Regulatory Update
April 1, 2019

In this update, we look at a former CFTC Chair's push for stronger crypto regulation and Bitwise's presentation to the SEC regarding bitcoin volume manipulation.

Former CFTC Chair: Time to Strengthen Crypto Regulation

There is a regulatory gap in the crypto space that needs to be addressed, according to a report published in March by Harvard fellow and former CFTC Chairman Timothy Massad. Massad served as Chairman under the Obama administration from 2014-2017. Prior to that, Massad played a major role in the federal response to the Financial Crisis of 2008, serving as the Department of Treasury's Assistant Secretary for Financial Stability and overseeing the Troubled Asset Relief Program (TARP).

In the paper, Massad described the need for increased regulatory oversight in the digital assets space and proposed some steps moving forward to better address present shortcomings.

The New Financial Intermediaries

Massad promoted that, contrary to the hype surrounding the ability of crypto-assets to displace intermediaries, the reality is that bitcoin trading platforms are acting as "the crypto equivalent of modern-day banking, but without any of the law or regulation to protect customers." He pointed out that deposits are often commingled among customers, not recorded on a blockchain, and surrounded by opaqueness regarding execution, settlement, and storage. On top of this, he said hackings continue to increase and threaten customer assets, which are not afforded the protection of SIPC insurance.

"Mind the Gap"

Massad heralded the efforts of the SEC and CFTC in policing the emerging industry, though expressed doubt as to whether the regulation by enforcement approach was optimal–it creates what he called a "whack-a-mole" dynamic between regulators and crypto platforms.

He argued that state legislation serves as "a weak foundation for an industry that strives to be international." Another regulatory agency or a fintech sandbox similarly offer little benefit in his perspective. Likewise, he warned that self-regulation is "no substitute for government regulation," though industry participants should continue developing standards.

Massad's Recommendations

Massad urged that regulators should act before an Enron-level crypto scandal. In his view, the Financial Stability Oversight Council (FSOC) is best positioned to unite all financial regulators and focus on the issues. An investigation and report commissioned by the FSOC is the first step, he proposed to inform future legislation granting supplemental authority to the SEC or CFTC.

After such a report, crowdfunding law, he offered, could act as a model for legislative action, citing how the JOBS Act adopted broad principles that the SEC later advanced through detailed regulation. He said these core principles should cover: customer protection, governance rules, conflicts of interests, prevention of fraud, pre- and post-trade transparency, and AML/KYC measures.

He proposed using creative thinking to devise "a hybrid approach" that allows investor protections requirements to be met in multiple ways. According to Massad, this could be a step forward in leveling the playing field between centralized and decentralized entities, citing the regulatory favor given to centralized entities with the example of the CFTC requirement that nearly all futures contracts trade on registered exchanges.

"Blockchain's potential won't be determined by regulation. However, we can, and should, act to create a regulatory framework with respect to the distribution and trading of crypto-assets that improves investor protection and addresses the broader societal interests at stake."

Bitwise to the SEC: Most Bitcoin Exchange Volume in Fake

On March 19, executives from Bitwise Asset Management met with members of the SEC to discuss the proposed rule change filed in January that would allow NYSE Arca to offer the Bitwise bitcoin ETF. The presentation included over 200 pages of powerpoint slides in which Bitwise made the argument that while 95% bitcoin trading volume reported by exchanges is fake or "non-economic in nature," "the real market for bitcoin is significantly smaller, more orderly, and more regulated than commonly understood."[1]

The presentation attempted to distinguish Bitwise's ETF proposal from previous proposals rejected by the Commission. It described how the Bitwise ETF will provide "direct exposure to bitcoin" by tracking the price on the top 10 crypto exchanges that display real trading volume. It will use a regulated and insured third-party custodian. Together, it proposed that these steps mitigate the SEC's issues with pricing, liquidity, custody, and manipulation.

Real Exchanges vs. Suspicious Exchanges

Bitwise offered descriptions of "real exchanges" and "suspicious exchanges." Suspicious activity, it pointed out, includes trades printed between the bid and ask (nearly perfect distribution of buy and sell orders, little variation in trade size, and larger spreads), large gaps with no volume, and monotonic trade volume. According to its research, Bitwise promoted that only 10 of the top 81 crypto exchanges revealed actual volume. It stated that real volume totals around $273 million instead of the alleged $6 billion.

[1] Bitwise used data from 81 regulated and unregulated cryptocurrency exchanges, starting with the ones with the most reported trading volume. *See* slide 41.

The Bright Side: "The Bitcoin Market Is More Orderly and Efficient Than Is Commonly Understood."

This actual volume is healthy, though, given bitcoin's comparison to gold, according to Bitwise. Their presentation referenced a comment letter to the Winklevoss ETF (the "Overdahl Letter") to which the SEC responded and indicated that bitcoin's average daily volume (ADV) on Gemini is not a concern "in an absolute sense."

Bitwise demonstrated that the bitcoin futures market is "significant," comparing the ADV of the CME bitcoin futures market ($85 million) to bitcoin's largest spot market reached ($110 million). Further, it forwarded that the "true nature of the actual market" is understood at an institutional level.

"The Bitcoin Market Is More Regulated and Surveilled Than Is Commonly Understood."

Bitwise examined the regulatory frameworks applied to the crypto space. It pointed to the 2013 FinCEN guidance that called on virtual currency business to apply as money services businesses (MSBs). Bitwise also described the advanced market surveillance tools used by the largest crypto exchanges to detect and deter illicit activity.

Responding to the SEC's previous determinations that bitcoin ETF filings failed to meet the standards set by Exchange Act Section 6(b)(5), Bitwise asserted that the bitcoin market is both "uniquely resistant" to manipulation and that there is a surveillance sharing agreement with a regulated market of significant size.

A decision from the SEC on the Bitwise ETF could come as soon as April, though it will likely use the full 240 days to submit its final decision, which would come in October.

Read more on our website

Our Response to the Bitwise Report

The information compiled by the team at Bitwise represents what many industry participants have suspected for a while. At LGO, we have made a commitment to bringing transparency to a space that has suffered from rampant fraud, manipulation, and misrepresentations.

Orders are time-stamped and recorded on the blockchain before being fed to the matching engine, creating an immutable order and trade history.

The blockchain becomes the source of truth and the guardian of transparency of the order book. Our protocol guarantees transparency in the price discovery process while maintaining the anonymity of market participants.

Other News

- CoinCenter: New Regulation Would Effectively Ban Crypto Exchanges in Mexico
- CoinTelegraph: Bakkt Delay Due to CFTC Concerns Over Its Planned Custody of Clients' Bitcoin: WSJ
- Bitcoin Magazine: After QuadrigaCX: New Regulations for Canadian Exchanges Are in the Works

The information provided is for informational purposes only. It does not constitute legal or investment advice.