking network which is used for international payments is extremely inefficient. With blockchain we can avoid the whole inefficiency of the correspondent banking system.

The link between the real world and crypto, I think, is mostly going to happen through stablecoins. And that's a problem precisely because stablecoins are vulnerable to bank runs. Stablecoins purport to have assets that back their coins one for one. And they release these account reports every so often. But we don't really know whether they do or not.

Stablecoins are the first time in 150 years that we see a privately produced circulating money. We already answered that question. It's bad to have that. And it's bad to have that because of financial stability reasons. That's why every country has a monopoly over cash production. And that's the basis for me saying we should have a Central Bank digital currency. It's the same as saying we should have government cash and not private bank notes like we did before the Civil War.

But I think the world is a completed place with lobbyists and people don't understand the issues. So, I think there'll have to be a financial crisis.

**Allison Nathan:** With questions about the regulatory



oversight of digital assets and the future of the crypto ecosystem sure to remain in focus, we'll continue to keep a close eye on it all. I'll leave it there for now.

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