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# Congress, Don't Rush Regulating Crypto (Opinion)

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# Opinion

## Congress, Don't Rush Regulating Crypto

A sprawling infrastructure bill is the wrong venue for regulating an industry as complex and systemically important as crypto.

**By Angela Walch**

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After months of negotiation, there appears to be bipartisan consensus on an infrastructure bill. A $28 billion surprise for the crypto industry was also tucked into the legislation: The U.S. Congress plans to tax various actors in the crypto financial system to help pay for infrastructure spending. It will do so by classifying these parties as “brokers” under the Internal Revenue Code.

The news hit the crypto industry like a bomb. The new tax classification could force many previously unregulated parties to conduct “know your customer” scrutiny on transacting parties, dramatically transforming the crypto ecosystem. Since the announcement, the entire crypto sector has been frantically trying to get policymakers to change course, and even though I am generally a critic of the crypto sector this time I think they are right. While I reserve comment on the substance of the proposed crypto legislation, the *process* being used to regulate crypto through an unrelated bill on infrastructure is deeply flawed and risks increasing rather than reducing harms to the public.

On July 27, I testified about the crypto financial system at a hearing of the U.S. Senate Banking, Housing, & Urban Affairs Committee. I explained that the crypto financial system has reached significant scale (in the trillions of dollars and growing), and that due to numerous links that have been built between it and the traditional financial system (such as futures products, investment funds and many others) there is potential for crises in the crypto financial system to spill over into the traditional financial system.

I further testified that mainstream beliefs about basic characteristics of crypto systems are flawed because they are based on idealized views of these systems rather than realistic ones. (To give this a bit more color, if you have heard that crypto systems are immutable, allow the direct transfer of value online without intermediaries and don’t require you to trust anyone because they are decentralized, then you need to look for more realistic sources of information.)

If investors and policymakers make decisions based on misunderstandings of the characteristics of crypto systems, then each decision is flawed and embeds risk. This leaves us with a ticking time bomb at massive scale that – due to many links between the crypto financial system and the traditional financial system – has the potential to impact the public at large, including people who may never have touched a cryptocurrency in their lives.

For all of these reasons, after researching cryptocurrencies since 2013 I believe we can no longer wait to engage in comprehensive, tailored regulation of the crypto financial system, as Sen. Elizabeth Warren called for in a letter to Treasury Secretary Janet Yellen on July 26. For over a decade, regulators, industry, and the courts have been sparring over how the crypto financial system fits into the regulatory structure of the traditional financial system, and it is time to stop trying to cram this square peg into a round hole. Crypto industry players have been complaining for years about a lack of regulatory clarity, and all the while systemic risk has been building as the crypto financial system has exploded in scale and links to the traditional financial system have multiplied.

One may think, therefore, that I would be happy to see the regulation of activities in the crypto financial system included in the infrastructure bill. Unfortunately, that is not the case.

For a number of reasons, I believe that this is the wrong way to go about regulating the crypto financial system.

First, as I explained in my Senate testimony, the crypto financial system is large, complex and intertwined with the traditional financial system. The market cap of cryptocurrencies hit a value of over $2 trillion in April, and that doesn't include the financial products tied to cryptocurrencies or the companies operating in the crypto financial system. In short, it is now massive, and it's fair to say that we now have a traditional regulated financial system and a smaller but still sizable, largely unregulated, crypto financial system.

As to complexity, the sociotechnical systems (known as "crypto-economic systems" among academics studying them) on which cryptocurrencies like bitcoin and ether operate are a complicated blend of software code, cryptography, software developers, miners and validators who add transactions to the blockchain, and users. Each system has its own "crypto-economic" incentive structure built into it, in theory designed to share power among its participants in a stable way.

Further increasing complexity are the products and services that operate on top of base level crypto systems like Bitcoin and Ethereum. A "decentralized" financial system, known as DeFi, now runs on the Ethereum network, with decentralized exchanges, lending protocols and other mirrors of the traditional financial system. Outside of the systems themselves, parties like crypto exchanges and wallet providers, along with investment funds, so-called “stablecoins,” and financial products that financialize digital assets, fill out this complex web.

Regarding linkages to the traditional financial system, the crypto financial system is no longer its own isolated world of enthusiasts. Coinbase, a large crypto exchange, went public earlier this year at a valuation of more than $85 billion. Venture capital funds like Andreessen Horowitz are devoting billions to investments in the crypto financial system. Futures in bitcoin and ether have traded for several years now. Companies like Tesla, MicroStrategy and Square have disclosed that they hold large amounts of cryptocurrencies. A recent survey revealed that seven in 10 institutional investors expect to buy or invest in digital assets in the future, and that more than half of institutional investors in Asia, Europe, and the U.S. currently invest in them. (I could go on.)

Second, given this scale and complexity, along with the numerous linkages to the traditional financial system, regulation of the crypto financial system should be done with great care and deliberation, rather than casually and in haste.

Regulating the crypto financial system now is like trying to fix an airplane in mid-flight – an incredibly challenging task. It is a live, ever-evolving system with multiple interacting parts that regulation could affect in surprising ways through feedback loops and spillover effects into the traditional financial system. These effects can result in real losses of value to millions of people in the U.S. and globally. Making changes to crypto systems through regulation needs to be done with humility and care, not by wildly swinging a hammer, as I fear we would do by rushing crypto regulation into an unrelated infrastructure package.

Getting regulation of the crypto financial system right will require thoughtful consultation with numerous parties, from expert technologists doing bleeding-edge work on crypto-economic systems, to academics from multiple fields, industry players, and experts on how the crypto financial system is the same as and different from the traditional financial system. The consultation should bring together a diversity of perspectives, including those who believe crypto is a wholly positive innovation, those who have serious concerns about its value and the risks it poses and those who fall somewhere in the middle.

A vital part of this consultation will be *fact-finding* to ensure thorough and accurate understanding of the technological and human systems within the crypto financial system. Though policymakers have ostensibly been fact-finding on crypto for years now, as I argued in my testimony, mainstream understanding of crypto systems is shallow and deeply flawed. Only with such an exhaustive process can the resulting regulation triangulate on the best, most nuanced outcome. Rushing partial regulation of the sector into an unrelated infrastructure bill short-circuits that essential process.

Regulation should find a balance where Congress does neither too much nor too little, where it fosters the good and tempers the bad, where systemic resilience and stability are enhanced, and where potential harms to the public are minimized. Clearly, this "Goldilocks" nirvana is a tall order that we can hope to achieve only through humility, open-mindedness, solicitation of deep and broad expertise, discussion, and debate, all of which require at least a modicum of *time*.

Further, we cannot forget that the crypto financial system is inherently global, seamlessly reaching across national borders. U.S. policymakers can expect to make a massive difference by regulating the crypto financial system domestically, but this doesn't make the risks posed by crypto go away elsewhere. Regulation will likely require cross-border regulatory cooperation like we have seen with the Financial Action Task Force for policing global money laundering and terrorist financing or the Basel Accords for global banking. Rushing partial regulation of the crypto financial system into an infrastructure package risks cutting short a coordinated international response to an international problem.

I appreciate the pressure that policymakers must feel to address the systemic risks from the crypto financial system. But just because policymakers and regulators have allowed it to grow to its present state largely unchecked, does not mean that rapid-fire, piecemeal regulation is the best way to address the situation. The crypto financial system has become a many-headed hydra, and taming this hydra will require thoughtful planning, strategizing and public debate rather than a shotgun approach bolted on as an afterthought to unrelated legislation.

The stakes here are high and the regulatory approach must be sound. I urge Congress to strike the crypto regulatory measures from the infrastructure legislation and to give regulation of the crypto financial system the time and attention it so urgently demands.

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