OneRiver Digital
ASSET MANAGEMENT

market notes: Competition Drives Clarity... Even in Regulation

27 JANUARY 2023

There's a time for nuance. Now is not that time. "Only someone living under a rock could think cryptocurrency markets don't need stronger regulation," observed former regulators Massad (CFTC) and Clayton (SEC). The private sector will lead regulatory solutions, clarity through the backdoor.

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1. "It is absolutely critical to reject Luddite conceptions of our markets as computer-crazed automata. Program trading, index arbitrage, futures markets, options markets, and several other useful innovations in our capital markets have been dangerously and incorrectly blamed for Black Monday's events." Joseph Grundfest, an SEC Commissioner under 40 years of age, offered in his elegant account of the 1987 Crash. It is a powerful essay on financial literacy.

2. After the 1987 Crash, the policy option was either to support financial innovation with better information and liquidity or a return to single-stock exchange to avoid the instability of futures, options, and program trading. Stock market crashes were not new. But 1987 was the first crash led by algorithms. In hindsight, the crash looks less ominous when stretching the axis of time, shown in Figure 1. Solutions like circuit breakers emerged – regulators invested in innovation, and markets evolved.

3. So, digital asset regulators and market participants aren't really pioneers after all! But the stakes are higher now – digital is disruptive to existing market mechanisms. The 1987 crash came at a time when economic growth was expected to be fostered by open, competitive markets. It was a friendly audience. The US was also sensitive to losing share in financial services, having been stung by past policy missteps.

4. Those missteps drove international USD funding markets to London – the Eurodollar market. Like any innovation, the Eurodollar market started quietly and small. And like every innovation, the leap to adoption was decades in the making. In 1957, the UK government suspended the use of the British Pound for international trade and banned credit refinancing. Banks didn't sit idly by – trade finance was still in high demand, and London banks shifted to US dollar deposits.

5. US policies, like Reg Q which capped US deposit rates, increased the attraction of offshore deposits. After all, the US was running balance of payments deficits, increasing US dollars into international markets. Holding those dollars in international banks avoided cumbersome US regulation. Midland Bank led the Eurodollar market with less than $100 million in deposits in the 1950s; the market was nearly on par with the entire US banking system in the 2000s.

6. Past lessons can inform digital assets markets, especially at this critical regulatory juncture. Regulation by enforcement is centerstage, intensified by the FTX collapse. "Enforcement is

ready to stand up" is the public declaration from SEC officials. The SEC brought 30 actions on digital asset markets last year, up 50%. The first-ever insider trading charge was levied. 71% of those impacted were individuals, not entities. And most attention is paid to fraudulent offerings.

7. With less fanfare, the CFTC is also active. The Commission brought 18 actions involving digital assets last year, 20% of all actions filed. The actions cover manipulation of the Digitex Futures native token; charged a DAO for offering leveraged commodities to retail investors outside of a registered exchange; addressed failures to register or seek designation as a designated contract market or futures commission merchant; and fraud.

8. Anxieties of regulation by enforcement only elevated with the joint statement of US banking regulators. Agencies declared a cautious approach to integrating digital assets into banking organizations, given last year's vulnerabilities. One of the big policy wins with the FTX downturn – there was no systemic consequence. We read the regulatory stance as a desire to reinforce that systemic resilience. Digital asset banking will be cautious in entering the mainstream.

9. LedgerX is another big policy win on the micro side. LedgerX, a futures and options exchange, was within the FTX family, but was spared from bankruptcy. Prudent regulation certainly played a role. LedgerX has been regulated by the CFTC since 2017. This demands segregation of client assets, a capital buffer to cover 12 months of operating costs, and an annual opinion from a certified public accountancy on the treatment of digital assets. Regulation by principle, not by technology, worked.

10. So, where are we headed? There is uncertainty among regulators and lawmakers. What do regulators want? SEC Commissioner Peirce is refreshingly clear: "the SEC wants to regulate crypto assets." Peirce makes a powerful point that is evident with all innovation – regulatory solutions are a last resort, not the first step. The private sector must drive solutions. This is already the quiet direction of regulated institutions. After all, exchanges were not on the enforcement list in 2022.

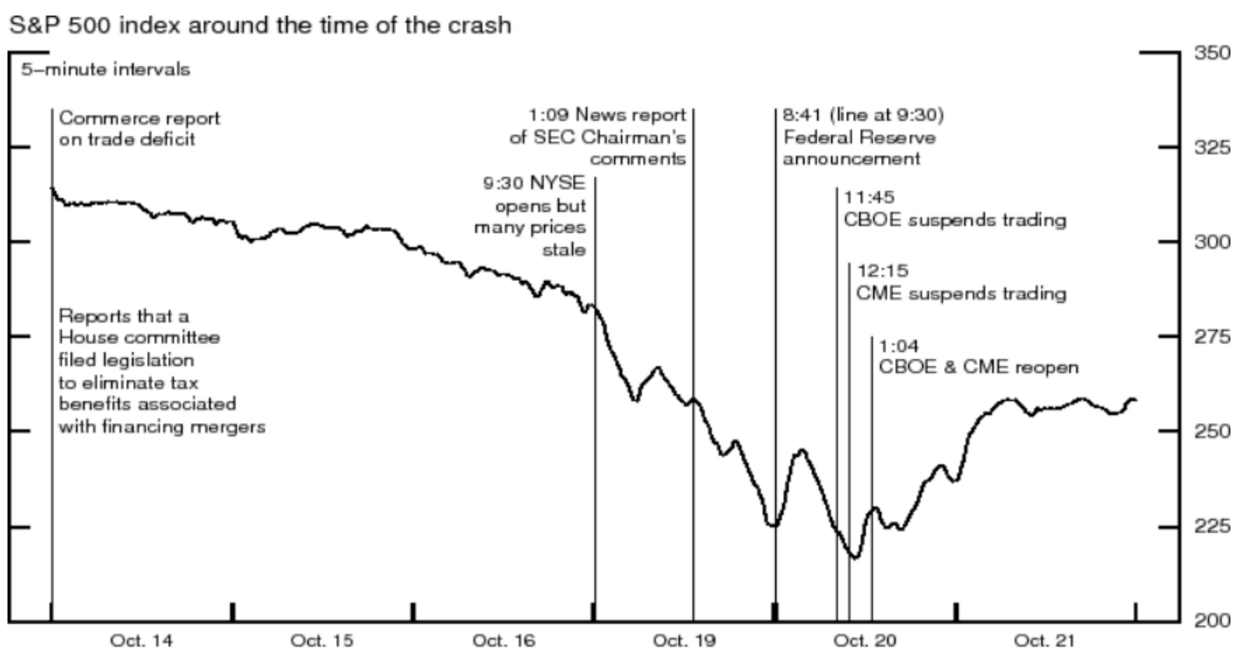
11. Peirce also offered a clever pathway forward. Governing statutes allow the SEC to waive or modify legal obligations when there is a valid reason for doing so. Using this authority, the SEC has provided bespoke relief through

exemptive orders or no-action letters. These pledge that staff will not recommend enforcement if certain conditions are met. Peirce likens such regulatory tools to the SEC's version of innovation sandboxing. Productive counsel.

12. Policy and regulators are a learned group. They understand the stakes are high. Even so, unintended consequences happen. The US and UK didn't intend for a gargantuan, offshore US-dollar financial market. The path was laid by a series of missteps. Now, the Fed is the liquidity provider of last resort to the global financial system, with cross-currency swap lines and reverse repo tools uniquely geared for solving US dollar liquidity strains that they don't oversee!

13. There are lessons from 2022. Those who learn them fastest will gain market share. This is not only the case for the private sector – there is also competition in public policy. Dubai, London, Zug, and Singapore – all have planted stakes in the ground to become a digital asset financial center. Adopting digital assets into the mainstream demands institutional standards, and the private sector is setting those standards (e.g., VARA). Digital isn't going anywhere. Investors demand clarity. And clarity will find a home.

Figure 1: Stretching Time and Perspective on 1987 Crash



Source: Federal Reserve Board. FEDS Paper 2007-13.

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