Crypto blind spots could blow up financial system

By *Elisa Barwick*

The Archegos blow-up which led to US$10 billion-plus in bank losses revealed major flaws in the US regulatory system's oversight of hedge funds. ("New derivatives disaster must be defused now!", *AAS*, 5 May.) Archegos collapsed in March, exposing at least nine global banks with which it had racked up highly leveraged debt to bet on share prices. The entity is what's known as a "family office" hedge fund, which caters for a small, exclusive circle of investors. Hedge funds are known for their use of sophisticated fund management instruments, including highly risky financial "derivatives" contracts, and in general are adept at escaping regulations vital to keeping the financial system stable. But due to their small client numbers, family offices are exempt from even basic regulations, and do not even have to register with the US Securities and Exchange Commission (SEC).

A 30 June US Congressional hearing of the House Financial Services Subcommittee on Oversight and Investigations on the topic "America on 'FIRE': Will the Crypto Frenzy Lead to Financial Independence and Early Retirement or Financial Ruin?", reported by Wall Street On Parade, revealed another critical point of regulatory vulnerability within the financial system: cryptocurrency. It also hinges on the dangerous activity of all hedge funds.

Alexis Goldstein, a witness from independent research organisation the Open Markets Institute, stated in her testimony to the Committee that hedge funds are not required to report any derivatives other than "long options" to the SEC. There is a similar blind spot on cryptocurrency trading by hedge funds, which they do not have to report at all.

Big Four global auditor PwC's *3rd Annual Global Crypto Hedge Fund Report 2021* reported a survey revealing that one in seven hedge funds invests 10 to 20 per cent of its assets in crypto, results similar to an Intervest survey cited in Goldstein's written submission to the committee. Funds make money betting on both the rise and fall of crypto. When Congresswoman Maxine Waters raised this growing area of investment during the hearing, Goldstein described a parallel process to what happened with Archegos to convey the dangers in this unregulated and opaque space, given that the big banks provide capital to the hedge funds through their role as prime brokers, as they did for Archegos.

Goldstein warned: "If hedge funds get farther into crypto, they don't care about direction. They'll go long, they'll go short. They can use leverage. There are lots of cryptocurrency exchanges like FTX and Binance and many others that allow people to use insane amounts of leverage—100 times to 1. … So what happens if a huge number of hedge funds have prime broker relationships with too-big-to-fail banks [and] all happen to be in similar crypto positions, whether it's long or short, and there's massive volatility in the market? They may have to sell some of their other assets. It may lead to margin calls in their non-crypto assets, which could lead to forced liquidations and sort of redound to the banks themselves in the form of counterparty risk."

100-1 leverage, 'in the dark'

In her submission, Goldstein repeated a warning from one of the regulating entities: "The Federal Reserve's May 2021 Financial Stability report noted that both the Archegos and GameStop volatility 'highlighted the opacity of risky exposures and the need for greater transparency at hedge funds and other leveraged financial entities that can transmit stress to the financial system'." Congresswoman Waters has tabled a discussion draft of a proposed "Capital Markets Engagement and Transparency Act of 2021" to rectify this.


Alexis Goldstein from the Open Markets Institute testifies at the House hearings on cryptocurrency. Photo: wallstreetonparade.com

Short of that, as Goldstein wrote, "The lack of reporting by private funds on their cryptocurrency positions will make it difficult for regulators to determine if this market creates systemic risk concerns." Regulators are completely "in the dark", she stressed. We concur with Wall Street On Parade's assessment: "Hmmm. Darkness and 100 to 1 leverage. What could possibly go wrong?"

Goldstein noted in her written submission that too-big-to-fail banks are themselves getting into crypto speculation, with Goldman Sachs planning to open a trading desk for crypto and other banks including BNY Mellon, Wells Fargo and Morgan Stanley either investing themselves, or offering investment services. In the domain of venture capital firms, Goldstein cited a single operator which holds some 28 per cent of total investment in Dogecoin, valued at over US$8 billion. Regulators in the UK and Canada have expressed concern over exchanges hosting crypto derivatives and securities trading. In addition, reports Goldstein, some cryptocurrency exchanges are now offering consumer credit cards and other forms of lending. According to a report by the House Financial Services Subcommittee, some exchanges reportedly exaggerate trading volumes with fake trades to attract participation. The US Commodity Futures Trading Commission has also warned that "decentralised finance" (DeFi) platforms, where cryptocurrencies and financial products are traded without an intermediary such as an exchange market, may in fact be illegal and responsible for creating a new "unregulated shadow financial market".

Goldstein concludes that "Regulators and lawmakers should not delay in examining the footprint of private funds in cryptocurrency markets."

It gets worse. Having become large transactors of the US Treasuries (federal government bonds) that are continually being pumped out in quantitative easing programs, risky hedge funds are increasingly relied upon by the Fed as critical players in liquidity markets.

Since the 2008 crisis hedge funds have played a greater role in the Treasury market, the Federal Reserve Board admitted in an April 2021 paper on hedge fund Treasury trading, but their role "is not well understood because they are less regulated than traditional broker-dealers and provide few disclosures". Hedge fund activity was a major factor in the September 2019 "repo", March 2020 "COVID-19" and March 2021 "Archegos" market crunches, all of which forced extraordinary Fed interventions that served only to exacerbate existing imbalances with more money-pumping. More on that soon.