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We've Seen This Movie Before

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If you listen to crypto executives, you'd think that they are some of the most besieged business leaders in history. By their telling, the industry has been lost in the regulatory wilderness, struggling with an impenetrable lack of clarity around which laws they're supposed to comply with or how they should go about complying. In their view, their technology is revolutionary and on the cusp of delivering huge gains in efficiency, economic growth and financial inclusion – if only Congress and regulators would provide rules of the road that unleash American innovation in the face of an increasingly competitive global landscape.

But make no mistake, the crypto industry is not a bunch of heroes fighting against all odds for their own survival. In fact, crypto industry maneuvers look a lot more like Keyser Söze in the Usual Suspects – cunning in their use of deceptive tactics to orchestrate their own immunity. And this crypto script is not new or unique, instead grounded in a long history of financial industry reboots of the same old plot.

The strategy is simple: ambitious firms adopt an approach akin to the Thomas Crowne Affair – executing a heist and endeavoring to woo the watchdogs into becoming accomplices. In the crypto version, firms develop non-compliant or questionably-compliant business models that they hope establish enough incumbency, profitability and political power that Congress and regulators are coerced to rewrite existing laws to retroactively bless them.

The script goes like this:

- **Past lawmakers did not and could not possibly have contemplated the innovation embodied in this new financial technology;**
- **These technological breakthroughs mean that there exists irreconcilable "uncertainty" regarding the application of current laws; and**
- **Lawmakers must adjust these outdated laws to help U.S. firms keep pace with foreign competitors.**

Unfortunately, despite the sweet talk, this movie doesn't have a happy ending. Regulators, Congress and the public need to learn how to foil this plot, fast, or else families are going to learn How to Lose their Retirement Savings in 10 Days.

Back to the Future

Crypto's current playbook should be viewed as a sequel to past efforts by the financial industry to prevent regulatory action while industry profits are soaring and risks to the broader economy are growing. A few examples from the recent past show just how much moneyed interests have perfected this script.

Creating the Modern Too Big to Fail Bank

Take, for example, in 1998 when Citicorp – the largest U.S. commercial bank back then – purchased Travelers, a large securities and insurance firm. At the time, the Glass-Steagall Act of 1933 was still on the books, requiring structural separation between commercial banks that take deposits and make loans, on the one hand, and investment banks and insurance companies, which speculate on securities markets and underwrite insurance policies, on the other. This structural separation, created by policymakers after years of investigations, was driven by the conflicts of interest that helped create the 1929 stock market crash. It was also meant to ensure that the newly created deposit insurance fund, which guaranteed bank depositors' money, was supporting lending in the economy instead of risky investment bets or unrelated insurance activities.

Therefore, given these longstanding restrictions, Citicorp's purchase of Travelers in 1998 was a bold gambit. Relying on a loophole that allowed banks to violate Glass-Steagall's structural separation requirements for a time-limited transition period, Citigroup's acquisition represented an audacious wager on the bank's ability to bend Congress to their will and repeal the 1933 law before their ownership of Travelers became impermissible. The *New York Times* in 1998 called this acquisition "do-it-yourself deregulation" and said that Citicorp and Travelers were "gambling that they can use their political muscle and the sheer weight of the marketplace to break down the longstanding barriers." Citicorp's press release at the time of the transaction was confident, declaring that the bank, "expect[s] that current laws restricting bank holding companies from participating in insurance underwriting activities will change in the foreseeable future to make the U.S. more openly competitive in global markets."

The gamble paid off. Citicorp and other large financial institutions launched a campaign with "an army of lobbyists and lawyers" and surged campaign donations such that – in relatively short order – the industry persuaded Congress to nix Glass-Steagall with the Gramm-Leach-Bliley Act (GLBA) in 1999. GLBA authorized the creation of the modern megabank, whose holding company could now own banks, securities firms, and insurance companies, thereby confirming the legality of Citi's strategy.

And the justification at the time? The Senate report accompanying the bill's passage cited that "developments in technology...have rendered the laws governing financial services unsuitable and outdated." Other sections in the Senate report quoted the Federal Deposit Insurance Corporation Chair as saying, "improvements in information technology and innovations in financial markets have rendered the current system increasingly obsolete." Meanwhile, financial analysts cautioned before passage that if Congress failed to enact the GLBA and bless the Citicorp acquisition it would represent "a failure to set clear ground rules" that would harm U.S. competitiveness.

President Bill Clinton, who signed the Glass-Steagall Act repeal into law, echoed the talking points from Citicorp's press release and noted at the signing ceremony that U.S. companies would be afforded "freedom to innovate in the new economy" and would be "better equipped to compete in global financial markets." A supportive lawmaker at the time echoed the sentiment, noting that the bill would remove "artificial structural limitations that place [American banks] at a competitive disadvantage in the constantly evolving international playing field."

Swooping in to Stop Derivatives Regulation

The next act in the script didn't come long after the destruction of Glass-Steagall's firewall. In the late 1990s, the use of financial derivatives was growing both in size and complexity. These new financial products, allowing banks to make leveraged bets on the performance of financial assets like mortgages, were exempted from regulation under a 1993 interpretation of the Commodities Exchange Act (CEA) by the Commodity Futures Trading Commission (CFTC).

Seeing this market explosion and fearing future financial instability, in 1998, the CFTC Chair Brooksley Born put out for comment a Concept Release for feedback that solicited the public's views on amending the 1993 loophole and applying a regulatory framework to financial derivatives using existing authorities of the agency under the CEA.

The backlash was immediate. Treasury Secretary Robert Rubin (an ex-Goldman Sachs executive and future Citigroup executive), Federal Reserve Chair Alan Greenspan and Securities and Exchange Commission (SEC) Chair Arthur Leavitt immediately released a public statement rebuking the CFTC's Concept Release. They cited the "legal uncertainty" it created in a "large and important" global market. Treasury Deputy Secretary Larry Summers shortly thereafter argued that the proposal "cast the shadow of regulatory uncertainty over an otherwise thriving market" and created "the risk that the U.S. will see its leadership position in derivatives erode" as big banks moved their activities to foreign markets.

And the call to stop the CFTC from acting didn't just come from other government officials. In fact, the lobbying push to stop the CFTC from acting was so overwhelming that the *Washington Post* reported that the Senate Agriculture Committee in a July 1998 hearing "had to switch to a larger room to accommodate the expected crowd of lobbyists representing banks, brokerage firms, futures exchanges, energy companies and agricultural interests." One account by Professor Emeritus of Law at George Washington University Art Wilmarth noted that the International Swaps and Derivatives Association (ISDA) – a trade association representing major banks and securities firms that were engaged in financial derivatives – "sprang into action" to stop Born's CFTC. Wilmarth describes a "tenacious campaign" with ISDA working hand-in-glove with the Treasury Department and Federal Reserve to block any regulation of these emerging and risky financial products.

Again, the lobbying campaign worked. Congress in late 1998 passed a six-month moratorium on the CFTC exercising any authority to regulate financial derivatives and Chair Born left the agency in June of 1999. Just months later, in November of 1999, her replacement – William Rainer –joined his colleagues at the Treasury Department, Federal Reserve and SEC to issue a report rebuking any CFTC action on derivatives (even after the conclusion of the moratorium), noting "a cloud of legal uncertainty has hung over the over-the-counter derivatives markets in the United States in recent years, which, if not addressed, could discourage innovation and growth of these important markets and damage U.S. leadership in these arenas by driving transactions off-shore."

The capitulation of the CFTC was not enough. By 2000, the industry was closing in on a complete and total victory to stop the use of existing law to apply regulation. The Commodity Futures Modernization Act (CFMA) was introduced in Congress and specified that over-the-counter derivatives between "sophisticated" parties could be transacted without oversight of the CFTC, SEC or even state enforcement. The draft law received broad support from the financial services industry in Congress, with Goldman Sachs, Morgan Stanley, Enron and other firms lauding lawmakers for "promoting innovation." The Securities Industry Association said that a failure of Congress to act would shift economic activity to a more "hospitable legal environment" outside the U.S. Finally, the Clinton Administration noted that a failure to pass the bill could result in the "movement of these markets to overseas locations with more updated regulatory regimes."

Eventually, the CFMA was "quietly inserted…into a $384 billion, 11,000-page omnibus spending bill" with some observers speculating that ISDA itself wrote the provisions sponsored by Senators Gramm and Lugar. Passage of the Act upended oversight to which trading markets had been subject since the New Deal and even pre-empted state laws relevant to gambling and "bucket shops," or places where people can illegally speculate on the price movements of securities and commodities.

The battle to stop the CFTC from acting had been won.

Thwarting State Action on Subprime Mortgages

At the same time as GLBA facilitated more merger activity and the derivatives market benefitted from the "certainty" (read: permissiveness) enabled by the CFMA, consumer advocates, local officials and housing organizations started to notice a proliferation of "nontraditional" mortgage loan products across the country. The mortgages had features like the absence of downpayments, refinancing arrangements that disregarded the borrower's ability to repay, and/or weak documentation of the homebuyer's income. Later, more exotic loan features proliferated, including interest-only, negative amortization (meaning, the loan balance perversely went up over time instead of down) and payment-option loans. At the same time, home prices started to churn upwards even while the unemployment rate remained steady and incomes were constant.

Seeing these local changes, groups like the Greenlighting Institute and National Community Reinvestment Coalition, along with cities like Cleveland, set-up meetings with Federal Reserve officials in Washington, D.C. and began asking the regulator to use existing authority under the Home Ownership and Equity Protection Act (HOEPA) to rein-in the predatory features of these mortgages offered to "subprime" borrowers, or borrowers with weaker or shallower credit histories. James Rokakis, the county treasurer of Cuyahoga County, Ohio, specifically recalls asking the Federal Reserve to use their power under existing law to "[declare] some of the lending practices to be 'clearly illegal,'" and called on regulators to combat the growth in these mortgages with enforcement measures.

In response to this public pressure, federal regulators did… nothing. Alan Greenspan, the Chairman of the Federal Reserve at the time, rebuffed pleas to examine the lending conducted by bank-affiliated mortgage companies, even on a pilot basis. In general, the supervision of these affiliates and subsidiaries dominating the subprime mortgage market was left to state agencies and the Federal Trade Commission, both of which lacked the resources of the Fed. Greenspan refused to intervene to either use HOEPA authority to write stricter rules against predatory lending or to use supervisory authority to leverage Fed resources to examine these high-risk affiliates and subsidiaries.

At the same time, the surge in advocacy by public interest groups did lead to action at the state level, with many jurisdictions passing legislation to curb the proliferation of subprime mortgage loans. In North Carolina, for example, the state legislature passed a bill that intended to "go far beyond HOEPA in limiting the practices that could be used in making high-cost loans." The State of Georgia soon followed in 2002 with a law similar to, but even stronger than, the North Carolina law. Other states like New Jersey, New York and New Mexico joined in, too.

But enactment of anti-predatory lending laws didn't go unnoticed, with the financial industry jolting into activity to thwart action by leveraging the countervailing power of federal officials. It was not enough that federal agencies were shirking their own authorities to combat subprime lending; the industry also wanted them to affirmatively gut state-level regulation. In the words of a *Wall Street Journal* article from the time detailing the lobbying power unleashed to combat emerging state laws, "federal lawmakers didn't pose much of a threat to the subprime industry in recent years… the states were a different matter."

The lobbying machine again fired itself up. During this period, large banks appealed to the White House and regulators to exempt thrifts and national banks (or lenders chartered at the federal level that operate across states) from state anti-predatory lending laws via a doctrine known as "preemption." Federal regulators, responding to these pleas, wielded preemption power aggressively, rebuffing states' attempts to adapt consumer protection laws to a changing financial marketplace.

Instead of framing these efforts as gutting the existing regulatory framework by deploying captured federal regulators to thwart states, banking lobbyists described the campaign as federal agencies "eliminat[ing] much of the uncertainty for national banks" and said that the effort would "[drive] new product innovation."

Lobbyists also opposed any legislative effort seeking to override federal regulators' posture of acquiescence, saying any attempt by Congress to set national standards would "simply stifle innovation," would "choke innovation," or would "run the risk of turning back the clock on innovation." In fact, the word "innovation" is mentioned 22 separate times in just one example of pre-crisis testimony.

Other lobbyists noted that attempts by private plaintiffs to sue under federal and state law for redress for subprime loans created "a great deal of uncertainty and anxiety in the mortgage industry." To the extent federal legislators should do anything at all, one panelist at a congressional hearing noted, "the main role [they] should play at this time is to rein in actions by States and municipalities." He urged, "immediate Congressional action to dismantle these new undesirable barriers."

And while it's hard to conceive of the financial services industry saying that curbs on domestic mortgage lending would somehow hurt the United States' international competitiveness, they did indeed find a way to make that case. Securitization, they argued, was a revolutionary technological innovation that allowed banks to slice and dice mortgage risk to offer more credit to homebuyers and to secure American economic dominance. A January 2007 report from McKinsey & Company, commissioned by then-New York City Mayor Michael Bloomberg and Senator Chuck Schumer, argued that Europe had a growing consumer credit securitization market that could "lead to a deterioration in U.S. competitiveness if markets and institutions fail to follow the pace increasingly set by their European competitors." The report further warned that the United States' days of dominance in securitization "may be numbered" and called on domestic policymakers to create a more hospitable environment for this technologically novel and innovative activity.

The result was a lack of meaningful subprime lending reform until the Fed finally exercised their authority in July of 2008 to approve "a final rule for home mortgage loans to better protect consumers and facilitate responsible lending." By then, the crisis was already in full swing and it was too late.

The Perfect Storm

A decade after the repeal of Glass-Steagall the *New York Times* noted that the acquisitions enabled by GLBA "fostered some of the financial innovations that many say contributed to the subprime mortgage crisis." Sanford Weill, the former Chairman and CEO of Citigroup, in 2012 called on Congress to break-up the very financial conglomerates that he, through the Citicorp-Travelers merger and its attendant lobbying, created.

The CFMA, too, was widely credited as a contributor, if not a catalyst, for the 2008 collapse. The seminal report by the Financial Crisis Inquiry Commission (FCIC) concluded that the "enactment of legislation in 2000 to ban the regulation by both the federal and state governments of over-the-counter derivatives was a key turning point in the march toward the financial crisis." Scholar Lynn Stout concluded that the "sudden development of an enormous market in financial derivative contracts was not the result of some new idea or 'innovation.' Rather, it was a consequence of the steady deregulation of financial derivatives trading." Former Treasury Secretary Robert Rubin during the post-crisis autopsy period clarified that he never actually disagreed with former CFTC

Chair Born but that the lobbying pressure from the financial services industry was insurmountable and contributed to the Treasury Department's capitulation on the issue.

The FCIC report likewise pointed to the inaction of federal regulators on subprime mortgage lending and the preemption of strong state laws as a central factor in the 2008 crisis. The report notes that the Fed "failed to build the retaining wall before it was too late" and blamed preemption for the surge in predatory loans across states that otherwise would have had a firewall.

Groundhog Day

There is a tragic throughline running through this long-running script: financial industry leaders blow past legal guardrails, citing that their technological innovations cannot possibly be cabined in by outmoded rules created by a previous generation. Regulatory and law enforcement officials are under-resourced and out-gunned even at times when they have the best intentions for fulfilling the public interest. Other times, these officials are captured by the very industries they're tasked to police. In either case, industries are too often able to establish economic power through their noncompliance with existing law and translate it into political power to rewrite the rules to bless their business models. This noncompliance in the face of clear existing legal precedent creates the very "uncertainty" that the industry points to as a justification to change the law. And the final rhetorical move is to invoke international competitiveness, hoping to scare lawmakers into believing that a failure to bend the law to an industry's favor will harm U.S. industries, jobs and growth.

Crypto has memorized this script and is reading their lines in an Oscar-worthy performance to many policymakers. Congressional hearings bemoan the "legal uncertainty" caused by applying longstanding laws to arrangements that look a lot like pre-existing investment schemes but are digital or blockchain-based. Crypto industry petitions to federal agencies say that Great Depression-era laws "[prevent] market participants from leveraging the efficiencies new technology can offer."

And again, testimony from industry leaders demands that Congress abandon existing law in favor of a new framework to enable their technological innovations, as not doing so would stifle American economic growth. "We are losing the race to build the kind of structures and support that fosters innovation here at home. You do not need to look far to see the risk of sending innovation offshore," one recent industry testimonial to Congress notes. Another lawmaker notes that, absent actions to stop the application of existing law by the Trump Administration, the United States "risks…forfeiting its leadership in financial technology,"

Meanwhile, the new Chair of the SEC is promoting an "innovation exception" to provide an avenue for a carve-out for certain investor protection and market integrity rules. New legislation in Congress seeks to add "innovation" to the mission of the SEC, as if creating new financial products were itself a goal, rather than a tool to serve investor or capital formation.

End Scene

None of the 2008 calamity was inevitable. Policymakers created the conditions for the crash by reading from the industry's script. There was no technological innovation in the first decade of the 2000s that required a new legal framework for finance and there wasn't much regulatory "uncertainty" except for whatever was created by firms' noncompliance with existing laws or regulators' refusal to enforce them. In each case, federal and state agencies had the tools in place to stop emerging financial activities from harming the wider economy – that is, until lobbyists and Congress stepped in to nullify those tools or ensure they were kept firmly on the shelf. The promise of international competitiveness proved illusory when the United States catalyzed a worldwide financial crisis that wiped out magnitudes more domestic wealth than it ever created, leading 90 percent of Americans had less wealth at the end of 2016 than they did in 2007. It's time for policymakers to rewind and chart a different ending.

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