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Cryptocurrencies Highlight The Need To Restructure Fin-Reg Framework

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In 2008, the world's first cryptocurrency – Bitcoin – was little more than an obscure idea. Now, a decade later, more than 1,600 different cryptocurrencies exist. Their total market value? About $300 billion.

Equally amazing is the fact that their underlying technology has helped spawn a race to develop all sorts of applications. That technology – the blockchain – offers the opportunity to directly transfer—and track—any sort of asset that can be digitized without a third-party intermediary. Today, people are trying to improve everything from stock purchases to real estate title transfers with blockchains, and they are facing all sorts of regulatory challenges.

As this process unfolds, many entrepreneurs have started using an initial coin offering (ICO) to raise startup funds. The ICO is similar to an initial public offering (IPO), but ICO investors are promised a digital token that can later be used on the application which is being built. In the first half of 2018, investors poured in more than $13 billion in ICOs.

The ICO provides a great example of the regulatory challenges surrounding cryptocurrencies. For instance, many ICOs look very much like a securities offering, suggesting anyone conducting an ICO should register with the Securities and Exchange Commission. Many other ICOs, however, do not seem to fit the securities mold.

Last week, the Cato Institute hosted a Capitol Hill briefing titled "Should Cryptocurrencies Be Regulated like Securities?" The short answer is: It depends.

As Mercatus' Brian Knight pointed out during the Cato briefing, cryptocurrency can be many different things – money, a security, property, and a commodity – all at the same time. In the U.S., that means multiple regulators (at the federal level: the IRS, FinCEN, the SEC, the CFTC, the CFPB, the FDIC, the OCC, or possibly the Federal Reserve) could regulate any given cryptocurrency.

That fact alone presents a problem. Moreover, Knight pointed out, these new technologies are pushing up against the bounds of a regulatory framework developed long before anyone had even thought of cryptocurrency. The core of federal securities law was written in the 1930s.

It is now entirely possible that someone issuing a token via an ICO could comply with all federal securities laws, yet run afoul of state money transmitter laws, thus triggering both state and federal criminal charges (go to the 23 minute mark). It is also possible that a money transmitting business could be in compliance with all money transmitting laws but run afoul of securities laws.

Brian suggested that policymakers think about whether this system is a good regulatory design. He recommended that Congress clarify some of these laws based on the underlying right that a given digital token represents. I agree with Brian, but would also go much further: Congress should scrap the whole system – banking and securities law – and start over.

Congress is not so good at making wholesale changes such as these, but there are many ways to improve the system, so that financial markets can more easily expand economic opportunities and help people achieve financial security. In 2017, The Heritage Foundation published a 23 chapter book filled with ideas; a few months prior, Mercatus released a 17 chapter book filled with proposals. There are too many ideas to include in this column (or to include in just two books), but here is a short list.

1. **Shrink regulatory discretion and micromanagement.** One of the main reasons the U.S. regulatory regime has been counterproductive for so long is because it empowers agencies to micromanage people's financial decisions—a process that substitutes regulators' judgments for those of private individuals. This approach has restricted competition and innovation while failing to deliver on safety. It also provides a false sense of security; compared to other actors in the market, regulators do not have superior knowledge of future risks. Congress should allow regulators less discretion and bar them from deciding which investments have merit. SEC Commissioner Hester Peirce's recent dissent in the bitcoin ETF case provides the perfect case study in how these aspects of the current system are counterproductive.

2. **Eliminate some regulatory agencies.**S. financial markets do not need to be regulated by every state as well as nearly 10 federal agencies. Maybe the U.S. does not need to consolidate into one super regulator like the U.K. did, but there is no good reason to have more than one federal banking regulator, or more than one capital markets regulator. Similarly, there was no need for the Bureau of Consumer Financial Protection, given that the Federal Trade Commission's mission is to protect consumers.

3. **Narrow the scope of consumer protection laws.** Consumer protection laws should focus on protecting consumers (and business owners) from fraud. In a sensible world, fraud would be limited to misrepresenting facts and misleading people, but the legal concept of fraud in financial markets has expanded well beyond such a practical point. Many financial companies now hesitate to make loans because the default presumption is often that a lender is trying to abuse the borrower by making a loan. Eliminating recent changes to the law would leave Americans fully protected against unfair, deceptive, and fraudulent practices.

4. **Narrow the scope of securities laws.** Securities law should remain focused on (1) deterring and punishing fraud; and, (2) fostering reasonable, scaled disclosure of information that is material to investors' choices. Currently, securities issuers have to disclose so much material that it makes it difficult for investors to find relevant

information. Companies will disclose relevant material regardless of the requirements because it is in their interest to do so. (In fact, many of the original disclosure laws provided no new public information and served only to protect large investment banks from competition).

5. **De-criminalize the use of money.** The Bank Secrecy Act/Anti-money laundering laws have effectively criminalized the use of money, and the presumption of innocence is all but gone. These laws force financial firms to file millions of reports per year on law-abiding citizens; it's incredibly expensive and appears to have been an enormous waste of resources. Surely Congress can develop better ways to help law enforcement catch criminals while allowing financial technology companies to prosper.
6. **Let financial firms be financial firms.**S. banking law remains stuck in the 1930s with regard to which functions banks should perform. All financial intermediaries function by pooling financial resources of those who want to save, and funneling them to others that are willing and able to pay for additional funds. This fact should be the underlying principle behind U.S. financial laws. It was never a good idea to restrict banks to only take deposits and make commercial loans, and doing so makes markets less stable. Congress can fix this problem by repealing the remaining sections of the horribly misguided Glass-Steagall Act and the pointless Volcker rule.
7. **Create new federal financial charters.** Even without rewriting the entire code, Congress could create new charters for financial firms. I've proposed one plan, but many versions of this idea could provide forward-looking entrepreneurs a way to prosper in the financial sector. For instance, Congress could allow smaller banks and credit unions to mutualize and begin their own private mortgage securitization market. A new charter could explicitly allow for such operations in return for certain capital or risk retention requirements. The charter could also allow these smaller institutions to offer a broad array of financial services, thus making it easier to innovate – or simply partner with FinTech companies – and to fill niche markets that larger banks tend to ignore. This approach would leave the U.S. banking sector bifurcated for now, but the country's largest banks have wholly bought into the existing massive regulatory framework. So let the biggest banks watch while smaller firms provide more of what the next generation of customers need.

This kind of framework would do a much better job of fostering access to financial services because it would not be openly hostile to the people who provide such services. It would provide a more traditional limited approach for regulators, thus acknowledging that the best government can do is provide a clear legal framework for people to gather information and make their own decisions. It would treat people like adults.

The tide of financial regulation has risen steadily since the early 1900s. It's well past the time to try a new approach.