

# Consumer Finance Monitor (Season 6, Episode 32): A Deep Dive Into Cryptocurrency and its Risks to Investors and the Banking System, with Special Guest, Arthur E. Wilmarth, Professor Emeritus, George Washington University Law School

Speakers: Alan Kaplinsky and Arthur Wilmarth

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly show brought to you by the Consumer Financial Services Group at the Ballard Spahr Law Firm. I'm your host, Alan Kaplinsky, the former practice group leader for 25 years, and now Senior Counsel of the Consumer Financial Services Group at Ballard Spahr and I'm very pleased to be moderating today's program. For those of you who want even more information, don't forget to go to our blog, [consumerfinancemonitor.com](http://consumerfinancemonitor.com), the same name as our podcast show. We've hosted the blog since 2011. We actually launched it on the very same day that the CFVB became operational, July 21st 2011. There is a tremendous amount of relevant industry content on our blog.

We also regularly host webinars on subjects of interest to those in the industry. If you want to subscribe to our blog or to be on the mailing list to receive invites for our many webinars, please visit us at [ballardspahr.com](http://ballardspahr.com). If you like our podcast show today, please let us know about it. Please leave us a review on whatever platform you use to obtain your podcast. Be it Apple Podcasts, Google Play, Spotify, or wherever. Also, please let us know if you have any ideas for other topics that we should consider covering or speakers that we should consider as guests on our show.

Turning to our program today, I'm very pleased and excited to be joined by somebody who's been a friend of mine for well over a decade and that is Professor Art Wilmarth, Arthur Wilmarth, who is Professor Emeritus at George Bus Washington University School of Law.

He was a member of the faculty at GW Law School from 1986 to 2020. He joined GW Law School's faculty after spending 11 years in private law practice, including as a partner in Jones Day's Washington DC office. He served as executive director of the Law School Center for Law Economics and Finance from 2011 to 2014. He is the author of *Taming the Megabanks: Why We Need a New Glass-Steagall Act*, which is published by Oxford Press in 2020, and co-editor of the *The Panic of 2008: Causes, Consequences and Implications for Reform* published by Edward Elgar in 2010. He's published more than 40 law review articles in book chapters in the fields, a field of financial regulation and American constitutional history. In 2005 the American College of Consumer Financial Services lawyers awarded him its prize for the best law review article published in the field of Consumer Financial services law during the previous year.

He has testified on financial regulatory issues before committees of the US Congress and the California legislature. 2010, he was a consultant to the Financial Crisis Inquiry Commission, the body that got established by Congress to report on the causes of the financial crisis of 2007 to '09. He is also a member of the International Advisory Board for the *Journal of Banking Regulation*. One other thing that, not on his bio, but how I got to know Art Wilmarth was for the work he did as outside council to the conference of State bank supervisors, CSBS, and very often in my practice I had issues that involved the conference and Art would be brought into the discussion by his client.

What we're going to be talking about today is a very recently written law review article that will very soon be published by the *Washington University Law Review* and the title of the article is *We Must Protect Investors and our Banking System from the Crypto Industry*. One would never know after reading this article that Art had retired from teaching at the law school because it is a, I would say a magnum opus is. It's a lengthy law review article, but with a tremendous amount of thought leadership

being given to this very naughty problem that seems to go on and on as to how we should be regulating crypto. No doubt we're already well behind the eight-ball, but that's usually the case when Congress tries to catch up with any kind of major technological development. Before we talk about your article, Art, it's really great to connect with you again and congratulations on this article, which I think is really going to sharpen the focus on what we ought to be doing with respect to crypto.

Arthur Wilmarth:

Many thanks, Alan. It's a great pleasure to be with you and with your audience and I certainly am very grateful to you for your interest in my article and giving me a chance to talk about it.

Alan Kaplinsky:

As a note to our listeners, my interview with Professor Wilmarth was recorded shortly before July 31. On July 31, after we recorded the podcast with Professor Wilmarth, a very important new opinion was issued by Judge Rakoff of the US District Court for the Southern District of New York on the question of whether cryptocurrencies should be treated as securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. In a case called SEC, Securities Exchange Commission, versus Terraform, that's T-E-R-R-A-F-O-R-M, Judge Rakoff denied Terraform's motion to dismiss the SEC'S complaint. The SEC alleged that Terraform issued five cryptocurrencies, the TerraUSD stablecoin, the LUNA digital token, and three other digital tokens that were securities under the 1933 and the 1934 acts. Judge Rakoff determined that all five cryptocurrencies were securities, whether they were purchased by institutional investors directly from Terraform or by retail investors in transactions with third parties.

Judge Rakoff strongly disagreed with Judge Torres's distinction in the Ripple case between institutional and retail investors. And you will note later in my interview with Professor Wilmarth, the professor gets into a lot of detail about the Ripple case. Judge Rakoff placed great emphasis on Terraform's public statements that the value of its tokens would increase as Terraform's ecosystem grew, and that Terraform would reinvest profits from sales of its tokens in order to expand its ecosystem and make it more valuable. Judge Rakoff concluded that Terraform's public representations caused both institutional and retail investors to expect that the value of their tokens would increase based on Terraform's efforts to expand its ecosystem.

I would note also for our listeners that this week we published on our blog, Consumer Finance Monitor, a discussion of Judge Rakoff's opinion in the Terraform case. We also pointed out something that I didn't get into with my interview with Professor Wilmarth. That to the extent that Judge Rakoff is correct, that these cryptocurrencies constitute securities, then that should eliminate the issue of whether or not you need to be licensed as a money transmitter under state money transmitter laws. And Lisa Lanham in our group, that is involved in the licensing practice, has made that point. That this difference of opinion in the Ripple case and now the Terraform case of two judges, both in the Southern District of New York, has also thrown this licensing, state licensing issue into somewhat of a cocked hat. My words, not the words of Lisa Lanham.

So the only other thing that I want to mention about this before we launch into my interview is that last week, Coinbase, which is a crypto exchange, filed a motion in the Southern District of New York to dismiss the SEC's enforcement action against Coinbase. The district court in the Coinbase case will have to address the conflict now that exists between the Ripple and the Terraform decisions.

Before we launch into a number of topics I want to discuss with you, even though the paper hasn't yet been published by the Washington University Law Review, it can be downloaded free of charge from the Social Science Research Network. If you go on that network and you do research under Arthur Wilmarth, I assume that your article will pop up and then it can be downloaded.

Arthur Wilmarth:

Yes.

Alan Kaplinsky:

Okay, great. All right, so in your article, Art, you make a distinction between, in talking about crypto, about the two major types of cryptocurrencies, the so-called fluctuating value cryptocurrencies and stablecoins. Can you explain to our listeners what they are and how they differ from one another?

Arthur Wilmarth:

Fluctuating value cryptocurrencies have no fixed value, and their so-called market value or traded value moves back and forth in conjunction with general market movements. Bitcoin and Ethereum are the two largest and most dominant fluctuating value cryptocurrencies. In contrast, stablecoins are instruments that represent and purport to maintain a stable value against a selected fiat currency, which in almost all cases is the US dollar. There are a small number of stablecoins that are linked to other fiat currencies like the Euro, but they're really very tiny in comparison.

Alan Kaplinsky:

And do they trade also the stablecoin?

Arthur Wilmarth:

Yes, they do. You can go to a cryptocurrency exchange or platform and buy stablecoins. The two biggest are Tether, which is a somewhat mysterious, murky instrument because it's an offshore stablecoin, not effectively linked to the US jurisdiction, although US residents do buy it and sell it. The other one, which is better known, is the USD stablecoin, which is issued by a consortium created by Circle and Coinbase. Tether and USD coin represent that they'll maintain parity with the US dollar, and they account for about 80% or more of the total stablecoin market.

Alan Kaplinsky:

I take it the for stablecoins is the currency, I forgot the expression you used, but most of them are tied to the US dollar. Does that mean that there are dollars that secure the stablecoin so that in the event the stablecoin loses value, you could look behind that to the security of the US dollar?

Arthur Wilmarth:

The most common stablecoins claim or purport to have reserves. The reserves for Tether are again somewhat shrouded in mystery. They claim that they have a certain amount of US treasuries or government guaranteed US securities and a certain number of bank deposits, but they also in the past have had a lot of commercial paper, including commercial paper from some Chinese companies. Circle represent and claim that they hold reserves consisting of either 90 day treasury bills or shorter or seven day repurchase agreements collateralized by not longer than 90 day treasury bills or bank deposits. They issue what are called attestation reports from a US auditing firm. They're not formally audited, but the attestation report claims or states that Circle holds the reserves that they say that it holds.

The USD coin is somewhat akin to a money market fund, and to my mind it has all of the shortcomings and vulnerabilities of a money market fund because if investors ever think that its reserves are not adequate investors are very likely to run. We've experienced two systemic runs on money market funds, particularly the prime money market funds that aren't backed completely by government securities or government guaranteed securities. We had two runs in 2008 and 2020, which required a complete rescue and bailout by the US government, and my concern with stablecoins, even ones like the USD stablecoin, which is supposed to be the cleanest and safest is that they're subject to exactly the same vulnerabilities and runs if people have any doubt about the adequacy of their reserves.

Alan Kaplinsky:

Yeah. I'd like to move on because there's a lot I want to cover with you. What are the primary uses and the risks of both fluctuating value crypto and stablecoin?

Arthur Wilmarth:

Fluctuating value cryptocurrencies haven't shown legitimate or lawful economic uses except for speculation. You can speculate in fluctuating value cryptocurrencies by obviously buying and selling or by lending them, essentially providing them to someone else with an agreed upon return or so-called staking in some cases. Bitcoin has a proof [of work] model where transactions are verified by miners who solve very complex problems, and when they verify a transaction that's added as a new block on the chain.

Ethereum is different because it wanted to respond to the growing controversies about the enormous amounts of energy being consumed by Bitcoin miners. Ethereum moved to a proof of stake system where if enough people owning enough Ethereum coins or Ether coins agree on verifying a transaction, their combined stakes will be sufficient to verify that transaction. Investors can lend out their coins for staking purposes and receive staking fees from the groups that perform these staking services.

With the fluctuating value cryptocurrencies, you're either going to make money by buying and selling for speculative purposes or by lending them out for loan transactions or these staking transactions and getting return from that.

Alan Kaplinsky:

Well I guess, since it's supposed to be a currency in some places, not too many in the United States, I don't think it'll get accepted the same way the US dollar would be accepted to pay for goods or services.

Arthur Wilmarth:

Places like El Salvador have experimented with the use of Bitcoin as a currency. My understanding is that hasn't gone very far because the value of Bitcoin collapsed between November of 2021 and the end of 2022 by about 70%. Even though it's somewhat rallied this year a little bit, it's still 60% below its peak in November 2021. Ethereum followed exactly the same pattern, running up a lot until November 2021 and then collapsing by 70% by the end of 2022, and today it's still about 60% below its peak. There's been a really limited take up of Bitcoin as a currency even in El Salvador, which obviously has had a very volatile currency.

The volatility of these fluctuating value cryptocurrencies has not made them effective or reliable as a payment instrument. A lot of the uses we've seen have been for criminal purposes. Both markets are shrouded in a lot of secrecy, and often the transactions are done by anonymous wallets that can't be traced very easily. Many criminals are using Bitcoin for money laundering transactions, for extorting people from ransomware attacks or other things, evading terrorist sanctions. We know that Russia, for example, has used Bitcoin to evade sanctions so that the amount of criminal use of these cryptocurrencies is very alarming.

These markets are not regulated in any systematic or effective way. They're largely non-transparent and opaque, and that was part of the marketing case for them. If you don't want your transactions to be transparent, if you don't want Big Brother watching what you're doing, come to crypto land, but that rapidly degenerates into criminal misuse of these currencies and transactions.

Alan Kaplinsky:

What about stablecoin uses? Is that different?

Arthur Wilmarth:

Stablecoins are linked to the problem of opacity and non-transparency because stablecoins came about as a way of allowing investors and traders in the fluctuating-value cryptocurrencies to exchange their fiat currency. In other words, if you had a bunch of dollars, you would exchange your fiat dollars into stablecoins, and then you would use the stablecoins either to trade in the fluctuating value cryptocurrencies or they could be used as collateral for lending transactions. Why were people flipping their dollars into stablecoins? Now, some people said, "Well, it was an easier way to go from Bitcoin to Ethereum, and if you wanted to go from one exchange or platform to another that supposedly stablecoins were an easier way to do that than using

dollars." I frankly don't understand that explanation because it seems to me that the US dollar is the most fungible and reliable currency in the world, and I can't imagine that stablecoins are considered more reliable or fungible than the dollar.

My suspicion is that it's harder for the authorities to trace transactions conducted by stablecoins than it would be if you conducted the equivalent transactions with the equivalent amount of US dollars, because once you start using large amounts of US dollars, money laundering laws, Bank Secrecy Act regulations, and FinCEN regulations are going to attach to that use of US dollars, but if you convert [dollars] into stablecoins and then dump the stablecoins into an anonymous digital wallet, it may be much harder for people like FinCEN to follow what you're doing. So my suspicion is that stablecoins initially were developed as a way of evading scrutiny and evading enforcement.

Now to be fair, the stablecoin advocates say, we're also developing stablecoins as a form of private digital dollars, and they could be used to accelerate and make more efficient various kinds of payment transactions. I think that is potentially true, although to me it's disturbing because these would be private digital dollars that at the moment are not regulated in any meaningful way and certainly [are] not subject to the kinds of regulations that apply to bank deposits. They would be substitutes for bank deposits, but would purport to have the same reliability as bank deposits, could be used for payment transactions of various types, both within and across borders, but wouldn't have the same oversight and regulation.

I don't see how payment stablecoins could coexist with digitized bank deposits, digital representations of bank deposits, without causing a lot of confusion and potentially undermining the effectiveness of banking regulation and indeed monetary policy. They would become a form of shadow deposits. The argument I developed in my book, *Taming the Megabanks*, was that we should say that nobody except for regulated and FDIC insured banks could issue deposits. That would include saying, no more money market funds. They would have to go into the banking system.

If we did away with these shadow deposits and put them back into the banking system, we would greatly increase the effectiveness of monetary policy as well as financial regulation generally, but if we allow stablecoins to exist, they're essentially a new form of shadow deposits and they're not even regulated as well as money market funds. This would compound the problem we have with shadow deposits and shadow banking existing outside the banking system with inadequate controls from either the monetary policy or financial regulation side.

Alan Kaplinsky:

Right, so you mentioned a little bit earlier there was a crypto boom in 2021 during the pandemic, the heart of the pandemic, and then there was a crash in 2022. What were the main factors that led to the boom and then what led to the crash?

Arthur Wilmarth:

The crypto boom was part of what has become known as the everything rally. The federal government authorized more than 5 trillion dollars of fiscal stimulus in response to the pandemic. That was more than four times as large as the amount of stimulus that was authorized in response to the global financial crisis of 2007-09.

Then you had the Fed essentially reauthorizing all of the monetary expansion policies that they had used in 2008-09 and adding some so that you not only had a complete guarantee of the wholesale financial markets, things like securities repurchase agreements and commercial paper and money market funds, but you had it expanded to include the entire corporate bond market and ultimately even so-called fallen angels that had become junk bonds.

The Fed's balance sheet more than doubled between the beginning of 2020 and the end of 2021. The broader M2 monetary supply showed a similar dramatic increase. Predictably, you had a tremendous increase in demand for investments of all types. At the same time, the Fed had reduced prevailing interest rates to zero, and so-called safe investments like government treasury bills of any reasonable duration, bank savings accounts were paying very little, and the only way to make money was to invest in risky things, so you see a tremendous uprush in demand for high technology stocks, for leveraged high-risk loans, junk bonds, commercial real estate, residential real estate, and crypto.

Crypto came along at this time and said, "We're the most high-yielding investment out there." That was true. The total market capitalization of all cryptocurrencies increased from 200 billion at the beginning of 2020 to almost 3 trillion by November 2021, a 1500% increase. There was the FOMO rally, the fear of missing out rally. People just thought, "I've got to get into this."

I see my friends and neighbors buying this stuff and they seem to become wealthy overnight. I have to get into it." And so that worked until finally inflation began to rise, inflation began to take off.

By November 2021, it was clear that the money supply was not going to keep expanding, government stimulus payments had basically run their course, and the Fed was going to start raising interest rates in 2022. [For] the NASDAQ, [crypto], and other higher risk investments, a peak was reached in November 2021 and then began to decelerate. As crypto decelerated and interest rates rose during 2022, a number of these [crypto] platforms that had grown very rapidly began coming unstuck and scandals were exposed [with] all sorts of misconduct.

As I argue in my article, [the crypto boom and crash] was reminiscent of the fraud that went on in the 1920s in the US stock market, the "Roaring Twenties," when stock trading was unregulated, and it [also] had hallmarks of the dot-com [and] telecom boom [and crash]. It [also] looked in some ways like the subprime mortgage boom [and crash]. These were all Ponzi schemes of different types, and the crypto boom and crash resembled a classic Ponzi scheme.

Alan Kaplinsky:

Let's turn to on the banking industry, I'm particularly interested about, were banks getting involved to some extent in the crypto business? What were they doing? They weren't accepting crypto deposits, I take it. You still, if you wanted to make a deposit, had to be US dollars. What types of things were the banks doing and were they being encouraged or discouraged by the regulators, both at the federal and the state level?

Arthur Wilmarth:

Yes, this was another area that was frankly a surprise to me as I got into it. I had seen evidence that some banks were getting into [the crypto] business, but the regulators kept saying it was so limited and so narrow and nothing to worry about, but as I began to look at it, I said, this doesn't look very limited to me. Wyoming in 2020 passed [a] law [to] create what they call special purpose depository institutions, which are essentially crypto banks, which could take crypto deposits and could provide custody services and other payment services to crypto providers and they would not be required to have federal deposit insurance. They would be required to have reserves for the crypto assets that they accepted as deposits. What those reserves would look like was somewhat left up to the discretion of the Wyoming regulator. They were supposed to be "reasonably safe." I wasn't very reassured by the restrictions [Wyoming] put on assets.

They issued four charters. Two that are better known are Custodia and Kraken, and they began providing custody services. I don't think Custodia and Kraken have yet gotten to the point of actually issuing stablecoins. New York chartered nine special purpose non-depository trust companies. They aren't allowed to take deposits, but they are allowed to provide custodial and fiduciary services. One of them called Paxos was allowed to issue stablecoins at first on behalf of Binance and then also on behalf of its own Paxos affiliate and to provide custody services.

New York told Paxos in February of this year to stop issuing the Binance stablecoin because Binance, which is the largest crypto exchange in the world, is unregulated in the United States, and the Commodity Futures Trading Commission has recently sued them for doing business in the United States as a commodities derivatives trader without compliance with the Commodity Exchange Act. You had this activity occurring at the state level and then you started seeing activity at the federal level. Bank of New York Mellon began offering custodial services for cryptocurrencies, including Bitcoin, with the approval of its regulators, the OCC and the New York Fed.

The OCC issued four letters in 2020 and 2021, and the first three allowed national banks to offer custodial services, to offer payment services and to issue their own stablecoins if they were backed by appropriate reserves and were linked only to the US dollar. In 2021, after the Biden administration came in and Acting Comptroller Hsu took office, [the OCC] issued a fourth letter saying, "You have to consult with us and get advance approval before you do any of these things, and you have to show us that what you're doing is safe and sound." But [the OCC] didn't withdraw any of the authorities that they had previously given.

Signature Bank in New York, which was a state nonmember bank, and Silvergate, which was a Fed member California state bank, developed payment platforms allowing crypto exchanges to bring dollars to the bank and exchange payments with their customers and any other customers of the bank on a 24/7/365 basis. These were payment platforms that were proprietary,

and if you were a customer of the bank, you could exchange payments with any other customer of the bank, including your own customers or other crypto platforms on a continuous basis.

At Silvergate, more than 90% of its deposits were crypto related deposits. [The percentage of crypto deposits at] Signature at one point was up to about 30%. It later went down. [Both banks] were involved with FTX and were both embroiled in the bankruptcy proceedings affecting FTX. There were class action lawsuits filed against both banks alleging that they enabled or allowed FTX to unlawfully commingle customer funds in their deposit accounts with FTX funds or the funds of Alameda, which was the affiliated hedge fund of FTX, and that the banks either knowingly or negligently allowed funds to be moved around [among] all these accounts so that customer accounts were not segregated and preserved.

Two banks were offering crypto trading services to their customers. One was something called Vast Bank from Oklahoma. It's a national bank and under Brian Brooks, who was the last Acting Comptroller under Donald Trump, [the OCC] had allowed them to offer this crypto trading service to their bank deposit customers, again, on a continuous basis where they could even devote part of their direct deposits to [make] crypto investments. When I last checked the Vast [Bank] website, [that service was] still operative. The OCC has not withdrawn that authorization.

Another bank is owned by SoFi, which used to be called Social Finance. SoFi has a digital trading subsidiary. SoFi acquired a California bank and renamed it SoFi Bank. It became a Fed member bank and the Fed said, "Crypto trading is not authorized for bank holding companies, but you have a transitional period since you just became a bank holding company. You can continue this for two years under the transitional authority, and you could extend it for three more years potentially with the Fed's approval." SoFi Bank was offering crypto trading services through its affiliate to its customers, and Senator Sherrod Brown and some of his colleagues on the Senate Banking Committee wrote a letter to SoFi and the Fed and said, "Why are you allowing this? This is very dangerous."

Then there was a strange bank out in Washington called FBH, [the parent holding company of Farmington State Bank], which temporarily was called Moonstone Bank. FTX bought a large equity investment in FBH, and their plan was to use FBH as a platform for doing crypto trading as an authorized banking activity without having to comply with SEC regulations. Well, that didn't get off the ground [before] FTX collapsed. FBH was owned by a guy named Jean Chalopin, who's connected to Deltec Bank, which is the major bank for Tether down in the Bahamas. The Fed allowed the change of control transaction, allowed FBH to become a state member bank, and the FTX investment shortly followed that transaction and I'm thinking, what is the San Francisco Fed thinking?

Because now they have Silvergate, which is essentially a crypto payments platform, and this Moonstone Bank, which is trying to become a full service crypto bank, and they're not objecting and they're allowing SoFi to continue doing a digital crypto trading service to bank customers on a transitional basis, and this made me very much concerned that the federal regulators were acquiescing and to some extent, perhaps, silently encouraging these various types of experiments with something that struck me as incredibly risky.

Now, after the FTX collapse, and then shortly after the Genesis Trading collapse, the federal regulators changed their tune and they issued a series of guidance letters between January and March of this year, in which they said, "Well, we're very concerned about this and we don't want crypto risks to get into the banking system, and we're going to look very seriously at anything that anybody does related to the crypto space." They pretty much said, "We would be almost certainly opposed to any bank engaging in trading or investing in cryptocurrencies directly." They didn't issue any official ban, but clearly the feeling was that they had thrown a lot of cold water on this. [However], it is fair to say that the barrier between banking and crypto is very permeable and not secure.

Alan Kaplinsky:

Okay, so we had Silvergate, Silicon Valley Bank, Signature Bank. All of them failed, and do you believe it was a result of their heavy involvement with crypto?

Arthur Wilmarth:

Yes. Crypto played unquestionably a dominant role in the collapse of Silvergate, I think a significant role in the collapse of Signature and certainly had a not insubstantial role in the failure of Silicon Valley Bank. So Silvergate was about a 10 billion

dollar bank. About 90% of its deposits were crypto related. During the crypto crash, and particularly after FTX collapsed, a lot of its crypto related deposits either were caught up in the FTX bankruptcy or were removed as the crypto crash continued, so they lost about two thirds of their deposits in the last three months of 2022. They were forced to go to the Federal Home Loan Bank of San Francisco and take out large advances from the Federal Home Loan Bank to make up for the deposits they lost.

By the beginning of March they were defunct, and so they went into voluntary liquidation. They weren't closed by the FDIC, but they went into voluntary liquidation, which is normally something you would not do unless you were pretty sure that you were going to be closed imminently. They claimed that they would be able to cover all their deposits with their remaining assets. I will be very interested to see if that actually turns out to be the case, but no doubt the collapse of Silvergate and its undeniable connection to crypto had a big impact on the other two larger banks, Silicon Valley Bank, which was almost a 200 billion dollar bank and Signature, which was slightly over a hundred billion.

Silvergate went into voluntary liquidation on the same morning that Silicon Valley Bank announced that it would sell off a large portion of its available for sales securities and would take almost a 2 billion dollar loss on that sale and disclosed that it was losing uninsured deposits and that it was taking out larger and larger amounts of Federal Home Loan bank advances and discount window loans. Silvergate's collapse accelerated the panic that was beginning to develop at Silicon Valley Bank.

Signature Bank had been experiencing the same deposit shrinkage and withdrawal that Silvergate had gone through. Signature tried to say that they were doing it deliberately to reduce their exposure to crypto. Perhaps so, but they lost a lot of their crypto related deposits in the last three months of 2022 and there was no doubt that as more stories came out about Signature's connection to crypto, some of their own uninsured depositors became very concerned. They had a lot of commercial real estate investors and entrepreneurs among their depositors. About 90% of their deposits were uninsured, not as heavily focused in crypto, but significantly related to crypto, so they were suffering shrinkage and loss of deposits and the need to rely more on Federal Home Loan Bank advances and discount window loans. When Silicon Valley Bank went down on the morning of Friday, March 10th, the run on Signature accelerated, and, over the weekend, the regulators concluded that Signature couldn't survive either, and so it was closed over the weekend.

Crypto was not a big part of the Silicon Valley Bank story as reported, at least not in most places. It wasn't the biggest part of their business, but they had significant exposure to crypto in the sense that they had made many venture capital loans to either venture capital firms that supported crypto startups, and in some cases to crypto startups themselves, and they also acted as custodian for deposits from crypto firms. In fact, some of the firms that had banked with Silvergate moved their deposits over to Silicon Valley Bank.

When Silicon Valley Bank was closed on Friday, March 10th, around noon, 3.3 billion dollars of Circle's reserves for the USD stablecoin were being held at SVB. Those deposits were frozen. The FDIC announced on Friday that they intended to, on Monday, transfer the insured deposits to a bridge bank that they would set up and pay an advance dividend on the uninsured deposits, but otherwise would not cover the uninsured deposits. The uninsured deposits would take some kind of haircut depending on what the estimated results of liquidating the bank would be. That caused a panic among venture capital firms, among technology firms, particularly the biotechnology startups that Silicon Valley Bank specialized in, and among crypto firms. When Circle finally disclosed later that day that they had 3.3 billion dollars of their reserves, which was about 10% of their cash reserves, tied up at Silicon Valley Bank, investors ran on the USD stablecoin. It broke the buck and fell to about 88 cents.

And the DAI stablecoin was a hybrid that had a lot of non-cash reserves, and they were holding USD stablecoins as part of the reserves. They broke the buck and fell to about 90 cents on the dollar. According to stories published in the Financial Times and a number of crypto journals, there was a crisis brewing that many crypto people thought would be worse than the Terra and possibly the FTX crises in terms of melting down the crypto ecosystem. All these technology, venture capital and crypto people were lobbying the Biden administration and Congress and the regulators, saying "You've got to save the uninsured deposits of Silicon Valley Bank." And as we know, they were saved, and the Fed set up a new Bank Term Lending Program to further help prop up banks.

I personally have a strong feeling that the impending meltdown of the crypto ecosystem might have had some impact on that decision to bail out all of Silicon Valley Bank's uninsured deposits. I can't imagine that it was irrelevant. All the uninsured deposits were protected on Monday the 13th. USD stablecoin and Dai restored their \$1 pegs and the crypto crisis was averted.



One Crypto insider said, "Well, this was like the Cuban Missile Crisis. We almost had a complete Armageddon, but we avoided it." This, I think shows exactly how vulnerable the stablecoin universe is. It also shows how dangerous it is for this unregulated crypto/stablecoin universe to be connected to the banking system in any way.

Alan Kaplinsky:

Well, what I wanted in our remaining time, I'd like to turn to what you've recommended. One of your recommendations is that the SCC should be the primary federal regulator of most fluctuating value cryptocurrencies rather than the commodities Future Trading Commission or the CFTC. Why is it that you think the FCC is the appropriate regulator here, and would it require legislation in order to accomplish that?

Arthur Wilmarth:

I agree with SEC Chairman Gensler that, with the exception of Bitcoin, most fluctuating value cryptocurrencies would fall into the classification of securities under either the Howey and Co. test or the Reves test [because] you're buying and selling these cryptocurrencies with the idea that you'll be making money based upon the actions of others. It's pretty clear that Ethereum is really governed by large groups that come together in these staking pools to make decisions that the passive investors are not involved in at all, and there is some centralized governance or management and that's how you make your money. That would fall under the Howey test, or if you're lending or staking your tokens, which is to me akin to lending, that would match the Reves test where you're lending out and you're expecting a return.

Bitcoin probably as currently operating doesn't fit into either of those tests because Bitcoin seems to be a completely decentralized system, with no governing group, no governing management. There's no continuing group that really exercises any control over it, and Chairman Gensler has admitted that.

For those tokens that do meet the Howey or Reves test, which I think are most of them, the SEC has much more comprehensive powers. For example, the CFTC cannot regulate spot trades in commodities. The CFTC doesn't really have a very strong or explicit investor protection mandate or much of a history of investor protection.

[The CFTC] can't regulate what we would think of as brokers or dealers if the brokers or dealers are only offering spot contracts as opposed to derivatives or futures. The SEC has comprehensive authority. Once [a token] is a security, [the SEC] has comprehensive authority over the trading [and] the exchanges [related to that token].

Alan Kaplinsky:

There's no need for legislation, I take it.

Arthur Wilmarth:

Yes, you wouldn't need legislation for any of that. You would simply need recognition that [most fluctuating-value cryptocurrencies] are securities, and there's litigation ongoing that would suggest that we'll get more clarity about just what cryptocurrencies qualify as securities.

Alan Kaplinsky:

Of course it probably wouldn't hurt for Congress to step up to the plate and confirm that, right?

Arthur Wilmarth:

Rather than letting it be done piece by piece through enforcement and litigation, it would be much better if Congress made it clear. If Congress decides that Bitcoin is really a commodity and not a security, then [Congress] ought to give the CFTC spot regulation authority over spot trades as opposed to only derivatives or futures [trades] if it's a commodity. The CFTC has also been more frequently captured by the industry it regulates, and the SEC's record is certainly not spotless, but it has tended to be at least somewhat more independent of the industries it regulates compared to the CFTC. It has more resources, again, more experience. I do think that based on its past track record, the SEC is the far safer pair of hands. If you were going to give

[regulatory authority over fluctuating-value cryptocurrencies] to the CFTC, you'd have to greatly increase their resources and their powers. Of course, as I say in the article, I'd be very happy to see the SEC and CFTC merged, so we didn't have these jurisdictional conflicts.

Alan Kaplinsky:

So Art, want to get your thoughts on the very recent enforcement actions against Binance and Coinbase. How does that impact the proposal that the SEC should be recognized as the primary regulator of fluctuating value cryptos?

Arthur Wilmarth:

I think in some ways the Binance and Coinbase enforcement actions proceed on grounds that the SEC has established in some of their previous cases, most recently the LBRY case up in New Hampshire, by saying that they believe that fluctuating value cryptocurrencies, our security is subject to the federal securities laws. What they did in the Binance and Coinbase cases that I think goes further is to say not just that the digital assets are securities, but that Binance and Coinbase are operating as brokers, and as securities exchanges, and as clearing facilities that need to be registered with the SEC under the laws and regulations governing such facilities. So that's a step further, I think.

Now, I think it was a natural step for the SEC to take. Because both Binance and Coinbase operate highly-integrated trading platforms that in fact appear to function as brokers, as exchanges, and as clearing facilities. So that in a sense, these two defendants, Coinbase and Binance, were operating much more integrated, offering facilities, performing a multitude of functions. Compared to some of the earlier cases that involved issuers of digital coins, for example, where they weren't operating trading facilities for those coins after issuing them.

Alan Kaplinsky:

Okay. And then, there's this very recent opinion from the Federal District Court, Southern District of New York, involving Ripple. And what kind of an impact do you think that might have on the Binance and Coinbase enforcement actions?

Arthur Wilmarth:

Well, Ripple is certainly only a half-victory for the SEC, and therefore arguably a half victory for the crypto industry, although I think that's yet to be seen. What the district judge said in Ripple, which is a Southern District of New York decision, is that the sales by Ripple of its XRP tokens to institutional investors, these were direct sales to institutional investors, which appeared to have been accompanied by various types of written documentation in various types of representations, both oral and written.

The district court held that those sales did satisfy the Howie Investment Contract test. Because the purchasers put up their money, paid money to Ripple that they expected to profit from their investments in the Ripple tokens to gain some kind of return on that investment. And that the various representations and statements made by Ripple, before and during the sales, led the institutional investors reasonably to expect that Ripple would exert efforts to improve the value of the Ripple token. To build the Ripple ecosystem, as it was called. And therefore the institutional investors were relying on a common enterprise in the efforts of others, particularly Ripple, to get the return they were looking for.

Now, interestingly, the district court then said, well, but it was very different with regard to sales that were made on other trading platforms, either by Ripple itself or by Ripple's two top executives. According to District Court, these were essentially faceless, anonymous transactions. The buyers did not know who the sellers were. The sellers did not know who the buyers were. And the court said, well, in those circumstances, the so-called, you could say retail buyers, those who bought through various types of trading platforms and what appeared to be anonymous transactions, they didn't know who they were dealing

with. Therefore, they were not relying upon a common enterprise, or the expectation that Ripple would be the one that improving their returns. Because they frankly didn't know whom they were dealing with.

I mean, that's an interesting conclusion. I think to my mind, that conclusion is not particularly persuasive with regard to either Coinbase or Binance in terms of the transactions occurring on Coinbase's and Binance's trading platforms. Because in that case, the buyers would certainly expect, I think reasonably, that Coinbase and Binance were in some sense the sponsors of and standing behind the trading platforms. And the fact that Coinbase and Binance were offering trading platforms on which their tokens were being traded was part of an overall common enterprise meant to enhance the value of whatever tokens they were selling on those trading platforms.

So to the extent that the crypto industry is saying that they've won this great victory, again, my reading of the case is that the facts were relatively special in terms of the fact that the trading platforms here had, at least as far as I can see in terms of the court's description, no connection to the issuer of the token. And no clear connection to the leading executives or other players involved with the issuer of the token. So if I were Coinbase or Binance, to me, I wouldn't take too much comfort from the Ripple decision. Now, clearly for other issuers that don't operate a trading platform, I think they can to some extent try to rely on this decision and say, look, as long as we don't operate, or sponsor, or in some way establish the trading platform, and these are transactions that are done anonymously, and the buyers don't know that we the issuer are on the other side, we can rely on this decision.

But I think that's a very different case from my perspective, when you have an integrated operation like Binance or Coinbase, where you're both issuing these tokens and you're establishing, and operating, and sponsoring the trading platforms on which these tokens are traded. Now, one interesting point in the Ripple case. The Howie Test says that the buyer of the security must expect that profits will come, essentially primarily from the efforts of either the seller or a third-party.

And one issue that I think that was not developed, that the SEC didn't pursue, is Ripple was clearly putting out various types of public statements about what a great thing their token was, and how they were building the Ripple ecosystem to make it more valuable and so on. And why their blockchain was so much better than either the Ethereum blockchain, or the Bitcoin blockchain. To the extent that Ripple had understandings or agreements with these trading platforms saying, hey, look. You provide the trading platform on which Ripple can be traded, and we will give you various kinds of inducements or benefits for doing that. And to the extent that that Ripple also may have said to the potential universe of buyers, hey, look, one reason that Ripple is such a valuable token is that, look at all the exchanges and platforms on which it's traded.

To the extent there were some kind of agreement and concert or cooperative action between Ripple and the trading platforms, I think one could make the argument that in fact, the buyers who bought on the platforms were expecting to get returns from a combination of actions, from Ripple and these third parties who were trading platforms. Now, based upon my reading of the decision, I haven't looked at the briefs. It doesn't look like the SEC tried to make that type of case. That look, in a sense, Ripple and these trading platforms were operating in concert. That there was a grand scheme to enhance the value of Ripple by encouraging these platforms to trade Ripple, and by making purchasers think that that was a good idea. I think if you had that kind of a showing of a common enterprise between the issuer of a token and the platforms on which it's traded, I think that the analysis could come out another way.

Alan Kaplinsky:

Yeah. Did you ever consider the CFPB as the appropriate regulator?

Arthur Wilmarth:

Well, you could imagine a situation in which you merge all three. I think there's always a balance between comprehensiveness and ability to manage and ability to handle a broad template of responsibilities. At what point does the agency become so overburdened with so many different things that it can't function effectively? I don't think putting the CFTC and the SEC

together would breach that [limit] because commodities are investment products, much like securities, and I don't see why they're not regulated in an equivalent manner. Once you put all of consumer protection together with [securities and commodities], it gets more daunting in terms of the agency's ability to do everything effectively, but I think it would be conceivable that one [agency] could do that. [In any case], there should be a sharp distinction between [investment] products, which are not deposits, and stablecoins.

Alan Kaplinsky:

Let's talk about stablecoins. In your article, you view them differently, right? You don't view them as securities, and why don't you describe what you're advocating for stablecoins.

Arthur Wilmarth:

If stablecoins simply pay dollar in dollar out, but no interest, then it's hard to argue that they are securities under current law because there's not a return of profit to the investor. He just gets his money back. An argument has been made, as suggested by Chairman Gensler, that they're really like the poker chips you buy at the casino in order to gamble, and so they're the entry into the world of gambling on cryptocurrencies, if they really do promise to give dollar in dollar out and they purport to have reserves backing them up, they're really offering deposit treatment in the same way that I believe that money market funds with a fixed net asset value clearly offer deposit treatment. All such deposits should be inside FDIC insured banks.

There's a very interesting 1982 Supreme Court case called *Weaver*, where the Supreme Court said that bank deposits are not securities. [The Supreme Court] said if they weren't inside FDIC insured banks, interest bearing deposits would certainly be securities under the test they later adopted in the *Reves* case, but they're not securities because we have a federal banking regulatory regime, which is a satisfactory and indeed preferable alternative and FDIC insurance provides additional protection, so there's no need for SEC regulation of bank deposits. Of course, if stablecoins actually paid interest and were outside the banking system, they certainly would be securities subject to SEC regulation, but my view is [that] all deposits, [including] both stablecoins and money market funds, should be brought inside the regulated banking system and be required to be FDIC insured.

The recent crisis we've had with Silvergate, Signature, SVB, and First Republic, indicates why that needs to happen. Let's take the Wyoming example. You could have a Wyoming crypto bank that's not FDIC insured, and what happens if people lose their confidence in whatever stablecoins that Wyoming bank is issuing? There would be a run and assuming that the Treasury or the Fed didn't step in some way, there would be a tremendous loss to the depositors. We saw exactly that happen with the collapse of state-sponsored deposit insurance systems, particularly in Ohio, Maryland, and Rhode Island, during the 1980s and early 1990s where the federal government gave limited help, but all [of those] systems collapsed and people lost a lot of money because, unlike the federal government, the state governments can't print money. They've got balanced budget requirements, they can't print money, so if whatever reserves they have are inadequate, there's no place to go [to get protection for depositors].

Obviously, with the federal banking system, the Fed can print money, the Treasury can issue guarantees. The FDIC has a hundred billion dollar line of credit with the Treasury, and explicitly has the full faith and credit of the US government behind it. The federal government can, in different ways, promise that bank depositors won't lose their money. There's a whole different issue as to whether we should go explicitly to 100% deposit insurance coverage. I don't think we need to resolve that issue to say it's clear that [the federal government needs to regulate all] deposits and, again, I'm referring to both stablecoins and money market funds. They're much more secure, much better regulated inside the banking system. The FDIC can assess deposit insurance premiums and build up the [Deposit Insurance] Fund, which of course, it cannot do for money market funds, it cannot do for stablecoins [that are issued by nonbanks or uninsured banks].

If a crisis occurs similar to SVB or First Republic or Signature, and it's a potentially systemic crisis, the Fed can step in with discount window loans, possibly emergency lending programs as they did with the Bank Term Lending Program under Section 13(3) of the Federal Reserve Act, or the Treasury can step in as they did with their guarantee from the Exchange Stabilization Fund. We have well-established mechanisms to ensure the stability of funds within the banking system, which we do not have outside. Everything outside is ad hoc, but the more we stretch [the federal safety net] outside the banking system as we did in

2008 and 2020 to prop up things that are not banking funds, we do two bad things. We arbitrage the banking system, and we undermine the effectiveness of banking regulation and monetary policy generally.

We bankify the financial markets and other things outside the banking system so that people get the protection without paying the price of regulation and the price of contributing to the Deposit Insurance Fund, and so we distort market discipline signals within the broader financial markets and we make those financial markets behave not like financial markets, but like subsidized, government-protected investments. You then create an asymmetric risk curve where investors feel, "Hey, shoot the moon because there's no limit on the upside." But now you've got a floor underneath you, so there's a floor on the downside, so why wouldn't investors take ridiculous risks thinking that the government has the downside? We have to move completely away from this system we've been living with since the 1990s. Let's understand what banking is and what banking should be. Let's have that be well protected, well-regulated and stable, and then let's have financial markets outside that are not subsidized by the government.

Alan Kaplinsky:

You have to amend the Federal Deposit Insurance Act in order to deal with the stablecoin being accepted as deposits.

Arthur Wilmarth:

Section 21 of the Glass-Steagall Act, which is part of the Federal Reserve Act (12 U.S.C. 378), says that nonbanks cannot issue deposits. It's a criminal statute. The government was asked to invoke that law in 1979 in response to Merrill Lynch's Cash Management Account, which was a money market account with check-writing privileges, and the DOJ refused on grounds that were certainly not adequate or satisfactory. They avoided all the functional similarities between money market accounts and deposits. At the time [Congress] passed [Section 21] in 1933 as part of the Glass-Steagall Act. [At that time], Congress was not confident that they could force all deposit taking banks to be federally regulated as FDIC insured banks, so [Section 21] allows for state-regulated banks that could accept deposits even if they're not federally insured, which is exactly the loophole that Wyoming has exploited with its so-called SPDI charter. You would have to amend the Federal Deposit Insurance Act to say that only FDIC insured banks can accept deposits.

By requiring all stablecoin issuers and indeed money market fund issuers to be FDIC insured banks, you would bring them into the Bank Holding Company Act because all FDIC insured banks are banks for purposes of the Bank Holding Company Act. That means that their parent companies would be subject to consolidated Fed supervision and regulation under the Bank Holding Company Act. More importantly, or I say equally importantly, commercial companies like Big Tech firms couldn't own such banks. I'm very concerned that Apple and the other Big Tech firms are very anxious to use stablecoins to get into the banking business without being regulated as banks. We know that Facebook tried to do that with its Libra and Diem project, which it abandoned, but a stablecoin would be the natural next step for Apple to take to become a payments provider and essentially a deposit provider. If we don't want Big Tech firms dominating our banking system and being subsidized as banks, we have to stop this from occurring.

Alan Kaplinsky:

Well, we have covered a lot of territory today and I'm wondering, Congress right now, they're not considering doing anything right now? I hope they're not, other than dealing with monetary issues.

Arthur Wilmarth:

[In] the House Financial Service Committee, there's a Republican draft and a Democratic draft of stablecoin bills bouncing around and both drafts raise concerns, particularly the Republican one. Unfortunately, neither bill says what I have recommended, that all stablecoin issuers must be FDIC-insured banks. It may be difficult with the divided Congress for any bill to emerge. I don't discount completely the ability of some combination of the crypto industry and the Big Tech industry to push something that would validate their stablecoins, but I certainly hope that will not occur.

Alan Kaplinsky:

Well I hope if they hold a hearing on it, you're invited to testify. You certainly should be with the amount of thought and care that you've given to this and your experience as essentially a bank regulatory lawyer and teaching in this area for so long. Thank you very much, Art, for being our guest today. I really appreciate it. We'll have to monitor developments and as things begin to crystallize at some point, probably not this year, but maybe next year, we'll want to have you back on the show to get your thoughts on what Congress is actually going to do. Thank you again.

Arthur Wilmarth:

Thank you Alan. I appreciate it very much and would be very delighted to have a further conversation if that seems warranted.

Alan Kaplinsky:

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