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## INTEREST RATES, VENTURE CAPITAL, AND FINANCIAL STABILITY

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*As central banks tightened interest rates during 2022 and 2023, important debates arose regarding the relationship between monetary policy and financial stability. This Article illuminates one path through which the prolonged period of accommodative monetary policy from 2009–2021 impacted financial stability: it traces how easy money and yield-seeking behavior in the wake of the Global Financial Crisis and COVID-19 pandemic led to a bubble in the venture capital industry, which in turn spawned a crypto bubble as well as a run on the VC-favored Silicon Valley Bank. This Article uses this account to illustrate the importance of proactive financial regulation both in preventing the financial crises that invite more accommodative monetary policy and in preventing accommodative monetary policy from sowing the seeds of future financial stability problems when it is deployed.*

*This Article is primarily a descriptive account, designed to highlight the venture capital industry's unexpected and underappreciated contribution to financial stability threats in the early 2020s. This Article does, however, suggest several policy implications of this account. It recommends increased monitoring of the venture capital industry by financial stability regulators, given that venture capital is well-positioned to generate asset bubbles now and in the future. It also argues for more aggressive enforcement of the securities laws to tamp down on the present crypto bubble, as well as for structural separation between crypto and the traditional financial system. More generally, this Article urges financial stability regulators to be vigilant during periods of accommodative monetary policy.*

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## I. INTRODUCTION

When a financial crisis, pandemic, or other calamitous event hits the economy, central banks tend to respond by lowering interest rates.<sup>1</sup> When inflation starts to pick up, central banks will typically respond by raising interest rates.<sup>2</sup> These actions can have implications for the stability of our financial system—sometimes in short order, and at other times, implications may take much longer to manifest. There is increasing interest in the relationship between monetary policy and financial stability, and this Article will illuminate one largely unexamined conduit through which the prolonged period of accommodative monetary policy from 2009–2021 impacted financial stability: through the venture capital (“VC”) industry.

During this period, investors had incentives to seek out riskier investments that would generate high returns unachievable from more staid investments (which yielded little in a low-interest-rate environment). This Article will focus on how such yield-seeking behavior spurred a bubble in the VC industry, which

1. Tobias Adrian, Fabio M. Natalucci & Mahvash S. Qureshi, *Macro-Financial Stability in the Covid-19 Crisis: Some Reflections* 14 (Int’l Monetary Fund, Working Paper No. 22/251, 2022).

2. *Id.* at 10–12.

in turn spawned a crypto bubble, as well as a run on the VC-favored Silicon Valley Bank (“SVB”). To be clear, the impacts of monetary policy on financial stability will probably be felt most keenly in other sectors of the financial system.<sup>3</sup> But financial stability risks can crop up in unexpected places, and it is precisely because VC funds are not typically considered pertinent to financial stability that they make such an interesting case study. By following one tendril of the impact of monetary policy through the VC industry to the crypto industry and SVB, policymakers can get a sense of the kinds of unexpected impacts that accommodative monetary policy can have on financial stability.

The unpredictable consequences of prolonged periods of accommodative monetary policy underscore the importance of proactively using financial regulation to prevent or mitigate financial instability in the first place.<sup>4</sup> Accommodative monetary policy is one of the most important tools available to respond to financial crises, but the 2008 crisis made it clear that such policy is not always enough to fully mitigate the harms of financial crises.<sup>5</sup> Furthermore, if accommodative monetary policy inspires yield-seeking behavior that causes a subsequent round of financial instability to erupt before interest rates have been meaningfully increased, traditional monetary policy will not even be available as a crisis response because interest rates will not have room to go lower—unconventional interventions of increasing magnitude may then be required of central banks.<sup>6</sup> Ex ante financial stability regulation designed to prevent or mitigate financial crises is inevitably imperfect and often undermined by political economy and human psychology—but such regulation can still be somewhat effective, and given the limitations and unintended consequences of monetary policy as an ex post crisis response, it is incumbent upon regulators to aggressively deploy financial stability regulation ex ante.<sup>7</sup>

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3. Regarding the financial stability implications of prolonged periods of low interest rates for corporate credit markets and housing sectors, see *id.* at 9–10. For a discussion of the financial stability implications of rising interest rates for sectors like banking, commercial real estate, and sovereign debt, see BD. OF GOVERNORS OF THE FED. RSRV. SYS., FINANCIAL STABILITY REPORT 16, 33, 59–60 (2023), <https://www.federalreserve.gov/publications/files/financial-stability-report-20230508.pdf> [<https://perma.cc/E77D-WWY6>].

4. “Monetary authorities . . . face a fundamental trade-off between providing policy support to boost economic growth in the near-term and ensuring macro-financial resilience in the longer-term.” Adrian et al., *supra* note 1, at 10.

5. Despite herculean interventions by the Federal Reserve, the people of the United States still experienced a severe recession following the 2008 financial crisis, with accompanying losses of jobs, wealth, and well-being. Janet L. Yellen, Vice Chair, Fed. Rsrv., A Painfully Slow Recovery for America’s Workers: Causes, Implications, and the Federal Reserve’s Response (Feb. 11, 2013), <https://www.federalreserve.gov/newsevents/speech/yellen20130211a.htm> [<https://perma.cc/JK5Z-5R36>]. The effects of the 2008 crisis still linger, impacting—among other things—income inequality and politics. See, e.g., Jonathan Bridges, Georgina Green & Mark Joy, *Credit, Crises and Inequality* 28 (Bank of Eng., Working Paper No. 949, 2021).

6. See GEORGE A. AKERLOF & ROBERT J. SHILLER, ANIMAL SPIRITS 79 (2009); Adrian et al., *supra* note 1, at 10. For an overview of non-traditional monetary policy tools, see RSRV. BANK OF AUSTL., UNCONVENTIONAL MONETARY POL’Y, <https://www.rba.gov.au/education/resources/explainers/pdf/unconventional-monetary-policy.pdf?v=2023-07-14-10-14-40> (last visited June 30, 2025) [<https://perma.cc/KE9R-YSR9>].

7. For a discussion of the limitations of a purely ex post response to financial stability regulation, see Hilary J. Allen, *Putting the “Financial Stability” in Financial Stability Oversight Council*, 76 OHIO ST. L.J. 1087, 1103–07 (2015).

The exploration of case studies in this Article is intended to increase the salience of the financial stability risks tied to monetary policy. These case studies also highlight the relevance of VC funds to financial stability. To be clear, there are other, more pressing risks to financial stability than those posed by VC funds.<sup>8</sup> And yet, the actions of VC funds have generated important financial stability concerns in the period of 2022–23 and so this Article offers some recommendations for how financial stability regulators should approach the VC industry going forward. It recommends increased monitoring of the VC industry in general to help detect developing asset bubbles, and more specifically, for increased enforcement of the securities laws against VC firms involved in crypto ventures (both by the SEC and through private litigation).

The rest of the Article will proceed as follows. Part II sketches in very broad strokes the financial stability risks that can arise from prolonged periods of accommodative monetary policy, as well as the stability risks associated with a “snapback” to higher interest rates following such a period. Part III explores one bubble facilitated by the period of accommodative monetary policy that followed the 2008 financial crisis and was prolonged by the COVID-19 pandemic: a bubble in VC investment. Part IV looks more specifically at two case studies that illustrate how this bubble in VC investment has threatened financial stability. It first looks at the crypto bubble that the VC industry helped facilitate and then looks at the role that the VC industry played in sparking the regional banking tumult associated with SVB’s failure. Part V then explores the implications of these case studies for financial regulatory policy. First, Part V considers how financial regulatory policy should address the stability risks associated with prolonged periods of accommodative monetary policy in general. Part V then makes the argument that financial stability regulation should pay more attention to the VC industry. Part VI concludes.

## II. MONETARY POLICY AND FINANCIAL STABILITY

### A. *Definitions and Background*

This Part will begin by providing some working definitions of “financial stability” and “monetary policy.” With regard to financial stability, many people think that the financial system is stable if we are not presently experiencing a crisis. Financial stability requires more than that, however: it requires the

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8. Private investment funds are probably not the most pressing financial stability risk, and even among these funds, hedge funds and private equity funds are probably more worthy of financial stability regulators’ attention than VC funds. For a discussion of financial stability risks associated with hedge funds, see FIN. STABILITY OVERSIGHT COUNCIL, 2022 ANNUAL REPORT 42–44 (2022), <https://home.treasury.gov/system/files/261/FSOC2022AnnualReport.pdf> [<https://perma.cc/JT7W-N8LM>]. For a discussion of financial stability risks associated with private equity, see Michael J. Hsu, Acting Comptroller, Off. of the Comptroller of the Currency, Preventing the Next Great Blurring, Speech at Vanderbilt University 9–12 (Feb. 21, 2024), <https://www.occ.gov/news-issuances/speeches/2024/pub-speech-2024-17.pdf> [<https://perma.cc/XEZ3-ZPNB>]; Andrew F. Tuch, *The Remaking of Wall Street*, 7 HARV. BUS. L. REV. 315, 360–66 (2017).

financial system to be resilient, to be able to absorb shocks without compromising the credit and payments functions on which the broader economy depends.<sup>9</sup> Financial stability regulation therefore seeks to make the financial system more robust to shocks in general, and sometimes, it seeks to prevent or limit the shocks themselves.<sup>10</sup> Financial stability regulators must always retain a degree of humility about their work, because the operation of something as complex as the financial system will always be somewhat unpredictable.<sup>11</sup> Despite this unpredictability, though, there are some dynamics that are well understood as particularly problematic for financial stability.

Asset bubbles, for example, are a common source of financial instability. In his seminal book *Irrational Exuberance*, economist Robert Shiller defines a “bubble” as:

a situation in which news of price increases spurs investor enthusiasm, which spreads by psychological contagion from person to person, and, in the process, amplifies stories that might justify the price increase and brings in a larger and larger class of investors, who, despite doubts about the real value of the investment, are drawn to it partly through envy of others’ successes and partly through a gambler’s excitement.<sup>12</sup>

Not all asset bubbles cause financial stability problems: Shiller’s work is identified most closely with the dot-com bubble of the late 1990s, when investors lost a lot of money but no financial crisis resulted.<sup>13</sup> A bubble is likely to cause financial stability problems, however, if highly leveraged financial institutions (like banks) are significantly exposed to that bubble, as they were to the subprime mortgage bubble of the mid-2000s.<sup>14</sup> When a bubble like that pops, it will impact the liquidity and maybe even solvency of the exposed financial institutions, and so they will pull back from extending the credit that the broader economy relies upon to grow.<sup>15</sup>

Even if financial institutions are not directly exposed to the asset bubble in question, they could still be compromised indirectly. They might be a creditor of

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9. William A. Allen & Geoffrey Wood, *Defining and Achieving Financial Stability*, 2 J. FIN. STABILITY 152, 155 (2006); HILARY J. ALLEN, DRIVERLESS FINANCE: FINTECH’S IMPACT ON FINANCIAL STABILITY 7 (2022).

10. Financial Stability Oversight Council, *FACT SHEET: The Financial Stability Oversight Council’s Proposed Analytic Framework for Financial Stability Risk Identification, Assessment, and Response*, U.S. DEP’T TREASURY (Apr. 21, 2023), <https://home.treasury.gov/system/files/261/FSOC-2023-Risk-Framework-Fact-Sheet.pdf> [<https://perma.cc/RC8D-XYUR>]; Analytic Framework for Financial Stability Risk Identification, Assessment, and Response, 88 Fed. Reg. 26307 (proposed Apr. 28, 2023).

11. MARTIN HELWIG, FINANCIAL STABILITY AND MONETARY POLICY, MAX PLANCK INST. FOR RSCH. ON COLLECTIVE GOODS 17–18 (2015), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2639532](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2639532) [<https://perma.cc/F9UZ-KUCV>].

12. ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 2 (3d ed. 2015).

13. *Id.*

14. FIN. CRISIS INQUIRY COMM’N, *THE FINANCIAL CRISIS INQUIRY REPORT* xix–xx (2011), <https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> [<https://perma.cc/GT73-L2WU>].

15. On the broader economic repercussions that flow from disruptions to credit channels, see BEN BERNANKE, *THE REAL EFFECTS OF DISRUPTED CREDIT: EVIDENCE FROM THE GLOBAL FINANCIAL CRISIS*, THE BROOKINGS INSTITUTION (2018), [https://www.brookings.edu/wp-content/uploads/2018/09/BPEA\\_Fall2018\\_The-real-effects-of-the-financial-crisis.pdf](https://www.brookings.edu/wp-content/uploads/2018/09/BPEA_Fall2018_The-real-effects-of-the-financial-crisis.pdf) [<https://perma.cc/6PAW-Y54M>].

a financial institution that *was* exposed to the bubble, or they could be affected by fire sale externalities or sentiment contagion.<sup>16</sup> Fire sale externalities occur when those who *are* exposed to the affected asset class (particularly if they borrowed money to buy those assets in the first place) need to sell *other* assets at fire sale prices in order to right their financial condition.<sup>17</sup> This will depress the prices of the assets being sold, creating potential problems for financial institutions exposed to *them*.<sup>18</sup> Sentiment contagion can be a problem because some financial institutions (particularly banks) depend so heavily on public confidence. Fears (even misplaced and unsupported fears) about a financial institution's exposure to an affected asset class can lead to a run on that institution.<sup>19</sup>

Banks in particular are susceptible to runs because of "maturity mismatch": bank liabilities like deposits can be withdrawn at any time, whereas many bank assets have a longer duration and therefore cannot be readily converted into cash without discounting their value.<sup>20</sup> Banks only have on hand a fraction of the amount they owe on deposits at any one time, and that is ordinarily fine because the odds are that not every depositor will seek to withdraw all of their funds at the same time. Panic, however, changes these odds. An individual depositor cannot rely on other depositors not to withdraw in the event of a panic, and if that first depositor refrains from withdrawing but others do not, that first depositor will be at a disadvantage because the bank will satisfy the earlier withdrawal requests by liquidating its best and most liquid assets, and the bank may not be able to process subsequent withdrawals.<sup>21</sup> Each individual depositor is therefore incentivized to withdraw as early as possible if confidence in the bank is threatened in any way, and the bank run can become a self-fulfilling prophecy.<sup>22</sup>

Financial stability regulators are highly attuned to the fragilities associated with leverage, interconnectedness, fire sales, and runs.<sup>23</sup> The private sector lacks the incentives and the information needed to address the systemic impacts of these kinds of fragilities, and so the job necessarily falls to financial stability regulators.<sup>24</sup> If these regulators do not succeed, the result may be a financial crisis that leads to a broader economic recession.<sup>25</sup> In the wake of such a crisis, we typically see central banks deploy highly accommodative monetary policy as an ex post response.<sup>26</sup>

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16. For background on fire sales and sentiment contagion, see Anil K. Kashyap, Richard Berner & Charles A.E. Goodhart, *The Macprudential Toolkit*, 59 IMF ECON. REV. 145, 147–50 (2011).

17. *Id.* at 148.

18. *Id.*

19. Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 404 (1983).

20. *Id.* at 403, 417; see Itamar Drechsler, Alexi Savov, Philipp Schnabl & Olivier Wang, *Deposit Franchise Runs* 34 (Nat'l Bureau of Econ. Rsch., Working Paper No. 31138, 2024).

21. Diamond & Dybvig, *supra* note 19, at 403.

22. *Id.* at 402.

23. Financial Stability Oversight Council, *supra* note 10.

24. ALLEN, *supra* note 9, at 221.

25. See BERNANKE, *supra* note 15, at 66.

26. Adrian et al., *supra* note 1, at 10.

At the risk of oversimplification, monetary policy entails increasing the money supply in an accommodative or expansionary phase to encourage economic growth, and reducing the money supply in a contractionary phase to limit inflation.<sup>27</sup> In the United States, monetary policy is carried out by the Federal Reserve, and its primary tool is setting targets for the federal funds rate (*i.e.*, “the interest rate that banks pay to borrow reserve balances overnight”).<sup>28</sup> The Federal Reserve then seeks to get interest rates to match targets through what are called “open market operations,” which entail buying government securities from banks, introducing cash into the system.<sup>29</sup> In extreme circumstances, the Federal Reserve may engage in “quantitative easing,” purchasing other types of assets in order to introduce even more money into the financial system.<sup>30</sup> Conversely, selling government securities and other assets can be used to reduce the money supply in order to combat inflation.<sup>31</sup>

After the collapse of the financial system in 2008, interest rates were kept historically “low for long.”<sup>32</sup> Target interest rates were reduced swiftly at the end of 2008, and remained as low as they could go until the end of 2015.<sup>33</sup> The Federal Reserve also began to experiment with quantitative easing in 2008, engaging in further rounds in 2010 and 2012.<sup>34</sup> After 2015, the Federal Reserve increased rates somewhat but the target never exceeded 2.5% during the period between 2016–2019.<sup>35</sup> Then, when the COVID-19 pandemic hit the United States in March 2020, the target rate was again reduced as low as it could go, where it remained until March 2022.<sup>36</sup> The Federal Reserve also engaged in unprecedented quantitative easing during 2020 and 2021, rapidly expanding the money supply.<sup>37</sup> Then, in the face of increasing inflation, the Federal Reserve started to

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27. *Monetary Policy: What Are Its Goals? How Does It Work?*, BD. OF GOVERNORS OF THE FED. RSRV. SYS., <https://www.federalreserve.gov/monetarypolicy/monetary-policy-what-are-its-goals-how-does-it-work.htm> (July 29, 2021) [<https://perma.cc/M8HT-FNRS>].

28. *Id.*

29. Laura J. Hopper, *What are Open Market Operations? Monetary Policy Tools, Explained*, FED. RSRV. BANK ST. LOUIS (Aug. 21, 2019), <https://www.stlouisfed.org/open-vault/2019/august/open-market-operations-monetary-policy-tools-explained> [<https://perma.cc/8RJH-UWWM>].

30. Arthur E. Wilmarth, Jr., *We Must Protect Investors and Our Banking System from the Crypto Industry*, 101 WASH. U. L. REV. 235, 254 (2023).

31. Hopper, *supra* note 29; see Steven Kelly, *Where Was the Last Place You Saw the Deposits?*, WITHOUT WARNING (July 18, 2023), <https://www.withoutwarningresearch.com/p/where-was-the-last-place-you-saw> [<https://perma.cc/8QQD-2VNR>].

32. Eric S. Rosengren, President & Chief Exec. Officer, Fed. Rsrv Bank of Bos., Keynote Address at the Norges Bank and International Banking, Economics and Finance Association Workshop: “Prepared for the Next Crisis? The Costs and Benefits of Financial Regulation”: Financial Stability and Regulatory Policy in a Low Interest Rate Environment 3–5 (Nov. 11, 2019).

33. Rates and dates are drawn from *Federal Funds Target Range—Upper Limit*, FED. RSRV. BANK OF ST. LOUIS (Apr. 1, 2025, 7:02 AM), <https://fred.stlouisfed.org/series/DFEDTARU> [<https://perma.cc/TT56-5AC3>].

34. Stephan Luck & Thomas Zimmermann, *Ten Years Later—Did QE Work?*, LIBERTY ST. ECON. (May 8, 2019), <https://libertystreeteconomics.newyorkfed.org/2019/05/ten-years-laterdid-qe-work/> [<https://perma.cc/QAA7-UVB9>].

35. *Federal Funds Target Range—Upper Limit*, *supra* note 33.

36. *Id.*

37. Wilmarth, *supra* note 30, at 254.

rapidly increase its target interest rate; by July 2023, the target rate had been increased to 5.25–5.5%.<sup>38</sup>

### B. *Competing Mandates*

The Federal Reserve is directed to carry out its monetary policy with a view to its dual mandate to pursue both price stability and full employment.<sup>39</sup> This dual mandate often requires a delicate balancing act. Too much inflation erodes people's savings and purchasing power and damages confidence in the dollar as a reliable store of value, but when interest rates are raised to reduce the amount of money in the economy and curb inflation, they can also curb economic growth and employment.<sup>40</sup>

This balancing act is rendered even more difficult when financial stability concerns are also taken into account.<sup>41</sup> Central banks are paying increasing attention to the interactions between monetary policy and financial stability<sup>42</sup>—this Article will engage with only a small slice of this bigger picture issue by focusing on how prolonged periods of low interest rates and other accommodative monetary policy have impacted the VC industry, and through it, financial stability. It is, however, worth setting the scene by considering in broad strokes how prolonged periods of accommodative monetary policy might undermine financial stability. As President of the Cleveland Federal Reserve Bank Loretta Mester put it in 2021:

A commitment to a protracted period of very low interest rates could encourage risk-taking as investors search for yield; it could lead to a build-up in leverage; and it could lead lenders to lower their credit standards and promote increased borrowing. While all of these are avenues through which monetary policy typically affects the economy, the concern is that these effects could be excessive and create or contribute to financial vulnerabilities.<sup>43</sup>

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38. *Federal Funds Target Range—Upper Limit*, *supra* note 33. For discussion of the drivers of this inflation and central bank responses, see Adrian et al., *supra* note 1, at 10–11.

39. 12 U.S.C. § 225a; *Monetary Policy: What Are Its Goals? How Does It Work?*, *supra* note 27.

40. Adrian et al., *supra* note 1, at 11.

41. While it has no statutory mandate to pursue financial stability, the Federal Reserve takes the position that such a mandate is implied from “the penumbra of the Federal Reserve Act.” Thomas C. Baxter, Jr., Exec. Vice President & Gen. Couns., Fed. Rsr. Bank of N.Y., *Financial Stability: The Role of the Federal Reserve System* (Nov. 15, 2013), <http://www.newyorkfed.org/newsevents/speeches/2013/baxl31120> [https://perma.cc/7CSB-APGC].

42. See JOINT TASK FORCE OF ESRB ADVISORY TECH. COMM. (“ATC”), ESRB ADVISORY SCI. COMM. (“ASC”) & ESCB FIN. STABILITY COMM. (“FSC”), *LOWER FOR LONGER—MACROPRUDENTIAL POLICY ISSUES ARISING FROM THE LOW INTEREST RATE ENVIRONMENT*, 3 (June 2021) [hereinafter “ATC, ASC & FSC”], [https://www.esrb.europa.eu/pub/pdf/reports/esrb.reports210601\\_low\\_interest\\_rate-199fb84437.en.pdf?902fd7a7eacd507c650ed631ebe7482e](https://www.esrb.europa.eu/pub/pdf/reports/esrb.reports210601_low_interest_rate-199fb84437.en.pdf?902fd7a7eacd507c650ed631ebe7482e) [perma.cc/A9EP-JM6L].

43. Loretta J. Mester, President & CEO, Fed. Rsr. Bank of Cleveland, *Financial Stability and Monetary Policy in a Low-Interest-Rate Environment* (June 22, 2021, 10:30 AM), <https://www.clevelandfed.org/collections/speeches/2021/sp-20210622-financial-stability-and-monetary-policy-in-a-low-interest-rate-environment> [https://perma.cc/5BLR-B6N9]; see also ULRICH BINDSEIL & STEVEN B. KAMIN, COMMITTEE ON THE GLOBAL

Ultimately, financial stability and monetary policy have an interactive relationship that is not fully understood. Central bankers and economists are actively debating the precise contours and predictability of their interplay, and what that means for the conduct of monetary policy.<sup>44</sup> It is relatively uncontroversial, however, to acknowledge—as President Mester did—that low interest rate policy implemented to assist economic growth in the wake of a financial crisis can sow the seeds for a future financial crisis by encouraging people to reach for yield. There are also concerns that if a future crisis erupts while interest rates remain low, the efficacy of conventional monetary policy tools as a response to that future crisis may be limited.<sup>45</sup> Unconventional monetary policy like quantitative easing will remain an option, but the resulting increase in the availability of “easy money” may also sow the seeds for a future crisis by encouraging speculation. Monetary policy could also potentially be stymied in its ability to control inflation, if a financial crisis forces the hand of a central bank, resulting in a shift to accommodative monetary policy before inflation has been tamed. Monetary policy is also typically effected through banks,<sup>46</sup> and so if bank stability is compromised by the one-two punch of prolonged accommodative monetary policy and then a financial crisis,<sup>47</sup> that will impede the implementation of any future monetary policy.

And then there are financial stability risks associated with exiting a prolonged period of accommodative monetary policy. It is hard to say if and when these stability risks may be significant enough to justify deviations from inflation-fighting interest rate hikes, but it remains true that once easy money ceases

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FINANCIAL SYSTEM, CGFS PAPERS NO. 61, 1 (July 2018), <https://www.bis.org/publ/cgfs61.pdf> [<https://perma.cc/3G6L-BDVV>] (“[L]ow rates could change firms’ incentives to take risks, which could engender additional financial sector vulnerabilities.”); ATC, ASC & FSC, *supra* note 42, at 4. (“[F]inancial stability risks may increase in the [low interest rate environment] due to the search-for-yield, resulting in an excessive build-up of leverage.”).

44. “[P]recise estimates of the probability of a financial crisis following credit and asset price booms remain unavailable. More importantly, how high the probability of a crisis should be permitted to climb before prompting preemptive policy action remains an open question.” Robin Greenwood, Samuel G. Hanson, Andrei Shleifer & Jakob Ahm Sørensen, *Predictable Financial Crises*, 77 J. FIN. 863, 864 (2022). *See, e.g.*, Adrian et al., *supra* note 1; John C. Williams, President & CEO, Fed. Rsrv. Bank of S.F., Presentation to the Deutsche Bundesbank Conference Housing Markets and the Macroeconomy: Challenges for Monetary Policy and Financial Stability (June 5, 2014), <https://www.frbsf.org/wp-content/uploads/Financial-Stability-and-Monetary-Policy-Happy-Marriage-or-Untenable-Union.pdf> [<https://perma.cc/FC8C-3DVE>]; Maximilian Grimm, Òscar Jordà, Moritz Schularick & Alan M. Taylor, *Loose Monetary Policy and Financial Instability* 1 (NBER Working Paper No. 30958, 2023), [https://www.nber.org/system/files/working\\_papers/w30958/w30958.pdf](https://www.nber.org/system/files/working_papers/w30958/w30958.pdf) [<https://perma.cc/SJF5-24GY>].

45. Rosengren, *supra* note 32, at 1–2.

46. “The close relationship between banks and the money supply has important consequences for public policy. Any breakdown of the banking system will affect the money supply and threaten the stability of the economy.” RICHARD SCOTT CARNELL, JONATHAN R. MACEY, GEOFFREY P. MILLER & PETER CONTI-BROWN, *THE LAW OF FINANCIAL INSTITUTIONS* 80 (7th ed. 2021). *See also* Mester, *supra* note 43 (“The strength of the banking system also allowed monetary policymakers to use their tools fully to support the economy.”).

47. Mester, *supra* note 43 (“Low interest rates could more directly impact the profitability of banks by lowering net interest margins and earnings, thereby limiting banks’ capital levels and their ability to lend through a downturn and changing their appetite for risk.”).

to be available, that can prick bubbles created during the period of accommodative monetary policy.<sup>48</sup> Although not all bubbles cause financial instability, financial stability will probably be impacted if banks and other leveraged financial institutions are significantly exposed to a bubble that pops.<sup>49</sup> Liquidity will also dry up as easy money disappears; when money is sloshing around during a prolonged period of low interest rates, financial institutions may underestimate the liquidity risks of the assets they acquired during their search for yield.<sup>50</sup> As liquidity evaporates, we might see forced fire sales of assets at discounted prices, which can transmit problems from asset class to asset class.<sup>51</sup>

The banking business model also has some inherent vulnerabilities that will be impacted if interest rates rise rapidly.<sup>52</sup> As a report from the Bank for International Settlements noted in 2018:

[A] period of prolonged low interest rates could well be followed by a sharp surge or “snapback” in interest rates. Such a snapback could be challenging for financial institutions, even in the absence of additional risk-taking. Banks would likely experience valuation losses on long-duration assets and credit losses on loans.<sup>53</sup>

The increase in interest rates in 2022 could be described as such a snapback, and in its 2023 Financial Stability Report, the Federal Reserve noted that:

Bank funding costs are likely to increase as deposit rates continue to rise following earlier policy rate hikes and would continue to do so with any additional policy firming. While deposit rates are likely to remain lower than market interest rates, higher funding costs may pressure the profitability of banks with large portfolios of fixed-rate assets that were acquired when interest rates were much lower. A sharp rise in interest rates could also lead to increased volatility in global financial markets, stresses to market liquidity, and a correction in asset prices. Liquidity pressures could subject banks to outflows of deposits and other forms of short-term funding.<sup>54</sup>

There is therefore no shortage of financial stability concerns associated with prolonged periods of accommodative monetary policy and subsequent shifts away from it. The remainder of this Article will focus on a narrow subset of these financial stability risks: the ones associated with the VC industry.

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48. SHILLER, *supra* note 12, at 228–29.

49. *See supra* note 14 and accompanying text.

50. This has been referred to as a “liquidity illusion.” ATC, ASC & FSC, *supra* note 42, at 44.

51. *Id.*

52. Matthew Richardson, Alexi Savov & Phillipp Schnabl, *Banks, Interest Rate Risk and Systemic Risk—Theoretical and Historical Perspectives*, in SVB AND BEYOND: THE BANKING STRESS OF 2023 35, 38–39 (Viral V. Acharya et al., eds., 2023).

53. BINDSEIL & KAMIN, *supra* note 43, at 2.

54. BD. OF GOVERNORS OF THE FED. RSRV. SYS., *supra* note 3 at 59–60.

## III. VENTURE CAPITAL

Some of the “easy money” made available during the period from 2009–2021 found its way into VC funds.<sup>55</sup> A VC fund is a type of private fund that specializes in providing equity capital to startup ventures, and typically couples that equity investment with the provision of management and strategy advice and guidance.<sup>56</sup> This “hands on” approach distinguishes VC from many other private fund investment strategies.<sup>57</sup> Another distinguishing factor is the expectation that many of the startup ventures a VC fund invests in will fail—which means that the fund must select a few “home run” ventures that grow exponentially in order for the fund to succeed.<sup>58</sup> A fund is typically formed for a limited duration of ten or twelve years, and so it must exit from all its venture investments before the end of that period.<sup>59</sup>

VC funds usually follow the typical private fund structure of pooling funds from investors in a limited partnership, where the investors are the passive limited partners, and an entity formed and controlled by the VC firm will act as general partner<sup>60</sup> (this structure allows investors to benefit from appealing tax treatment).<sup>61</sup> The fund’s general partner will invest the pooled funds in ventures chosen by the VC firm (or an affiliated entity).<sup>62</sup> Ultimately, the VC firm’s compensation will be a function of the dollar amount of assets invested in the fund, and of the profits the fund can generate.<sup>63</sup>

Charts from the Financial Times (reproduced below)<sup>64</sup> show that in the United States, both the number of VC deals and the dollar amount invested in

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55. Yueran Ma & Kaspar Zimmermann, *Monetary Policy and Innovation* 1 (Nat’l Bureau of Econ. Rsch., Working Paper No. 31698, 2023). See *infra* note 64 and accompanying chart.

56. Elizabeth Pollman, *Adventure Capital*, 96 S. CAL. L. REV. 1341, 1345 (2024).

57. Other distinguishing factors include the types of companies invested in, and staged financing. *Id.* at 1351–52.

58. SEBASTIAN MALLABY, *THE POWER LAW: VENTURE CAPITAL AND THE MAKING OF THE NEW FUTURE* 9 (2022).

59. “Vetting and selling startups takes time, so VCs only have about five to six years between investment and exit for their startups to grow in value.” Matthew T. Wansley & Samuel N. Weinstein, *Venture Predation*, 48 J. CORP. L. 813, 832 (2023).

60. STEPHEN J. LUBBEN, *CORPORATE FINANCE*, 438–41 (2014).

61.

Because VC funds are partnerships, capital gains flow directly to investors without being taxed. Furthermore, if investors are tax-exempt, such as non-profit pension funds or foundations, they do not pay any taxes at all. The VC limited partnership thus represented an attractive vehicle for a broad class of institutional investors.

The VC industry has also lobbied to have the capital gains tax rate reduced to incentivize investors who are not tax-exempt. Peter Lee, *Enhancing the Innovative Capacity of Venture Capital*, 24 YALE J.L. & TECH. 611, 628–29 (2022).

62. “Venture capital firms raise capital from passive limited partners, organized in funds with 10-12 year terms, charging an annual management fee and a percentage of profits: Acting as general partner of the fund, venture capitalists make and monitor investments in a portfolio of startups.” Pollman, *supra* note 56, at 1353.

63. “The LPs compensate the VCs in two ways: an annual management fee of 2% of the fund’s assets and ‘carried interest’ equal to 20% of the fund’s profits.” Wansley & Weinstein, *supra* note 59, at 832.

64. Richard Waters, *Venture Capital’s Silent Crash: When the Tech Boom Met Reality*, FIN. TIMES (July 31, 2022), <https://www.ft.com/content/6395df7e-1bab-4ea1-a7ea-afaa71354fa0> [https://perma.cc/QJR7-H2GD].

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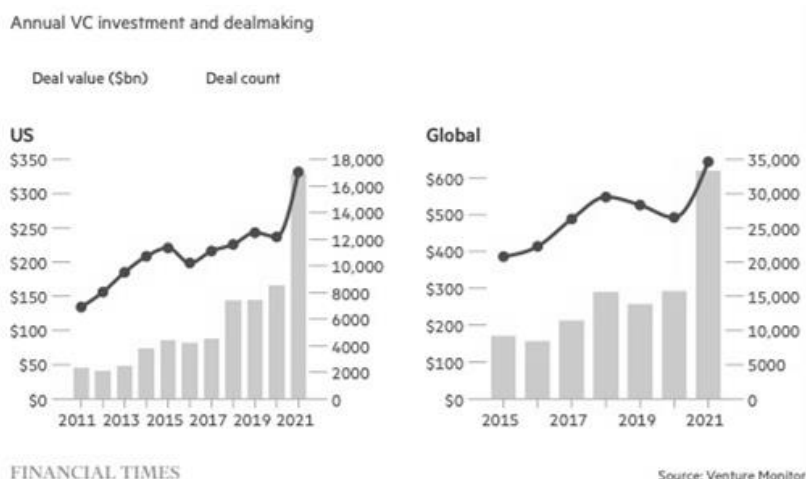
VC increased at a reasonably steady pace during the post-financial crisis era of low interest rates, with a significant spike in investment in 2021. As reported in the *Financial Times*,

[t]he scale of the most recent venture boom has dwarfed that at the end of the 1990s, when annual investment peaked at \$100bn in the US. By comparison, the amount of cash pumped into American tech start-ups [in 2021] reached \$330bn. That was twice as much as the previous year, which was itself twice the level of three years earlier.<sup>65</sup>

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65. *Id.*

FIGURE 1



This spike in VC investment has been described by more than a few commentators as a bubble.<sup>66</sup> Economist Robert Shiller has observed that bubbles typically have multiple idiosyncratic and entangled causes, but emphasizes that the impact of these causes tends to be amplified in ways that remain reasonably consistent from bubble to bubble.<sup>67</sup> He borrows from the engineering literature to describe these amplification mechanisms as “feedback loops” where “the initial impact of the precipitating factors is amplified, resulting in much larger price increases than the factors themselves would have suggested.”<sup>68</sup> For example, as asset prices go up, that can create expectations that the price will go up further and build confidence in the asset, such that more people buy the asset—which drives the price up further, and confirms optimistic expectations.

Shiller’s explanation of bubbles emphasizes that demand (even amongst sophisticated investors) is not always driven by the kinds of factors an economist would consider rational—instead, demand can be increased by investors’ “fear of missing out” (“FOMO”), or by envy from those who have watched from the sidelines as others made money.<sup>69</sup> Demand cannot increase forever, though—especially when that demand has been fueled in part by easy money that is no longer available. Once demand falls off, the feedback loop can become a vicious cycle, where the attention and enthusiasm that fueled the upswing of the bubble

66. See, e.g., *id.*; Allison Baum Gates, *Are We in a Venture Capital Bubble?*, FORBES (July 5, 2021, 5:00 PM), <https://www.forbes.com/sites/allisonbaumgates/2021/07/05/are-we-in-a-venture-capital-bubble/?sh=3d401f986f08> [<https://perma.cc/XX6G-3KQT>]; Tony Yiu, *The Venture Capital Bubble Is Finally Over*, MEDIUM (Dec. 13, 2022), <https://medium.com/alpha-beta-blog/the-venture-capital-bubble-is-finally-over-4dbffee55302> [<https://perma.cc/FTM4-R9HZ>].

67. SHILLER, *supra* note 12, at 70.

68. *Id.* at 84.

69. *Id.* at 80 (“How one feels certainly depends on one’s recent experience in investing.”).

convert to panic and distrust that encourage selling behavior, driving prices down in a way that only confirms the panic and distrust and encourages more selling.

Shiller's perspective is helpful for understanding the most recent VC bubble. Yield-seeking behaviors inspired by prolonged low-interest rate environments are generally understood to have increased interest in VC investments, but FOMO and other narrative factors were also relevant.<sup>70</sup> The VC industry was an integral part of the dot-com bubble where "new era stories" about the transformative potential of the internet abounded;<sup>71</sup> new stories about transformative technologies surely help explain the more recent VC bubble as well. There is now a general consensus, though, that some of the air has come out of the venture capital bubble.<sup>72</sup> The number and value of deals done in the third and fourth quarters of 2022 fell significantly,<sup>73</sup> and this is at least partially attributable to the changes in interest rate policy made in 2022.<sup>74</sup> At the end of 2022, industry publication Venture Monitor reported that:

The inflation that drove the federal-funds rate to multidecade highs has also impacted the venture industry. For the past several years, VC has been an attractive asset class for major allocators. While the United States' VC funds have returned impressive values to their LPs, one factor driving the growth of investment in alternative assets such as VC has been low interest rates, which made it difficult to generate returns in more traditional asset classes. As interest rates rise, allocators are diversifying, and this is likely to involve moving some assets away from VC.<sup>75</sup>

To be clear, the end of the VC bubble does not mean that VC coffers are empty. Many VC funds built up war chests while interest rates were low, but now there is no guarantee that these war chests will be replenished with new capital.<sup>76</sup>

Fortunately, the end of a VC bubble is unlikely to have any immediate financial stability implications; a VC investor cannot withdraw their money from a VC fund before the end of the fund's term, and so we need not be worried about runs on VC funds.<sup>77</sup> Even if individual VC funds are unable to exit profitably from enough startup ventures end and up closing at a loss at the end of their 10-year terms, the financial stability implications of VC investors ending up with negative returns are likely to be muted.<sup>78</sup> But such losses could certainly scare

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70. "'If there was one word to describe it, it was Fomo,' says Eric Vishria, a partner at Benchmark Capital. The 'fear of missing out' he points to brought a stampede at the peak of the market." Waters, *supra* note 64.

71. On dot-com era new era stories, see SHILLER, *supra* note 12, at 41–43.

72. Waters, *supra* note 64.

73. PITCHBOOK & NVCA, VENTURE MONITOR Q4 2022, at 5 (2023), <https://pitchbook.com/news/reports/q4-2022-pitchbook-nvca-venture-monitor> [<https://perma.cc/D366-ZHU3>].

74. Other dampening factors may include increasing challenges for VCs seeking to exit investments. See Elizabeth Pollman, *Startup Failure*, 73 DUKE L.J. 327, 372–76 (2023).

75. PITCHBOOK & NVCA, *supra* note 73, at 3.

76. Waters, *supra* note 64.

77. Tuch argues that runs on private equity funds are similarly unlikely because of constraints on withdrawals. Tuch, *supra* note 8, at 353–54.

78. Jacob Robbins, *How Bad Was 2022 for VCs? It Depends Where You Look*, PITCHBOOK (Jan. 23, 2023), <https://pitchbook.com/news/articles/vc-trends-charts-2022> [<https://perma.cc/8LPY-QPXU>] (“[O]verall exit

investors away from venture capital funds in the future.<sup>79</sup> Such negative returns would only impact the stability of the broader financial system if the investors proved unable to absorb these losses and started to engage in destabilizing behaviors like fire sales of other assets. Such outcomes are unlikely if investors are well diversified.

But the VC bubble has already demonstrated its impact on financial stability in other ways.<sup>80</sup> For example, as we will explore in Section IV.B, a significant amount of the glut of VC investment ended up deposited with Silicon Valley Bank, rendering that bank unstable in a way that damaged confidence in the banking system more broadly.<sup>81</sup> And the VC bubble also propagated a crypto bubble that, if regulatory authorities had handled it differently, might have had serious financial stability implications<sup>82</sup>—and might still, if VCs are successful in lobbying for changes in regulatory policy.

#### IV. CASE STUDIES

The previous Part discussed the money that rushed into VC funds during a period of prolonged accommodative monetary policy. This Part will consider the financial stability implications of what VC funds have done with that money. In doing so, it will explore some of the factors that predispose the VC industry to inflating asset bubbles in boom times. Such asset bubbles can be directly detrimental to those who invest in the affected assets (particularly those who invest later in the cycle)—this raises questions about investor protection that are largely beyond the scope of this Article.<sup>83</sup> If leveraged financial institutions also invest in these asset bubbles, though, then that can threaten financial stability.<sup>84</sup> If a

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activity plummeted in 2022. Annually, exit activity value dropped below \$100 billion for the first time in five years.”); Waters, *supra* note 64 (“[I]nvestors who put the bulk of their latest funds to work at the peak of the market could be facing the sort of negative returns that have not been seen since the dotcom crash at the turn of the century.”).

79. For a discussion of the possibility of investor exodus from the venture capital asset class, see Robin Wigglesworth, *A Minsky Moment for Venture Capital?*, FIN. TIMES (May 4, 2022), <https://www.ft.com/content/077de7e3-e4e3-49d5-8a76-3cbbc4f492f5> [<https://perma.cc/M56B-R6RK>].

80. The bubble of VC investment has also generated harms beyond financial stability risks that are outside the scope of this article. For example, the glut of venture capital has enabled startups to engage in predatory pricing that can

harm consumer welfare by raising prices and reducing consumer choice . . . can harm the economy in a more subtle way by distorting the price signal and leading third parties to make economically irrational decisions . . . can harm society in the long run by misallocating capital to predatory pricing and away from genuine innovations.

Wansley & Weinstein, *supra* note 59, at 859. As Wansley and Weinstein note, “[i]t may not be a coincidence that venture predation became so popular in the late 2010s—a period of low interest rates, a frothy stock market, and an unprecedented amount of money pouring into venture capital.” *Id.* at 857.

81. *See infra* Section IV.B.

82. *See infra* Sections IV.A–B.

83. There is some discussion of investor protection regulation in *infra* Subsection V.B.2.

84. *See supra* note 14 and accompanying text.

financial crisis results, then people who never even invested in the bubble themselves will be harmed, albeit indirectly.<sup>85</sup>

The VC industry is particularly prone to inflating asset bubbles for several reasons. First, while the VC industry is often lionized for its nonconformist ability to identify idiosyncratic genius,<sup>86</sup> reality often fails to match that narrative. Peter Lee, drawing on both academic research and interviews with Silicon Valley figures, demonstrates that the innovative capacity of venture capital is impeded by three interlocking factors: entrepreneurs often need social ties with VC firms to receive funding, VCs often exhibit herd mentality, and VC funds must be able to “exit” from projects in the medium term because of how these funds are structured.<sup>87</sup> These three factors can also contribute to the development of asset bubbles. The herd mentality is most significant; while it might sometimes maximize profits for the VC firms themselves, this mentality can help a bubble of investments in VC firms translate into socially suboptimal bubbles in the areas that those VC firms fund.

While herd mentality has been observed among all kinds of fund managers,<sup>88</sup> it is exacerbated in the VC context by the “groupthink” that arises from the tightknit social networks between VC firms and founders.<sup>89</sup> Lee observes that “[h]istorical evidence reveals several trends of ‘hot’ technologies receiving significant VC funding and then losing favor. Perhaps owing to the close-knit, socially connected nature of the VC-startup ecosystem, information signals from a few key decisionmakers can steer significant shifts in funding trends.”<sup>90</sup> In the relatively small and hyperconnected world of Silicon Valley VC, interest from one marquee name VC firm can sometimes be all that is needed to spark interest in a particular type of investment,<sup>91</sup> particularly because VC firms often co-operate with one another in syndicated deals, rather than trying to outcompete one another.<sup>92</sup> Lee notes his interviewees’ observations that this herding “creates significant waste and overlooks promising innovations outside the mainstream.”<sup>93</sup> One such interviewee commented that “there’s just countless examples of that, where poor quality innovation is what actually makes it to market, ‘cause of the team, the network, the location, the hype, the everything.”<sup>94</sup>

Another trait that predisposes VC investment towards creating bubbles is that VC returns are generated primarily from one big success—what Sebastian

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85. ALLEN, *supra* note 9, at 7 (“[F]inancial system failure has significant implications for the people and businesses that make up the broader economy.”).

86. MARGARET O’MARA, *THE CODE: SILICON VALLEY AND THE REMAKING OF AMERICA* 4–6 (2019).

87. Lee, *supra* note 61, at 615–17.

88. For discussion of incentives and evidence of herding by fund managers, see generally Sushil Bikhchandani & Sunil Sharma, *Herd Behavior in Financial Markets*, 47 *IMF STAFF PAPERS* 279 (2001).

89. Lee, *supra* note 61, at 650.

90. *Id.* at 616.

91. *Id.* at 656.

92. Wansley & Weinstein, *supra* note 59, at 835.

93. Lee, *supra* note 61, at 616.

94. *Id.* at 645.

Mallaby has called “power law.”<sup>95</sup> It is entirely expected that VC funds will see many of their investments become worthless, and so those funds won’t worry about failures in the same way traditional financiers would.<sup>96</sup> Instead, the focus is on the possible exponential upside of a new business, even if its success seems somewhat unrealistic.<sup>97</sup> Optimism is therefore structural, and not just a matter of groupthink. This is exacerbated because it is difficult to express pessimism in startup investment—short-selling of startup shares is not possible in any meaningful sense, and so there is a pronounced and asymmetric preference for optimism over pessimism.<sup>98</sup>

VC’s relative lack of concern about their failed investments may help explain why VC firms sometimes perform less diligence on their investments than the public would expect. Low levels of diligence can contribute to the growth of bubbles, as they allow more and lower quality startups to enter the market. These limitations of VC oversight may also persist after VC funds first invest in a project:

[T]he board [on which VC interests are represented] typically invests little in compliance and internal controls . . . because . . . the company is usually still figuring out if it can even make an innovative product or service that people want and develop a strategy to bring it to market.<sup>99</sup>

If the project goes well, then VCs “need the company’s valuation to keep going up in order to raise another round of financing and not get significantly diluted, and eventually to reach an exit that generates returns.”<sup>100</sup> The desire for exponential growth and profits certainly provides an incentive for VC firms to refrain from being too critical of their investments, as does the clubby nature of the relationships between VCs and founders (VCs are sometimes too worried about scaring away founders to exercise real oversight).<sup>101</sup>

Many of these factors were heightened or exacerbated by the prolonged low-interest rate environment we experienced prior to 2022. VC firms had a glut of money, which they had to deploy *somewhere*; as one industry commentator put it, with money flooding into VC funds, things “quickly went from not enough capital to not enough ideas for the flood of capital to fund.”<sup>102</sup> In such an environment, it would not be surprising for herding to intensify, startup valuations to increase, and diligence standards to suffer—and that is ultimately what came to

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95. Mallaby chose the term “power law” because “the winners advance at an accelerating, exponential rate, so that they explode upward far more rapidly than in a linear progression.” MALLABY, *supra* note 58, at 7.

96. “[H]e learned not to worry about the bets that went zero. All he could lose was one times his money.” *Id.* at 9.

97. *See id.* at 12.

98. Jesse M. Fried & Jeffrey N. Gordon, *The Valuation and Governance Bubbles of Silicon Valley*, CLS BLUE SKY BLOG (Oct. 10, 2019), <https://clsbluesky.law.columbia.edu/2019/10/10/the-valuation-and-governance-bubbles-of-silicon-valley/> [<https://perma.cc/7S84-FHQ3>].

99. Elizabeth Pollman, *Startup Governance*, 168 U. PENN. L. REV. 155, 202 (2019).

100. *Id.*

101. *Id.* at 206.

102. Yiu, *supra* note 66.

pass.<sup>103</sup> This recent VC bubble was notable for its significant herding of investments into several sectors: ultrafast delivery companies, fintechs in general, and crypto more specifically.<sup>104</sup> The next Section will focus on crypto.

### A. *Crypto*

The chart from the Financial Times reproduced below shows significant growth in crypto investments in 2021, and the bust that followed the failure of Terra/Luna in May 2022—the beginning of 2022’s “crypto winter.”<sup>105</sup> It also shows the crypto rally that started at the end of 2023.

FIGURE 2

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103. “It is widely recognized that overvaluation was prevalent in the VC market before this [2022] downturn . . .” Ma & Zimmermann, *supra* note 55, at 4. “It wasn’t just the high prices investors were prepared to pay not to miss the boat: periods for conducting due diligence were drastically shortened and protections that investors usually build in to protect their investments fell by the wayside.” Waters, *supra* note 64. *See also id.* (“And investment discipline was loosened, with VCs spreading their bets widely across entire sectors rather trying to single out the small number of big winners that had traditionally provided the lion’s share of the industry’s profits.”) With regards to diligence for crypto investments more specifically, see Erin Griffith & David Yaffe-Bellany, *Investors Who Put \$2 Billion into FTX Face Scrutiny, Too*, N.Y. TIMES (Nov. 11, 2022), <https://www.nytimes.com/2022/11/11/technology/ftx-investors-venture-capital.html> [<https://perma.cc/BZM3-JMVH>].

104. Waters, *supra* note 64 (“Asked which sectors are likely to prove the biggest disappointments, most venture investors list the same handful: the ultrafast delivery companies, like Gopuff and Gorillas, that have set out to bring customers their grocery items in as little as 20 minutes; fintechs that embarked on an expensive campaign to build large consumer businesses; and blockchain-based ventures that have been caught up in the crypto crash.”).

105. *Digital Assets Dashboard*, FIN. TIMES, <https://digitalassets.ft.com> (last visited June 30, 2025) [<https://perma.cc/2ENX-9Y7H>]. The valuation figures cited for crypto assets are highly manipulable and often convey limited or misleading information, but even taking these numbers with many grains of salt, crypto’s boom and bust cycle is clear (on the manipulability of crypto valuations, see Matt Levine, *FTX’s Balance Sheet Was Bad*, BLOOMBERG (Nov. 14, 2022, 12:09 PM), <https://www.bloomberg.com/opinion/articles/2022-11-14/ftx-s-balance-sheet-was-bad> [<https://perma.cc/6B9W-5RGR>]; Molly White, *Cryptocurrency “Market Caps” and Notional Value*, MOLLY WHITE (July 17, 2022), <https://blog.mollywhite.net/cryptocurrency-market-caps-and-notional-value/> [<https://perma.cc/DH7F-YF6T>].

The good news from a financial stability perspective is that, because few traditional financial institutions were significantly exposed to crypto, 2022's crypto industry implosions had limited impact on the real economy.<sup>106</sup> The bad news is that by 2024, the crypto industry was recovering. While this rebound might superficially seem positive, in the longer term, the persistence of the crypto industry is likely to prove negative for financial stability—especially as the traditional financial system increasingly embraces crypto.<sup>107</sup> This Section will argue that the VC industry has played a central role in facilitating this integration of crypto and traditional finance, as well as building the crypto industry in the first place.

### 1. *Crypto and Financial Stability*

In previous work, I have explored in detail how the complexity, leverage, rigidity, and runs that characterize the crypto markets—as well as the underlying operational fragilities of blockchain technology—replicate and exacerbate the fragilities we see in traditional finance without providing any meaningful improvements in capital intermediation, transaction processing, or financial inclusion.<sup>108</sup> While the general consensus circa 2023 was that crypto business models did not yet threaten the stability of the broader financial system,<sup>109</sup> financial regulators around the world expressed concerns that if the crypto markets continue to integrate with traditional finance, then banks and other critical financial intermediaries could be compromised by the boom-bust cycle of the crypto markets.<sup>110</sup> If this were to happen, even people who eschewed crypto investments

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106. “[I]nstitutions’ exposure [to crypto investments] is small relative to their balance sheets . . .” Natasha Che, Alexander Copestake, Davide Furceri & Tamarro Terracciano, *The Crypto Cycle and US Monetary Policy* 3 (Int’l Monetary Fund, Working Paper No. 23/163, 2023). “[D]espite crypto’s large user base and the substantial losses to many investors, the market turmoil in 2022 had little discernible impact on broader financial conditions outside the crypto universe, underlining the largely self-referential nature of crypto as an asset class.” Giulio Cornelli, Sebastian Doerr, Jon Frost & Leonardo Gambacorta, *Crypto Shocks and Retail Losses*, BIS BULLETIN (Feb. 20, 2023), <https://www.bis.org/publ/bisbull69.pdf> [<https://perma.cc/4C73-3JS9>].

107. See Cornelli et al., *supra* note 106.

108. ALLEN, *supra* note 9, at xiv; Hilary J. Allen, *DeFi: Shadow Banking 2.0?*, 64 WM. & MARY L. REV. 919, 919, 924 (2023). See generally Hilary J. Allen, *Fintech and Techno-Solutionism*, 98 S. CAL. L. REV. 761 (2025). See also Angela Walch, *The Bitcoin Blockchain as Financial Market Infrastructure: A Consideration of Operational Risk*, 18 N.Y.U. J. LEGIS. & PUB. POL’Y 837, 842 (2015); Wilmarth, *supra* note 30, at 241. The crypto exchange Coinbase conceded in court that it facilitates the sale of collectibles (effectively, digital Beanie Babies) rather than transformational financial services. Blake Montgomery, *Cryptocurrency Like Beanie Babies, Says Coinbase in US Regulator’s Lawsuit*, GUARDIAN (Jan. 18, 2024), <https://www.theguardian.com/technology/2024/jan/18/coinbase-cryptocurrency-lawsuit-beanie-babies-securities-sec> [<https://perma.cc/HGU7-ZJBV>].

109. Cornelli et al., *supra* note 106.

110. See, e.g., *id.*; FIN. STABILITY BD., ASSESSMENT OF RISKS TO FINANCIAL STABILITY FROM CRYPTO-ASSETS 5 (2022), <https://www.fsb.org/2022/02/assessment-of-risks-to-financial-stability-from-crypto-assets/> [<https://perma.cc/39WL-4U4H>]; FIN. STABILITY OVERSIGHT COUNCIL, REPORT ON DIGITAL ASSET FINANCIAL STABILITY RISKS AND REGULATION 4 (2022), <https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf> [<https://perma.cc/E2K9-XV8Y>].

would be impacted by a crypto crash and the ensuing financial instability. This Article will incorporate this literature on crypto and financial stability threats by reference, and take it as given that crypto could threaten a financial crisis if it integrated with traditional finance. The purpose of *this* Article is to examine the role that the VC industry has played in supporting the crypto industry, and in trying to encourage the integration of crypto and traditional finance.

As already discussed, economist Robert Shiller has observed that every bubble is a product of many different factors.<sup>111</sup> For the dot-com era stock bubble of the late 1990s, Shiller identified, amongst other factors, the availability of new internet technologies, generational factors (the relevant generation there was the Baby Boomers), the presence of new 24-7 business news channels, and an increased interest in gambling.<sup>112</sup> All of these factors have analogues in the crypto bubble. The crypto bubble can be partially attributed to excitement around the development of new blockchain technologies (which are often marketed, not coincidentally, as “the next internet,” notwithstanding their lack of demonstrated utility and inherent limitations).<sup>113</sup> The crypto bubble can also be explained in part by the millennial generation having a sense of precarity and distrust of traditional finance as a result of their formative experiences with the financial crisis of 2008.<sup>114</sup> It can be attributed to the rise of new social media channels for disseminating “new era stories” about crypto,<sup>115</sup> and to a new comfort with gambling typified by the ascension of sports betting.<sup>116</sup> The crypto bubble can also be explained in part by fiscal policy stimulus measures implemented during the pandemic that left many consumers with extra funds and few places to spend

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111. See *supra* notes 67–69 and accompanying text.

112. SHILLER, *supra* note 12, at 41.

113. For examples using this descriptor, see *The State of Crypto*, A16ZCRYPTO, <https://api.a16zcrypto.com/wp-content/uploads/2023/04/State-of-Crypto.pdf> (last visited June 30, 2025) [<https://perma.cc/FG32-YFGR>] (“Web3 is the next evolution of the internet . . .”); Jana Arbanas, Allan V. Cook & Chris Arkenberg, *The Metaverse and Web3: The Next Internet Platform*, DELOITTE (July 25, 2022), <https://www2.deloitte.com/us/en/insights/industry/technology/web3-and-metaverse-the-future-of-the-internet.html> [<https://perma.cc/H9RA-HUR6>]. For some cold water on these claims, see *Letter in Support of Responsible Fintech Policy*, SCRIBD (June 1, 2022), <https://www.scribd.com/document/579937076/Letter-in-Support-of-Responsible-Fintech-Policy> [<https://perma.cc/HG5P-8T3A>]; Molly White, *Narrative Over Numbers: Andreessen Horowitz’s State of Crypto Report*, CITATION NEEDED (May 9, 2023), <https://newsletter.mollywhite.net/p/andreessen-horowitzs-state-of-crypto> [<https://perma.cc/27D5-DKFR>].

114. Andrew Van Dam, *The Unluckiest Generation in U.S. History*, WASH. POST (June 5, 2020), <https://www.washingtonpost.com/business/2020/05/27/millennial-recession-covid/> [<https://perma.cc/NP4D-HCXQ>]; ALLEN, *supra* note 9, at 24.

115. Regarding the use of social media channels to discuss investment strategies, see Sergio Alberto Ricci & Christina M. Sautter, *Corporate Governance Gaming: The Collective Power of Retail Investors*, 22 NEV. L.J. 51, 84 (2021); Sue S. Guan, *Meme Investors and Retail Risk*, 63 B.C. L. REV. 2051, 2063–65 (2022).

116. The rise of gambling culture is a particularly interesting parallel. “The rise of gambling institutions, and the increased frequency of actual gambling, had potentially important effects on our culture and on changed attitudes toward risk taking in other areas . . .” SHILLER, *supra* note 12, at 58. Shiller also notes that the highest recorded stock market volatility “occurred during a ‘gambling craze’ that was brought on not by legalization, but by the organized crime that was inadvertently created by the prohibition of alcoholic beverages from 1920 to 1933.” *Id.* at 59. In the early 2020s, interest in gambling seems to be growing in the United States. Stephen Marche, *America’s Gambling Addiction Is Metastasizing*, ATLANTIC (Nov. 26, 2021), <https://www.theatlantic.com/ideas/archive/2021/11/world-our-casino/620791/> [<https://perma.cc/6GQ6-YMMZ>].

them<sup>117</sup>—as well as by consumers’ yield-seeking behaviors during prolonged periods of low-interest rates.<sup>118</sup>

Regardless of what sparks a particular bubble, Shiller’s work establishes that the same kinds of feedback loops amplify the impact of those sparks.<sup>119</sup> Shiller has described feedback loops in the stock market as “naturally occurring Ponzi processes,” because:

even if there is no manipulator fabricating false stories and deliberately deceiving investors in the aggregate stock market, tales about the market are everywhere. When prices go up a number of times, investors are rewarded sequentially by price movements in these markets, just as they are in Ponzi schemes. There are still many people (indeed, the stock brokerage and mutual fund industries as a whole) who benefit from telling stories that suggest that the market will go up further. There is no reason for these stories to be fraudulent; they need only emphasize the positive news and give less emphasis to the negative. The path of a naturally occurring Ponzi scheme—if we may call speculative bubbles that—will be more irregular and less dramatic, since there is no direct manipulation, but the path may sometimes resemble that of a Ponzi scheme when it is supported by naturally occurring stories.<sup>120</sup>

Such “naturally occurring Ponzi processes” are not restricted to the stock market, and given that the entire crypto industry has been described as Ponzi-like,<sup>121</sup> it is worth considering the role that stories and other interventions from VC firms have played in creating and perpetuating the crypto bubble.

A Ponzi scheme exists where “early investors are paid returns from funds provided by new investors, as opposed to being paid from actual returns of a purported investment,”<sup>122</sup> and some members of the crypto industry freely admit that it is Ponzi-like in its attributes.<sup>123</sup> After all, crypto assets (with the exception

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117. For a discussion of the impact of Covid-era stimulus (and monetary policy) on investment choices, see Wilmarth, *supra* note 30, at 255; Darren Aiello et al., *Who Invests in Crypto? Wealth, Financial Constraints, and Risk Attitudes*, (Nov. 1, 2023), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4281330](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4281330) [<https://perma.cc/M4RN-2GE6>].

118. “Crypto fans had a fun ride, powered by exuberant risk taking in an era of low interest rates.” Derek Thompson, *The Crypto Crash Is Just the Start*, ATLANTIC (May 13, 2022), <https://www.theatlantic.com/newsletters/archive/2022/05/worrying-signs-economy-inflation-crypto/629848/> [<https://perma.cc/SV82-YBYX>].

119. *See supra* notes 67–68 and accompanying text.

120. SHILLER, *supra* note 12, at 93–94.

121. *Id.*; *see also* Brian Sozzi, *Nouriel Roubini Says ‘Literally 99% of Crypto Is a Scam,’* YAHOO FIN. (Jan. 18, 2023), <https://finance.yahoo.com/news/nouriel-roubini-crypto-scam-144628068.html> [<https://perma.cc/TVX8-6GKV>] (quoting economist Nouriel Roubini as describing crypto as “[a] total real-bubble Ponzi scheme that is going bust”); BEN MCKENZIE & JACOB SILVERMAN, *EASY MONEY: CRYPTOCURRENCY, CASINO CAPITALISM, AND THE GOLDEN AGE OF FRAUD*, 26, 180–81 (2023). In addition to the entire crypto industry being Ponzi-like, it is also rife with actual frauds, as catalogued by Molly White’s website. *See* Molly White, *Web3 Is Going Just Great*, <https://web3isgoinggreat.com> (last visited June 30, 2025) [<https://perma.cc/Y8ZU-TFMN>].

122. Catherine Carey & John K. Webb, *Ponzi Schemes and the Roles of Trust Creation and Maintenance*, 24 J. FIN. CRIME 589, 589 (2017).

123. Perhaps most infamously, in April 2022, Sam Bankman-Fried conceded on the Odd Lots podcast that crypto yield farming was Ponzi-like. Tracy Alloway & Joe Weisenthal, *Matt Levine on the Collapse of FTX and*

of some asset-backed stablecoins) are not backed by any productive economic activity or other assets—they have no value unless new buyers can be attracted to the market or existing holders can be encouraged to buy more.<sup>124</sup> Like any bubble or Ponzi process, though, the crypto industry required some initial investors to get started and establish credibility—attracting the first investments is often the most challenging part of a Ponzi scheme.<sup>125</sup> So what attracted VC to crypto ventures in the beginning?

## 2. *Venture Capital and the Building of the Crypto Industry*

Ultimately, despite their reputation for taking moon shots, VC firms are seeking “investments with high upside, relatively short time frames, and less risk.”<sup>126</sup> VC funds are not designed to last forever—they are typically formed for 10 years, after which the fund will be liquidated and its assets will be distributed to the limited partner investors.<sup>127</sup> Lee has observed that software/internet businesses are very appealing to VC funds because they are typically less capital-intensive and quicker to set up than things like biotech and cleantech, which then leaves more time to exit.<sup>128</sup> Crypto ventures were particularly attractive to VC funds between 2020–22.<sup>129</sup> During that period, it was relatively quick and inexpensive to generate the rapid, exponential growth that VC funds prize:<sup>130</sup> growth could be generated by sentiment and didn’t require the development of prototypes or infrastructure.

The unique exit strategies that crypto ventures offer (or, more precisely, the unique exit strategies that are available so long as the securities laws are not enforced against crypto ventures) also appealed to VC firms. Typically, VC funds exit their venture investments either by finding a company willing to acquire the venture, or by orchestrating an IPO of the venture’s stock.<sup>131</sup> Unless an IPO is

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*Alameda*, BLOOMBERG (Nov. 17, 2022), <https://www.bloomberg.com/news/audio/2022-11-17/matt-levine-on-the-collapse-of-ftx-and-alameda-podcast> [<https://perma.cc/TSF7-QKSK>]. See, e.g., Daniel Kuhn, *Is Crypto a Ponzi? Define ‘Ponzi,’* COINDESK, <https://www.coindesk.com/opinion/2022/01/18/is-crypto-a-ponzi-define-ponzi> (June 14, 2024, 11:31 AM) [<https://perma.cc/BL9V-33XZ>].

124. Tonantzin Carmona, *Debunking the Narratives About Cryptocurrency and Financial Inclusion*, BROOKINGS (Oct. 26, 2022), <https://www.brookings.edu/research/debunking-the-narratives-about-cryptocurrency-and-financial-inclusion/> [<https://perma.cc/BCZ8-PZ9B>].

125. Carey & Webb, *supra* note 122, at 595.

126. Lee, *supra* note 61, at 668–89.

127. *Id.* at 667.

128. *Id.* at 668. For more on the pressures VC faces to exit investments, see Pollman, *supra* note 99, at 209.

129. Venture capital’s “role in the [crypto] bubble of 2020-22 is undeniable: ultra-low interest rates to stimulate the global economy after the pandemic generated free money that was directed into speculation, and few assets offered as much promise as crypto.” Scott Chipolina, *Venture Capital Not Done with Crypto Yet*, FIN. TIMES (Sept. 8, 2023), <https://www.ft.com/content/14428c6e-63f8-4868-a85f-2d20f2c7973e> [<https://perma.cc/D5FM-A9VE>].

130. “The distribution of returns from a successful venture portfolio follows a power law. Most of the startups will fail or generate only modest growth, but one or two will grow exponentially. The outsized returns from those outlier companies must offset the losses from the rest of the portfolio.” Wansley & Weinstein, *supra* note 59, at 817–18.

131. *Id.*; Lee, *supra* note 61, at 624.

pursued, securities laws prohibit VC funds from selling their venture interests to the general public (at least in the United States) for one year.<sup>132</sup> Even after that year has passed, securities exchanges are prohibited from listing unregistered securities, making it challenging for VCs to connect with retail buyers and therefore limiting their exit opportunities.<sup>133</sup> With crypto ventures, however, VC funds typically receive tokens in connection with their investments. If these tokens are not considered to be securities, then resales will be unrestricted. Some VCs recognize that the tokens *may* be securities, so they wait for a year, but then sell them to the US public on unregistered crypto exchanges<sup>134</sup> (at this point, any primary securities violation will be committed by the exchange for listing unregistered securities, not by the VC).<sup>135</sup> The practical effect is that if the securities laws are not enforced against VCs or crypto exchanges, VCs have ways to exit their crypto investments as soon as their contractual lock-up expires.<sup>136</sup>

After making their initial investments in crypto ventures, VC funds have incentives to sustain the Ponzi-like bubble (at least until they exit from all such ventures).<sup>137</sup> As Wansley and Weinstein have observed, “[t]he most successful VCs . . . do not just try to *find* home runs—they try to *build* home runs.”<sup>138</sup> The VC firm Andreessen Horowitz (often referred to as “a16z”) has been particularly aggressive in building the crypto industry, and so a16z will be used as a case study here to illustrate ways in which VC firms can use funds amassed during a prolonged period of accommodative monetary policy to help propagate and sustain a bubble in another asset class.

As of May 2022, a16z had funded more than \$7.6 billion in crypto and Web3 ventures<sup>139</sup> (Web3 seeks to use blockchain infrastructure to financialize

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132. This is the practical result of the interaction of Section 5 of the Securities Act of 1933 and the SEC’s Rule 144 made pursuant thereto. For further elaboration, see Matt Levine, *When is a Token Not a Security?*, BLOOMBERG (June 7, 2023, 2:30 PM), <https://www.bloomberg.com/opinion/articles/2023-06-07/when-is-a-token-not-a-security?embedded-checkout=true> [https://perma.cc/EU9V-HB4D].

133. The prohibition lies in Section 5 of the Securities and Exchange Act of 1934. For further elaboration, see *id.*

134. *Id.*

135. See *infra* notes 296–99 and accompanying text.

136. Max Parasol, *The Risks and Benefits of VCs for Crypto Communities*, COINTELEGRAPH (July 8, 2022), <https://cointelegraph.com/magazine/risks-benefits-venture-capital-funds-crypto-communities/> [https://perma.cc/4KXL-7Y36] (“VCs often buy a huge chunk of tokens at an early stage at a very low price, and these tokens are often time-locked, so they can’t be sold for one or two years. When the time is up, VCs face the dilemma of dumping their tokens—which makes them a fortune but tanks the price of the community’s holdings—or hanging on. Typically, VCs are perceived to choose the former.”).

137. “In fact, they do not even need the [business] to be profitable at the time they cash out. They just need to create the *impression* of future profitability, so they can sell their shares at an attractive price.” Wansley & Weinstein, *supra* note 59, at 818. “[R]ising coin prices were parlayed into more ventures to support valuations and the bubble inflated.” Chipolina, *supra* note 129.

138. Wansley & Weinstein, *supra* note 59, at 833.

139. *Where a16z Is Investing in Crypto and Blockchain*, CBINSIGHTS (July 29, 2022), <https://www.cbinsights.com/research/a16z-andreessen-horowitz-crypto-blockchain-investments/> [https://perma.cc/3SVM-BAJS].

interactions, and is in many ways a rebranding of crypto).<sup>140</sup> A16z's first crypto investment was in the crypto exchange Coinbase in 2013, and it has since launched several dedicated crypto venture funds, backing at least 75 crypto/blockchain companies.<sup>141</sup> As one industry publication put it, "[c]rypto has become central to a16z's business, and the firm plans to own large portions of the digital world."<sup>142</sup> A16z therefore has a vested interest in the success of the crypto industry.

The academic literature on VCs suggests that a few big names can create hype around a particular sector,<sup>143</sup> and as a marquee firm, a16z certainly had the clout to attract other VC firms to crypto and blockchain ventures. Intentionally or not, a16z seems to have exploited VC's herd mentality to build interest in these kinds of ventures among other VC firms: it has invested in crypto alongside firms like Coinbase Ventures, Paradigm, Animoca Brands, Dragonfly Capital, Sound Ventures, Tiger Global Management, Coatue Management, Variant Fund, and CoinFund.<sup>144</sup>

A16z has also sought to tell the story of crypto more broadly, presumably in order to attract retail investors to the crypto ventures it funded. A16z made media appearances,<sup>145</sup> published policy whitepapers,<sup>146</sup> and created forums like its "web3 with a16z crypto" podcast and "web3 weekly" newsletter.<sup>147</sup> Through these channels, a16z seemed to be harnessing narrative to build confidence in the crypto industry<sup>148</sup> (as Shiller notes, during a bubble, there will always be those

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140. "At its core, Web3 is a rebranding of crypto and blockchain." Peter Kafka, *Web3 Is the Future, or a Scam, or Both*, VOX (Feb. 1, 2022, 6:30 AM), <https://www.vox.com/recode/22907072/web3-crypto-nft-bitcoin-metaverse> [<https://perma.cc/BU4W-K9DJ>]; see also Molly White, *Blockchain Solutionism (Lecture Transcript)*, (Sept. 21, 2022), <https://blog.mollywhite.net/blockchain-solutionism-lecture/> [<https://perma.cc/E5JP-5VEX>].

141. *Where a16z Is Investing in Crypto and Blockchain*, *supra* note 139.

142. *Id.*

143. Lee, *supra* note 61, at 656. As one example, one journalist covering the Terra/Luna collapse reported, "One very senior risk analyst at a crypto VC fund told me he held grave reservations regarding the 'algorithm stablecoin.' But his team was assuaged by the cap table having some big names in crypto capital . . ." Parasol, *supra* note 136.

144. *Where a16z Is Investing in Crypto and Blockchain*, *supra* note 139.

145. A16z is known for its savvy in using media to promote its investments. "Analyst and former a16z partner Benedict Evans has called the firm 'a media company that monetizes through VC.'" Elizabeth Lopatto, *Andreessen Horowitz Saw the Future—but Did the Future Leave It Behind?*, VERGE (May 3, 2023, 10:00 AM), <https://www.theverge.com/23697708/andreessen-horowitz-a16z-investing-tech> [<https://perma.cc/M53W-DCJF>].

146. See, e.g., *Principles and Models of Web3 Decentralization*, A16ZCRYPTO, [https://a16z.com/wp-content/uploads/2022/04/principles-and-models-of-decentralization\\_miles-jennings\\_a16zcrypto.pdf](https://a16z.com/wp-content/uploads/2022/04/principles-and-models-of-decentralization_miles-jennings_a16zcrypto.pdf) (last visited June 30, 2025) [<https://perma.cc/8RPN-J2QM>]; Miles Jennings, *Regulate Web3 Apps, Not Protocols*, A16ZCRYPTO (Sept. 29, 2022), <https://a16zcrypto.com/posts/article/web3-regulation-apps-not-protocols/> [<https://perma.cc/X2ZA-VQCH>]; Miles Jennings & Brian Quintenz, *Regulate Web3 Apps, Not Protocols Part II: Framework for Regulating Web3 Apps*, A16ZCRYPTO (Jan. 11, 2023), <https://a16zcrypto.com/posts/article/regulate-web3-apps-not-protocols-part-ii-framework-for-regulating-web3-apps/> [<https://perma.cc/8PS6-4WBV>].

147. White, *supra* note 113.

148. Stories are an important part of building confidence, with confidence being not just the emotional state of an individual. It is a view of other people's confidence, and of other people's perceptions of other people's confidence. It is also a view of the world—a popular model of current events,

“who benefit from telling stories that suggest that the market will go up further”).<sup>149</sup> So-called “new era stories”—which capitalize on new technologies to make the case that the laws of financial gravity no longer apply—can be particularly compelling fodder for bubbles.<sup>150</sup>

As I have explored at length elsewhere, however, the new era stories that are being told about blockchain technology’s decentralization, democratization, and efficiency, are hollow.<sup>151</sup> Ultimately, the technological decentralization generated by blockchain technology does nothing to guarantee economic decentralization.<sup>152</sup> A system can have lots of nodes, but if someone controls most of the nodes, they control the system—and concentration of economic power in crypto is often worse than in traditional financial markets.<sup>153</sup> It is this concentration of economic power that presumably makes crypto and Web3 ventures attractive to VC firms like a16z. If the goal of crypto and Web3 were true decentralization, then no centralized entity would profit—and without the possibility of a return, no VC firm would be funding those ventures.<sup>154</sup>

In addition to promulgating transformational narratives around blockchain and crypto, a16z has also sought to deploy strategies of “regulatory entrepreneurship” to help build the crypto industry. Pollman and Barry define regulatory entrepreneurship as “pursuing a line of business in which changing the law is a significant part of the business plan”—and they note that this kind of approach can “lead to negative consequences when companies’ interests diverge from the public interest.”<sup>155</sup> Regulatory entrepreneurship strategies are characteristically deployed by startups,<sup>156</sup> perhaps because such strategies have an asymmetric

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a public understanding of the mechanism of economic change as informed by the news media and by popular discussions.

AKERLOF & SHILLER, *supra* note 6, at 55.

149. SHILLER, *supra* note 12, at 94.

150. AKERLOF & SHILLER, *supra* note 6, at 55.

151. Hilary J. Allen, *DeFi: Shadow Banking 2.0?*, 64 WM. & MARY L. REV. 919, 920 (2023); Hilary J. Allen, *The Superficial Allure of Crypto*, INT’L MONETARY FUND (Sept. 2022), <https://www.imf.org/en/Publications/fandd/issues/2022/09/Point-of-View-the-superficial-allure-of-crypto-Hilary-Allen> [<https://perma.cc/LP8X-8CTK>]; Hilary J. Allen, *The Case for Banning Crypto*, FOREIGN AFFS. (Apr. 5, 2023), <https://www.foreignaffairs.com/united-states/crypto-currency-finance-blockchain-case-banning-rewards> [<https://perma.cc/8H27-852B>]; Hilary J. Allen, *Fintech and Techno-Solutionism*, 98 S. CAL. L. REV. 761, 762 (2025); Carmona, *supra* note 124.

152. Sirio Aramonte, Wenqian Huang & Andreas Schrimpf, *DeFi Risks and the Decentralization Illusion*, BIS Q. REV. 21 (Dec. 2021), [https://www.bis.org/publ/qtrpdf/r\\_qt2112b.pdf](https://www.bis.org/publ/qtrpdf/r_qt2112b.pdf) [<https://perma.cc/DWB4-C2MW>].

153. David Rosenthal, *EE380 Talk*, DSHR’S BLOG (Feb. 9, 2022), <https://blog.dshr.org/2022/02/ee380-talk.html> [<https://perma.cc/5Q7R-ZE22>] (“Gini coefficients of cryptocurrencies are extremely high.”). For more examples of founders and whales exercising their power in purportedly decentralized applications, see Scott Chipolina, *Cryptocurrency Fallout Delivers Sharp Kick to Decentralised Finance Dreams*, FIN. TIMES (June 22, 2022), <https://www.ft.com/content/3d1a2409-4030-4a26-be27-dbc25f6fd75> [<https://perma.cc/X9QS-WD4B>].

154. This issue was the subject of Twitter spat between a16z partner Chris Dixon and Twitter founder Jack Dorsey. For background, see Alex Konrad, *How Chris Dixon’s Dive Down the Crypto Rabbit Hole Made Him the World’s Top Venture Capitalist*, FORBES (Apr. 12, 2022), <https://www.forbes.com/sites/alexkonrad/2022/04/12/midas-list-chris-dixon-crypto-capitalist/> [<https://perma.cc/J7NM-W3HJ>].

155. Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383, 383–84 (2017).

156. *Id.* at 424.

payoff structure for the VC funds that invest in and provide advice to those startups. If regulatory entrepreneurship succeeds in changing the law to benefit the businesses they have invested in, VC funds will profit handsomely. If regulatory entrepreneurship fails, it will typically be the businesses who bear the consequences of legal non-compliance—not the VC funds.<sup>157</sup> VC funds (which, recall, provide management guidance to the businesses they invest in) therefore have skewed incentives to encourage businesses to engage in regulatory entrepreneurship.

One regulatory entrepreneurship strategy entails “strategically operating in a zone of questionable legality or breaking the law until they can (hopefully) change it,”<sup>158</sup> and this strategy can prove particularly effective when a new technology is involved in the business model. As a society, we tend to be far too credulous of technology’s transformative power,<sup>159</sup> and VC firms can sometimes harness that credulity to convince regulators to allow them to forge ahead with business models based on new technologies “[e]ven if existing regulations or statutes use broad language that, when read literally, prohibit the company’s activity.”<sup>160</sup>

During the Biden Administration, the U.S. Securities and Exchange Commission, however, was not swayed by these industry talking points, and took the view that activities that are central to some of the crypto business models that A16z has funded—like allowing the general public to trade unregistered securities—did not comply with the securities laws.<sup>161</sup> This did not stop these kinds of

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157. *But see infra* notes 273–81 and accompanying text on the possibility of VCs being held liable for securities law violations.

158. *See* Pollman & Barry, *supra* note 155, at 399. Pollman and Barry also describe other regulatory entrepreneurship strategies: “They seek to grow ‘too big to ban’ before regulators can act, sometimes referred to as ‘guerilla growth.’ Perhaps most dramatic, they mobilize their users and stakeholders as a political force.” *Id.* at 390. These descriptions also resonate: the crypto industry has sought exponential growth and its lobbyists now argue that it is too big and entrenched to ban. *See, e.g.,* Kristin Smith, *The Case for Regulating, Not Banning, Crypto*, COINDESK (Apr. 27, 2023), <https://www.nasdaq.com/articles/the-case-for-regulating-not-banning-crypto> [<https://perma.cc/S7LU-DMNE>]. As for the mobilization of users, Grayscale Investments sought to follow Uber’s playbook and have investors petition the SEC to grant Grayscale’s application for a spot Bitcoin ETF. Kevin Helm, *Grayscale Investments Asks Investors to Help Convince SEC to Approve Bitcoin Spot ETF*, BITCOIN.COM (Feb. 22, 2022), <https://news.bitcoin.com/grayscale-investments-investors-help-convince-sec-approve-bitcoin-spot-etf/> [<https://perma.cc/FF32-BY5H>].

159. The term “technological solutionism” was coined by Evgeny Morozov to describe the tendency to view “all complex social simulations either as neatly defined problems with definite, computable solutions or as transparent and self-evident processes that can be easily optimized,” with “the latest technologies mak[ing] the fixes easier, cheaper, and harder to resist.” EVGENY MOROZOV, *TO SAVE EVERYTHING, CLICK HERE: THE FOLLY OF TECHNOLOGICAL SOLUTIONISM* xiv–xv, 5 (2013).

160. Pollman & Barry, *supra* note 155, at 398. *See generally* Hilary J. Allen, *Fintech and Techno-Solutionism*, 98 S. CAL. L. REV. 761 (2025).

161. A16z was an early investor in the crypto exchange Coinbase, against which the SEC brought an enforcement action for operating as an unregistered securities exchange, broker, and clearing agency. Press Release, Sec. Exch. Comm’n SEC Charges Coinbase for Operating as an Unregistered Securities Exchange, Broker, and Clearing Agency (June 6, 2023), <https://www.sec.gov/news/press-release/2023-102> [<https://perma.cc/H7U2-NUKJ>]. The SEC also brought an enforcement action against the Binance crypto exchange, in which the SEC alleges that unregistered securities were traded on the Binance platform, including Solana tokens. *See* Complaint at 1, SEC v. Binance Holdings Ltd., (No.1:23-cv-01599). A16z is an investor in Solana as well as Coinbase.

businesses from forging ahead, but increased enforcement activity from the SEC and heightened VC firms' interest in seeking accommodative legislative and regulatory change. Notably, a16z used money invested with it during periods of accommodative monetary policy to aggressively lobby regulators and legislators for new legal frameworks.<sup>162</sup> Most of the proposals that emerged from this process were designed to deprive the SEC of jurisdiction over the crypto industry, instead conferring that jurisdiction on the Commodity Futures Trading Commission (which is a much smaller agency with very limited experience regulating retail-dominated markets).<sup>163</sup>

It is no secret that a16z has been pursuing a regulatory entrepreneurship strategy with regard to crypto for years: as one New York Times article from 2021 put it, “[d]elivering significant returns on all this [crypto] investment, executives at [a]16Z quickly realized, would necessitate playing a major role in shaping rules for these companies.”<sup>164</sup> A16z has sent numerous letters to federal regulators, hired a significant number of former government officials, engaged in campaign financing, and organized fundraisers for elected officials;<sup>165</sup> one article reported that “a16z’s leaders have given millions of dollars to pro-crypto candidates and PACs that wound up supporting them.”<sup>166</sup> Around the time of the 2022 elections, the crypto industry was spending amounts on lobbying that were roughly comparable to the defense and pharmaceutical industries.<sup>167</sup>

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*Portfolio*, A16ZCRYPTO, <https://a16zcrypto.com/portfolio/> (last visited June 30, 2025) [<https://perma.cc/PV32-BJKU>]. For further elaboration on the SEC’s views on crypto, see Gary Gensler, *Kennedy and Crypto*, SEC EXCH. COMM’N (Sept. 8, 2022), <https://www.sec.gov/news/speech/gensler-sec-speaks-090822> [<https://perma.cc/J2VV-YM93>].

162. See *infra* notes 164–67 and accompanying text.

163. See, e.g., Lummis-Gillibrand Responsible Financial Innovation Act, S.B.2281, 118th Cong. (2023); Digital Commodities Consumer Protection Act, H.R. 8950, 117th Cong. (2022); Financial Innovation and Technology for the 21st Century Act, H.R. 4763, 118th Cong. (2024). For elaboration on concerns about transferring jurisdiction from the SEC to the CFTC, see Letter from Dennis M. Kelleher to House Agric. and Fin. Servs. Comm. Leadership, Dennis M. Kelleher, Better Strategies Co-Founder, President and CEO, Better Strategies, to Patrick Henry, Chairman, Fin. Servs. Comm., Maxine Waters, Ranking Member, Fin. Servs. Comm., Glenn Thompson, Chairman, Agric. Comm. and David Scot, Ranking Member, Agric. Comm. (July 11, 2023), <https://bettermarkets.org/wp-content/uploads/2023/07/Final-Ltr-to-FSCAG-re-cryptocurrency-.pdf> [<https://perma.cc/7VEK-2NCW>].

164. Eric Lipton, Daisuke Wakabayashi & Ephrat Livni, *Big Hires, Big Money and a D.C. Blitz: A Bold Plan to Dominate Crypto*, N.Y. TIMES, <https://www.nytimes.com/2021/10/29/us/politics/andreessen-horowitz-lobbying-cryptocurrency.html> (Nov. 1, 2021) [<https://perma.cc/TZ8Q-S3PE>].

165. See *id.*; *supra* notes 164–67 and accompanying text.

166. David Jeans & Sarah Emerson, *Andreessen Horowitz’s Crypto Lobbying Is Paying Off*, FORBES (Oct. 17, 2022), <https://www.forbes.com/sites/davidjeans/2022/10/17/andreessen-horowitz-crypto-lobbying-washington/?sh=4d48b58d46e7> [<https://perma.cc/D7VG-5D2J>].

167. Allyson Versprille & Bill Allison, *Crypto Industry Eclipses Defense, Big Pharma in Political Giving*, BLOOMBERG (June 2, 2022, 1:17 PM), <https://www.bloomberg.com/news/articles/2022-06-02/crypto-industry-eclipses-defense-big-pharma-in-political-giving> [<https://perma.cc/T3FR-3DE3>] (“Political donations from the sector surged to more than \$26 million during 2021 and the first three months of [2022]. That influx of cash is outpacing spending by internet giants, drug makers and the defense industry . . .”).

### 3. *Venture Capital and Crypto After the Crypto Winter of 2022*

Ultimately, Ponzi-like processes are not sustainable indefinitely.<sup>168</sup> Many investors exited the crypto markets during the “crypto winter” of 2022, which began with the failure of the Terra stablecoin in May 2022, and culminated in the failure of the FTX crypto exchange in November 2022. That crypto winter started only two months after the Federal Reserve began its rate hikes, and while correlation does not prove causation, this sequence of events is not surprising.<sup>169</sup> Rate hikes reduce the amount of money available in the economy, and Ponzi-like processes tend to fall apart when there are no new investors and existing investors need to cash out.<sup>170</sup> Many other crypto ventures also failed (and many people lost money they could ill-afford to lose), but the crypto winter of 2022 did not spell the end of the crypto industry. Notwithstanding that more than fifteen years had passed without identifying any significant use case for crypto or its underlying permissionless blockchain technology (other than speculation and funding illicit activities),<sup>171</sup> VC firms that had invested heavily in crypto and blockchain ventures (and not yet exited) had strong economic motivations to try to revive interest in them.

One strategy VC firms used to try to rebuild interest in crypto was to double down on pro-crypto narratives. For example, in 2023, a16z promulgated a hype-filled “State of Crypto” presentation,<sup>172</sup> and in early 2024, a16z partner Chris Dixon published the crypto book *Read Write Own: Building the Next Era of the Internet*.<sup>173</sup> We will use the 2023 “State of Crypto” presentation as an illustration of a16z’s aggressive attempts to reclaim the narrative around crypto. Technologist Molly White offers detailed critiques of the choice and presentation of data in the State of Crypto report and of its claims about blockchain scalability,

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168. Carey & Webb, *supra* note 122, at 590 (“Mathematically, it is virtually impossible for a Ponzi scheme to be sustainable given that an exponentially increasing number of new members would be required . . .”).

169. One IMF working paper found “restrictive [interest rate] policies render the risk positions of investors less sustainable, and thus they reduce their exposure to crypto assets.” Che et al., *supra* note 106, at 5. The same paper found that “crypto ventures that benefited from high crypto returns were concomitantly supported by the low interest-rate environment.” *Id.* at 6.

170. *Id.*; Carey & Webb, *supra* note 122, at 590.

171. A report from the UK’s House of Commons Treasury Committee found that “[u]nbacked cryptoassets have no intrinsic value, and their price volatility exposes consumers to the potential for substantial gains or losses, while serving no useful social purpose. These characteristics more closely resemble gambling than a financial service, an impression reinforced by the evidence we have received of consumer behaviour.” HOUSE OF COMMONS TREAS. COMM., REGULATING CRYPTO 3 (2023), <https://committees.parliament.uk/publications/39945/documents/194832/default/> [<https://perma.cc/NM2S-VBLR>]. For a discussion of the use of crypto for money laundering, ransomware attacks, and sanctions evasion, see *Understanding the Role of Digital Assets in Illicit Finance: Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs*, 117th Cong. 11 (Mar. 17, 2022) (testimony of Shane T. Stansbury), <https://www.congress.gov/117/chr/CHRG-117shrg52387/CHRG-117shrg52387.pdf> [<https://perma.cc/N2VN-9P6P>].

172. See generally *The State of Crypto*, *supra* note 113.

173. Journalists have reported that this book was propelled onto the New York Times Bestseller List by sales of this book to a16z’s portfolio companies. Jordan Pearson, *How Tech Firms Made a Crypto-Boosting Book an NYT Best Seller by Gaming the System*, VICE (Feb. 8, 2024, 3:51 PM), <https://www.vice.com/en/article/n7emkx/chris-dixon-a16z-read-write-own-nyt-bestseller> [<https://perma.cc/F7G2-L24G>].

environmental impact, and decentralization.<sup>174</sup> We can focus on the report's claims about decentralization as an example of its flaws. As already explored, blockchain's technological decentralization does nothing to prevent economic centralization, and so claims about blockchain's ability to achieve meaningful decentralization are entirely disingenuous.<sup>175</sup> And yet the 2023 State of Crypto report says things like:

Blockchains transfer control from centralized entities to decentralized communities<sup>176</sup>

and:

We believe recent setbacks underscore the failure of opaque, centralized systems in contrast to the resilience of decentralized infrastructure. We believe decentralized computing platforms can also counter the trend of power consolidating into the hands of a few giant tech corporations. The internet needs web3. Those who understand this will fight for the future of these technologies.<sup>177</sup>

This presentation seems calculated to restore crypto investors' faith in the ventures that a16z had funded.<sup>178</sup> But with interest rates high and money scarcer, the crypto industry also needed to go beyond placating existing crypto investors and find new investors. Strategies for attracting new money to the crypto industry (even as rates rose) included attempts to make crypto assets legitimate investment options for retirement savings, and to attract institutional investors.<sup>179</sup> Attempts to make crypto investments an option in 401(k) plans had limited success. Although Fidelity created a Bitcoin 401(k) plan option for employers to offer to their employees,<sup>180</sup> the Department of Labor advised 401(k) plan fiduciaries in 2022 "to exercise extreme care before they consider adding a cryptocurrency option to a 401(k) plan's investment menu for plan participants."<sup>181</sup> The protracted battle over Bitcoin exchange-traded products (or "ETPs"), however, was resolved in a way that benefitted the crypto industry.<sup>182</sup> Once the SEC approved

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174. White, *supra* note 113.

175. See *supra* notes 151–54 and accompanying text.

176. *The State of Crypto*, *supra* note 113, at 8 (emphasis removed).

177. *Id.* at 2.

178. White, *supra* note 113 (emphasis removed) ("The truth is that Andreessen Horowitz needs crypto to do well. With an asset class so dependent on sentiment for value, they seem to be hoping that if they can convince both their investors and the general public that everything is going just great and crypto prices are about to take off again, they can cause it to become true.")

179. See, e.g., Tara Siegel Bernard, *Fidelity's New 401(k) Offering Will Invest in Bitcoin*, N.Y. TIMES (Apr. 26, 2022), <https://www.nytimes.com/2022/04/26/business/crypto-401k-fidelity.html> [<https://perma.cc/WJ2K-FVLJ>].

180. *Id.*

181. *Compliance Assistance Release No. 2022-01: 401(k) Plan Investments in "Cryptocurrencies,"* U.S. DEP'T LAB. EMP. BENEFITS SEC. ADMIN., (Mar. 10, 2022), <https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/compliance-assistance-releases/2022-01> [<https://perma.cc/Y476-BDD2>].

182. The Chicago Mercantile Exchange and the CBOE Futures Exchange first listed Bitcoin futures (*i.e.*, contracts to buy or sell Bitcoin at a fixed price on a future date) in early 2017; in early 2018, the CFTC issued a "backgrounder" document that stated its position that the agency lacked the authority to block these Bitcoin

Bitcoin ETPs in January 2024, institutional investment rushed in, with some outlets reporting nearly \$8 billion of new investment in the two months following approval.<sup>183</sup>

Some pension funds have also invested directly in crypto over the years, but usually not in significant amounts.<sup>184</sup> Banks have also largely (although not entirely) eschewed crypto investments,<sup>185</sup> but if Congress were to pass bespoke legislation designed to accommodate crypto business models, compliance with that legislation could further legitimize crypto investments and result in more institutional investment.<sup>186</sup> It is therefore not surprising that, notwithstanding crypto's terrible year in 2022, lobbying pressure from a16z and the crypto industry continued to intensify in 2023 and 2024.<sup>187</sup> Reporting from Pitchbook in late

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futures. Lee Reiners, *Bitcoin Futures: From Self-Certification to Systemic Risk*, 23 N.C. BANKING INST. 61, 61, 73–74 (2019). The SEC, rather than the CFTC, has authority over ETPs that allow investors to indirectly invest in commodity futures; but given the CFTC's position on Bitcoin futures, it would have been challenging for the SEC to deny approvals for ETPs that allowed for indirect investment in Bitcoin futures, and the SEC started to approve such products in 2022. The SEC refused, however, to approve any application for ETPs that held Bitcoins (or any other crypto) directly, expressing concerns about manipulation and lack of regulatory oversight over the Bitcoin spot markets (while the CFTC has jurisdiction over commodity futures, it has only very limited jurisdiction over the underlying spot markets for the commodities themselves). Grayscale Investments sought judicial review of the SEC's decision to deny its application to issue a Bitcoin ETP, and in August 2023, the D.C. Circuit ruled in favor of Grayscale, on the grounds that the SEC had not made out the case for why spot Bitcoin ETPs posed risks of manipulation that Bitcoin futures ETPs did not. In January 2024, the SEC approved spot Bitcoin ETPs. Commissioner Crenshaw issued a powerful dissent, highlighting the risks of manipulation in the spot Bitcoin markets and also noting that consumers were likely to confuse ETPs with ETFs, which have more investor protections attached than ETPs. See Caroline A. Crenshaw, Statement Dissenting from Approval of Proposed Rule Changes to List and Trade Spot Bitcoin Exchange-Traded Products (Jan. 10, 2024), [https://www.sec.gov/news/statement/crenshaw-statement-spot-bitcoin-011023#\\_ftn20](https://www.sec.gov/news/statement/crenshaw-statement-spot-bitcoin-011023#_ftn20) [<https://perma.cc/L5TC-L4FZ>].

183. Phillip Stafford, *FT Cryptofinance: This Time Isn't Different for Bitcoin Rally*, FIN. TIMES (Mar. 8, 2024), <https://www.ft.com/content/41d3cd7a-0c41-40bd-9983-825603eb5c6d> [<https://perma.cc/L69D-VWLY>].

184. *Crypto Fallout Leaves U.S. Retiree Benefits Mostly Unscathed*, PENSIONS & INVS. (Nov. 21, 2022, 12:55 PM), <https://www.pionline.com/pension-funds/crypto-fallout-leaves-us-retiree-benefits-mostly-unscathed> [<https://perma.cc/TXP7-NT9H>] (“Most of the largest U.S. state and local government pension funds have dodged the ongoing fallout from the collapse of crypto exchange FTX by not directly investing in digital tokens. For the pensions that have dipped into the risky asset class, the investments represent just a small amount of the retirement funds’ portfolio, and much of the limited exposure is indirect via crypto-related stocks or other investment products.”).

185. US banking regulators have advised banks that they consider many activities relating to crypto assets to be unsafe or unsound practices. Joint Statement of the Board of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp. & Off. of the Comptroller of the Currency, (Jan. 3, 2023), <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf> [<https://perma.cc/55A5-SKTK>]. Of course, several financial institutions have not heeded these warnings. Silvergate and Signature Banks’ crypto activities are discussed elsewhere in this Article (although it should be noted that these banks do not appear to have invested directly in crypto assets). See *infra* notes 212–16 and accompanying text.

186. Stephen Cecchetti & Kim Schoenholtz, *Let Crypto Burn*, FIN. TIMES (Nov. 17, 2022), <https://www.ft.com/content/ac058ede-80cb-4aa6-8394-941443eec7e3> [<https://perma.cc/7WSE-9R6E>].

187. Kollen Post, *Bear Market Barely Dents Crypto Lobby, with Quarterly Spending Still Near \$7 Million*, FORTUNE CRYPTO (Feb. 16, 2023, 1:54 PM), <https://fortune.com/crypto/2023/02/16/bear-market-crypto-lobby-quarterly-spending-near-7m/> [<https://perma.cc/6DSS-U9SU>]; Jasper Goodman, *Crypto Titans Launch 2024 Election Play with \$78M Super PAC Spend*, POLITICO (Dec. 18, 2023, 6:31 AM), <https://www.politico.com/news/2023/12/18/crypto-firms-investors-78m-super-pacs-00132199> [<https://perma.cc/9KU6-F8CR>]; Jeans & Emerson, *supra* note 166.

2022 noted that a16z's crypto fund focused heavily on crypto lobbying even as it retreated somewhat from new deals.<sup>188</sup> If such lobbying efforts succeed, it will be a net negative for society as a whole (because crypto provides little utility and integrating crypto with the rest of the financial system would create new threats to financial stability).<sup>189</sup> It would, however, be a boon to the VC firms who have yet to exit their crypto ventures.

### B. *Silicon Valley Bank*

We just considered potential threats to financial stability that might arise from crypto's VC-facilitated growth and integration with the broader financial system. This Section will look at a threat to financial stability that has already crystallized: the failure of Silicon Valley Bank ("SVB") and ensuing regional bank panic. To be clear, SVB's collapse resulted from a constellation of failures, including failures by the bank's management as well as its regulators.<sup>190</sup> These failures are largely beyond the scope of this Article, though.<sup>191</sup> This Section will focus instead on the role that the VC industry played in SVB's collapse.

Two aspects of SVB's collapse are notable in this regard. First, the aggressive growth of SVB ("from \$71 billion to over \$211 billion in assets from 2019 to 2021")<sup>192</sup> was fueled largely by uninsured deposits from VC funds and the firms they backed. As the Federal Reserve's report on SVB notes, "[b]etween 2019 and 2021, SVBFG tripled in size as it benefited from rapid deposit inflows during rapid venture capital (VC) and technology sector growth in a period of exceptionally low interest rates."<sup>193</sup> Second, the run itself was notable for its "highly correlated withdrawals from SVBFG's concentrated network of VC investors and technology firms who . . . withdrew uninsured deposits in a coordinated manner at an unprecedented rate."<sup>194</sup> Before diving into these issues, though, it is helpful to have a little more background on SVB and the events of March 2023.

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188. James Thorne, *As Crypto Deals Slow, a16z's Chris Dixon Shifts to Accelerator Reboot, Regulations*, PITCHBOOK (Oct. 17, 2022), <https://pitchbook.com/news/articles/andreessen-horowitz-crypto-school-regulation-deals> [<https://perma.cc/7MU7-BSLN>].

189. See *supra* Subsection IV.A.1.

190. Jeanna Smialek, *Before Collapse of Silicon Valley Bank, the Fed Spotted Big Problems*, N.Y. TIMES (Mar. 19, 2023), <https://www.nytimes.com/2023/03/19/business/economy/fed-silicon-valley-bank.html> [<https://perma.cc/D8CT-J6MP>].

191. For discussions of these issues, see, e.g., MICHAEL S. BARR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, REVIEW OF THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF SILICON VALLEY BANK (2023), <https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf> [<https://perma.cc/2WWK-GTT3>]; Anat Admati, Martin Hellwig & Richard Portes, *When Will They Ever Learn? The US Banking Crisis of 2023*, VOX EU CEPR (May 18, 2023), <https://cepr.org/voxeu/columns/when-will-they-ever-learn-us-banking-crisis-2023> [<https://perma.cc/EH7S-BZJD>].

192. BARR, *supra* note 191, at i.

193. *Id.* at 2.

194. *Id.* at 4.

### 1. *The Failure of SVB and Broader Regional Bank Panic*

Silicon Valley Bank was founded in Santa Clara, California in 1983, and its business model focused on providing financial services to VC-backed firms.<sup>195</sup> During the VC bubble discussed in Part III, deposits rushed into SVB.<sup>196</sup> SVB invested a significant amount of this new deposit funding in treasuries and asset-backed securities with longer-term maturities.<sup>197</sup> While these were high-quality assets, they bore interest rate risk in the sense that their market value would decrease as interest rates increased.<sup>198</sup> The Federal Reserve began to increase interest rates in 2022, but SVB management abandoned several interest rate risk-mitigating hedges that had previously been in place.<sup>199</sup> This was a bad bet, as the Federal Reserve continued to raise interest rates throughout 2022 and into 2023.<sup>200</sup>

Rising interest rates also impacted the VC and tech industries that SVB served. Tighter monetary policy is associated with reduced demand for new products as well as reduced appetite for riskier high-yield investments, and 2022 and 2023 witnessed a significant cooling of the VC market.<sup>201</sup> Starting in the second quarter of 2022, as venture funding decreased and some startups began to struggle, SVB began to see increased withdrawals from its tech-heavy customer base.<sup>202</sup> On Wednesday, March 8, 2023, SVB publicly announced that it needed to engage in an emergency capital raise because it had sold \$21 billion of securities at a loss of \$1.8 billion in order to free up cash to service deposit withdrawals.<sup>203</sup> Following this announcement, more than \$40 billion of deposits ran from SVB on Thursday, March 9, and management anticipated that another \$100 billion would run on Friday, March 10.<sup>204</sup>

Realizing that SVB could not recover from this bank run, regulators put SVB into FDIC receivership on March 10.<sup>205</sup> Although not every bank failure constitutes a threat to financial stability, a single bank run *can* metastasize into a larger banking panic if it undermines confidence in banks that were somehow

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195. Ben Foldy, Rachel Louise Ensign & Justin Baer, *How Silicon Valley Turned on Silicon Valley Bank*, WALL ST. J. (Mar. 12, 2023), <https://www.wsj.com/articles/how-silicon-valley-turned-on-silicon-valley-bank-ee293ac9> [<https://perma.cc/L6NE-HW6Z>] (“It took four decades to build Silicon Valley Bank and its parent company, SVB Financial Group, into the startup world’s pre-eminent financier.”).

196. *Id.* (“SVB built a banking franchise around startups—companies, founders, venture-capital firms. It grew when they did. Deposits rose 86% in 2021.”).

197. *Id.*; BARR, *supra* note 191, at 2.

198. Richardson et al., *supra* note 52, at 39.

199. BARR, *supra* note 191, at 24.

200. *See supra* note 38 and accompanying text.

201. Ma & Zimmermann, *supra* note 55, at 1, 13, 16.

202. Richardson et al., *supra* note 52, at 47 n.49 (“SVB had suffered an initial drop in deposits starting in the second quarter of 2022 . . . SVB served as a bank to technology companies and their executives, as well as to venture capital firms. Due to the difficulty in raising capital in this sector, firms had begun to draw down their deposits to make payroll and other expenses during this period.”).

203. SVB Financial Group, Current Report (Form 8-K) (Mar. 8, 2023); Admati et al., *supra* note 191.

204. BARR, *supra* note 191, at i.

205. *Id.*

interconnected with or exposed to the first bank, or undermines confidence in banks that had no direct exposure to the first bank but appear to have similar risk profiles.<sup>206</sup> During the weekend following SVB's failure, federal authorities considered whether the latter kind of contagion could engender broader financial instability, and concerns about contagion were fueled by several prominent VCs who publicly called for bailouts of SVB's uninsured depositors (a group comprised largely of venture capital and tech firms), in order to prevent what they described as an impending economic calamity.<sup>207</sup> On the Sunday following SVB's failure, regulators issued a statement promising to make all of SVB's uninsured depositors whole, invoking the systemic risk exception to the legal requirement that SVB be resolved in the way that posed the least cost to the deposit insurance fund.<sup>208</sup>

And so in March 2023, regulators ultimately concluded that SVB's failure could threaten the broader financial system—notwithstanding that since 2019, regulators had been primed to view banks of SVB's size as posing little threat to financial stability.<sup>209</sup> The 2019 shift towards more tailored regulatory requirements for all but the largest banks—enthusiastically implemented by then-Federal Reserve Vice Chair for Supervision Quarles, and required to some degree by the passage of the Economic Growth Regulatory Relief and Consumer Protection Act—had been a departure from the more stringent regulatory approach that had been instituted after the 2008 crisis.<sup>210</sup> Many had criticized that departure at the time, and SVB's failure confirmed many of those critics' fears: a run on a bank of SVB's size was indeed deemed to have compromised the stability of the financial system. There was a notable exodus of deposits from regional

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206. Diamond & Dybvig, *supra* note 19, at 402.

207. Edward Ongweso Jr., *The Incredible Temper Tantrum Venture Capitalists Threw Over Silicon Valley Bank*, SLATE (Mar. 13, 2023, 11:24 AM), <https://slate.com/technology/2023/03/silicon-valley-bank-rescue-venture-capital-calacanis-sacks-ackman-tantrum.html> [<https://perma.cc/A4TP-77PA>].

208. *Bank Regulation: Preliminary Review of Agency Actions Related to March 2023 Bank Failures: Highlights*, U.S. GOV'T ACCOUNTABILITY OFF. (Apr. 28, 2023), <https://www.gao.gov/products/gao-23-106736> [<https://perma.cc/N43S-T3CG>] (“On March 12, 2023, the Secretary of the Treasury approved the systemic risk exception, which authorized FDIC to guarantee insured and uninsured deposits of the two banks. FDIC and the Federal Reserve Board assessed that not guaranteeing the uninsured deposits likely would have resulted in more bank runs and negatively affected the broader economy. The Secretary of the Treasury concurred with this assessment and made the determinations. After determining that additional banks might need support and to minimize financial contagion, the Federal Reserve created the Bank Term Funding Program on March 12, 2023. The program provides eligible banks with additional liquidity by allowing the 12 Reserve Banks to provide loans of up to 1 year. Federal Reserve staff documented how the program met the requirements for an emergency lending facility under section 13(3) of the Federal Reserve Act, and Treasury approved the program. As of April 19, 2023, outstanding advances under the program were approximately \$74 billion.”).

209. BARR, *supra* note 191, at iii (“In 2019, following the passage of EGRRCPA, the Federal Reserve revised its framework for supervision and regulation, maintaining the enhanced prudential standards (EPS) applicable to the eight global systemically important banks, known as G-SIBs, but tailoring requirements for other large banks. For Silicon Valley Bank, this resulted in lower supervisory and regulatory requirements, including lower capital and liquidity requirements. While higher supervisory and regulatory requirements may not have prevented the firm's failure, they would likely have bolstered the resilience of Silicon Valley Bank.”).

210. For an overview of regulatory tailoring and its critics, see generally Graham S. Steele, *The Tailors of Wall Street*, 93 U. COLO. L. REV. 993 (2022).

banks to larger, more regulated “too big to fail” banks in the wake of SVB’s failure.<sup>211</sup>

The regional bank Signature Bank failed on March 12 (two days after SVB), and the regional bank First Republic failed several months later, on May 1, 2023.<sup>212</sup> Signature Bank’s failure is also pertinent to this Article’s discussion because its fragilities derived in part from its exposure to the struggling crypto industry,<sup>213</sup> highlighting another crypto-related financial stability risk (while most banks have thus far eschewed crypto business, Signature Bank and Silvergate Bank—which voluntarily liquidated itself on March 8, 2023—had aggressively pursued business models based on providing banking services to crypto businesses).<sup>214</sup> It is also worth noting that SVB itself had some interconnections with the crypto industry which may have contributed to the SVB panic<sup>215</sup> and that the bailout of SVB’s uninsured depositors functioned as an indirect bailout of the crypto industry by protecting \$3.3 billion of USDC stablecoin reserves that had been deposited with SVB (the USDC stablecoin is an important on-ramp for crypto speculation).<sup>216</sup>

## 2. *The Role Played by Venture Capital*

With that background, we can return to the role that the VC industry played in this episode of financial instability. In yet another illustration of the close social ties and herd mentality that characterize the VC industry, VC firms banked at SVB themselves, as well as encouraging—sometimes even requiring—their funded ventures to do so.<sup>217</sup> The result was that SVB’s deposit base was highly concentrated. As the SVB website noted immediately prior to its collapse, it provided financial services to “nearly half [of] U.S. venture-backed technology and

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211. CECILIA CAGLIO, JENNIFER DLUGOSZ & MARCELO REZENDE, FLIGHT TO SAFETY IN THE REGIONAL BANK STRESS OF 2023 (2023), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4457140](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4457140) [<https://perma.cc/75XQ-CW5J>].

212. Maureen Farrell, Jeanna Smialek & Lauren Hirsch, *First Republic Bank Is Seized by Regulators and Sold to JPMorgan Chase*, N.Y. TIMES (May 1, 2023), <https://www.nytimes.com/2023/05/01/business/first-republic-bank-jpmorgan.html> [<https://perma.cc/RS3L-Q9LJ>].

213. Richardson et al., *supra* note 52, at 37.

214. FDIC, OPTIONS FOR DEPOSIT INSURANCE REFORM, 6–7 (2023), <https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf> [<https://perma.cc/5WP6-JTCQ>].

215. *Written Testimony Before the H. Comm. on Financial Services Subcommittee on Financial Institutions & Monetary Policy Subcommittee on Oversight and Investigations*, 118th Cong. 7 (2023) (statement of Gregory Becker, Former Chief Executive Officer of SVB), <https://docs.house.gov/meetings/BA/BA20/20230517/115923/HHRG-118-BA20-Wstate-BeckerG-20230517.pdf> [<https://perma.cc/7HUH-6AFQ>].

216. Wilmarth, *supra* note 30, at 292. SEC Chair Gary Gensler has described stablecoins as poker chips for the crypto casino. Tory Newmyer, *SEC’s Gensler Likens Stablecoins to ‘Poker Chips’ Amid Call for Tougher Crypto Regulation*, WASH. POST (Sept. 21, 2021), <https://www.washingtonpost.com/business/2021/09/21/sec-gensler-crypto-stablecoins/> [<https://perma.cc/SP3Q-8BBP>]. USDC, the second largest stablecoin, held \$3.3 billion of reserves with SVB at the time SVB was placed into FDIC receivership. Once USDC’s issuer disclosed this exposure publicly, the USDC stablecoin lost its \$1USD peg and its value fell below 90 cents. Steven Kelly, *Stablecoins Deliver on Their Promise: Disrupting Banks*, WITHOUT WARNING (May 16, 2023), <https://www.withoutwarningresearch.com/p/stablecoins-deliver-on-their-promise> [<https://perma.cc/7WTX-BXAW>].

217. Ongweso, *supra* note 207.

life sciences companies,” and those companies accounted for more than half of SVB’s deposits.<sup>218</sup> As already discussed,<sup>219</sup> the amounts involved were significant—due in large part to the glut of VC financing amassed during the period of highly accommodative monetary policy from 2020–2021.<sup>220</sup>

Following the massive influx of money into VC funds and then startups, over 92.5% of SVB’s deposits exceeded the FDIC’s \$250,000 cap—and were therefore uninsured—at the time of SVB’s collapse.<sup>221</sup> Without the guarantee of deposit insurance, deposit funding is more likely to run.<sup>222</sup> Following SVB’s public disclosure of its losses on March 8, some VC firms began to urge the ventures they funded to withdraw their deposits from SVB.<sup>223</sup> Other VC firms may have sought to withdraw their own funds first:<sup>224</sup> as one Wall Street Journal article reported, “VCs pulled their money and urged their portfolio companies to do the same. Some debated if they should wait to warn startups to buy themselves more time to move their own, much bigger, balances.”<sup>225</sup> Given the self-fulfilling nature of runs, many VC firms were aware that their withdrawals and warnings might spell the end of SVB.<sup>226</sup> For many, though, the need to protect their investments won out over their desire to preserve SVB, and they both withdrew and encouraged their portfolio companies to withdraw—although they often did so without publicizing it.<sup>227</sup>

In sum, the VC firms that had “encouraged founders to use Silicon Valley Bank, leading to dangerous concentration, were the ones urging startups to pull their funds when it looked like the bank was in trouble.”<sup>228</sup> The speed of the run

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218. BARR, *supra* note 191, at 18–19.

219. See *supra* notes 192–93 and accompanying text.

220. Richardson et al., *supra* note 52, at 46; see also *supra* Part III.

221. BARR, *supra* note 191, at 88.

222. FDIC, *supra* note 214, at 1.

223. Ongweso, *supra* note 207.

224. VC firms often kept funds that they had raised from investors but not yet allocated to startup ventures at SVB. Jack Milligan, *An Ecosystem of One: How SVB Financial Became The Venture Capital Industry’s Leading Bank*, BANK DIRECTOR MAGAZINE 12, 18 (2022), <https://www.svb.com/contentassets/466600f7f44349c8b6e7e9a28bf168e1/bank-director-magazine-january-2022.pdf> [<https://perma.cc/BMV7-WCCA>].

225. Foldy et al., *supra* note 195.

226. As one Bloomberg article reported, “There’s been plenty of debate, even within the normally friendly world of venture capital, about the morality of investors advising companies to bail on SVB—depleting its deposit base and exacerbating its cash crunch.” Saritha Rai, Lizette Chapman, Sarah McBride & Priya Anand, *SVB’s Demise Swirled on Private VC, Founder Networks Before Hitting Twitter*, BLOOMBERG (Mar. 29, 2023, 7:00 PM), <https://www.bloomberg.com/news/articles/2023-03-29/svb-bank-run-fears-swirled-on-vc-founder-networks-before-hitting-twitter> [<https://perma.cc/AU72-BX4X>].

227. *Id.* (“In an email thread of more than 1,000 founders backed by Andreessen Horowitz, many entrepreneurs were encouraging each other to pull cash from the bank. David George, a general partner at the firm, weighed in somewhat cryptically: ‘Hi all, We know you have questions about how to handle the SVB situation,’ he wrote. ‘We encourage you to pick up the phone and call your GP.’ In many cases, investors stayed off social media during these critical hours. One venture investor with dozens of investments in common with both Sequoia Capital and Andreessen Horowitz said some of their founders received personal phone calls from the two venture giants early Thursday morning. ‘I’ve never seen phone calls be as popular as they were for those 48 hours.’”).

228. Sarah McBride & Olivia Solon, *SVB Run Exposes Rifts in Typically Chummy Venture Capital World*, BLOOMBERG (Mar. 15, 2023), [https://www.bloomberglaw.com/bloomberglawnews/private-equity/X9QJU53S000000?bna\\_news\\_filter=private-equity#jcite](https://www.bloomberglaw.com/bloomberglawnews/private-equity/X9QJU53S000000?bna_news_filter=private-equity#jcite) [<https://perma.cc/F9DE-DXT7>].

was remarkable, but while numerous accounts have pointed to the role that online banking and social media played in driving the speed of the run on SVB, those explanations are not particularly satisfying.<sup>229</sup> It is much more likely that the speed of the run was driven by SVB's reliance on a tight-knit community for its (mostly uninsured) deposits.<sup>230</sup> When there are fewer but larger depositors, each withdrawal will have a bigger impact, and this will make a run faster and worse: "the quicker the requests for cash come in, the quicker asset sales must take place, which increases the likelihood that those assets will have to be sold at discounted prices."<sup>231</sup> Depositor concentration at SVB was in many ways worse than it might appear at first blush, as multiple accounts belonging to different firms could effectively all run in lockstep if those firms shared a VC funder who recommended withdrawing. VC firms were therefore uniquely situated to precipitate a run on SVB.

SVB was placed into FDIC receivership at 11:15 am (California time) on Friday, March 10,<sup>232</sup> but the fate of SVB's uninsured depositors was not decided until the evening of Sunday, March 12. On that Sunday evening, authorities announced their decision to invoke the systemic risk exception to the FDIC's least cost resolution requirement.<sup>233</sup> Doing so allowed the FDIC to incur the significant cost of making all of SVB's (and Signature Bank's) uninsured depositors whole, in order to staunch the regional banking panic and preserve financial stability.<sup>234</sup> If the systemic risk exception had not been invoked, the least cost resolution requirement would likely have precluded the FDIC from guaranteeing many billions of dollars' worth of uninsured deposits at SVB. From March 10–12, members of the venture capital and startup communities therefore had incentives to exacerbate the broader regional banking panic in order to convince authorities to invoke the systemic risk exception.<sup>235</sup> Concerns about contagion were

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229. Large withdrawals can only be executed by wiring funds (which take a lot longer to process than small online or mobile banking transactions), and the bulk of social media activity relating to SVB happened when it was already in its death throes, or after its failure. For further discussion of this issue, see Steven Kelly, *Have Banking Apps and Twitter Really Changed Bank Runs?*, WITHOUT WARNING (May 11, 2023), <https://www.withoutwarningresearch.com/p/have-banking-apps-and-twitter-really> [<https://perma.cc/FK9U-296Z>]; Hilary J. Allen, *Digital Bank Holidays*, 41 YALE J. ON REG. 856, 868 (2024).

230. Kelly, *supra* note 229.

231. ALLEN, *supra* note 9, at 78.

232. U.S. GOV'T ACCOUNTABILITY OFF., GAO-23-106736, BANK REGULATION: PRELIMINARY REVIEW OF AGENCY ACTIONS RELATED TO MARCH 2023 BANK FAILURES 38 (2023), <https://www.gao.gov/assets/gao-23-106736.pdf> [<https://perma.cc/6MYV-QQAD>].

233. Press Release, Fed. Rsrv., Fed. Deposit Ins. Corp. & Dep't Treasury, Joint Statement by the Department of the Treasury, Federal Reserve, and FDIC (Mar. 12, 2023) (on file with FDIC), <https://www.fdic.gov/news/press-releases/2023/pr23017.html> [<https://perma.cc/CUK3-F3FA>].

234. 12 U.S.C. § 1823(c)(4) requires the FDIC to resolve failed banks in the way that is least costly to the deposit insurance fund. In 12 U.S.C. § 1823(c)(4)(G), however, there is a systemic risk exception, which if invoked, allows the FDIC to incur extra cost in the receivership process in order to avoid serious adverse effects on economic conditions or financial stability. Invoking this systemic risk exception is a very convoluted process, which requires convincing 2/3 of the FDIC board, 2/3 of the Federal Reserve's Board of Governors, and the Treasury Secretary (in consultation with the President) that there will be a broader financial panic if least cost resolution is pursued.

235. Ongweso, *supra* note 207.

indeed fueled by several prominent VCs who publicly called for bailouts of SVB's uninsured depositors in order to prevent what they described as an impending economic calamity.<sup>236</sup>

## V. IMPLICATIONS

The primary goal of this Article has been descriptive, to show that the risks to financial stability arising from prolonged periods of accommodative monetary policy can sometimes unfurl in unexpected ways. This Part will, however, suggest some implications of this descriptive account that policymakers and regulators might wish to consider going forward. This Part does not wade into the controversy over the extent to which central banks should be mindful of the financial stability impacts of their monetary policy.<sup>237</sup> Instead, it starts from the uncontroversial premise that financial regulation provides a critical toolkit for protecting against financial instability and offers some thoughts on deploying that toolkit in an environment that is affected by monetary policy. The second Section of this Part will consider whether regulation of VC firms should be adapted in light of this Article's descriptive account.

### A. *Financial Stability Regulation Generally*

The overarching takeaway from this Article is that when policymakers respond to financial crises with prolonged periods of accommodative monetary policy, that can sow the seeds for the next round of financial instability—and those seeds may sprout in unexpected ways. This reality militates against relying entirely on ex post strategies for responding to bouts of financial instability. Notwithstanding that ex ante attempts to make the financial system more robust to crises will never be perfect,<sup>238</sup> fatalism about such crises will ensure dependence on accommodative monetary policy that will inspire potentially destabilizing yield-seeking behavior. It is therefore critical that financial regulation hold the line on financial institutions' prudential risk management, on the understanding that risk-seeking activities in periods of easy money can contribute to a later bust.<sup>239</sup> Effective financial stability regulation must also go beyond a focus on

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236. *Id.*

237. See *supra* note 44 and accompanying text.

238. Iman Anabtawi & Steven L. Schwarcz, *Regulating Ex Post: How Law Can Address the Inevitability of Financial Failure*, 92 TEX. L. REV. 75, 93–102 (2013).

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A loose monetary policy stance to ease financial conditions may be necessary to stimulate economic growth in the near-term but could lead to a buildup of financial vulnerabilities, threatening macro-financial stability down the road...In an environment where accommodative monetary policies are needed to support economic growth, monetary and financial authorities need to proactively monitor financial vulnerabilities and risk taking, and they should develop and deploy adequate macroprudential tools that apply to both banks and nonbank financial institutions to preserve financial stability.

Adrian et al., *supra* note 1, at 14–15. “The first line of defence by prudential authorities should be to continue to build resilience in the financial system by encouraging adequate capital, liquidity, and risk management.” BINDSEIL & KAMIN, *supra* note 43, at 3.

individual institutions, and grapple with financial institutions' potential interactions with one another, and with the broader financial markets.<sup>240</sup>

Financial regulation therefore has a critical role to play in preventing the financial crises that invite accommodative monetary policy, and when accommodative monetary policy *is* implemented, in preventing it from sowing the seeds of future financial stability problems. Financial regulation over the last fifteen years deserves a mixed report card in this regard. There is insufficient space here to cover the waterfront on financial stability regulation wins and losses since 2008; instead, I will draw a few examples from the subject matter already covered in this Article. If we look specifically at SVB, for example, the regulators supervising the bank failed to act aggressively enough in response to known interest rates and other risks at the bank.<sup>241</sup> After the fact, the Federal Reserve conceded that its “[s]upervisors did not fully appreciate the extent of the vulnerabilities as Silicon Valley Bank grew in size and complexity.”<sup>242</sup>

As for banking regulators' approaches to regulating crypto, in 2020 and 2021, the Office of the Comptroller of the Currency authorized nationally-chartered banks to hold crypto assets in custody for their customers, and to hold reserves for a type of crypto asset known as a stablecoin, allowing some intertwining of the banking and crypto spheres.<sup>243</sup> But in a Joint Statement issued on January 3, 2023, banking regulators confirmed their position that banks should not issue or invest in crypto assets themselves; they also raised concerns about bank business models that cater to the crypto industry.<sup>244</sup> This Joint Statement was a financial stability “win,” and as of the time of writing, banking and crypto remain largely separate. Still, Silvergate and Signature, the two U.S. banks that focused their business models on providing services to the crypto industry, both failed in March 2023—and government support from the deposit insurance fund was made available to uninsured Signature Bank depositors, and indirectly, to users of the USDC stablecoin.<sup>245</sup>

Unfortunately, both political economy and human psychology can undermine *ex ante* financial stability regulation. A financial crisis can mobilize the public to support harm-reducing financial stability regulation that industry would otherwise resist, but as memories of that crisis fade, so too will the public interest in those policies.<sup>246</sup> Industry, on the other hand, never stops resisting regulations that reduce its profitability, and so such regulations are likely to be abandoned or

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240. Jeremy C. Kress & Jeffrey Y. Zhang, *The Macroprudential Myth*, 112 GEO. L.J. 569, 578 (2024).

241. BARR, *supra* note 191, at 6.

242. *Id.*

243. Wilmarth, *supra* note 30, at 268.

244. BD. OF GOVERNORS OF THE FED. RESRV. SYS., FED. DEPOSIT INS. CORP. & OFF. OF THE COMPTROLLER OF THE CURRENCY, JOINT STATEMENT ON CRYPTO-ASSET RISKS TO BANKING ORGANIZATIONS (Jan. 3, 2023), <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf> [https://perma.cc/55A5-SKTK].

245. FDIC, *supra* note 214, at 6–7; Wilmarth, *supra* note 30, at 288.

246. See John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1024 (2012).

underenforced in the longer term. Professor Coffee has labeled this cycle “the regulatory sine curve,”<sup>247</sup> and in 2012 he predicted that “interest-group politics will produce a major down-sizing in the Dodd-Frank Act, both by way of administrative implementation and legislative revision.”<sup>248</sup> The regulatory tailoring associated with the enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act in 2018 confirmed that prediction—and contributed to the failure of Silicon Valley Bank.<sup>249</sup>

Industry lobbying also seeks to exploit the fact that regulators themselves may lose interest in financial stability regulation as memories of crisis recede. Humans often display an “availability bias,” in the sense that events less easily called to mind are less salient to them than more recent or vivid events.<sup>250</sup> For example, many of the financial stability implications of rising interest rates are not new. During the Savings & Loan Crisis of the 1980s, many depository institutions failed because of their mismanagement of interest rate risk during a “snapback” period of significant interest rate increases.<sup>251</sup> But after the prolonged period of low interest rates following 2008, we now have people in charge (at both banks and regulatory agencies) who have either never experienced or forgotten their experience with rising interest rates. As one Wall Street Journal article put it, “Bankers that grew up in the easy-money era following the 2008 crisis failed to ready themselves for rates to rise again. And when rates went up, they forgot the playbook.”<sup>252</sup> Post-mortems of the regulatory supervision of SVB suggest that to some degree, regulators also forgot the playbook.<sup>253</sup>

While the salience of SVB’s failure has ensured that financial stability risks associated with interest rate changes are now receiving increased attention,<sup>254</sup> there are no easy solutions to the political and psychological challenges that ex ante financial stability regulation faces in good times. Similar political and psychological challenges are implicated in the long-standing “leans vs. clean” debate about whether central bankers should use monetary policy to tamp down on frothy markets, or just clean up (by lowering interest rates, among other things) once a problem arises.<sup>255</sup> One important takeaway from that debate is that

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247. “[R]egulatory oversight is never constant but rather increases after a market crash and then wanes as, and to the extent that, society and the market return to normalcy.” *Id.* at 1029.

248. *Id.* at 1027.

249. See *supra* notes 209–211 and accompanying text.

250. Anabtawi & Schwarcz, *supra* note 238, at 97–98.

251. Admati et al., *supra* note 191.

252. Foldy et al., *supra* note 195.

253. BARR, *supra* note 191, at i–ii.

254. For example, one recent paper examines the interplay between interest rate risk and liquidity risk when a bank has uninsured deposits. Itamar Drechsler, Alexi Savov, Philipp Schnabl & Olivier Wang, *Deposit Franchise Runs 1* (Nat’l Bureau of Econ. Rsch., Working Paper No. 31138), <http://www.nber.org/papers/w31138> [<https://perma.cc/PDF3-NL9E>]. See also Richardson et al., *supra* note 52, at 140.

255. “Should policymakers rely on ex ante measures to lean against potential financial imbalances as they build up, and thereby lower the probability of a bad event ever happening, or should they do most of their work ex post, focusing on the clean-up?” Jeremy C. Stein, Member of the Bd. of Governors of the Fed. Rsrv. Sys., Lessons from the Financial Crisis for Monetary Policy, Speech at the Nat. Bureau of Econ. Rsrch. Conf. (Oct. 18, 2013), (transcript available at <https://www.bis.org/review/r131107b.htm>) [<https://perma.cc/F33T-JCCV>].

“personnel is policy,” and putting the right people in charge can be key to ensuring consistently public-minded policy at times when such policy does not attract overt public support.<sup>256</sup> The same is true of financial stability regulation: the regulatory sine curve is not an “iron law” of financial regulation, and some regulators are more likely to hold firm on financial stability regulation even in good times. Appointing the right personnel to key positions is therefore critical to effective ex ante financial stability regulation.

A plethora of more structural proposals have also been made to help address, or at least mitigate, the political and psychological barriers to ex ante financial stability regulation. The most effective approach would probably be to restructure the U.S. financial regulatory architecture so that there is a single prudential regulator mandated to focus on financial stability, but unfortunately, such restructuring faces seemingly insurmountable political obstacles.<sup>257</sup> More limited measures have a greater chance of implementation, and there is no shortage of interesting proposals for “countercyclical” and “macroprudential” regulatory improvements designed to focus attention on the systemic vulnerabilities that can arise during good times.<sup>258</sup> Once again, however, it may be hard to get such proposals off the ground unless they are backed by a committed champion in a key policy-making role, or the broader public is calling for them.

I have previously considered whether storytelling might help provide ballast against the regulatory sine curve by invigorating public support even in the absence of a crisis.<sup>259</sup> Part of the reason why financial stability regulation is not salient to the public is that it is a complex concept and there is rarely a direct, easy-to-follow conceptual path from threats to financial stability to the ultimate crisis.<sup>260</sup> I have therefore advocated for financial regulatory agencies to tell stories about the financial stability harms they foresee in order to make those harms more accessible and salient to the public. SVB, Silvergate, and Signature certainly serve as cautionary tales, but the past does not predict the future, and stories about a full-blown crypto-inspired financial crisis could alert the public to the stakes of allowing crypto to integrate into the traditional financial system, for example.<sup>261</sup> In addition to building public support for regulatory efforts, the process of formulating and telling such stories could also limit the impact of

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256. Robert C. Hockett, *Bubbles, Busts, and Blame*, 37 CORNELL L.F. 14, 18 (2011) (“Chairmen William McChesney Martin and, later, Paul Volcker took seriously the Fed’s role as countercyclical macroeconomic stabilizer. Both of those well regarded custodians of our credit-money system seem to have understood the systemic prisoners’-dilemma-like structure of asset price bubbles and consumer price inflations alike. And so both employed the Fed’s principal systemic levers to ‘lean against the wind’ and ‘take away the punch bowl just as the party was getting good’ in order to stabilize asset and consumer price inflations. Volcker’s immediate successor, Chairman Greenspan, alas, saw things differently.”).

257. Kress & Zhang, *supra* note 240, at 624; Hilary J. Allen, *Putting the “Financial Stability” in Financial Stability Oversight Council*, 76 OHIO ST. L.J. 1087, 1138 (2015).

258. *See id.* at 627.

259. Hilary J. Allen, *Regulatory Managerialism and Inaction: A Case Study of Bank Regulation and Climate Change*, 86 J.L. & CONTEMP. PROBS. 71, 92–96 (2023).

260. *Id.*; *see also* Coffee, *supra* note 246, at 1028.

261. For an example of such a story, *see* Allen, *supra* note 9, at xiii–xxi.

availability bias on regulators, “free[ing] them from the confines of their models and historical experience.”<sup>262</sup>

In many ways, the overarching purpose of *this* Article is to record the story of some recent episodes of actual and potential financial instability in an attempt to raise the salience of financial stability risks associated with prolonged periods of low interest rates. Doing so can help build support for proactive financial stability regulation that aims to prevent the financial crises that would necessitate such “low for long” environments.

### B. Regulation of Venture Capital

#### 1. Monitoring

While the broader purpose of this Article has been to explore how financial stability risks can be generated during prolonged periods of low interest rates, the case studies used in this Article highlight that the VC industry is well positioned to build bubbles and exacerbate panics. This Section will therefore consider whether financial stability regulation should pay more attention to VC funds, which have typically flown beneath the radar of financial stability regulation and policy. The response to the wave of regional bank failures kicked off by Silicon Valley Bank has unsurprisingly focused on improving regulation of banks themselves,<sup>263</sup> but regulators seeking to protect financial stability must also look beyond banks to other parts of the financial system to see “how different developments fit together and where the unseen risks might be hidden.”<sup>264</sup>

There is some appreciation that financial stability risks might be hidden in some kinds of private funds,<sup>265</sup> but VC funds have largely escaped even this kind of scrutiny. I suspect this may be because, unlike many hedge funds, VC business models do not typically involve much leverage.<sup>266</sup> Significant leverage has long been understood to be inimical to financial stability: in this context, “leverage” describes the use of debt to multiply return on investment.<sup>267</sup> If a leveraged investment loses value, losses will also be multiplied, which is why leverage can be so damaging to financial stability in downturns.<sup>268</sup> VC funds and the startups

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262. Allen, *supra* note 259, at 91.

263. To give an example of the kind of regulatory changes that might be necessary, following the run on SVB, banking regulators have expressed interest in reconsidering “how venture capital funds are treated under the liquidity coverage ratio.” Victoria Guida (@vtg2), X (Apr. 28, 2023, 2:10 PM), <https://x.com/vtg2/status/1652027523814035457> [<https://perma.cc/6YNX-FFV9>].

264. HELLWIG, *supra* note 11, at 20.

265. Gary Gensler, *Statement on Form PF*, U.S. SEC. EXCH. COMM’N (May 3, 2023), <https://www.sec.gov/news/statement/gensler-statement-form-pf-050323> [<https://perma.cc/N2E6-RL2X>]; *see also* FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 8, at 44; Hsu, *supra* note 8, at 14–15; Tuch, *supra* note 8, at 360–66.

266. On the financial stability concerns associated with hedge funds’ use of leverage, *see* FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 8, at 42–44.

267. CARNELL ET AL., *supra* note 46, at 7–10.

268. *Id.*

they invest in don't typically take on a lot of debt,<sup>269</sup> and when the money used to make investments is not borrowed, financial stability regulators are typically less concerned. And so it makes perfect sense for financial stability regulators to pay more attention to leveraged funds, but in this Article, I have explored how VC firms are well positioned to leverage *other* things—like their reputation for being iconoclastic genius finders, insensitivity to losses, and funding that rushes to them in low interest rate environments when investors are seeking yield—to magnify bubbles on the upswing, and panics on the downswing.<sup>270</sup>

If these bubbles and panics do not significantly impact other financial institutions, then they will remain largely irrelevant from a financial stability perspective. Financial stability regulators should still be paying attention to the VC industry, though, to see if it feeds any bubbles that *are* likely to impact other financial institutions (*e.g.*, a bubble in AI-related investments).<sup>271</sup> Leveraged financial institutions might have direct exposures to the affected asset class or, if a bubble in one asset class pops, it could drag down prices in other asset classes (whether through sentiment contagion or fire sale externalities),<sup>272</sup> and leveraged financial institutions may have invested in those other asset classes. Financial stability regulators should monitor for the possibility of these kinds of dynamics.

To help financial regulators detect any bubbles emerging from VC investment (and any interactions of those bubbles with the traditional financial system), it would be helpful for financial regulators to know which startups are receiving VC funding, and what their valuations are. It might also be helpful for regulators to know which startups are likely to be guided by the same VC firm, and therefore manage their financial affairs in lockstep (as many of them did during the run on SVB)—this could provide advance warning that particular banks have high vulnerabilities to coordinated runs by their startup customers.<sup>273</sup>

A starting point for this kind of monitoring would be the data compiled by Pitchbook, a research and data firm that maintains a database of VC deals.<sup>274</sup>

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269. VC funding can sometimes involve leverage, though. For example, before its failure, SVB pioneered “venture debt financing.” See Silicon Valley Bank, *Understanding Venture Debt Financing*, <https://www.svb.com/startup-insights/venture-debt/how-does-venture-debt-work/> (last visited June 30, 2025) [<https://perma.cc/9H7U-BYWT>].

270. See *id.*

271. Cory Doctorow, *What Kind of Bubble Is AI?*, LOCUS (Dec. 18, 2023), <https://locusmag.com/2023/12/commentary-cory-doctorow-what-kind-of-bubble-is-ai/> [<https://perma.cc/NDB2-J8N9>].

272. See *supra* notes 16–19 and accompanying text. For a discussion of increased interconnectedness between crypto and equity markets, for example, see TARA IYER, IMF, CRYPTIC CONNECTIONS: SPILLOVERS BETWEEN CRYPTO AND EQUITY MARKETS, GLOBAL FINANCIAL STABILITY NOTES NO. 2022/01, 3 (Jan. 2022), <https://www.imf.org/en/Publications/global-financial-stability-notes/Issues/2022/01/10/Cryptic-Connections-511776> [<https://perma.cc/2RW3-SG7V>].

273. This proposal that financial stability regulators monitor for the possibility of coordinated panicked behavior is somewhat novel, and once again, a proposal that might be more necessary in other parts of the financial system. For example, I have previously raised the possibility of a SEC rule that permits the agency “that allows it to collect data about the circumstances in which [high frequency trading] algorithms are programmed to stop trading.” Hilary J. Allen, *The SEC as Financial Stability Regulator*, 43 J. CORP. L. 715, 764 (2018).

274. *Who We Are*, PITCHBOOK, <https://pitchbook.com/about> (last visited June 30, 2025) [<https://perma.cc/UV4G-N3H5>].

Crunchbase and other existing sources may also provide useful information.<sup>275</sup> Disclosure to Pitchbook and Crunchbase, however, is voluntary and may not include all the information financial regulators require (or may not include it in the standardized format that regulators will need to make sense of the market). Fortunately, several legal mechanisms already exist through which further, potentially more standardized information could be obtained for financial stability regulation purposes. The Office of Financial Research, which was formed pursuant to 2010's Dodd-Frank Act, is authorized by Section 153(f) of that Act to subpoena data from "financial companies" to assist it in analyzing risks to the financial system.<sup>276</sup> The Office of Financial Research is directed to only exercise this subpoena power, though, if the information is not already readily available to it through agencies like the SEC.<sup>277</sup> The SEC already collects some information from the VC management companies that advise VC funds through Form PF. Some of this information would undoubtedly be useful in assessing any threats to financial stability posed by the VC industry, but Form PF is in many ways looking for information about leverage, interconnectedness, and other more typical financial stability concerns.<sup>278</sup> If our focus is the growth of bubbles and the power that the VC industry wields over the financial decisions of the startups it

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275. "Crunchbase is a company that provides information about businesses. Their content includes investment and funding information, individuals in leadership positions, and corporate news." *Crunchbase*, WIKIPEDIA, <https://en.wikipedia.org/wiki/Crunchbase> (last visited June 30, 2025) [<https://perma.cc/YSU5-XLFB>].

276. "Financial company" is defined by Section 201(11) of Dodd-Frank to include "any company that is predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k))." Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 201(a)(11)(iii), 124 Stat. 1443 (2010) (codified at 12 U.S.C. § 5371). VC management companies presumably engage in activities like investing for others, providing investment advisory services, and merchant banking activities that are covered by Sections 4(k)(4)(A), (C) and (H) of the Bank Holding Company Act. Banking Holding Company Act, 12 U.S.C. 1843(k)(4)(A), (C), (H).

277. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 153(f)(1)(B), 154(b)(1)(B)(ii).

278.

Form PF disclosure requirements include a breakdown of the net asset value (NAV) that the investment manager manages, including the percentage of the reporting fund's NAV that was managed using high-frequency trading strategies. Form PF requires investment advisers to disclose the five trading counterparties to which the reporting fund has the greatest net counterparty credit exposure and the dollar amount owed to each creditor. It also requires that the manager identify changes in market factors and their effect on the portfolio's long and short components as a percentage of NAV. Additional disclosures include any information about the counterparties' collateral and other credit support posted to the respective reporting funds, as well as trading and clearing mechanisms subject to liquidity constraints and the duration of those constraints. Form PF is also intended to improve the SEC's understanding of reporting funds' liquidity, exposure, and assets. Accordingly, Form PF requires investment advisers to disclose the time increments needed to liquidate a certain percentage of the reporting fund's portfolio, the dollar value of long and short positions in each asset class, the value of turnover by asset class, the types of creditors and the market value of borrowings from them, and the aggregate value of all derivative positions for each advised fund. Finally, Form PF requires disclosure of the reporting fund's restrictions (if any) on investor withdrawals and redemptions and other information pertaining to investor liquidity, such as the percentage of NAV.

Wulf A. Kaal, *Private Investment Fund Regulation—Theory and Empirical Evidence from 1998 to 2016*, 20 U. PA. J. BUS. L. 579, 591–92 n.61 (2018). For a discussion of the use (and limitations) of Form PF for financial stability purposes, see FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 8, at 44.

funds, then Form PF may need to be amended for VC firms, or the Office of Financial Research may need to exercise its subpoena power to supplement it.

If this monitoring of the VC industry reveals a need for new regulatory strategies, the Financial Stability Oversight Council (a council of regulators created in 2010 to monitor threats to financial stability) can recommend that individual regulatory agencies adopt new regulatory approaches for financial activities that impact financial stability.<sup>279</sup> The Financial Stability Oversight Council also has the statutory power to designate non-bank financial firms as systemically important and to subject them to heightened prudential supervision by the Federal Reserve.<sup>280</sup> although the Council retreated from entity designation during the first Trump Administration,<sup>281</sup> under the leadership of Treasury Secretary Yellen, the Council proposed guidance to reinvigorate this designation power.<sup>282</sup> As a result, designation may be an option, notwithstanding that it is highly unlikely that any VC firm would be systemically important enough to warrant such a designation.<sup>283</sup>

## 2. *Crypto-Specific Enforcement*

In addition to considering these kinds of approaches to addressing the VC industry's potential impact on financial stability, it is also worth considering whether financial stability would benefit from any crypto-specific regulation of VC firms. As explored in Section IV.A, prominent members of the VC industry continue to pump the crypto industry and seek to facilitate its integration with the traditional financial industry, which could damage financial stability in the longer term.

I have argued previously that rigorous enforcement of existing law is the best way to regulate crypto.<sup>284</sup> Banking regulators should limit banks' exposures

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279. Dodd-Frank Wall Street Reform and Consumer Protection Act § 120. For discussion of this power, see Jeremy C. Kress, Patricia A. McCoy & Daniel Schwarcz, *Regulating Entities and Activities: Complementary Approaches to Nonbank Systemic Risk*, 92 S. CAL. L. REV. 1455, 1475 (2019); Allen, *supra* note 7, at 1115–19.

280. Dodd-Frank Wall Street Reform and Consumer Protection Act § 113. For discussion of this power, see Kress et al., *supra* note 279, at 1473–74.

281. *Id.* at 1480–81.

282. Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies: Proposed Rules, 88 Fed. Reg. 82 (proposed Apr. 28, 2023) (to be codified at 12 C.F.R. pt. 1310), <https://home.treasury.gov/system/files/261/FSOC-2023-Proposed-Nonbanks-Guidance.pdf> [<https://perma.cc/6YN7-SS5J>].

283. Tuch argues that designation of private equity funds is similarly unlikely. Tuch, *supra* note 8, at 367–68.

284. *The Future of Digital Assets: Identifying the Regulatory Gaps in Digital Asset Market Structure U.S. H. Comm.on Fin. Serv., Subcomm. on Digit. Assets, Fin. Tech., and Inclusion*, (2023) (statement of Hilary J. Allen, Professor of Law, American University Washington College of Law), <https://docs.house.gov/meetings/BA/BA21/20230427/115821/HHRG-118-BA21-Wstate-AllenH-20230427.pdf> [<https://perma.cc/Z5JB-46SX>]. *Crypto Crash: Why the FTX Bubble Burst and the Harm to Consumers Before the Senate Committee on Banking, Housing, and Urban Affairs*, (2022) (statement of Hilary J. Allen, Professor of Law, American University Washington College of Law), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4331362](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4331362) [<https://perma.cc/NNY3-DU9F>].

to crypto (so that crypto bubbles have limited impact on traditional finance),<sup>285</sup> and the SEC should rigorously enforce the investor protections in the securities laws.<sup>286</sup> Rigorous enforcement of the securities laws will likely have an incidentally beneficial impact on financial stability by limiting the supply of crypto assets, and thus any crypto bubble.<sup>287</sup> Where the SEC and private litigators can both enforce the securities laws directly against VC firms, the intensity of private litigation may be on a different wavelength to the “regulatory sine curve” discussed above<sup>288</sup> and so could help fill the void if lobbying or a change in Presidential administration ends up limiting enforcement by the SEC.

Section 5 of the Securities Act of 1933 prohibits the offer or sale of a security without first registering with the SEC, unless an exemption from registration is available.<sup>289</sup> Investors who have purchased a security that was offered or sold in violation of Section 5 have a remedy under Section 12(a)(1) that is essentially a put right: so long as the statute of limitations has not expired, investors can demand their money back.<sup>290</sup> This remedy is not just available against the issuer of the security; it is also available against any “statutory seller” who “successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner.”<sup>291</sup> If a VC firm helps market unregistered securities in the form of tokens issued by its crypto ventures, that VC firm might end up satisfying the definition of “statutory seller,” even if it never holds or passes title to the token in question. In such circumstances, the VC firm would be liable to refund token investors and may face enforcement actions from the SEC as well.

This kind of statutory seller claim was asserted against a 16z and the crypto-focused VC firm Paradigm in the Second Circuit case of *Risley v Uniswap*: ultimately, the claim did not succeed because of the tenuous links between the VC

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285. See *supra* note 244 and accompanying text.

286. See *supra* note 160 and accompanying text.

287. Registration under Section 5 of the Securities Act requires a significant amount of disclosure on the part of the issuer (including the provision of audited financial statements), and it takes time and money to prepare these disclosures. Over the years, Congress and the SEC have crafted numerous exemptions to Section 5’s registration requirements where it was decided that capital formation could be better facilitated by dispensing with some investor protections, because the investors in question were able to fend for themselves. As a result, the most widely-used exemptions restrict who is eligible to purchase the securities in question, and restrict resales of those securities. Most crypto assets, however, are Ponzi-like in the sense that they need significant amounts of demand and liquidity to support their value. Restricting the pool of eligible investors, as well as limiting the liquidity of the crypto assets through resale restrictions, is therefore unlikely to be an appealing avenue for crypto issuers. If ventures who issue crypto assets to retail investors face enforcement actions for failure to comply with Section 5, it will change their cost-benefit calculus, discouraging the creation of crypto assets unless those assets have some long-term value creation potential that justifies the expense of the registration process. See *The Future of Digital Assets*, *supra* note 284, at 12–13.

288. See *supra* note 247 and accompanying text.

289. Securities Act of 1933, Pub. L. No. 22, §5, 73 Stat. 74, 77 (1933).

290. *Id.* §§ 12–13.

291. *Pinter v. Dahl*, 486 U.S. 622, 647 (1988).

firms and the issuers of the “scam tokens” in question.<sup>292</sup> In a subsequent Ninth Circuit case, however, *Risley* was distinguished, and statutory seller claims against a16z and Paradigm (amongst other defendants) survived a motion to dismiss.<sup>293</sup> This could potentially open the door for similar suits in the future, especially where VC firms have funded or otherwise have direct relationships with the token issuers.<sup>294</sup>

The SEC can also bring enforcement actions under Sections 5 and 15(a) of the Securities Exchange Act of 1934 (which require registration of securities exchanges and broker/dealers, respectively).<sup>295</sup> Individual investors may also have recourse for violations of these provisions, as Section 29(b) of that Act allows for rescission and restitution of contracts made in violation of Sections 5 and 15(a), so long as such claims are brought in a timely manner.<sup>296</sup> Such private actions under the 1934 Act would not target VC firms directly (although plaintiffs might assert—as the plaintiffs did unsuccessfully in *Risley*—that VC firms were liable for these kinds of violations as control persons),<sup>297</sup> but suits against crypto exchanges may still indirectly impact VCs by limiting their options for exiting from crypto investments. While the Section 29(b) claims against the Uniswap exchange in *Risley* were dismissed, that decision was informed by concerns about the “decentralized” nature of the Uniswap exchange<sup>298</sup>—private suits brought with respect to centralized exchanges controlled by VC firms could be decided differently. The SEC itself has brought enforcement actions against the centralized crypto exchanges Coinbase and Binance for, among other things, unlawfully facilitating the buying and selling of crypto securities:<sup>299</sup> if

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292. *Risley v. Universal Navigation Inc.*, No. 1:22-cv-02780, at 45–48 (S.D.N.Y. Aug. 29, 2023), ECF No. 90 (order granting defendants’ motions to dismiss).

293. *Houghton v. Leshner*, No. 22-cv-07781-WHO, at 6–7, 11 (N.D. Cal. Sept. 20, 2023), ECF No. 94 (order denying defendants’ motion to dismiss).

294. “In Judge Orrick’s order denying defendants’ motion to dismiss, the court rejected defendants’ claims that they were merely ‘collateral’ participants in the transaction. . . . [This decision] might pave the way for further digital asset solicitation suits in the Ninth Circuit.” *Crypto Quarterly: Digital Assets, Blockchain, and Related Technologies Update*, ROPES & GRAY (2023), [https://www.ropesgray.com/-/media/files/alerts/2023/11/20231120\\_crypto\\_newsletter.pdf](https://www.ropesgray.com/-/media/files/alerts/2023/11/20231120_crypto_newsletter.pdf) [<https://perma.cc/U4U7-GXKR>].

295. For examples of crypto-related enforcement actions brought by the SEC, see *supra* note 161 and accompanying text.

296. For an overview of this kind of private litigation, see *Discovering a Discovery Rule in Crypto Cases? The Uphill Struggle Plaintiffs Face in Trying to Resurrect Time-Barred ICO Claims*, O’MELVENY (Apr. 14, 2020), <https://www.omm.com/resources/alerts-and-publications/alerts/discovering-a-discovery-rule-in-crypto-cases/> [<https://perma.cc/T5E9-K7HR>].

297. *Risley*, No. 1:22-cv-02780, at 48–49.

298. *Id.* at 37–38.

299.

According to the SEC’s complaint, since at least 2019, Coinbase has made billions of dollars unlawfully facilitating the buying and selling of crypto asset securities. The SEC alleges that Coinbase intertwines the traditional services of an exchange, broker, and clearing agency without having registered any of those functions with the Commission as required by law.

SEC Charges Coinbase for Operating as an Unregistered Securities Exchange, Broker, and Clearing Agency, SEC (June 6, 2023), <https://www.sec.gov/news/press-release/2023-102> [<https://perma.cc/H7U2-NUKJ>]; Press Release, SEC, SEC Files 13 Charges Against Binance Entities and Founder Changpeng Zhao (June 5, 2023), <https://www.sec.gov/news/press-release/2023-101> [<https://perma.cc/H3ZS-NX2C>].

successful, these suits would impair VC firms' ability to use crypto exchanges to exit their investments.

In sum, a meaningful threat of private litigation and SEC enforcement against VC firms for unregistered securities offerings could force the VCs (rather than just the businesses they fund) to bear the consequences of legal non-compliance. If registration requirements are enforced against crypto exchanges, VCs will not be able to sell tokens and exit as easily as they have in the past. VC firms will ultimately have fewer incentives to fund crypto ventures in the first place, and where they do contemplate funding such ventures, they will have better incentives to perform due diligence because they will have "skin in the game" for a longer period of time.

## VI. CONCLUSION

The zeitgeist seems to be shifting towards a more critical reckoning with the VC industry, and people are starting to ask whether it is good public policy to rely on (and indeed subsidize) the VC industry to direct our innovation priorities.<sup>300</sup> This reckoning is beyond the scope of this Article, as are proposals to improve VC governance, but this Article *has* called for a more critical assessment of the role that the VC industry has played in making our financial system more fragile in the early 2020s.

The VC industry's ability to do so arose in large part because of the prolonged period of accommodative monetary policy that followed the 2008 financial crisis (which was prolonged even further because of the COVID-19 pandemic). Because responding to financial crises with prolonged periods of accommodative monetary policy will encourage yield-seeking behaviors that can sow the seeds of the next crisis, it is critical that regulators and policymakers take steps *ex ante* to make financial crises less likely. This kind of *ex ante* regulation will always face political and psychological challenges, but its chances of success can be increased by appointing the right people to key financial regulatory positions, and by conveying to the public the stakes of getting financial stability regulation wrong.

When it comes to regulating the VC industry itself, regulators should consider reorienting their perspective on what threats to financial stability the industry might pose. Although the VC industry is by no means the most pressing threat to financial stability, it would be worthwhile for financial stability regulators to be mindful of the role that the VC industry can play in building bubbles and coordinating panics. Keeping an eye on the VC industry may require new and different kinds of monitoring by regulatory authorities, but the legal foundations for such monitoring already exist. Legal foundations also already exist for enforcing securities registration requirements against the crypto industry (and perhaps even directly against VC firms). If the SEC or private litigants pursue such

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300. See, e.g., Lee, *supra* note 61, at 617; Wansley & Weinstein, *supra* note 59, at 819; Ongweso, *supra* note 207.

enforcement actions, crypto investments will presumably be less attractive to VC firms, and crypto's potential financial stability risks may never come to fruition.