[JTC: I would add that, rather than relying on political oversight in the first place, all businesses should be "regulated" – that is, evaluated publicly, by independent private institutions, especially insurers and auditors. Expecting that governments will prevent fraud is the base problem.]

Return of the Great American Bubble Machine

By Matt Taibbi

Albeit with new wrapping and new jargon, crypto has been infected by the same old problems of insider finance

On May 12, 2022, just over fourteen years after the collapse of Bear Stearns, the *New York Times* announced another crash. In a story entitled, "Cryptocurrencies Melt Down in a 'Perfect Storm' of Fear and Panic," the lede read:

> *A steep sell-off that gained momentum this week starkly illustrated the risks of the experimental and unregulated digital currencies.*

The story told of a mass investor flight from cryptocurrency markets, which has since caused an astonishing $700 billion in losses. There were several key triggering events, including the collapse of a "stablecoin" product called TerraUSD. A stablecoin is a type of digital currency that's usually pegged to the value of a "stable" reserve asset like a dollar. They are often used to enter and exit trades for other cryptocurrencies, like Bitcoin.

In theory, stablecoins work, if they're backed by real assets and by guarantees that hog-tie the customer to their money in adverse conditions. Part of the idea behind a stablecoin is to be the calmer end of the volatile crypto experience. As *Bloomberg* put it, stablecoins can be a "safe haven" for investors, who can keep their holdings "protected from wild swings in the crypto market" without need to "convert their holdings into traditional money." But the implosion of TerraUSD put a big early dent in the "safe haven" description.

That wasn't the only factor. Just days after TerraUSD lost its "peg" and started its freefall in early May, financial observers found an eyebrow-raising passage in the already-disappointing quarterly 10-Q report of a crypto market leader, Coinbase. In addition to reporting a $430 million loss and a 19% drop in users, the company stated:

> *In the event of a bankruptcy, the crypto assets we hold in custody on behalf of our customers could be subject to bankruptcy proceedings and such customers could be treated as our general unsecured creditors.*

Coinbase is the largest cryptocurrency trading platform in the United States. When a customer stores cryptocurrency in a Coinbase wallet, those funds in theory can only be accessed with a cryptography-protected key, making it, again in theory, the unique property of the customer.

This type of protection is supposedly what's at the heart of the crypto revolution, powered by its underlying Blockchain technology. The new method for storing data creates unique, timestamped "chains" of information visible to everyone in a digital community. In a theoretical Blockchain world all financial history would be visible, instantly recallable, and set in stone, making customers immune to the kind of non-transparent, triple-dealing corruption that ruined those who placed their trust in infamous black boxes like Lehman Brothers prior to 2008.

The Coinbase disclosure however brought back some of these memories. In the event of a bankruptcy, the firm's 10-K release said, risk existed that people with funds in Coinbase wallets could find themselves fighting with other Coinbase creditors in a legal proceeding to decide who was owed first. No matter how sound a company it was or is, Coinbase posed the same theoretical problems that all financial institutions posed to customers in the pre-crypto world, forcing users to put trust in those opaque institutions known as "centralized" ledgers.

The incident triggered headlines like, "Coinbase admits users could lose crypto" and "Coinbase admits risk to investor fund," and caused market mayhem. $200 billion vanished from the valuation of crypto companies within 24 hours as, among other things, the share price of Bitcoin, the leading crypto product, fell on the news.

Coinbase CEO Brian Armstrong insisted the passage had been inserted at the insistence of the S.E.C., and that while it was "possible, however unlikely," that there could be fight over who's owed what in a Coinbase bankruptcy, "your funds are safe with Coinbase." However, the damage was done. More serious problems that popped up later at companies like Vauld, Celsius, and others continued the plunge, raising a general level of panic where just a year ago, euphoria reigned.

Much like the mid-90s, when the arrival of genuinely revolutionary Internet technology was delayed by a parade of overhyped pretenders with names like Webvan, Pets.com, and DrKoop.com, the crypto boom is being stalled by a fine-print reckoning. In an extraordinary irony, this market's recent success seems to have only replicated on a grand scale the exact problems Blockchain technology was designed to cure, only in a different guise, and in language even more inaccessible to ordinary people.

The crypto market is straining under the weight of a perhaps insuperable contradiction. On the one hand, digital currencies were created in significant part with the idea of replacing or improving upon "centralized" finance, including regulatory authorities. If a Blockchain world with a thriving international digital currency were to exist, it would perhaps fatally undercut the financial and political authority of governments. Crypto doesn't really want to be regulated, and for at least one logical/perhaps-legitimate reason – there are some illegitimate ones I'll get to – governments don't want to regulate it, in the same way capitalist countries once hesitated to recognize the Soviet Union.

"Even among the progressives in regulatory agencies, there's been a reluctance to engage really strongly with crypto," is how Georgetown professor Adam Levitin puts it. "I think in part there's a hope that some of the fire would just kind of burn itself out, for there's a fear of legitimizing crypto through regulation."

Using digital currencies to help the billions around the world with no access to banking services become participants in a system that has long excluded them is a great thing, in theory. The issue is the

structure of these companies. If a stablecoin firm is taking your dollar and trying to make money lending it somewhere, they're just "unregulated, uninsured, unaudited banks," as one financial analyst puts it.

Misperceptions about how certain types of investments were "fully hedged," "asset-backed," or faced only "de minimus" exposure to loss, were a major factor in causing the huge buildup of unrecognized risk that caused the last financial collapse fourteen years back. This market is now giving off a strong whiff of *déjà vu*. I'll break a longstanding personal ban on a certain journalistic cliché to quote another former regulator:

"It's 2008 on crack."

On March 18, 2008, two days after the collapse of the legendary Wall Street firm Bear Stearns, another member of what was then known as the "Big Five" group of top investment banks, Lehman Brothers, made a dramatic announcement. The CNN headline said it all:

Lehman weathers the stor

Brokerage quiets talk about its imminent collapse af beat forecasts. Shares surge 46%.

Bear had just imploded after short sellers pounced on rumors it was overwhelmed with mortgage debt, causing a massive run to the exits that ended with a state-aided sale of the bank to J.P. Morgan Chase. In a desperate attempt to avoid the same fate, Lehman had its Chief Financial Officer, Erin Callan, make a series of announcements designed to publicly dispel notions it was broke. Saying the bank is in a "strong liquidity position," Callan announced that Lehman was sitting atop a liquidity "pool" that included "$34 billion and $64 billion in assets."

For Matthew Lee, at the time a Senior Vice President in Lehman's finance division, the "liquidity pool" stunt was staggering to behold, and one of the last straws on his journey to blowing the whistle on the firm to auditor Ernst & Young. The way he saw it, Lehman was trying "by hook or crook" to do anything to avoid having its credit downgraded by ratings agencies like Moody's and Standard & Poor's. Such a move would have triggered a series of losses leading to a financial death-spiral, similar to the one that destroyed Bear. So the firm simply lied about how much money it had.

"Lehman employed some exceptionally silky smooth talkers, the kind of talkers that successfully sell sun lamps in the Middle East, and ice cream above the Arctic Circle," Lee recalls now. "I always

thought Lehman representatives did a brilliant job of convincing rating agencies of anything… Ratings agencies are not full of sharp knives, and easily manipulated." The "liquidity pool" remains an iconic event in the history of financial corruption, perhaps the ultimate example of what can happen when investors are forced to rely on the word of an opaque financial institution.

Lehman didn't have $34 billion. The bank turned out to have put collateral it had already pledged to other actors in its "pool." Chase, for instance, had already accepted at least $5 billion of the "collateral" Lehman said it had available. This is like saying you've got $500 in the bank, when you've already mailed a check for at least $100 of that to pay your phone bill. Investigators later determined the "pool" in reality contained no more than $1-$2 billion.

Of course, Lehman's condition soon became clear, and the bank would collapse, leading to one of the most extraordinary months in the history of finance. In September, 2008, the world learned that not just Bear and Lehman were bust, but also AIG, Merrill Lynch, Washington Mutual, Wachovia, and a long list of other titans.

The collapse of firms like Bear Stearns and Lehman Brothers, and the tsunami of losses that followed in September and October of 2008, wiping out as much as 40% of the world's wealth according to some estimates, underscored a basic problem in the global financial system. How can you tell when a systemically crucial firm, or even a government, is lying? How can anyone feel safe in a system full of black boxes run by ethically challenged millionaires and billionaires?

On January 3, 2009, an anonymous computer developer going by the name Satoshi Nakamoto created the first "Bitcoin," a form of digitized currency designed as a technological solution to the problems posed by companies like Lehman Brothers. In fact, the "genesis block" of Bitcoin, i.e. the first-ever unique unit of digital currency, had a message written into its code:

> **The Times 03/Jan/2009 Chancellor on brink of second bailout for banks**

Referring to a story by the *London Times* about the 2008 crash, this genesis block was intended to make sure the world never forgot that a corruption-fueled financial bubble was essentially the inspiration for the cryptocurrency movement, or at least for the creation of the most famous of the cryptocurrencies, Bitcoin.

"2008 was definitely the thing that gave birth to Bitcoin," says Vitalik Buterin, CEO of Ethereum. Buterin added that the success or failure of the crypto movement will depend in significant part on whether or not it lives up to its stated principles.

"The really key idea is whatever the rules are, they're transparent," he said. "Everyone sees what there are. They're in the code, and everyone's agreed to them. And there isn't one central actor that can manipulate the system, kick people off of it, shut down people's accounts, change the rules, or decide that they want to, without everyone else's consent."

In theory, Blockchain really could break the grip powerful insiders have had on money and political power since time immemorial. The potential benefits even reach into areas like speech. If you can rely on a vast digital community to confirm you're good for your dinner bill instead of a third-party guarantor like, say, the Visa corporation, then there would be no inaccessible, unaccountable payment

processors to hold Internet speech or book sales hostage. As the former CEO of a major Internet company put it, commenting on a recent episode involving the freezing of PayPal accounts for alt-media firms, “Bitcoin is the only answer.”

However, if the transparency goal isn’t maintained in crypto finance, and risk is allowed to exist that digital assets could end up fought over in something like a bankruptcy court, then you’ve just exchanged one brand of “centralized ledger” for another — maybe even a worse version. “There are so many good things about this industry, right? The micropayments, the cheap transactions, the transparency on chain and so on,” says a high-ranking executive for another oft-criticized crypto firm. “But there is also a ton of centralized behavior still.”

It’s the perhaps-insuperable paradox hanging over this $3 trillion market. Are these firms really beacons of a new form of cryptographically guaranteed transparency, or are they just less-insured, less-regulated, less-audited versions of the same take-our-word-for-it securities and banking operations that melted down the world economy fourteen years ago? “That’s the weird thing about crypto,” says Georgetown professor Adam Levitin, who specializes in bankruptcy and commercial law. “It’s a mix of incredible transparency with incredible opacity.”

The pandemic accelerated the contradictions. Since the arrival of Covid-19, the value of Bitcoin and Ethereum surged to record highs, with the market blowing past $3 trillion, and decentralized finance suddenly looked more like immediate reality than a distant idealized future. Virtually every major institutional player on Wall Street set itself up to cash in on the CryptoBoom. Wells Fargo and Chase launched Bitcoin funds in August of 2021, while both the NASDAQ and the NYSE began listing crypto-based exchange-traded funds, and in yet another stone cold repeat of 2008, pension funds began plunging their money into crypto properties, with the Houston firefighters’ fund in October of 2021 being among the first.

Even the ultimate symbols of upper-class financial respectability, the auction houses Sotheby’s and Christies, got in on the act. These companies, whose very names imply frumpy establishment legitimacy, not only began accepting cryptocurrency as payment for properties like an untitled $5.4 million Keith Haring painting, but held auctions for NFTs, or non-fungible tokens, a kind of digital currency that at the time was having success as a speculative investment.

Sotheby’s for instance auctioned a set of digital cartoon characters called “CryptoPunks,” seeking as much as $30 million. The houses sold an astonishing $250 million in NFTs in 2021, with the artist Michael Winklemann, who calls himself “Beeple,” selling the “first portrait of a human born in the Metaverse,” a “piece” called HUMAN ONE, for $29 million. Blockchain technology is the reason HUMAN ONE could be uniquely owned, like a Van Gogh. But was this a Van Gogh, or just a boring-ish tweet with 6000 likes? A different Beeple work called “Everydays: The First 5000 Days,” sold for $69.3 million. Somehow, a technology whose existence in theory imperiled the entire traditional financial establishment became, overnight, the darling fixation of that same establishment.

It should have been a huge red flag, and wasn’t. But an even bigger warning was ignored.

Financial bubbles always expand the same way. Before insiders start scooping up winnings to go shopping for Maseratis and private islands, they buy up all the questions. Read: they buy the politicians.

A former Hill staffer explains about #CryptoCrash: "I first knew there was a problem, frankly, when people in on the Democratic side started jumping ship."

Nobody was surprised when figures from the Trump administration jumped back and forth from crypto's payroll. Whether it was former SEC Division of Trading and Markets chief Brett Redfearn joining Coinbase just before its historic $86 billion IPO, or Trump hiring former Coinbase executive Brian Brooks to be the chief of the lead banking regulator, the Office of the Comptroller of Currency (OCC), or even Republican Senator Pat Toomey going on Twitter to say basically that regulators should lay off doing anything at all about anything until Congress debated the issue "in full," adding, "Why rush?"

That Republicans (and especially libertarians) who understood/supported some of the antigovernment, deregulatory concepts in the crypto market might take industry money was not surprising. It was much more of a surprise, to some anyway, when a flood of supposedly pro-regulation Democratic staffers and pols went the same way, capitalizing on the incredible 5200% surge in political giving that this year pushed crypto past big tech, big Pharma, and even the defense sector in the realm of political contributions. Former Democratic staffers rushed to fill key posts at key firms.

Former Chuck Schumer aide Jonah Krane joined the financial consultancy Klaros, former Ed Markey and Allison Lee aide Justin Slaughter joined Paradigm, and uber-liberal former Bart Chilton aide Salman Banaei joined Uniswap. Even the spokesperson at Circle with whom I spent much of the last two weeks jousting (see "Financial Bubble Era Comes Full Circle") is a former Sherrod Brown aide. At a time when Republicans and Democrats seemed unable to agree on anything at all, a host of elected officials began making bipartisan shows of force on behalf of crypto companies.

The most amazing moment may have come when SEC chief Gary Gensler — a former Goldmanite usually thought of as one of the good guys by financial reform types — began making noises about regulating the crypto world. Almost immediately, a group of House members nicknamed the "Blockchain Eight" sent a blistering letter slamming Gensler and demanding he justify asking crypto firms for voluntary submissions of information.

Saying "Crypto startups must not be weighed down by extra-jurisdictional and burdensome reporting requirements," Republicans like Warren Davidson of Ohio and Byron Donalds of Florida joined hands with Democrats like New Jersey's Josh Gottheimer and Jake Auchincloss of Massachusetts to desist from "voluntary document production," even using the age-old trick that bank-controlled pols once employed of asking Gensler if he'd "conducted a cost-benefit analysis to determine the fairness and efficacy of [his] requests."

The start is always the same: a gang of insiders talks up a hot new property, and perhaps aided by a titillating infusion of institutional money and Federal Reserve cash, the public is enticed by the picture of an ascending new asset class.

In the last two great financial disasters, the tech stock boom of the nineties and the mortgage-backed securities mania of the mid-2000s, investors were also wowed by rhetoric, often coming from the highest authorities, suggesting that a technological fix to risk itself had been discovered. Whether it was Alan Greenspan's "new paradigm" of growth without inflation, or assurances that the the self-interest of financial firms would prevent a mortgage disaster, or encouragement to use your home equity as an ATM machine, ordinary people were urged by big names to jump on in, the water's great! So it's been with the crypto market, another "new thing" that saw everyone from Tom Brady, Steph Curry, and Matt Damon urging ordinary people to jump in the market, because "fortune favors the brave." Politicians also got in on the cheerleading action.

"What we don't want to do is choke a new industry and innovation out so that we lose out on opportunities," said New Jersey Senator and former presidential candidate Cory Booker. He added, "This is a really important space if we get the regulation right, that can actually be helpful to the industry and protecting consumers." In another forum, he suggested crypto was a "democratizing" force that could help minorities close the financial gap.

Booker, along with New York's Kirsten Gillibrand, is considered among the most "crypto-friendly" members of the upper house, and according to *Fortune*, near the top of the list of politicians who've taken donations from crypto interests. Meanwhile Wyoming Republican Cynthia Lummis, who reportedly owns about $200,000 in Bitcoins, was quick to suggest TerraUSD was an outlier and not a systemic issue. "There are a couple types of stablecoins. The one that failed is an algorithmic stablecoin, very different from an asset-backed stablecoin," she told CNBC.

Similar sentiments were echoed at the 2022 meeting at Davos, where the current IMF chief urged those in attendance not to overreact. "I would beg you not to pull out of the importance of this world," said Kristalina Georgieva, about cryptocurrency. "It offers us all faster service, much lower costs, and more inclusion, but only if we separate apples from oranges and bananas."

By early this year, with midterms firmly in sight, one saw politicians in every direction with their arms draped around crypto CEOs, sometimes literally. Just prior to the collapse of TerraUSD, for instance, the chair of the House Financial Services, Maxine Waters, invited a series of speakers to a panel on crypto. A photo was released showing Waters literally embracing some of the top heavies in the crypto market, including Circle's Jeremy Allaire, FTX's Sam Bankman-Fried, and Armstrong of Coinbase.

Jeremy Allaire, Brian Armstrong, Sam Bankman-Fried, Maxine Waters, and Chris Brummer

Some sources laughed when the subject of this photo came up, explaining that it sent a clear message to, say, a line investigator at the SEC or CFTC who might otherwise be thinking of investigating this or that company. The message is twofold: any attempt to elevate an issue with a key donor will not get your party's backing, and moreover, you might find your funds cut in the next appropriations season. If you mess with Congress's money, they will mess with yours.

After the collapse of every financial bubble, the same question is asked. How could it happen? How did no one notice janitors and manicurists with no savings were buying McMansions all over the country? How did brigades of regulators and examiners miss that storied names like Bear and Lehman were actually flat broke? How did it happen that the people supposedly responsible for spotting problems at one of the world's largest companies, AIG, was the Office of Thrift Supervision, a savings and loan regulator that barely had any staff that understood insurance, let alone the hundreds of millions in exotic derivative pseudo-insurance a tiny AIG sub-unit was selling out of an office in London?

It was the regulatory version of the famous "pointing Spiderman" meme: the chief cops on the financial beat all thought someone else had responsibility for new financial instruments. Were credit default swaps and collateralized debt obligations the problem of state insurance departments, or banking authorities like the Fed or the OCC, or securities regulators like the SEC, or what? As one former federal banking official put it, "The market was just bespoke enough to make everyone think it was someone else's beat."

The tragedy of a corrupted crypto universe is exactly the same story, of a "bespoke" financial market grown to fantastic dimensions in a regulatory dead zone, with a cash-fattened congress keeping questions to a minimum, and the same old insiders extracting billions before a crash that will inevitably be paid for by the rabble again. In fifteen or twenty years, maybe, crypto will evolve to revolutionize finance and eliminate insider corruption in the way its adherents hoped, much as the Internet eventually really did change everything from commerce to communication. But we're still at the stage of clearing out the phonies, the Pets.com and eToys equivalents, and there are a lot still out there. More, sadly, *TK*.