Is the U.S. Trying to Kill Crypto?*

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No system of regulation can safely be substituted for the operation of individual liberty as expressed in competition.
Louis D. Brandeis (1856-1941) U.S. Supreme Court Justice.

Introduction.
It would be an understatement to say that U.S. crypto regulations are complex and confusing – if they exist at all. Although there are several regulators who claim to oversee crypto companies, the individual responsibilities between them are far from clear. There are several federal laws that may, in theory, deal with cryptocurrencies to some extent, however, depending on the nature of the asset, different laws apply.

The U.S. has a variety of federal agencies regulating various asset classes. The agency in charge will depend on whether an asset is a money transmitter, security, or commodity/derivative. There is still little clarity on the classification of different crypto assets and, as a result, which agency regulations apply.[1] To add to this Kafkaesque situation, in certain cases, a crypto company may fall under the jurisdiction of more than one government agency.

As of this writing, there are several initiatives which may influence the industry in the near future. One of them is the "Responsible Financial Innovation Act", which aims to create the first comprehensive regulatory framework for digital assets. However, this Act is still a work in progress and has not been approved yet.

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* Opinions, findings, and conclusions expressed in this paper are solely those of the author.
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[1] https://sumsub.com/blog/crypto-regulations-in-the-us-a-complete-guide-2023/

In January 2023, the Biden White House issued a (rather crypto-unfriendly) “Roadmap to Mitigate Cryptocurrencies’ Risks.”[1] In April 2023, the administration is reportedly preparing to release an initial government-wide strategy on digital assets, including cryptocurrencies, as an executive order.

So yes, there are recommendations, proposals, initiatives, strategies, etc., but nothing concrete - yet. Nothing much seems to be happening except continuous acrimony between, for example, the SEC and the CFTC about who is entitled to regulate what. This, in sharp contrast with what is happening in other jurisdictions.

Most of us familiar with cryptocurrencies, are aware of the fact that several U.S. Government agencies have launched a fight against the cryptocurrency industry. Ostensibly, the idea is that the government wants to protect investors from fraud, money laundering, and cybercrime that may occur in the crypto space.

Regulatory agencies have a tendency to excess and overreach in pursuit of their specific objectives. Their determination often leads to a lack of consideration for other important goals, such as fostering a strong and expanding economy. This narrow focus can result in regulations that have costs that outweigh their benefits.[2]

A recent article by Nic Carter clearly outlines how the U.S. Government is quietly trying to ban crypto in a coordinated, ongoing effort across virtually every financial regulator to deny crypto firms access to banking services.[3]

The article describes how regulators have been coming down hard on banks that accept deposits from cryptocurrency clients, issue stablecoins, engage in crypto custody, or try to hold cryptocurrency as a principal. These banks have faced severe pressure from regulators, who consistently emphasize the importance of "safety and soundness" and assert that any involvement with public blockchains is considered excessively risky for a bank.

Governments have a unique resource that private entities lack: the power to use coercion. Carter argues that the crypto industry is facing a comprehensive and highly organized crackdown, orchestrated by the U.S. government through the banking sector. This plan, which involves various financial regulators, was clearly outlined in memos, regulatory guidance, and blog posts. Even experienced professionals in the crypto industry are

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[1] https://www.whitehouse.gov/nec/briefing-room/2023/01/27/the-administrations-roadmap-to-mitigate-cryptocurrencies-risks/
[2] https://rtp.fedsoc.org/paper/government-regulation-the-good-the-bad-the-ugly/
[3] https://www.piratewires.com/p/crypto-choke-point

concerned about the scope and coordination of the plan, fearing that it may result in crypto businesses losing access to banking services, stablecoins being left without the ability to manage crypto flows, and exchanges being completely cut off from the banking system. These are serious developments that demand further examination.

The Problem with Government Regulations.

The late economist Milton Friedman was a strong advocate for free market capitalism and believed that government regulation often had a negative impact on economic growth and individual freedoms. According to Friedman, government regulations hindered competition, increased costs for businesses, and created inefficiencies in the marketplace. He argued that the best way to promote economic growth was to reduce government intervention and allow the market to operate freely.[1]

John Stuart Mill defined individual liberty as the freedom to do as one pleases, as long as one does not harm others, or infringe on their freedom. He also maintained that individual liberty should be protected from both government and social tyranny. He believed that individual liberty was essential for human development and social progress.[2]

In the financial sector, strict regulations have the potential to impede innovation by diverting the focus of firms towards compliance rather than the development of novel products and services. This shift in focus can ultimately restrict access to new technologies and financial products, hampering the overall efficiency and effectiveness of the financial system.

The presence of regulations can lead to a culture of risk-aversion in financial institutions, deterring them from taking risks to create new products or services due to the potential for negative regulatory consequences. This risk-aversion can in turn limit the emergence of innovative ideas and solutions that can drive growth and success in the financial sector.

Complying with regulations can be a resource-intensive and time-consuming task, taking away valuable resources that could have been utilized for research and development. Smaller firms may be at a disadvantage in this regard, as they may struggle to allocate sufficient resources towards both compliance and innovation simultaneously.

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[1] Friedman, M. (1962). *Capitalism and freedom*. Chicago: University of Chicago Press.
[2] *On Liberty* is an influential essay written by philosopher John Stuart Mill (1806-1873). The essay was first published in 1859 and remains one of the most important works in the tradition of liberal political philosophy.

Regulatory approval can also hinder the introduction of new financial products and services, as firms may be hesitant to invest in research and development without certainty that their products will receive regulatory approval. Delays in the approval process can create additional uncertainty, further impeding the pace of innovation in the financial sector.

Firms may find it difficult to create new products or services that fall outside of the prescribed regulatory framework. Moreover, regulations can have unintended consequences, particularly if they are overly draconian and inflexible. For example, much of the U.S. crypto industry may move offshore to jurisdictions that have a friendlier, more balanced approach to regulation and thus are more welcoming.

The significance of financial regulation to our economic well-being cannot be overstated. Nevertheless, a majority of regulatory mechanisms function without any adequate oversight (who regulates the regulators?). Consequently, regulatory bodies have frequently failed to meet the public's expectations and have eroded public confidence. For the crypto industry it is important for regulators to strike a balance between promoting innovation and protecting consumers through prudent regulation.

Finally, one may question whether the current U.S. regulatory system is sustainable. The current moves against crypto would not create an environment that is competitive, efficient, and adaptable to meet the evolving needs of consumers. Regulators, with their usual myopia, typically demonstrate their concern and responsiveness by continuously introducing new regulations, but they don't necessarily evaluate the impact and effectiveness of the existing rules. Consequently, regulators tend to move from one regulation to the next without fully understanding, or anticipating, the consequences of their actions. And because regulators do not operate within a system of checks & balances, they can pretty much do as they please.[1]

F.A. Hayek believed that government planning is usually based on a “pretense of knowledge”, as it assumes that central authorities can have all the relevant information and expertise to manage complex social phenomena. This important argument is often conveniently forgotten by those in power.[2]

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[1] https://rtp.fedsoc.org/paper/government-regulation-the-good-the-bad-the-ugly/

[2] "The Road to Serfdom" is a book written by economist Friedrich A. Hayek (1899-1992), first published in 1944. The book is a critique of socialism and a warning against the dangers of centralized planning and government control over the economy and society.

In conclusion, while regulations are important to ensure stability and security in the financial system, there is a need to balance them with an enabling environment that fosters innovation and creativity. Striking this balance will not only promote growth and development in the financial sector but also contribute to the larger economic and social goals of society.

Is there a better way?

The intended objective of regulation is to improve the overall welfare of society, rather than diminish it. Stated differently, regulations should have a net positive impact, outweighing any negative effects.

So, what should be done? Below, a number of key features of comprehensive and effective government regulation of the crypto industry are suggested.

First and foremost, the regulation should have clear objectives, such as preventing money laundering and terrorist financing, protecting consumers from fraud and scams, and promoting financial stability. But at the same time, the regulatory process should be transparent and open to public debate, including opportunities for stakeholders to provide feedback.

Flexibility in regulations is of utmost importance for the crypto industry. The emergence of new technologies and changing market conditions can create opportunities and challenges for the crypto industry. Regulations that are too rigid, or burdensome, can stifle innovation and impede growth in the industry.

Therefore, regulations should be designed to be flexible enough to accommodate changes in technology and market conditions. However, this flexibility should be proportionate to the risks involved, and should not compromise the safety and stability of the financial system. A careful balance must be struck between innovation and regulation.

Regulations should also be consistent with other laws and regulations to avoid conflicts and ensure a level playing field for all market participants. This consistency can help to promote confidence and trust in the crypto industry, which is crucial for its growth and development.

Effective enforcement mechanisms are also critical to ensure compliance with regulations. This includes appropriate sanctions for non-compliance to deter bad actors from engaging in illicit activities that could harm investors and the broader financial system.

Periodic review of regulations is necessary to ensure that they remain relevant and effective. As the crypto industry evolves, regulations may need to be updated or modified to reflect new developments and changing risks. It is important to conduct a rigorous analysis of the costs and benefits of any regulatory changes to ensure that they are well-designed and effective.

Overall, regulating the crypto industry requires a delicate balance between ensuring consumer protection and fostering innovation. The regulatory framework should take into account the unique features of cryptocurrencies, such as their decentralized nature and lack of a central authority, while also addressing the potential risks they pose to financial stability and the broader economy. To achieve this balance, regulators should work closely with industry participants, financial professionals, and other stakeholders to develop a regulatory framework that promotes innovation while also protecting consumers and maintaining financial stability.

Looking abroad?

In the words of the late Walter Wriston:[1] "Capital goes where it is welcome and stays where it is well treated." By capital, Wriston meant both that which you carry in your wallet and in your head.

There is proposed legislation in other parts of the world that may serve as a regulatory model for the U.S. For example, the European Union has proposed a new regulation called MiCA (Markets in Crypto Assets) that aims to harmonize the legal framework for crypto assets across the EU, protect investors, ensure market stability, and prevent illicit flows. Although, the MiCA proposal is still under negotiation and has not been adopted yet, it is expected to enter into force by 2024.[2]

Perhaps the best example of how it could and *should* be done is in Dubai. Cryptocurrency regulation in Dubai is both innovative and progressive. It passed its first crypto law – VAL (Virtual Assets Regulation Law) – in February, 2022. The law covers a broad range of crypto assets and activities, such as issuance, trading, custody, advisory, and payment services. The law also established an independent regulatory body – VARA (Virtual Assets Regulatory Authority) – to oversee and license the crypto sector in Dubai.[3]

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[1] Walter Wriston (1919-2005) former CEO of Citigroup, was widely regarded as the single most influential commercial banker of his time.

[2] For the full text of MiCA from the European Council: https://data.consilium.europa.eu/doc/document/ST-13198-2022-INIT/en/pdf

[3] This is the best example of how it should be done: https://www.vara.ae/en/

The VAL law aims to provide clarity, security, and innovation for crypto businesses and investors in Dubai. It also seeks to align with international standards and best practices for combating money laundering, terrorism financing, and other illicit activities involving crypto assets.[1]

Dubai is one of the first jurisdictions in the world to adopt a comprehensive crypto regulatory framework. It is expected to attract more crypto firms and investors to its growing digital economy.[2]

Conclusion.

The US government is currently engaged in a widespread crackdown on the cryptocurrency industry through the banking sector. A well-coordinated plan involving multiple financial regulators, is raising concerns in the crypto community that the industry may become unbanked, stablecoins could be stranded, and exchanges could be cut off from the banking system. This is a shortsighted and misguided approach.

Regulation should aim to improve the overall welfare of society rather than impede it, meaning its benefits should outweigh its costs. The U.S. government needs to develop a clear and consistent regulatory framework for crypto that is unprejudiced and does not stifle innovation, or competition.

Political polarization has become a major concern in the U.S., as evidenced by the growing divide between political parties and their inability to effectively govern the country. However, in the realm of cryptocurrency regulation, prioritizing the promotion of "public goods" rather than catering to partisan and special interests may offer a way forward that benefits everyone.

The term "public goods" refers to goods and services that are beneficial to society as a whole, such as public infrastructure, education, and healthcare. In the context of cryptocurrency, promoting public goods could mean creating regulations that encourage innovation, promote transparency and accountability, and protect consumers and investors.

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[1] https://www.coindesk.com/policy/2023/03/02/dubais-crypto-industry-welcomes-new-licensing-regime-amid-global-regulatory-uncertainty/

[2] https://www.arabianbusiness.com/opinion/regulation-is-key-to-cryptos-reputation-and-adoption-dubai-can-lead-the-way

In contrast, catering to partisan and special interests, or "public bads," could result in regulations that stifle innovation, favor certain players in the market, or fail to adequately protect consumers and investors.

To ensure that a crypto regulatory framework promotes public goods, policymakers must prioritize the interests of society as a whole rather than their own narrow interests. This would mean engaging with a broad range of stakeholders, including industry experts, consumer advocates, and government officials, to develop regulations that are balanced, effective, and widely supported.

The reintroduction of liberal economic principles in the U.S. over 40 years ago represented a major shift in economic policy, emphasizing free markets and limited government intervention. These principles are still relevant today and remain a cornerstone of many economic policies and debates.[1]

At the heart of these principles is the promotion of entrepreneurship, allowing individuals to innovate and create new businesses and products. This is achieved by reducing barriers to entry, such as excessive regulation and bureaucratic red tape. These principles promote the kind of freedom advocated by Milton Friedman and F.A. Hayek[2] over 60 years ago.

Consumer choice is also a central tenet of liberal economic principles. By allowing consumers to make choices freely in the marketplace, businesses are incentivized to produce high-quality goods and services at competitive prices. This not only benefits consumers but also promotes economic growth and prosperity.

Finally, liberal economic principles emphasize individual freedom, allowing individuals to live according to their own preferences and make their own choices. This includes the freedom to engage in economic activity, and to pursue goals and aspirations without undue interference from the government.

Politicians and government agencies that interfere with these principles do so at their own risk. Policies that restrict entrepreneurship, limit consumer

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[1] https://www.economist.com/special-report/2022/01/10/however-justified-more-government-intervention-risks-being-counterproductive

[2] *The Road to Serfdom* (1944) is a classic work in political philosophy and economics by F.A. Hayek (1899-1992) that has inspired politicians, scholars, and general readers for decades. In the book, Hayek emphasizes the importance of the free market and individual choice in promoting economic growth and maintaining personal liberties.

choice, or infringe on individual freedom, are likely to stifle economic growth and innovation, ultimately harming both individuals and society as a whole.