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Beware the Proposed US Crypto Regulation— It May be a Trojan Horse

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Opinion **Cryptocurrencies**

Beware the proposed US crypto regulation – it may be a Trojan horse

Creating a bespoke regime will inevitably become a route for traditional financiers to avoid their own tougher rules

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There is a danger that crypto legislation, such as that proposed for stablecoins, is misinterpreted as a government seal of approval, encouraging sceptics to invest their money © JinOdin/Alamy

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Following the spectacular failure of crypto exchange FTX International, there have been renewed calls for crypto legislation (including from the industry itself). But many of the proposals so far would be worse than the status quo — at least for the general public. Crypto firms such as FTX were involved in drafting many of the mooted US bills. The exchange's implosion should not become a pretext for rushing these into law.

It is unfortunately true that many of FTX's users have suffered mightily. The good news, though, is that the broader economy hasn't suffered as a result of its failure (the economic fallout from crypto flops such as Terra/Luna and Celsius this year was similarly limited). Since crypto isn't integrated with the traditional financial system, the pain has not spread to those who chose not to invest in crypto in the first place.

US banking regulators in particular have stood firm against the merging of crypto with traditional finance. Legislation that legitimises crypto could very well break this down, in which case future crypto failures will be more likely to disrupt broader economic growth. Government officials may even feel compelled to step in with bailouts when the next crypto firm implodes. Policymakers should beware legislation that positions crypto as yet another financial market that is "too big to fail".

There is also a danger that crypto legislation may be misinterpreted as a government "seal of approval", encouraging sceptics to invest their money. This is particularly a risk of the proposed stablecoin legislation. Right now, the primary use case for stablecoins is speculating in decentralised finance, not — as is often claimed by industry proponents — for making payments. Stablecoins are not a great way to make payments for a number of reasons, but the proposed bills would all extend some form of government safety net to them. If that encourages people to start using them for payments, then it potentially puts governments and central banks on the hook in the event of future stablecoin runs.

Legitimisation is not the only Trojan horse embedded in these crypto bills. Any legislation that creates a bespoke crypto regulatory framework will create opportunities for traditional financial assets to migrate into the new regime and so sidestep existing financial regulation. This problem is unavoidable because it's impossible to define "crypto asset" (or "digital asset" or "digital commodity") in a way that excludes traditional financial assets.

Ultimately, there's nothing particularly special about crypto assets. They are just computer files, whose ownership is recorded on a blockchain (a type of database). Pretty much any financial asset could be represented as a computer file, and the ownership of any such computer file could be recorded on a blockchain. If the bespoke crypto regulatory regime is "lighter touch" than those for other financial assets, it's going to be tempting for financial asset providers to put those assets on the blockchain (something that JPMorgan is already experimenting with).

Not only is this a path to deregulation, it is also a path to shakier financial infrastructure. Traditionally, providers of critical infrastructure are subject to stringent regulation. By contrast, blockchains are open-source software, maintained by unidentified and unaccountable core software developers. Do we really want our financial system to rest on such shaky foundations?

It's not yet entirely clear what happened at FTX, although many reports suggest illegal activity was involved. The US Securities and Exchange Commission, Commodity Futures Trading Commission and the Department of Justice are already investigating — and within the existing legal framework. If any new legislation *is* adopted after FTX's failure, that legislation should make clear that existing laws apply to crypto (and if a crypto product or service can't comply, then it shouldn't exist). This is not the time to adopt new crypto legislation drafted at the industry's behest.