

Testimony of Mr. Ben McKenzie Schenkan
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Senate Banking Committee

Chairman Brown, Ranking Member Toomey, and Members of the Committee:

Thank you for your invitation to testify before the Committee on matters relating to the growth of crypto trading and lending, as well as the recent collapse of FTX/Alameda and the broader implosion of the cryptocurrency markets.

A little over a year ago I embarked on a journey to explore the inner workings of the cryptocurrency industry. My initial reaction was one of confusion. I am an actor, and therefore words are the tools of my trade. I also hold a degree in economics. When I began to look at the cryptocurrency industry, many of the words used did not correlate to their functional reality, economically or otherwise.

“Cryptocurrencies” are not currencies by any reasonable economic definition, as they are unable to fulfill any of the three functions of money. They are a poor medium of exchange, unit of account, and store of value. Bitcoin cannot work as a medium of exchange because it cannot scale. The Bitcoin network can only process 5 to 7 transactions a second. By comparison, Visa can handle tens of thousands. To facilitate that relatively trivial amount of transactions, Bitcoin uses an enormous amount of energy. In 2021, Bitcoin consumed 134 TWh in total, comparable to the electrical energy consumed by the country of Argentina. Bitcoin simply cannot ever work at scale as a medium of exchange.

Other blockchains are more efficient, but suffer from other problems, such as hacks and periodic outages. Even amongst cryptographers, blockchain technology is considered to be of limited use, only potentially applicable in small systems requiring low throughput. Some view it even more dimly. Bruce Schneier is one of the leading cryptographers in the field, a lecturer at the Harvard Kennedy School and a board member of the Electronic Frontier Foundation:

What blockchain does is shift some of the trust in people and institutions to trust in technology. You need to trust the cryptography, the protocols, the software, the computers and the network. And you need to trust them absolutely, because they're often single points of failure.

I've never seen a legitimate use case for blockchain. I've never seen any system where blockchain provides security in a way that is impossible to provide in any other way.

Blockchain technology is at least 30 years old, not some new invention with a still-promising future.

I interviewed cryptographer David Chaum recently. Chaum's work in the early 1980s laid the intellectual foundation for blockchain, and he is widely credited with being a pioneer of cryptographic methods of payment. Even he referred to blockchain as "primitive".

Cryptocurrencies are similarly unable to serve as an adequate unit of account or store of value, primarily because of their volatility. For a currency to be consistently useful, it must remain relatively consistent over time. Bitcoin and all other cryptocurrencies have never been able to do so. Despite the industry's insistence to the contrary, their volatility has not lessened over time. The precipitous collapse of the entire cryptocurrency market over the last year provides a good example. Imagine a scenario in which the US dollar lost 70% of its value in less than a year. Pandemonium—and a global recession—would ensue.

Unfortunately, the problems with crypto as money run even deeper than that. What cryptocurrency wants to be is private money, unencumbered by interference from a nation-state issuer. We have tried private money before, during the Free-Banking Era (1837-1864) when banks were allowed to issue their own notes. It did not work very well. In many states, banks failed at alarming rates, often due to fraud.

The need for a trusted third party to backstop the banks was the impetus behind the creation of the Federal Reserve in 1913, as well as the Federal Deposit Insurance Corporation. Since the FDIC's creation in 1933, not a single penny of insured deposits has been lost. People trust that when they put their money in a licensed US bank, it will be there when they need it, and the federal government provides that assurance in times of crisis. In exchange for that FDIC license, banks must comply with a litany of regulations.

Crypto's stated goal of creating a 'trustless' form of money by removing all intermediaries between individuals wishing to transact directly holds understandable appeal. Everyone is aware of the myriad flaws in our current financial system, and banks are rarely looked upon favorably by the general public. There are many reasons for this, not the least of which is their complicity in the debacle that was the subprime crisis.

However, that does not mean that cryptocurrency is any better. In fact, it cannot function as a currency, and for a very simple reason. You cannot create 'trustless' money because *money is trust*. We made it up; it's a social construct. Like all social constructs, money relies on trust forged through social consensus. You can no more create a 'trustless' money than you can a governmentless government or a religionless religion. The applicable words are anarchy and cult.

What 'trustless' means in practice in crypto is placing your trust in the people who run the exchanges, or issue the coins, or anyone else who takes your real money in exchange for lines of computer code stored on ledgers called blockchains. Code does not fall from the sky; people write it. I believe few of the people in the cryptocurrency industry have earned the trust of the public.

Cryptocurrencies are not currencies, and they are not used like them. Alongside my colleague, journalist Jacob Silverman, I visited the only country in the world trying to use cryptocurrency as money: El Salvador. It is not working. The Chivo wallet system set up by the government is largely ignored. According to the government's own figures, less than 2% of remittances use Chivo. Instead El Salvador's president, Nayib Bukele, has reportedly gambled some of his government's money—meaning his people's money—on Bitcoin. If this is true, then much like the overwhelming majority of cryptocurrency investors, Bukele has lost money on his wager.

How are cryptocurrencies used by the wider public? Tens of millions of Americans, and supposedly hundreds of millions of people worldwide, have bought and sold crypto primarily through centralized exchanges such as Binance and until recently, FTX. To state the obvious, transacting through a centralized exchange run through shell corporations in the Caribbean and elsewhere is the antithesis of the stated goal of cryptocurrency to create a peer-to-peer currency that would avoid all intermediaries.

The cryptocurrency industry is in fact heavily centralized, and a few key players wield enormous power. For example, according to recent reporting from *The New York Times* and *The Wall Street Journal*, a small group of elite crypto executives communicate via the encrypted app Signal. It would be wise to remember the words of Adam Smith:

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices...

Because cryptocurrencies don't really do anything in the real world they are at best an exercise in a zero-sum game of chance, much like online poker. Fittingly enough, several key players in the cryptocurrency industry cut their teeth in the online poker craze of the late 2000s. Chairman Gensler of the SEC has referred to stablecoins as "the poker chips in the casino" and I believe his metaphor is apt. The largest stablecoin in crypto by a country mile is Tether. Stuart Hoegner, Tether's general counsel, was once the compliance officer for Excapsa, which was the holding company of Ultimate Bet, an online poker website from the era. Ultimate Bet was ultimately revealed to have a secret 'god mode' where insiders could see the other players cards so as to cheat them.

Working alongside Mr. Hoegner at Excapsa/Ultimate Bet was Daniel Friedberg, former general counsel of FTX and now its chief regulatory officer. Stuart Hoegner's company Tether counts as its biggest client Alameda Research, the sister company of FTX. According to reporting from crypto media company *Protos*, Alameda purchased some \$36.7 billion worth of Tether coins. Given Alameda's current insolvency, it would be wise to ask where this money came from and what arrangement existed between the two companies.

So if cryptocurrencies are not currencies, then what are they? Well, what do they do? How do they function in the real world? People put money into them and expect to make money off of them, through no work of their own. As members of this committee well know, that is an

investment contract under American law. More precisely, it is a security: 1) an investment of money 2) in a common enterprise 3) with the expectation of profit 4) to be derived from the efforts of others. To my mind, every coin or token easily satisfies the four prongs of the Howey Test.

The rapid rise of cryptocurrency both in purported value and number of tokens issued should give us all pause. There are now over 20,000 cryptocurrencies, more than all the securities offered for sale through the major US stock exchanges. An estimated 40 million Americans have bought or sold cryptocurrency at some point. According to the industry's own polling, the majority of investors who have ever purchased Bitcoin did so in 2021. Given the recent collapse in the price of Bitcoin, it is reasonable to assume most of them have lost money.

When added to the millions already locked out of their accounts at places like FTX and Celsius those numbers soar even higher. A non-exhaustive list of crypto players who have stopped or paused withdrawals just this year includes BlockFi, Voyager Digital, Genesis, CoinFlex, Gemini, Three Arrows Capital, Hodlnaut, Poolin, Digital Surge, Orthogonal Trading, AAX, Hoo, SALT, Babylon Finance, Nuri, Bithumb, Upbit, Coinone, Babel Finance, WazirX/CoinDCX, Bexplus, AEX, Vault, 2gether, Finblox, and well, you get the point.

There are many reasons that so many customers cannot get their money back, but the simplest one is that much of it was never there to begin with. The prices of these speculative so-called 'digital assets' were bid up/manipulated far beyond the actual real money backing them.

You don't have to take my word for it. In March of this year, I asked Alex Mashinsky, CEO of the now failed crypto lending firm Celsius, how much real money was in crypto and he estimated: "10 to 15 percent. The rest is speculation." Given crypto's market cap at the time (~\$1.8 trillion), that would imply only a few hundred billion dollars of actual money was backing these assets. When I asked Sam Bankman-Fried the same question in July of this year, he broadly concurred with Mashinsky, estimating around \$200 billion was left in crypto. Personally, I suspect the true number to be far, far lower, but even taking these assessments at face value there is no denying that the amount of nominal value of crypto far exceeds the actual dollars in the crypto 'ecosystem'.

Leverage accounts for some of this disparity, and is not unique to crypto. It exists in our regulated markets as well. But as Professor Hilary Allen points out, with crypto the potential leverage in crypto is far higher:

The amount of leverage in the system can also be increased by simply multiplying the number of assets available to borrow against. That is a significant concern with DeFi, where financial assets in the form of tokens can be created out of thin air by anyone with computer programming knowledge, then used as collateral for loans that can then be used to acquire yet more assets.

Of course leverage is not the sole culprit behind the collapse of crypto. One of the other contributing factors is fraud. Cryptocurrency has attempted to assemble a parallel financial universe that in some ways mirrors our regulated one, only absent meaningful regulations. Be careful what you wish for. The simple truth is that in an unregulated market, at every juncture where value is transferred from one party to another, not only is there nothing preventing one or more parties from committing fraud, there is often very little even disincentivizing them from doing so. If you can rip people off and get away with it, why not do it?

If you lose money in cryptocurrency, advocates proudly state the only person you have to blame is yourself. DYOR (“Do Your Own Research”) is their motto. The system cannot fail; you can only fail the system. The language of crypto is eerily reminiscent of multi-level marketing schemes. Words such as ‘community’ obscure the financial nature of these endeavors, cloaking them in a false sense of shared purpose. The illegal version of multi-level marketing schemes are called pyramid schemes.

Now that tens of millions of Americans have lost money in crypto, and millions more have been prevented from withdrawing their money as crypto companies shut down, seemingly on a daily basis, we are left with an obvious question: **is any of this worth it?**

Our securities laws have been on the books since the 1930s. They were written broadly on purpose; ever since there has been money, people have been interested in gathering quantities of it and putting it to productive use so as to make more of it. Most of these endeavors are well-intentioned, if not always successful. But some are nothing more than lies designed to separate people from their money.

Securities that have no underlying value are often described as Ponzi schemes. As such, under American law Ponzi schemes are regulated by the Securities and Exchange Commission.

I submit to you today that the entire cryptocurrency industry resembles nothing more than a massive speculative bubble built on a foundation of fraud. In my opinion, it is the largest Ponzi scheme in history by an order of magnitude.

Cryptocurrency is in fact only a story, or rather a constellation of stories that form an economic narrative. As Nobel prize-winning economist Robert Shiller has observed, an economic narrative can be defined as:

a contagious story that has the potential to change how people make economic decisions, such as the decision to...invest in a volatile speculative asset.

Shiller’s first example? Bitcoin.

If cryptocurrency is only a story then it is fitting that I am here, for I am a storyteller at heart. I know a few things about money and lying. I learned about money from my economics degree,

as well as by making a bit of it during my two decades spent in showbusiness. I know about lying because as an actor I do it for a living.

Unfortunately for the tens of millions of Americans who have lost money in cryptocurrency, the reality behind the story has become apparent to all who care to see it. The economic narrative surrounding cryptocurrency is untrue. In fact, it is a story meant to deceive.

We should give the SEC, DOJ, OFAC and other relevant agencies the resources and support they need to enforce laws already in existence today. They should act swiftly before more Americans are hurt.

Let the chips fall where they may.

Ben McKenzie Schenkkan