Q&A

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Lessons learned from the recent failures in the crypto market

Has the failure of certain cryptoasset service providers and stablecoins and the downturn of the market since 2021 revealed major fragilities of the crypto ecosystem? To what extent are these events attributable to crypto-specific issues?

Events over the last year reveal notable fragilities within asset classes, among critical financial market intermediaries, and, more generally across the financial market ecosystem. On the heels of a global health crisis, monetary and fiscal policies have endeavored to effectively address challenging conditions driving macroeconomic indicators, including international supply chain disruptions, persistent and extreme volatility, and inflationary pressures. Geopolitical events, most significantly Russia's invasion of Ukraine, have contributed to additional pricing volatility in many of our key markets and, simultaneously, record trading volume on global platforms. Notably, markets have demonstrated significant resilience in response to this confluence of pressures.

Almost a year ago, a daisy-chain of counterparty risk management failures triggered liquidity crises and cascading losses among a handful of critical cryptoasset service providers. The series of crises (a contagion) in cryptomarkets reveal debilitating governance and risk management failures within individual firms and the interconnectedness among several of the largest institutions in the crypto ecosystem.

In May of 2022, the TerraUSD stablecoin fell below its fixed value, triggering a selloff. TerraUSD and its sister coin Luna lost $40 billion in value. One month later, citing extreme market conditions, Celsius Network, a crypto lender with $11.8 billion under management, ceased permitting withdrawals. Following the Celsius announcement, on a near weekly basis crypto asset providers faced insurmountable liquidity crises and failed. Crypto lender Babel Finance halted withdrawals citing "unusual liquidity pressures." Ten days later, crypto hedge fund Three Arrows Capital defaulted on loan payments to crypto lender Voyager—and Voyager collapsed. Later in the year, FTX and BlockFi experienced similar pressure and in January of 2023 the lending unit of Genesis suffered a market rout. In the face of these liquidity crises, the firms formed a queue as each filed for bankruptcy protection in turn.

In many ways, the macroeconomic challenges in traditional financial markets have demonstrated the effectiveness of post-financial crisis reforms designed to enhance governance (specifically risk management policies among systemically important intermediaries), minimize single points of failure, and strengthen resilience by requiring appropriate allocation of financial reserves and other default-centered reforms. And perhaps as importantly, the post-crisis traditional finance setting includes regulatory responses that are global in nature and comprehensive in effect. These features are regulatory constructs and glaringly absent within cryptomarkets, possibly fostering endemic fragilities and governance and risk management failures. Governance, risk management, recovery, and resilience reforms comprise critical elements that must inform crypto asset regulation.

Do we have a clearer view on the economic value of cryptoasset activities and the opportunities and risks for different types of investors?

To confirm that crypto asset activities have economic value, we must first identify the problem that these introducing these assets will solve. We must ensure disparate exposure to risk of loss does not amplify existing inequities.

Careful study of crypto markets crises reveals important observations regarding two classes of market participants and their trading behavior following the episodes of crypto market shocks. First, according to a recent paper by the Bank of International Settlements, as losses resulting from the crypto crises mounted, major exchanges that execute trading and settlement for retail investors witnessed a marked increase in account activity and upticks in trading volume. Evidence of trading activity also suggests significant sell-offs by large and sophisticated investors. An analogy proves illustrative.

One might describe the sophisticated investors— those who own 1,000 or more crypto units—as "whales" and the retail investors as "the krill." The study carefully details and further demonstrates that the increased retail market exposure is even more pronounced in emerging economies such as Brazil, India, Pakistan, Thailand, and Turkey. Under such conditions, it is important to note and address the likelihood that, in stormy seas, the whales eat the krill.

Second, participation of institutional investors also merits careful evaluation. In the context of FTX's collapse, two Canadian pension funds acknowledged significant investments in the crypto ecosystem. In 2019, the Ontario Teachers' Pension Plan ("OTPP") launched the Teachers' Venture Growth platform. In October 2021, OTPP invested $75 million in FTX International and its US entity, FTX. US (together "FTX"). In January 2022, OTPP increased its investment in FTX.US by $20 million. On November 11, 2022, FTX filed for bankruptcy. OTTP announced its intention to write-off the fund's $95 million investment in FTX. Similarly, Caisse de dépôt et placement du Québec, Canada's second largest pension fund manager has written off its $150 million investment in crypto lending platform Celsius Network.

As we survey the costs of crypto crises or the contagion over the last year, it is imperative to note and address the losses experienced by these two classes of market participants. Beyond the challenges posed in evaluating the complexities surrounding crypto investment decisions, the Commission has filed a number of notable enforcement actions presenting well-supported and disturbing claims of fraud, misappropriation, and other concerning misconduct. Recent events reveal devastating losses experienced by unsuspecting retail customers lured by marketing schemes into transactions that rendered their investments worthless. Coupled with these scams, bankruptcies in the crypto ecosystem have converted ordinary customers (depositors) into general unsecured creditors. We are executing our mandate to enforce against misconduct. For the mounting and sobering questions regarding the more challenging catalysts that prompted losses over the last year, we must identify effective risk management, market, and regulatory interventions.

Can the use of the technology underlying crypto activities have a significant added value for the financial system? Are vibrant cryptoasset market necessary for the sustained development of these technologies?

There are use cases for blockchain or distributed digital ledger technology that may prove valuable including the possibility that these technologies may enhance climate resiliency. Reliable carbon accounting—meaning real transparency—requires verification in low-trust environments. During a recent meeting of the Market Risk Advisory Committee, which I sponsor, we also recently discussed other potential uses in financial markets including clearing and settlement, digital identities, and global payment systems. The nature and extent of any relationship between these use cases and currently circulating cryptocurrencies is not yet clear.

How are the opportunities and risks from cryptoassets being addressed in the US in policy and supervisory terms? Is there a need for global coordination on this topic?

The United States Congress is currently considering several bipartisan bills that aim to introduce a regulatory framework for cryptocurrency and stablecoins. While we await Congressional action, we may advance and inform the regulatory dialogue within the Commission, with our fellow federal and state regulatory agencies, and with international regulators in jurisdictions around the world. During a keynote speech at the Federal Reserve Bank of Chicago Financial Markets Group Fall Conference hosted only one week after FTX announced plans to enter bankruptcy proceedings, I encouraged the Commission to consider initiating a notice and comment rulemaking process to evaluate the need for regulation mandating segregation of customer funds, treatment of customer funds, and the introduction of financial resource requirements for certain derivatives clearing organizations that offer direct clearing to retail customers. Recently, I advanced suggestions regarding corporate governance, risk management, and compliance reforms including introducing effective auditing, internal controls, risk management oversight, and appropriate governance of conflict of interests.

International standard-setting bodies including, the FSB, the Basel Committee on Banking Supervision, and IOSCO, have each introduced thoughtful work that should be foundational in the development of any crypto regulatory framework. We note the active development of standards by the tri-partite dialogue in the European Union and policymakers in the United Kingdom—among others. We look forward to working with counterparts to identify an effective direction of travel for creating and implementing regulatory standards.