

COINCIDENCE OR COORDINATED? THE ADMINISTRATION'S ATTACK ON THE DIGITAL ASSET ECOSYSTEM

HEARING BEFORE THE SUBCOMMITTEE ON DIGITAL ASSETS, FINANCIAL TECHNOLOGY, AND INCLUSION OF THE COMMITTEE ON FINANCIAL SERVICES U.S. HOUSE OF REPRESENTATIVES ONE HUNDRED EIGHTEENTH CONGRESS FIRST SESSION

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COINCIDENCE OR COORDINATED? THE ADMINISTRATION'S ATTACK ON THE DIGITAL ASSET ECOSYSTEM

Thursday, March 9, 2023

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DIGITAL ASSETS,
FINANCIAL TECHNOLOGY,
AND INCLUSION,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2128, Rayburn House Office Building, Hon. French Hill [chairman of the subcommittee] presiding.

Members present: Representatives Hill, Lucas, Emmer, Davidson, Rose, Steil, Timmons, Donalds, Flood, Houchin; Lynch, Foster, Gottheimer, Torres, Sherman, Green, Casten, and Nickel.

Ex officio present: Representative Waters.

Also present: Representative Nunn.

Chairman HILL. The Subcommittee on Digital Assets, Financial Technology, and Inclusion will come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

I want to thank our witnesses for being here today. It is an outstanding panel, and I now recognize myself for 4 minutes to give an opening statement.

Today, I am very excited to hold the inaugural meeting of the new Subcommittee on Digital Assets, Financial Technology, and Inclusion. To start, I want to thank Full Committee Chairman McHenry for asking me to lead this new subcommittee and for his leadership in recognizing the important need to comprehensively address the topic of digital assets. I also want to thank Full Committee Ranking Member Waters for her foresight in holding that first Libra hearing back in 2019, and for creating the Task Forces on Fintech and Artificial Intelligence, and for her continued engagement and willingness to work in a bipartisan manner.

Finally, I am looking forward to working with my good friend from Massachusetts, the ranking member of this subcommittee, Congressman Lynch. He is always a thoughtful partner, and we are reprising our roles that we had together leading the Fintech Task Force a few years ago.

To all of the members of this committee, no matter what your views are about crypto, it is imperative that we recognize the unique role of Congress to legislate, and that no amount of enforce-

ment actions or regulatory guidance can ever replace that or be a substitute. As a legal matter, only Congress can establish the regulatory framework for digital assets, and I strongly believe that we need that in this country. That is why this subcommittee is holding its first hearing to examine the Administration's recent actions on digital assets.

But let me be very clear. This hearing is not a partisan attack on the Securities and Exchange Commission or the banking regulators. We will hold other hearings to discuss the comprehensive policies as well as the fraud and failure of FTX and Sam Bankman-Fried and the millions of people hurt by his dishonesty and scam. But it is absolutely critical that we first discuss the scope and significance of recent regulatory pronouncements and supervisory failures of the past year. By assessing the regulatory gaps, supervisory failures, and enforcement actions, we can build a case for a shared bipartisan vision of this regulatory framework.

The shared goal is to protect investors, foster innovation, and ensure that America continues to lead rather than follow in this space, but that means Congress has to do the hard work of working across the aisle to reach a consensus and not just posturing or sticking our heads in the sand. That is why I was so glad to see Ranking Member Waters recently call on the Treasury, the Fed, the CFTC, and the SEC to get together with Congress and address digital asset regulation. We cannot have the agencies trying to front-run the Legislative Branch.

Last Congress, this committee, under then-Chairwoman Waters and Ranking Member McHenry, made good progress on payment stablecoin legislation, and I believe we should work together on a product that can pass out of this committee with bipartisan support. The Treasury and the Fed were constructive partners in that process, and we want that to continue.

That being said, payment stablecoins are just one part of the broader digital economic system, and I hope we can bring in customer protections that exist in the current financial regulatory system to cover digital assets. I am a strong proponent of the theory and the approach, same risks, same activities, same rules, and I believe we should create a functional framework that is tailored to the specific risks of digital assets.

In fact, we need to support technological innovation. We need to ensure appropriate controls and accountability. We need to give no quarter to fraudsters, scammers, or criminals, and we need to reinforce leadership in the global financial system for U.S. competitiveness. These are the Administration's own principles as outlined in their Executive Order for looking at digital assets.

So, I look forward to hearing from our witnesses on the impact of the Administration's approach and how Congress can work together on that. With that, I yield back, and I yield to my friend, Ranking Member Lynch, for an opening statement.

Mr. LYNCH. Thank you very much, Mr. Chairman. Let me congratulate you, as well as Congressman Warren Davidson as Vice Chair, on your recent elevations. It was an honor to serve with you as the Chair of the Task Force on Financial Technology last Congress, and I hope that we might continue some of the work that we began in that task force. We can play an important role in

shaping policy in the digital assets and fintech space, and I believe there are areas in which we can immediately find common ground. Innovation has the potential to increase the accessibility and lower the costs of financial service products. But I am also likely to exercise some caution about the risk to consumer financial data, some of the hidden fees, the lack of transparency, and the misleading marketing practices that were heretofore exercised in this industry. I plan to continue to voice those concerns in this Congress.

I do remain optimistic in the potential for great innovation in financial services and the myriad possibilities of blockchain technology. Given the collapse of much of the crypto industry this year, including the recent news involving Silvergate Bank and the scrutiny over Binance's practices, I have some lingering concerns about the volatility and risks that crypto assets pose to consumers, particularly low-income and underrepresented communities.

The collapse of TerraUSD, Celsius, BlockFi, and FTX speak to the larger regulatory gaps in this space, including lack of corporate controls, inadequate liquidity or reserves, commingling of assets, and irresponsible practices. I do worry that these practices exist across the industries and are a result of insufficient oversight and lack of regulatory guidance. I commend the actions of our Administration, the Biden Administration, through its reports, guidance, and Executive Orders, to thoughtfully examine the benefits and risks of crypto products.

I also have concerns about the exposure of crypto companies to our traditional banking system. I am encouraged to see that our prudential banking regulators are recommending caution. Yesterday's announcement about the liquidation of Silvergate Bank illustrates why we need a separation between crypto assets and the traditional banking system, and why guidance from the Fed, the OCC, and the FDIC is needed.

Prior to the collapse of the crypto industry, the hype was astounding. From celebrity endorsements to Super Bowl ads, companies sold crypto assets as revolutionary products that would transform our financial ecosystem. Crypto companies deliberately misled consumers about the risks of their products, some even going so far as to falsely claim that their products were FDIC-insured. It is clear that Congress must play a role in reining in some of these crypto companies.

While I am confident that my colleagues across the aisle agree that we need a legislative solution to the digital asset space, how we get there may pose a challenge. There appear to be conflicts between the crypto industry and the SEC surrounding how crypto assets should be regulated. SEC Chair Gensler has stated that the vast majority of crypto assets are indeed securities, as illustrated and just defined by the Howey test, and should be regulated as such.

Crypto companies must come in compliance with existing security laws which ensure that investors and markets are protected. The crypto industry and many of my Republican colleagues have spun a false narrative that the SEC regulates through enforcement, and makes it impossible for the industry to come into compliance, when in reality, the SEC is enforcing the law and has provided appropriate direction. These arguments also conflict with the

accusation that the SEC did not go far enough in taking actions to prevent the FTX collapse. This attack on the SEC is a tactic employed by the crypto industry to evade compliance with the laws because the industry knows that it would not meet the justifiably-high standards that make our financial system the envy of the world.

In closing, I am disappointed that the consumers' voice has been missing from all of these conversations, and I am disturbed by the way in which crypto companies, specifically in the past, have targeted low-income and minority communities. Many have made misleading claims about the promises of their products, such as faster payments, lower-cost remittances, and wealth-building vehicles. This type of predatory inclusion is not unique to the crypto industry; it is common in fintech, and is reminiscent of the 2008 financial crisis and prior events. So, I plan to explore these issues more this year.

I urge my colleagues to look beyond industry talking points about regulatory overreach, and instead I ask that we direct our attention to thoughtfully addressing the risks of the crypto industry as well as its potential. Thank you. I yield back.

Chairman HILL. I thank the gentleman from Massachusetts. I look forward to working with him. And now, I will turn to the Vice Chair of the subcommittee, the gentleman from Ohio, Mr. Davidson, who is also the Chair of our Housing and Insurance Subcommittee, for 1 minute.

Mr. DAVIDSON. Thank you, Mr. Chairman. The regulatory environment for the digital asset ecosystem has come to a critical inflection point. Because there are no clear rules of the road for centralized digital asset trading platforms that list non-security digital assets, American users, our constituents and consumers, are not adequately protected while participating in these markets.

It is our job in Congress to craft an appropriate, fit-for-purpose legal framework for these assets and this space. It is our job. It is our duty. It is long-overdue. We must establish clear rules for trading platforms that provide Americans with the necessary protections and ensure market integrity. However, these rules must provide a clear framework that is flexible enough to accommodate innovation. These rules must also preserve Americans' ability to self-custody their digital assets.

Congress must do everything in its power to ensure that American citizens can access this transformational technology and have the right to possess their stake and ownership right—private property—in the technology. Preserving self-custody is a critical step in this effort. Because of this, I am working on a reintroduction of the Keep Your Coins Act, to protect Americans' ability to manage their own digital assets and to make permissionless peer-to-peer transactions.

Thank you for your attention, and I look forward to diving into these critical issues with our witnesses today.

Chairman HILL. Thank you, Mr. Davidson. We now welcome the testimony of our witnesses. First, Mr. Mike Belshe. Mr. Belshe is a 30-year Silicon Valley veteran, and co-founded BitGo, a digital asset financial services provider, where he currently serves as CEO.

Second, Dr. Tonya Evans. Dr. Evans is a full tenured professor at the Pennsylvania State University Dickinson School of Law, specializing in entrepreneurship, innovation, intellectual property, and new technologies such as blockchain and digital assets.

Third, Mr. Jonathan Gould. Mr. Gould is a partner at Jones Day law firm where he specializes in bank and financial regulatory strategy. Before Jones Day, he served as the Senior Deputy Comptroller and Chief Counsel for the Office of the Comptroller of the Currency.

Fourth, Mr. Paul Grewal. Mr. Grewal has served as chief legal officer at Coinbase since August of 2020. Mr. Grewal can provide perspective on how digital asset products, services, and firms can be incorporated in the U.S. framework.

And our final witness is Mr. Lee Reiners. Mr. Reiners is the policy director at the Duke Financial Economics Center at Duke University.

We thank each of you for taking the time to be here. Each of you will be recognized for 5 minutes to give an oral presentation of your testimony.

And without objection, each of your written statements will be made a part of the record.

We will start with Mr. Belshe. You are now recognized for 5 minutes for your oral remarks.

STATEMENT OF MIKE BELSHE, CEO AND CO-FOUNDER, BITGO

Mr. BELSHE. Chairman Hill, Ranking Member Lynch, and members of the subcommittee, thank you for the opportunity to offer testimony today about the digital asset regulatory environment in America. I am co-founder and CEO of BitGo, an institutionally-focused digital assets company based in Palo Alto, California. We have been building regulated products and platforms for digital assets and are regulated by numerous State and Federal regulators, including the New York Department of Financial Services, the South Dakota Division of Banking, the SEC, and the Financial Crimes Enforcement Network (FinCEN). We are primarily known for our role as the first purpose-built digital asset custodian. Trust companies are different than banks in that we are not depositories. We do not lend assets. We are solely focused on the technology and compliance related to the safekeeping of our clients' assets in segregated accounts.

I hope it is clear that BitGo and all of the regulated firms building digital asset technologies and services in America are absolutely and unequivocally committed to preventing financial crime, providing the utmost investor protections, abiding by sanctions controls, building safety and soundness in our custodians and banks, and building stable market structure. We are not seeking to avoid regulatory oversight. We are not here for the purpose of building speculative assets in markets. We are here to make the financial services system better.

It has been over 10 years now since the invention of bitcoin and the blockchain unlocked the creation of digital property and the ability to transfer digital property in a peer-to-peer fashion. This seemingly-simple technology has a profound effect: It enables the instant transfer of value between anyone across the globe. It also

creates smart contracts which have the potential to replace much of modern finance in a more transparent and fair manner. Stock-brokers, money managers, and market makers can all be implemented as transparent code.

Innovation is what I want to talk about today. Software has a tendency that once it enters an industry, it pushes innovation and change faster than that industry has ever experienced before, and that is what has happened to our financial industry in recent years. Software is changing it fast. But unlike other industries which software has upended, American finance is highly-regulated. It is not enough for our businesses to move quickly. Our regulators need to move quickly, too, and if they do not, we will all be surpassed by other nations who will.

When BitGo decided to pursue a trust company charter back in 2017, we first reached out to the OCC for Federal oversight of our safekeeping activity. At the time, the OCC clearly stated that it would not allow a charter for any business in the digital asset space, so instead, we pursued a State-chartered trust company. This left us with a question as to whether our fiduciary safekeeping powers will be considered a qualified custodian in the eyes of the SEC.

To answer this very basic question of how to provide custody of assets to regulated firms under the Investment Advisers Act, BitGo proactively and voluntarily approached the SEC back in 2018 and submitted a formal no-action letter to the SEC. Ultimately, the SEC declined to opine on our letter. With the OCC closed for business, and the SEC unwilling to answer, the question remains how to custody digital assets under the Advisers Act. That question has lingered for years until just a few weeks ago when the SEC issued a draft amendment to the custody rule. While we are happy that the amendment affirms that BitGo's State-chartered fiduciary trust company is indeed a qualified custodian, it took over 4 years to answer that single question. If it takes that long to answer the most basic of questions, how can we expect to answer the myriad of other questions that will follow without falling behind global competing markets?

The year 2022 was an undeniably miserable year for digital assets, with a number of dramatic failures in the system. This has led opponents of digital assets to wrongly proclaim, "I told you so. Digital assets are unsafe for banks and the financial system." But the underlying problem is not caused by including digital assets in our markets. The problem is caused by excluding digital assets from our markets. Our regulatory failure to keep pace with innovation has created a regulatory exclusion, which is directly responsible for harming the very investors that we are supposed to protect.

In 2020, the OCC briefly opened its doors to digital assets and encouraged OCC-chartered custodians to participate in the market. This was short-lived, however, and the door was closed less than a year later with no plan for regulators as to what the right approach should be.

At some point, we have to ask ourselves the question, why do Americans flock to weak digital asset opportunities that are managed offshore? The reason is not because they want to. It is hard

to do and risky. The reason is because we have failed to keep pace and to create safe paths to invest under the safety of American regulatory supervision. Thank you very much.

[The prepared statement of Mr. Belshe can be found on page 46 of the appendix.]

Chairman HILL. Thank you, sir. Dr. Evans, you are recognized for 5 minutes.

**STATEMENT OF TONYA M. EVANS, PROFESSOR, PENN STATE
DICKINSON LAW**

Ms. EVANS. Chairman Hill, Ranking Member Lynch, and distinguished members of the subcommittee, thank you for the opportunity to testify today about the current U.S. regulatory landscape as applied to emerging crypto asset ecosystems. I view today's hearing through a nonpartisan academic lens, and I accepted the invitation to help inform and calibrate the conversation about the current regulatory environment in this latest wave of financial and technological innovation in a \$1-trillion emerging market.

I also wish to express concerns about the future of America's leadership in innovation in this area when a powerful agency uses its broad discretionary powers on a piecemeal basis without also providing commensurate clarity for regulated parties or a fair opportunity for good-faith actors to understand the rules and the consequences that apply in an entire industry.

And I intend to also highlight the tremendous loss of wealth accumulation opportunities for communities of color, especially the Black community, if investment and innovation opportunities in the crypto asset ecosystem are driven offshore. Accordingly, as Congress considers how best to reevaluate its delegation of powers to the SEC, and whether to empower the CFTC further in some capacity, I offer three points to consider.

One, given that the heads of the SEC and the CFTC do not actually agree on the character and nature of whether and under what circumstances certain crypto assets, especially Ether, or commodities, or securities, reconsider bipartisan legislation across oversight committees that would clarify the taxonomy of crypto assets, limit unpredictable and incongruous executive agency actions, and consider empowering the CFTC to regulate spot crypto asset markets.

Two, ensure that all citizens, especially those who have been systemically marginalized, have equal access and opportunity to thrive safely, legally, and confidently in the future of wealth and innovation.

And three, request the SEC Chair to appear before congressional oversight committees to explain how its current practice of an aggressive piecemeal approach to regulation of crypto assets comports with the efficient and effective regulation, and how this practice aligns or doesn't align with the legislative mandate to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation.

I want to punctuate briefly my concerns that in this latest economic boom, systemically-marginalized populations will continue to be left behind under the well-intentioned guise of investor and consumer protections, as well as not so well-intentioned streams of fear, uncertainty, and doubt from legacy financial institutions and

other parties with a vested interest in seeing the crypto economy fail, that wealthy early adopters and legacy institutions protecting their high-net-worth clientele will again reap the upside risk and reward of early adoption, leaving another generation of systemically-marginalized people behind.

For example, legacy financial institutions have seized the early mover opportunity among their peers to innovate in delivering products and services in the digital future by leveraging blockchain technology or offering direct or indirect exposure. Despite public comments, injecting misguided narratives about crypto assets, major banking and financial institutions, like Deutsche Bank, Morgan Stanley, and even longtime bitcoin skeptic, JPMorgan Chase, have all recognized the value proposition of crypto and blockchain.

In conclusion, the technology provides an opportunity to include crypto assets taxed as capital assets in a portfolio, build new and innovative products for the decentralized web, re-skill to bring a legacy company into the future of innovation, prepare students for the future of work and industry, or to sit before this esteemed body today with a seat at the table to inform and influence the direction of legislation and the regulation of digital money. With every country, including the United States, working on its own protected sandbox of digital asset innovation, private markets deserve the same, to innovate safely, legally, and with clarity right here in the United States.

Again, thank you for this opportunity, and I look forward to your questions.

[The prepared statement of Dr. Evans can be found on page 50 of the appendix.]

Chairman HILL. Thank you, Dr. Evans.

Mr. Gould, you are now recognized for 5 minutes.

STATEMENT OF JONATHAN V. GOULD, PARTNER, JONES DAY

Mr. GOULD. Chairman Hill, Ranking Member Lynch, and members of the subcommittee, thank you for the opportunity to discuss the Administration's actions with respect to the digital asset ecosystem. I am speaking today solely in my personal capacity. I am not speaking on behalf of any clients or of my law firm. My testimony is my own.

Over the last 18 months, the Federal banking agencies have issued a number of public guidance documents. This guidance has articulated agency concerns with risks associated with digital asset activities of banks, expressed their skepticism that many of these activities can be conducted in a safe and sound manner, and imposed procedural barriers to their commencement. My written testimony summarizes these guidance documents. The pace and coordination of these issuances have increased this year, with two joint agency statements in as many months, and an important policy statement from the Federal Reserve.

As Congress considers the actions of the Federal banking agencies, there are three attributes of bank supervision that I would like to highlight. First, bank supervision is, by design, confidential, particularized, and potent. Although the agency issuances I mentioned are public, their application is not. The confidential nature of this supervisory relationship facilitates the flow of information

between bank and regulator, but it can also frustrate accountability and oversight.

Second, safety and soundness. The primary lens through which these agency issuances are framed in the goal of prudential regulators like the OCC, the Federal Reserve, and the FDIC, can be a subjective concept. Banking agencies have issued thousands of pages of public, non-binding guidance detailing their interpretations of what safety and soundness means in a variety of contexts to help banks achieve it, and to facilitate consistency and the agencies' supervisory expectations and approach.

Finally, although agency guidance is technically non-binding, banks rarely challenge or disregard it. The practical consequences of doing so can be significant in light of the supervisory process through which guidance is applied. Given these attributes of bank supervision, generalized and negative statements raising safety and soundness concerns about particular industry sectors must be made carefully lest they be interpreted by the public or bank examiners as an outright prohibition.

Anecdotal evidence suggests that agency actions over the last 18 months, while responsive to developments in the digital asset ecosystem, are indeed having a chilling effect on banks' practical ability to engage in digital asset activities, as well as their willingness to entertain or maintain digital asset entities as banking customers. Because of the confidential nature of the supervisory relationship, it is impossible for the public to assess the actual causal effect of these agency actions.

There are several areas that would benefit from congressional attention. First, the agencies' actions might be disproportionate, whether in nature or magnitude, to the risks posed by digital assets. Relatedly, the strategy to address the risks posed by digital assets may be less than optimal. Risk elimination strategies are often less-effective over the long-term than risk management strategies, as the former tend to push financial risks into less-visible corners of the economy where our ability to monitor and manage it can be challenging.

Second, the agencies' actions might be overbroad and risk chilling innovative activities. Precluding banks from exploring new technologies, like distributed ledgers or decentralized networks, to achieve traditional banking activities, like payments or deposit taking, risks diminishing the important role played by banks in our economy.

Finally, safety and soundness pronouncements are, in some sense, a reflection of the agencies' risk tolerance for individual banks and the banking system as a whole. Congress should have a key role in defining the risk tolerance of our banking system, especially when it involves industry-specific attention, as seems to be the case here. And if it disagrees with the agencies' risk assessment or risk tolerance, it can and should do something about it.

The confidential nature of the supervisory relationship necessarily limits the public's ability to assess the actual effects of the banking agencies' guidance. Congress is not so limited. It has the oversight ability to move beyond anecdote to examine how these guidance documents are being implemented and their effect. Armed with this information, it can then make an informed decision about

the propriety or prudence of the banking agencies' actions. I encourage it to do so.

Thank you again for the opportunity to testify. I look forward to your questions.

[The prepared statement of Mr. Gould can be found on page 60 of the appendix.]

Chairman HILL. Thank you, Mr. Gould.

Mr. Grewal, you are now recognized for 5 minutes.

**STATEMENT OF PAUL GREWAL, CHIEF LEGAL OFFICER,
COINBASE GLOBAL, INC.**

Mr. GREWAL. Good afternoon. Thank you, Chairman Hill, Ranking Member Lynch, and members of the subcommittee for inviting me to testify today about how crypto can make our financial system better and why we need new rules for crypto. I also wish to express my appreciation to Full Committee Chairman McHenry and Ranking Member Waters.

My name is Paul Grewal, and I am the chief legal officer at Coinbase. Coinbase was founded in 2012 with a mission to increase economic freedom in the world and to be the most trusted, secure, and compliant onramp to the crypto economy. We are the largest crypto trading platform in the United States and became a public company on April 14, 2021. Our products enable tens of millions of consumers, institutions, and developers in the United States, and more around the world, to discover, transact, and engage with crypto and Web3 applications in a safe and reliable way.

Today, I would like to share with you three points that underscore the urgent need for sound rules for crypto. First, we need to update our financial system, and the time to act is now: 80 percent of Americans believe the financial system is unfair, and 67 percent believe it needs a serious upgrade. Crypto, along with the blockchain technology that underpins it, should be part of the solution. With 20 percent of Americans holding crypto today, the American people are voting with their feet and their wallets. They want a financial system that is easier, faster, and more efficient. They are already using crypto for payments because it is cheaper and more secure. They are sending remittances to family and friends in countries where the local currency is unstable, and creating a lifeline in places that are being torn apart by war.

In Ukraine, for example, the power of crypto is obvious. The country has embraced crypto to raise money for humanitarian efforts and to reduce stress on its financial system since the invasion by Russia. Simply put, crypto and blockchain technology are helping to make the financial system operate more efficiently and securely. With just a phone and an internet connection, Americans and individuals around the world can securely and safely transfer value or ownership.

Second, if we fail to adopt rules that both permit and foster this next-generation technology, the United States will lose its position as a global leader in finance. The rest of the world is not waiting for us. The European Union, the U.K., Australia, Hong Kong, and Singapore, just to name a few, are putting in place regulatory frameworks that are creating high standards for crypto. America seems to be the only developed country dragging its feet. As other

countries are bringing crypto safely into the regulatory perimeter, we should be doing the same. We should not be pushing it into the shadows and hoping it will simply go away. It will not go away. Crypto is built on a transformational technology that consumers want and innovators know can make our financial system better. This is a race to the top that the United States cannot afford to lose.

Third, we need to protect consumers. Emerging technologies can attract bad actors, and crypto has seen its fair share. We need a regulatory framework that promotes the benefits of crypto, while keeping people safe. On this, we do not need to compromise. For our part, Coinbase has embraced consumer protection and regulation for over a decade. We protect consumers by prioritizing prudent risk management, employing rigorous standards for listing digital assets, and fighting every day against illicit finance, market manipulation, and fraud.

Let me be clear: Coinbase fully complies with all sanctions and all anti-money laundering rules in the United States and abroad. We work tirelessly with law enforcement and have built and continue to build industry-leading tools to help find and stop criminals. We also protect customers through transparency. As a public company, we disclose audited financial statements, our methods for safeguarding customer assets, our business operations, and any risk factors as part of our quarterly reporting that makes Coinbase distinct in the crypto economy.

But transparency is not enough. We need clear rules that work. To that end, last July we filed a petition for rulemaking with the SEC. We provided 50 questions that need to be answered to create a registration pathway for crypto developers and trading platforms like Coinbase. These regulatory issues are complex, and Americans are best-served by having the opportunity to engage with their government on decisions that affect their everyday lives.

Although the SEC could resolve these questions under existing authority, we also urge Congress to act. The 20 percent of Americans who already own crypto need clear rules just as much as Coinbase and the rest of the industry. Legislation should contain strong consumer and investor protection standards for digital asset intermediaries, create a registration pathway for offering digital assets securities and non-securities, and develop a comprehensive framework for stablecoins.

In closing, we need to get the rules right for crypto. Imagine if the United States failed to embrace the transformational potential of the internet in the 1990s or smartphones in the 2000s. Without pro-innovation regulation, we live in a far less connected, enriching, and dynamic place. This is the approach we need to take with crypto. We don't want to be looking back and thinking, "What if?"

I look forward to answering all of your questions. Thank you.

[The prepared statement of Mr. Grewal can be found on page 65 of the appendix.]

Chairman HILL. Thank you, Mr. Grewal.

And Mr. Reiners, you are now recognized for 5 minutes.

**STATEMENT OF LEE REINERS, POLICY DIRECTOR, DUKE
FINANCIAL ECONOMICS CENTER, DUKE UNIVERSITY**

Mr. REINERS. Chairman Hill, Ranking Member Lynch, and distinguished members of the subcommittee, thank you for inviting me to testify in today's hearing. My name is Lee Reiners, and I am the policy director at the Duke Financial Economics Center, and a lecturing fellow at Duke Law. At Duke, I teach courses in cryptocurrency law and policy, and financial regulation. Prior to entering academia, I spent 5 years examining systemically-important financial institutions at the Federal Reserve Bank of New York.

The title of today's hearing implies that the main impediment to the growth and success of the digital asset or crypto industry is regulation, specifically overzealous enforcement by existing financial regulatory agencies, but I would argue that the crypto industry's main problem is the product it is selling. Cryptocurrency is wholly unconnected to the productive purpose that defines finance, which is helping businesses, individuals, and governments raise, save, transmit, and use money for socially- and economically-useful ends. This leaves you with an asset class with no fundamentals that trades entirely on sentiment. In fact, I have repeatedly asked crypto proponents to explain their valuation methodology to me, and I have yet to receive a straight answer.

Despite this inherent flaw with their product, and the fragilities revealed by the implosion of FTX, and multiple other crypto entities over the past year, the crypto industry wants us to believe that their salvation lies in Congress granting them, "regulatory clarity," but regulation is not some magical pixie dust you can sprinkle on an asset class and transform its fundamental essence. The truth is that the crypto industry wants the same thing as every industry that came before: light touch regulation and favorable taxation.

Most of the crypto industries' ire is directed towards the SEC for simply doing its job. It is important to remember that Congress intentionally crafted our securities laws to be principles-based. In the seminal case, *SEC v. Howey*, the Supreme Court found that, "the term, 'investment contract,' embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who see the use of the money of others on the promise of profits." Cryptocurrency and blockchain technology are simply the latest scheme deployed by those seeking to profit from other people's money.

And despite the industry's claims, the SEC has been clear and consistent about crypto, dating to the chairmanship of Jay Clayton. Both Chair Clayton, and his successor, Chair Gensler, have said that most cryptocurrencies are securities that need to be registered with the Commission. The SEC has also brought over 130 cryptocurrency-related enforcement actions, and they have yet to lose a single case.

For any neutral observer, the law is very clear: The SEC is not a merit-based regulator. Anyone can raise money from the public regardless of how bad the business idea may be, provided they register with the Commission and disclose the relevant risks to prospective investors. However, the entity must have something to disclose if they are to register.

Imagine if a corporation approached the SEC because they wanted to do an IPO of common stock, but the company had no cash flows or a credible plan to generate cash flows, no audited financial statements, and the stock it was selling conferred no legal rights on the purchaser. If the SEC told that corporation that it wasn't ready to sell to the public markets, would you say that the SEC was acting inappropriately? Incredibly, many token issuers and crypto firms who fit this example claim that the SEC is treating them unfairly.

I applaud the SEC and other financial regulatory agencies for enforcing the law. However, more must be done. While I agree with Chairman Gensler that most cryptocurrencies are securities that are subject to registration and disclosure requirements, some cryptocurrencies are most likely commodities. While the CFTC regulates commodity derivatives, they do not regulate commodity spot markets. The practical effect of this structure is that cryptocurrency exchanges in the U.S. are presently not regulated at the Federal level.

In my written testimony, I provide a detailed roadmap for how Congress can close this gap by carving out cryptocurrency from the definition of, "commodity," in the Commodity Exchange Act, and recognizing cryptocurrencies as securities under special definition to the securities laws. This will give the SEC exclusive authority to regulate all aspects of the crypto industry. I realize that giving the SEC additional authority under its present leadership is unpalatable to some members of this committee. However, SEC Chairs come and go. The American people are looking to Congress to exercise foresight in determining how to regulate the crypto industry for the long term. The SEC was endowed with a mandate to protect investors, and investor protections are sorely lacking in crypto markets.

I appreciate the committee's focus on this crucial task, but it is worth noting that this is not a race. As you know, passing financial regulatory legislation is hard, and once in place, it tends not to change, absent some future crisis. I look forward to working with you to make sure we get it right the first time. Thank you.

[The prepared statement of Mr. Reiners can be found on page 124 of the appendix.]

Chairman HILL. I appreciate your testimony. We will now turn to Members' questions, and I will first recognize myself for 5 minutes.

First, let me say thanks to the panel. It is an excellent, diverse set of views on a very complicated subject, so all of you have been very helpful to our committee. We are grateful for that. And even inside a regulated framework, we have huge dislocation and the potential for malfeasance, fraud, and there is just plain mismanagement. Look at the dot-com boom, which was fully under the scope of the SEC, between March of 2000 and October of 2002, and \$5 trillion was lost by people who followed the rules effectively. I am excluding WorldCom and Enron in that pure fraud; I am just talking about how Mr. Reiners is not buying his pets on Pets.com.

And then, you go to the next crisis in our society, which was the mortgage crisis created by the policies of the Bush and Clinton Administrations for housing, fully under the most-regulated thing on

the planet, and yet it was taken advantage of, and there were huge losses that led to the crisis. So, we all recognize that inside or outside a regulatory framework, we can still have huge financial challenges and criminal issues as well. And in my view, you are better off with that regulatory framework, and I think each of you have given your perspective on that.

SEC Chair Gensler has insisted that the SEC's 2019 Framework provides sufficient clarity now for market participants to apply the securities laws to the digital asset ecosystem. And he has repeated on his routine CNBC appearances and other television appearances that one just has to come in and register, which is sort of a theme for him, and that he will work with them. And that is how it is going to be since 2019, and it has been effective.

Let me start with you, Mr. Grewal. You are the chief legal officer for one of the largest and most recognized platforms. What does that look like in practice? Is there a path for companies to come in and register as a national securities exchange?

Mr. GREWAL. Thank you, Chairman Hill. The answer to your question is, at present, no, and I say so definitively because Coinbase very much wishes to register with the SEC. We do not currently list digital asset securities, but we have a great interest in making these products and services available to Americans who want them. In order to be able to do that, a national security exchange registration must be made available. Perhaps alternatively, a broker-dealer or ATS alternative might be considered. But in either case, we have not been able to successfully register with the SEC, despite our best efforts and despite conversations with the Commission that go back now many, many months.

Chairman HILL. Thank you for that. How about BitGo's experience, Mr. Belshe? How was your experience with, "come in and visit?" And can you come in and register, in your experience?

Mr. BELSHE. As I mentioned in my testimony, we did visit the SEC all the way back in 2018. It is worth noting that this is not the current Administration's SEC, this was the prior Administration's SEC, so the problem is not any specific Administration. It is actually systemic to just getting questions answered. The basic question of how should those covered by the Investment Advisers Act have custody obviously should be answered.

A second point to note is that the common problem around ruling by enforcement as opposed to ruling by direct answering of what is allowed and what is not. Recent enforcement actions around staking as a service left the entire industry confused. We can see, in an enforcement action, a long list of potential problems that the SEC might have with that particular product, but we can't tell exactly which parts of that were specifically problematic and if any of those parts of that service were acceptable behaviors.

Chairman HILL. Thank you. Let me turn to Mr. Gould, and let's switch subjects. I think that come in and register is not quite as straightforward as perhaps it is being presented by the Commission. Mr. Gould, I am looking at the American Bankers Association statement for the record: "Prudential regulators have instructed banks to proceed in the digital asset ecosystem with extreme caution, requiring advanced supervisory notice and formal approval." And yet, it says that banking agencies are not prohibited or dis-

couraged from providing banking services to customers. That seems kind of contradictory to me. You referenced risk elimination versus risk management, so as a former Comptroller, how should the banking agencies look at that?

Mr. GOULD. The way I think about safety and soundness guidance is that it provides a path, one path to get to how to do the activity and perform the activity in a safe and sound manner. I think a lot of the guidance that we are seeing is more negatively-phrased. It is focusing on kind of the risks associated, but it is not necessarily showing any kind of credible path to actually be able to perform whatever the activity is in a safe and sound manner.

Chairman HILL. Thank you. My time has expired. And I recognize the ranking member of the subcommittee, Mr. Lynch, for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman. Mr. Reiners, we hear that it has been suggested that the, “come on in and register,” model does not work. Are there deeper reasons in your mind as to why these crypto firms are unwilling to come in and register with the SEC?

Mr. REINERS. Yes. Thank you, Congressman. It is important to note that the crypto industry, despite knowing the rules, has willfully chosen to operate outside the regulatory perimeter. I think the main reason that they haven’t come in and been registered is because it would be unprofitable for them to do so. When you look at crypto platforms or exchanges, how they are currently structured, that model is not allowed in traditional securities markets. You cannot be the broker, the exchange, the market maker, the clearing agent, the custodian, and in some cases, they have venture arms that are investing in tokens that they end up listing. You can’t do that. The national securities exchange has to make themselves open to registered broker-dealers. So, the reason that they are not, “coming in and registering,” is because it would be unprofitable for them to do so. And they are trying to convince you and the public that the SEC is acting unfairly and arbitrarily when they are making a deliberate choice.

Mr. LYNCH. Let me go to that point. As you mentioned, both the former Chair, Chair Clayton, and the current Chair, Chair Gensler, have both taken basically the exact same position with respect to cryptocurrencies, well, most of them, the vast majority of them as securities. So, there has been no difference in terms of Mr. Clayton’s position, who was appointed by a Republican Administration, and Mr. Gensler, who was appointed by President Biden.

The underlying mission of the SEC, the reason it was created was to provide a counterbalance to the asymmetry between investors and the industry itself. There was an asymmetry of information and knowledge, expertise between a customer or an investor and the seller of that security, which is what triggers the whole requirement for disclosure.

From my own experience in trying to investigate some of these cryptocurrencies and stablecoins, sometimes it is nothing more than a very, very technical—and I have an engineering degree—White Paper, and that is it. That is it for the average person who wants to invest in some of these products. Following the collapse of FTX, a lot of the crypto players attempted to distance them-

selves by claiming that FTX was the bad apple, but until that point, up until their collapse, they were actually sort of the model. They were actually an industry leader. And I am just wondering, if you share the concerns, could you speak to the potential future risks that can occur in this space if this activity continues to go unregulated?

Mr. REINERS. FTX was just one of many bad apples. I would suggest that the entire industry is rotten, frankly, and we are going to see more unless we bring this industry inside the regulatory perimeter. We are going to continue to see more everyday Americans get harmed by crypto platforms and crypto firms. FTX, the crypto industry likes to point out, is just like you said, "a bad apple." This is not an indictment of crypto with underlying blockchain technology, but it was all made possible by crypto.

FTX was founded in 2019, and 3 years later, at the time of its failure, it was worth \$32 billion. That is only possible with crypto, where you can just mint tokens out of thin air. And when you look at how the FTX fraud was run, it was the FTT exchange token that was underpinning the whole thing. Alameda Research was borrowing customer assets from FTX, using FTT, a token that FTX created out of thin air, as collateral, and when users were withdrawing their funds from the platform, FTX was selling FTT. The moment that the Binance CEO, Changpeng Zhao, tweeted that he was selling his stash of FTT, the game was over. So, crypto and the unique nature of crypto was what fueled FTX's rise, and it is what made FTX collapse in the blink of an eye.

Mr. LYNCH. Thank you, Mr. Chairman. My time has expired, and I yield back.

Chairman HILL. I thank the ranking member.

I now turn to the distinguished ranking member of the full Financial Services Committee, my friend, Ms. Waters, for 5 minutes for her questions.

Ms. WATERS. Thank you very much, Mr. Hill. Mr. Reiners, recently, Full Committee Chairman McHenry and Subcommittee Chair Huizenga sent a letter to SEC Chair Gensler demanding records and communications between the SEC's Enforcement Division and the Justice Department regarding charges against FTX founder, Sam Bankman-Fried, and his subsequent arrest. I was deeply perplexed by this approach from our Republican leadership, as the bad actor here is not the SEC, but Mr. Bankman-Fried and his colleagues. When I was the Chair of the Full Committee, we regularly brought in the heads of companies to answer to Congress. It is this reason that I wrote to Chairman McHenry urging him to compel testimony from Sam Bankman-Fried as soon as possible. Was it wrong for the SEC to bring a civil enforcement against him, Sam Bankman-Fried, for harming U.S. investors? Was the SEC wrong for doing its job?

Mr. REINERS. Not at all, and I applaud the SEC, as well as the CFTC, for bringing enforcement actions very quickly. And I also should give credit to the Department of Justice and the Southern District of New York for bringing criminal charges very, very quickly. Sam Bankman-Fried will have his day in court, and we will learn more about what happened during that time, but I think

the authorities acted very quickly and very aggressively, and rightfully so.

Ms. WATERS. Okay. Let me continue. Last month, the OCC, along with the Fed and the FDIC, released a joint statement on the liquidity risks to banks resulting from crypto market vulnerabilities, including examples of effective risk mismanagement practices. Nevertheless, the California Department of Financial Protection and Innovation announced that Silvergate Bank, a prominent banking partner for crypto companies, had voluntarily begun the process of liquidation. This came after the collapse of FTX, which led to a run on Silvergate late last year. It seems to me that these developments validate the bank regulators in expressing caution, the banks dealing with crypto currencies. Do you agree?

Mr. REINERS. I do agree, and I think this is another example of the banking agency simply doing their job and enforcing their safety and soundness mandate.

Ms. WATERS. I want you to know that when I became chairwoman, we took a close look at Facebook as it tried to launch its own global Stablecoin, which it called Libra, if you remember. When Mark Zuckerberg testified before our committee, I challenged him to not proceed with their project unless they had regulatory approval to do so. Later on, Facebook tried to partner with Silvergate Bank, but Treasury Secretary Janet Yellen opposed this, and Facebook subsequently folded its operation. So given the problems that Silvergate Bank and the crypto market are now facing, had Facebook been approved back then, I wonder whether millions of additional investors could have lost their money? In light of these lessons we are learning, Mr. Reiners, do you believe regulators are overreaching in their cautious approach towards crypto currencies?

Mr. REINERS. Not at all, and I appreciate your focus a few years ago, Ranking Member Waters, on Facebook's Libra project. I think the main reason it generated so much attention was Facebook's scale. We still live in a fiat currency world. If you use crypto, at some point, you are going to have to cash out. That is where we can enforce regulation, and that is where I think this committee's focus should be. But because Facebook has over 2 billion active monthly users across its suite of products—Instagram, Messenger, WhatsApp—there was the real possibility that people could be essentially living their lives in Libra, and maybe someday, in Mark Zuckerberg's version of the metaverse, they will be again, I don't know.

But the reason that Facebook ultimately backed down was because of political pressure and the focus that you and many others here put on them. But from my vantage point, there were really no legal or regulatory restrictions that forced them or required them to back down. So I think as this committee moves forward and thinks about how to regulate crypto, it is very clear that we should button that up and not allow these Big Tech companies to issue stablecoins or something similar.

Ms. WATERS. I have to yield back, but let me just say, you said you had some recommendations that you are letting us have access to, and I would love to take a look at those, and then talk with you.

Thank you. I yield back the balance of my time, and thank you, Chairman Hill.

Chairman HILL. The gentlewoman yields back. Now, we will turn to the gentleman from Oklahoma, Mr. Lucas, for 5 minutes.

Mr. LUCAS. Thank you, Chairman Hill, for holding this hearing, the first of the Digital Assets Subcommittee. And I look forward to working with you, and Ranking Member Lynch, and the rest of the subcommittee as we look to bring much-needed regulatory clarity to the digital assets arena.

I would first like to focus on the SEC's regulatory approach. The SEC has decided the best way to communicate on what the law is regarding digital assets is through enforcement actions. The SEC contends that digital asset intermediaries can simply go in and register, while at the same time not giving real guidance or any indication of what a special registration process looks like. More practical, I should say. Someone called it special. Professor Evans, could you discuss how to square the SEC's enforcement approach with its mandate to protect investors and maintain fair, orderly, and efficient markets, please?

Ms. EVANS. Yes, thank you for the question. In thinking about the mandate for the SEC and regulating, and encouraging, and supporting orderly markets, they have quite broad discretion, as you know, and part of that discretion is the ability to leverage the full power that it has. Obviously, Congress cannot become a subject matter expert on everything, and so when delegating your legislative authority to an agency, you are trusting them to use that discretion wisely.

Part of that process is also the ability to leverage the tools that they have at their disposal. That is, the adjudication procedure and also rulemaking to selectively use adjudication and to select the actual parties or regulated interests that they would focus on leaves the rest of the industry to wonder, because it is case-by-case rather than the broad rulemaking or even guidance that would give some perspective to the ecosystem.

Mr. LUCAS. Many of the legislative proposals to provide clarity in this space grant the Commodity Futures Trading Commission (CFTC) spot market authority over crypto. Since the CFTC was first established through the Commodity Futures Trading Commission Act of 1974, the agency has been a principles-based regulator. This principles-based approach is fundamental to the CFTC's regulatory framework, which enables it to be an innovative and proactive regulator. Now, with that said, jurisdiction over the spot market authority deserves a robust conversation around what is best for investors, consumers, and even the agencies.

Mr. Grewal, could you share your thoughts on where spot market authority for crypto assets should belong?

Mr. GREWAL. Thank you very much, Congressman. You are correct in identifying that spot market authority for crypto assets currently represents a gap in the overall legislative landscape. We would certainly support any legislation which made clear that the CFTC had such authority in order to enforce and establish those principles which are appropriate for the spot market.

Mr. LUCAS. Professor Evans, would you like to tackle this question as well?

Ms. EVANS. There is a clear gap, a concerning one, when you think of the nature of programmable currency that can change form from commodity to security during the life cycle of a currency, to be sure. So, ensuring that there is no gap between derivatives markets on the commodity side and the securities market is critical.

Mr. LUCAS. Yesterday, after months of uncertainty, a major lender in the crypto industry, Silvergate, announced it would be winding down and liquidating its bank.

Mr. Grewal, there is real anxiety about crypto market downturns like we are currently experiencing having an impact on the traditional financial sector. Can you speak to this concern?

Mr. GREWAL. Congressman, I appreciate the question. The concern is real, and important, and, of course, legitimate. With respect to Silvergate, we were certainly made aware, as was the rest of the market, that it had made the voluntary decision to wind down operations this week. Prior to this, Coinbase executed a longstanding plan for the orderly disposition of corporate and customer funds, so we have no particular exposure to that bank at present.

But the issue generally of crypto firms, and exposure to banks which may be at risk, is an important one. We think transparency offers the solution here. It is very, very important for investors and for market regulators to understand what these risks are, what exposure individual firms may have, and, of course, most importantly, for firms to have prudent risk management plans in place so that in the event of a failure, a wind-down, or anything else, customer funds are always kept safe. And that is exactly what we think could happen as part of not only legislation, but regulatory oversight pursuant to rulemaking.

Mr. LUCAS. My time has expired. Thank you, Mr. Chairman.

Chairman HILL. Thank you, Mr. Lucas.

The Chair now recognizes the distinguished ranking member of the subcommittee, my friend, Dr. Foster, for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman, and thank you to our witnesses. A little more than a year ago, when we had Sam Bankman-Fried and various crypto luminaries in front of this committee, I asked them what I considered the foundational question about crypto assets, which is that if we wish to prevent crypto assets from being used for ransomware, if we wish to prevent wash trades and other market manipulation, is there any alternative to having every crypto transaction ultimately associated with a traceable legal identity issued by a country with which we have extradition treaties? And their answer at the time was, no, that this was necessary if you are going to have self-custody, and if you are going to allow self-custody and permissionless transactions, you will have ransomware, and you will not be able to prevent wash trades.

Has anything changed in the last year? Is there a magic technology that would allow us to prevent crypto assets from being used for ransomware and so on that does not rely on having ultimately a traceable legal identity, a license plate, if you will, on every crypto wallet? Just for the record, no one volunteered such a magic technology.

Yes, Mr. Reiners, are you aware of one?

Mr. REINERS. I am not aware, other than if you have every country in the world comply with the guidance put out by the Financial Action Task Force (FATF) around preventing crypto from being used by money launderers, ransomware hackers and whatnot, but we know that is not happening. And when it comes to ransomware, really, all roads lead to Russia. I think Chainalysis has said that over 70 percent of ransomware proceeds ultimately get cashed out in Russia. And certainly, the Office of Foreign Assets Control (OFAC) has ramped up its designation activity when it comes to those Russian-based exchanges, but, again, it is very easy to open a new one.

Mr. FOSTER. Yes, that is right. It is a lack of a legally-traceable identity from a country with which we have extradition treaties. That is where the rubber hits the road on this, so it is interesting that that has not changed. The way I view this is, just imagine that we are at the birth of the automobile industry, and someone says, I have this great new product called the automobile, but if you ask me to put license plates on the automobile, if you ask for a driver's license for operators, you will crush innovation. And the exact opposite is actually true, that it was essential to the healthy development of the automobile industry that we have this system of license plates, of driver's license, of VIN numbers to prevent theft in vehicles and vehicle parts, so all of this, and it is something that is recognized by every civilized country. And an analogous licensing regime is certainly technically possible.

I had a discussion yesterday with Mr. Grewal about this, and you recognize its utility and its feasibility, and it is simply that when you want to possess a crypto asset, you say, okay, get it in your wallet, and I will go register your wallet using a secure digital ID, mobile driver's license, or passport, or something like that, to register yourself in that wallet. And it can be a secret number, it can be cryptographically-secured, but sort of like James Bond's rotating license plates, if you remember the movie, but that would allow you to have the same guarantee that you have with cars, that normally when you are driving down the road, you have no idea who is in the car next to you, but you know that there is a valid license plate on it. And you know that if they come into your neighborhood and they run over your dog, you can go to a judge, prove a crime has been committed, and drag that person into court for running over your dog or whatever. And this has been essential, and it would be completely unacceptable to live in a world where automobiles could drive through your neighborhood or cross international borders with unlicensed operators and unlicensed cars.

And this is the essential thing that has to be provided for the healthy development of the crypto industry. Somewhere, there has to be an Application Programming Interface (API) provided by a trusted third party to register your crypto wallets, and then at that point, it can be anonymous and everything else. But that is, I think, the essential ingredient that we have to come to terms with and where I hope this Congress eventually settles as the only way to prevent these from being used for ransomware, market manipulation, you name it. Does anyone have thoughts on this?

I will start with Mr. Grewal. You have had 18 hours to think about this concept.

Mr. GREWAL. Thank you, Congressman. I appreciate the opportunity to think another hour or two about this very important subject. What you are describing, sir, of course is the critical importance of attribution so that we can link illicit activity or other activity, which is properly the subject of government action or civil law action, to individuals. I would also call out and underscore two other points in your comments, which I think are important to any system, which makes sense, court supervision or appropriate government oversight in an independent branch. I think that is critical. You mentioned the importance of extradition from countries with which we have treaties. The point is that we need to be able to, through legal process, link illicit activity to actors who are responsible for that activity.

We think there is a way to do this technically that does not involve the mass collection of personally-identifiable information. I do not think that is what your comments or questions were suggesting, but I think that is important as well so we can strike the right balance between personal privacy and holding people accountable for committing illegal activity.

Mr. FOSTER. Thank you.

Chairman HILL. The gentleman's time has expired. We now recognize the gentleman from Minnesota, Mr. Emmer, who is also the Majority Whip of the U.S. House, for 5 minutes.

Mr. EMMER. Thank you, Chairman Hill and Ranking Member Lynch, for holding this important hearing today, and thank you again to our witnesses for your testimony.

Crypto technology is shifting economic power from centralized institutions back into the hands of the people. It is transformational, and it can be threatening to unelected bureaucrats and, quite frankly, some elected people here in Washington, D.C. This threat is most saliently observed through several recent administrative actions. On January 3, 2023, the Fed, the FDIC, and the OCC issued a statement discouraging banks from holding crypto or servicing crypto clients on a, "safety and soundness basis." On February 7, 2023, the Federal Reserve published a statement in the Federal Register, seemingly turning this perspective into a final rule without following the public comment process outlined in the Administrative Procedure Act.

In the midst of this, on January 27, 2023, the White House National Economic Council published the Administration's roadmap to mitigate cryptocurrency risks. This report summarizes President Biden's political plan to lawlessly abuse the administrative state to push American crypto firms and their United States customers into offshore, unregulated, opaque, and unsafe markets.

These recent actions are an explicit display of what Congress and the American people already noticed: This Administration is weaponizing the banking sector to de-bank legal crypto activity here in the U.S., using scare tactics to run an entire industry out of the country. And the collapse of FTX should warn us of the vulnerable position we are putting American consumers in when we do not compete to keep crypto firms onshore. Clearly, the Administration's policies are motivated by a thirst for increased control over the American people, because here in Congress, crypto is not

partisan. Republicans and Democrats have an 8-year history of working productively together on solutions to this space.

Mr. Gould, no regulator has understood the importance of unlocking access to financial services for crypto companies better than the OCC, under Brian Brooks. Of course, you did great work on that team, so I am going to ask you a series of questions that will, I hope, assist our committee's work. First, in your view, is the Administration's regulatory posture towards digital assets encouraging or discouraging financial institutions from offering services to digital asset firms?

Mr. GOULD. Discouraging.

Mr. EMMER. In your view, is the Administration's regulatory posture towards digital assets encouraging or discouraging financial institutions from innovating themselves, and offering digital asset products and services to their clients?

Mr. GOULD. Discouraging.

Mr. EMMER. As it concerns innovation and consumers, what is the potential impact of the Administration's negative wide-ranging statements on safety and soundness with financial institutions engaging in digital asset activities?

Mr. GOULD. One possible consequence is that it drives it into less-visible areas of our economy where we can't monitor it. We can't manage the risks associated with it. Another possible outcome is that it increases the technology gap between the larger banks, which continue to invest and expand in technology versus the smaller banks, which, frankly, do not have the same resources and aren't able to pursue as aggressively investments in technology.

Mr. EMMER. Can you please give us an example of when an Administration has taken this type of regulatory posture toward an industry in the past, and what the effects were?

Mr. GOULD. Many people have suggested that it is similar to what happened with Operation Choke Point, but there are important differences. Number one is that what the Administration is doing currently is transparent, at least to the extent you can do that within the confidential supervisory system. They have been very clear, to their credit, on what their views are and what their concerns are.

Number two, I think it is different from Operation Choke Point in the sense that, as I understood Choke Point, it was more focused on discouraging banks from banking in certain industry sectors. This is actually broader than that because this also applies to essentially discourage existing banks from exploring new technologies, including digital assets.

Mr. EMMER. Thank you. This Administration's attempt to de-bank the crypto community and prevent financial institutions from offering digital asset products and services to customers is a lazy and destructive regulatory strategy that is already chilling innovation and subjecting users of digital assets to less-sophisticated jurisdictions that are not equipped to manage the potential risks. Again, I appreciate everybody being here today, and hopefully we are going to do some productive work going forward.

Thank you, Mr. Chairman. I yield back.

Chairman HILL. The gentleman yields back. I will now recognize the gentleman from New York, Mr. Torres, for 5 minutes.

Mr. TORRES. Thank you, Mr. Chairman. The lesson learned from the FTX collapse is that companies like FTX—offshore, deregulated, centralized, overleveraged companies—have the highest risk of losing customer funds and defrauding their customers.

My first question is for Mr. Belshe regarding the enforcement priorities of the SEC. Is the SEC prioritizing enforcement actions against the worst actors like FTX—offshore, deregulated, overleveraged, centralized actors—or is the SEC taking action against companies that are the opposite of FTX, onshore regulated companies?

Mr. BELSHE. I am not aware of any actions that the SEC took against FTX or Sam Bankman-Fried prior to its collapse, so you have to argue that it is the latter, that it is actually the folks are trying to do it right. And you do have to wonder if we couldn't have avoided the massive amounts of money that flowed to FTX if the basic principle of a bitcoin exchange-traded fund (ETF) had been provided and approved by the SEC when there had been 25-plus valid applications, some from Invesco and other reputable firms who have done ETFs for many years in the past.

Mr. TORRES. The CFTC and the SEC seem to be engaged in a regulatory turf war over digital assets. In December 2022, the CFTC, in a court filing, declared Ether to be a commodity. Yet in February 2023, SEC Chair Gary Gensler, in an interview with New York Magazine, disagreed with the CFTC, declaring everything other than bitcoin to be a security.

Mr. Grewal, is it fair to say that the mixed messaging from the SEC and the CFTC and the regulatory confusion it creates underscores the need for Congress to step in and bring legal clarity to the status of digital assets?

Mr. GREWAL. I believe it does underscore that point, Congressman Torres. As you point out, if the Chairs of two of the most important regulators applicable to our industry and to this part of the economy can't agree on the security status of one particular token, that obviously speaks to the challenge for anyone else looking to stay on the right side of the rules and make proper determinations that are in accordance with legal expectations. That is a long way of saying, yes, sir.

Mr. TORRES. Bloomberg Opinion writer, Matt Levine, who is no crypto cheerleader, made the following observation about the SEC's approach to regulating crypto: "The SEC is being ruthless and creative about exploiting legal provisions to expand its powers, and the industry seems to be playing catch-up." What Mr. Levine describes as Chair Gensler's creative use of his authority led him to declare Ether as a security and stablecoin as a security, even though neither one clearly constitutes a security under the Howey test.

The Howey test has four criteria, as I understand it, including an investment of money in a common enterprise with the expectation of profit to be derived from the efforts of others. When it comes to a stablecoin, one might wonder, where is the expectation of profit? If I buy a stablecoin pegged to the U.S. dollar, I am not buying it because I expect the profit. I am buying it in order to use that stablecoin as a digital dollar on the blockchain. Is that a fair assessment, or am I missing something, Mr. Grewal?

Mr. GREWAL. I think that is a fair assessment, Congressman Torres. It is absolutely the case that USD-backed stablecoins, such as those that you described, come with no expectations of profit. There may be other problems with the Howey test, but of course, that one fatal flaw renders it anything but a security.

Mr. TORRES. And, Mr. Belshe, when it comes to Ether, where is the centralization? What is the central entity from whose efforts I, as an investor, would expect to derive profits with respect to a decentralized asset like Ether?

Mr. BELSHE. I think the determinations for this will have to be argued kind of from both sides. It shows that decentralization is something that forms over time. It shows that the determination of these assets is clearly not clear at all. Perhaps bitcoin, when it was started by one guy, was centralized, and yet today, no one argues that it is centralized, and the same thing applies for any new innovation. Some sort of incubation period where something can grow from a centralized status to decentralized seems warranted, and this is unique to digital assets.

Mr. TORRES. I actually want to address that question to Coinbase. Are there assets that could begin as securities and then morph into something else as it becomes decentralized? The example would be Ether, that it was likely a security at the time of an initial coin offering (ICO), but has become decentralized over time. What do you think of that analysis?

Mr. GREWAL. Speaking generally, Congressman Torres, I agree that assets can change character over time, and to be completely fair, I suppose it is equally true that an asset that began as a commodity might evolve into security in some form as well. But certainly, assets which are centralized, which are controlled by a managerial group, can, over time, decentralize in ways that would take them clearly outside of any reasonable understanding of the definition of a security.

Chairman HILL. The gentleman from New York yields back.

We now turn to the Vice Chair of the subcommittee, Mr. Davidson, who is also the Chair of our Housing and Insurance Subcommittee, for 5 minutes.

Mr. DAVIDSON. I thank the chairman, I thank our witnesses, and I am excited to finally have this subcommittee in existence. And to have this hearing; as someone who has basically pleaded for this day since 2017, it is pretty exciting. On the other side, as somebody who has paid attention to this space, essentially since I got on the committee 6 years ago, it is painful to hear arguments that we have worked through in industry, and with legislators, and regulators since that time, and yet no actions happen. We have legislation that has been drafted on the shelves for years, and people in the industry are publicly and privately coming in and asking, when are we going to actually get something done?

I will admit I am a little dismayed when I hear some of my colleagues essentially continue to push, either purposefully or through ignorance, an idea that these assets are the same things as a centrally-managed, centrally-controlled database, when the entire computing architecture of this space structures it differently so that you cannot have the same type of compliance tools in every application. You cannot have the same effect. You have to comply with it

differently. And as we talk about that, it is great to kind of bridge the divide, close the, “We do not understand it” arguments, and just let people be exposed for the positions that they have.

Towards that end, I ask unanimous consent to submit for the record statements from the Club for Growth, the Blockchain Association, the Chamber of Digital Commerce, the Crypto Council for Innovation, and the National Association of Federally-Insured Credit Unions.

Chairman HILL. Without objection, it is so ordered.

Mr. DAVIDSON. I thank the chairman, and I just would ask Professor Evans, does the Securities and Exchange Commission regulate the payment system or securities?

Ms. EVANS. Clearly, securities.

Mr. DAVIDSON. Thank you. And the legal clarity that we are seeking, frankly, wants to make sure that investors, innovators, and regulators, like Chairman Gary Gensler, also know that the Securities and Exchange Commission does not regulate the payment system.

Mr. Grewal, the CEO of Coinbase, Mr. Armstrong, has made comments in the past in support of individuals moving crypto assets off exchanges and to self-hosted wallet, self-custody. Do you believe that protecting their customers’ ability to eliminate third-party risk through self-custody is an important first step in consumer protection?

Mr. GREWAL. I do, Congressman, yes.

Mr. DAVIDSON. So for people who were caught in bad investments in the past, because this area has been unregulated, and people have been abusive, and have outright misrepresented things, if they had custody of the assets and it was in their possession, what was their risk if the centrally-managed unit collapsed or went bankrupt?

Mr. GREWAL. There would be none, Congressman.

Mr. DAVIDSON. Because they actually own their property. It is sort of like if the bank goes out of business and you have all your cash, even if you have an account with the bank, well, you didn’t lose any money because you had your cash. Now, not everyone is going to choose to do that, but we certainly should not prohibit it. Just like cash, we have made it almost illegal, but not entirely, and in this space, we have people who are overtly trying to make self-custody illegal.

Mr. Grewal, how does Coinbase work to prevent market manipulation, fraud, or conflicts of interest, things that would be barriers to making the spot market function?

Mr. GREWAL. Congressman, we have important policies and procedures to address each of those concerns, but our programs go far beyond just what we write down in paper. We have transaction monitoring systems. We also monitor for inside activity. All of these things are aimed at identifying behavior that would give concern not only to regulators, to lawmakers such as yourself, but to Coinbase itself because our entire business proposition, our entire value for our customers is grounded in trust.

Mr. DAVIDSON. Yes. Thank you for that, and maybe particularly so now as a publicly-traded company, so I thank you for that. I think it is important to address one of the issues in the space with

Silvergate. I wish I had time to go into depth with some of the questions, but fundamentally, the run on their assets was precipitated by fraud. The shiny object was digital assets and crypto that led people to create accounts in relationships with FTX, but does anyone care to comment on, why did FTX fail? Was it because they held digital assets, or was it because they commingled funds, and committed fraud, and misrepresented what they did?

Mr. BELSHE. I will try. FTX made a fundamental misrepresentation, which is that they claimed to have an exchange, which is a part of trading infrastructure. And with all of our trading infrastructure, we want to see well-understood risks and controls, whether you are a broker-dealer, an exchange, or otherwise. And what they did is they took funds out of that exchange and sent it over to their prop trading firm against the knowledge of their clients.

Mr. DAVIDSON. Thank you, and I yield back.

Chairman HILL. Thank you, Mr. Davidson. We now turn to my friend from Houston, Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman, and I thank the ranking member as well for this hearing.

Friends, I was here when Bernie Madoff made off. Need I say more? Now, we have FTX. I am really concerned about the investors. I appreciate a desire to innovate, but all innovation isn't positive. Credit default swaps were an innovation that proved to be quite detrimental.

Mr. Reiners, you have iterated previously on this topic, but what do we need to do to protect investors?

Mr. REINERS. Thank you, Congressman Green. To protect investors in crypto, you simply need to impose the same standards and safeguards that have long been present in traditional securities markets. You have to have segregation of customer assets from firm assets. You have to have adequate disclosure so that investors can make informed decisions about how to risk their capital. You have to have these firms produce audited financial statements, not proof of reserves. You have to have prohibitions on conflict of interest. You can't allow these firms to front-run their own customers, which is what is happening currently in crypto markets.

This is not rocket science. The blueprint is there. It is just a matter of Congress clarifying once and for all that one agency—I prefer it to be the SEC because they were created to protect investors; the CFTC does not have an investor protection mandate. In the markets that the CFTC oversees, commodity derivatives markets are principally made up of large, sophisticated, institutional investors. They do not have a long history of protecting retail markets, so it is not that complicated. We figured it out. Generally speaking, of course, there are going to be frauds from time to time, just like Bernie Madoff, but the recipe is there.

Mr. GREEN. Some of your colleagues seem to think that this in some way would thwart innovation and prevent these businesses from developing appropriately. What is your response to that?

Mr. REINERS. Of course, I reject that premise. U.S. capital markets are the envy of the world, and there are a variety of reasons for that. But one of them is that we have a robust regulatory environment, that you can deploy your capital here with adequate in-

formation, that you have legal remedies available to you. So for the crypto industry to benefit long-term, it is going to need those same guardrails. Obviously, there is a massive trust deficit right now with crypto. The average American just does not trust it, and rightfully so. So for this industry to succeed long-term, and people can disagree with me on the underlying utility and merits of crypto, but I still think we can agree on the need for there to be a robust regulatory environment, because that will allow users to trust it, and to know that they have protections, and the industry will benefit perhaps over the long term. But absent that, those guardrails, people are continuing not to trust crypto, and it will sort of be the plaything of technologically-sophisticated individuals.

Mr. GREEN. Thank you. Just a closing comment, I was somewhat amazed recently when I pulled up to a service station in a neighborhood where most of the people are wage earners, probably not sophisticated investors, and there was a bitcoin ATM readily available. I really am concerned about people who assume that regulations exist that do not, and that they are protected when they are not. It causes me consternation, and I am not getting a great sense of belief that the industry is as interested in the investors as they are in making profits. I yield back the balance of my time.

Chairman HILL. The gentleman yields back. Mr. Rose of Tennessee is recognized for 5 minutes.

Mr. ROSE. Thank you, Chairman Hill and Ranking Member Lynch, for holding this hearing, and thanks to our witnesses for taking the time to be with us today and for sharing your expertise. I am going to dive right in.

Mr. Grewal, will you describe the existing—and this is a broad question, I know—regulatory structures for digital asset trading platforms, and discuss the current authorities of the SEC and the CFTC when it comes to regulating digital asset trading platforms?

Mr. GREWAL. Thank you, Congressman. I can certainly speak to that issue with respect to Coinbase's own experience as a platform that is regulated here in the United States. Just to give you some sense of the scope of our oversight, we have something like 45 money transmission licenses across the United States. We are also licensed as a BitLicensee under New York law.

At the Federal level, we have a registered DCM, and we are seeking to register an FCM with the CFTC. We are also registered as a money services business (MSB) with FinCEN as part of the Department of the Treasury. Even within the SEC, we actually have registered broker-dealers, two of them I believe, but we are not able to do anything with them because there are no digital asset securities that are currently available for listing. So, that is the broad landscape that we currently face. What we do not have, though, is a viable path for registration, either as a national securities exchange or as a broker-dealer, ATS, with the SEC, and that is, I think, an important part of the gap that we believe legislation could help fill.

Mr. ROSE. Thank you, and this next question is for all of you, so we will go across the dais down there when I get finished asking the question. It seems that in the digital asset space, much of the friction, at least in the U.S., is between who would be the primary regulator, given that we have separate securities and derivatives

regulators. Previous Congresses have considered merging the two regulators to provide more regulatory certainty.

A 1995 GAO report found that merging the SEC and the CFTC could yield a number of benefits, including reducing regulatory uncertainty, enhancing market efficiency and innovation, and increasing regulatory effectiveness. In 2012, now-SEC Commissioner, Hester Peirce, called a merger of the SEC and CFTC politically difficult to engineer but added that it would be a reasonable step towards much-needed regulatory consolidation. Additionally, the Treasury Department, under President Trump, also considered an SEC-CFTC merger, but ultimately opted not to pursue the policy.

I am curious about each of your opinions on whether the digital assets industry would benefit from having a combined securities and derivatives regulator, and we will start on my left and go across, if you do not mind. Mr. Belshe?

Mr. BELSHE. It is easy to say, “digital assets.” Today, we classify at least five different types of assets as digital assets. We have stablecoins, we have cryptocurrencies, we have DeFi tokens, we have digital property like NFTs. I think I am probably leaving off some. Having a single regulator for five very diverse and different activities probably is not exactly the right approach. I think we talked a lot about the SEC because of the definition of what is a security and what is not. In terms of what is a security, I think it should be under the SEC. I think it is unlikely to see a hybrid of the CFTC and the SEC. But then lastly, I think the right approach is what was mentioned earlier by Mr. Davidson, which is a principle-based approach to regulation of digital assets.

Mr. ROSE. Professor Evans?

Ms. EVANS. Yes. Thank you, Congressman. If we were beginning today, and I speak normatively as an academic, what you might create, and ideally, some hybrid version might be applicable. Although, I agree with my colleague that given the complexity and the nuances of the different types of tokens and coins, it is not likely. But if I recall correctly, in the enabling legislation for both the SEC and the CFTC, there is some language that calls upon them to work jointly in some capacity, although it is rarely used, and I would lean into that language and see what might be created in light of things that already exist.

Mr. GOULD. Congressman, although I am not an expert on market regulation, I would just note that in the Federal banking agency space, there are multiple regulators and they serve different functions. And generally speaking, as long as those different missions and tensions are handled constructively, it is valuable having multiple regulators in the banking agency space.

Mr. ROSE. Thank you.

Mr. GREWAL. Congressman, in the past, Coinbase has urged the adoption of a unified regulator across securities, commodities, and other types of digital assets. We, however, have recognized the political challenges that Commissioner Peirce and others have pointed to. The main point, we think, is to have a unified framework, even if it involves individualized or separate regulators. With the right rules, we can manage the complexity of different regulators taking their fair share.

Mr. REINERS. Congressman, I will quickly note that Paul Volcker also thought the CFTC and the SEC should be merged, and I agree with him on that, and this divergence has very, frankly, bizarre outcomes. So in 2017, the CFTC permitted the listing of cash settled bitcoin futures contracts, while the SEC continues to rightfully—

Mr. ROSE. My time has expired. I'm sorry.

Mr. REINERS. We have ETF and bitcoin futures as different things.

Mr. ROSE. I would welcome your follow-up on that. Thank you.

Chairman HILL. Mr. Reiners, please—

Mr. ROSE. I yield back.

Chairman HILL. —feel free to answer his question in writing.

Mr. Casten is now recognized for 5 minutes.

Mr. CASTEN. Thank you, Mr. Chairman. Mr. Reiners, I hope you will forgive me for starting with just a really simple question. What, in your estimation, is the market value of the total traded crypto assets today?

Mr. REINERS. You can go to coin market cap, and I think it is a little over a trillion dollars, although market cap, when it comes to cryptos, is a troubling metric, frankly, because anyone can create a token, hold a bunch for themselves, sell 10 for \$100 and then say, oh wow, we have a billion-dollar market cap token here.

Mr. CASTEN. You have anticipated why I asked the question. You mentioned you get one of the pithier explanations of the FTX bankruptcy that I have heard, which I appreciate, and essentially with what you just described, FTT, there was more desire for dollars than FTT, and all of a sudden, there was a run on the bank, as it were. If I understand the Silvergate bankruptcy, it's sort of the same story. It sounds like they were sort of doing dollar settlement of crypto trades, and all of a sudden, there was more demand for dollars than they had in reserves, and so they had washed that out. Is that a reasonable characterization of the Silvergate bankruptcy?

Mr. REINERS. Yes, Congressman, I think that is fairly reasonable. Silvergate suffered a liquidity crisis. Over 90 percent of their deposits were affiliated with crypto firms, and once crypto melted down, of course, there was essentially a run on the bank. They had to sell assets to meet that run. A lot of those assets were fixed-income assets that have gone down in value since the Fed started raising interest rates, so they lost money on that. That was a hit to capital, and then it became a sort of capital liquidity play on one another and brought them to the brink of failure.

Mr. CASTEN. The reason I started with the capitalization is that as I am sitting here, Silvergate is described as one of the most-important banks in crypto, with a \$12-billion bankruptcy; FTX, one of the major exchanges, an \$8-billion bankruptcy; Celsius, \$4 billion; Genesis, \$3 billion. I do not think I have left out any of the major bankruptcies. In aggregate, that is about \$28 billion. If the major players in the industry are going bankrupt and accounting for 3 percent of the nominal value, I am saying, is the trillion dollars real or not? How much of the value of this is inflated? Now, \$28 billion is the market cap of Walgreens. I am happy to be on the corner and happy and healthy, but nobody would say that

Walgreens is systemically important. Given what you have done in the systemically-important banking space, are there any legitimately systemically-important crypto players? If this industry went away tomorrow, from a financial perspective, does it matter?

Mr. REINERS. It wouldn't move the needle one bit on GDP, unemployment, or anything. Chair Powell would probably never bring it up. We just had obviously a massive crypto failure, a crypto winter, \$2 trillion in market cap, whatever that is worth, just evaporated, and, yet, this is not a systemic risk event, as you said. The average person is not feeling this or experiencing this in any meaningful way, and, frankly, that is a policy success, a little celebrated policy success, because it could have been a lot worse.

As we have heard today, the crypto industry is desperately trying to become integrated with the traditional financial system, which is, frankly, ironic given that the origins of crypto was to exist outside the financial system. The very first bitcoin block had a text in there that said, from The Times of London newspaper, "Chancellor on brink of second bailout." Now, they are looking for the banking system for their salvation, which is—

Mr. CASTEN. And I agree. I am glad it is not. Maybe there is no systemic failure because we have done such a good job up here. I am always willing to take credit for that. Maybe it just is not really that big because if the trillion dollars is ridiculously overinflated, we do not have a special subcommittee on Walgreens. I raise all of that because I think you have made the good case of much of crypto as a security. There are other good cases to be made about it as a commodity. Is there any good case for crypto as a currency, because I am left saying, what is the value for cryptos or currency? That is basically a late-night Glenn Beck Gold Bug ad. It is something that is finite, that is valued by a few people, but I can't pay my taxes, and I can't pay my mortgage with it.

Mr. REINERS. It is far too volatile to be used as a medium of exchange as a currency. If you are a merchant, why would you accept payment in something that could go down by 20 percent within an hour because Elon Musk sent out a tweet, right? It has completely failed as a currency. People like to talk about stablecoins being used as a currency, but the reality is, as Gary Gensler said, they are the, "poker chips," at the casino. People use stablecoins so they can speculate on overseas exchanges and in DeFi, right? That is the main reason stablecoins exist.

Mr. CASTEN. I realize I am close to time, and I do not want to sound like such a Luddite up here, because I think blockchain is a fascinating technology. There are fascinating conversations about Web 3.0. But it strikes me that this conversation has become complicated because we have talked about it as a currency instead of acknowledging that this is a volatile thing. Blockchain is fine but to be continued, but I think if we regulate it as one of the other things that it actually claims to be, we will probably find a way through. Thank you, and I yield back.

Chairman HILL. The gentleman yields back. The Chair now recognizes Mr. Steil for 5 minutes.

Mr. STEIL. Thank you very much, Mr. Chairman. Mr. Chairman, I would like to just make a quick comment that I actually think that stablecoins have a lot of potential opportunity here. And it is

something that I hope we spend a little time on in this committee, because I do think I disagree with the previous witness' comment. I think it actually provides us a lot of opportunity.

Let me shift gears here, and if I can, Mr. Grewal, I am going to direct some of these questions to you. I spent a lot of time thinking about how we get the policies here right, in large part because I think it is really important that we are innovating here in the United States of America rather than allowing a lot of these types of products to be offshore, in large part for the protection of Americans and American investors, American consumers. And if we look back at the FTX implosion, a lot of individuals were hurt, including many in the United States.

As you know, as I know, and as many people have learned, FTX was headquartered in the Bahamas, not here. Although it had some domestic subsidiaries, the bulk of its operations were offshore, outside the protections of the United States Government. And if we want to protect investors and foster innovation, I think we need to be encouraging digital asset businesses to domicile here in the United States, not enforce foreign jurisdictions that have less-robust rules of the road and regulations to protect people. But, as I am looking at the SEC, it seems like they are failing to provide a clear framework to facilitate responsible U.S.-based leadership on digital assets.

The question here is, we have seen Chairman Gensler, and he recently gave an interview this week in which it seemed like he may have waved off concerns that digital asset businesses would continue to migrate overseas. He said, "We lose more if investors get harmed here." How do you view those comments? Where would continued digital assets' offshoring be in relation to the investor outcomes that we want here in the United States?

Mr. GREWAL. As an American cryptocurrency exchange incorporated under the laws of the State of Delaware, we obviously have a strong interest in seeing robust protections for consumers that recognize the need for innovation right here in the United States. I can't help but observe, however, Congressman, that even as we are debating issues such as, what is the definition of a security, or which agency ought to have primary jurisdiction over one element of the regulatory framework or another, other countries around the world are moving ahead. The U.K., Australia, Singapore—and I could list many, many other countries that are taking a sensible approach to these issues and are attracting real capital and real jobs that create real national security concerns for the United States if this gap, if this race continues unaddressed by our country.

Mr. STEIL. Let's dig in on that a little bit. There is a discussion of whether or not the regulatory path forward is clear, so I want to go back to Chairman Gensler's comments on that. We have seen a flurry of enforcement actions from the SEC after many of the firms in the crypto space, and he was recently quoted as saying, "The path to compliance is clear." I understand, kind of in other words, that he is arguing that digital asset firms can and should register with the SEC, and the failure to do so is a choice. That is how I heard that comment. Maybe you could share with me how you view that comment? And then further, in your interaction with

the SEC, is the path to compliance clear for your firm or for firms in the same space?

Mr. GREWAL. Congressman, what I can say with respect to registration is that we actually share the goal I laid out just a minute ago. Coinbase is eager to be able to offer digital asset securities here in the United States under the supervision of the SEC. And to that end, we have pursued registration under a number of different models, some that we have proposed and others that staff of the SEC have suggested. But to date, we have been unable to reach an accommodation and identify a path towards registration or that would result in registration for the simple fact that the current registration rules don't make a lot of sense when it comes to digital assets.

Mr. STEIL. I am assuming you are going back and forth with the SEC. I know last summer, you sent a petition outlining a series of questions that you had. Could you characterize your interaction with the SEC, and have you received answers to the questions that you asked last summer?

Mr. GREWAL. Yes, sir. In July of last year, we filed a formal petition for rulemaking under the procedure set out in the Administrative Procedure Act, seeking rules along the lines that we have been discussing. I would characterize our interactions with the SEC as always professional. We held no particular grudge towards the Commission, even as we have strong policy disagreements. We have received no answer to our petition.

Mr. STEIL. You received no answer to your petition. I think that says the future and the path year may be less than clear. We have an opportunity to clarify that. Thank you for your testimony today.

Mr. Chairman, I yield back.

Chairman HILL. Thank you, Mr. Steil. Mr. Nickel is recognized for 5 minutes.

Mr. NICKEL. Thank you to all of our witnesses for being here today, and a special welcome to Mr. Reiners, who is from Duke University in the great State of North Carolina. I saw that, and I imagine you have not been looking at your phone. I did look at mine and did note that Duke is up significantly at the half. And, Mr. Chairman, we have been talking a lot about the SEC today, but you and the good people of the Great State of Arkansas' 2nd District as well will be much more interested in another SEC at 7:00 tonight.

Chairman HILL. I'm looking forward to it.

Mr. NICKEL. But I am glad to be working across the aisle to make progress on digital asset regulation. This emerging technology has incredible potential. It has the power to bring more fair and equitable access to financial services for everyday Americans, especially those who are unbanked. It also has the power to reduce costs, increase efficiency, and grow our economy. However, without proper regulation, digital assets can be harmful to consumers.

Additionally, without clear rules of the road, we risk this technology revolution moving outside of the United States. I think it is essential to our economy and our national security that America remain the world's dominant financial center. Because of this, I am happy to be co-sponsoring Chairman McHenry's Keep Innovation in America Act, along with Congressman Torres. This bill provides

the regulatory clarity needed to ensure crypto innovation remains in the U.S., and directs the Treasury Secretary to conduct a study on this issue so that we can better regulate it going forward.

Mr. Reiners, what additional regulation do you believe is needed in this industry to encourage innovation here in America while also protecting consumers?

Mr. REINERS. Congressman, first, I appreciate the update on the Duke game, because it has been on my mind, and I will just note that we are peaking at the right time of year here.

I laid out in my written testimony what I think is the right approach. And I would just push back slightly on the concept that there is any innovation here worth embracing, frankly. Crypto has been around for 14 years. That is a pretty long track record, to take a step back and look at the harms that has caused and the benefits, and on the harm standpoint, the ledger is pretty long. It facilitates ransomware attacks, which have absolutely crippled America's small businesses, municipalities, and healthcare systems. It undermines our national security by sanctions evasion and terrorist financing.

I would just note that North Korea stole \$1.7 billion worth of crypto last year to fund their ballistic missile program. And then, of course, there are the environmental impacts associated with proof-of-work mining, and then the numerous investor losses, as well as frauds, hacks, and scams. So, when you look at that in its totality, what are the benefits that we are receiving in return? I don't really see any. I think as lawmakers, you need to be clear-eyed about what is happening here. And because of that, investor protection, I think, should be front and center, while also minimizing risk to financial stability. I think letting the SEC fulfill its mandate to protect investors and giving them exclusive oversight over crypto is the right approach.

Now, I will concede, it doesn't necessarily mean that all of the rules that apply to traditional securities firms should apply one-to-one for crypto firms. One area that I think many people in crypto would agree with me on is perhaps there is a need for a customized disclosure framework, because the information that crypto investors want is probably different than what a normal equity investor would want. And even Chair Gensler has alluded to this point and noted that asset-backed securities have a different disclosure regime. That is a long-worded answer there, but I think the SEC is best-suited to impose some investor protections here.

Mr. NICKEL. Thank you. Mr. Grewal, the Board of Governors of the Federal Reserve System issued a policy statement that confers new obligations on the State member banks regarding the permissibility of engaging in crypto asset-related activities. The policy statement seems like it significantly impacts the ability of consumers to access the crypto ecosystem through safe and well-regulated outlets. How will this rule hurt consumers and innovation?

Mr. GREWAL. Congressman, the challenge, of course, with any new rule is that it has unintended consequences or downstream effects, which aren't necessarily contemplated at the time of its enactment. In this particular case, let me be very clear, we support rules for disclosures to consumers and investors that allow them to make informed decisions about what they are investing in, who

they are banking with, and the like. So to the extent we all share that goal, we think progress in this way would be constructive.

Chairman HILL. The gentleman yields back. Mr. Flood is recognized for 5 minutes.

Mr. FLOOD. Thank you, Mr. Chairman. I would like to thank our witnesses for coming today, and I really look forward to hearing your feedback on some of the SEC's recent actions related to digital asset custody.

Mr. Gould, I am referring specifically here to Staff Accounting Bulletin (SAB) 121, which asked public banks to hold custody in crypto assets on balance sheet. Can you speak to how this differs from how the OCC regulates custody?

Mr. GOULD. Sure. The SAB 121 guidance document that you referenced begs the question of, if a bank is subject to that guidance and, thus, it has to treat the assets it is custodying as if they were on its balance sheet, it begs the question of what is the appropriate regulatory capital treatment for those assets? And at least to my knowledge, the answer is unknown at this point. The Basel Committee has proposed regulatory capital treatment, which is highly punitive. But to my knowledge, I am not sure what banking agencies are telling banks that are attempting to custody digital assets and that are subject to that SAB 121 guidance, which, again, I think has a chilling effect on their willingness to custody those digital assets.

Mr. FLOOD. And speaking of that potential risk to discourage banks from taking custody, what do you think the practical effects will be? If you were advising a bank board, if you were advising the CEO of a bank, what would you say to them about SAB 121?

Mr. GOULD. I think it would be a question of the bank's risk appetite as well as its available capital and whether or not they want to devote high levels of capital potentially to engage in an activity custody, which, at least traditionally, is not the most lucrative of activities.

Mr. FLOOD. Mr. Gould, I appreciate the answer, and I fear that investors would not be very well-served by an environment where banks cannot custody digital assets. If banks can't provide these services, can you speak to who might fill the void? Is there a risk of American investors' crypto assets being custodied largely offshore? And that has been mentioned already today.

Mr. GOULD. I agree. I think there is that risk, and obviously, banks historically have custodied all manner of assets, whether they be electronically-stored assets or physical assets. So, banks have a long history of managing risks associated with the custodying assets.

Mr. FLOOD. Thank you. Chairman Gensler claims that he wants investors' digital assets to be protected, but at the same time, the SEC has taken actions that have driven some of the safest, most highly-regulated institutions out of digital asset custody. That just doesn't make much sense. He is creating a situation where he is going to drive digital asset activities offshore and leave American investors less safe as a result.

Next, I would like to touch on the SEC's latest custody rule-making. First, I want to express the importance of keeping a pathway for custodians with a State charter to become a qualified cus-

todian under the rule. I wrote and passed the Nebraska Financial Innovation Act, which allows Nebraska State-chartered banks to custody digital assets. Other States, like Wyoming and New York, have their own pathways to becoming a digital asset custodian. I believe it would be a grave mistake for the SEC to cut custodians who are already regulated at the State level entirely out of the market.

I am also concerned that the SEC's updated custody rules effectively prohibit self-custody, and could block new entrants to the marketplace. And from what I have heard, if a startup wants to issue a new crypto token, registered investment advisors likely would have trouble custodizing the asset themselves with the rule's new requirements. This could present a significant barrier to entry for new issuers because it might take some time for qualified custodians to build up the technical capability to custody their asset.

So, Mr. Grewal, if an issuer of a new crypto token wants to work with a qualified custodian, but no qualified custodian has built up the technical ability to handle their token, what would that issuer be blocked out of? The market? Do you view that as a potential concern?

Mr. GREWAL. If there were no firm available because it lacked the technical capacity to serve that customer, that customer remains unserved.

Mr. FLOOD. What should we expect? Mr. Grewal, the SEC's new custody rule expands its reach beyond funds or securities to assets, including all assets. Can you speak briefly to how this rule might affect the marketplace for things like paintings, baseball cards, or NFTs?

Mr. GREWAL. Artwork and baseball cards are a little outside of my day job, Congressman, but I certainly think the fact that the rule does extend to all assets, as you suggest, is something that needs to be noted and paid very careful attention to. That is a dramatic expansion of the very strict requirements that apply to qualified custodians, so I think that is something in which a lot of industries, not just crypto, are going to be very interested.

Mr. FLOOD. Thank you, Mr. Grewal. Mr. Chairman, I yield back.

Chairman HILL. Thank you, Mr. Flood. The gentleman from California, Mr. Sherman, who is also the ranking member of our Capital Markets Subcommittee, is recognized for 5 minutes.

Mr. SHERMAN. The title of this hearing says, "The Administration's Attack on the Digital Asset Ecosystem." I just wish it was true. The Administration is not doing all they can to try to keep this scourge out of our economic system. In fact, if there was a conspiracy against crypto in the Democratic Party, I would know about it. I think they would have invited me to it. Unfortunately, it doesn't exist.

We are told that we need to serve investors, because we expect investors to provide the capital that drives our economy, because when we hear the word, "investor," we think of people who are building apartment buildings so people can live there. People are building factories. Here, we are dealing with investors in a burglary tool factory or similar to investing in the North Korean economy.

John Maynard Keynes, I think, coined the term, “animal spirits,” as a very valuable asset for a capitalist economy, which is the willingness of the people to take a risk, which is an essential element in building an economy. We, in Congress, have subsidized that to the tune of hundreds of billions of dollars a year. We do that through not only the capital gains allowance, but full forgiveness upon death of all capital gains on investments.

Mr. Reiners, can you think of a reason why the incentives that we give to have people invest in housing and businesses should apply to those who are investing in a chance to undermine the dollar, or at least partially displace the dollar as the world’s reserve currency?

Mr. REINERS. No, I cannot.

Mr. SHERMAN. Now, when you have a strong incumbent in a business area and you are trying to partially take market share, it is wise to name your company or your product after what you perceive to be its advantage. Jolt Cola has more caffeine; it says so right in the name. You want to Jolt? Cryptocurrency has done the same thing. Cryptocurrency literally means, “hidden money.”

Mr. Reiners, can you think of some people who would find hidden money to be better than unhidden money?

Mr. REINERS. Of course, people who wanted to do bad things.

Mr. SHERMAN. Evade tax laws would be the biggest market. Sam Bankman-Fried is right now hoping that he can evade bankruptcy laws and keep his assets out of the hands of his claimants, and the one thing I do want to say to my colleagues here is we can’t trash Sam Bankman-Fried and then support his bill. He wasn’t around here as a shorts fashion model. He was around Rayburn and Congress for one purpose, and that was to keep the SEC out of crypto. They want the patina of regulation, but they don’t want the most-effective business regulator.

Mr. Reiners, a currency is supposed to be a store of value, and a medium of exchange, and a measuring stick of value. Does the dollar do that?

Mr. REINERS. Yes, very well, and it has for a long time.

Mr. SHERMAN. So, aside from the fact that it is hard to hide from the IRS, and sanctions evaders, and those enforcing our human trafficking laws, and those enforcing our laws against drug dealing, can you think of anything that crypto adds to people doing honest transactions in conformity with U.S. law?

Mr. REINERS. I cannot.

Mr. SHERMAN. And it is talked about as if crypto is a better payment system, but as I understand it, if I want to transfer crypto to somebody, and they want to buy a sandwich with it, I have to take my dollars, pay a fee, and convert it to crypto. They then get the crypto, they have to pay a fee, convert it to dollars, and go down to McDonald’s and buy a hamburger. Is that an efficient payment system?

Mr. REINERS. No, not at all. And I would point out, the fees in the crypto economy are quite high when you compare them to securities markets.

Mr. SHERMAN. Thank you.

Chairman HILL. The gentleman yields back. Votes have been called on the House Floor, and we will continue our questioning

until we have about 200 votes left. And we will now turn to Mr. Timmons for 5 minutes.

Mr. TIMMONS. Thank you, Mr. Chairman. I want to start off my time by saying that I look forward to working with all of my colleagues on the subcommittee as we continue to shape foundational legislation for the digital asset ecosystem. The digital asset space has garnered a great deal of headlines recently, and I think the call for legislative action is building serious momentum, even more so. Recent aggressive actions by regulators show that Congress needs to enact legislation tailored to the digital asset ecosystem that appropriately addresses the risks, while ensuring that the clear benefits of this new technology are not held back. Republicans on this committee have long advocated for increased collaboration with regulators to produce legislation that addresses the risk and benefits of the digital asset ecosystem.

The SEC seems to want to classify all digital assets, besides bitcoin, as securities. But I am worried that this neglects the actual use cases for this technology and risks chilling development and innovation before the value is ever realized.

Mr. Grewal, can you talk about some of the potential use cases for this technology outside of the finance space, as that is where the greatest promise seems to lie, in my opinion?

Mr. GREWAL. Thank you very much, Congressman. You are right to point out that within the financial space, of course, payments are important, and I would also call out remittances. Workers here in the United States are using crypto to send money home as we speak today, and are doing so faster, cheaper, and more securely than ever before.

Outside of financial use cases, there are interesting and important new cases emerging every day. I will just highlight a couple of them to answer your question directly. When it comes to carbon credits and other forms of environmental protection, blockchain-based technologies are able to help track those credits and make sure that they properly account for environmental remediation. There are also digital health records that are emerging that are blockchain-based and offer important value to patients who want to be able to have true data portability, while protecting their personal information. Decentralized identification offers another important non-financial use case that we think facilitates attribution of activity online without the collection of highly-intrusive, voluminous, personally identifiable information.

Mr. TIMMONS. Would any of those potential uses you just laid out ever be realized if we regulate every token as a security?

Mr. GREWAL. It is not likely, Congressman. The fact of the matter is that our Federal securities laws impose significant burdens on issuers, and in certain cases, those burdens are appropriate where the tokens are, in fact, securities. However, many, many tokens are not securities. They offer practical utility in certain cases. They may operate as commodities in other cases. In any event, the burdens of the Federal securities laws yield very little benefit, and, as a result, net-net disincentivize productive economic activity.

Mr. TIMMONS. Sure. Thank you. Professor Evans, same two questions to you. Could you talk about potential uses that maybe he

didn't touch on, and what would happen if we regulated every token as a security?

Ms. EVANS. Thank you, Congressman, for your question. I am very excited actually about use cases regarding identity. The idea that you could go to a store, if someone has to be 21 to buy a product, even as a matter of personal security as a woman where I live, you just need to know whether I am over 21 or under 21, and so uses of that nature are very intriguing. There are other use cases beyond NFTs for collectibles as well that go into healthcare and all sorts of other intriguing issues. Final point, I think of supply chain issues as well. Not everything will use cryptographically-secured assets, but certainly the underlying technology for distributed ledgers.

Mr. TIMMONS. Thank you for that. Crypto is a trillion-dollar industry by market cap, and other regulators may want to move quickly to manage risk. It is imperative that this is done in a thoughtful and reasonable manner. The January joint statement by the banking regulators highlighting liquidity risks associated with certain sources of funding from digital asset entities, and last month's final rule by the Federal Reserve essentially prohibiting State member banks from holding digital assets as principal and discouraging Federal banks from engaging with the industry—both of those things are very concerning to me. I don't find them to be thoughtful or reasonable.

Mr. Gould, with few banks willing to provide banking services to companies in the digital asset space, how does the example of Silvergate demonstrate the risk of overconcentration?

Mr. GOULD. I think, in part, the agency guidance runs the risk of being self-fulfilling, in that they are warning about concentration risk, and, of course, that is having the understandable impact of making banks even more hesitant to bank crypto entities or crypto customers. And you can see the continuing kind of shrinking of the number of banks that are willing to bank those customers and, thus, further concentrating the risk in the very few remaining banks that will bank them.

Mr. TIMMONS. Thank you for that. Thank you, Mr. Chairman. I yield back.

Chairman HILL. The gentleman yields back. Mrs. Houchin is now recognized for 5 minutes.

Mrs. HOUCHIN. Thank you, Chairman Hill and Ranking Member Lynch, for holding this hearing, and thank you to the witnesses for your testimony, for speaking with us today.

Crypto digital assets and other areas of financial technology have shown immense potential and opportunity over the last several years, especially as the total market capitalization for digital assets has risen above \$1 trillion. And technologies, like blockchain and stablecoins, continue to change the ways that Americans interact with the financial sector. Despite this, you have all highlighted that companies in the digital assets industry face great difficulty when trying to do business and grow here in America from a lack of regulatory clarity from our Federal agencies, to a restrictive approach from the Administration. Threats to the industry may push innovators elsewhere, causing the U.S. to lose its leading role in digital assets.

Mr. Belshe, in your testimony, you highlighted the need for regulators to move quickly, alongside innovative businesses. What would be the impact on U.S. competitiveness within the global economy if we continue at the current pace?

Mr. BELSHE. I think we are currently on track to move this industry mostly out of the United States. Now, some might like that in this room. I think those of us on the panel are mostly not that way. Look, Americans are seeking out these assets. We have heard statistics: 20 percent of Americans are interested in touching digital assets today. The use cases are many, and they keep coming quickly, so there is a whole technology sector here which is at risk. And someone had asked the question, what if we just turned it off today, what impact would it have? Let's take Paul Krugman's quote from back in, I don't know, 1998, when he said, "The entire internet is going to have no more value than the fax machine." And what if we had taken his advice and just turned it off back then?

Mrs. HOUCHIN. Yes.

Mr. BELSHE. The use cases that we just heard a few moments ago, there are many, and there are many that haven't even arisen yet. So it will be, I think, devastating to the American businesses.

Mrs. HOUCHIN. Thank you. We have heard some testimony today suggesting that a regulatory structure is, "not a race." But isn't there great risk to American leadership and competitiveness on the world stage and to the stability and preeminence of the U.S. dollar if we fail to establish clear guidance and rules for digital asset innovators, while other countries appear to be moving full speed ahead?

Mr. Belshe?

Mr. BELSHE. That is what is happening, and then I think it gets a little bit worse because this does overlap with money and finance. So, it is not just a business issue. It is actually a political power and dominance issue. China has a central bank digital currency (CBDC). It is not perfect, but they are exploring it. They are exporting it all through the Belt and Road Initiative, and a few years from now, they will have a large economy, which they control. So, the U.S. has a choice as to whether it wants to participate, and we need to make that decision now.

Mrs. HOUCHIN. Is it also fair to say that the lack of action on how to define and regulate crypto over the last few years under this Administration, and the movement of the crypto industry overseas to unregulated places like the Cayman Islands, might have been avoided with a program of oversight like you are seeking?

Mr. BELSHE. For sure. We have flip-flopped even without changing the legislation, and I think everybody here should be concerned about that. The OCC opened for business for digital assets just a couple of years ago and then slammed the door shut. The laws didn't change, the regulations didn't change, and yet the Administration changed.

Mrs. HOUCHIN. Yes.

Mr. BELSHE. This is a problem.

Mrs. HOUCHIN. Mr. Grewal, several countries and international organizations have begun to introduce and implement regulatory frameworks for the digital asset ecosystem, including the European Union, which has worked tirelessly in the markets in crypto assets

regulation. What is the impact that efforts in the U.K., Japan, China, and the EU will have on the regulatory environment for digital assets in the U.S., and what has prevented the United States from leading the charge for a digital asset regulation globally?

Mr. GREWAL. Thank you for the question, Congresswoman. There is no question there is tremendous creativity and progress being made in many markets all over the world. You have listed several of them. And I want to be very clear that progress and creativity is not simply about allowing the crypto industry to do whatever it wants. These are serious Democratic jurisdictions that are imposing strict limits on what these crypto firms can do, like ours, and imposing strict requirements on the Know Your Customer/Anti-Money Laundering (KYC/AML) rules. All of the security issues are important, so this is not a race to the bottom, Congresswoman. This is very much a race to the top, and right now, we are losing in this country.

Mrs. HOUCHIN. I couldn't agree more. I thank you so much. Digital assets and crypto, in my view, is the space race of our generation. We have to figure this out, and not that we are doing it too quickly, we are going to do it expeditiously, but we cannot do it. In order to bolster America's global leadership, ensure national security, and support innovation in our financial markets, it is vital to cultivate an environment that allows these technologies to grow. Thank you, Mr. Chairman. I yield back.

Chairman HILL. The gentlewoman yields back. Mr. Donalds of Florida is recognized for 5 minutes.

Mr. DONALDS. Thank you, Mr. Chairman. And witnesses, thanks for being here.

Mr. Chairman, as some of my colleagues were going through questioning, I was reading through testimony, and actually reading the President's budget right now, which is comical in a lot of areas, and it brings up an interesting question for me. We here in Washington, D.C., have a habit of creating program after program after program and spending hundreds of millions and billions of dollars. We pat ourselves on the back. We say these programs work. We have no idea of efficacy. We borrow trillions of dollars more to continue the spending, and we just rinse and repeat the programs, and then add to them, conflating that with, we have a burgeoning industry on our hands.

And the first step is to figure out who is going to regulate it, how quickly, without asking the first fundamental question of, does the SEC or the CFTC even have the technical capacity or know-how to regulate the industry that they both are clamoring to get their hands on, especially Chair Gensler? He is ready, this guy is, he is frothing at the mouth, Mr. Chairman.

So I am confounded by this, because we have been through regulatory schemes in the United States before. The most recent large-scale regulatory scheme came after the financial collapse. We all know it as Dodd-Frank. Dodd-Frank has been an albatross across community banking in these United States. And yet, in the President's own budget, he has billions of dollars more for programs for small business owners through the Small Business Administration (SBA), more program dollars through the minority business outlet

fund, whatever we want to call it, when the real remedy is actually a more streamlined regulatory environment for the banking industry so community banks can flourish in these United States. And businesses, whether they are owned by Black people, Hispanic people, or White people, whether rich, middle-income, or poor, all have access to capital to grow their businesses without Washington having to appropriate dollars into these funky programs that we know are average at best, which brings us back to digital assets.

And this is really a question for all of the witnesses: Do the agencies that currently exist have the technical capacity to adequately regulate a digital assets space? And then the second question is, if they don't, wouldn't it be better for Congress to do something novel and actually create a regulatory sandbox so that the industry can actually prepare the regulatory environment since they have the technical capacity way past anybody over at the SEC, especially considering that from what I hear, Chair Gensler works everybody like a dog over there?

Mr. Belshe, you can go first, and we can go down the list.

Mr. BELSHE. On the technical capacity, I think, might not be the best question, but the principle-based approach will give some flexibility in how we move forward. I do agree with you, if you hand it to the existing regulators, it will have a tremendous gravity to end up with the same market structures that we have today. The same market structures we have today aren't perfect. There are a lot of inefficiencies. The bankers participating in those systems are making more money today than they have ever made before. We can do a lot better, so you have to foster the innovation to get a better market structure. This isn't to avoid market structure. It is to recognize that the technology in front of us today can settle transactions in real time all the time, not having to go through four different middlemen.

Mr. DONALDS. Ms. Evans?

Ms. EVANS. Thank you, Congressman. This is kind of a, "both-and," answer for me because on the one hand, I have great respect for Hester Peirce, for example, at the SEC. I think she has been very thoughtful in how she approaches it. And I think of Commissioner Kristin Johnson from the CFTC, who has also been very thoughtful for a long time. But to your point, technical capacity in this space is critically important. As a professor, obviously, I am always going to lean into education, but it has to be education to have true subject matter experts. Whether they agree or disagree, they have to understand the fundamental underlying technology, or it is difficult, if not impossible, to regulate efficiently and effectively.

Mr. DONALDS. Quick follow-up for you, Ms. Evans, do the agencies have that educational know-how for this fledgling industry? Yes or no?

Ms. EVANS. It is difficult for me to say without knowing the inner workings. I have not seen much from the perspective of leaning into the language of it, but I think a lot of education can go around in all spaces on the legislative and the regulatory side.

Mr. DONALDS. Ms. Evans, I would postulate that answer as, "no." And that is no disrespect to your answer, but considering how fresh this technology is, I doubt people who have been in the agency

space for 5 to 7 years have that ability. I know I am out of time, and I apologize. I really wanted to hear your answer, Mr. Reiners. I really wanted to hear that, but you know what? You could submit it to us in writing, and I would love to see it.

Thank you, Mr. Chairman.

Chairman HILL. Thank you, Mr. Donalds.

Mr. Nunn is now recognized for 5 minutes.

Mr. NUNN. Thank you very much, Mr. Chairman, and thank you for letting me join in on today's hearing on the Administration's attack on the digital asset ecosystem. As we have heard from our colleagues today, I think we are very excited about the potential for this technology, and we want to make sure that if we are not defining the rules of the road, someone else in the world will, and we need to be forward-leaning on this.

Unfortunately, through many of the last couple of years, the Administration's regulatory enforcement approach has failed to provide adequate protections for our digital asset market. Blockchain technologies and digital assets, as we noted, are here to stay in the United States. Personally, I have served as a military officer for nearly 2 decades, particularly in the intelligence area, operating against Russia and China. After 9/11, I deployed multiple times and served thousands of hours working in counterintelligence, specifically serving as the Director of Cybersecurity at the National Security Council (NSC).

And that is why I am introducing the Financial Technologies Protection Act of 2023, which will establish an independent financial technology working group, as my colleague highlighted, to combat terrorism and illicit financing through use of these financial systems, because not only can digital assets be used for good, they are clearly being used for ill. This will be chaired by the Secretary of the Treasury, and include the Under Secretary for Terrorism and Financial Intelligence, and senior-level representatives from the Department of Justice, the United States Secret Service, the Financial Crimes Enforcement Network (FinCEN), and the Federal Bureau of Investigation, among others. Additionally, we include five appointed by the Under Secretary for Terrorism and Financial Intelligence to represent financial technology companies, financial institutions, and organize and engage in this research, building both the public and private enterprise to be able to address these threats.

This working group will conduct independent research on terrorism, their illicit use of new financial technologies, while also developing legislative and regulatory proposals to improve anti-money laundering, counterterrorism, and other illicit efforts in this space. I believe now, more than ever, we have witnessed over the last year with Russia's unprovoked attack on Ukraine that our constituents must know their Representatives are doing everything they can here in Washington. We must protect families, not just in my home State of Iowa, but across the United States, and make this space a successful area for those who want to do well.

Mr. Grewal, I will start with you, as the chief legal officer at Coinbase. We hear a lot about the risk that crypto might move offshore, given the lack of regulatory clarity and the approach being taken by our current financial regulators seeming to restrain this

industry. Could you explain the downsides associated with a crypto company that were to move offshore and the threat it could have from that terrorist element?

Mr. GREWAL. Thank you, Congressman. As I have indicated earlier, we are not only an American company incorporated here in the United States, we are a proud American company. And we very much intend to continue to invest in the United States and in this market, even as we pursue other opportunities around the world. The fact of the matter is that as regulatory clarity emerges in jurisdictions other than the United States, it becomes more and more attracted to invest capital, to place jobs, and to develop technologies outside the United States for the simple fact that we know what the rules are, we know where the boundary is, and we know where we have to go to avoid even getting close to that boundary.

And there is a material impact. There will be a material impact to the security of the United States if those technologies are developed outside the U.S. for one simple reason, Congressman. Our sanctions programs, which you alluded to in your comments, are at the core of our ability to prevent bad actors from gaining access to funds which facilitate bad acts. You can't have an effective sanctions program based here in the United States if the technologies that would be subject to those sanctions programs are being developed elsewhere.

Mr. NUNN. Very good. Mr. Belshe, I would like to ask you, we just talked about the left and right parameters of this, being able to control not only the sanctions aspect of it, but the additional elements of having an uncontrolled currency that the United States would have a very hard time getting its arms around if we are not part of the process in developing a digital asset, which the United States has control over. Could you talk to us about the national security implications?

Mr. BELSHE. Sure. Look, we could ban cryptocurrencies and digital assets in the United States, but it won't prevent them from being used outside the United States.

Mr. NUNN. Right.

Mr. BELSHE. So, we either figure out how to bring it in and have the best chance of understanding it, helping lead the world in terms of the rules around how you manage it, or we delegate that to someone else. The choice is ours. I think we want to manage that rather than give it to others.

Mr. NUNN. Thank you very much. I think that we have a responsibility to help define this battlespace when it is favorable to the United States, when it helps grow our economy, that helps us innovate and be a leader in this space, and not be on our back heels, being responded to by those who would be adversaries towards us or those who would use it for a nefarious process. I really appreciate your testimony today and the great wealth of knowledge that you have offered us.

Mr. Chairman, I yield back.

Chairman HILL. The gentleman yields back. I would like to thank our witnesses for an outstanding panel, and I appreciate the participation of our Members.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing.

Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is adjourned.

[Whereupon, at 4:22 p.m., the hearing was adjourned.]

A P P E N D I X

March 9, 2023

Testimony of
Mike Belshe

On Behalf of
BitGo, Inc.

Before the
Subcommittee on Digital Assets, Financial Technology and Inclusion
Of the
House Financial Services Committee

March 9, 2023

Chairman Hill, Ranking Member Lynch, and members of the subcommittee, thank you for the opportunity to offer testimony today about the digital asset regulatory environment in America. I am the Co-Founder and CEO of BitGo, an institutionally-focused digital assets company based in Palo Alto, California with offices in Sioux Falls and New York City, and employees in 22 states, including Indiana, Oklahoma, Illinois, Florida, Massachusetts, New Jersey, Texas, and more. We've been building regulated products and platforms for digital assets, and are regulated by numerous state and federal regulators, including the New York Department of Financial Services (NYDFS), South Dakota Division of Banking, the SEC, and FinCEN. We are primarily known for our role as the first purpose built digital asset fiduciary Trust Company. Trust Companies are different from banks in that we are not depositories, do not lend assets, and are focused solely on the technology and compliance related to the safekeeping of our clients assets in segregated accounts.

My personal background is in technology. I am a 30 year veteran of Silicon Valley, having started my early career at Netscape, worked at numerous startups, founded a company building the first search engine for email, was an early developer of Chrome at Google, and I am the creator of HTTP/2.0, the open protocol which drives almost all web based communications across the globe today. For the last 10 years, I have focused specifically on digital assets and their ability to bring transparency and reduced risk to the financial system, along with advocating for sensible regulation.

I hope it is clear that BitGo and all of the regulated firms building digital asset technologies and services in America are absolutely and unequivocally committed to preventing financial crime, providing the utmost investor protections, abiding by sanctions controls, building safety and soundness in our custodians and banks, and building a stable market structure. We are not seeking to avoid regulatory oversight, we are not here for the purpose of building speculative assets and markets. We are here to make the financial system better.

It has been over 10 years since the invention of Bitcoin and the blockchain unlocked the creation of digital property and the ability to transfer digital property in a peer to peer fashion. This seemingly simple technology has profound effect, and enables the instant transfer of value

between anyone across the globe. The second big innovation is that of smart contracts, which have the potential to replace much of modern finance. Stock brokers, money managers, and market makers can be implemented in transparent code.

So innovation is what I want to talk about today.

Software has a tendency, that once it enters an industry, it pushes innovation and change faster than that industry has ever changed before. And that is what has happened to our financial industry in recent years - software is changing it fast. But unlike other industries which software has upended, American finance is highly regulated. It's not enough for our businesses to move quickly - our regulators need to move quickly too. And if they don't we will be surpassed by other nations who will.

When BitGo decided to pursue a Trust Company charter back in 2017, we reached out first to the OCC for federal oversight of our safekeeping activity. At the time, the OCC clearly stated it would not allow a charter for any business in the digital asset space, so we instead pursued a state-chartered Trust Company. This left us with a question as to whether our fiduciary safekeeping would be considered a "qualified custodian" in the eyes of the SEC.

To answer the very basic question of how to provide custody of assets to regulated firms under the Investment Advisers Act, BitGo proactively and voluntarily approached the SEC back in 2018, and submitted a formal no-action letter to the SEC. Ultimately, the SEC declined to opine on our letter. With the OCC closed for business and the SEC unwilling to answer, the question remained - how to custody digital assets under the Advisers Act.

That question lingered for years until just a few weeks ago, when the SEC issued a draft amendment to the Custody Rule. While we are happy the amendment affirms that BitGo's state-chartered, fiduciary trust company is indeed a qualified custodian, it took over 4 years to answer that single question. If it takes that long to answer the most basic questions, how can we expect to answer the myriad of other questions that will follow without falling behind global competing markets?

Some of our federal regulators today state, "Just come talk to us. Fill out a form, and we'll sort this out." That statement does not match BitGo's experience. Further, the claim that questions about how to handle digital assets have already been answered or are well understood is also untrue. Regulators can either declare that digital assets are regulated in the same way as other assets, and thereby apply the same rules, or regulators can say that they are different, and create new rules. But what regulators cannot be allowed to do is to claim that assets are different, and also claim that the rules are already understood.

As a side-note, I want to point out that this is not uniquely the fault of the current administration's approach to guidance. We filed our letter to the SEC in 2018, under the prior administration's oversight. The difficulty of keeping up with innovation is constant; but technology is getting faster and more global, so keeping up is going to get much harder.

2022 was an undeniably miserable year for digital assets, with a number of dramatic failures in the system. This has led opponents of digital assets to wrongly proclaim, "I told you so, digital assets are unsafe for the banks and the financial system."

But the underlying problem is not caused by *including* digital assets in our markets; the problem is caused by *excluding* digital assets from our markets. Our regulatory failure to keep pace with innovation has created a regulatory exclusion which is directly responsible for harming the very investors we are supposed to protect.

There is no doubt that our established trading markets do mitigate risk better than crypto markets. This is because crypto markets today are the most vertically operated markets anywhere, with exchanges acting in every capacity, from the seller's broker, to the buyer's broker, to the exchange, to the clearing house, to the custodian. It doesn't take a market expert to realize this structure inherently creates a single point of failure.

Why then, do we not recognize that the best thing we could do to mitigate risk in crypto markets would be to help the established trading markets, banks, and custodians, our stewards of risk mitigation, participate in these markets?

In 2020, the OCC briefly opened its doors to digital assets and encouraged OCC chartered custodians to participate in the market. This was short lived, however, and the door was closed less than a year later, with no plan from regulators as to what the right approach should be.

At some point, we have to ask ourselves why do American investors flock to weak digital asset opportunities managed offshore? The reason is not because they want to - it's hard to do and risky. The reason is because regulators have failed to keep pace and create safe paths to invest under the safety of American supervision.

Regulatory exclusion has had another unfortunate side effect. The digital asset sector is now a trillion dollar industry, and requires proportional banking support. By refusing to allow our traditional banks to participate, regulators have inadvertently created significant *concentration risk* on a handful of relatively small banks. Silvergate Bank this last week experienced a run on the bank. This was no fault of Silvergate, which grew its business through successful, innovative digital asset products. But with few other banks in the industry, Silvergate soon found itself with a heavy reliance on a single asset class, enabling the possibility of a bank run once the match of fear was lit. Had regulators provided clear guidance to enable banks (and I posit that every bank in America has wanted to participate in digital assets for at least 4 years now), we created a single point of failure in our banking system. It is regulatory exclusion, not the activities of Silvergate, which caused the run on the bank.

To conclude, I'd like to remind everyone why we're here. We are here because we can have better markets, better payment systems, and better financial services, but only if we embrace smart innovation. The blockchain is the first global technology that enables investor participation

at an equal level to banks. It enables financial inclusion for all, creates transparency within our institutions, reduces risk to the investor, and will help maintain the US position in the global economy.



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**Testimony before the House Financial Services Subcommittee
 On Digital Assets, Financial Technology, and Inclusion**

Hearing Title: Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem

Submitted by Dr. Tonya M. Evans on March 9, 2023

Professor, Penn State Dickinson Law
 Co-Hire, Penn State Institute for Computational and Data Sciences
 Author, *Digital Money Demystified*

To Chairman Hill and Distinguished Members:

Thank you for the invitation to participate in this important conversation about the current United States regulatory landscape as applied to the emerging crypto asset ecosystem. I welcome the opportunity to explore the chilling impact of *ad hoc* agency enforcement actions, as well as the benefits of comprehensive, bipartisan legislative efforts by policymakers, and thoughtful rulemakings and prudent use of regulator discretionary powers on the emerging crypto asset class. The optimal balance between cultivating a competitive, and transparent regulatory environment, and establishing effective and clear regulatory frameworks on which the crypto asset industry (and their professional representatives) can reasonably rely, is essential to guide industry decision-making and growth.

I view today's hearing topic through a non-partisan academic lens to express my concerns for investors and innovators participating in the latest wave of financial innovation when a powerful agency uses its broad discretionary powers on a piecemeal basis without also providing commensurate clarity for regulated parties or fair opportunity for good faith actors to understand the rules and the consequences that apply to the entire industry. Such is clearly in the best interests of the country, if our collective goal is, in fact, to protect U.S. investors and consumers.

My goal today is three-fold: 1) to advocate for clear rules and regulations for the crypto asset ecosystem and efficient, effective approaches toward that end; 2) to ensure that laws, rules, and regulations are crafted to promote best practices and policies that continue to strengthen access and inclusion for all Americans (not just the wealthy few) in the digital asset ecosystem and future of money, work, and innovation while also protecting those communities from financial and predatory harms; and 3) to encourage Congress to use its legislative authority to enact laws to rebalance its delegation of authority to the Securities and Exchange Commission (SEC) and to empower the Commodity Futures Trading Commission (CFTC) to regulate spot digital asset markets.

Such lofty but achievable goals also serve to protect American consumers and investors, and to encourage businesses to innovate here in the United States by promulgating rules for *all* regulated parties, while enhancing the benefits and mitigating the risks of this emerging and potentially revolutionary technology. These goals are especially important at this pivotal and consequential moment in history as we emerge from the economic ravages of the pandemic, especially for those citizens who have been historically and systemically marginalized and disenfranchised in the current financial and technology sectors.

I am an intellectual property and technology lawyer and full-tenured professor at Penn State Dickinson Law School with a distinguished co-hire appointment at the Penn State Institute for Computational and Data Sciences. My research, scholarship, and teaching focus primarily on the intersection of law and economic justice in innovation and new technologies and includes a range of doctrinal and experiential courses; most notably, blockchain, cryptocurrency and the law, copyright law, information privacy law, and administrative law. Prior to joining Dickinson Law, I served as Associate Dean of Academic Affairs at the UNH Franklin Pierce School of Law, where I created and directed the school's Blockchain, Cryptocurrency & Law online professional certificate program, developed its curriculum, and managed its world-class instructor pool.

I am the founder and CEO of the Advantage Evans Academy, digital asset onboarding to prepare members of marginalized communities, as well as legacy leadership, to enter the digital asset space safely, legally and confidently, and host of the Tech Intersect Podcast, a weekly show that highlights new and notable experts at the intersections of law, business and technology. From 2020-21, I also served as Chair of the Maker Ecosystem Growth Foundation, the now-dissolved entity that developed and deployed the MakerDAO protocol. My full curriculum vitae has been submitted with this written testimony.

Call-to-Action in President Biden's 2022 Executive Order re: Digital Currencies

One year ago today, President Biden signed an Executive Order (EO) calling for an executive agency-wide approach to the responsible development of digital assets.¹ Section 1 detailed the Administration's digital currency policy. It called upon the administrative state to take strong steps to reduce the risks that digital assets could pose to consumers, investors, and business protections; maintain financial stability and financial system integrity; combat and prevent crime and illicit finance; ensure national security and the ability to exercise human rights; to promote financial inclusion and equity; and to address climate change and pollution.²

Section 2 identifies six goals of the Executive Branch to give effect to its newly articulated policy to: protect consumers, investors, and business in the United States;³ protect United States and global financial stability and mitigate systemic risk;⁴ mitigate the illicit finance and national

¹ See Exec. Order No. 14067, 87 FR 14143 (Mar. 9, 2022).

² See Exec. Order No. 14067, 87 FR 14143 (Mar. 9, 2022).

³ See Exec. Order No. 14067, 87 FR 14143 (Mar. 9, 2022).

⁴ See Exec. Order No. 14067, 87 FR 14143 (Mar. 9, 2022).

security risks posed by misuse of digital assets;⁵ reinforce U.S. leadership in the global financial system and in technological and economic competitiveness, including through the responsible development of payment innovations and digital assets;⁶ promote access to safe and affordable financial services;⁷ and support technological advances that promote responsible development and use of digital assets.⁸

Importantly, given the topic of today's hearing, Section 3 calls for interagency coordination, led by the Assistant to the President for National Security Affairs (APNSA) and the Assistant to the President for Economic Policy (APEP). This coordination mandate reaches every executive agency from the Cabinet-level to independent agencies and officials.⁹

Section 4 articulates the Administration's policy regarding the research, development, and possible deployment of a U.S. central bank digital currency (CBDC), to create a digital and programmable version of its physical counterpart.¹⁰ Note that a U.S. CBDC option would serve as legal tender, be convertible one-for-one into other forms of central bank money (reserve balances or cash), and would, presumably, settle nearly instantly.¹¹

Section 5 addresses measures to protect consumers, investors, and businesses, "... from risks of crimes such as fraud and theft, other statutory and regulatory violations, privacy and data breaches, unfair and abusive acts or practices, and other cyber incidents faced by consumers, investors, and businesses."¹²

Sections 6-10 cover (listed in order): actions to promote financial stability, mitigate systemic risk, and strength market integrity; actions to address finance and national security risks; a call to foster international cooperation and United States competitiveness; definitions of terms of art; and other general provisions.

⁵ See Exec. Order No. 14067, 87 FR 14143 (Mar. 9, 2022).

⁶ See Exec. Order No. 14067, 87 FR 14143 (Mar. 9, 2022).

⁷ See Exec. Order No. 14067, 87 FR 14143 (Mar. 9, 2022).

⁸ See Exec. Order No. 14067, 87 FR 14143 (Mar. 9, 2022).

⁹ This includes the Board of Governors of the Federal Reserve System, the Consumer Financial Protection Bureau (CFPB), the Federal Trade Commission (FTC), the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and other Federal regulatory agencies.

¹⁰ See also, Jesse Hamilton, COINDESK.COM, *Ex-Biden Adviser Said Administration Was Pushing for Digital Dollar* (Feb 28, 2023 at 6:22 p.m. EST, Updated Mar 1, 2023 at 9:51 a.m. EST), <https://www.coindesk.com/policy/2023/02/28/ex-biden-adviser-said-administration-was-pushing-for-digital-dollar> (last visited: Mar. 5, 2023).

¹¹ Nellie Liang (Under Secretary for Domestic Finance Speech), "Next Steps to the Future of Money and Payments" (Mar. 1, 2023), Workshop was organized by The Atlantic Council GeoEconomics Center, The Digital Assets Policy Project of the Harvard Kennedy School Mossavar-Rahmani Center for Business and Government, The MIT Digital Currency Initiative, and Stanford University's Future of Digital Currency Initiative, <https://home.treasury.gov/news/press-releases/jy1314> (last visited: Mar. 7, 2023).

¹² See Exec. Order No. 14067, 87 FR 14143 (Mar. 9, 2022).

A “Framework” that Has Yet to Fulfill Its Promise

On September 16, 2022, the White House released what it described as the “First-Ever Comprehensive Framework for Responsible Development of Digital Assets.” The commonly accepted understanding of the word framework is ‘an essential supporting structure’ or ‘basic structure underlying a system, concept, or text’, for example. But the Administration’s proffered framework failed in that regard, serving more as a report-out of initial agency findings and recommendations than a workable framework regulated parties could reasonably rely on to operate lawfully within clear rules of engagement for this novel, programmable, dynamic asset class.

Instead, good faith industry participants, and the financial and legal professionals charged with the considerable task of zealously representing them, are left with little on which to rely, unless or until they trip a hidden regulatory wire that leads to retroactively applied sanctions and cessation of services at the hands of powerful regulators, most notably the SEC.¹³ Based on this interagency call-to-action by the country’s Chief Executive, we need not guess whether the recent and substantial uptick of interest, inquiry, and aggressive action from agencies is coordinated. The simple answer (indeed the *only* answer) is yes.

Answering the call of this question, however, is only the first step. The next is for Congress to examine how agencies, generally, and the SEC in particular, are using their statutorily prescribed powers, including considerable discretionary powers, to give effect to this coordinated policy call-to-action. Although agencies have followed up on reporting requirements by issuing initial reports and findings, none have offered any clarity on the appropriate rules of engagement that protect consumers, investors and businesses while also ensuring the country’s leadership in innovation as the next iteration of the world wide web (web3) continues to be developed on the rails of decentralized protocols, automated performance via smart contracts and crypto assets.

It remains unclear how responsible builders and market participants in the future of money, work, and creativity can operate confidently, efficiently, and with clarity. Without such a foundation, private industry development will be left in a holding pattern or will simply move valuable tax dollars and opportunities to jurisdictions with clearer rules and policies that encourage, rather than stifle, innovation.

Finally, while the Administration moves forward to consider launching its own version of digital money to “squeeze out” private currencies,¹⁴ industry actors and their representatives are left to their own devices to read the proverbial tea leaves of principles of law from case-specific

¹³ Case in point is the recent settlement between the SEC and Kraken over its staking product. Kraken was fined \$30 million and prohibited from ever relaunching a staking product in the U.S. In a blistering rebuke, SEC Commissioner Hester Peirce dissented in that case, arguing that “Using enforcement actions to tell people what the law is in an emerging industry is not an efficient or fair way of regulating,” and given that staking systems are not all the same, “one-off enforcement actions and cookie-cutter analysis does not cut it.” Statement Kraken Down: Hester Pierce Statement on SEC v. Payward Ventures, Inc., et al.” (Feb. 9, 2023), <https://www.sec.gov/news/statement/peirce-statement-kraken-020923> (last visited: Mar. 7, 2023).

¹⁴ See Jesse Hamilton, COINDESK.COM, *Ex-Biden Adviser Said Administration Was Pushing for Digital Dollar* (Feb. 28, 2023), <https://www.coindesk.com/policy/2023/02/28/ex-biden-adviser-said-administration-was-pushing-for-digital-dollar> (last visited: Mar. 5, 2023).

piecemeal enforcement actions rather than to be assured of clear rules promulgated, after notice-and-comment, to apply prospectively to *all* regulated parties.

Separating Fact from Fiction

In 2022, the crypto asset ecosystem experienced numerous crises at the hands of major players that caused reverberating effects within both the crypto asset economy and broader economy.¹⁵ The domino effects of crypto lender and exchange failures have subsequently been used by critics as exhibit A to support a narrative that all crypto assets—all 22,700+ tokens and native coins (and counting)—are scams and fraudulent. This is both counterproductive and patently false. Case in point, in its 2022 report on crypto crime, Chainalysis found “[t]ransactions involving illicit addresses represented just 0.15% of cryptocurrency transaction volume in 2021.”¹⁶ If there is any hope for meaningful, well calibrated regulation of the crypto asset ecosystem, it is important to separate fact from fiction.

For example, disgraced FTX and Alameda Research founder Sam Bankman-Fried is accused of diverting billions of dollars in customer funds to a trading platform he controlled. He is charged, essentially, for using his power, position, and privilege to maximize his profits at the expense of FTX investors, customers, employees, and the crypto asset industry. The list of charges in the federal indictment, as well as the SEC and CFTC actions currently on pause pending the federal case, allege that he and his cohorts misappropriated customer funds held in yield bearing accounts that promised an eight percent return to leverage up his hedge fund and make extremely risky investments. All without the knowledge or consent of customers.

Misuse of client funds is clearly illegal and has serious consequences. What Bankman-Fried is accused of doing, however, is not a failure of a cryptographically secured asset, or its underlying technology. What he is accused of doing is what a litany of now-infamous financial fraudsters have been convicted of in the past, namely: Enron, Bernie Madoff, Lehman Brothers, Theranos, and WorldCom, to name just a few.

Bankman-Fried’s alleged criminal activities were not a crypto asset problem any more than the aforementioned frauds were a U.S. dollar problem. The charges against Bankman-Fried describe classic fraud. All the charges leveled against him and his cronies, were apparently done using centralized ledgers and fraudulent bookkeeping to perpetrate fraud valued into the billions while good faith market participants chose, instead to move to jurisdictions providing clarity for innovators and investors and consumers.¹⁷

¹⁵ See, generally, Julian Mark, WASHINGTONPOST.COM, *The companies that helped create 2022’s ‘crypto winter’* (Dec. 5, 2022), <https://www.washingtonpost.com/business/2022/12/05/crypto-ftx-collapse-bankruptcy-companies/> (last visited: March 6, 2023).

¹⁶ See Report: *Crypto Crime Trends for 2022: Illicit Transaction Activity Reaches All-Time High in Value, All-Time Low in Share of All Cryptocurrency Activity* (Jan. 6, 2022) (<https://blog.chainalysis.com/reports/2022-crypto-crime-report-introduction/>). The annual report shows percentage of crypto crime as compared to overall use down considerably and becoming a smaller and smaller part of the cryptocurrency ecosystem: 1.42% (2017), 0.76% (2018), 3.3% (2019), 0.62% (2020), and 0.15% (2021). 2019

¹⁷ For example, crypto borrowing and lending platform Nexo chose to move its operations overseas rather than spin its proverbial wheels and remain at the whims of the SEC without clear guidance, rules or regulations on

The Deleterious Impact on the Future of Financial Access and Inclusion

Web 3.0 has the potential to be the decentralized and democratized internet promised when Web 2.0 first emerged. An optimally functioning public, permissionless blockchain gives true access to all. For example, from its inception, the Bitcoin protocol has been fully permissionless, secure and transparent to mitigate (or in some cases eliminate) the asymmetry of information that plagues the current opaque, privileged financial system.

Given the still relatively early-stage development of the distributed ledger infrastructure, it is imperative that private and public entities work together to explore and enhance those aspects of the blockchain, decentralized finance, crypto assets, and stablecoins that empower, include, and uplift all communities, not just the privileged. A critical and unique opportunity exists to achieve these aspirations, one that has not existed since the dot com era that created enormous Silicon Valley wealth for generations. The reason is because in a decentralized financial environment, it matters not one's race, ethnicity, age, gender, orientation, or any "othered" characteristic.

Further, legacy financial institutions have seized the early-mover opportunity among their peers to innovate in delivering products and services for the digital future by leveraging blockchain technology or offering direct or indirect exposure to crypto to their customers. Despite public comments injecting misguided narratives about crypto assets, major banking and financial institutions like Deutsche Bank, Morgan Stanley, and even long-time Bitcoin skeptic JPMorgan, have all recognized the value proposition of crypto and blockchain and started to position themselves for a decided advantage in this new distributed value frontier. This includes giving exposure to high-net-worth individuals.¹⁸

Unchecked imbalance in access to future wealth-generating opportunities only serves to reinforce the status quo of yesteryear. Without sufficient investment, education, resources and support, small businesses—especially minority and women-owned businesses—will likely be eclipsed by large enterprises looking to stake their proverbial flags in this new world of fintech advancement. They will also be left to suffer the greatest harm when bad actors are allowed to flourish and good actors are driven offshore, as occurred in the most recent bear market.

FDIC.com defines economic inclusion as when "... all consumers have access to safe, affordable financial products and services." Accordingly, "[o]wnership of a transaction account is a first step toward economic inclusion". Yet, the current system is broken because it does not serve all Americans equitably. In fact, a 2019 FDIC Survey titled "Key Findings from How America Banks: Household Use of Banking and Financial Services"¹⁹ revealed that 5.4 percent

which to rely and innovate in the U.S. *See, generally*, Tom Blackstone, CoinTelegraph.com, Nexo leaving US, says country lacks clear regulations (Dec. 5, 2022) <https://cointelegraph.com/news/nexo-leaving-us-says-country-lacks-clear-regulations> (last visited: Mar. 6, 2023).

¹⁸ *See, generally*, Ian Allison, COINDESK.COM, *Deutsche Bank Quietly Plans to Offer Crypto Custody, Prime Brokerage* (Feb 12, 2021 at 9:10 p.m. EST, Updated Sep 14, 2021 at 8:11 a.m. EDT), <https://www.coindesk.com/business/2021/02/13/deutsche-bank-quietly-plans-to-offer-crypto-custody-prime-brokerage/> (last visited: Mar. 6, 2023).

¹⁹ <https://www.fdic.gov/analysis/household-survey/index.html> (Nov. 14, 2022).

of U.S. households (approximately 7.1 million) were “unbanked” in 2019. Twenty-nine percent of unbanked households reported not having enough money to meet minimum balance requirements”, the first-most cited reason, and 16.1 percent cited a lack of trust in the banking system as the main reason for not having an account—the second-most cited main reason.

McKinsey & Co reports that “A lack of financial inclusion for black Americans exists at every level of the financial system.”²⁰ And the International Monetary Fund (IMF) describes financial inclusion as the critical bridge between improved economic opportunity and improved economic outcomes. The black community’s historical distrust of the centralized power of government, and healthcare and banking systems further compounds problems while widening the wealth gap.²¹

In 2020, the Hamilton Project released a comprehensive evaluation of wealth in the U.S.²² It found evidence of staggering racial disparities in generational wealth accumulation. For example, in 2016, the net worth of a typical White family was \$171,000, nearly 10 times greater than that of a black family (\$17,150). The report also shows that families with the same income can have dramatically different wealth profiles, thanks to lower debt, past accumulated income, inherited wealth, and other liquid assets. This wealth gap can be viewed both as a cause and a symptom of a lack of access to affordable and reliable means to save, borrow and invest, especially when coupled with redlining and predatory loan practices that perpetuate and exacerbate these chronic concerns.

In the 2022 Ariel/Schwab Black Investor Report, surveyors included crypto asset investment statistics for the first time. The report found that:

- 25% of Black Americans currently own crypto
- 23% cited excitement over crypto as being the reason they started investing
- twice as many Black Americans as White ranked crypto as the best investment choice overall (8% vs 4%)
- Black crypto investors are more likely than Whites to believe it’s safe (33% vs 18% of Whites)

Additionally, Black Americans are saving and investing significantly more than they did in 2020, with the highest contributions coming from new investors, high earners, and young respondents. But trust in legacy financial institutions is still very low. The surveyors conclude that “[t]here is a clear need for financial institutions to build trust and address the education gap between Black and White investors.”

This data point is likely the reason crypto assets and defi are so attractive to Black investors, especially digital natives. The idea of a trusted intermediary—a bank, for example—is no longer needed to have a secure way to exchange value and leverage crypto assets to earn interest or

²⁰ <https://www.mckinsey.com/industries/public-and-social-sector/our-insights/the-case-for-accelerating-financial-inclusion-in-black-communities>

²¹ <https://www.forbes.com/sites/ericbrotman/2020/09/30/the-wealth-gap-widens-covid-19s-k-shaped-recovery/?sh=52f453bcce6e>

²² https://www.hamiltonproject.org/blog/examining_the_black_White_wealth_gap.

extract value like equity out of a home, all without the gatekeepers in a system plagued with systemic ills like racism and sexism that has not proved itself to be trustworthy.

Sadly, this distrust is well earned and reaches back to the first bank created specifically for Black citizens in America. The Freedman's Bank, created by President Abraham Lincoln with oversight by the Office of the Comptroller of Currency, was allowed to fall into corrupt hands leading to the bank's collapse and caused "a major blow to the confidence and livelihood of scores of [B]lack depositors who trusted the bank [and country] with their savings."²³

Role of Administrative Agencies

Congress regularly delegates its lawmaking function to executive agencies, and does so for good and practical reasons. Legislators simply cannot think of every single detail required to implement policy and procedure. Nor do they have the luxury of time or experience to develop deep subject matter expertise. Accordingly, Congress enacts enabling legislation to empower agencies led, presumably, by subject matter experts without having to develop the expertise itself. That delegation of power often comes with considerable discretion.

Some agencies are empowered to render case-specific determinations through adjudicative powers that apply to one or a few regulated parties and to create rules and regulations having the effect of law through rule promulgation and apply to *all* regulated parties within the agency's reach. Rulemakings are applied prospectively, are general, in nature, apply to a large number of people, depend on social facts, are usually followed by adjudications (not the other way around) and are protected by the democratic process (rather than a specific due process inquiry).²⁴ In contrast, adjudications are intended to be retrospective, specific, applicable to one or only a few people, depends on specific facts related to the party to the adjudication and dependent on specific facts, generally preceded by rulemaking, and are susceptible to abuse and corruption.²⁵

The Securities and Exchange Commission

Numerous agencies are empowered to oversee and to regulate American financial markets and institutions.²⁶ Much thought, discussion and proposed legislation has focused on the

²³ See Marcus Anthony Hunter, CHICAGOREPORTER.COM, *Black America's distrust of banks rooted in Reconstruction* (Feb. 22, 2018) <https://www.chicagoreporter.com/black-americas-distrust-of-banks-rooted-in-reconstruction/> (last visited: Mar. 7, 2023). See also, Carl R. Osthaus, FREEDMEN, PHILANTHROPY, AND FRAUD: A HISTORY OF THE FREEDMAN'S SAVINGS BANK (URBANA, IL, 1976); REGINALD WASHINGTON, "THE FREEDMAN'S SAVINGS AND TRUST COMPANY AND AFRICAN AMERICAN GENEALOGICAL RESEARCH," PROLOGUE, 29: 2 (SUMMER 1997), AT [HTTP://WWW.ARCHIVES.GOV/PUBLICATIONS/PROLOGUE/1997/SUMMER/FREEDMANS-SAVINGS-AND-TRUST.HTML](http://www.archives.gov/publications/prologue/1997/summer/freedmans-savings-and-trust.html) (last visited: Mar 7, 2023).

²⁴ Hickman & Pierce, FEDERAL ADMINISTRATIVE LAW CASES AND MATERIALS (2020, Foundation Press).

²⁵ *Id.*

²⁶ The Federal Reserve Board (the FRB or Fed) provides commercial banking oversight and regulates bank holding companies (BHCs); Office of the Comptroller of the Currency (OCC) is an independent bureau within the Treasury Department that supervises, regulates, and issues charters to banks; The Federal Deposit Insurance Corp. (FDIC) insures bank deposits; Commodity Futures Trading Commission (CFTC) is an independent authority that regulates commodity futures and options and related derivatives markets, and facilitates competitive and efficient market trading; The Financial Industry Regulatory Authority (FINRA) oversees all securities firms, trains financial services

appropriate agency to take the lead, if any, in regulating the crypto asset market. The SEC and CFTC have become the consensus agencies at issue.²⁷ They enjoy distinct areas of jurisdiction but also have joint powers to regulate financial markets with the overall goal of acting in a coordinated, complementary, and effective manner, to protect investors and ensure the integrity of the markets.

Congress established the SEC in response to the Stock Market Crash of 1929 and the resulting Great Depression. The agency was created to regulate the securities industry and enforce the Securities Act of 1933 and the Exchange Act of 1934. Since that time, its mission and discretionary powers have grown considerably. Its regulatory mandate is three-fold: to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation. In addition to enforcing rules and regulations regarding securities trading, including disclosure requirements for public companies, the agency's oversight authority includes the regulation of investment advisers and broker-dealers.

The SEC is a very powerful agency with broad discretionary powers. Through its enabling legislation, it is empowered to choose rule promulgation or adjudications to fulfill its statutory mandate. The agency is also empowered to choose against whom it will exercise its enforcement authority making it more difficult to understand the rules of the road regarding crypto assets and when it will enforce those unwritten rules.²⁸ Congress can, and must, act to curtail regulation by enforcement via statutory limitation and also empower the CFTC to regulate virtual currency and other spot markets in addition to derivatives markets.

Conclusion

The SEC has chosen to wield its considerable discretionary authority in the aggressive way that Justice Robert H. Jackson warned of in his strongly worded dissent in the 1947 Supreme Court decision *S.E.C. v. Chenery II*. In that seminal administrative law case, admittedly a win for SEC discretionary authority, Justice Jackson reminds us “[s]urely an administrative agency is not a law unto itself?”²⁹ Or at least it should not be. Administrative agency officials are not elected by the People; Congress is.

Accordingly, as Congress considers how best to re-evaluate its delegation of powers to the SEC and empower CFTC to have jurisdiction over spot crypto asset markets, I offer these three points to consider:

professionals, licensing and testing agents, and oversees mediation and arbitration processes for disputes between customers and brokers; The Securities and Exchange Commission (SEC) enforces federal securities laws and oversees most of the securities industry. Other implicated

²⁷ See Joel Seligman, CLSBLUESKY.LAW.COLUMBIA.EDU, *The Lummis-Gillibrand Responsible Financial Innovation Act*, The CLS Blue Sky Blog (June 27, 2022), <https://clsbluesky.law.columbia.edu/2022/06/27/the-lummis-gillibrand-responsible-financial-innovation-act/> (last visited: Mar. 6, 2023).

²⁸ See *Heckler v. Chaney*, 470 US 821 (1985). See also, David Zaring, *Enforcement Discretion at the SEC* (noting that “[a]gencies have always enjoyed unfettered discretion to choose their enforcement targets and their policymaking fora.”).

²⁹ 332 U.S. 194, __ (1947).

- Re-consider legislation with bipartisan support across oversight committees that would reign in unwieldy executive agency actions and empower the CFTC to regulate spot crypto asset markets;
- Ensure that all citizens have equal access and opportunity to thrive safely, legally and confidently in the future of work, wealth and industry; and
- Request the SEC to appear before Congressional oversight committees to explain how its aggressive piecemeal approach to regulation of crypto assets comports with efficient and effective regulation and in line with its legislative mandate to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation.

Sincerely,

Tonya M. Evans

Tonya M. Evans
Professor of Law

Testimony of Jonathan V. Gould
Partner, Jones Day
Before the U.S. House Financial Services Subcommittee on Digital Assets, Financial
Technology and Inclusion
hearing on
“Coincidence or Coordinated? The Administration’s Attack on the Digital Asset
Ecosystem”

March 9, 2023

Chairman Hill, Ranking Member Lynch and Members of the Subcommittee: thank you for the opportunity to discuss the administration’s actions with respect to the digital asset ecosystem.

Over the last 18 months, the Federal banking agencies have issued a number of public guidance documents. This guidance has articulated agency concerns with risks associated with digital asset activities of banks, expressed their skepticism that many of these activities can be conducted in a safe and sound manner, and imposed procedural barriers to their commencement. My testimony summarizes these guidance documents and identifies areas for further Congressional scrutiny and oversight. My testimony is my own. I am speaking today solely in my personal capacity; I am not speaking on behalf of any clients or my law firm.

Following a crypto “sprint” in 2021 and over the course of 2022, the Federal banking agencies each issued guidance documents addressing the digital asset activities of banks. The OCC moved first, issuing an interpretive letter in November 2021 that addressed digital asset activities, among other things.¹ The OCC did not challenge the legal conclusions of its earlier letters addressing certain digital asset activities,² but instead emphasized the fact that any banking activity, including digital asset activities, must be conducted in a safe and sound manner. Rather than addressing safety and soundness concerns in the ongoing supervisory process, as is the case with respect to many bank activities, the letter required banks to address them to the OCC’s satisfaction *before* the bank could engage in digital asset activities. As part of this supervisory “non-objection” process, the OCC evaluates the bank’s risk management and controls, and its understanding of compliance obligations. As a practical matter, this letter

¹ See OCC Interpretive Letter 1179 (Nov. 18, 2021), <https://www.occ.treas.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf>.

² See Interpretive Letter 1170 (July 22, 2020), <https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf> (concluding that banks may provide cryptocurrency custody services on behalf of customers, including by holding the unique cryptographic keys associated with cryptocurrency); Interpretive Letter 1172 (Sept. 21, 2020), <https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1172.pdf> (concluding that banks may accept deposits that serve as “reserves” for stablecoins that are backed by fiat currency on a 1:1 basis and held in hosted wallets); Interpretive Letter 1174 (Jan. 4, 2021), <https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-2a.pdf> (concluding that banks may serve as a node on an independent node verification network (INVN) such as a distributed ledger and may use INVNs and related stablecoins to conduct permissible banking activities, such as payments).

created a procedural mechanism that the OCC can use to delay or prevent banks from commencing digital asset activities.

Following in the footsteps of the OCC, the FDIC and Federal Reserve each issued similar guidance documents in 2022. In April, the FDIC issued a financial institution letter directing banks it supervises that intend to engage in, or that are currently engaged in, any activities involving or related to crypto assets to notify the FDIC.³ In addition to prior notice, per this letter, FDIC-supervised banks should provide the FDIC with information sufficient to allow the agency to assess the safety and soundness, consumer protection, and financial stability implications of the proposed digital asset activities. The FDIC promised to provide “relevant supervisory feedback” to the bank.

The Federal Reserve followed suit in August 2022 with guidance identifying potential risks and requiring banks it supervises to provide prior notice before engaging in crypto-asset-related activity with the promise of providing “relevant supervisory feedback, as appropriate, in a timely manner” in return.⁴ Neither the FDIC nor the Federal Reserve addressed the legal permissibility of any specific crypto-related activity in their respective 2022 letters.⁵

The pace and coordination of these issuances have increased this year, with two joint agency statements in as many months, and an important policy statement from the Federal Reserve.

In January of this year, the OCC, Federal Reserve and FDIC issued a joint statement on crypto-asset risks that set forth the agencies’ approach to digital assets in the most explicit terms yet.⁶ After listing a number of risks evident over 2022, the statement noted the importance of preventing risks related to the crypto-asset sector that cannot be mitigated or controlled from migrating to the banking system. Most significantly, the agencies expressed skepticism that crypto-asset-related activities could be conducted in a safe and sound manner at the current time. Although the digital asset activities addressed by earlier OCC guidance may still be legally permissible for banks in the abstract, the agencies’ view that these activities are “highly likely to

³ See FDIC Financial Institution Letter, Notification of Engaging in Crypto-Related Activities (April 7, 2022), <https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html#letter>. The FDIC also issued a second financial institution letter addressing misconceptions about the scope of deposit insurance coverage and its application to certain crypto companies. See FDIC Financial Institution Letter, Advisory to FDIC-Insured Institutions Regarding Deposit Insurance and Dealings with Crypto Companies (July 29, 2022), <https://www.fdic.gov/news/financial-institution-letters/2022/fil22035.html>.

⁴ See Federal Reserve, SR Letter 22-6, Engagement in Crypto-Asset-Related Activities by Federal Reserve-Supervised Banking Organizations (Aug. 16, 2022), <https://www.federalreserve.gov/supervisionreg/srletters/SR2206.htm>.

⁵ Unlike the OCC, neither the FDIC nor Federal Reserve is generally charged with defining the scope of bank permissible activities in the first instance since neither is a chartering authority. But see note 9 and accompanying text.

⁶ See Federal Reserve Board, FDIC and OCC, Joint Statement on Crypto-Asset Risks to Banking Organizations (Jan. 3, 2023), <https://occ.treas.gov/news-issuances/news-releases/2023/nr-ia-2023-1a.pdf>.

be inconsistent with safe and sound banking practices” makes the path forward narrow or nonexistent barring a change in the agencies’ view.⁷

Just last month, the OCC, Federal Reserve and FDIC issued a joint statement on liquidity risks to banks resulting from crypto-asset market vulnerabilities.⁸ The guidance focused on funding risks to banks from holding deposits that are associated with crypto-asset-related entities, whether deposits for the benefit of end customers of crypto entities or deposits that constitute stablecoin reserves. The agencies noted the importance of effective risk management to mitigate any such liquidity risks and reminded banks of their need to comply with brokered deposit rules and reporting requirements.

Between these joint agency issuances, the Federal Reserve issued a policy statement imposing limits, including approval requirements, on digital asset activities and other novel activities of state member banks.⁹ More specifically, the Federal Reserve created a rebuttable presumption that state member banks may engage as principal only in activities permissible for national banks unless explicitly authorized to do so by Federal statute or FDIC regulation—and may only do so subject to any attendant conditions imposed by the applicable Federal regulator. Otherwise, the Federal Reserve will treat requests to engage in such a “novel and unprecedented” activity as a change in the general character of the business of the bank such that the state member bank must obtain Federal Reserve permission under Regulation H, under a rebuttable presumption that the activity is impermissible. Unlike the guidance documents discussed above, which are technically non-binding, the Federal Reserve’s policy statement is framed as a rule and thus purports to be enforceable.

As Congress considers the actions of the Federal banking agencies, there are three attributes of bank supervision that I want to highlight. First, bank supervision is by design confidential, particularized and potent.¹⁰ Although the agency issuances mentioned above are public, their application is not. The confidential nature of the supervisory relationship facilitates the flow of information between bank and regulator, but it can also frustrate accountability and oversight.

Second, safety and soundness, the primary lens through which these agency issuances are framed and the goal of prudential regulators like the OCC, Federal Reserve and FDIC, can be a subjective concept. Banking agencies have issued thousands of pages of public, non-binding guidance detailing their interpretations of what safety and soundness means in a variety of

⁷ The agencies also have “significant safety and soundness concerns with business models that are concentrated in crypto-asset-related activities or have concentrated exposures to the crypto-asset sector.” *Id.*

⁸ See Federal Reserve Board, FDIC and OCC, Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities (Feb. 23, 2023), <https://www.occ.treas.gov/news-issuances/news-releases/2023/nr-ia-2023-18a.pdf>.

⁹ See Federal Reserve Board, Policy Statement on Section 9(13) of the Federal Reserve Act (Feb. 7, 2023), codified at 12 CFR § 208.12, <https://www.federalregister.gov/documents/2023/02/07/2023-02192/policy-statement-on-section-913-of-the-federal-reserve-act>.

¹⁰ For more on the differences between bank regulation and supervision, see then Federal Reserve Vice-Chairman Randy Quarles’s “Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision” (Jan. 17, 2020), <https://www.federalreserve.gov/newsevents/speech/quarles20200117a.htm>.

contexts to help banks achieve it and to facilitate consistency in the agencies' supervisory expectations and approach.

Finally, although agency guidance is technically non-binding,¹¹ banks rarely challenge or disregard it. The practical consequences of doing so can be significant in light of the supervisory process through which guidance is applied.

Given the attributes of bank supervision noted above, generalized and negative statements raising safety and soundness concerns about particular industry sectors must be made carefully lest they be interpreted by the public or bank examiners as an outright prohibition.¹² Anecdotal evidence suggests that agency actions over the last 18 months, while responsive to developments in the digital asset ecosystem, are indeed having a chilling effect on banks' practical ability to engage in digital asset activities as well as their willingness to entertain or maintain digital asset entities as banking customers. Because of the confidential nature of the supervisory relationship, it is impossible for the public to assess the actual causal effect of these agency actions.

There are several areas that would benefit from Congressional attention. First, the agencies' actions might be disproportionate – whether in nature or magnitude – to the risks posed by digital assets. This is a judgment call, but it may be helpful to consider the extent to which the risks the agencies cite in their guidance are unique to digital assets and the magnitude of the harm to the banking system posed by these risks, particularly as compared to other risks confronting the banking system. Some of the risks posed by digital assets are well known and understood to banks and supervisors alike. Congress might also consider whether the agencies are responding to other risks to the banking system, such as rising consumer debt, cyber threats and the impact of interest rate risk on bank investment portfolios, in similar or proportionate fashion, and whether the harms posed by those risks exceed potential harms posed by digital asset activity.¹³

Relatedly, the strategy to address the risks posed by digital assets may be less than optimal. Regardless of intent, the agencies' actions seem to be having the practical effect of prohibiting banks from engaging in digital asset activities or providing banking services to digital asset customers. Risk elimination strategies are often less effective over the long term than risk management strategies. As we have seen repeatedly, risk elimination strategies tend to push financial risk into less visible corners of the economy where our ability to monitor and manage it can be challenging, rather than eliminating that risk outright.

Second, the agencies' actions might be overbroad and risk chilling innovative activities. Precluding banks from exploring new technologies, like distributed ledgers, to achieve traditional banking activities, like payments or deposit-taking, risks diminishing the important

¹¹ See, e.g., 12 CFR §§ 4.81 *et seq* (Statement Clarifying the Role of Supervisory Guidance).

¹² Note the inclusion in certain agency issuances of the following disclaimer: "Banking organizations are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation." See e.g., Federal Reserve Board, FDIC and OCC, Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities (Feb. 23, 2003).

¹³ See, e.g., OCC Semiannual Risk Perspective (Fall 2022), <https://www.occ.treas.gov/publications-and-resources/publications/semiannual-risk-perspective/files/pub-semiannual-risk-perspective-fall-2022.pdf>.

role played by banks in our economy. The vague and occasionally shifting definitions used in agency guidance may cause banks to think twice about any use of distributed ledger technology or decentralized networks. And the Federal Reserve's recent policy statement applies to any novel and unprecedented activity of state member banks – whatever those may be – not just digital asset activities.

Finally, safety and soundness pronouncements are, in some sense, a reflection of the agencies' risk tolerance for individual banks and the banking system as a whole. Congress should have a key role in defining the risk tolerance of our banking system, especially when it involves industry-specific attention as seems to be the case here. And if it disagrees with the agencies' risk assessment or risk tolerance, it can and should do something about it.

The confidential nature of the supervisory relationship necessarily limits the public's ability to assess the actual effects of the banking agencies' guidance. Congress is not so limited. It has the oversight ability to move beyond anecdote to examine how these guidance documents are being implemented and their effect. Armed with this information, it can then make an informed decision about the propriety or prudence of the banking agencies' actions. I encourage it to do so.

Thank you again for the opportunity to testify. I look forward to your questions.



Testimony of Paul Grewal

Chief Legal Officer
Coinbase Global, Inc.

Before the U.S. House Committee on
Financial Services

Subcommittee on Digital Assets, Financial Technology
and Inclusion Subcommittee

Thursday, March 9, 2023



Good afternoon. Thank you, Chairman Hill, Ranking Member Lynch and members of the committee for inviting me to testify today about the critical need for new rules for crypto.

My name is Paul Grewal and I am the Chief Legal Officer at Coinbase. I joined Coinbase in August 2020 following four years as the Vice President and Deputy General Counsel at Facebook, Inc. Prior to Facebook, I served for six years as a U.S. Magistrate Judge for the U.S. District Court of the Northern District of California, a partner at Howrey LLP, and a Judicial Law Clerk for the U.S. Court of Appeals for the Federal Circuit and the U.S. District Court for the Northern District of Ohio. I joined Coinbase because throughout my career I've seen what sound law and policy can do to allow technology to improve real people's lives. At Coinbase that is my core responsibility.

Today I would like to leave you with three key thoughts:

First, the time to act to fix our financial system is now. 80% of Americans believe the financial system is unfair and 67% believe it needs a serious upgrade. Crypto – and the blockchain technology on which it's built – is part of the solution. This is increasingly evident in places like Ukraine where crypto solves challenges like monetary stability and secure access to services and money. Crypto is a fair, accessible, efficient and transparent system that leverages digital assets built on blockchain technology to securely transfer value or ownership.

Second, blockchain technology is transformational, but we are at risk of pushing the benefits and the control of that transformation overseas if we fail to adopt clear rules and regulations. The rest of the world is not waiting for us, and they will benefit from our absence. Europe, the UK, Australia, and Singapore – just to name a few – are putting in place regulatory frameworks that are creating high standards for crypto. It is truly a race to the top, and the U.S. is already behind. That is bad for our economic future and our national security.

Third, we need a regulatory framework that embraces the benefits of crypto, while also protecting consumers. Crypto is a technology that makes the existing financial system work better. But the benefits, such as enabling faster and cheaper payments or settling in real-time, require laws and rules that reflect a new way of thinking and an eye toward progress. We need policymakers to work together to develop a comprehensive framework that provides pathways for customers to access both digital asset commodities and digital asset securities in the U.S.

Why do we need new rules for crypto?

The U.S. is at a once-in-a-generation inflection point: we have the opportunity to be the leader in the digital currency space by leveraging the promise of crypto and the blockchain technology that underpins it to modernize our financial system, enable efficiency and accessibility, ensure consumer security and protection, and solidify our position as a geopolitical powerhouse. This opportunity comes as American consumers are calling for an updated financial system. According to new research from [Morning Consult](#), 80% of Americans think the current financial

coinbase

system is unfair and 67% believe it needs a major upgrade or a complete overhaul.¹ But if we fail to heed this call and embrace our leadership role on crypto now, we will concede more than a promising industry – we will risk surrendering the economic and geopolitical leadership we have worked hard for over the last century.

Global superpowers like the U.K., Japan, China, and the EU have taken significant steps to embrace digital currencies through adoption or regulatory progress. The EU, for example, is working to implement Market in Crypto-Assets (“MiCA”) legislation, which created a comprehensive regulatory framework intended to close the gaps in existing financial services legislation and establish a harmonized set of rules designed for crypto assets, companies, and services. China launched a digital yuan and is piloting services and systems to advance digital currency adoption across the country. Instead of keeping pace and developing our own transparent regulatory framework in the U.S., we are falling behind. While our global economic dominance is being challenged by these competitors, U.S. regulators have taken sporadic and ambiguous enforcement actions based on decades-old rules designed for a system that looks more and more like the past.

Three in four Americans who own crypto agree that cryptocurrency and blockchain represent the future of finance, but we are losing the race to build the kind of structures and support that fosters innovation here at home. You do not need to look far to see the risk of sending innovation offshore. While we once dominated the semiconductor industry, the shifts that pushed development offshore in the 1980s and 1990s still haunt us today. For the past few years, chip shortages have negatively impacted industries across our economy. We should keep these lessons in mind as we consider the modern rules and regulations that will define breakthrough technologies like crypto and the blockchain, and we should ensure the power to shape them stays here in America.

By embracing crypto we can respond to calls from everyday Americans for an updated financial system and solidify the U.S. as the incumbent leading global economic and political powerhouse of this century. In a digital-first future economy, we can imagine a world in which stablecoins are predominantly minted and issued dominated by the U.S. dollar, thereby ensuring the continued leadership of the U.S. dollar as the world’s reserve currency and serving as the gold standard for international currency transfers, remittances, and exchanges, and expanding financial access to millions of unbanked and underbanked people around the world. Already, crypto and the blockchain have exemplified the potential dominance of a U.S. digital currency in Ukraine, where the United Nations Refugee Agency (UNHCR) used USDC, a U.S. dollar-backed stablecoin, to get financial aid efficiently and directly into the hands of those impacted by the regional conflict.

This is a critical moment for our country. We have the opportunity to lead from the front on digital currencies and reap the geopolitical and economic benefits that position provides. Or, we can

¹ Morning Consult. *Crypto Currency Perception Study*. 24 Feb 2023.
https://assets.ctfassets.net/c5bd0wqjc7v0/VWuOkBwNXZsqhd6EWtkEL/7f94f8b6fbb222f3faf4d0346e473012/Morning_Consult_Cryptocurrency_Perception_Study_Feb2023_Memo__1_.pdf



concede our leadership role to adversaries who are eager to take the reins as this century's global heavyweight. If we choose the latter, we will take a step back from the geopolitical playing field, limit our influence and submit to the rules, regulations, and innovations of foreign players, all to the detriment of American consumers.

How does Coinbase keep customers and the wider cryptoeconomy safe?

Coinbase was founded in 2012 with a mission to increase economic freedom in the world, and be the world's most trusted, secure, and compliant onramp to the cryptoeconomy. Our products enable tens of millions of consumers, institutions, and developers around the world to discover, transact, and engage with crypto assets and web3 applications. We enable our customers to trade and custody assets, but we list assets only after they have been through a rigorous legal, compliance, and information security review.

Over our ten year history we have built the necessary infrastructure for a reliable and efficient digital asset ecosystem. Today we have a durable business model that prioritizes prudent risk management and emphasizes transparency with customers, market participants, and government authorities, all to help encourage the cryptoeconomy's development. That transparency is punctuated by our decision to make Coinbase a publicly traded company, which offers among the strongest investor – and ultimately consumer – protections any market participant can provide given the long and rich history of public market regulation in the U.S. We believe the transparency required as a public company, which includes disclosures of audited financial statements that detail audit and disclosures of customer assets safeguarded on our platform, business operations, and risk factors, makes us distinct in the cryptoeconomy.

Coinbase has always strived to be the most trusted, safe, and compliant crypto platform, which means putting consumers first and working hard to protect them. As a result, we have embraced regulation for ourselves for over a decade, worked constructively with regulators and our own industry to develop comprehensive pro-consumer regulatory frameworks here and overseas, and developed robust operating controls and risk management practices that protect consumers and the crypto ecosystem as a whole. Some of these controls have been implemented through our work with regulators like the New York Department of Financial Services ("NYDFS"), whose supervisory oversight through its BitLicense and trust charter helped to prevent the transmission of risks from the events of 2022 to companies within its regulatory purview. This illustrates the importance of having a regulatory regime tailored to crypto specific risks and characteristics, while also demonstrating to Federal regulators that such a regime is possible to implement.

A little about how we think about protecting customer assets: we hold our customer assets 1:1 at all times, which means we do not lend or rehypothecate customer assets without their consent, and we do not engage in fractional reserve banking with respect to customer assets. We deposit, transfer, and custody customer cash and crypto assets in multiple jurisdictions and with multiple institutions. In each instance, we are required to safeguard customers' assets using bank-level security standards applicable to our hot and cold wallet and storage systems,



as well as our financial management systems related to such custodial functions. Our security technology is designed to prevent, detect, and mitigate inappropriate access to our systems by internal or external threats. We believe we have developed and maintained administrative, technical, and physical safeguards designed to comply with applicable legal requirements and industry standards.

At all times, we appropriately ledger, properly segregate, and maintain separate accounts for our corporate crypto assets and customers' crypto assets. Coinbase Custody Trust Company, LLC provides cold storage custody services with crypto assets held separately in dedicated addresses and ledgered using a proprietary combination of hardware security modules. Coinbase, Inc. provides crypto trading services with crypto assets held in an omnibus manner on the blockchain and separated using a ledger system. As a U.S. public company, these practices are subject to annual audits and quarterly reviews, which, among other things, require that our independent registered public accounting firm reviews and audits our crypto reserves, internal controls and reconciliation processes.

Importantly, we have structured our platform so that our customer assets are protected. Our various user, custody and client agreements clarify the applicability of Uniform Commercial Code ("UCC") Article 8 to custodied crypto assets. UCC Article 8 provides that financial assets held by Coinbase are not property of Coinbase and not subject to claims of our general creditors. If anything ever happens to Coinbase, our customers will not be standing in line, as we've sadly seen happen to other companies' customers over the past year.

In addition to safeguarding customer assets on the platform, Coinbase is committed to the prevention and detection of illicit activity and keeping Coinbase customers and the U.S. financial system safe from bad actors. We have implemented a comprehensive Financial Crimes Compliance program that adheres to U.S. BSA / AML and sanctions requirements. This Program incorporates all of the traditional components and controls you would expect from a financial institution, and it is further bolstered by a characteristic unique to cryptocurrency – the public ledger of transactions within the blockchain. We have developed industry-leading security and investigative capabilities that enable our compliance and global investigations teams to trace the proceeds of crime and attribute blockchain addresses to known entities. We frequently train state, federal, and international law enforcement agencies to identify and pursue illicit use of digital asset technologies, and have twice been recognized by FinCEN for providing essential intelligence to law enforcement authorities. In 2019, we received the Private/Public Partnership award from Homeland Security Investigations for our contribution to major law enforcement investigations.

Specific to sanctions, we have a multi-layered program that enforces sanctions set out by OFAC and other global regulators. We screen customers against lists of sanctioned parties, including those maintained by the United States, United Kingdom, European Union, United Nations, Singapore, Canada, and Australia. These checks are conducted during onboarding, as well as routinely throughout the customer lifecycle. If a customer lives in a sanctioned country or region, or if they are identified as a sanctioned individual or entity, they cannot open an account on our



platform. Similarly, we use geofencing controls to prevent access to the Coinbase website, as well as our products and services, by anyone using an IP address in a sanctioned geography (e.g., Crimea, North Korea, Syria, and Iran). Further, Coinbase maintains a sophisticated blockchain analytics program to identify sanctions evaders, high-risk behavior, study emerging threats, and develop new mitigations. For example, we have methods for identifying accounts held by sanctioned individuals outside of Coinbase, even if we don't have direct access to their personal information.

We also invest heavily in compliance tools designed to prevent market manipulation, fraud, and conflicts of interest. We have clear trading rules that prohibit a wide range of fraudulent and manipulative trading activity, including prohibitions on spoofing, wash-trading, and layering, among other manipulative behaviors. These rules can be found at https://www.coinbase.com/legal/trading_rules. We employ proprietary software and techniques, combined with an industry leading third-party trade surveillance software platform that is also utilized at several large global banks and broker-dealers, to identify and address potentially fraudulent or manipulative trading activity on our platform. This software monitors and detects the trading activities of participants on the platform for potential market manipulation, fraud, behavioral patterns, rule violations, and generates alerts in real time. The software and alerts are monitored by a team that have significant traditional financial regulatory, trading, and surveillance experience.

With respect to conflicts of interest and the use of customer data, Coinbase has a variety of policies and disclosures in place to help ensure a fair, transparent and equal experience across our suite of trading products. Customer transactions on our trading platforms are executed on an agency basis where we act only on behalf of, and at the direction of, our clients. Some other examples of our efforts to avoid conflicts of interest include:

- When Coinbase buys crypto for corporate investment, it does that outside of our platform so that we are not trading across from our customers.
- Investments by Coinbase's venture capital arm, Coinbase Ventures, are publicly disclosed on our website so that customers are aware of our material investments.
- The website for Coinbase's Learning Rewards discloses that Coinbase may receive service fees from asset issuers in connection with its educational content.

Finally, at Coinbase, we protect consumers by rigorously assessing every crypto asset to ensure every asset meets our legal requirements (i.e., Does it satisfy the key legal standards for determining whether or not an asset is a security?), our information security requirements (i.e., Does the technology protect consumers from harmful cybersecurity risks?), and our compliance requirements (i.e., Is it associated with scammers, fraud, or illicit activity?)

Specific to our legal requirements, we conduct a thorough review that analyzes potential assets under applicable securities laws, including U.S. securities laws as regulated by the Securities and Exchange Commission (the SEC). We inform our analysis using, among other resources, the SEC Staff's [Framework for "Investment Contract" Analysis of Digital Assets](#). In addition, we consider new developments in the law and the regulatory landscape, including staff



commentary, the results of enforcement actions and settlements, court rulings, and new trends in the crypto industry itself. More specifically, we conduct the following:

- **Factual Diligence:** Coinbase collects information from a number of sources, including from the asset project team or publicly available information, to best understand the facts surrounding the asset's function, current state, and history.
- **Howey Analysis for Investment Contracts:** Coinbase performs an analysis under the Howey line of securities cases to determine the likelihood that offers and sales of the asset qualify as offers and sales of an investment contract under U.S. securities laws. Our analysis is multifactorial and takes into consideration a wide array of facts and circumstances as informed by our factual diligence. As the regulatory landscape continues to evolve, so does our process, and we constantly strive to make changes to keep up with new developments in regulatory guidance, changes in black letter law, and applicable results from enforcement actions, settlements, and judgments.
- **Other Securities Analysis:** When appropriate, Coinbase will also evaluate whether the asset has characteristics of other instruments that may be deemed to be securities, such as a note or stock. For example, we may evaluate to what extent the asset is identified or marketed as an investment and whether the issuer filed a registration statement or claimed an exemption to applicable securities laws. When appropriate, Coinbase also considers whether the asset has features resembling a class of financial instruments known as derivatives.

Why don't the existing rules work?

Current Rules are Incompatible With Blockchain Technology

Coinbase believes that regulation can and should play an important role in our industry. But today's rules in the U.S. do not account for the technological ways in which crypto markets operate. Coinbase has been calling on regulators for more than a decade to create clear rules of the road for crypto. Coinbase first testified before this Committee in 2018² in order to deliver one straightforward message: we need clear and consistent rules in order to spur new capital formation and protect investors. We highlighted the fact that utility tokens, which were emerging at the time, do not fit neatly into the *Howey* framework. We said Congress should insist that the SEC and CFTC coordinate, as they have in the past, to clarify how companies, markets and investors can determine whether an individual token is a security or a commodity. We also said the agencies should clarify rules around what constitutes a security in this space by looking at issues such as whether there is a central issuer and the role of investment contracts at the time of issuance. Five years later, we have the same core message: we need clear rules.

SEC registration of a company, product, or asset is not a simple exercise; it is actually very complicated. Coinbase wants to work with the SEC to enable digital asset securities to be

² Testimony of Michael Lempres (Coinbase). House Financial Services Subcommittee on Capital Markets, Securities, and Investment. 14 March 2018.
<https://www.coinbase.com/blog/coinbases-written-testimony-for-the-subcommittee-on-capital-markets-securities-and-investment>



offered in the United States, because there is no path to do that currently. Before any exchange can offer digital asset securities, the rules need to be modernized. Just as regulatory and legislative developments were necessary to address the transition from a paper-based financial system to a computer-based system, new rules are necessary to address the novel features and benefits of blockchain technology.

The current rules never contemplated transactions that could move at the speed of the Internet. Even today, "digital" securities transactions settle in an analog world, typically two days later. That delay is because the existing rules require a chain of intermediaries performing various functions, including custody, brokerage, order matching, clearing, and settlement. Existing rules classify these functions, define which intermediary must perform them, and separately regulate each. Consumers pay for every step in that chain. But surely we can agree that these inefficiencies should only persist if they serve a purpose for consumers, and that consumers should only have to pay for steps that reduce their risk.

The technology available today can and should replace many of those steps; in many cases because it inherently eliminates the risks the steps were designed to mitigate. For example, blockchain as a settlement layer can eliminate the counterparty risk from transactions that take days to settle with traditional financial institutions. Blockchain innovation powers financial services that can be made available more widely, and at a lower cost without adding risk for customers. Continuing to insist on intermediaries that not only add costs for customers, but also have been rendered obsolete by technology, is the equivalent of mandating horses be hitched to the *front* of cars in order to pull them, when the car itself is designed to replace the horse. Of course regulators should be focused on mitigating risk. But if the same transaction can be completed through alternative technology that achieves the same regulatory objectives with greater efficiency and at a lower cost, we should consider new rules. When technology improvements mean that the rules that used to apply are no longer necessary, we should embrace that future. It is better for consumers, it is better for innovation, it is better for the United States.

Exchange Registration

I would like to speak specifically to the suggestion that there is a path for crypto companies to register as a National Securities Exchange (NSE). This path does not yet exist, which is why Coinbase does not list securities on our platform even though we believe there is a real market for those services – a market that currently exists entirely offshore. The Exchange Act generally requires securities, digital or otherwise, to be traded on an SEC-registered exchange.³ To register as an NSE, a platform must submit an application to the SEC demonstrating the exchange is "organized and has the capacity to be able to carry out the purposes of the Exchange Act," including by ensuring fair access to its facilities, and preventing fraudulent and

³ See 15 U.S.C § 78e (prohibiting most off-exchange securities transactions by broker-dealers and unregistered exchanges).



manipulative practices.⁴ As of this writing, the SEC has never determined that facilitating the trading of non-security digital assets, such as Bitcoin, furthers the purposes of the Exchange Act. Nor is such a determination expected. Bitcoin and other non-security digital assets are not “securities” and thus are outside of the Exchange Act’s jurisdiction, and hence the SEC’s jurisdiction. Moreover, the SEC has repeatedly rejected attempts to register exchange traded products that would grant exposure to digital assets, arguing there is no “significant, regulated market” for the underlying assets causing regulated fraud surveillance to be unavailable.⁵

This creates a catch-22 for digital asset trading platforms. They cannot satisfy the purposes of the Exchange Act, as interpreted by the SEC, because they facilitate trades in non-securities that are outside the scope of the SEC’s jurisdiction and thus outside the purposes of the Exchange Act. Then, because the SEC has rejected the registration of digital asset exchange traded products citing the lack of a significant regulated market, no such market can form. Consequently, any digital asset trading platform wanting to register as an NSE cannot satisfy the Exchange Act’s requirements. Because failure to satisfy these requirements precludes registration as an NSE, digital asset trading platforms have no legal path to do so.

Asset Registration

Registration as an NSE would only solve half the problem, however. Without assets registered as securities, nothing would be available to trade on an NSE. Even for assets that might be properly considered securities, there is no workable path to register. We need to create those paths.

Not surprisingly, many projects issuing digital assets use these tokens differently than the way in which traditional companies use securities like debt and equity, which poses real challenges in applying the existing registration and disclosure frameworks for securities offerings. A digital asset is often designed to be directly used in exchange for goods and services on a software network. This is unlike a traditional security, such as a class of stock or a bond, which represents a claim on the profitability of the corporate issuer, but otherwise has no intrinsic use. For example, a share of Apple stock is not needed to operate an iPhone, but ETH tokens are necessary to execute a smart contract on the Ethereum network. This utility makes the digital assets an integral part of the operation of the network, but this utility neither looks like a securities transaction nor should be treated as one. Because the value of these tokens can only be fully realized when they are used for their utility function, investors can only realize a profit if

⁴ See 15 U.S.C. § 78f(b)(1), (2), (5).

⁵ See See Order Setting Aside Action by Delegated Authority and Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, To List and Trade Shares of the Winklevoss Bitcoin Trust, Exchange Act Rel. No. 83723 (July 26, 2018), 83 FR 37579 (Aug. 1, 2018) (“Winklevoss Order”); Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, To Amend NYSE Arca Rule 8.201-E (Commodity-Based Trust Shares) and To List and Trade Shares of the United States Bitcoin and Treasury Investment Trust Under NYSE Arca Rule 8.201-E, Exchange Act Rel. No. 88284 (Feb. 26, 2020), 85 FR 12595 (Mar. 3, 2020) (“USBT Order”); Order Disapproving a Proposed Rule Change To List and Trade Shares of the VanEck Bitcoin Trust Under BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, Exchange Act Rel. No. 93559 (Nov. 12, 2021), 86 FR 64539 (Nov. 18, 2021).

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the tokens can function as intended. That is, there must be a way for them to be held and used outside the confines of a securities dealer, bank, or other qualified custodian.

Additionally, one of the primary goals of many digital asset development teams is to eventually relinquish control over their networks to their network participants. In practice this means that after the project is operational and reaches a critical mass of users, the team's practical control over the live protocol, network, and token diminishes significantly. Sometimes, the initial sponsor of the protocol dissolves or disaffiliates from the protocol initially (e.g., by relinquishing IP rights to a separately managed and owned, arm's length entity) or otherwise relinquishes control gradually over time. In other cases, although the initial sponsor may continue to perform certain commercial or administrative operations, it is no longer selling digital assets to raise capital for the enterprise and the digital assets have an operational consumptive use.

Regardless of the path to decentralization, a digital asset token can live and thrive without its issuer. This is in stark contrast to the typical SEC reporting company whose securities are tied to the viability of ongoing operations and especially control, such that when the company ceases to exist, e.g., following a bankruptcy, so do the securities. Traditional companies do not form with the express intent of eventually dissolving.

Critically, there comes a point where the original development team may not have a unique ability to modify or influence the functionality of the network, protocol or token, and, as such, is no longer in a position to be the primary source of decision-useful information to token holders. Indeed, once this transition occurs, there may cease to be a set of 'company insiders' to share their unique knowledge about information material to the company's success. At that point, the value of the token, and implied return from holding it, flows from the use and efforts of network participants. In these instances, there is likely no continued benefit to market participants in requiring an issuer to file reports with the SEC. The laws and rules that we have today do not account for, let alone provide a solution for, this new reality. The point where the public knows as much as insiders, and there may be no one left to file the reports because the development team has moved on to other projects. The purpose of the federal securities laws no longer requires such disclosures, and the project likely no longer meets the elements set out in *Howey* or any other existing securities law test.

Coinbase Has Always Been and Remains Willing to Engage With Regulators

At Coinbase, we have spent countless hours and tens of millions of dollars trying to determine how to make the legal and technological pieces fit together. We have met regulators where they are and engaged willingly to find a path forward on key issues like staking, defining what constitutes a digital asset security, registering as a Broker Dealer/Alternative Trading System, issuing tokenized equities and digital asset securities, and custodying crypto. In fact, as previously noted, we filed a petition with the SEC in July 2022 identifying key issues that would create a roadmap for effective regulation of digital asset securities. We filed the petition with the SEC because many substantive questions need to be answered for there to be a viable market in the US for digital asset securities. Although the SEC has not acted on our petition, to further contribute to this effort, we submitted our own response to the petition, detailing a potential



solution for registering investment contracts involving digital assets. We are pleased that more than 1,600 submissions were also sent to the SEC in support of our petition, including from the Center for Markets Competitiveness at the US Chamber of Commerce, and other organizations. Our full petition and response can be found in Appendix B and Appendix C, respectively.

Following our submission, we began weekly meetings with the SEC. The meetings, which have included staff from the Divisions of Trading & Markets and Corporation Finance, have resulted in wide ranging policy discussions about market structure, custody, issuer disclosure, the definition of securities, staking, and registration. Given our very real interest in resolving the complexities of applying an existing market structure to digital assets and registering both tokenized equities and investment contracts related to digital assets to trade alongside digital asset commodities, Coinbase has enthusiastically and in good faith engaged in the meetings. Along the way, we have made numerous proposals to the SEC, most recently on January 7, 2023. We believe the proposal would have achieved the Commission's goal of ensuring investor protection, fair, orderly and efficient markets, and facilitating capital formation. Although the SEC has slowed these conversations over the last two months, we are eager to continue them and move forward. Our goal is ultimately to create a pathway for not only Coinbase, but for the entire ecosystem.

How can legislation solve the problem?

Blockchain and digital asset technology is transformative and presents opportunities across the economic and geographic spectrum. Crypto will create new jobs and bring benefits to every district in the U.S., including financial services use cases like financial inclusion, faster and cheaper payments, and programmable money to non-financial use cases like data ownership, digital art, and supply chain management for pharmaceuticals and critical technologies. Congress should enact legislation that will result in rules for the intermediaries that provide access to digital assets in order to enable responsible innovation, ensure consumer protection, and safeguard our national security interests. Failing to act will result in the U.S. falling behind both technologically and economically.

Although I understand this Committee does not have jurisdiction over the Commodity Futures Trading Commission, I would like to briefly note why legislation should address both SEC and CFTC authorities. The CFTC has stated – and CFTC enforcement actions have confirmed – that at least some crypto assets, including Bitcoin, fall within the definition of a “commodity” under the U.S. Commodities Exchange Act of 1936 (the “CEA”). That means the CFTC should be the primary regulator of digital asset commodities, yet the CFTC does not currently have authority to regulate spot markets for digital assets beyond policing for market manipulation and fraud. There is no framework at the federal level for the regulation of digital asset spot markets, specifically the registration of trading platforms, brokers, dealers, and custodians who provide digital asset commodity services. I would urge this committee to work with your colleagues on the House Agriculture Committee to ensure both the SEC and CFTC engage on digital assets, and that a regulatory regime tailored to the specific needs and risks presented by the assets and markets in each commission's jurisdiction.



A Path to Protect Consumers

Legislation should contain strong consumer and investor protection standards for digital asset intermediaries and service providers so customer assets are safeguarded at all times.

- Require centralized trading platforms and custodians to hold customer assets 1:1, proving their reserves through independent audits.
- Ensure customer assets are bankruptcy-remote and protected from a platform's creditors in an insolvency, such as by requiring customer accounts to follow Article 8 of the UCC, or be held at SEC or CFTC registered entities.
- Follow eligible investment rules as promulgated by federal and state regulators.
- Require segregation of house and customer funds at all times, subject to a buffer of funds that platforms may add to client wallets as needed to ensure liquidity and facilitate trading and other operational needs.
- Direct the SEC to permit the custody and distribution of digital assets securities at registered broker dealers, including those that operate on permissionless blockchains.
- Direct regulators to address gaps in disclosures so that consumers have relevant information and a uniform understanding of the risks of the asset class.

A Path for Regulation of Trading and Markets

Legislation should enable consumers to buy and sell diverse digital assets on U.S. registered trading platforms. While agencies have existing authority that could provide a pathway in certain instances, it is clear Congress needs to create a comprehensive approach that resolves the gaps in current law and clearly directs the agencies to act.

- Direct the SEC to permit existing digital asset trading platforms to register as an Alternative Trading System—which is currently permitted for trading securities—under existing SEC authority/rules to facilitate trading in digital assets involving securities.
- Provide the CFTC with authority to register trading platforms, dealers, brokers and custodians that provide services for digital asset tokens that are not deemed to be securities, including tokens distributed as part of an investment contract.
- Establish a clear framework to resolve which tokens are securities and which are not, recognizing that tokens issued through an investment contract may change over time - tokens issued pursuant to a securities offering can become commodities.
- Permit trading platforms to custody digital assets recorded on permissionless blockchains, recognizing that clearing agencies and transfer agents are no longer required to settle transactions. Other intermediaries can exist in the same corporate family subject to guardrails to protect against conflicts of interest.

A Path for Listing New Security Tokens and Raising Capital

Token listing is the often overlooked element to comprehensive legislation. Innovators should be able to build with reasonable confidence their product can come to market, without spending millions in legal fees to understand how, and without finding that there is not actually a way to



proceed under existing rules. There must be a path for offerings involving tokens to list as securities on SEC-registered trading platforms. Congress needs to provide a way for builders to succeed.

- The U.S. does not currently have a functioning primary market for crypto securities, and in particular investment contracts involving digital assets ("ICDAs").
- A key inhibitor to a functioning primary market for digital asset securities, including investment contracts, is the lack of a workable set of registration and reporting requirements. Existing disclosure requirements are not tailored to digital assets or designed to protect investors in this distinct marketplace.
- Workable solutions have been put forward to the SEC. Congress should include those solutions in legislation. See Petition for Rulemaking - Digital Asset issuer Registration and Reporting (Dec. 6, 2022), *available at* <https://www.sec.gov/comments/4-789/4789-20152418-320297.pdf>.

A Path for Financial Stability and a Faster, Cheaper Payments System in Stablecoins

- Stablecoins should be backed by real assets, and bank-like supervision of stablecoin issuers is appropriate to prove it.
- Both banks and non-banks should be able to issue stablecoins.
- Stablecoins should be treated as cash by the tax code; given asset-backed stablecoins do not generate gains or losses when used, IRS reporting of each transaction with a stablecoin is unnecessary.

Closing

In closing, the crypto market, despite the recent downturn, represents more than \$1 trillion in total market capital, which must be protected by both regulators and market participants. Coinbase, as the largest publicly traded crypto platform in the U.S., is committed to being the most trusted, safe, and compliant crypto platform in the world. We have policies and procedures in place to protect consumers, while meeting the demands of innovators, builders, and everyday Americans who want to access and use crypto. We have taken a longstanding public stance on wanting a robust regulatory framework for crypto and made multiple efforts with SEC and other regulators to achieve it. We understand we have to work within the system as we find it, and we want to meet regulators where they are. But we need some modifications to the rules to achieve both the benefits of crypto like cheaper and faster payments in order to make the system work. We need a durable solution that will pave the way for this innovation to flourish in the U.S., while also protecting consumers today and tomorrow.



Appendix A:

How is Coinbase currently regulated?

One of our highest priorities at Coinbase is to restore confidence, trust, and belief in the cryptoeconomy. We are doing that by continuing to build products and services that consumers want in a way that meets rigorous regulatory standards, or adheres to long-standing regulatory principles where the absence of regulatory standards persist.

Coinbase is subject to a wide range of laws and regulations enacted by U.S. federal, state, and local and foreign governments and regulatory authorities. We seek licenses and registrations to ensure compliance with the rules in the jurisdiction where we operate. We also readily comply with increasingly strict legal and regulatory requirements relating to the detection and prevention of countering terrorist financing, anti-money laundering, and economic and trade sanctions.

We have implemented anti-money laundering and counter-terrorist financing programs

Coinbase is registered as a money services business with the Financial Crimes Enforcement Network ("FinCEN") and serve on the Department of the Treasury's Bank Secrecy Act Advisory Group. As such, we are subject to various anti-money laundering and counter-terrorist financing laws, including the Bank Secrecy Act (the "BSA") in the United States, and similar laws and regulations abroad. The BSA requires us to among other things, develop, implement, and maintain a risk-based anti-money laundering program, provide an anti-money laundering-related training program, report suspicious activities and transactions to FinCEN, comply with certain reporting and recordkeeping requirements, and collect and maintain information about our customers. In addition, the BSA requires us to comply with certain customer due diligence requirements as part of our anti-money laundering obligations, including developing risk-based policies, procedures, and internal controls reasonably designed to verify a customer's identity. Many states and other countries impose similar and, in some cases, more stringent requirements related to anti-money laundering and counter-terrorist financing.

We have implemented a compliance program designed to prevent our platform from being used to facilitate money laundering, terrorist financing, and other illicit activity in countries, or with persons or entities, included on designated lists promulgated by the Office of Foreign Assets Control ("OFAC"), and equivalent foreign authorities. Our compliance program includes policies, procedures, reporting protocols, and internal controls, and is designed to address legal and regulatory requirements as well as to assist us in managing risks associated with money laundering and terrorist financing. Anti-money laundering regulations are constantly evolving and vary from jurisdiction-to-jurisdiction. We continuously monitor our compliance with anti-money laundering and counter-terrorist financing regulations and industry standards and implement policies, procedures, and controls in light of the most current legal requirements.



We comply with economic and trade sanctions

Coinbase is also required to comply with economic and trade sanctions administered by the United States, the European Union, or E.U., relevant E.U. member states, and other jurisdictions in which we operate. Economic and trade sanctions programs administered by the U.S. Department of Treasury's Office of Foreign Asset Control prohibit or restrict transactions to or from (or dealings with or involving) certain countries, regions, governments, and in certain circumstances, specified individuals and entities such as narcotics traffickers, terrorists, and terrorist organizations, as well as certain digital currency addresses.

We hold money transmission and payment services licenses

In the United States, Coinbase has obtained 45 licenses to operate as money transmitters or the equivalent in the states where such licenses or equivalent are required to conduct our business, as well as in the District of Columbia and Puerto Rico. In addition, we have obtained a BitLicense from the New York State Department of Financial Services ("NYDFS"). As a licensed money transmitter and an entity subject to the BitLicense regulatory regime, we are subject to, among other things, the BSA, restrictions and requirements with respect to the investment of customer funds and use and safeguarding of customer funds and crypto assets, and bonding, capital requirements including our aggregate net worth, prudential compliance obligations associated with customer notice and disclosure, reporting and recordkeeping requirements applicable to the company, as well as control persons and inspection and examination by state regulatory agencies. These state licensing laws also cover matters such as regulatory approval of controlling stockholders, directors, and senior management of the licensed entity.

Outside the United States, we have obtained licenses to provide crypto-asset custody and trading from the German Federal Financial Supervisory Authority. We are also registered as a crypto asset exchange service provider in Japan which provides crypto-asset and first-party payments services to Japanese customers pursuant to registration with the Kanto Local Finance Bureau of the Ministry of Finance of Japan, covering both crypto-asset and first-party payment services. In Singapore, we operate under the Payment Services Act and are supervised by the Monetary Authority of Singapore ("MAS"). We are presently operating under an In-Principal Approval status subject to MAS final approval to become a Major Payments Institution. Under these licenses and registrations, we are subject to a broad range of rules and regulations including in respect of AML, safeguarding of customer assets and funds, regulatory capital requirements, fit and proper management, operational controls, corporate governance, customer disclosures, reporting and record keeping.

We operate a Trust company for custodial services, and are and will remain a Qualified Custodian

Our subsidiary, Coinbase Custody Trust Company, LLC ("CCTC"), operates as a New York State-chartered limited purpose trust company, which is subject to regulation, examination, and supervision by the NYDFS. NYDFS regulations impose various compliance requirements including, without limitation, operational limitations related to the nature of crypto assets we can



hold under custody, capital requirements, BSA and anti-money laundering program requirements, affiliate transaction limitations, and notice and reporting requirements.

As a state-chartered trust company in good standing, CCTC also operates as a Qualified Custodian under existing SEC rules established pursuant to the Investment Advisers Act of 1940. The SEC recently issued a significant proposed rulemaking related to the Qualified Custodian rule that has raised concerns in many sectors of both digital and traditional finance. Under the proposal, we are confident that CCTC's existing business practices will ensure it will remain a qualified custodian. Although we do have concerns with some aspects of the proposal, we are encouraged the SEC is having a public notice-and-comment rulemaking to collect stakeholder feedback—exactly how the regulatory process is supposed to work. Comments will help the SEC calibrate the final rule to meet the needs of investors and the market, and we look forward to engaging in the process.

We have international licenses

We serve our customers through Electronic Money Institutions authorized by the U.K. Financial Conduct Authority and the Central Bank of Ireland. We comply with rules and regulations applicable to the European e-money industry, including those related to funds safeguarding, corporate governance, anti-money laundering, disclosure, reporting, and inspection. We are, or may be, subject to banking-related regulations in other countries now or in the future related to our role in the financial industry.

We have Broker-Dealer licenses

Currently, two Coinbase subsidiaries, Coinbase Capital Markets and Coinbase Securities, are registered with the SEC as broker-dealers under the Securities and Exchange Act of 1934. They are also members of and subject to the rules of the Financial Industry Regulation Authority ("FINRA"). Both subsidiaries are presently inactive due to ongoing challenges in applying existing regulations to the world of digital assets.

We operate a Designated Contract Market

In February 2022, Coinbase acquired LMX Labs, LLC, a designated contract market ("DCM") regulated by the CFTC, in connection with our acquisition of FairXchange, Inc. Separately, Coinbase Financial Markets, Inc., a separate subsidiary, has applied for registration as a futures commission merchant ("FCM") with the National Futures Association. FCMs and DCMs are subject to numerous regulatory requirements, including strict capital requirements.



Appendix B:

Coinbase Petition for Rulemaking - Digital Asset
Securities Regulation

Submitted to the Securities and Exchange
Commission

July 21, 2022



July 21, 2022

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Petition for Rulemaking – Digital Asset Securities Regulation

Dear Ms. Countryman:

Coinbase Global, Inc. ("Coinbase") is filing this petition⁶ with the U.S. Securities and Exchange Commission ("Commission" or "SEC") requesting that the Commission propose and adopt rules to govern the regulation of securities that are offered and traded via digitally native methods, including potential rules to identify which digital assets are securities. Digitally native securities are recorded and transferred using distributed ledger technology and do not rely on centralized entities or certificated forms of ownership that characterize traditional financial instruments.⁷ Transactions in these securities (henceforth "digital asset securities") are executed and settled in real time, permanently recorded on blockchains, and visible with equal access to all market participants. This is a paradigm shift from existing market practices, rendering many of the Commission rules that govern the offer, sale, trading, custody, and clearing of traditional assets both incomplete and unsuitable for securities in this market.

The U.S. does not currently have a functioning market in digital asset securities due to the lack of a clear and workable regulatory regime. Digital assets that trade today overwhelmingly have the characteristics of commodities. Coinbase, like many other exchanges, has intentionally and conscientiously steered well clear of securities to ensure that we are able to operate in full compliance with applicable laws and regulations. However, new rules facilitating the use of digital asset securities would allow for a more efficient and effective allocation of capital in financial markets and create new opportunities for investors.

Globally, many jurisdictions are actively pursuing regulation that meets the specific needs of the crypto market, ensuring investors are well-protected. For example, the EU recently reached agreement on Markets in Crypto Assets (MiCA) regulation first proposed in 2020, and countries and markets such as Australia, Brazil, Dubai, Hong Kong, Switzerland, and the United Kingdom have taken important steps towards establishing (or have already established) regulations around crypto.⁸

⁶ See 17 C.F.R. 201.192(a).

⁷ In this petition we are focused on "native" digital asset securities—that is, digital asset securities that exist on a distributed ledger, only in tokenized form. Many, but not all, of the considerations discussed herein would apply similarly to digital asset securities that represent a tokenized version of a traditional security (e.g., tokenized common stock).

⁸ Council of the EU, *Digital finance: agreement reached on European crypto-assets regulation (MiCA)* (June 31, 2022), <https://www.consilium.europa.eu/en/press/press-releases/2022/06/30/digital-finance-agreement-reached-on-european-crypto-assets-regulation-mica/>; Australian Government, The Treasury, *Crypto asset secondary service providers: Licensing and custody requirements (Consultation Paper)* (Mar. 21, 2022), <https://treasury.gov.au/consultation/c2022-259046>; Chamber of Deputies, Projeto de Lei Nº 4401, De 2021, (Aug. 21, 2021), <https://www.camara.leg.br/propostas-legislativas/1555470>; Dubai Financial Services Authority, *Consultation Paper No. 143, Regulation of Crypto Tokens* (Mar. 8, 2022), https://dfsae.thomsonreuters.com/sites/default/files/net_file_store/CP143_Regulation_of_Crypto_Tokens.pdf; Legislative Council of Hong Kong, *Anti Money Laundering and Counter-Terrorist Financing (Amendment) Bill*, (June

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The SEC, however, has not yet taken constructive steps in this direction. Despite the well-recognized growth and rapidly developing practices in the digital asset ecosystem, and the Commission's stated view that some digital assets are securities, the Commission has yet to constructively engage with digital asset market participants on the design of a workable regulatory framework, let alone propose any new rules governing this activity. Moreover, as of the publication of its most recently updated regulatory agenda on June 22, 2022, the Commission has not indicated any intention to do so.⁹

Instead, the Commission appears to be following an enforcement-first approach to addressing crypto-related regulatory challenges. Indeed, the Commission recently announced that the Enforcement Division's Crypto Assets and Cyber Unit would soon double in size.¹⁰ Leading with enforcement actions before ensuring regulatory clarity results in arbitrary outcomes with limited value as guiding precedent. Several parties have been the subject of extensive investigation while others—with nearly identical products or services—have apparently been subject to none. This approach has led to both confusion and the uneven treatment of market participants.

Rather than initiate new rulemaking, Chair Gensler has repeatedly stated through speeches and testimony that the vast majority of digital tokens are securities, and has asked issuers and exchanges that offer, sell, and trade them to come in and register.¹¹ We disagree that the majority of digital assets are securities. For those digital assets that are securities, registration under the current rules is, for many market participants, either not possible or not economically viable given the associated and unnecessary compliance burdens. Additionally, when existing regulations are unworkable, some market participants may be less willing to invest the resources necessary to follow the rules. Failure to resolve these shortcomings leaves investors unprotected due to a lack of regulatory clarity, prevents market participants from leveraging the efficiencies new technology can offer, and materially impairs capital formation in the blockchain technologies that underlie digital assets. This is wholly inconsistent with the SEC's mission.

In October 2021, we issued our *Digital Asset Policy Proposal – Safeguarding America's Financial Leadership* through which we hoped to initiate a broad and wide-ranging conversation about the role digital assets play in our economic future.¹² As part of that proposal, we offered a bold idea to regulate digital assets under a separate framework with a single regulator as a way to ensure that investors are properly protected and innovation can occur without, what we believe, may be restricting and cumbersome labels of security and commodity. Our proposal would require a government-wide focus to

24, 2022), <https://www.gld.gov.hk/egazette/pdf/20222625/es32022262516.pdf>; Swiss Federation, *Federal Act on the Adaptation of Federal Law to Developments in Distributed Electronic Ledger Technology* (Jan. 14, 2021), <https://fedlex.data.admin.ch/liv/fga/2020/2007>; HM Treasury, *Government Sets Out Plan to Make UK a Global Cryptoasset Technology Hub*, (Apr. 4, 2022), <https://www.gov.uk/government/news/government-sets-out-plan-to-make-uk-a-global-cryptoasset-technology-hub>.

⁹ The Commission submitted its agenda of rulemaking actions pursuant to the Regulatory Flexibility Act on April 26, 2022, to the Regulatory Information Service Center for inclusion on the Unified Agenda of Federal Regulatory and Deregulatory Actions. The agenda that was published did not indicate any rulemaking actions to be considered in the current agenda (next 12 months) or the long-term agenda that relates to digital asset regulation. SEC, *SEC Announces Spring 2022 Regulatory Agenda* (June 22, 2022), <https://www.sec.gov/news/press-release/2022-112>.

¹⁰ SEC, *SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit* (May 3, 2022), <https://www.sec.gov/news/press-release/2022-78>.

¹¹ See, e.g., Sander Lutz, *SEC Chair Gensler Threatens Action Against Unregistered Crypto Exchanges* (May 18, 2022), <https://decrypt.co/100806/sec-chair-gensler-threatens-action-against-unregistered-crypto-exchanges> (stating to the House Financial Services and General Government Subcommittee that "[t]he crypto exchanges should come in and register . . ."); Public Statement, Chair Gary Gensler, SEC, *2021 Aspen Security Forum: The View from the SEC: Cryptocurrencies and National Security* (Aug. 3, 2021), <https://www.youtube.com/watch?v=tusQLLCgrDs> (inviting digital asset trading platforms to "come in, register, work with the SEC.").

¹² Coinbase, *Digital Asset Policy Proposal – Safeguarding America's Financial Leadership*, (Oct. 2021), <https://assets.ctfassets.net/c5bd0wqic7v0/7FhSemtQvq4P4yS7sJCKMj/a88939d651d7ee24a56a897e2d37ef30/coinbase-digital-asset-policy-proposal.pdf>.



create a fundamentally new and comprehensive regime for digital assets. We remain committed to continuing the discussion about the right way to regulate digital assets. This petition, however, is more specific. We are seeking a transparent and collaborative process to engage directly with the SEC as a means to initiate a discussion about what the SEC can do within its own authority to provide clarity and certainty regarding the regulatory treatment of digital asset securities.

Coinbase firmly believes that a new regulatory framework is needed to ensure that the SEC can fulfill its responsibility to oversee the digital asset securities markets. We respectfully petition the Commission to propose new rules for the offer, sale, registration, and trading of digital asset securities. Existing rules, unchanged, do not achieve the goals of the Commission when applied to digital asset securities. Following the well-established rulemaking process would allow for input from a wide range of stakeholders, advance the goals of transparent and orderly policy development, and result in clear rules and fair notice to all market participants.

Now is the time for the Commission to begin a public dialogue. The recent collapse of the TerraUSD stablecoin, the bankruptcy of crypto-lenders such as Celsius, ongoing questions about the efficacy of how digital asset markets operate, and the potential onset of another crypto winter can help inform a regulatory path forward. The lessons learned can be used to reinforce the best practices, and guide the industry in building new infrastructure and product offerings. Establishing regulatory guardrails is critical to the future success of digital asset innovation in the United States.

As an initial step, the Commission should solicit input from the public. Many of the unresolved issues are complicated, and developing effective and efficient solutions will require a broad understanding of the technology underpinning developing market practices and products. We believe that we and other market participants will also benefit from an open discussion. The Commission has historically published concept releases for large, novel, or complicated issues, commensurate with the issues related to regulation of digital assets; such public engagement would be an appropriate model to follow here.¹³

As part of this process, the Commission should also consider whether appropriately tailored interpretive guidance and no-action relief could be used to facilitate new activities within existing regulatory frameworks. Doing so will provide the Commission with an opportunity to assess the efficacy of emerging market practices with the ability to later promulgate rules, if appropriate. Any such guidance and other relief must avoid imposing new requirements or exercising policy-making authority that is more appropriately conducted through notice and comment rulemaking pursuant to the Administrative Procedure Act.

It is imperative that the Commission start this process now. Digital asset securities have not yet been widely offered on regulated platforms because the existing rules do not accommodate them. Until the Commission provides regulatory certainty and a workable framework for digital asset securities, it is not feasible for market participants to "come in and register."¹⁴ And the inability to do so risks not only stunting the development and growth of this market, but also invites those least committed to regulatory compliance to exploit existing ambiguities.

If the U.S. fails to act alongside the efforts of other jurisdictions, global market practices will conform to rules tailored to the preferences of foreign authorities. And once market participants begin implementing foreign rules, the regulatory options available to the Commission will become more limited in order to

¹³ SEC, *Concept Release on Equity Market Structure* (Jan. 14, 2010), <https://www.sec.gov/rules/concept/2010/34-61358.pdf>; SEC, *Concept Release on the U.S. Proxy System* (July 14, 2010), <https://www.sec.gov/rules/concept/2010/34-62495.pdf>.

¹⁴ Gary Gensler, *Prepared Remarks of Gary Gensler On Crypto Markets Penn Law Capital Markets Association Annual Conference* (Apr. 4, 2022), <https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422>.



avoid substantially raising compliance costs of U.S. firms operating internationally. The U.S. has historically been the world's leader in maintaining and regulating unparalleled capital markets; action is needed to preserve that position for the digital asset securities market.

As the only U.S. public company that operates a digital asset trading platform, Coinbase understands the value of market oversight through clear and workable regulation, and we welcome opportunities to work with policymakers to build a safe, open, and fair crypto ecosystem. We believe appropriately tailored regulation is essential to encouraging capital formation in the digital asset industry, protecting digital asset customers and investors, and facilitating the wider adoption of digital asset technology. We do not currently trade or facilitate trading in digital asset securities because of a lack of clear and workable regulation. But we would consider doing so through our SEC-registered securities broker-dealer subsidiaries¹⁵ once rules are in place that can accommodate the technological manner in which digital asset securities would be offered, sold, traded, custodied, and cleared.

In petitioning the Commission for rulemaking we recognize that existing regulatory questions will be challenging to solve. We know because we have spent more than a year thinking about how to do it. Last October we published a set of principles that we believe should underpin a regulatory framework.¹⁶ And now we offer views on a set of detailed questions that we believe should be answered as part of the process necessary to implement an effective regulatory framework for digital asset securities that promotes the SEC's mission, achieves key regulatory objectives, and encourages innovation that benefits market participants.

Our petition focuses only on areas in which we believe we have expertise, and should not be viewed as a comprehensive list of issues and questions related to the regulation of digital asset securities. For example, regulation pertaining to the Investment Company Act of 1940 and the Investment Advisers Act of 1940 would benefit from consideration through a similar process that solicits the input from knowledgeable market participants. We encourage the Commission to initiate a process to solicit input from areas of the market not covered by our petition.

Key Considerations

There are three primary challenges when applying existing rules to digital asset securities:

1. Lack of clarity regarding how to determine whether a digital asset is a security;
2. Requirements that are fundamentally incompatible with the operation of digital asset securities; and
3. Requirements that are technically possible, but unnecessary or overly burdensome as compared to potential alternative and more efficient rules.

Although Coinbase, and other digital asset trading venues, have identified a number of digital assets that are clearly not securities, and therefore may trade without SEC registration, there are other assets that

¹⁵ Coinbase Securities, Inc. and Coinbase Capital Markets Corp.

¹⁶ See, e.g., Coinbase's Digital Asset Policy Proposal (#dApp) at <https://assets.ctfassets.net/c5bd0wojc7v0/77FhSemiQvq4P4yS7sJCKM/a98939d651d7ee24a56a897e2d37ef30/coincbase-digital-asset-policy-proposal.pdf>.



are harder to classify relying on the SEC's application of the *Howey* and *Reves* tests. Many of the questions we ask below highlight the challenge of identifying which of these digital assets, if any, fall within the Commission's jurisdiction, the lack of clarity with existing regulatory requirements, and the ways in which the existing regulatory requirements are fundamentally incompatible with the operation of digital asset securities.

Other questions reflect requirements for which compliance is possible, but otherwise not well-suited to digital asset securities premised on distributed-ledger technology. For example, custody requirements contemplate a broker-intermediated model—such as national securities exchanges use today—that is unnecessary for real-time settlement on blockchains. Each of the questions is also fundamentally tied to the determination of whether a digital asset is a security. Certainty on the applicable regulatory framework would not only provide greater protection for investors, but also permit the formation of an efficient digital asset market environment.

Finally, in addressing these questions, we believe the Commission should consider the following:

1. Not All Digital Assets Are Securities

Most digital assets are designed to enable simple functions that provide economic gates to commercial applications and services. They are not securities. Their value is determined by adoption and use, and the disclosures that token holders need are materially different from those of a public company. The issuer registration, disclosure, and listing requirements for securities are currently tailored to the issuers of debt and equity in public companies. But most digital assets—coins and tokens that trade on exchanges like Coinbase—do not represent ownership stakes in complicated public companies or pay a return to investors through dividends or interest.

The Commission should provide clarity regarding which digital assets, if any, are securities. The lack of clarity creates a risk that issuers of non-security digital tokens will feel compelled to comply with public company reporting requirements that are unnecessary, may lead to investor confusion, and may render innovative blockchain projects not economically viable despite the value they could bring to users and the broader economy.

2. Needed Disclosures Are Different

The SEC disclosure regime has historically focused on ensuring that investors have material information necessary to make an informed investment decision. Current disclosure requirements, however, do not cover a number of features unique to digital assets that would undoubtedly be considered important when making an investment decision. For example, investors would likely find information about the risk of a network attack, what kind of governance rights are embedded in which tokens, who has the ability to change the code underlying the assets or the network, and other features that do not exist with respect to traditional securities to be material. Additionally, investors would benefit from comparable disclosures across each digital asset security to assist in identifying differences among investment opportunities. At the same time, the operations of a digital asset issuer are typically less complex than those of a large public company, so investors would likely not require the same level of disclosure in several areas relevant to traditional public companies to make an informed decision.

3. Real-Time Settlement of Financial Transactions is Possible

Digital assets and blockchain technology hold the promise of a more efficient and resilient plumbing for financial transactions. This new infrastructure is being built, from the start, to enable peer-to-peer operability with straight-through-processing between different types of service providers. The

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decentralized structure prevents any one service provider from being the sole gate between market participants. The result is enhanced competition, more seamless services, faster settlements, greater transparency, and the opportunity to automate complex financial transactions. The opportunity to eliminate unnecessary gates and layers of intermediation should ultimately lead to enhanced investor protections (for example by improving market transparency by recording transactions on a public blockchain), improved functionality, and lower transaction costs.

Today's rules, however, do not allow for securities markets to take advantage of these improvements. For example, existing custody rules do not contemplate real-time settlement of transactions on blockchains. They are tailored for trades that typically take two days to settle through a series of intermediaries who must manage default during that period. Real-time settlement on blockchains obviates this need, allowing counterparties to redeploy their capital immediately, improving the allocative efficiencies of markets relative to current practices. Other rules, particularly those promulgated by Regulation National Market System ("NMS"), do not contemplate digitally native securities, and do not provide a clear compliance path for blockchain transactions.

4. Fewer Market Intermediaries Are Required

Another important innovation of digital asset markets is the ability to conduct reliable transactions without the need for third-party intermediaries. Trading platforms like Coinbase offer direct access to both retail and institutional traders, letting them execute transactions 24 hours a day, seven days a week. However, rules designed for securities markets trading predate blockchain technology, when the only way to create trust in the financial system was to require the use of separate intermediaries, such as brokers, custodians, exchanges, market makers, transfer agents, and clearing agencies, each with conflicting interests and incentives. Ensuing regulations were premised on the existence of, and need to regulate these intermediaries, enshrining them and their role in law.¹⁷

Historical intermediation models should be permitted where they continue to add value, but not required when they do not or other methods achieve the same goal. For example, intermediaries should not be required when a transaction can be completed through alternative technological means that achieve the same regulatory objective. Just as regulatory and legislative developments were necessary to address the transition from a paper-based financial system to a computer-based system, a modernization effort is needed today to address the novel features and benefits of blockchain technology.

Key Questions

Each of these goals cannot be achieved without rethinking and reframing specific parts of existing securities regulation so that it is more efficient and effective for digital asset securities in the context of distributed-ledger technology. In the following sections, we provide an outline to frame the topic and follow with a number of questions that we believe are important to consider as part of any rulemaking exercise. We have views with respect to each and over time will seek to further share our perspectives. We strongly encourage other market participants to do the same. Our "answers" are just one of many relevant voices, and we hope for and expect a robust discussion that productively informs the Commission and its Staff.

I. Classification of Digital Assets as Securities

¹⁷ For additional exploration of the existing regulatory framework, and why it is not properly tailored for digital asset markets, see Coinbase's Digital Asset Policy Proposal (#dApp) at <https://assets.ctfassets.net/c5bd0wojc7v0/7FhSemiQvq4P4yS7sJCKM/a98939d651d7ee24a56a897e2d37ef30/coinbase-digital-asset-policy-proposal.pdf>.

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The threshold question in the development of a regulatory framework for digital asset securities is the determination of whether a particular digital asset is in fact a security, and thus subject to the Commission's jurisdiction and the securities laws.¹⁸ The Commission has taken the view that if a digital asset is a security, its regulatory oversight applies to all aspects of the lifecycle of the security and the parties that are involved in it, including the initial offering of that digital asset as well as any subsequent trading by investors and their dealings with intermediaries.¹⁹

The determination of whether a non-traditional asset (such as a digital asset) is a security relies heavily on legal tests developed by case law and ultimately Supreme Court decisions. Where the characteristics of an instrument do not clearly fit into one of the well-settled terms, the SEC and federal courts typically analyze whether the instrument is a "security" through the lens of the *Howey*²⁰ and *Reves*²¹ tests. However, these tests were developed before the emergence of digital assets and are not tailored to their unique properties and use. As a result, application of these existing tests to digital assets fails to take into account the unique characteristics of digital assets.

The differences between traditional securities and digital assets underscore the challenges with applying these tests to digital assets. While traditional securities typically represent a claim to the assets and profits of a specific corporate issuer, whose management makes choices that influence the success of the company and therefore the return on investment in its securities, digital assets often have decentralized groups of developers whose involvement with a project may ebb and flow over time. The extent to which digital asset holders reasonably rely on the efforts of particular promoters, or the extent to which those efforts are "undeniably significant ones"²² is much less clear with regard to digital assets.

Further, while many may purchase digital assets with the hope of price appreciation, unlike traditional securities, digital assets typically have functional non-investment uses within a protocol—making them much more akin to real property, which is also often purchased with the hope of price appreciation, but nevertheless is fundamentally a commodity intended for usage.²³ Non-investment use cases include, for example: paying transaction, or "gas" fees; voting on governance proposals related to the operation of the protocol; serving as a medium of exchange for native applications; and helping secure a network.

¹⁸ A "security" is defined in the federal securities laws by reference to lists of instruments that include, for example, stocks and notes like bonds issued by companies. See Section 2(a)(1) of the Securities Act (defining a security as "[A]ny note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim.") Despite differences, the Supreme Court has indicated that the definitions of "security" under the Securities Act and the Exchange Act are treated the same. *SEC v. Edwards*, 540 U.S. 389, 393 (2004), citing *Reves v. Ernst & Young*, 494 U.S. 56, 61 n.1 (1990). In addition, the "elements of *Howey* are also applicable to the [Investment Company Act]." *SEC v. Banner Fund Int'l*, 211 F.3d 602, 614 n.* (D.C. Cir. 2000).

¹⁹ See U.S. Sec. & Exch. Comm'n, Chair Gary Gensler Letter to Sen. Warren (Aug. 5, 2021), https://www.warren.senate.gov/imo/media/doc/gensler_response_to_warren_-_cryptocurrency_exchanges.pdf.

²⁰ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (resulting in the so-called "Howey test").

²¹ *Reves v. Ernst & Young*, 494 U.S. 56 (1990) (resulting in the so-called "Reves test").

²² *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 482 (9th Cir.).

²³ *Cf. United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975).



Coinbase has developed a rigorous process to analyze and review each digital asset, before making any digital asset available on its platforms. These processes ensure that Coinbase is not facilitating transactions in or providing trading infrastructure for digital asset securities. Due to today's substantial regulatory uncertainty, Coinbase is over-inclusive in what it views as a potential security, out of an abundance of caution to ensure that its practices comply with existing applicable law. Coinbase therefore often excludes digital assets based on the mere possibility that they might be securities.

Not all market participants have the resources to apply the same rigorous process. This in turn can result in significant burdens in meeting the Commission's expectation that each market participant conduct and document its own legal analysis for each and every digital asset with which it interacts.²⁴

Applying the *Howey* and *Reves* tests piecemeal to an entire market sector has proven itself to be an unworkable solution. The SEC needs to provide clarity on the question of what, in the context of digital assets, constitutes a security. This may be achieved by defining a digital asset security through rulemaking, through the creation of a digital asset security offering exemption, or through other regulatory actions. In particular, such a rule should be objective and clear such that it produces predictable, consistent and replicable results, and can be applied by all market participants.

For example, the rule should address, consistent with applicable case law, when an "investment of money" has or has not occurred. If the SEC is of the view that airdrops (i.e., digital assets provided free of payment) constitute an investment of money—a position that is likely irreconcilable with case law²⁵—it should clearly state that position and clarify in which circumstances that would be the case. Similarly, unlike traditional securities whose sole purpose is to represent an investment, digital assets often provide functionality, utility, or a consumptive use, aside from any speculative value. The Supreme Court has noted that "when a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply."²⁶ Further, even if the value of an asset, like a dwelling or precious metal, may appreciate, and even if some purchasers may purchase the asset with speculative intent, that does not necessarily convert the consumable asset into a security. The proposed SEC rulemaking therefore should be explicit, in the digital asset context, as to the Commission's view on how the presence or lack of functionality, consumability, and/or utility of the digital asset impacts (and negates) its status as a security.

Given the complexity of the issue, the Commission should seek public input on the classification of digital assets as securities in advance of, or as part of, any proposed rulemaking related to these issues.

Key questions for the Commission to consider and seek public input on:

²⁴ See SEC Strategic Hub for Innovation and Financial Technology Letter to the New York State Department of Financial Services (Jan. 27, 2020), <https://www.sec.gov/files/staff-comments-to%20nysdfs-1-27-20.pdf> ("Market participants should not rely on a model framework, whitelist, or state license when evaluating compliance with the federal securities laws – without also undergoing careful legal analysis under the federal securities laws" supported by, for example, "opinion[s] of securities counsel.").

²⁵ *SEC v. Rubera*, 350 F.3d 1084, 1090 (9th Cir. 2003), quoting *Hector v. Wiens*, 533 F.2d 429, 432 (9th Cir. 1976). While in the context of analyzing whether a "sale" of a particular security occurred, there may be arguments that any form of benefit to an issuer could be sufficient consideration to constitute a sale subject to Section 5 of the Securities Act. See, e.g., SEC, SEC Brings First Actions to Halt Unregistered Online Offerings of So-Called "Free Stock" (July 22, 1999), <https://www.sec.gov/news/headlines/webstock.htm>. The question under *Howey*, however, is whether the asset is a security in the first place, which requires there to be an investment of money, not that the distribution of the asset provided a non-monetary benefit to the issuer. See also Joseph A. Hall, *Howey*, Ralston Purina and the SEC's Digital Asset Framework, 52 REV. OF SEC. & COMMODITIES REG. 137 (June 19, 2019), https://www.davispolk.com/files/howey_ralston_purina_sec_digital_asset_framework.pdf (questioning the Digital Asset Framework's "seemingly contradictory" assertion that the "investment of money" prong of *Howey* can be satisfied without an investment of money).

²⁶ *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975).



- 1) Are the *Howey* and *Reves* tests the appropriate tests for determining whether digital assets are securities?
 - a) What risks were these tests designed to identify and are those risks consistently presented in digital asset securities?
 - b) How should the use and utility of a digital asset, apart from any potential investment purpose, impact the analysis?
 - c) Are these tests capable of consistent application to digital assets by issuers, intermediaries, and other market participants? Does this application lead to results that are conducive to advancing the SEC's mission and promoting innovation? Does the application of the *Howey* and *Reves* tests to the specific facts and circumstances of each digital asset result in inefficient markets, an inconsistent application of the law, and/or other adverse consequences?
- 2) Should the SEC use its exemptive authority under Section 28 of the Securities Act of 1933 (the "Securities Act") and Section 36 of the Securities Exchange Act of 1934 (the "Exchange Act") to exempt certain transactions (e.g., those for consumptive use) in certain digital assets that may otherwise be securities but for which—for the reasons explained in the remaining sections of this petition—the existing regulatory regime is inappropriate?²⁷ If such transactions are exempted, should an alternative regime be applied and what should that regulation look like?
 - a) Should the Staff reconsider the view in the Digital Asset Framework that receipt of tokens without investing money may nonetheless satisfy the "investment of money" prong under *Howey*?
 - i) If not, how does the Staff reconcile this position with existing case law, which requires a recipient to "commit his assets to the enterprise in such a manner as to subject himself to a financial loss"?²⁸
 - b) How should digital assets that provide significant non-investment use cases (e.g., paying transaction, or "gas" fees; voting on governance proposals related to the operation of the protocol; serving as a medium of exchange for native applications; and helping secure a network) be analyzed under the "reasonable expectation of profits" prong of *Howey*?
 - i) Would a finding that such digital assets satisfy this prong conflict with Supreme Court precedent, which has stated that where a purchaser is not "attracted solely by the prospects of a return" on his investment . . . [but] is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply"? More generally, how should "consumption"

²⁷ Section 28 of the Securities Act provides that "[t]he Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." Section 36 of the Exchange Act provides that, subject to certain exceptions inapplicable here, "the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."

²⁸ See *supra* note 19.

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factor into the investment contract analysis, giving due regard to the Court's decision in *United Housing v. Forman*?²⁹

- ii) How should market participants regard digital assets that provide both investment uses and non-investment-based consumptive uses, in light of *Howey* case law that explains the existence of speculative purchasers of an asset and the potential to sell an asset for more than you paid for it does not, on its own, mean that the asset is an investment contract under *Howey*?
- iii) How should the "efforts of others" prong of the *Howey* test be understood with respect to the "expectation of profits" prong? How relevant is the presence of price fluctuations on secondary trading platforms to the *Howey* analysis, given that the price may fluctuate based on the supply and demand of the digital asset for its consumptive use?
- iv) How should the "expectation of profits" prong be understood to ensure that it does not include digital commodities, where even if bought by a particular buyer with the hope of profit, any such profit is based on supply and demand for the commodity, not the performance of the issuer?
- c) What efforts may be properly classified as "essential managerial efforts" for digital assets that operate on permissionless blockchains or protocols, where independent, unaffiliated nodes are responsible for processing transactions, securing the network, and approving software implementations, or where such separate parties may be involved in proposing or implementing changes to the network or system?
 - i) How can purchasers be reliant upon the efforts of others in the case of digital assets that have no identifiable central party that could be recognized as an "issuer"?
- 3) Recognizing the importance of creating a predictable framework for market participants, how can the SEC provide greater clarity and certainty on which digital assets constitute securities? Should the Staff revisit the Digital Asset Framework and provide bright-line rules that could be applied more consistently and predictably?
- 4) Following a reconsideration of, or an exercise of exemptive authority for, the application of the *Howey* and *Reves* tests to digital assets, should the SEC conduct formal or informal public evaluations, such as through a no-action letter or other consultative process, to decide whether a digital asset is a security? Who should be able to seek, and rely on, such a determination?
- 5) Should other parties, such as the original promoters, be able to make similar determinations that—absent a formal disagreement from the SEC—third-party market participants could rely on? Should those determinations have to follow a particular process? If so, should there be a timeline during which the Commission must respond?
- 6) Should a digital asset be viewed independently from the transaction in which it was initially sold—such that the sale may have been a securities transaction, but the asset is not a security? In a traditional company, the company may produce a product that it sells, and from which it derives its profits. The shareholders share in these profits. A digital asset issuer, however, may sell its tokens to raise capital to develop the network on which those same tokens will be used. The product and the

²⁹ 421 U.S. 837.



security are represented by the same digital asset, creating a unique coincidence of investment, on the one hand, and use and consumption, on the other.

- 7) Does the current manner in which the *Howey* test is applied result in or promote the maintenance of fair, orderly, and efficient markets consistent with the SEC's tripartite mission?
- 8) Does the current manner in which the *Howey* test is applied result in sufficient certainty and consistency to protect investors in a manner that is consistent with the SEC's jurisdiction and tripartite mission?
- 9) Does the current manner in which the *Howey* test is applied result in sufficient certainty and consistency to facilitate capital formation in a manner that is consistent with the SEC's jurisdiction and tripartite mission?
- 10) In practice, how does a digital asset security transition to be a non-security digital asset? What constitutes "sufficient decentralization" for purposes of transitioning from a security to a non-security?³⁰ How would that determination be made and what would be the mechanism for converting a digital asset from a security to a non-security?
 - a) Is there a difference, or should there be one, depending on whether the digital asset was initially sold in an offering that did not comply with the federal securities laws, or was instead initially sold pursuant to a registration exemption (such as Regulation D or Regulation S)?
 - b) Must the path to sufficient decentralization be predetermined at the time of the digital asset's launch, or may decentralized attributes be introduced over time?
- 11) Even if initially sold in a securities offering, can uses of a digital asset for non-investment purposes (e.g., to use the asset for its actual technological purpose), including transactions on the secondary market to acquire the digital asset for such non-investment purposes, be deemed to be non-securities transactions?

II. Issuance of Digital Asset Securities

A. Registration and Exemptions

The federal securities laws require that the offer or sale of any security be registered with the Commission, unless an exemption is available.

Registration under Section 5 and Section 12 must be sought by the issuer of the security.³¹ Given the nature of digital securities, however, it may not be either feasible or necessary to identify an "issuer" as required under the securities laws. When an issuer registers an offering, it provides a number of disclosures about the operation of the issuer, its financial statements, its leadership, what risks it may face, and information about various other parts of the business. The purpose behind registration, and therefore requiring these disclosures, is to ensure that investors have the material information they need to make informed decisions. The insiders of the issuer, such as management, have information about the

³⁰ William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)* (Jun. 14, 2018) <https://www.sec.gov/news/speech/speech-hinman-061418> (expressing the view that "current offers and sales of Ether are not securities" because Ether had become "sufficiently decentralized.").

³¹ See, e.g., Form S-1, Form 10 (each requiring execution by a representative of the prospective registrant).

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issuer that will affect the value of its securities and therefore the disclosure rules require the insiders to make material information public.

In many cases, however, the value of a digital asset—unlike the value of stocks and bonds—is not dependent on the operations of the issuer or the issuer's financial condition. Rather, the value of a digital asset routinely depends on the general supply and demand for using the digital asset. In such cases, there is little information possessed by the issuer that is unavailable to the public or that impacts the value of the digital asset, making traditional securities disclosures about the issuer irrelevant to holders of digital assets. In fact, the typical information that the federal securities laws require public companies to disclose presents the risk of misleading investors in digital assets, who may believe this information to be material to their investment decision because the SEC mandated its disclosure.

There are, additionally, digital assets that are created or managed by a diffuse group of individuals, who are not a central "team" at all. Some digital assets are developed by dispersed groups of individuals who may not even know each other's true identities. Current application of existing securities regulations may treat this group as the "issuer" but there is little insider information that this group has, and requiring them to coordinate and assume liability for disclosures would be both impracticable and futile. In such circumstances, the kind of information asymmetries that the federal securities laws are designed to remedy do not exist.³²

Mandated disclosures serve a regulatory purpose when there is material information to be pushed out into the market. A diffuse collection of individuals may not have such information to disclose. The SEC's Digital Asset Framework suggests that these dispersed groups may be "Active Participants," or "APs," whose efforts are relevant for determining whether the digital asset is itself a security. But the framework does not itself provide a determinative test for identifying who qualifies as an AP, or specify if these APs are subject to the registration requirements of Section 5 and Section 12.³³

If the digital asset is a security, then failure to register would violate Section 5 and subject the "issuer" to penalties. But failure to register does not only impact the issuer—it also makes it effectively impossible for national securities exchanges and other secondary markets to lawfully facilitate trading of the digital asset security. U.S. digital asset securities markets, like on that Coinbase may develop, that seek to comply with the U.S. federal securities laws therefore may not facilitate trading in these assets; instead, trading for these assets occurs on less well-regulated and/or offshore platforms where there is little oversight or investor protections.

Exceedingly few issuers have successfully registered a digital asset security under Section 5 and Section 12,³⁴ with many others having failed in attempts to do so.³⁵ As a result, very few digital asset securities are

³² *Hinman, supra* note 24.

³³ SEC Staff, Framework for "Investment Contract" Analysis of Digital Assets, <https://www.sec.gov/files/dlt-framework.pdf>.

³⁴ See INX Limited, *Prospectus Supplement*, https://www.sec.gov/Archives/edgar/data/1725882/000121390020023202/ea125858-424b1_inxlimited.htm.

³⁵ See, e.g., American CryptoFed DAO, Filings, <https://www.sec.gov/edgar/browse/?CIK=1881928> (SEC staff rejecting S-1 filing for "serious deficiencies" relating to requirements to comply with the form, resulting in withdrawal); Monster Products, Inc., Filings, <https://www.sec.gov/edgar/browse/?CIK=1675583> (same). See also Carrier EQ, LLC (f/k/a Airfox), Form 8-K (noting the issuer would discontinue the development of AirTokens because "[c]urrent laws and regulatory regimes do not provide for the Company to utilize the AirTokens as envisioned by the Company. . . ."); Paragon Coin, Paragon Coin Update (explaining that the issuer was filing for bankruptcy after its "plans were impossible to achieve due to several legal mistakes"); Jamie Chacon, Gladius Network shuts down as ICO investors cry foul (Nov. 25, 2019), <https://decrypt.co/12044/gladius-network-shuts-down-ico-investors-cry-foul> (issuer shutting down after settling an SEC enforcement action that required the issuer to register).



available for trading in the U.S. This is despite the fact that the lack of information that would have been mandated through the registration process would not have provided material information to the market even if the process had been successfully completed.

Key questions for the Commission to consider and seek public input on:

- 12) Given the potential non-investment uses of digital assets that the Commission today seems to believe may be securities as described in Section II.A, and that digital asset securities typically operate on decentralized and open-source blockchains that are publicly accessible to all, what should be the goal of any registration regime for digital asset securities?
 - a) What risks do digital asset securities present that may not be presented by traditional securities?
 - b) What risks might digital asset securities mitigate, or not present, and how should these changes in risk profile be recognized in the kind of disclosures provided to investors?
 - c) Who, if anyone, should be responsible for registration when there is no identifiable central entity that controls the token or protocol, or when the issuer does not believe registration requirements apply?
 - i) If an entity does serve as an issuer for purposes of a registration of an offering of digital assets, how long should the "issuer" be responsible for the ongoing disclosure requirements that may be required?
 - ii) Are Active Participants responsible for these ongoing disclosure requirements? What if the persons who may be properly treated as APs change over time?
 - iii) Would such a digital asset security have a means to be offered on a regulated digital asset securities trading platform? Should that digital asset still be categorized as a security and should it be subject to SEC regulation?
 - iv) What regulatory goal would such registration accomplish? Is there a way that regulation could be tailored to achieve this goal?
 - v) Should the concept of "active participant" exist at all? How does it promote the goals of the federal securities laws in reducing information asymmetries?
- 13) Taking into consideration that a digital asset team's operations and relationship to the digital asset security may differ meaningfully from the relationship between traditional issuers and the securities they issue, for example, if they are not receiving any proceeds of an offering, should the Commission use its exemptive power under Section 28 of the Securities Act and Section 36 of the Exchange Act to exempt certain developers or promoters of digital asset securities from registration, and/or ongoing disclosure requirements if the SEC were to determine they are subject to its regulatory reach?
- 14) Should platforms be able to facilitate trading in digital asset securities if the initial offer or sale was not registered under Section 5, or the "issuer" of the digital asset security has not complied with the requirements of Section 12?



- a) If there is no central entity that controls the token or protocol, or no one that views themselves as an issuer willing or realistically able to comply with the registration requirements, should trading platforms be permitted to facilitate the trading of the digital asset security if sufficient information about a digital asset security is otherwise available to potential investors without mandatory disclosures?
 - b) What responsibility and potential liability, if any, would a platform have for the accuracy and completeness of the disclosures?
- 15) Are digital asset "investment contract" securities "equity" securities under Section 12(g)?
- 16) May a broker-dealer be permitted, under certain circumstances, to facilitate the resale of digital asset securities, even if they were initially sold without registration or an available exemption?

B. Relevant Disclosures

The existing registration process for securities offerings requires a number of disclosures designed to ensure that the market has the same material information about the company as company insiders have. There are also exemptions from registration for offerings by entrepreneurs and small companies, but they too have their own regulatory disclosure requirements. While the required disclosures are fewer and different, they rest on the same assumptions and the belief that insider information is more limited in type or scope, or that the investors participating in these exempt offerings have superior access to the insiders and their information.

Aside from the difficulties with registration, discussed in the section above, there is also a mismatch between the disclosures required for traditional securities offerings and what investors in digital asset securities need. As a result, existing disclosure requirements are not well-designed to meet the regulatory goals of ensuring that the market has the information it needs about the securities being offered or traded.

Disclosure requirements are the hallmark of the federal securities laws. Rather than judge the suitability of investments for public investors, the federal securities laws are designed to protect investors by requiring issuers to provide material information about the securities they issue, and the risks associated with investing in them, that are both accurate and not misleading.

But the Commission's disclosure requirements for the offer and sale of securities and ongoing disclosure requirements are designed for traditional corporate entities that typically issue and register equity and debt securities. The disclosure requirements under the federal securities laws focus on disclosure about companies, their management and their financial results—topics that poorly fit the decentralized and open-source nature of blockchain-based digital asset securities. Digital asset securities that are not tokenized versions of traditional securities raise different investor disclosure considerations than ordinary corporate securities. For example, even if these assets have value primarily based on the promoter's efforts, they generally do not provide holders any rights over the residual value of the issuer, or a claim on the issuer's assets. They are neither equity nor debt.

Digital assets that the SEC may claim are securities often function on decentralized protocols with many contributors, and every holder of a digital asset security can typically examine for themselves the functionality and governance structure of the asset. As a result, the existing disclosure requirements are both under-inclusive and over-inclusive of the information that is relevant to an investor in a digital asset

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security.³⁶ For example, information that may be relevant to digital asset security investors, such as its "tokenomics" (e.g., the supply schedule of the digital asset security),³⁷ or on-chain governance (rather than traditional boards of directors), are not specifically captured by existing disclosure requirements.³⁸

The result of applying existing disclosure requirements to digital asset securities offerings would be to leave investors exposed. They would be led to believe that information that is irrelevant is actually important to their decision, while missing several pieces of information that could significantly affect the value of the digital assets they hold.

Key questions for the Commission to consider and seek public input on:

- 17) What disclosures should be required for digital asset securities, given their different features as compared to traditional securities?
 - a) What information about the digital asset security, the underlying platform, and those responsible for the development of the digital asset security and the platform should be shared with those who are considering acquiring the digital asset security?
 - b) What existing disclosure requirements are not applicable to digital asset securities? For example, should certain disclosures required under the Williams Act and Section 16 of the Exchange Act be modified or exempted for digital asset securities?
 - c) What new disclosures should be required?
- 18) If it is necessary to provide those that are transacting in a digital asset security certain information about the digital asset security and related matters on an ongoing basis, how should relevant information be disclosed so that it is accessible and useful, taking into account the fact that traditional methods of disclosure may be less effective for digital asset security investors?
- 19) Even if the relevant assets were registered or exempt from registration, how would Rule 15c2-11 apply to broker-dealers facilitating trading in digital asset securities?³⁹ The same challenges noted above with respect to registration—the difficulty in obtaining information about the issuer and the over- and under-inclusive relevancy of the information—apply to the information sought by Rule 15c2-11.

³⁶ Chris Brummer, *Disclosure, Dapps and DeFi*, Forthcoming, Stanford Journal of Blockchain Law and Policy (Mar. 24, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4065143#:~:text=Disclosure%20in%20decentralized%20finance%20is,known%20what%20they're%20buying.

³⁷ See Robert Stevens, *What Is Tokenomics and Why Is It Important?* (Apr. 11, 2022), <https://www.coindesk.com/learn/what-is-tokenomics-and-why-is-it-important/#:~:text=A%20portmanteau%20of%20%E2%80%9Ctoken%E2%80%9D%20and,like%20what%20utility%20it%20has.>

³⁸ See, e.g., Disclosure, Dapps and DeFi, *supra* note 30 ("[T]he base layer disclosure documents for securities law fail to anticipate the particular technological features of decentralized technologies and infrastructures . . . they assume and inquire only into governance, technology, and other operational features inherent to industrial economies, and which are often different, or altogether absent in digital and blockchain-based economies.").

³⁹ Rule 15c2-11 generally requires, before a broker-dealer may publish a quotation for a security or submit a quotation into a quotation medium, that the broker-dealer must have in its possession specified information about the security and its issuer that it believes are reliable and materially accurate, and much of that information be publicly available.



- 20) Should the SEC preempt state blue sky requirements under Section 18 of the Securities Act, for example, by determining that for certain transactions, investors are “qualified purchasers”? If not, given the limited number of digital asset securities that would be listed on a national securities exchange, could a secondary market develop if state-by-state qualification is required?

III. Trading Digital Asset Securities on National Securities Exchanges

One of the central innovations of digital asset trading technology is the ability of both retail and institutional traders to have direct access to platforms that execute transactions 24 hours a day, seven days a week. Transactions settle in real time. And broker-dealer intermediaries are no longer needed as the digital asset market infrastructure has developed so that exchange and trading services, clearing, settlement, and custody can be provided effectively and more efficiently by the same entity.

However, registering a trading platform for digital asset securities faces a series of significant challenges. Notably, Chair Gensler has suggested that such platforms should register as national securities exchanges (“NSEs”), rather than alternative trading systems (“ATSS”).⁴⁰ But existing NSE regulation does not contemplate the existence of, or need for, disintermediated trading. Exchanges require membership to trade directly, and such membership is available only to broker-dealers.⁴¹ Moreover, methods of trading securities outside of a NSE—either on ATSSs or over the counter (“OTC”)—also require the use of a broker-dealer. ATSSs are themselves registered as broker-dealers while OTC trading is facilitated by a network of broker-dealers. None of these models is designed to accommodate direct investor access to a trading venue, which is wholly inconsistent with the current models of digital asset trading and inserts unnecessary layers of intermediation.

Another challenge with Chair Gensler’s approach is that it does not contemplate the side-by-side trading, on the same platform, of digital assets securities and digital assets that are not securities. This is problematic because trading in digital assets that are securities would entail trading many that are not. Unlike traditional securities, which are typically purchased using fiat currency, given the 24/7 trading market, digital assets are often traded for digitally native currencies such as stablecoins, or a cryptocurrency like Bitcoin, which is a commodity. For example, a trader might buy U.S. dollar-backed stablecoins and then use these assets as a store of value for purchases of various other digital assets. We anticipate, given existing practices and preferences in the market, that investors in digital asset securities would buy those assets in the same way, using a stablecoin or other digital store of value.

To register as an exchange, a person must first meet the definition of “exchange”—including that it brings together purchasers and sellers of securities.⁴² Its registration must also be approved by the Commission, which must consider, by statute, whether the exchange is “so organized and has the capacity to be able to carry out the purposes of the Exchange Act.”⁴³ Facilitating the trading of non-security digital assets, such as Bitcoin, has not yet been recognized as furthering the purposes of the Exchange Act. For a platform to register as a securities exchange, while also listing non-securities digital assets, the Commission may need to clarify that registered exchanges may facilitate trading in both security and

⁴⁰ Gary Gensler, *Prepared Remarks of Gary Gensler On Crypto Markets Penn Law Capital Markets Association Annual Conference* (Apr. 4, 2022), <https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422>.

⁴¹ Under Section 6(c) of the Exchange Act, only registered broker-dealers may be admitted as members of a national securities exchange. Further, under Section 6(b) and 19(g), national securities exchanges are self-regulatory organizations (“SROs”), and are required to enforce their member broker-dealers’ compliance with the securities laws. As they currently operate and under current law, it is not clear that digital asset trading platforms could comply with these requirements, nor is it clear there is a regulatory benefit of requiring that they restructure to do so.

⁴² Exchange Act § 3(a)(1).

⁴³ Exchange Act § 6(b)(1).

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non-security digital assets. Finally, securities on NSEs do not currently trade 24/7, but open and close each day through an auction process on their listing venue. They must also comply with a number of other regulations, including most notably Regulation NMS, that may require clarification before they can be easily applied to digital asset securities exchanges. Regulation NMS, for example, assumes the existence of a national market for each listed security, and imposes a number of requirements to harmonize pricing and fees across venues. Digital assets, however, trade on a global scale, with around-the-clock trading. It is not clear how various provisions of these rules would work in a global, 24/7 market.

Key questions for the Commission to consider and seek public input on:

- 21) Recognizing the difficulties in determining which digital assets should be properly classified as securities under existing legal tests,⁴⁴ should a platform be permitted to register with the SEC as a national securities exchange on the basis that some of the assets on the platform may be securities, without making a definitive determination with regard to any particular asset?
- 22) If an asset-by-asset determination must be made, should a single platform be permitted to register with the SEC for trading both security and non-security digital assets?
 - a) Could such a platform meet the definition of "exchange," and be organized to carry out the purposes of the Exchange Act, even for the non-securities?
 - b) Would its rules relating to non-securities be subject to the same requirements as those relating to securities?
 - c) Would the Commission provide exchanges with legal certainty regarding its security versus non-security determinations?
- 23) Could a national securities exchange facilitating trading in digital asset securities be permitted to follow the typical non-intermediary model used by existing non-security digital asset exchanges?⁴⁵
 - a) If intermediaries are required:
 - i) How would this impact the viability of these platforms, particularly given the challenges of operating a broker-dealer for digital asset securities?⁴⁶
 - ii) Would the introduction of intermediaries potentially result in increased fees for consumers?
 - iii) How could the introduction of new digital asset trading technologies provide better investor protections? How should the Commission consider these potential benefits as part of any rulemaking?
 - b) If intermediaries are not required:

⁴⁴ See *supra* Section I.

⁴⁵ As discussed in Section IV.A below, this model is critical to the operation of digital asset markets and an improvement from traditional market structures.

⁴⁶ See *infra* Section VI.B.



- i) How would traditional exchange responsibilities, such as operating as an SRO, apply in the context of non-broker-dealer (including retail) users?
 - ii) Would more limited regulatory requirements, such as engaging in market surveillance as an operator of the market, be more appropriate?
- 24) Would the SEC permit a digital asset security exchange to list digital asset securities that are also traded on unregulated platforms, notwithstanding its Section 6(b)(5) concerns raised in the spot Bitcoin ETF context?
 - a) If not, and given the ease in operating an unregulated trading platform and supporting digital asset securities thereon, would such a prohibition have the practical effect of applying to virtually all digital asset securities, and thereby harm investors by depriving them of any regulated platforms to acquire such assets?
- 25) Would the full scope of NSE requirements apply to an exchange trading digital asset securities? If so:
 - a) What would be the appropriate listing standards for digital asset securities? Existing listing standards typically consider, among other things, quantitative and qualitative standards that are more relevant for corporate securities than digital asset securities.
 - b) Could any national securities exchange grant unlisted trading privileges to a digital asset security listed on another exchange?
 - c) The rules of NSEs generally require that all transactions effected on the exchange be cleared through a registered clearing agency; would this be required for digital asset securities? See also Section IV.D.
 - d) How would the various NMS plans apply?
 - i) Should there be different NMS plans specifically designed and more appropriate for digital asset securities?
 - ii) Would the SROs need to amend their Consolidated Audit Trail rules to contemplate digital asset securities?
 - e) Would Regulation SCI apply? How would its references to "industry standards" be interpreted—as applying to the traditional securities industry or the digital asset industry?
- 26) Would digital asset securities traded on an exchange be deemed NMS securities, and therefore NMS stock? NMS stock is defined as any NMS security (generally all exchange-listed securities) other than an option. If so:
 - a) How would the various requirements under Regulation NMS, which are designed for traditional corporate stock and shares of stock, apply?
 - b) Would there be a national best bid and offer ("NBBO") for a digital asset security?
 - c) Given 24/7 markets, should non-U.S. trading platforms be included in the NBBO?



- d) What would constitute a "round lot" under Regulation NMS, where digital asset securities are not measured in "shares?" Would all orders for and transactions in digital assets that are investment contracts be "odd lots" and thus excluded from various aspects of Regulation NMS?
 - e) How would Rule 611—i.e., the Order Protection Rule, which generally prohibits "trade-throughs"—and the relevant exceptions apply?
 - f) What data would be required to be reported to the tape as "core data"?
 - g) How would the various other reporting requirements, such as under Rules 605 and 606, which contemplate shares of stock, apply?
 - h) What pricing increment(s) would be permitted under Rule 612, which prohibits sub-penny quotations for stocks priced at \$1.00 or more per share?
- 27) How would Regulation SHO apply?
- a) Would exchange-listed digital asset investment contracts be considered equity securities for purposes of Rule 200(g), Rule 203, and Rule 204?
 - b) Would exchange-listed digital asset investment contracts be "covered securities," by virtue of being "NMS stocks," for purposes of Rule 201?

IV. Custody of Digital Asset Securities

A. Digital Asset Trading Platforms

One of the most significant innovations of digital assets is the ability to conduct "real-time" or T+0 settlement. Existing regulations regarding the custody of securities, however, make it impossible to realize this considerable benefit. While custody rules for traditional securities are appropriately motivated by a clear regulatory interest—ensuring that customers can rely on their assets being held securely—they allow trades to settle on a T+2 timeframe. This delay permits third-party intermediaries to settle transactions. But if the settlement timeframe is compressed to seconds, reliance on third parties becomes impossible.

Traditional securities are typically held on behalf of investors by a custodial bank or broker-dealer (themselves holding through the Depository Trust Company). This facilitates post-trade settlement through existing channels and permits an investor to centralize their cash and securities with third-party custodians, making trading on multiple venues more capital-efficient. However, it means that real-time settlement (i.e., "t-zero" settlement) is not possible given that the third-party custodians must facilitate post-trade settlement.

The structure of existing digital asset trading platforms is different. Real-time settlement is expected because it is inherent to blockchain technology. Transfers of digital assets do not require intermediaries. But in order to provide real-time settlement off-chain, existing digital asset trading platforms must settle transactions on their own books—as opposed to the books of third-party custodians. Digital asset trading platforms can only settle transactions on their own books if they custody the digital assets themselves, which explains the difference in market structure.

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The need to provide custody services to customers means that digital asset trading platforms may wish to register as a broker-dealer, or register an affiliate as a broker-dealer.⁴⁷ For the real-time settlement model to work, all users of the platform would in turn be required to custody their assets with that custodian, through the same broker-dealer. Once again, existing rules present a roadblock.

First, real-time settlement means that clearing is not necessary. Clearing exists because there is a risk that, between the time the trade is made and when it settles, one party may fail to deliver either the money or the assets. That risk diminishes as the time lag disappears. Without the risk created by the time lag between execution and settlement, many of the rules related to clearing may not be necessary. On the other hand, new rules may be required to account for a unique feature of the blockchain—that entries are immutable. Whereas traditional markets can unwind transactions that are completed in error, fraudulently, or without proper authorization, this is not possible with digital asset securities. Reversing a transaction would require a new transaction.

The direct-trading model, and its need for exchange-based custody, also raises questions under Section 6(b)(2) of the Exchange Act, the “fair access” rule. This rule generally requires exchanges to allow any broker-dealer to become a member. This requirement may prohibit a digital asset security exchange from limiting membership to that one broker-dealer (i.e., itself or its affiliate). The alternative, admitting several broker-dealers as members that each separately handle custody of its own customers’ securities, again prevents real-time settlement because it would require the introduction of post-trade netting and a clearing agency (to settle all of the trades of the various brokers). If digital asset platforms register as exchanges, they must, under current rules, allow other brokers to access the platform. This requirement has the effect of requiring clearing, and therefore eliminating the ability to effectuate real-time settlement, which was the purpose of the exchange custodial assets in the first place.

Additionally the SEC has traditionally been hesitant to allow an exchange, or an affiliate of an exchange, to act as a full-service broker for customers on the exchange because of (i) the potential unfair advantage that one broker-dealer would have, and (ii) conflicts of interest the exchange would face in regulating its affiliated broker-dealer member.⁴⁸ When there are only a handful of large exchanges, these concerns are valid. In the digital assets markets, however, because trading platforms also serve as custodians and

⁴⁷ Although “mere custody” of securities, on its own, may not itself require a firm to register as a broker-dealer, the Commission and its Staff have regularly viewed custody combined with transaction execution or other services as potentially requiring registration under Section 15(a). See, e.g., Transfer Online, SEC Denial of No-Action Request (May 3, 2000) (transfer agent may be subject to broker-dealer registration when, in addition to custody services, it brings buyers and sellers of securities together, receiving a fee based on the completion of a transaction); M&A Brokers, SEC No-Action Letter (Jan. 31, 2014); GlobalTec Solutions, LLP, SEC No-Action Letter (Dec. 28, 2005); Swiss American Securities, Inc., Streetline, Inc., SEC No-Action Letter (in each case, granting relief from broker-dealer registration where the proposed services did not also include custodial services or securities).

⁴⁸ See, e.g., Order Approving Proposed Rule Change by the Pacific Exchange, Inc., as Amended, and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 4 and 5 Concerning the Establishment of the Archipelago Exchange as the Equities Trading Facility of PCX Equities, Inc., Exchange Act Release No. 44983 (Oct. 25, 2001) (“The Commission recognizes that the potential for unfair discrimination may be heightened if a national securities exchange or its affiliate owns or operates a broker dealer. This is because the financial interests of the national securities exchange may conflict with its responsibilities as an SRO regarding the affiliated broker-dealer. For this reason, the national securities exchange must not serve as the self-regulatory organization that is primarily responsible for examining its affiliated broker-dealer. Moreover, a conflict of interest would arise if the national securities exchange (or an affiliate) provided advantages to its broker-dealer that are not available to other members, or provided a feature to all members that was designed to give its broker-dealer a special advantage”). The Commission has also required national securities exchanges to implement rules prohibiting such exchanges from being affiliated with a broker-dealer member without prior SEC approval. See, e.g., New York Stock Exchange Rule 2B; Nasdaq Stock Market, General Rule 2, Section 4(a); Cboe BZX Exchange Rule 2.10.

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because most trades occur directly, without an intermediary, the competition for customers is between exchanges, not between brokers. This structure, in which customers trade directly on the platform, also significantly mutes any risk that a platform could provide undue advantage to its own broker-dealer; the broker and the platform operate as one service for the customer. It is a fundamentally different business model and therefore presents a different set of risks, necessitating a different regulatory regime.

Key questions for the Commission to consider and seek public input on:

- 28) Can a digital asset securities exchange provide custody of digital asset securities without also being subject to registration as a broker-dealer?
- 29) If broker-dealer registration would be required, would a digital asset securities exchange be permitted to limit membership to one affiliated broker-dealer?
- 30) Would a digital asset securities exchange be permitted to custody both digital asset securities and non-security digital assets?
- 31) Given the differences in business models between traditional securities markets and digital asset markets, what risks might be presented by a digital securities trading platform that do not exist for traditional platforms or exchanges? What risks exist for traditional trading venues that would not exist for digital asset security trading venues?

B. Broker-Dealers

Custody rules present a second major hurdle for digital asset securities markets. As noted above, custody requirements embrace the traditional intermediated model, and provide detailed requirements for how intermediaries may safeguard customer assets, making them difficult to apply to digital asset markets. But these requirements are based on the assumption that assets—or more accurately the proof that a person holds the asset—takes a certain physical form. Proof of ownership of digital assets is represented differently. The Commission has not yet put forward a workable means of achieving the regulatory goal of broker-dealer custody rules: ensuring that customer assets are securely held while facilitating the trading in which customers wish to engage.

Rule 15c3-3, known as the "Customer Protection Rule," is central to this issue. The rule requires that a broker-dealer maintain "physical possession" or "control" over customers' fully paid and excess margin securities in particular ways set out in the rule, such as by holding the paper security certificate (physical possession) or holding through a bank or clearing agency (control). Rule 15c3-3, originally adopted in 1972, does not list holding blockchain private keys as a permitted method of physical possession or control, and the SEC Staff's general position has been that holding blockchain private keys does not qualify as good physical possession or control.⁴⁹

Rather, the staff has suggested that broker-dealers effectively must avoid becoming subject to the rule, by only facilitating transactions in digital asset securities that do not involve the broker-dealer maintaining custody.⁵⁰ Furthermore, even though, by its terms, Rule 15c3-3 applies to cash and securities, the Staff

⁴⁹ SEC, *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities* (July 8, 2019), <https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities> (the "Joint Staff Statement").

⁵⁰ *Id.*



has suggested that broker-dealers would be required to comply with the possession or control obligations even when custodial digital assets that are not securities.

The SEC has attempted to provide a path forward. These attempts, however, are time-limited, not enshrined in final rules, and have ultimately proved not to be workable. In September 2020, the SEC Staff approved a process by which ATSs could facilitate transactions in digital asset securities, where custody is maintained by a third-party custodian (the “Three-Step No-Action Letter”),⁵¹ and in December 2020, the Commission released a time-limited conditional no-action position related to broker-dealer custody of digital assets (the “Commission No-Action Position”).⁵² Both documents required significant limitations on the business activities of broker-dealers who custody digital assets, and do not present a workable solution. We are not aware of any firms that have sought to rely on the Commission no-action position. As a result, even if a digital asset security exchange were to adopt a broker-intermediated model, there appear to be no broker-dealers that could act as members because of Rule 15c3-3 and the limitations of the SEC’s current “special purpose” digital asset security custody position.⁵³

As part of issuing its December 2020 no-action position, the Commission requested comment from the public on its approach.⁵⁴ Despite receiving dozens of comment letters in response to its request, the Commission has not revised its position or used these comments to inform rulemaking.⁵⁵ We urge the Commission to reengage on this issue to find a workable solution that provides robust customer protection while also enabling investors to access the digital asset securities markets.

Broker-dealers are also subject to Rule 15c3-1, known as the “Net Capital Rule.” The Net Capital Rule is designed to ensure that broker-dealers maintain sufficient unencumbered, liquid capital available at all times to satisfy customer claims promptly. A broker-dealer’s net capital is calculated by starting with its net worth under generally accepted accounting principles (“GAAP”),⁵⁶ and then making various adjustments prescribed by the rule, in particular, deducting non-allowable assets such as those not readily convertible into cash.⁵⁷ While customer assets custodied by a broker-dealer are typically not recorded on a broker-dealer’s balance sheet, recent SEC Staff guidance (“SAB 121”)⁵⁸ announced the SEC accounting Staff’s view that certain entities that hold custody of customers’ digital assets should account for their obligation to safeguard the digital assets by recording (i) a liability on their balance sheet for their obligation to return the digital assets, and (ii) an offsetting asset “similar in nature to an indemnification asset,” but “separate and distinct from the crypto-asset itself”—i.e., essentially a “stub” accounting entry.⁵⁹

While by its terms aimed at issuers of securities and SEC reporting companies, it is not clear the extent to which the SEC Staff would view SAB 121 as applicable to broker-dealers that hold custody of digital asset

⁵¹ FINRA, SEC No-Action Letter at 2 (Sept. 25, 2020), <https://www.sec.gov/divisions/marketreg/mr-noaction/2020/finra-ats-role-in-settlement-of-digital-asset-security-trades-09252020.pdf>.

⁵² Custody of Digital Asset Securities by Special Purpose Broker-Dealers, Exchange Act Release No. 34-90788, 86 Fed. Reg. 11,627 (effective Apr. 27, 2021), <https://www.sec.gov/rules/policy/2020/34-90788.pdf>.

⁵³ See, e.g., Hester M. Peirce, Statement, *In the Matter of Poloniex, LLC* (Aug. 9, 2021), <https://www.sec.gov/news/public-statement/pierce-statement-poloniex-080921> (noting the limited usefulness of the SEC’s no-action relief).

⁵⁴ Commission No-Action Position, *supra* note 46 at 16–17.

⁵⁵ SEC, *SEC Policy Statement: Custody of Digital Asset Securities by Special Purpose Broker-Dealers* (last modified May 3, 2022), <https://www.sec.gov/comments/s7-25-20/s72520.htm>.

⁵⁶ See Exchange Act Rule 15c3-1(c)(2) and Interp. /01.

⁵⁷ See Exchange Act Rule 15c3-1(c)(2)(iv).

⁵⁸ SEC, Staff Accounting Bulletin No. 121, <https://www.sec.gov/oaca/staff-accounting-bulletin-121>.

⁵⁹ *Id.* at n.8.

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securities for customers, where those broker-dealers are not issuers or reporting companies.⁶⁰ If SAB 121 applies to a broker-dealer's financial accounting, all digital assets and digital asset securities custodied by a broker-dealer for its customers would be added to the broker-dealer's liabilities, thus decreasing the broker-dealer's net worth under GAAP. And on the other side of the balance sheet, although the broker-dealer would be able to add some type of offsetting stub asset entry, such an asset would likely be deemed "not readily convertible into cash" under the Net Capital Rule, as there is no market for this accounting stub. For purposes of computing a broker-dealer's net capital, therefore, its liabilities would increase by the fair value of the digital asset securities held in custody, while its allowable assets would not increase by a corresponding amount. Accordingly, for every dollar worth of digital asset securities custodied, the broker-dealer would have a dollar reduction in its net capital, which the broker-dealer would need to replace with allowable assets. In effect, the parent company of the broker-dealer would need to contribute a dollar of cash as additional equity into the broker-dealer for every dollar worth of digital asset security custodied by the broker-dealer. Such a business model would, of course, be non-economic and unsustainable, and no broker-dealers would be able to offer custody services in digital asset securities.

Key questions for the Commission to consider and seek public input on:

- 32) Is it practical for digital asset security trading platforms to operate in a non-custodial manner as suggested by the Joint Staff Statement or the Three-Step No-Action Letter?
- 33) How should "possession" and "control" be understood with regard to custody of digital asset securities?
- 34) Should banks or trust companies, to the extent permitted to provide custody services pursuant to their applicable regulatory regime, be eligible to act as "good control locations" through which broker-dealers could maintain custody of their customers' digital asset securities (and non-security digital assets) in compliance with Rule 15c3-3?
 - a) Under the existing Customer Protection Rule, banks can serve as good control locations for securities under Rule 15c3-3;⁶¹ is there any basis to treat digital asset securities custodied with a bank differently?
- 35) How should Rule 15c3-3 be amended to explicitly consider its application to digital assets?
- 36) What protections or structures would be appropriate to adequately protect customers in the event of the insolvency of a broker-dealer that custodies digital assets for customers (whether securities or not)?
- 37) Should non-security digital assets be subject to Rule 15c3-3 at all, given that they are neither cash nor securities?
- 38) What best practices exist for the custodying of digital assets that should be adopted as requirements through securities regulation?
- 39) What benefits does distributed ledger technology offer with respect to transparency of transaction activity that might address risks addressed through regulation for traditional securities? What new

⁶⁰ SAB 121 by its terms applies to "crypto-assets," which would appear to include digital asset securities, as SAB 121 defines the term broadly as "digital asset[s] that [are] issued and/or transferred using distributed ledger or blockchain technology using cryptographic techniques." *Id.* at n.3.

⁶¹ Exchange Act Rule 15c3-3(c)(5).



risks does the technology introduce regarding mistaken or unauthorized transactions, and how can these risks be mitigated through regulation?

- 40) How should Rule 15c3-1 be amended to explicitly consider its application to digital assets, including with regards to digital assets held by customers, in inventory, or used as collateral?
- 41) If a broker-dealer holds custody of digital asset securities, would SAB 121 apply to the broker-dealer's capital requirement calculations? If SAB 121 does apply:
 - a) Would the SEC consider adjusting net capital calculations under Rule 15c3-1 so that broker-dealers with material custody business are not effectively prevented from meeting their net capital requirements?
- 42) Would the SEC permit the offsetting stub asset to be allowable for purposes of a broker-dealer's net capital, even though it may not be readily convertible into cash?

C. Requirement for and Role of Transfer Agents

Distributed ledger technology provides an unchangeable record of transactions, visible to all. This could revolutionize how transfer agents can facilitate securities trades. Before the advent of blockchain technology, there was no way to ensure that transactions were recorded accurately and records were properly maintained without the use of third parties. To facilitate the traditional intermediated market structure, transfer agents were established to record changes of ownership, maintain the issuer's security holder records, cancel and issue certificates, and distribute dividends. Some transfer agents are required to be registered with the SEC, or if the transfer agent is a bank, with a bank regulatory agency. Blockchain technology offers to improve this process, performing most if not all of these tasks, with limited labor costs, and without the risks of human error.

It is not clear, however, that existing rules will permit the use of this new technology. We understand that the Commission has only been willing to approve offerings of securities involving a transfer agent where that transfer agent has ultimate control over the official stockholder registry of a security, including the ability to unilaterally make changes to it (e.g., per a court order or to correct errors).⁶² Based on structures that have been approved, it appears that the SEC has not permitted a registered transfer agent to look to a blockchain as its official stockholder registry, and has required that the transfer agent know the identity of each registered owner.⁶³ This position prevents the securities markets from realizing the efficiencies offered by the new blockchain technology, harming investors, markets, and issuers alike.

Key questions for the Commission to consider and seek public input on:

- 43) Is a transfer agent necessary for digital asset securities, where records of ownership, at least pseudonymously, are publicly available?

⁶² See, e.g., Arca U.S. Treasury Fund, Form N-2, <https://www.sec.gov/Archives/edgar/data/1758583/000121465920005869/s624200n2a2.htm> ("Although records of peer-to-peer transactions are viewable on Ethereum, record and beneficial ownership of the Fund's shares is reflected on the records of DTAC, LLC, the Fund's transfer agent (the 'Transfer Agent'). The Transfer Agent is regulated by the Securities and Exchange Commission ('SEC'). The Transfer Agent's records constitute the official shareholder records of the Fund and govern the record ownership of ArCoins in all circumstances.").

⁶³ See *id.*



- 44) How may a person properly act as a transfer agent of a digital asset security, given the nature of blockchain-based assets?
- 45) Are there circumstances under which a registered transfer agent should be able to look to the blockchain as its official records?

D. Clearing Agency Status of Blockchains

There is currently uncertainty surrounding whether the blockchain, the nodes, miners, or validators on the blockchain, or others involved in facilitating the blockchain, are acting as a "clearing agency" and subject to registration with the SEC. A person who engages in "clearing" activities must generally register with the SEC as a clearing agency. A person is a "clearing agency" if, among other things, it acts as an "intermediary in making payments or deliveries or both in connection with transactions in securities," it "acts as a custodian of securities in connection with a system for the central handling of" fungible securities, or it "otherwise permits or facilitates the settlement of securities transactions . . . without physical delivery of securities certificates."⁶⁴

Given the functionality of various components of blockchain technology, it is possible that any or all of these components may be erroneously labeled "clearing agencies." Because a blockchain and each of its components operates without central control, it is not clear how it or any part of it could register as a clearing agency. Nor is the relevance or workability of clearing agency rules evident in the context of digital asset trading occurring on blockchain technology. Many of the rules applicable to clearing agencies are designed to ensure that there is clarity regarding how trades are settled, ensuring it operates fairly and in good faith with respect to all parties, and establishing it as a means of promoting compliance throughout the market. Once again, blockchain technology is specifically designed to mitigate many of the risks that regulation of clearing agencies is intended to address, such as ensuring trades settle, in an open, transparent, and provably final way. Therefore, not only is it unclear how the blockchain or other similar technology could register, it is not clear that the rules applicable to clearing agencies are needed with respect to digital asset securities.

Key questions for the Commission to consider and seek public input on:

- 46) Does the Commission view a blockchain on which digital asset securities may be transferred to be acting as a clearing agency? What risks does a blockchain present that would justify the application of these regulations? What risks does a blockchain mitigate that are presented by traditional clearing agencies? What new risks does blockchain present?
- 47) If so, who would be required to register? Each node, miner, or validator? A group representing them? Would this be practical, considering the often highly distributed nature of nodes, miners, and validators?
- a) How would nodes, miners and validators satisfy the requirements to assure fair representation of their members and participants in the selection of their directors and the administration of their affairs, particularly where there are no formalized members, participants, or directors?⁶⁵

⁶⁴ Exchange Act § 3(a)(23).

⁶⁵ Exchange Act § 17A(b)(3)(C).



- b) Would nodes, miners, and validators be required to become SROs like other clearing agencies?⁶⁶ If so, would changes to the network require filings with and approval by the SEC under Rule 19b-4?
 - c) Would nodes, miners, and validators be required to establish, implement, maintain and enforce the detailed written policies and procedures mandated by Exchange Act Rule 17Ad-22(e)?
 - d) Would Regulation SCI apply to nodes, miners, and validators?⁶⁷ How would its references to "industry standards" be interpreted—as applying to the traditional securities industry or the digital asset industry?
 - e) Would nodes, miners, and validators be subject to examination by the Office of Compliance Inspections and Examinations' Office of Clearance and Settlement?
- 48) Given the typical permissionless nature of blockchains, how could registration be effected or enforced?
- 49) Could a broker-dealer or exchange facilitate trading of a digital asset security that could, or must, be settled over a blockchain that is not registered as a clearing agency?
- 50) In light of the difficulties described above with any potential registration, would the Commission offer a class exemptive order excluding blockchains from clearing agency registration? What conditions would be appropriate?

V. Necessary Preconditions to Rulemaking

The questions and challenges in this petition highlight the difficult and complex legal, policy, and technical considerations relating to the application of the existing federal securities law regime to digital asset securities. To properly weigh the costs and benefits raised by digital asset security activities, and to understand the market, practices, and needs of investors and market participants, the SEC should engage with all relevant stakeholders to inform the rulemaking we suggest above. We believe the Commission should take the following steps:

First, the SEC needs to seek input from market participants. The SEC has not yet obtained widespread public input, as it frequently does for novel and significant rulemakings. Rather, to date, the SEC has primarily engaged through non-public, bilateral discussions with particular industry members, or through enforcement investigations. It also does not appear that the SEC has engaged with, or solicited input from, retail investors. There is also no representation from the digital asset community on the Investor Advisory Committee or any of the SEC's other advisory committees.

The Commission has frequently used requests for comment, concept releases, advisory committees, and public roundtables to obtain useful public input prior to proposing specific rulemaking items. For example, the SEC first solicited public comment on climate disclosure in March 2021, a full year before proposing climate disclosure rules and, similarly, the SEC issued a concept release on the harmonization of securities offering exemptions in 2019, over a year before adopting rules.⁶⁸ The SEC has also pursued

⁶⁶ Exchange Act § 3(a)(28).

⁶⁷ 17 CFR 242.1000 (including registered clearing agencies in the definition of "SCI SROs").

⁶⁸ Acting Chair Allison Herren Lee, *Public Input Welcomed on Climate Change Disclosures* (Mar. 15, 2021), <https://www.sec.gov/news/public-statement/lee-climate-change-disclosures>; SEC, *The Enhancement and Standardization of Climate-Related Disclosures for Investors* (Mar. 21, 2022),

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these forms of public engagement to obtain information about many other areas of potential rulemaking, including with regard to equity market structure, fixed income market structure, transfer agent regulation, “proxy plumbing,” and emerging market considerations, among others. Banking regulators have similarly solicited public input on digital assets, for example by issuing requests for information.⁶⁹

One of the key reasons to conduct public outreach is to ensure that the rules proposed will actually function as intended when put into practice. Given the considerable differences in how digital assets operate, such input would help the Commission to understand the risks and how best to mitigate them. Thoughtful digital asset security rulemaking will require input from professionals with a deep technical expertise in the operation of digital assets and markets.

Second, the SEC’s approach to digital asset regulation should be informed by ongoing developments in the executive and legislative branches. The Biden Administration has commissioned a number of reports on digital assets from various agencies in its March 2022 Executive Order,⁷⁰ and this work has only just begun. The Commission itself is requested to contribute to two of these reports, and the knowledge that the Commission gains through this process will be critical to any Commission rulemaking. Congress is also actively working on legislation that could materially affect the regulatory landscape.⁷¹

Third, coordination between the SEC and other agencies, most notably the CFTC, is critical. CFTC Commissioner Pham and SEC Commissioner Peirce have recently recommended such joint collaboration, noting that “crypto is still early in its development,” and such cooperation “would benefit the capital markets, not just the crypto markets.”⁷²

* * *

The core question is how best to achieve the SEC’s mission and promote the innovation and application of digital assets and blockchain technology within the capital markets and our economy more broadly. How best to regulate digital asset securities raises complex and novel issues, and will require thoughtful

<https://www.sec.gov/rules/proposed/2022/33-11042.pdf>; SEC, *Concept Release on Harmonization of Securities Offering Exemptions* (June 18, 2019), <https://www.sec.gov/rules/concept/2019/33-10649.pdf> (Concept Release; Request for Comment); SEC, *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets* (Nov. 2, 2020), <https://www.sec.gov/rules/final/2020/33-10884.pdf> (Final Rule).

⁶⁹ FDIC, *FDIC Issues Request for Information on Digital Assets* (May 17, 2021), <https://www.fdic.gov/news/press-releases/2021/pr21046.html>.

⁷⁰ Biden Administration, *Executive Order on Ensuring Responsible Development of Digital Assets* (March 9, 2022), <https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/>.

⁷¹ See, e.g., Lummis-Gillibrand Responsible Financial Innovation Act (released June 7, 2022), <https://www.lummis.senate.gov/wp-content/uploads/Lummis-Gillibrand-Responsible-Financial-Innovation-Act-Final.pdf>.

⁷² Caroline D. Pham and Hester M. Peirce, *Making progress on decentralized regulation — It’s time to talk about crypto together* (May 26, 2022), <https://thehill.com/blogs/congress-blog/3503277-making-progress-on-decentralized-regulation-its-time-to-talk-about-crypto-together/> (“As an initial step, we are calling on our agencies to hold a joint set of public roundtables to evaluate recent market events and risks, and to discuss how to regulate crypto responsibly. These roundtables would be open to the public, and panelists would include crypto users, investor and customer advocates, industry members, and other regulators. The goal would be to assess whether new regulations are necessary to protect the public and the markets, how existing regulations might be modernized to better account for innovation, and how technology is likely to reshape our markets. We could start with topics such as digital asset trading platforms, crypto derivatives, stablecoins, decentralized finance, and the balance between privacy and anti-money laundering measures.”).



and rigorous engagement with all stakeholders. We appreciate the opportunity to provide input to the Commission on these important matters and hope the Commission will seek broad public input on how digital asset securities markets can be appropriately regulated in a manner that facilitates investor protection, capital formation, and efficient markets with the integrity investors and other market participants have come to expect. For that reason, we respectfully petition the Commission to solicit broader input from the public to address all relevant questions and challenges related to the regulation of digital asset securities with the goal of informing an important rulemaking on this subject. As noted above, we are committed to this endeavor as well, and expect to submit our thoughts on how to address some of these challenges in a series of follow-up responses to this petition.

We would be pleased to answer any questions the Commission or its Staff may have regarding our petition. We appreciate the Commission's continuing attention to this important matter and for allowing us an opportunity to present our views.

Sincerely,

Paul Grewal

Chief Legal Officer

Coinbase Global, Inc.

cc:
 Hon. Gary Gensler, Chair
 Hon. Hester Peirce, Commissioner
 Hon. Caroline Crenshaw, Commissioner
 Hon. Mark Uyeda, Commissioner
 Hon. Jaime Lizárraga, Commissioner

Appendix

A Brief Overview of *Howey* and *Reves**Howey*

Whether an instrument constitutes an “investment contract” is determined by reference to a test articulated by the Supreme Court in *SEC v. W.J. Howey Co.*⁷³ In 1946, the Supreme Court articulated the *Howey* test in a case involving speculative investments by purely financially motivated parties in a Florida citrus grove profit-generating enterprise—activity plainly within the scope of the federal securities laws. The Court held that the investments amounted to “investment contracts” and thus “securities” because they involved each of the following features:

- (1) an investment of money;
- (2) in a common enterprise;
- (3) made with a reasonable expectation of profits; and
- (4) based predominantly upon the entrepreneurial or managerial efforts of the promoter or other third parties.⁷⁴

In analyzing whether a particular instrument is an investment contract, the Supreme Court has emphasized that “form should be disregarded for substance and the emphasis should be on economic reality.”⁷⁵ The SEC has adopted a similar position, indicating that “[d]etermining whether a transaction involves a security does not turn on labelling . . . but instead requires an assessment of the economic realities underlying a transaction . . . All of the relevant facts and circumstances are considered in making that determination.”⁷⁶ An asset must meet each requirement of the *Howey* test to be an investment contract.

Reves

The *Reves* test was articulated by the Supreme Court in 1990 to interpret the term “any note.” It is unreasonable to think Congress intended to apply federal securities regulation to every “note”—otherwise a homeowner would have to file a registration statement with the SEC when signing a mortgage note and could only refinance that note through a broker-dealer. Accordingly, the Court laid out a test that considers:

⁷³ 328 U.S. 293, 301 (1946).

⁷⁴ *Id.* (“The test [for an investment contract] is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.”); *see also Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel*, 439 U.S. 551, 558–62 (1979); *SEC v. Edwards*, 540 U.S. 389, 393 (2004).

⁷⁵ *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 848–49 (1975) (internal quotation marks and citations omitted).

⁷⁶ *In re Munchee, Inc.*, Securities Act Release No. 10445, at 9 (Dec. 11, 2017).

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- (1) the motivations of the buyer and seller;
- (2) the plan of distribution of the instrument;
- (3) the reasonable expectations of the investing public; and
- (4) the presence of an alternative regulatory or other risk-reducing regime.⁷⁷

Unlike the *Howey* test, which requires satisfaction of each of its requirements for an asset to be deemed a security, the *Reves* test is simply a set of factors that a court should consider in making its decision, with no one factor being dispositive or entitled to a particular weighting.

⁷⁷ *Reves v. Ernst & Young*, 494 U.S. 56, 66–67 (1990).



Appendix C:

Coinbase Petition for Rulemaking - Digital Asset
Issuer Registration and Reporting

Submitted to the Securities and Exchange
Commission

December 6, 2022



December 6, 2022

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Petition for Rulemaking – Digital Asset Issuer Registration and Reporting

Dear Ms. Countryman:

Coinbase Global, Inc. ("Coinbase") is filing a comment in response to our July 21, 2022 petition for rulemaking on digital asset securities Regulation ("Petition").

As we explained in our Petition, the U.S. does not currently have a functioning market for crypto securities, and in particular investment contracts involving digital assets ("ICDAs"). A key inhibitor to such a market is the lack of a workable set of regulatory requirements for prospective digital asset issuers to register offerings deemed to involve an investment contract and make corresponding disclosures in compliance with securities laws. Issuers and investors would benefit from clear rules adapted to ICDAs that promote compliance and foster safe and transparent practices, including by providing investors with information material to evaluating ICDAs.

In our comment today, we propose a framework (attached as an appendix) designed to achieve this. If implemented, we believe it would create a reasonable and clear path for digital asset developers to raise capital from U.S. investors, provide a disclosure foundation to make ICDAs eligible for trading through SEC-registered intermediaries and platforms, and thus create the necessary economic incentive for a vibrant secondary market in digital asset securities with strong investor protections.

Our views are based on our extensive work with digital asset development teams and years of making asset listing decisions based on legal, compliance, and information security considerations. As we explain in more detail below, the needs of ICDA investors differ substantially from investors in traditional securities because the purpose of ICDAs and the manner in which an ICDA issuer typically offers digital assets is substantially different than an initial public offering of traditional securities. Accounting for these differences in an appropriately tailored registration and reporting regime would better protect investors, provide workable guidance to issuers, and give the SEC greater insight into the health and viability of the market itself.



Digital Assets – And ICDA – Are Different

Although federal securities laws have recognized “investment contracts” since 1933, SEC rules focus primarily on traditional debt and equity, and do not address the unique features of investment contracts. ICDA, which incorporate distributions of digital assets, present an additional layer of new features that do not exist in any other class of securities. Recognizing that ICDA are different from traditional securities is critical to establishing a proper regulatory framework. Below we describe three properties of these assets that need to be accounted for in order to establish a workable and effective registration and reporting regime.

1. Different information informs investment decisions

Investors in ICDA require different information than what is found in traditional securities disclosures for companies issuing debt and equity. Unlike an equity stake in a company, an ICDA does not give the holder any residual economic interest in the issuer. So, while traditional securities reflect the value of the issuer as a whole, and depend on the issuer’s financial well-being, ICDA reflect the value of a specific digital asset project, which can depend on factors that are not specifically enumerated in securities disclosure requirements under regulation S-K. These factors center on the technical details about the protocol or networks on which the digital asset operates, how the code may be updated or changed, or how transactions are validated. A principles-based disclosure approach for ICDA-specific disclosures can, to some extent, accommodate these differences, but there is also an opportunity to organize and report disclosures as a standardized schedule of decision-useful information. We provide examples of how this could work in our proposed framework, which calls for disclosure of information about the ICDA issuer, the investment contract, and the underlying digital asset.

2. Digital Assets Have Intrinsic Utility

An ICDA involves the sale of digital assets that are often designed to be used in exchange for goods or services on a decentralized network. In contrast, traditional securities represent a claim on the profitability of the corporate issuer, but otherwise have no intrinsic use or consumptive value. For example, a share of Apple stock is not needed to operate an iPhone, while digital assets are often needed to, among other things, execute smart contracts on blockchain protocols and/or applications. In many cases, continuous operation of blockchain protocols requires the programmatic distribution of digital assets, for example, as an economic incentive or reward given to protocol participants for securing or validating transactions on a blockchain. This utility makes a digital asset an integral part of the operation of the protocol even if the ICDA separately also has the qualities of an investment. An important implication is that the intrinsic utility of a digital asset can only be fully realized when they are held and used outside the confines of a securities dealer, bank, or other qualified custodian. That is, using or



transferring the underlying digital asset to access or transact over a good or service should not be viewed as always involving a securities transaction.

3. Control Can Become Decentralized Over Time

One of the primary goals of many digital asset development teams is to eventually relinquish control over their protocol to a community of users. In practice this means that after the project is operational and reaches a critical mass of users, the team's practical control over the live protocol and digital asset diminishes significantly, if not entirely. An initial sponsor of the protocol may dissolve or disaffiliate from the protocol initially (e.g., by relinquishing IP rights to a separately managed and owned, arm's length entity) or otherwise relinquish control gradually over time.

Regardless of the path to decentralization, digital assets can live and thrive without their issuer. In contrast, traditional securities like debt and equity are inextricably tied to the viability of an issuer as a going concern.

Critically, for an ICDA, there comes a point where the original development team may not have a unique ability to modify or influence the functionality of the digital asset or protocol and/or application on which it functions. At this time, the development team is no longer in a position to be the primary source of decision-useful information to digital asset holders. Indeed, once this transition occurs, the information asymmetries that existing securities laws are designed to alleviate disappear. Instead, the value of the digital asset, and implied return on capital from holding it, flows from the use and efforts of a community of users. Therefore, after this point, there is limited to no continued benefit to market participants in requiring the ICDA issuer to file reports with the SEC.

Path to a Workable and Effective Registration and Reporting Framework

The unique features of ICDA's pose certain challenges to the existing securities law frameworks. But these challenges are not insurmountable. Our proposed disclosure framework provides a path for sale of ICDA's to the general public and to make the ICDA's eligible for trading through SEC-registered intermediaries and platforms. Importantly, this framework accounts for the fact that the goal of many ICDA issuers is to develop protocols or networks that eventually operate without any ongoing effort on their part.

Our proposed framework for ICDA's depends on some overarching considerations.

- A principles-based approach to disclosures for ICDA's must be augmented with a publicly disclosed, standardized set of requirements and expectations to facilitate a streamlined issuance, trading, and reporting process – one that accommodates the practical realities of small development teams that do not plan to grow into large organizations.

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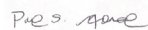
- The disclosure regime must define an *ex ante* set of conditions whereby reporting is no longer required. Without a specified exit process, there will not be sufficient incentive for the vast majority of ICDA issuers to enter a US registration framework, driving innovation offshore.
- The criteria for exiting SEC reporting following the issuance of an ICDA must be clear enough that issuers can reasonably exit through a notice and self-certification process. The trigger for exit should be the point at which the issuer is no longer exercising essential managerial control over the project, or its ongoing involvement with the project otherwise no longer meets the definition of an investment contract security.
- To enable use and consumption of digital assets underlying the ICDA at all times during the protocol development, an issuance and reporting regime that enables secondary market trading should not unduly impede the self custody, transfer, or use of the digital assets.
- While our focus here is on issuer offers and sales of ICDA's and ongoing reporting, we note that it is equally important for the SEC to develop a workable and effective regulatory regime for trading platforms to transact in ICDA's, which similarly does not exist today. Given that the SEC has consistently stated that SEC-registered platforms cannot facilitate trading in digital asset securities not offered and sold pursuant either to an effective registration statement or exemption from registration, providing a path toward registration of ICDA offerings is a necessary prerequisite to compliant secondary market trading. We refer to our petition on the broader set of issues and questions that require action.

We are broadly encouraged by the statements the Chair has made about flexibility the Commission could use to address digital asset disclosures, e.g.,:

*"Given the nature of crypto investments, I recognize that it may be appropriate to be flexible in applying existing disclosure requirements. Tailored disclosures exist elsewhere — for example, asset-backed securities disclosure differs from that for equities."*⁷⁸

It is in the spirit of this suggestion that we are proposing our framework.

Sincerely,



Paul Grewal
Chief Legal Officer
Coinbase Global, Inc.

⁷⁸ https://www.sec.gov/news/speech/gensler-sec-speaks-090822#_ftnref12



Appendix

Proposed ICDA Disclosure Framework

The proposal below would apply only to investment contracts involving digital assets (ICDAs) that are issued on a blockchain or distributed ledger. The proposal is not intended to be applicable to equity, debt or other types of traditional securities merely issued in digital form.⁷⁹

ICDA OFFERING DISCLOSURE

An ICDA issuer seeking to offer and sell digital assets to the general public would be required to file with the SEC an initial disclosure including the following information: (1) Issuer-Related Disclosures; (2) Investment Contract Disclosures; (3) Digital Asset-Specific Disclosures:

(1) Issuer-Related Disclosure

(Aligned with disclosure requirements in Regulation S-K or AB to elicit comparable but more appropriately tailored information)

- Security transactional and risk factor information
 - Offering summary (S-K 503)
 - Intended use of proceeds (S-K 504)
 - Determination of offering price (S-K 505)
 - Plan of distribution (S-K 508)
 - Material risks related to the offering (General and Specific) (S-K 105)
- Business description (e.g., S-K 101 + reg AB)
 - Business experience in the digital asset space
 - Information related to management and capitalization
 - Relationships with affiliated entities and other transactional parties (AB)
 - Material roles and responsibilities related to the digital asset, its development deployment and post-launch supporting activities (AB)
 - Permissible and restricted activities related to the protocol and/or digital assets (AB)
- Digital asset holder information (including lockups and release schedules, pricing, and discounts)

⁷⁹ The term ICDA does not include an asset that provides the holder of the asset with any of the following rights in a business entity: (i) a debt or equity interest in that entity; (ii) liquidation rights with respect to that entity; (iii) an entitlement to an interest or dividend payment from that entity; (iv) a profit or revenue share in that entity *solely* from the entrepreneurial or managerial efforts of others; or (v) any other financial interest in that entity. These exclusions are consistent with those set forth in the proposed Lummis-Gillibrand Responsible Financial Innovation Act.

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- Issuer digital asset holdings and rights (new)
- Digital assets authorized for issuance under compensatory digital asset plans (S-K 201)
- Digital asset holdings (and rights to digital assets) of management and owners (or affiliated owner groups) of more than 5% of digital assets (S-K 403)
- Representations and warranties (reg AB)
 - Representations and warranties relating to the digital assets, remedies available against transactional parties for such reps/warranties, and information on how any transaction agreements can be modified or amended and/or whether there are any material claims that other parties may have on the digital assets
- Financial disclosures and MD&A
 - To the extent material to the ICDA investment, issuer financial statements covering the two most recently completed fiscal years or such shorter period as the issuer has been in existence (reg S-X)
 - MD&A focused on issuer capital deployed to develop the digital asset and protocol and/or application over the period covered by the financials (S-K 303)

(2) Investment Contract Disclosure

(Relevant disclosures not specifically elicited by existing rules)

- **Description of Investment** – Information about the investment opportunity or common enterprise
 - Initial and ongoing rights and obligations associated with the investment contract
 - How investors could expect profits from the issuer's managerial efforts
 - Anticipated future development, including features, integrations, functionality, etc. ("Key Milestones")
- **Relevant transactional parties** – to the extent applicable and material
 - Any entity (other than the issuer) responsible for significant development efforts related to the digital asset (AB)
 - Key digital asset-related service providers material to the asset or offering

(3) Digital Asset-Specific Disclosures

(Information specific to the operation of the digital asset or protocol)

- **Digital Asset Functionality** – Commercial and operational information about the digital asset and the protocol on which it will function
 - Technical description of the digital asset and the protocol on which it will function (e.g. consensus mechanism, on-chain components, smart contracts, etc.)

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- Intended and actual functionality of the digital asset and the protocol on which it will function
 - Calculations underpinning distribution of digital asset rewards, if any, whether through staking, reallocation of network fees, or some other mechanism
 - Results of any third-party security and code audits completed
 - Risk factors related to the digital asset or protocol on which it will function that may materially affect the digital asset's functionality and/or utility
- **Digital Asset Economics ("Tokenomics")** – Digital asset supply and distribution information, pricing, lockups, and release schedules
 - Initial supply and any contemplated or potential changes in digital asset supply
 - Digital assets distributed via consensus mechanism
 - Digital assets distributed to:
 - Issuing entity, sponsor and/or foundation, community, or other
 - **Schedule Digital Asset ("DA")** – A standardized schedule of common, digital asset-specific information that is material to understanding the operation of the digital asset and protocol and/or application in which it functions.⁸⁰ This information provided by issuers should be comparable across projects and protocols. See example items below.

ICDA SECONDARY MARKET DISCLOSURE

ICDA issuers that previously sold ICDA's other than through the [ICDA Offering Disclosure](#) framework would be required to provide an initial disclosure for the ICDA's to be eligible for trading through an SEC-registered intermediary or platform, including on a National Securities Exchange, through a broker-dealer on an alternative trading system (ATS), or OTC quotations.

- Information contained in the [ICDA Offering Disclosure](#) would satisfy this requirement. However, an [ICDA Secondary Market Disclosure](#) would not need to include the disclosures listed under the section "Security Transactional Summary and Risk Factors".

ONGOING DISCLOSURES

Ongoing disclosures should be a part of any [ICDA Offering Disclosure](#) or [ICDA Secondary Market Disclosure](#) framework and would be required until the issuer has filed a Closing Certification. The following disclosures would be required only to the extent they are material to a continued understanding of the ICDA:

⁸⁰ These disclosures could be presented on schedule analogous to Schedule AL, used with offerings conducted pursuant to Regulation AB.



- Annual updates to the following information from the [ICDA Offering Disclosure](#) or [ICDA Secondary Market Disclosure](#)
 - Issuer-Related Disclosures
 - Business description
 - Digital asset holder information
 - Financial disclosures and MD&A
 - Investment Contract Disclosures
 - Progress towards completing Key Milestones anticipated in Investment Contract Disclosures and any new anticipated milestones
 - Asset-Level Disclosures
 - Results of digital asset audits
 - Digital asset functionality
 - Digital Asset Economics
 - Schedule DA
- Material event reporting
 - Any fundamental change to the digital asset or protocol or any event impacting the ongoing viability of the project or issuer
 - E.g. hacks, breaches, and other cyber security events; digital asset and/or protocol mergers; departure of key personnel; material modification to rights of digital asset holders; issuer change of control
 - This would not require disclosure of routine, ministerial changes (e.g., regular code updates)

PREEMPTION OF STATE LAW

Offers and sales of ICDAAs pursuant to any [ICDA Offering Disclosure](#) framework are not subject to state securities laws registration and qualification requirements.

SUFFICIENCY OF INFORMATION

The initial and ongoing disclosure provided pursuant to any [ICDA Offering Disclosure](#) or [ICDA Secondary Market Disclosure](#) framework would satisfy the specified information requirements of Exchange Act Rule 15c2-11(b) and adequate current public information requirements of Securities Act Rule 144(c).



DISCLOSURE RESPONSIBILITY OF ISSUER-AFFILIATED ENTITIES

Consistent with market practice in certain other asset classes (e.g. asset-backed securities), the issuance of an ICDA may involve one or more affiliated entities. Only one entity would be responsible for the required disclosures (referred to herein as the "issuer") and should be the entity providing the essential ongoing managerial services related to the digital asset and protocol and/or application. The ICDA issuer may not necessarily be the same legal entity that mints or distributes the digital asset.

DIGITAL ASSET TRANSFERABILITY AND USE

Nothing in this disclosure framework should be construed as limiting the ability of a holder of a digital asset purchased in an ICDA transaction to self custody, freely transfer or use the digital asset for consumptive or other utility purposes.

- The issuer's contractual reps and warranties related to the digital asset transfer with the digital asset to subsequent purchasers

CLOSING CERTIFICATION

In the event an ICDA issuer no longer exercises essential managerial functions for or control over a digital asset, or the digital asset no longer otherwise meets the definition of a security, the ICDA issuer may file a Closing Certification with the SEC, attesting that such criteria have been met.

- The Closing Certification would not affect the remedial rights of any party to an ICDA transaction.
- Consistent with the requirements of Exchange Act Rule 12g-4:
 - An issuer's duty to file reports with the SEC shall be suspended upon filing of the Closing Certification
 - The SEC would have 90 days to review and respond to a Closing Certification
 - If Closing Certification is subsequently withdrawn or denied, the issuer would be required to file all reports which would have been required had the Certification not been filed



SCHEDULE DA

(non exhaustive list of potentially applicable Schedule DA disclosures)

Governance and Control

- Identify parties that:
 - Organize and implement protocol features and changes thereto
 - Coordinate social media, marketing, and press relations
 - Can change digital asset supply and/or release schedules
 - Have access to MNPI
 - Own IP rights and affiliation with issuer
 - Are responsible for code audits
- Description of any decentralized governance over the protocol or digital asset
 - Voting eligibility requirements
 - Distribution of voting power
 - Description of what can be controlled by the decentralized governing body
- Protocol development
 - Scope and number of third party contributions to project, including the number of third party developers and dApps
 - Frequency and number of code contributions in code repository
 - Process for code change implementation
 - Specify ongoing development efforts

Computation

- Number of participants providing hash power to and operating nodes on the protocol and/or application upon which the digital asset functions
- Measure of computational power (hash rate), including any limit on the number of transactions that can be verified on a blockchain network in a given block
- Process and eligibility to create How nodes are created and how open access is to node participation, including estimated costs to operate a node and basis for estimate
- Estimated cost to successfully attack the network and basis for estimate
- Number of blockchain wallet choices available to an end user for purposes of interactions with the protocol and/or application
- Software licensing information, including whether code base underlying digital asset, protocol and/or application are published as open source software

Economic considerations

- Insider, affiliates, early contributor digital asset ownership
- Market capitalization and liquidity of digital asset

coinbase

- Degree of digital asset in circulation compared to total digital asset supply, digital assets locked and/or digital assets available for staking
- Description of network transaction fees
- Funding releases or rewards for developers, employees, contributors, etc.
- Efforts for exchange listing(s), market making, airdrops, etc.
- Number and list of known exchanges where digital asset is listed (centralized or decentralized)

Potential additional information

- Network layers and cross-chain integrations
- Number of network forks

**Hearing on
Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem
Before the U.S. House Financial Services Committee Subcommittee on Digital Assets,
Financial Technology and Inclusion**

Thursday, March 9, 2023

Prepared Statement

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Chairman Hill, Ranking Member Lynch, and Members of the Committee:

Thank you for inviting me to testify at today's hearing. My name is Lee Reiners, and I am the Policy Director at the Duke Financial Economics Center and a lecturing fellow at Duke University School of Law.¹ I teach courses in cryptocurrency law and policy, cybersecurity policy, climate change and financial markets, and financial regulation, and my research focuses on how new financial technologies and climate change fit within existing regulatory frameworks. Prior to entering academia, I spent five years examining systemically important financial institutions at the Federal Reserve Bank of New York. On February 14, 2023, I testified in front of the Senate Banking Committee for a hearing titled, "Crypto Crash: Why Financial System Safeguards are Needed for Digital Assets."² For today's hearing, I am resubmitting my Senate testimony with a few updates.

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¹ The views expressed in my testimony are mine alone and do not represent the views of the Duke Financial Economics Center, the Duke University School of Law, or Duke University.

² See a recording of the hearing and witness testimony at <https://www.banking.senate.gov/hearings/crypto-crash-why-financial-system-safeguards-are-needed-for-digital-assets>

I. Executive Summary

The title of today's hearing implies that the main impediment to the growth and success of the digital asset (or crypto) industry is regulation; specifically, overzealous enforcement by existing financial regulatory agencies. But I would argue that the crypto industry's main problem is the product it is selling. Cryptocurrency "is wholly unconnected to the productive purpose that defines finance: helping businesses, individuals, and governments raise, save, transmit, and use money for socially and economically useful ends."³ This leaves you with an asset class with no fundamentals that trades entirely on sentiment. In fact, I have repeatedly asked crypto proponents to explain their valuation methodology to me and I have yet to receive a straight answer.

Despite this inherent flaw with their product and the fragilities revealed by the implosion of FTX and multiple other crypto entities over the past year, the crypto industry wants us to believe that their salvation lies in Congress or the Securities and Exchange Commission (SEC) granting them "regulatory clarity." But regulation is not some magical pixie dust you can sprinkle on an asset class and transform its fundamental essence. The truth is that the crypto industry wants the same thing as every industry that came before – light touch regulation and favorable taxation.

Most of the crypto industry's ire is directed towards the SEC for simply doing its job. It is important to remember that Congress intentionally crafted our securities laws to be principles-based. In the seminal case *SEC v. Howey*, the Supreme Court found that the term "investment contract:"

*"[E]mbodies a flexible, rather than a static, principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."*⁴

Cryptocurrency and blockchain technology are simply the latest scheme deployed by those seeking to profit from other people's money.⁵ And despite the industry's claims, the SEC has been clear and consistent about crypto dating to the chairmanship of Jay Clayton. Both Clayton and his successor, Gary Gensler, have said most cryptocurrencies are securities that need to be registered with the Commission. The SEC has also brought over 130 cryptocurrency-related enforcement actions and they have yet to lose a single case.⁶ For any neutral observer, the law is very clear.

The SEC is not a merit-based regulator. Anyone can raise money from the public regardless of how bad the business idea may be, provided they register with the Commission and disclose

³ Todd H. Baker, "Let's Stop Treating Crypto Trading as If It Were Finance," *The CLS Blue Sky Blog*, November 29, 2022, <https://clsbluesky.law.columbia.edu/2022/11/29/lets-stop-treating-crypto-as-if-it-were-finance/>.

⁴ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

⁵ Note that there are other statutory standards and legal tests beyond "Howey" that can be applied to determine whether or not a given cryptocurrency is a security. I elaborate on some of these below.

⁶ Cornerstone Research, "SEC Tightens Cryptocurrency Enforcement," January 18, 2023, <https://www.cornerstone.com/insights/press-releases/sec-tightens-cryptocurrency-enforcement/>. Note that additional enforcement actions and settlements since this article was published push the total number over 130.

the relevant risk factors to prospective investors. However, the entity must have something to disclose if they are to register. Imagine a corporation approached the SEC because it wanted to do an IPO of common stock, but the company had no cash flows or a credible plan to generate cash flows, no audited financial statements, and the stock it was selling conferred no legal rights on the purchaser. If the SEC told that corporation that it wasn't ready to sell to the public markets, would you say that the SEC acted inappropriately? Incredibly, many token issuers and crypto firms who fit this example claim that the SEC is treating them unfairly.

I applaud the SEC and other financial regulatory agencies for enforcing the law. However, more must be done. While I agree with chairman Gensler that most cryptocurrencies are securities that are subject to registration and disclosure requirements, some cryptocurrencies are most likely commodities.⁷ While the Commodity Futures Trading Commission (CFTC), regulates commodity derivatives, they do not regulate commodity spot markets. The practical effect of this structure is that cryptocurrency exchanges in the U.S. are presently not regulated at the federal level.⁸ That is a gap that Congress must close as soon as possible.

In what follows, I detail several options for regulating the crypto sector in a way that protects investors and maintains financial stability. But first, in Section II, I make the case for why a comprehensive regulatory regime is needed by describing crypto's negative impacts on financial inclusion, national security, economic security, and our environment. In Section III, I note that despite the crypto industry's persistent efforts to integrate into mainstream finance, the fallout of FTX's failure was isolated within the crypto sector due in part to the actions of the SEC and federal banking agencies. Section IV provides an overview of several options for regulating cryptocurrency that do not involve Congress imposing traditional financial regulatory safeguards on the crypto sector. These options include (1) banning cryptocurrency, (2) regulating cryptocurrency as gambling, and (3) using existing regulatory authorities to regulate crypto without additional legislation. While each of these options has merit, I believe the best, and most feasible, path forward is for Congress to carve out cryptocurrency from the definition of a commodity in the Commodity Exchange Act and recognize cryptocurrencies as securities under a special definition to the securities laws.

Section V provides a detailed roadmap for how Congress can give the SEC exclusive authority to regulate all aspects of the crypto industry and provide greater certainty to market participants. The SEC simply has more expertise, more resources, and more appetite for enforcement in the crypto realm than the CFTC does. Most importantly, unlike the CFTC, the SEC has a statutory mandate to protect investors. As I note below, bringing cryptocurrency within the definition of a security in federal law does not necessarily mean that the requirements currently applicable to securities issuers and intermediaries will apply to crypto firms on a one-for-one basis. For example, current requirements for issuer disclosure may not be well-suited to

⁷ Bitcoin has long been considered by most observers and senior regulators to be a commodity. However, recent reporting by Paul Kiernan at the Wall Street Journal indicates that just five "maintainers" are responsible for updating and maintaining Bitcoin's core software. Thus, the Howey Test's efforts of other prong may be implicated and Bitcoin could possibly be considered an investment contract, and therefore a security. See Paul Kiernan, "Bitcoin's Future Depends on a Handful of Mysterious Coders," WSJ, Feb 16, 2023, <https://www.wsj.com/articles/bitcoin-core-maintainers-crypto-7b93804>

⁸ They are registered with the Financial Crimes Enforcement Network (FinCEN) for the purpose of complying with laws around money laundering and terrorist financing. In addition, many will hold state money transmitter licenses.

elicit the most useful information for crypto purchasers. Therefore, Congress can grant the SEC authority to develop tailored requirements for crypto issuers and intermediaries should the SEC feel such requirements are warranted.

If Congress does not wish to give the SEC exclusive authority over crypto, then lawmakers should consider passing legislation that requires crypto intermediaries to implement basic customer safeguards, such as segregating customer assets from firm assets. Section V also provides additional information on how Congress can impose such discrete requirements on crypto intermediaries before concluding with an examination of why treating crypto exchanges as self-regulatory organizations is a mistake.

I conclude my testimony in Section VI by offering my perspective on the best path forward on stablecoin regulation, where I do see the potential for a bipartisan solution. I recommend Congress grants the SEC the authority to regulate stablecoins like money market mutual funds, with strict requirements that stablecoin reserves be held in cash and Treasury securities and that these reserves be subject to periodic audits and disclosure.

I realize that giving the SEC additional authority under its present leadership is unpalatable to some members of this committee. However, SEC chairs come and go. The American people are looking to Congress to exercise foresight in determining how to regulate the crypto industry for the long-term. This requires lawmakers to look at the core competencies at the relevant agencies. The SEC was endowed with a mandate to protect investors, and investor protections are sorely lacking in crypto markets.

I applaud the committee's focus on this crucial task, but it is worth noting that this is not a race. The crypto industry is eagerly pointing to favorable regulatory regimes abroad as an example for U.S. lawmakers to follow, and warning that if the U.S. does not act quickly, new and existing crypto firms will set up shop overseas. However, getting it right is more important than being first. Passing financial regulatory legislation is hard, and once in place, it tends not to change absent some future crisis. Quickly passing crypto legislation will not matter if we end up experiencing a crypto-fueled 2008-style financial crisis down the road.

Even if you disagree with me on the underlying merits of cryptocurrency, we should still be able to agree on the need for a robust regulatory regime for crypto that protects investors and minimizes the risks to financial stability. For the crypto industry to grow and generate sustainable profits for the long-term, consumers need to trust it. The crypto industry currently suffers from a trust deficit, but this can be remedied if consumers know they have the same basic safeguards in crypto that they have come to know and expect from the traditional financial system.

Thorough disclosure and robust regulation played a critical role in making U.S. capital markets the envy of the world. The cryptocurrency industry will need similar guardrails if it is going to have any long-term success.

II. Cryptocurrency's Long and Tortuous History

Satoshi Nakamoto introduced the first cryptocurrency, Bitcoin, to the world in a nine-page white paper posted to an online cryptography mailing list on Halloween 2008, and the first Bitcoin transaction was posted in January 2009.⁹ Fourteen years, thousands of cryptocurrencies, and trillions of investor losses later, crypto scarcely resembles the “purely peer-to-peer version of electronic cash” first envisioned by Satoshi.

By technology standards, crypto is not new. For comparison, the iPhone was introduced in 2007. Anyone who held a smartphone in their hand for the first time immediately recognized its transformative potential; now, 85% of Americans own a smartphone.¹⁰ More recently, OpenAI made the artificial intelligence chatbot ChatGPT available to the public in November 2022; two months later, ChatGPT had 100 million monthly active users, “making it the fastest-growing consumer application in history,” according to one study.¹¹

After fourteen years and innumerable claims that crypto represents the future of money, finance, or something else, we have yet to see crypto’s killer use case. In fact, only 16% of U.S. adults have invested in, traded, or used cryptocurrency.¹² For those that have, the two most commonly cited reasons are (1) it is a different way to invest (78%), and (2) it is a good way to make money (75%). In other words, most people invest in cryptocurrency for no other reason than they think they can sell it to someone else at a higher price in the future.

However, fourteen years have provided ample evidence of the dire harm cryptocurrency inflicts throughout our society, which I will now detail.

a. Investor Losses

After peaking at \$69,000 in November 2021, Bitcoin has proceeded to decline by roughly 70%. Over the same time, the market cap of all cryptocurrencies went from \$3 trillion to \$1 trillion, a staggering loss of wealth in a short period of time. According to a study released last November by the Bank for International Settlements, around three-quarters of people who invested in Bitcoin between 2015 and 2022 lost money.¹³ Similarly, Pew reports that 46% of those who invested in cryptocurrency admit their investments have done worse than expected, while only 15% say they have done better than expected.¹⁴ Both surveys were conducted before

⁹ Satoshi Nakamoto, “Bitcoin: A Peer-to-Peer Electronic Cash System,” accessed January 30, 2023, <https://bitcoin.org/bitcoin.pdf>.

¹⁰ Pew Research Center, “Mobile Fact Sheet,” November 16, 2022, <https://www.pewresearch.org/internet/factsheet/mobile/>.

¹¹ Krystal Hu, “ChatGPT Sets Record for Fastest-Growing User Base - Analyst Note,” *Reuters*, February 2, 2023, <https://www.reuters.com/technology/chatgpt-sets-record-fastest-growing-user-base-analyst-note-2023-02-01/>.

¹² Michelle Faverio and Navid Massarat, “46% of Americans Who Have Invested in Cryptocurrency Say It’s Done Worse than Expected,” Pew Research Center, November 21, 2022, <https://www.pewresearch.org/fact-tank/2022/08/23/46-of-americans-who-have-invested-in-cryptocurrency-say-its-done-worse-than-expected/>.

¹³ Raphael Auer, Giulio Cornelli, Sebastian Doerr, Jon Frost and Leonardo Gambacorta, *Crypto Trading and Bitcoin Prices: Evidence from a New Database of Retail Adoption* (Basel, BIS: 2022), accessed January 30, 2023, <https://www.bis.org/publ/work1049.pdf>.

¹⁴ Faverio and Massarat, “46% of Americans.”

the collapse of FTX, so the number of crypto investors who have suffered losses is surely higher now.

The same Pew study cited above found that “Asian, Black and Hispanic adults are more likely than White adults to say they have ever invested in, traded or used a cryptocurrency.”¹⁵ A 2022 survey from Charles Schwab found that one-quarter of Black Americans own cryptocurrency, compared to 15% for White Americans.¹⁶ Particularly troubling was Schwab’s finding that “Black investors are more than twice as likely to say cryptocurrency was their first investment” (11% of Black investors compared to 4% of White investors.) In December 2022, JPMorgan Chase released a report that analyzed data from 600,000 checking account customers who had bought crypto and found “[m]ost individuals who transferred money to crypto accounts did so when crypto-asset prices were significantly higher than recent levels, and those with lower incomes likely made purchases at elevated prices relative to higher earners.”¹⁷ Unfortunately, crypto losses have centered disproportionately on groups that have historically been excluded from the traditional financial system and the wealth-building opportunities it provides.

Such data flies in the face of the repeated claims by the crypto industry that crypto promotes financial inclusion by providing easy access to financial services and an opportunity to build wealth. The Treasury Department looked into those claims and concluded in a report released last September that “the potential financial inclusion benefits of crypto-assets largely have yet to materialize.”¹⁸ Similarly, in a thoroughly researched article for the Brookings Institution, Tonantzin Carmona assessed the industry’s claims that crypto promotes financial inclusion and found that “crypto’s current capabilities do not match the needs of the groups it purports to serve” and that crypto “carries a host of risks and drawbacks that undermine its benefits.”¹⁹

Beyond the investing losses associated with cryptocurrency’s extreme volatility, millions of ordinary investors have fallen victim to countless frauds, scams, and hacks in the crypto sector. Blockchain analytics company Chainalysis recently reported that “2022 was the biggest year ever for crypto hacking, with \$3.8 billion stolen from cryptocurrency businesses.”²⁰ Crypto hacks and scams have led to a surge in consumer complaints. According to a September 2022 report from the Department of Justice, the Consumer Financial Protection Bureau (CFPB) published 2,404 cryptocurrency-related consumer complaints in its Consumer Complaint Database in 2021, and more than 1,000 cryptocurrency-related complaints during 2022 year-to-

¹⁵ Ibid.

¹⁶ Schwab Moneywise, “Ariel-Schwab Black Investor Survey (2022),” accessed February 8, 2023,

<https://www.schwabmoneywise.com/tools-resources/ariel-schwab-survey-2022>.

¹⁷ Chris Wheat and George Eckerd, *The Dynamics and Demographics of U.S. Household Crypto-Asset Use* (New York: JPMorgan Chase Institute, 2022), <https://www.jpmorganchase.com/institute/research/financial-markets/dynamics-demographics-us-household-crypto-asset-cryptocurrency-use>.

¹⁸ U.S. Department of the Treasury, *Crypto-Assets: Implications for Consumers, Investors, and Businesses*, (Washington, DC: GPO, 2022), https://home.treasury.gov/system/files/136/CryptoAsset_EO5.pdf.

¹⁹ Tonantzin Carmona, *Debunking the Narratives about Cryptocurrency and Financial Inclusion*, (Washington, D.C.: Brookings, 2022) <https://www.brookings.edu/research/debunking-the-narratives-about-cryptocurrency-and-financial-inclusion/>.

²⁰ Chainalysis, “2022 Biggest Year Ever For Crypto Hacking with \$3.8 Billion Stolen, Primarily from DeFi Protocols and by North Korea-Linked Attackers,” *Chainalysis*, February 1, 2023, <https://blog.chainalysis.com/reports/2022-biggest-year-ever-for-crypto-hacking/>.

date.²¹ The report also noted that “[t]he CFPB has also received hundreds of servicemember complaints involving cryptocurrency assets or exchanges in the last 12 months, approximately one-third of which concerned frauds or scams.”²² In June 2022, the Federal Trade Commission issued a report finding that “since the start of 2021 more than 46,000 people have reported losing over \$1 billion in crypto to scams – that’s about one out of every four dollars reported lost, more than *any* other payment method.”²³ The median individual loss was a staggering \$2,600.

In their September report, the Treasury Department bluntly summarized cryptocurrency’s risks to consumers:

*“Consumers and investors are exposed to improper conduct in the crypto-asset ecosystem for a variety of reasons, including a lack of transparency as well as the fact that crypto-assets have relatively novel and rapidly developing applications. This leads to frequent instances of operational failures, market manipulation, frauds, thefts, and scams.”*²⁴

b. National Security Risks

Cryptocurrency is increasingly being used by organized crime syndicates and nation-states to undermine U.S. national security. We know that Iran, Russia, and North Korea are using cryptocurrency to bypass U.S. economic and financial sanctions.²⁵ The United Nations and U.S. intelligence officials have noted that North Korea’s cyber operations are used to fund the country’s illicit ballistic missile and nuclear programs.²⁶ North Korea’s brazenness was revealed to the public last year when the venture capital-backed “Web 3” video game, Axie Infinity, was hacked by the Lazarus Group and \$620 million in the cryptocurrency Ether was stolen.²⁷ In January, the FBI announced that the Lazarus Group was also behind the \$100 million hack of

²¹ The United States Department of Justice, “Justice Department Announces Report on Digital Assets and Launches Nationwide Network,” September 16, 2022, <https://www.justice.gov/opa/pr/justice-department-announces-report-digital-assets-and-launches-nationwide-network>.

²² Ibid.

²³ Emma Fletcher, “Reports Show Scammers Cashing in on Crypto Craze,” Federal Trade Commission, August 11, 2022, <https://www.ftc.gov/news-events/data-visualizations/data-spotlight/2022/06/reports-show-scammers-cashing-crypto-craze>.

²⁴ U.S. Treasury, *Crypto-Assets*.

²⁵ Emily Flitter and David Yaffe-Bellany, “Russia Could Use Cryptocurrency to Mitigate U.S. Sanctions,” *The New York Times*, February 24, 2022, <https://www.nytimes.com/2022/02/23/business/russia-sanctions-cryptocurrency.html>; Kyle Barr, “Iran Plans to Use Crypto to Pay for Imports to Help Get Around Sanctions,” *Gizmodo*, August 9, 2022, <https://gizmodo.com/iran-crypto-imports-sanctions-1849389297>; Mike Orcutt, “This Is How North Korea Uses Cutting-Edge Crypto Money Laundering to Steal Millions,” *MIT Technology Review*, April 2, 2020, <https://www.technologyreview.com/2020/03/05/916688/north-korean-hackers-cryptocurrency-money-laundering/>.

²⁶ Christian Davies and Scott Chipolina, “How North Korea Became a Mastermind of Crypto Cybercrime,” *Ars Technica*, November 14, 2022, <https://arstechnica.com/information-technology/2022/11/how-north-korea-became-a-mastermind-of-crypto-cyber-crime/>.

²⁷ Aaron Schaffer, “North Korean Hackers Linked to \$620 Million Axie Infinity Crypto Heist,” *The Washington Post*, April 14, 2022, <https://www.washingtonpost.com/technology/2022/04/14/us-links-axie-crypto-heist-north-korea/>.

Harmony Protocol.²⁸ Chainalysis estimates that North Korea-linked hackers stole roughly \$1.7 billion worth of cryptocurrency in 2022 (by way of comparison, North Korea's total exports totaled \$142 million in 2020).²⁹ Just last week, Reuters reported on a confidential United Nations report that found North Korea stole more cryptocurrency assets in 2022 than any other year.³⁰ Anne Neuberger, US deputy national security adviser for cyber security, said in July 2022 that North Korea "uses cyber to gain, we estimate, up to a third of their funds for their missile program."³¹

Terrorist organizations have also been soliciting cryptocurrency donations for several years.³² In December 2022, blockchain analytics firm TRM Labs reported that an ISIS affiliate in Afghanistan recently began "accepting cryptocurrency donations amid ramped-up propaganda and recruitment efforts." That is in keeping with a trend, noted by the Treasury Department last November, of ISIS increasingly using virtual assets service providers to finance their subordinates in central and south Asia.³³ In January, TRM Labs also reported that KillNet, a pro-Russian cybercriminal group, uses crypto to raise funds for Russia's illegal invasion of Ukraine and targets critical infrastructure in countries opposed to the invasion.³⁴ The U.S. Cybersecurity and Infrastructure Security Agency (CISA) noted last April that KillNet is just one of many Russia-aligned cyber groups conducting malicious activities against the U.S. and our allies.³⁵ Finally, in January 2022, the Government Accountability Office (GAO) issued a report finding that "[v]irtual currency is increasingly used illicitly to facilitate human and drug trafficking."³⁶

c. Economic Security

Cryptocurrency has fueled a surge in ransomware that has victimized American businesses, healthcare systems, and state and local governments. In May 2022, the majority staff on the Homeland Security & Governmental Affairs Committee released a startling report on

²⁸ Sander Lutz, "FBI Confirms North Korea Behind \$100 Million Harmony Hack," *Decrypt*, January 24, 2023, <https://decrypt.co/119861/fbi-north-korea-lazarus-horizon-harmony-bridge-hack>.

²⁹ Chainalysis, "Biggest Year Ever."

³⁰ Michelle Nichols, "Exclusive: Record-Breaking 2022 for North Korea Crypto Theft, UN Report Says," *Reuters*, February 7, 2023, <https://www.reuters.com/technology/record-breaking-2022-north-korea-crypto-theft-un-report-2023-02-06/>.

³¹ Davies and Chipolina, "North Korea."

³² For example, see The United States Department of Justice, "Global Disruption of Three Terror Finance Cyber-Enabled Campaigns," August 13, 2020, <https://www.justice.gov/opa/pr/global-disruption-three-terror-finance-cyber-enabled-campaigns>.

³³ See TRM, "New Evidence Confirms ISIS Affiliate in Afghanistan Accepting Cryptocurrency Donations," *TRM Insights*, accessed February 10, 2023, <https://www.trmlabs.com/post/new-evidence-confirms-isis-affiliate-in-afghanistan-accepting-cryptocurrency-donations> and U.S. Department of the Treasury, *Fact Sheet: Countering ISIS Financing*, November 18, 2022, <https://home.treasury.gov/system/files/136/Fact-Sheet-on-Countering-ISIS-Financing.pdf>.

³⁴ TRM, "Spotlight on KillNet: The Cybercriminal Group Raising Funds for Russia's War in Ukraine," *TRM Insights*, accessed February 10, 2023, <https://www.trmlabs.com/post/spotlight-on-killnet-the-cybercriminal-group-raising-funds-for-russias-war-in-ukraine>.

³⁵ Cybersecurity and Infrastructure Security Agency, "Russian State-Sponsored and Criminal Cyber Threats to Critical Infrastructure," accessed February 10, 2023, <https://www.cisa.gov/uscert/ncas/alerts/aa22-110a>.

³⁶ U.S. Government Accountability Office, "Virtual Currencies: Additional Information Could Improve Federal Agency Efforts to Counter Human and Drug Trafficking [Reissued with Revisions Feb. 7, 2022]," January 10, 2022, <https://www.gao.gov/products/gao-22-105462>.

ransomware.³⁷ The report notes that, in 2021, “ransomware attacks impacted at least 2,323 local governments, schools, and healthcare providers in the United States” and that the FBI “received 3,729 ransomware complaints with adjusted losses of more than \$49.2 million.” The report acknowledges that these numbers underestimate the true scale of the problem because many ransomware victims do not report to authorities. As evidence, they cite data from Chainalysis that found “malign actors received at least \$692 million in cryptocurrency extorted as part of ransomware attacks” in 2020. The report notes that “cryptocurrency, typically Bitcoin, has become a near-universal form of ransom payment in ransomware attacks, in part, because cryptocurrency enables criminals to extort huge sums of money from victims across diverse sectors with incredible speed.”

The Treasury Department’s Financial Crimes Enforcement Network (FinCEN) releases periodic “Financial Trend Analysis” of ransomware-related Bank Secrecy Act (BSA) filings. The most recent analysis, from November 2022, covers ransomware trends in BSA filings from July–December 2021 and notes that “FinCEN received 1,489 ransomware-related filings worth nearly \$1.2 billion in 2021.”³⁸ The total number of ransomware filings, and the dollar value of these filings, in 2021 exceeded the previous ten years combined. In their previous Financial Trend Analysis, covering data from the first six months of 2021, FinCEN identified Bitcoin as the most common ransomware-related payment method, with the use of Monero — a cryptocurrency that provides even more privacy than Bitcoin — on track to increase in the years to come.³⁹

d. Environmental Damage

The proof-of-work consensus mechanism used to maintain the Bitcoin blockchain is extremely energy intensive — by design — and contributes to carbon emissions, electronic waste, noise pollution, and supply chain disruptions.⁴⁰ A report released last September by the White House Office of Science and Technology Policy (OSTP) estimated that, as of August 2022, electricity usage for crypto-assets ranged between 120 and 240 billion kilowatt-hours per year, which is comparable to all the electricity consumed by Argentina or Australia and the annual electricity usage of all conventional data centers in the world.⁴¹ The OSTP estimated that the U.S. is home to roughly one-third of global crypto use and that this consumes about 0.9% to 1.7% of total U.S.

³⁷ United States Senate Committee on Homeland Security & Governmental Affairs, “Use of Cryptocurrency in Ransomware Attacks, Available Data, and National Security Concerns,” accessed February 8, 2023, <https://www.hsgac.senate.gov/wp-content/uploads/imo/media/doc/HSGAC%20Majority%20Cryptocurrency%20Ransomware%20Report.pdf>.

³⁸ U.S. Treasury Financial Crimes Enforcement Network, “Financial Trend Analysis: Ransomware Trends in Bank Secrecy Act Data Between July 2021 and December 2021,” accessed February 8, 2023, https://www.fincen.gov/sites/default/files/2022-11/Financial%20Trend%20Analysis_Ransomware%20FTA%202_508%20FINAL.pdf.

³⁹ U.S. Treasury Financial Crimes Enforcement Network, “Financial Trend Analysis: Ransomware Trends in Bank Secrecy Act Data Between January 2021 and June 2021,” accessed February 8, 2023, https://www.fincen.gov/sites/default/files/2021-10/Financial%20Trend%20Analysis_Ransomware%20508%20FINAL.pdf.

⁴⁰ Proof-of-work’s goal is to make it prohibitively expensive to overwhelm the network with hashing power, thereby preventing bad actors from taking over the blockchain. The block reward provides an incentive for honest miners to incur the computational expense.

⁴¹ The White House, “Climate and Energy Implications of Crypto-Assets in the United States,” accessed February 6, 2023, <https://www.whitehouse.gov/wp-content/uploads/2022/09/09-2022-Crypto-Assets-and-Climate-Report.pdf>.

electricity usage, which contributed to 25 to 50 metric tons of carbon dioxide emitted per year or 0.4% to 0.8% of U.S. greenhouse gas emissions.

Because Bitcoin mining — the process that verifies and adds new transactions to the blockchain — relies on highly specialized computers that quickly become obsolete, mining produces 35,000 tons of electronic waste per year, “equivalent to the annual electronic waste generation of the Netherlands.”⁴² Cryptocurrency’s energy consumption has certainly come down in the wake of Ethereum’s switch to the far more energy-efficient proof-of-stake consensus mechanism last September, but it remains needlessly high.⁴³ The University of Cambridge’s Bitcoin Electricity Consumption Index indicates that Bitcoin consumes more electricity per year (106.4 TWh) than the Philippines and slightly less than the Netherlands.⁴⁴ Due to its libertarian roots and lack of any coordinating body, there is little chance that the Bitcoin blockchain would ever migrate to a less energy-intensive consensus mechanism absent a government mandate.

Crypto mining has also exacerbated the global shortage of semiconductor chips.⁴⁵ Crypto miners use application-specific integrated circuit (ASIC) hardware to improve speed and efficiency. Given the short lifespan of ASIC computers at constant use, miners can run through valuable chips quickly. A positive association has been found between the MSCI worldwide semiconductor index return and crash periods of the cryptocurrency market, meaning the two industries are closely tied.⁴⁶

Local businesses and residents can also be negatively impacted when a crypto mining facility opens nearby. For example, in Plattsburgh, NY, crypto mining resulted in residential electric bills that were reportedly up to \$300 higher than usual during the winter of 2018, causing the city to introduce the nation’s first 18-month moratorium on new mining operations.⁴⁷

III. The Crypto Crash Could Have Been Much Worse

a. Financial Stability Implications

While millions of Americans have suffered crypto-related financial losses over the past year, we should be thankful that problems in the crypto sector have not spilled into the traditional financial system and threatened financial stability. That outcome was not preordained, and it

⁴² Ibid., 26.

⁴³ The Ethereum Foundation has claimed that the transition reduced Ethereum’s energy consumption by 99.95%. See Q.Ai, “Proof-Of-Stake: Will The Ethereum Merge Really Lead To A Rally?” *Forbes*, September 27, 2022, <https://www.forbes.com/sites/qai/2022/09/27/proof-of-stake-will-the-ethereum-merge-really-lead-to-a-rally/?sh=566f65d0223d>.

⁴⁴ University of Cambridge, “Cambridge Bitcoin Electricity Consumption Index (CBECI),” accessed February 1, 2023, <https://ccaf.io/cbeci/index/comparisons>.

⁴⁵ Diana Li, “Crypto Mining Is Exacerbating Chip Shortage and Energy Consumption, Skeptics Say,” *Six Feet Forward*, January 4, 2022, <https://wp.nyu.edu/coveringcovid/2022/01/04/crypto-mining-is-exacerbating-chip-shortage-and-energy-consumption-skeptics-say/>.

⁴⁶ Tripti Rathi, “Effect of Cryptocurrency Mining on Semiconductor Industry,” *SSRN*, January 11, 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4005868.

⁴⁷ Congressional Research Service, “Bitcoin, Blockchain, and the Government Sector,” August 9, 2019, <https://crsreports.congress.gov/product/pdf/R/R45863>.

represents a little-celebrated policy success. Last October, the Financial Stability Oversight Council warned:

“Crypto-asset activities could pose risks to the stability of the U.S. financial system if their interconnections with the traditional financial system or their overall scale were to grow without adherence to or being paired with appropriate regulation, including enforcement of the existing regulatory structure.”⁴⁸

At its peak in November 2021, the crypto market (\$3 trillion) was significantly larger than the value of subprime mortgages in the U.S. in March 2007 (\$1.3 trillion), and we have never had “appropriate regulation.”⁴⁹ Therefore, the lack of systemic implications is due primarily to the limited interconnections between the crypto ecosystem and the traditional financial system. But what is true today may not be true tomorrow, and over the past six years, the crypto industry has waged an aggressive campaign to integrate crypto into mainstream finance in such a way that the two would be indistinguishable. These efforts, some successful, others not, include:

- The launch of cash-settled Bitcoin futures contracts in December 2017.⁵⁰ There are now multiple U.S.-listed cryptocurrency derivatives contracts that anyone can access.
- Repeated unsuccessful attempts to list a spot Bitcoin ETF. In June 2022, Grayscale Investments sued the SEC after its latest attempt to convert the Grayscale Bitcoin Trust (GBTC) into a spot Bitcoin ETF was denied.⁵¹
- The listing of an ETF that tracks the price of Bitcoin futures in 2021.⁵²
- The unsuccessful attempts of state-chartered “crypto banks” to obtain a Federal Reserve Master Account and access to the Federal Reserve’s payment system. In June 2022, Wyoming-chartered crypto bank Custodia sued the Federal Reserve Board of Governors and Federal Reserve Bank of Kansas City for delaying a decision on its master account application.⁵³

⁴⁸ Financial Stability Oversight Council, *Report on Digital Asset Financial Stability Risks and Regulation 2022* (Washington, D.C.: Financial Stability Oversight Council, 2022) <https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf>.

⁴⁹ Associated Press, “Will Subprime Mess Ripple through Economy?” *NBC News*, March 13, 2007, <https://www.nbcnews.com/id/wna17584725>. The Financial Crisis Inquiry Commission also provided information about subprime mortgage originations in the years leading up to 2008, showing that “[i]n 2006, \$600 billion of subprime loans were originated,” with slightly more being originated in 2005 and somewhat fewer in 2004. Financial Crisis Enquiry Commission, “The Financial Crisis Enquiry Report,” (Washington, D.C.: GPO, 2011), <https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

⁵⁰ Reuters Staff, “Cboe, CME to Launch Bitcoin Futures Contracts,” *Reuters*, December 7, 2017, <https://www.reuters.com/article/us-bitcoin-futures-contracts/cboe-cme-to-launch-bitcoin-futures-contracts-idUSKBNIE10KC>.

⁵¹ Ryan Browne, “Grayscale Sues SEC after Rejection of Bid to Turn the Largest Bitcoin Fund into an ETF,” *CNBC*, June 30, 2022, <https://www.cnbc.com/2022/06/30/grayscale-sues-sec-after-rejected-bid-to-turn-bitcoin-fund-into-etf.html>.

⁵² Tanaya Macheel, “First Bitcoin Futures ETF Rises More than 4% in Trading Debut on the NYSE,” *CNBC*, October 19, 2021, <https://www.cnbc.com/2021/10/19/first-bitcoin-futures-etf-rises-2percent-in-trading-debut.html>.

⁵³ James Rubin, “Crypto Bank Custodia Sues Federal Reserve,” *CoinDesk*, June 8, 2022, <https://www.coindesk.com/policy/2022/06/07/crypto-bank-custodia-sues-federal-reserve/>. Note that last month the Federal Reserve Board rejected Custodia’s membership application, and the Kansas City Fed rejected Custodia’s master account application. See Anna Hrushka, “Custodia Bank Denied Fed membership, Master Account,”

- BNY Mellon, the world's largest asset custodian, going live last October with its Digital Asset Custody platform in the U.S., allowing select institutional clients to hold and transfer Bitcoin and Ether.⁵⁴
- Fidelity Investments, the country's largest provider of 401(k) plans by total assets, starting to allow companies (from fall 2022) to offer employees the option to invest up to 20% of their 401(k)s in Bitcoin.⁵⁵
- A 2022 application by FTX to the CFTC that would have permitted FTX to self-clear non-intermediated crypto derivatives traded on margin by retail investors.⁵⁶

The failure of crypto to fully integrate into mainstream finance is due to a combination of luck and prudent action by a handful of regulatory agencies. Below, I single out the actions of the SEC and the federal banking agencies. However, the Department of Labor also deserves recognition for releasing guidance last year expressing “serious concerns about the prudence of a fiduciary's decision to expose a 401(k) plan's participants to direct investments in cryptocurrencies, or other products whose value is tied to cryptocurrencies.”⁵⁷ The Department's actions likely prevented more employers from including Bitcoin as an investment option in their employees' 401(k) plans.

b. The SEC's Consistent Approach to Crypto

Despite the crypto industry's self-serving cries for “regulatory clarity,” the SEC's stance on cryptocurrency has been clear and consistent dating from the chairmanship of Jay Clayton. Both Clayton and his successor, Gary Gensler, have said most cryptocurrencies are securities that need to be registered with the Commission.⁵⁸ As John Reed Stark, the former head of the SEC's Office of Internet Enforcement, noted, critics of the SEC's stance toward cryptocurrency overlook an important aspect of U.S. securities law — “securities regulation is not meant to be precise but is instead intentionally drafted to be broad and all-encompassing.”⁵⁹ This is why the definitions of “security” in Section 2(a)(1) of the Securities Act of 1933 (Securities Act), 15 U.S.C. 77b(a)(1) and Section 3(a)(10) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78c(a)(10) include not only conventional securities, such as “stock[s]” and “bond[s],” but also the more general term “investment contract.” In the seminal case *SEC v. Howey*, the Supreme Court found that the term “investment contract.”

Banking Dive, January 30, 2023, <https://www.bankingdive.com/news/crypto-custodia-denied-fed-membership-master-account-caitlin-long-kansas-city/641529/>.

⁵⁴ BNY Mellon, “BNY Mellon Launches New Digital Asset Custody Platform,” October 11, 2022, <https://www.bnymellon.com/us/en/about-us/newsroom/press-release/bny-mellon-launches-new-digital-asset-custody-platform-130305.html>.

⁵⁵ Greg Iacurci, “Fidelity, ForUsAll Now Offering 401(k) Investors Access to Cryptocurrency,” *CNBC*, November 4, 2022, <https://www.cnbc.com/2022/11/04/fidelity-forusall-offering-401k-investors-access-to-cryptocurrency.html>.

⁵⁶ Commodity Futures Trading Commission, “CFTC Seeks Public Comment on FTX Request for Amended DCO Registration Order,” March 10, 2022, <https://www.cftc.gov/PressRoom/PressReleases/8499-22>.

⁵⁷ U.S. Department of Labor, “Compliance Assistance Release No. 2022-11: 401(k) Plan Investment in ‘Cryptocurrencies,’” <https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/compliance-assistance-releases/2022-01>.

⁵⁸ Gary Gensler, “Kennedy and Crypto,” (speech, Washington, D.C., September 8, 2022), <https://www.sec.gov/news/speech/gensler-sec-speaks-090822>.

⁵⁹ John Stark, “Big Crypto's Bogus Demands for ‘Regulatory Clarity,’” *The FinReg Blog*, November 28, 2022, <https://sites.duke.edu/thefinregblog/2022/11/28/big-cryptos-bogus-demands-for-regulatory-clarity-2/>.

*“[E]mbodies a flexible, rather than a static, principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”*⁶⁰

Along these lines, in *Reves v. Ernst & Young*, in which the Supreme Court was asked to decide whether demand notes offered by a business are securities, the Court stated that:

*“The fundamental purpose undergirding the Securities Acts is ‘to eliminate serious abuses in a largely unregulated securities market.’ United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 421 U.S. 849 (1975). In defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of ‘countless and variable schemes devised by those who seek the use of the money of others on the promise of profits,’ SEC v. W.J. Howey Co., 328 U.S. 293, 328 U.S. 299 (1946), and determined that the best way to achieve its goal of protecting investors was ‘to define the term “security” in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.’ . . . Congress therefore did not attempt precisely to cabin the scope of the Securities Acts . . . Rather, it enacted a definition of ‘security’ sufficiently broad to encompass virtually any instrument that might be sold as an investment” (emphasis added).*⁶¹

Federal courts have repeatedly confirmed the SEC’s jurisdiction in numerous crypto-related enforcement actions. In fact, as of January 18, 2023, the SEC has brought over 130 crypto-related enforcement actions without losing a single case.⁶² In most of these cases, the SEC has applied the Howey Test to argue that the cryptocurrency in question is an investment contract, and therefore a security subject to SEC registration and disclosure requirements. The U.S. Supreme Court’s *Howey* case and subsequent case law have found that an “investment contract” exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.

The SEC has used “multiple distribution channels to share its message and concerns regarding crypto, digital trading platforms, initial coin offerings, and other digital asset products and services over the past decade.”⁶³ The SEC first made investors aware of the dangers of investing in cryptocurrency in 2013 when the Office of Investor Education and Advocacy issued an Investor Alert on “Ponzi Schemes Using Virtual Currencies.”⁶⁴ A year later, the same office

⁶⁰ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

⁶¹ *Reves et al. v. Ernst & Young*, 494 U.S. 56 (1990).

⁶² Cornerstone Research, “SEC Tightens Cryptocurrency Enforcement,” January 18, 2023, <https://www.cornerstone.com/insights/press-releases/sec-tightens-cryptocurrency-enforcement/>; John Reed Stark, “Why ‘SEC Regulation by Enforcement’ is a Bogus Big Crypto Catchphrase,” LinkedIn, January 23, 2023, <https://www.linkedin.com/pulse/why-sec-regulation-enforcement-bogus-big-crypto-john-reed-stark/?published=t>.

⁶³ Stark, “Big Crypto’s Bogus Demands.”

⁶⁴ U.S. Securities and Exchange Commission, “Ponzi Schemes Using Virtual Currencies,” accessed January 9, 2023, https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf.

issued an Investor Alert on “Bitcoin and Other Virtual Currency-Related Investments.”⁶⁵ In 2017, the Commission released a Section 21(a) Report of Investigation that looked at the facts and circumstances of The DAO, which offered and sold approximately 1.15 billion DAO tokens in exchange for a total of approximately 12 million ether (“ETH”) over a one-month period in 2016.⁶⁶ The SEC applied the Howey Test to the DAO tokens and concluded they were securities under the Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act”). While The DAO and DAO tokens were no longer operational at the time due to a high-profile hack that had resulted in the theft of most of the tokens, the Commission chose to release the report so as “to advise those who would use a Decentralized Autonomous Organization (“DAO Entity”), or other distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws.”⁶⁷ In 2019, the SEC released a “Framework for ‘Investment Contract’ Analysis of Digital Assets,” which provided additional details on when a digital asset has the characteristics of an investment contract and “whether offers and sales of a digital asset are securities transactions.”⁶⁸

The SEC has also publicized its position on cryptocurrency in countless enforcement actions,⁶⁹ multiple speeches,⁷⁰ congressional testimony,⁷¹ and several official SEC statements⁷² and proclamations.⁷³ Chairman Gensler, has spoken frequently about the perils and illegality of crypto lending platforms and decentralized finance,⁷⁴ warning that their failure to register with the SEC may violate U.S. securities laws.⁷⁵ In one interview, Gensler said:

“The law is clear, it’s not about waving a wand. Congress spoke about this in 1934 . . . When a [digital] platform has securities on it, it is an exchange, and it’s a question of

⁶⁵ U.S. Securities and Exchange Commission, “Investor Alert: Bitcoin and Other Virtual Currency-Related Investments,” May 17, 2013, <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investor-39>.

⁶⁶ U.S. Securities and Exchange Commission, “Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO,” July 25, 2017, <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

⁶⁷ Ibid.

⁶⁸ U.S. Securities and Exchange Commission, “Framework for ‘Investment Contract’ Analysis of Digital Assets,” April 3, 2019, <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>.

⁶⁹ U.S. Securities and Exchange Commission, “Crypto Assets and Cyber Enforcement Actions,” November 4, 2022, <https://www.sec.gov/spotlight/cybersecurity-enforcement-actions>.

⁷⁰ Gary Gensler, “Remarks Before the Aspen Security Forum,” (speech, Washington D.C., August 3, 2021), <https://www.sec.gov/news/speech/gensler-aspen-security-forum-2021-08-03>.

⁷¹ Gary Gensler, “Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee,” (speech, Washington, D.C., May 26, 2021), <https://www.sec.gov/news/testimony/gensler-2021-05-26>.

⁷² Jay Clayton, “Statement on Cryptocurrencies and Initial Coin Offerings,” U.S. Securities and Exchange Commission, December 11, 2017, <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

⁷³ U.S. Securities and Exchange Commission, “Statement on Potentially Unlawful Online Platforms for Trading Digital Assets,” March 7, 2018, <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading>.

⁷⁴ Michael McSweeney, “Gensler Sets SEC Sights on DeFi, Crypto Lending and More in Expansive Speech on Regulation,” *The Block*, February 10, 2023, <https://www.theblock.co/post/113416/gensler-speech-crypto-defi-lending-sec>.

⁷⁵ Ben Werschul, “Crypto Platforms that Don’t Register with the SEC do Business ‘Outside the Law’: Gensler,” *Yahoo News*, March 4, 2022, <https://finance.yahoo.com/news/crypto-platforms-dont-register-with-sec-outside-the-law-gensler-164215740.html>.

whether they're registered or they're operating outside of the law, and I'll leave it at that."⁷⁶

On September 8, 2022, Chairman Gensler gave a speech reflecting on the flexibility of the securities laws and the SEC's consistency in applying those laws to cryptocurrency.⁷⁷ Gensler noted that of the 10,000 different cryptocurrencies in the market, "the vast majority are securities."⁷⁸ Gensler went on to note that the SEC has spoken with a "pretty clear voice" when it comes to cryptocurrency "through the DAO Report, the Munchee Order, and dozens of enforcement actions, all voted on by the Commission" and that "[n]ot liking the message isn't the same thing as not receiving it."⁷⁹

In January, the nonprofit Better Markets released a report detailing the SEC's strong record on crypto regulation and enforcement.⁸⁰ The report identifies the SEC's three-pronged strategy to bring the crypto industry into compliance with federal securities laws: (1) publicly urging the industry to come in and speak with the agency in order to come into compliance, (2) selectively bringing enforcement actions, and (3) using its authority to "deny crypto firms' requests to unlawfully engage in certain types of activities."⁸¹

Under the latter prong, the SEC has repeatedly rejected attempts by exchanges seeking to list shares of a trust or exchange-traded funds (ETFs) that track the price of Bitcoin. The SEC's main concern has always been manipulation in the underlying Bitcoin spot market. When they first rejected an application to list and trade shares of a Bitcoin trust in 2017, they noted that the proposal was inconsistent "with Section 6(b)(5) of the Exchange Act, which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices and to protect investors and the public interest."⁸² Recent events reveal that crypto markets continue to be rife with fraud and manipulation, and the SEC's refusal to permit a Bitcoin ETF saved would-be investors a lot of money.⁸³

While the SEC has largely been an effective cop on the beat, their track record on crypto is not spotless. Unfortunately, they failed to stop Celsius and Gemini from offering their customers

⁷⁶ McSweeney, "Gensler Sets SEC Sights."

⁷⁷ Gensler, "Kennedy and Crypto."

⁷⁸ Ibid.

⁷⁹ Ibid.

⁸⁰ Better Markets, "The SEC's Excellent Record on Crypto: Regulation & Enforcement," *Better Markets*, January 25, 2023, https://bettermarkets.org/wp-content/uploads/2023/01/BetterMarkets_SEC_Record_On_Crypto_01-25-2023.pdf.

⁸¹ Ibid., 3.

⁸² U.S. Securities and Exchange Commission, "Self-Regulatory Organizations; Bats BZX Exchange, Inc.; Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, to List and Trade Shares Issued by the Winklevoss Bitcoin Trust," March 10, 2017, <https://www.sec.gov/rules/sro/batsbzx/2017/34-80206.pdf>.

⁸³ I defended the SEC's approach to crypto exchange-traded products in two blog posts from 2018 and 2019. See Lee Reiners, "SEC Stands Firm Against New Bitcoin ETF Proposals," *The FinReg Blog*, January 12, 2018, <https://sites.duke.edu/finregblog/2018/01/12/sec-stands-firm-against-new-bitcoin-etf-proposals/>; Lee Reiners, "The SEC Should Continue to Say No to Bitcoin Exchange-Traded Products," *The FinReg Blog*, June 18, 2019, <https://sites.duke.edu/finregblog/2019/06/18/the-sec-should-continue-to-say-no-to-bitcoin-exchange-traded-products/>.

a cryptocurrency lending product despite these products being available for several years and the Commission filing successful enforcement actions in similar cases, like BlockFi, and preventing Coinbase from offering its cryptocurrency lending product, Lend. Celsius filed for bankruptcy last July, leaving roughly 600,000 account holders unable to access their assets, collectively valued at \$4.2 billion at the time of bankruptcy.⁸⁴ After the collapse of FTX last November, the cryptocurrency exchange Gemini halted customer withdrawals from its Earn program after its lending partner, Genesis Global, decided to pause withdrawals.⁸⁵ In January, the SEC charged Genesis and Gemini with offering unregistered securities in connection with the Earn program, but this action came too late to help Gemini customers who have over \$900 million stuck in that program.⁸⁶

The SEC has also been slow to bring civil charges against cryptocurrency exchanges for being an unregistered securities exchange⁸⁷ or broker-dealer despite repeated claims by Chairman Gensler that most crypto platforms are offering unregistered securities and the Commission bringing enforcement actions in other cases that imply a crypto exchange was operating an unregistered securities exchange.⁸⁸ Last July, the SEC filed “insider trading charges against a former Coinbase product manager, his brother, and his friend for perpetrating a scheme to trade ahead of multiple announcements regarding certain crypto-assets that would be made available for trading on the Coinbase platform.”⁸⁹ In their complaint, the Commission provides a detailed analysis as to why nine of the cryptocurrencies defendants traded in are securities. These

⁸⁴ In January, the Celsius bankruptcy judge ruled that customers’ crypto deposits at Celsius are owned by Celsius, meaning these customers are now unsecured creditors in the bankruptcy estate. See Dietrich Knauth, “U.S. Judge Says Celsius Network Owns Most Customer Crypto Deposits,” *Reuters*, January 6, 2023, <https://www.reuters.com/business/finance/us-judge-says-celsius-network-owns-most-customer-crypto-deposits-2023-01-05/>.

⁸⁵ Q.Ai, “Gemini Crypto Pauses Withdrawals, Fallout Continues From FTX Collapse,” *Forbes*, November 30, 2022, <https://www.forbes.com/sites/qai/2022/11/30/gemini-crypto-pauses-withdrawals-fallout-continues-from-ftx-collapse/?sh=6d8de0264a84>.

⁸⁶ Shortly after the SEC filed charges, Genesis filed for Chapter 11 bankruptcy protection. See Rohan Goswami, “Crypto Firms Genesis and Gemini Charged by SEC with Selling Unregistered Securities,” *CNBC*, January 12, 2023, <https://www.cnbc.com/2023/01/12/sec-charges-genesis-and-gemini-with-selling-unregistered-securities.html>; Rohan Goswami, “Crypto Lender Genesis Files for Bankruptcy in Latest Blow to Barry Silbert’s DCG Empire,” *CNBC*, January 20, 2023, <https://www.cnbc.com/2023/01/20/crypto-lender-genesis-trading-files-for-bankruptcy-barry-silbert-digital-currency-group.html>.

⁸⁷ In 2018, the SEC filed an enforcement action against the EtherDelta founder for operating an unregistered securities exchange. This was the first such enforcement action in the digital asset space. See “SEC Charges EtherDelta Founder With Operating an Unregistered Exchange,” November 8, 2022, <https://www.sec.gov/news/press-release/2018-258#:~:text=The%20Securities%20and%20Exchange%20Commission,an%20unregistered%20national%20security%20exchange>. In 2021 the SEC did charge digital asset trading platform Poloniex with operating an unregistered exchange. See “SEC Charges Poloniex for Operating Unregistered Digital Asset Exchange,” August 9, 2022, <https://www.sec.gov/news/press-release/2021-147>.

⁸⁸ See Gensler, “Aspen Security Forum,” where he noted, “A typical trading platform has more than 50 tokens on it. In fact, many have well in excess of 100 tokens. While each token’s legal status depends on its own facts and circumstances, the probability is quite remote that, with 50 or 100 tokens, any given platform has zero securities.” See also Gensler, “Kennedy and Crypto”, where he said, “Given that many crypto tokens are securities, it follows that many crypto intermediaries are transacting in securities and have to register with the SEC in some capacity,” “Furthermore, these platforms likely are trading securities,” and “I’ve asked staff to work on a number of projects related to the platforms. First is getting the platforms themselves registered and regulated much like exchanges.”

⁸⁹ U.S. Securities and Exchange Commission, “SEC Charges Former Coinbase Manager, Two Others in Crypto Asset Insider Trading Action,” July 21, 2022, <https://www.sec.gov/news/press-release/2022-127>.

charges imply that Coinbase was offering unregistered securities on its platform, but the SEC has yet to file an enforcement action against Coinbase.

Regulating complex financial markets is difficult, and it is unrealistic to expect the SEC or any other agency to catch every violation before investors are harmed. With cryptocurrency, the SEC's job is made that much harder by the fact that an unlimited supply of cryptocurrencies can be minted out of thin air, the industry's deliberate choice not to comply with securities laws, and the industry's aggressive lobbying for light-touch regulation on Capitol Hill and state capitols throughout the country.⁹⁰

c. Federal Banking Agencies

The federal banking agencies (Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency) also deserve commendation for limiting the systemic implications of the crypto market's collapse. Each agency had sound guidance in place at the time of FTX's failure expressing concerns over banks' abilities to engage in crypto-asset activities in a safe and sound manner and requiring banks to notify their appropriate regulator before engaging in such activity. This guidance likely limited banks' willingness to engage in crypto-asset activities and restricted a potentially large contagion channel through which volatility in the crypto markets could have spilled into the traditional financial system.

Budding bank-crypto connections and the crypto-asset sector's "significant volatility and vulnerabilities over the past year" prompted the federal banking agencies to issue a "Joint Statement on Crypto-Asset Risks to Banking Organizations" on January 3, 2023 (Joint Statement).⁹¹ The Joint Statement lists eight "key risks associated with crypto-assets and crypto-asset sector participants that banking organizations should be aware of" and reinforces previously issued guidance by each agency that requires supervised firms to inform their respective regulators of any crypto-related activities they wish to engage in or are currently engaged in. However, the Joint Statement uses more forceful language and "calls into question the safety and soundness practices of those engaging in crypto-assets, including banks with concentrated exposure to the crypto-assets sector."⁹² Furthermore, the Joint Statement includes language that suggests banks are not permitted to hold crypto-assets on their balance sheet (custody excluded):

"Based on the agencies' current understanding and experience to date, the agencies believe that issuing or holding as principal crypto-assets that are issued, stored, or

⁹⁰ For an example, see Alexander Sammon, "The Eight Congressmen Subverting the SEC's Crypto Investigation," *The American Prospect*, March 25, 2022, <https://prospect.org/power/eight-congressmen-subverting-secs-crypto-investigation/>.

⁹¹ Board of Governors of the Federal Reserve System, "Agencies Issue Joint Statement on Crypto-Asset Risks to Banking Organizations," January 3, 2023, <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf>.

⁹² Deloitte, *Banking Regulators Reinforce Wall for Bank Involvement in Crypto-Assets*, (New York: Deloitte, 2023) accessed January 16, 2023, https://www2.deloitte.com/content/dam/Deloitte/us/Documents/dcrs/Deloitte_Banking%20brick%20wall%20for%20crypto_January%202023.pdf.

*transferred on an open, public, and/or decentralized network, or similar system is **highly likely to be inconsistent with safe and sound banking practices***" (emphasis added).⁹³

On January 23, 2023, the Board of Governors issued a Policy Statement (208.112) that provides additional clarity on the types of crypto-asset activity state member banks can engage in.⁹⁴ The statement notes "the Board will presumptively exercise its authority to limit state member banks to engaging as principal in only those activities that are permissible for national banks," and provides Supplementary Information that clarifies that state member banks are not permitted to hold crypto-assets as principal. One month later, in response to massive deposit outflows at several crypto-focused banks, the banking agencies issued a joint statement highlighting liquidity risks to banks that rely on funding from crypto-asset-related entities (the statement reiterates existing liquidity risk management principles.)⁹⁵

Despite clear guidance and repeated warnings around banks' crypto-asset activities, FTX's failure revealed that several banks were more exposed to crypto-asset activities than previously realized. Two notable examples are Silvergate Capital Corporation and Moonstone Bank. Silvergate positioned itself as the leading bank for cryptocurrency exchanges (including FTX) and investors. At the end of September 2022, deposits from crypto clients made up 90% of the bank's overall deposit base, leaving the bank highly exposed to a volatile sector.⁹⁶ This risk became manifest post-FTX's collapse when the bank experienced \$8.1 billion in deposit outflows during the fourth quarter of 2022, more than 60% of its total deposits.⁹⁷ To meet deposit outflows, Silvergate was forced to sell assets, resulting in a loss of \$718 million, which exceeded "the bank's total profit since at least 2013."⁹⁸ Silvergate was also forced to borrow \$4.3 billion from the Federal Home Loan Bank of San Francisco to stay afloat.⁹⁹ Last week, Silvergate announced they were delaying the release of their annual report because they were evaluating their "ability to continue as a going concern for the twelve months following the issuance of these financial statements."¹⁰⁰

⁹³ Board of Governors, "Joint Statement."

⁹⁴ Board of Governors of the Federal Reserve System, "Policy Statement on Section 9(13) of the Federal Reserve Act," January 27, 2023, <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230127a2.pdf>.

⁹⁵ Board of Governors of the Federal Reserve System, "Agencies Issue Joint Statement on Liquidity Risks Resulting from Crypto-Asset Market Vulnerabilities," February 23, 2023, <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230223a.htm>.

⁹⁶ Marc Rubinstein, "These Banks Were Left Holding the Bag in Crypto Implosion," *The Washington Post*, November 23, 2022, https://www.washingtonpost.com/business/these-banks-were-left-holding-the-bag-in-crypto-implosion/2022/11/22/b8dc2096-6a2b-11ed-8619-0b92f0565592_story.html.

⁹⁷ David Benoit, "Silvergate's Deposit Run Is Worse Than Great Depression-Era Runs," *The Wall Street Journal*, January 5, 2023, <https://www.wsj.com/livecoverage/stock-market-news-today-01-05-2023/card/silvergate-s-deposit-run-is-worse-than-great-depression-era-runs-CqZpNYLAuWIR1Rwv422l?page=1>.

⁹⁸ David Benoit, "Silvergate Raced to Cover \$8.1 Billion in Withdrawals During Crypto Meltdown," *The Wall Street Journal*, January 5, 2023, <https://www.wsj.com/articles/silvergate-raced-to-cover-8-1-billion-in-withdrawals-during-crypto-meltdown-11672895207?page=1>.

⁹⁹ Kate Berry, "Silvergate Bank Loaded up on \$4.3 Billion in Home Loan Bank Advances," *American Banker*, January 10, 2023, <https://www.americanbanker.com/news/silvergate-bank-loaded-up-on-4-3-billion-in-flhb-advances>.

¹⁰⁰ David Hollerith, "Silvergate stock crashes after company delays annual report, reveals new losses," YahooFinance, March 2, 2023, <https://finance.yahoo.com/news/silvergate-stock-crashes-after-company-delays-annual-report-reveals-new-losses-121923800.html>.

Another unpleasant surprise came in a FTX bankruptcy filing when it was revealed that Alameda Research, a crypto trading firm founded and owned by Sam Bankman-Fried, made an \$11.5 million investment in the parent company (FBH Corp.) of Washington state-based Farmington State Bank in March 2022, more than double the bank's net worth at the time.¹⁰¹ Farmington then changed its name to Moonstone Bank, and shortly thereafter, Moonstone's deposit base jumped from \$10 million — where it had been for decades — to \$84 million, of which \$71 million came from just four accounts.¹⁰² Alameda's investment came on the heels of Farmington's pivot to servicing crypto firms after the bank was purchased by FBH in 2020 and received a Federal Reserve Master Account in 2021.¹⁰³ According to Camden Fine, the former president and CEO of the Independent Community Bankers of America, "[t]he fact that an offshore hedge fund that was basically a crypto firm was buying a stake in a tiny bank for multiples of its stated book value should have raised massive red flags for the F.D.I.C., state regulators and the Federal Reserve."¹⁰⁴

I encourage bank regulators to learn from these examples and ramp up their efforts to better understand all the ways in which banks under their supervision are exposed to crypto. Bank regulators should formalize a horizontal exercise that will gather this information and make the results public, so that bank customers and investors will not be surprised when the next large crypto firm fails and they find out their bank was over-exposed to crypto. I also encourage the FDIC to revisit its rules around brokered deposits, which may have played a role in Silvergate's liquidity problems.¹⁰⁵

As noted in a forthcoming article I co-authored with Sangita Gazi, "the Joint Statement signals a new era of intense regulatory scrutiny of *any* bank involvement in crypto-asset activity, but there remains the question: where should regulators draw the line?" Some scholars have called for a "Glass-Steagall 2.0" that would completely separate banking and crypto, but this is beyond the agencies' ability to implement and would require congressional action.¹⁰⁶ As the Joint Statement makes clear, "[b]anking organizations are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation." Provided cryptocurrency and its progeny, like stablecoins, are legal in the U.S., banks are free to conduct business with crypto firms. However, bank regulators do have the authority to impose additional prudential requirements on such activity and they should develop a comprehensive framework that clarifies the type of crypto-asset activity banks can engage in

¹⁰¹ Protos, "The Curious Case of FTX and Farmington State Bank, aka Moonstone," *Protos*, November 24, 2022, <https://protos.com/the-curious-case-of-ftx-and-farmington-state-bank-aka-moonstone/>.

¹⁰² Stephen Gandel, "Crypto Firm FTX's Ownership of a U.S. Bank Raises Questions," *The New York Times*, December 6, 2022, <https://www.nytimes.com/2022/11/23/business/ftx-cryptocurrency-bank.html>; Moonstone Bank, "FBH Corp. raises \$11.5M in private equity funding from Alameda Research Ventures," Cision PR Newswire, March 7, 2022, <https://www.prnewswire.com/news-releases/fbh-corp-raises-11-5m-in-private-equity-funding-from-alameda-research-ventures-301497307.html>.

¹⁰³ Protos, "The Curious Case."

¹⁰⁴ Gandel, "Crypto Firm."

¹⁰⁵ Kyle Campbell, "Policy Advocates Question Brokered Deposit Role in Silvergate Run," *American Banker*, February 3, 2023, <https://www.americanbanker.com/news/policy-advocates-question-brokered-deposit-role-in-silvergate-run>.

¹⁰⁶ Hilary J. Allen, "Crypto Crash: Why the FTX Bubble Burst and the Harm to Consumers," Statement before the Senate Commission on Banking, Housing, and Urban Affairs, December 14, 2022, <https://www.banking.senate.gov/imo/media/doc/Allen%20Testimony%2012-14-22.pdf>.

and the prudential requirements (capital and liquidity) required to engage in such activity. That may require the bank agencies to implement more rigorous standards than the Basel Committee on Banking Supervision's final prudential standard for crypto-asset exposures, issued in December 2022.¹⁰⁷

IV. Regulatory Options That Do Not Involve New Financial System Safeguards

This section will introduce and briefly discuss three options for regulating cryptocurrency that do not involve Congress imposing traditional financial regulatory safeguards on the crypto sector. These options are (1) banning cryptocurrency, (2) regulating cryptocurrency as gambling, and (3) using existing regulatory authorities to regulate crypto without additional legislation. Any proposal to regulate the crypto industry must be assessed by how well it protects investors and maintains financial stability. I refer to these two goals as the “dual mandate” of crypto regulation.

a. Banning Cryptocurrency

The most effective way to protect investors and preserve financial stability would be to ban cryptocurrency outright. I argued for this approach in the wake of the Colonial Pipeline hack in a 2021 op-ed, in which I called out crypto's connection to ransomware and noted that the associated costs outweigh any benefits crypto provides.¹⁰⁸ Given crypto's negative externalities detailed above, the case for a crypto ban has only grown stronger. More recently, Professor Hilary Allen argued for a crypto ban in front of this Committee in December.¹⁰⁹ Addressing the retort that crypto's decentralized nature makes a ban impossible to enforce, Professor Allen correctly noted:

“[C]rypto is not actually decentralized,¹¹⁰ and so there are many people against whom such a ban could be enforced. Most obviously, centralized exchanges (like FTX) serve as important gateways to the crypto markets. If they were banned from listing cryptoassets, then the market for cryptoassets would most likely diminish significantly.”

Further buttressing Professor Allen's point is the fact that China banned cryptocurrency in 2021.¹¹¹ While there are certainly some Chinese citizens who transact in crypto, the industry has completely pulled out of China, and the country was spared the fallout from the most recent “crypto winter.” Berkshire Hathaway vice-chairman Charlie Munger is an admirer of China's crypto ban, writing in the Wall Street Journal in February 2023 that “the communist government of China recently banned cryptocurrencies because it wisely concluded that they would provide more harm

¹⁰⁷ Basel Committee on Banking Supervision, *Prudential Treatment of Cryptoasset Exposures* (Basel: BIS, 2022), accessed January 7, 2023, <https://www.bis.org/bcb/publ/d545.pdf>.

¹⁰⁸ Lee Reiners, “Ban Cryptocurrency to Fight Ransomware,” *WSJ*, May 25, 2021, <https://www.wsj.com/articles/ban-cryptocurrency-to-fight-ransomware-11621962831>.

¹⁰⁹ Allen, “Crypto Crash.”

¹¹⁰ Sirio Aramonte, Wenqian Huang, and Andreas Schrimpf, “DeFi Risks and the Decentralization Illusion,” *BIS Quarterly Review*, (December 2021).

¹¹¹ BBC News, “China Declares All Crypto-Currency Transactions Illegal,” *BBC News*, September 24, 2021, <https://www.bbc.com/news/technology-58678907>.

than benefit.”¹¹² You can disagree with the means — as Mr. Munger and I do — by which China implemented a ban, but they have proven it can be done.¹¹³

b. Regulating Cryptocurrency as Gambling

Some commentators have noted that cryptocurrency’s lack of fundamental value and speculative nature make crypto “investing” akin to gambling. Columbia professor Todd Baker noted:

*“Crypto trading is wholly unconnected to the productive purpose that defines finance: helping businesses, individuals, and governments raise, save, transmit, and use money for socially and economically useful ends.”*¹¹⁴

Fabio Panetta, a member of the executive board for the European Central Bank, had similar things to say about unbacked crypto-assets:

*“They do not perform any socially or economically useful function: they are rarely used for payments and do not fund consumption or investment. As a form of investment, unbacked cryptos lack any intrinsic value, too. They are speculative assets. Investors buy them with the sole objective of selling them on at a higher price. In fact, they are a gamble disguised as an investment asset.”*¹¹⁵

Baker argues that it is a categorical error to equate crypto with finance and that subjecting crypto to traditional financial regulation would legitimize crypto-asset activities and jeopardize financial stability. The solution, therefore, is to regulate crypto like gambling.

While these commentators are correct in their diagnosis that crypto investing is no different from gambling, I disagree that the cure is to regulate crypto as gambling. For starters, unlike with crypto exchanges, gamblers do not leave their money at the casino at the end of the night. This fact alone calls for more robust investor protections. Second, gambling is regulated at the state or tribal and local levels in the U.S. Regulating crypto as gambling would therefore allow some states to implement lax regulations and could lead to a race to the bottom whereby states compete to woo the crypto industry by adopting ever more lenient regulation (this is already happening to a certain extent).¹¹⁶ Finally, while gambling’s negative externalities have immediate effects on individual families and surrounding communities, those impacts don’t have the same

¹¹² Charlie Munger, “Why America Should Ban Crypto,” *WSJ*, February 2, 2023, <https://www.wsj.com/articles/why-america-should-ban-crypto-regulation-economy-finance-china-england-trading-currency-securities-commodity-gamble-11675287477>.

¹¹³ Mr. Munger notes in his *WSJ* article: “What should the U.S. do after a ban of cryptocurrencies is in place? Well, one more action might make sense: Thank the Chinese communist leader for his splendid example of uncommon sense.”

¹¹⁴ Todd H. Baker, “Let’s Stop Treating Crypto Trading as If It Were Finance,” *The CLS Blue Sky Blog*, November 29, 2022, <https://clsbluesky.law.columbia.edu/2022/11/29/lets-stop-treating-crypto-as-if-it-were-finance/>.

¹¹⁵ Fabio Panetta, “Caveat Emptor Does Not Apply to Crypto,” *Financial Times*, January 4, 2023, <https://www.ft.com/content/95249051-f9f0-494d-9fa0-c7cca8edaa69?shareType=nongift>.

¹¹⁶ See Eric Lipton and David Yaffe-Bellany, “Crypto Industry Helps Write, and Pass, Its Own Agenda in State Capitols,” *The New York Times*, April 10, 2022, <https://www.nytimes.com/2022/04/10/us/politics/crypto-industry-states-legislation.html>.

potential as crypto to create broader ripple effects through the financial system and the economy. Therefore, a more comprehensive financial regulatory approach that does not validate crypto as legitimate financial activity is needed.

c. Using Existing Authorities to Regulate Crypto without Additional Legislation

Post-FTX, many policymakers have called on financial regulators to use their existing legal authority more aggressively to clean up the crypto industry and protect investors.¹¹⁷ I agree that regulators can, and should, do more, but I also believe that congressional action is needed to close gaps in the current regulatory framework. Most pleas for regulatory action are focused on the SEC, and as noted above, the SEC has aggressively used its enforcement authority when warranted. But bringing a successful enforcement action takes time and resources, two things that any regulator will tell you are always in short supply. Furthermore, despite repeated pleas from Chairman Gensler to the industry to come in and get registered, the crypto industry has willfully chosen to operate outside the regulatory perimeter. It simply is not possible for the SEC to litigate an entire industry into compliance, and even if they did, there would still be some cryptocurrencies, like Bitcoin, that would be considered commodities and not securities.¹¹⁸

The CFTC has classified Bitcoin and Ethereum — and by extension, other cryptocurrencies that are similarly structured — as commodities (courts have also upheld this classification). While the CFTC regulates commodity derivatives, they do not regulate commodity spot markets, although they do have enforcement authority for fraud and manipulation in commodity spot markets. The CFTC also needs to do more to protect crypto investors, but, apart from a few meaningful enforcement actions, the agency has unfortunately demonstrated little desire to do so at the scale needed.

Beginning with the CFTC's decision to permit the self-certification of cash-settled Bitcoin futures in 2017 — despite ample evidence of manipulation in Bitcoin that could lead to manipulation of the futures contract — the CFTC has given the crypto industry most of what they have asked for.¹¹⁹ That is why the agency became the preferred regulator of the crypto industry¹²⁰ and why Sam Bankman-Fried was an outspoken advocate¹²¹ for the Digital

¹¹⁷ Jennifer Schonberger, "Elizabeth Warren Calls on SEC to Use 'Full Force of its Regulatory Powers' in Crypto Crackdown," *Yahoo News*, January 26, 2023, <https://news.yahoo.com/elizabeth-warren-calls-on-sec-to-use-full-force-of-its-regulatory-powers-in-crypto-crackdown-210442856.html>.

¹¹⁸ SEC Chairman Gary Gensler has said that Bitcoin is a commodity. See Kevin Helms, "SEC Chair Gensler Affirms Bitcoin Is a Commodity — 'That's the Only One I'm Going to Say,'" *Bitcoin.com*, June 27, 2022, <https://news.bitcoin.com/sec-chair-gensler-bitcoin-is-a-commodity/>.

¹¹⁹ The self-certification process allows designated contract markets (DCMs) to list new derivative products one day after submitting in writing to the CFTC that the product complies with the Commodity Exchange Act (CEA) and CFTC regulations.

¹²⁰ Robert Schmidt and Allyson Versprille, "Crypto Platforms Ask for Rules But Have a Favorite Watchdog," *Bloomberg*, March 31, 2022, <https://www.bloomberg.com/news/articles/2022-03-31/crypto-exchanges-want-say-in-rules-under-biden-administration?leadSource=uverify%20wall>.

¹²¹ Paul Kiernan, "FTX's Collapse Upends Sam Bankman-Fried's Washington Play," *WSJ*, November 28, 2022, https://www.wsj.com/articles/ftx-collapse-upends-sam-bankman-frieds-washington-play-11669545002?mod=hp_lead_pos4. Note also that FTX hired several former CFTC employees, see Dennis M. Kelleher, "FTX'S Penetration of the CFTC by a Revolving Door Hiring Spree of Former CFTC Officials," *Better*

Commodities Consumer Protection Act (DCCPA), which would create a new federally recognized asset class called digital commodities and give oversight of digital commodity markets to the CFTC.¹²² The CFTC was also actively considering granting FTX's application to amend its order of registration as a Derivatives Clearing Organization ("DCO"), which would have revised FTX's existing non-intermediated model to allow for clearing of margined, as well as fully collateralized, trades.¹²³ I wrote a public comment letter with Professors Hilary Allen and Ryan Clements opposing FTX's application and attended a public roundtable held at the CFTC to discuss intermediation in derivatives trading and clearing, which was precipitated by FTX's application.¹²⁴ The CFTC pretended that the roundtable was not designed to discuss any specific application, but the presence of Sam Bankman-Fried and several of his employees made it clear that participants were there to weigh in on FTX's application. Had FTX been successful in its attempt to offer retail investors direct access to crypto derivatives on margin 24/7, more Americans would have suffered losses when the firm collapsed.

As noted, the CFTC does have fraud and manipulation enforcement authority over commodity spot markets, but they have used this authority sparingly when it comes to crypto. In December, CFTC Chairman Rostin Behnam told the U.S. Senate Committee on Agriculture, Nutrition, and Forestry that the agency "has brought more than 60 enforcement cases in the digital asset space since 2014" and that these enforcement actions began with a referral or whistleblower tip from an external source.¹²⁵ Relying on the goodwill of strangers to let you know when something is amiss in crypto markets is absurd. Crypto-related frauds and scams are discussed daily on Twitter, Discord, Telegram, Reddit, and countless other online communication channels. There is nothing stopping the CFTC from creating dedicated surveillance teams to monitor these channels for signs of commodities fraud. Chairman Behnam's testimony also betrays one of the reasons the CFTC gave for permitting the self-certification of Bitcoin futures in 2017:

"Had it even been possible, blocking self-certification would not have stemmed interest in Bitcoin or other virtual currencies nor their spectacular and volatile valuations. Instead,

Markets, December 26, 2022, <https://bettermarkets.org/newsroom/fixs-penetration-of-the-cftc-by-a-revolving-door-hiring-spree-of-former-cftc-officials/>.

¹²² U.S. Congress, Senate, *Digital Commodities Consumer Protection Act of 2022*, S.4760, 117th Congress, introduced in Senate August 3, 2022, <https://www.congress.gov/bills/117/congress/senate/bills/4760/text>. I co-wrote a public letter with Hilary Allen and Mark Hays that identifies a number of shortfalls in the DCCPA, see <https://ourfinancialsecurity.org/wp-content/uploads/2022/09/AFR-Letter-Stabenow-Bill.pdf>.

¹²³ Commodity Futures Trading Commission, "CFTC Seeks Public Comment on FTX Request for Amended DCO Registration Order," March 10, 2022, <https://www.cftc.gov/PressRoom/PressReleases/8499-22>.

¹²⁴ Hilary Allen, Ryan Clements, and Lee Reiners, "Non-Intermediate Clearing of Crypto Derivatives on Margin Is a Bad Idea," *The FinReg Blog*, May 12, 2022, <https://sites.duke.edu/thefinregblog/2022/05/12/non-intermediate-clearing-of-crypto-derivatives-on-margin-is-a-bad-idea/>; Commodity Futures Trading Commission, "CFTC Announces Roundtable Discussion on Non-intermediation," April 27, 2022, <https://www.cftc.gov/PressRoom/PressReleases/8519-22#:~:text=CFTC%20Announces%20Staff%20Roundtable%20Discussion%20on%20Non%20intermediation,-April%2027%2C%202022&text=Washington%2C%20D.C.%20%E2%80%94%20Staff%20of%20the,in%20derivatives%20trading%20and%20clearing>.

¹²⁵ Commodity Futures Trading Commission, "Testimony of Chairman Rostin Behnam Before the U.S. Senate Committee on Agriculture, Nutrition, and Forestry," December 1, 2022, <https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam29>.

it would have ensured that the virtual currency spot markets continue to operate without federal regulatory surveillance for fraud and manipulation."¹²⁶

At the time, the CFTC believed requiring Bitcoin futures exchanges to enter into information-sharing agreements with Bitcoin spot market platforms would give the agency greater visibility into the workings of the Bitcoin spot market. They were mistaken, and the agency is still flying blind.

V. Applying Traditional Financial Regulatory Principles and Frameworks to Crypto

The lack of crypto spot market regulation is a glaring gap in oversight that Congress must address. As noted above, the CFTC has jurisdiction over commodity derivatives, but they do not oversee commodity "spot" or cash markets, except in instances of fraud or manipulation.¹²⁷ Because U.S.-based crypto exchanges argue that they only list commodities, no federal agency presently supervises crypto exchanges on an ongoing basis.¹²⁸ No one would suggest that it is a good idea for the New York Stock Exchange or the NASDAQ to be unregulated, yet that is exactly the situation we currently have with crypto exchanges. As a result, cryptocurrency exchanges do not have to:

- Provide audited financial statements;
- Provide books and records upon request to a federal regulatory agency;
- Have exchange listing standards;
- Enforce codes of conduct against exchange members;
- Segregate customer assets from firm assets;
- Have rules governing conflicts of interest;
- Maintain net capital at required levels to protect customers and creditors from monetary losses if the exchange fails; or
- Pay into a government-mandated insurance fund that would make customers whole if the exchange were to fail or lose customer assets.¹²⁹

It also means that cryptocurrency exchanges are allowed to fulfill multiple functions that are typically separated in traditional securities markets, this includes being a broker, market maker,

¹²⁶ Commodity Futures Trading Commission, "CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets," January 4, 2018, https://www.skadden.com/-/media/files/publications/2018/10/the-distributed-ledger-october-2018/fn18_2_backgrounder_virtualcurrency01.pdf.

¹²⁷ CFTC jurisdiction is also implicated when a commodity is offered for trading on a margined, leveraged, or financed basis. See LABCFTC, "A CFTC Primer on Virtual Currencies," October 17, 2017, https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/abcftc_primercurrencies100417.pdf.

¹²⁸ Of course, SEC Chairman Gary Gensler believes most U.S. crypto exchanges are listing securities and operating unregistered securities exchanges. But the SEC has yet to file an enforcement action asserting that; therefore, crypto exchanges remain unregulated for the time being. Also, the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") does consider "administrators" and "exchangers" of convertible virtual currencies to be money services businesses subject to regulations implementing the Bank Secrecy Act. See Financial Crimes Enforcement Network, "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies," March 18, 2013, <https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering>.

¹²⁹ This list is by no means exhaustive.

exchange, clearing agency, and custodian. As we saw with FTX, comingling these “various functions within crypto intermediaries creates inherent conflicts of interest and risks for investors.”¹³⁰ And most importantly for crypto investors, the lack of federal cryptocurrency spot market regulation is one reason why investors become unsecured creditors when a crypto intermediary fails, as millions of Americans found out the hard way over the past year.¹³¹

What is needed is one dedicated regulatory agency with exclusive oversight over cryptocurrency issuance and trading. The threshold questions, however, are which agency should be given this task, and what should be the extent of its authority? I have previously argued that this authority should be given to the SEC.¹³² The following section will detail the benefits of Congress granting the SEC exclusive oversight over crypto markets.

a. Congress Should Grant the SEC Oversight over Cryptocurrency Spot Markets

The debate around whether a given digital asset is a commodity, security, or something else must be addressed if one agency is to have sole authority over digital asset markets. This bifurcation has contributed to strange outcomes in trading markets. For example, the CFTC permitted the listing of cryptocurrency futures contracts, and the SEC subsequently authorized an ETF tracking cryptocurrency futures, but the SEC has yet to authorize a spot cryptocurrency ETF. A spot cryptocurrency ETF and cash-settled cryptocurrency futures both provide exposure to cryptocurrency without requiring investors to ever take possession of cryptocurrency. The fact that we have one without the other makes little sense. Furthermore, it is not entirely clear how securities and commodities law apply to novel crypto projects, such as decentralized finance (DeFi) protocols. For example, can a token issued by a decentralized autonomous organization (DAO) be considered an investment contract if there truly is no central party, or parties, essential to the DAO’s performance?¹³³

The only way to address this uncertainty is by statutorily recognizing and defining cryptocurrency or a similar term (crypto-assets or digital assets) in federal law. Of course, most financial assets are digital, so the definition must be precise enough to exclude traditional assets

¹³⁰ Gensler, “Kennedy and Crypto.”

¹³¹ Bankruptcy law is private law, and if there are adequate private law arrangements in place to segregate funds, crypto investors should be protected even if there is no regulation in place. But per crypto exchanges’ terms of service, there are no such arrangements. See Adam J. Levitin, “Not Your Keys, Not Your Coins: Unpriced Credit Risk in Cryptocurrency,” *Texas Law Review*, August 28, 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4107019.

¹³² Lee Reiners, “Congress Should Grant the SEC Oversight of Digital Asset Spot Markets,” *The CLS Blue Sky Blog*, April 21, 2022, <https://clsbluesky.law.columbia.edu/2022/04/21/congress-should-grant-the-sec-oversight-of-digital-asset-spot-markets/>.

¹³³ The governance tokens for most DAOs tend to be concentrated in the hands of founders, venture capitalist funders, and crypto whales. Therefore, enforcement efforts could be targeted at these holders. See Chainalysis, “Dissecting the DAO: Web3 Ownership is Surprisingly Concentrated,” *Chainalysis Blog*, June 27, 2022, available at <https://blog.chainalysis.com/reports/web3-daos-2022/>. The FSOC Report on Digital Asset Financial Stability Risks and Regulation uses the UNI governance token to illustrate the point that “the top 1 percent of addresses of certain governance tokens hold over 90 percent of the total supply.” See Financial Stability Oversight Council, *Report on Digital Asset Financial Stability*.

that are already subject to robust regulation, yet broad enough to incorporate cryptocurrency as well as current and future cryptocurrency offshoots (DAOs, DeFi, non-fungible tokens (NFTs), etc.). Importantly, whatever crypto regulatory regime Congress devises cannot be less stringent than existing financial regulation, otherwise, it will be arbitrated by legacy firms.

I urge Congress to carve out cryptocurrency, or a similar term like crypto-asset, from the definition of a commodity in the Commodity Exchange Act and recognize cryptocurrencies as securities under a special definition to the securities laws. This would give the SEC exclusive authority to regulate all aspects of the crypto industry and provide greater certainty to market participants, as no Howey test analysis would be needed to determine whether the asset qualifies as a security. The SEC simply has more expertise, more resources (although, to be clear, additional funding would be required), and more appetite for enforcement in the digital assets area than the CFTC does. Most importantly, unlike the CFTC, the SEC has a statutory mandate to protect investors. It is worth noting that even former CFTC Chairman Timothy Massad agrees that the SEC should be given oversight over digital asset spot markets: “Despite my personal affection for the CFTC, the SEC may be better suited to the task because it is more focused on retail investors and cash markets.”¹³⁴

Bringing cryptocurrency within the definition of security in federal law does not necessarily mean that the requirements currently applicable to securities issuers and intermediaries will apply to crypto issuers and intermediaries on a one-for-one basis. Cryptocurrency is unique in multiple ways, and it may make sense for the SEC to craft more customized rules so that crypto issuers and intermediaries can better comply with the spirit of securities laws. Even Chairman Gensler has acknowledged this point, noting in a speech last September:

*“Given the nature of crypto investments, I recognize that it may be appropriate to be flexible in applying existing disclosure requirements. Tailored disclosures exist elsewhere — for example, asset-backed securities disclosure differs from that for equities.”*¹³⁵

SEC Commissioner Hester Peirce elaborated on this point in a speech at Duke University in January:

“Whether Congress gives the disclosure task to the SEC or another regulator, several models exist. A few projects have been able to navigate their way through existing registration regimes. Disclosure under current regulations, however, is not well-suited to elicit the most useful and appropriate information for token purchasers because it does ‘not cover a number of features unique to digital assets that would undoubtedly be considered important when making an investment decision,’ as a recent petition to the SEC argued. Instead, traditional disclosures are ‘designed for traditional corporate entities that typically issue and register equity and debt securities’ and ‘focus on disclosure about companies, their management, and their financial results — topics that poorly fit the decentralized and open-source nature of blockchain-based digital asset

¹³⁴ Timothy G. Massad, *It's Time to Strengthen the Regulation of Crypto-Assets*, (Washington, D.C.: Brookings, 2017) <https://www.brookings.edu/wp-content/uploads/2019/03/Economics-Studies-Timothy-Massad-Cryptocurrency-Paper.pdf>.

¹³⁵ Gensler, “Kennedy and Crypto.”

securities. ' Thus, a more tailored crypto disclosure regime would be good for investors and crypto companies. ' ”¹³⁶

In authorizing legislation granting the SEC oversight over crypto, Congress can order the SEC to engage in notice and comment rulemaking around a crypto disclosure regime. This would have the added benefit of giving the public a formal opportunity to weigh in on the information they think is most relevant to make an informed crypto investment decision.

Beyond *what* information should be disclosed regarding prospective crypto purchases, there is also the issue of *who* is responsible for disclosure. Some cryptocurrencies, like Bitcoin, “do not provide a claim on an identifiable issuer since coins can be created or “minted” according to a protocol which has been coded by computer developers often based in overseas or unknown locations.”¹³⁷ Therefore, who is responsible for Bitcoin’s disclosure? The European Union’s proposed Markets in Crypto-assets (MiCA) regulation punts on this issue by exempting crypto-assets that are created through mining from the obligation to publish a white paper (a form of prospectus).¹³⁸ The U.S. should not adopt that approach. Instead, for cryptocurrencies without an identifiable issuer, the crypto exchange should be required to take on the responsibilities of the issuer if they wish to list the cryptocurrency (this idea was recently proposed by His Majesty’s Treasury in the U.K.)¹³⁹

If cryptocurrency is classified as a security, then cryptocurrency exchanges would be required to register as national securities exchanges or else qualify for an exemption, such as operating an “alternative trading system.”¹⁴⁰ As noted previously, crypto exchanges operate very differently than traditional securities exchanges; if they are forced to register with the SEC as a securities exchange, their business model would have to change (this is one reason why crypto exchanges have been so resistant to SEC registration). The Securities Exchange Act of 1934 (1934 Act) and the regulations thereunder list the requirements that apply to national securities exchanges. Among them, exchanges must permit any SEC-registered broker-dealer in good standing to become a member¹⁴¹ and must deny membership to a non-registered broker-dealer.¹⁴² That means that absent any carve-out in new legislation, retail investors would no longer be able to directly access crypto exchanges. Instead, they would have to trade crypto through an SEC-registered broker-dealer (note that there are already broker-dealers, like Robinhood, providing crypto trading to retail investors).

¹³⁶ Hester M. Pierce, “Outdated: Remarks before the Digital Assets at Duke Conference,” (speech, Duke University, January 20, 2023), <https://www.sec.gov/news/speech/peirce-remarks-duke-conference-012023>.

¹³⁷ His Majesty’s Treasury in the United Kingdom floated this possibility in a crypto-asset consultation released earlier last month. See HM Treasury, *Future Financial Services Regulatory Regime for Cryptoassets: Consultation and Call for Evidence* (London: HM Treasury, 2023) https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1133404/TR_Privacy_edits_Future_financial_services_regulatory_regime_for_cryptoassets_vP.pdf.

¹³⁸ Council of the European Union, “Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937 (MiCA) - Letter to the Chair of the European Parliament Committee on Economic and Monetary Affairs,” October 5, 2022, <https://data.consilium.europa.eu/doc/document/ST-13198-2022-INIT/en/pdf>.

¹³⁹ HM Treasury, *Future Financial Services*.

¹⁴⁰ U.S. Code 15 § 78e.

¹⁴¹ *Ibid.* § 78f(b)(2).

¹⁴² *Ibid.* § 71f(c)(1).

Brokers serve valuable purposes in securities trading, mainly in terms of protecting investors and ensuring a smooth trading experience. Brokers are held to stringent requirements around asset custody, capital, rehypothecation, and order routing. Under the latter, brokers are subject to a “duty of best execution,” which requires them to obtain the best price possible on a customer’s order.¹⁴³ Given that crypto exchanges in the U.S. currently function as both the broker and the exchange, and that consumers seem to prefer this model as opposed to placing crypto trades through a broker, it may not make sense to split these functions apart provided sufficient investor safeguards are in place. Therefore, Congress should consider authorizing a new entity under federal securities law called a “national cryptocurrency exchange” and allow the SEC to craft rules to regulate such exchanges. That would give the SEC flexibility to force crypto exchanges to give up the multiple roles that they currently play (broker, exchange, custodian, etc.) or allow crypto exchanges to continue to perform some of these functions subject to appropriate safeguards. No matter what, national cryptocurrency exchanges should be required to segregate individual customers’ assets from firm assets and other customers’ assets. Nor should national cryptocurrency exchanges be permitted to list traditional securities (if they want to list both, they should be required to register as a traditional securities exchange with the SEC). If the SEC permits a national cryptocurrency exchange to custody customer assets — as opposed to requiring the use of a qualified custodian — that exchange should also be subject to special resolution administered by the Securities Investor Protection Corporation (“SIPC”) so that, in the event of exchange failure, customer assets fall outside the bankruptcy estate and customers are insured against losses up to \$500,000.¹⁴⁴

In authorizing legislation, Congress should also make clear that the SEC has the authority to draft rules governing DeFi applications. These rules may not look all that different from existing requirements. Accessing DeFi protocols directly requires a level of technological sophistication that most people do not have. Therefore, several firms have developed online user interfaces that allow users to access DeFi protocols.¹⁴⁵ These firms should be required to register as broker-dealers.¹⁴⁶ Protocols that truly are decentralized, meaning they run exclusively on blockchain-based smart contracts and are not reliant on the efforts of others, present more of a regulatory challenge. However, the potential risk associated with those protocols is limited by the fact that very few people have the technological wherewithal to access them directly as well as the fact that DeFi is an entirely self-referential system with little tie-in to real-world assets. Given that the main risks currently associated with DeFi are flaws in the underlying code that

¹⁴³ *Securities Exchange Act Release No. 51808* (June 9, 2005), 70 FR 37496, 37538 (June 29, 2005) (“Regulation NMS Adopting Release”). See also *Geman v. SEC*, 334 F.3d 1183, 1186 (10th Cir. 2003) (“[T]he duty of best execution requires that a broker-dealer seek to obtain for its customer orders the most favorable terms reasonably available under the circumstances.”) (quoting *Newton*, supra note 8, 135 F.3d at 270); *Kurz v. Fidelity Management & Research Co.*, 556 F.3d 639, 640 (7th Cir. 2009) (describing the “duty of best execution” as “getting the optimal combination of price, speed, and liquidity for a securities trade”).

¹⁴⁴ SIPC, *The Investor’s Guide to Brokerage Firm Liquidations* (Washington, D.C.: SIPC, 2015)

<https://www.sipc.org/media/brochures/Liquidations-Web.pdf>

¹⁴⁵ See, e.g., Ariel Shapira, “DEXs and KYC: A Match Made in Hell or a Real Possibility?” *CoinTelegraph*, March 23, 2022, <https://cointelegraph.com/news/dexs-and-kyc-a-match-made-in-hell-or-a-real-possibility>.

¹⁴⁶ Sam Bankman-Fried made a similar argument last October: “If you host a website aimed at facilitating and encouraging US retail to connect to and trade on a DEX [decentralized exchange], this may end up falling under something like a broker-dealer/FCM/etc.” See Sam Bankman-Fried, “Possible Digital Asset Industry Standards,” October 19, 2022, <https://www.ftxpolicy.com/posts/possible-digital-asset-industry-standards>.

result in hacks,¹⁴⁷ the SEC could begin by requiring independent code audits and IT security tests of DeFi protocols.¹⁴⁸ The Commission should retain the flexibility to impose more stringent requirements on DeFi protocols if needed.

To be clear, if my recommendation is implemented, many, if not most, crypto issuers would be unable to comply. This is a good thing, as most cryptocurrencies provide no productive purpose — does anyone believe we need, or should want, over 20,000 different cryptocurrencies?¹⁴⁹ Crypto issuers who seek access to public markets will have to comply with Section 5 of the Securities Act of 1933, which prohibits the offer or sale of a security without first registering with the SEC unless an exemption from registration is available. As Professor Hilary Allen noted, most “cryptocurrencies require significant amounts of demand and liquidity to support their value.”¹⁵⁰ That means it will be unfeasible for most crypto issuers to seek an exemption from registration because those exemptions restrict who is eligible to purchase the securities in question and the resale of those securities. Thus, most crypto issuers will have to register with the SEC, and incurring the associated costs only makes sense if the token has “some long-term value creation potential.”¹⁵¹

Bringing digital assets within the securities laws will also allow investors to avail themselves of Rule 10b-5 of the 1934 Act, which provides an additional measure of investor protection by making it illegal for any person to defraud or deceive someone, including through the misrepresentation of material information, with respect to the sale or purchase of a security.¹⁵²

My proposal would also grant the SEC oversight of stablecoins. If enacted, the Commission should impose strict requirements that all stablecoin reserves be held in cash or U.S. Treasury securities and subject stablecoin issuers to routine audits and disclosure. I offer more detailed thoughts on stablecoins below, but it is worth noting that my proposal does not preclude Congress from regulating stablecoin issuers as banks or bank subsidiaries. The Supreme Court’s *Marine Bank v. Weaver* decision held that “deposits” are “securities” for purposes of the federal securities laws unless those deposits are accepted either by FDIC-insured U.S. banks or by foreign banks that are governed by regulatory regimes providing comparable protections to their depositors.¹⁵³ Thus, as professor Arthur Wilmarth has noted, it is possible for stablecoins to be regulated as both “deposits” and “securities” unless Congress decides to bring stablecoins into the banking system and protect them with FDIC insurance.¹⁵⁴

b. Congress Can Enact Discrete Requirements for Crypto Intermediaries

¹⁴⁷ According to Chainalysis, DeFi hacks accounted for 82%, or \$3.1 billion, of all crypto stolen by hackers in 2022. See Cheyenne DeVon, “Crypto Investors Lost Nearly \$4 Billion to Hackers in 2022,” *CNBC*, February 4, 2023.

<https://www.cnbc.com/2023/02/04/crypto-investors-lost-nearly-4-billion-dollars-to-hackers-in-2022.html>

¹⁴⁸ HM Treasury, *Future Financial Services*.

¹⁴⁹ Data on the number of cryptocurrencies comes from CoinMarketCap, accessed February 8, 2022,

<https://coinmarketcap.com/>.

¹⁵⁰ Allen, “Crypto Crash.”

¹⁵¹ *Ibid.*

¹⁵² U.S. Code 17 § 240.10b-5.

¹⁵³ *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

¹⁵⁴ Arthur S. Wilmarth, “It’s Time to Regulate Stablecoins as Deposits and Require Their Issuers to Be FDI Insured Banks,” *Banking & Financial Services Policy Report*, 41, 2 (2022), https://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2834&context=faculty_publications.

If Congress does not want to assign crypto oversight to a single agency, lawmakers should consider passing legislation that requires crypto intermediaries to implement basic customer safeguards. The most urgently needed reform is a ban on the commingling of customer assets with company assets. Unfortunately, commingling seems to be the norm in the crypto industry, and restricting this practice will go a long way toward minimizing investor losses when crypto firms fail. Crypto intermediaries should also be required to inform customers about their rights and risks in a simple and easy-to-understand format. Too many crypto investors have found out the hard way that they have no legal rights vis-à-vis the crypto issuer, or that they will be an unsecured creditor if the crypto platform in possession of their assets fails.

In addition to those common-sense requirements, Congress should also consider requiring the following customer protections and market integrity guardrails recently put forth by CFTC Commissioner Christy Goldsmith-Romero:

- Resolution of conflicts of interest with respect to insiders and affiliated entities;
- Broad application of the Bank Secrecy Act (including its anti-money laundering provisions);
- Strong cybersecurity requirements; and
- Broker fiduciary duties to customers.¹⁵⁵

If those requirements become law, some agency will need to enforce them. Rather than settle the “is it a commodity or security” debate, Congress could simply instruct the CFTC and SEC to engage in a joint rulemaking and share enforcement authority. There is precedent for this, as the two agencies did engage in joint rulemaking to implement Title VII, which governed the regulation of derivatives, of the Dodd-Frank Act.

c. Self-Regulatory Organizations Are a Mistake

Others have argued that Congress should designate crypto exchanges as self-regulatory organizations (SROs) as a first step toward comprehensive crypto regulation.¹⁵⁶ This is like letting the fox guard the henhouse. It is true that traditional financial exchanges have long operated as SROs, but these firms have also been subject to robust regulatory scrutiny by the CFTC or SEC, with both agencies having the ability to disapprove of SRO rule changes. Traditional SROs also operate within established regulatory regimes; in the absence of a clear regulatory regime for crypto, we would be asking crypto exchange SROs not only to supervise and take enforcement actions against market actors but also to devise a regulatory regime from first principles. That is more responsibility than traditional SROs have, and it is a responsibility that the crypto industry certainly hasn’t earned.

¹⁵⁵ Commodity Futures Trading Commission, “Keynote Address by Commissioner Christy Goldsmith Romero at The Wharton School and the University of Pennsylvania Carey Law School,” (speech, Wharton, January 18, 2023), <https://www.cftc.gov/PressRoom/SpeechesTestimony/oparomero5>.

¹⁵⁶ Yesha Yadav, “Toward a Public-Private Oversight Model for Cryptocurrency Markets,” *Vanderbilt Law Research Paper No. 22-26*, accessed January 15, 2023, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4241062.

Furthermore, the members of traditional financial exchanges are sophisticated institutions — broker-dealers in the case of securities exchanges and futures commission merchants in the case of commodity derivatives exchanges — who themselves are typically subject to regulation and examination. In other words, I cannot place a trade directly on the NASDAQ, but I can place a trade on Charles Schwab who then routes the trade to NASDAQ, or some other venue or market maker, for execution. By contrast, crypto exchanges are principally used by less sophisticated retail investors who are more vulnerable to predacious behavior on the exchange.

Arguing for crypto exchanges to be designated as SROs rests on the false premise that exchanges have an economic incentive to police themselves and the behavior on their platforms. If you can trust the exchanges, then more users will trade on them — or so the logic goes. But if that were true, then crypto exchanges would have already come together and voluntarily formed an SRO. In fact, the industry attempted a voluntary SRO in 2018 that went nowhere. Gemini Exchange founders Cameron and Tyler Winklevoss advanced a proposal for the Virtual Commodity Association (VCA), which was intended to be non-profit, independent (not a trade organization), and “in compliance with global standards and best practices for SROs.”¹⁵⁷ In addition to “sound practices” compliance, the proposed VCA would also seek to promote “price discovery, efficiency, and transparency” while providing incentives for “the detection and deterrence of manipulative and fraudulent acts and practices.” As events over the past year have demonstrated, the VCA has had no impact in cleaning up the crypto spot market (the VCA’s website lists just two working group members: Gemini and bitFlyer).¹⁵⁸

Professor Ryan Clements noted that voluntary SROs face several challenges, including “classic economic problems like organizing ‘the commons’ and dealing with free-riders, as well as practical and legal considerations like ensuring [SRO] accountability, enforcing non-compliance penalties, facilitating government oversight, creating suitable member incentives to participate, and ensuring a high cost of expulsion.”¹⁵⁹ Some of these challenges may be addressed by SROs operating with a government mandate and the legal authority to enforce rules, but publicly mandated crypto SROs will only work if the industry has a serious interest in regulatory compliance. As noted previously, the crypto industry, including U.S.-based exchanges, has chosen to operate outside the regulatory perimeter and repeatedly thumb its nose at regulators. For example:

- After the SEC told Coinbase that their proposed Lend product needed to be registered with the Commission, Coinbase CEO Brian Armstrong tweeted: “Some really sketchy behavior coming out of the SEC recently.”¹⁶⁰

¹⁵⁷ Cameron Winklevoss, “A Proposal for a Self-Regulatory Organization for the U.S. Virtual Currency Industry,” *Medium*, January 30, 2020, <https://medium.com/@winklevoss/a-proposal-for-a-self-regulatory-organization-for-the-u-s-virtual-currency-industry-79e4d7891cfc>.

¹⁵⁸ “Members,” Virtual Commodity Association, accessed February 9, 2023, <https://virtualcommodities.org/#Members>.

¹⁵⁹ Ryan Clements, “Can a Cryptocurrency Self-Regulatory Organization Work? Assessing Its Promise and Likely Challenges,” *The FinReg Blog*, June 21, 2018, <https://sites.duke.edu/thefinregblog/2018/06/21/can-a-cryptocurrency-self-regulatory-organization-work-assessing-its-promise-and-likely-challenges/>.

¹⁶⁰ Brian Armstrong (@brian_armstrong), tweet, September 8, 2021, 10:06 a.m., accessed February 10, 2023, https://twitter.com/brian_armstrong/status/1435439291715358721.

- After the SEC filed a civil complaint against Gemini and Genesis alleging the Gemini Earn product was an unregistered security, Gemini co-founder Tyler Winklevoss tweeted that the SEC's "behavior is totally counterproductive" and akin to a "manufactured parking ticket."¹⁶¹
- Last July, the CFTC filed a civil complaint against Gemini "for making false or misleading statements of material facts or omitting to state material facts to the CFTC in connection with the self-certification of a Bitcoin futures product."¹⁶² The complaint alleges that in the months leading up to the self-certification of the CBOE Futures Exchange ("CFE") cash-settled Bitcoin futures contract in December 2017, Gemini engaged in a systematic effort to deceive the CFTC about the trading volume on the Gemini exchange and in the Gemini Bitcoin Auction.¹⁶³
- In 2015, after New York implemented the comprehensive BitLicense to regulate crypto firms operating in the state, the crypto exchange Kraken announced they were discontinuing service to New York residents and released a blog post calling the BitLicense "a creature so foul, so cruel that not even Kraken possesses the courage or strength to face its nasty, big, pointy teeth."¹⁶⁴ Several years later, after the New York Attorney General's office released a report on crypto trading platforms, Kraken's CEO, Jesse Powell, tweeted: "NY is that abusive, controlling ex you broke up with 3 years ago but they keep stalking you, throwing shade on your new relationships, unable to accept that you have happily moved on and are better off without them."¹⁶⁵
- Last week, after SEC Chairman Gary Gensler went on CNBC¹⁶⁶ to discuss the Commission's charges against Kraken for failing to register the offer and sale of their crypto assets staking-as-a-service program,¹⁶⁷ Mr. Powell tweeted: "Oh man, all I had to do was fill out a form on a website and tell people that staking rewards come from staking? Wish I'd seen this video before paying a \$30m fine and agreeing to permanently shut down the service in the US. How dumb do I look. Gosh."¹⁶⁸

¹⁶¹ Tyler Winklevoss (@Tyler), tweet, January 13, 2023, 6:10 a.m., accessed February 10, 2023, <https://twitter.com/tyler/status/1613674686646484992?s=20&t=gKb89UcYRa7k99h7w3ZBeA>.

¹⁶² Commodity Futures Trading Commission, "CFTC Charges Gemini Trust Company for Making Material False or Misleading Statements and Omissions to the Commission," June 2, 2022, <https://www.cftc.gov/PressRoom/PressReleases/8540-22>.

¹⁶³ Last June, I wrote a blog post that highlighted how Gemini's deceit is a perfect example of why the CFTC's self-certification process is flawed. See Lee Reiners, "CFTC Complaint Against Gemini Reveals Weaknesses in the Agency's Approach to Virtual Currency," *The FinReg Blog*, July 20, 2022, <https://sites.duke.edu/thefinregblog/2022/07/20/cftc-complaint-against-gemini-reveals-weaknesses-in-the-agencys-approach-to-virtual-currency/>.

¹⁶⁴ Krakenfx, "Farewell, New York," *Kraken Blog*, June 8, 2017, <https://blog.kraken.com/post/253/farewell-new-york/>.

¹⁶⁵ Castro, Amy, "'Someone's Got to Be the Voice of Reason' — Kraken Responds to NY AG Report," *Bitcoin Magazine*, September 20, 2018, <https://bitcoinmagazine.com/business/someones-got-be-voice-reason-kraken-responds-ny-ag-report>.

¹⁶⁶ "SEC's Gary Gensler on Kraken Staking Settlement: Other Crypto Platforms Should Take Note of This," *CNBC*, February 10, 2023, <https://www.cnbc.com/video/2023/02/10/short-sec-chair-gensler-heres-why-we-cracked-down-on-kraken.html>.

¹⁶⁷ U.S. Securities and Exchange Commission, "Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay \$30 Million to Settle SEC Charges," February 9, 2023, <https://www.sec.gov/news/press-release/2023-25>.

¹⁶⁸ Jesse Powell (@jespow), tweet, February 11, 2023, 5:44 a.m., accessed February 10, 2023, https://twitter.com/jespow/status/1624177588074848256?s=20&t=HOdh3N_p01j2PI85fpaINA.

These do not sound like firms and executives that are eager to assume the role of regulator.

Rather than allow crypto exchanges to serve as their own SROs, it would be better for Congress to grant SRO authority to an independent entity, like FINRA. CFTC Commissioner Christy Goldsmith Romero noted that an “independent SRO would avoid certain conflicts of interest and bring consistency across exchanges” and provide an “important bulwark to ensure that exchanges have the corporate governance, personnel, systems and controls required of a regulated market holding assets for U.S. customers.”¹⁶⁹

VI. Stablecoins

I conclude by offering my thoughts on the best path forward on stablecoin regulation, where I do see the potential for a bipartisan solution. In November 2021, the President’s Working Group on Financial Markets (PWG), joined by the FDIC and OCC, released a report on stablecoins that called on Congress to pass legislation that would require fiat-backed stablecoin issuers to be insured depository institutions.¹⁷⁰ In an op-ed last November, I explained why this is the wrong approach, and I will borrow heavily from that piece here.¹⁷¹

The PWG and banking agencies are concerned about a potential run on fiat-backed stablecoins that could be triggered if stablecoin holders have reason to doubt the quantity and quality of reserves backing their stablecoin. To address this risk, regulators want fiat-backed stablecoin issuers to be insured depository institutions subject to federal supervision and regulation. That approach would make sense if stablecoins were a widely used payment mechanism, but they are not, and I doubt they ever will be. Instead, stablecoins are principally used to trade other cryptocurrencies and participate in DeFi protocols, which is why Gary Gensler likens stablecoins to poker chips at the casino — if you want to speculate in the crypto economy, you need stablecoins.¹⁷²

If stablecoin issuers are forced to become banks, it would give stablecoins instant credibility, propel the growth of DeFi — a new form of shadow banking — and deepen connections between the highly regulated banking system and the unregulated crypto economy, thereby increasing the chances that a problem in one would spill into the other.

Fears about a run on fiat-backed stablecoins are misplaced. As I noted in November:

¹⁶⁹ Commodity Futures Trading Commission, “Keynote Address.”

¹⁷⁰ U.S. Department of the Treasury, “President’s Working Group on Financial Markets Releases Report and Recommendations on Stablecoins,” November 1, 2021, <https://home.treasury.gov/news/press-releases/jv0454>.

¹⁷¹ Lee Reinert, “Regulators Are Thinking about Stablecoins in the Wrong Way,” *The Hill*, November 12, 2022, <https://thehill.com/opinion/finance/3731399-regulators-are-thinking-about-stablecoins-in-the-wrong-way/>.

¹⁷² Crypto News, “SEC Chair Gensler Compares Stablecoins to Poker Chips at Casinos,” *Crypto News*, September 22, 2021, <https://cryptonews.net/news/legal/1909625/#:~:text=The%20SEC%20chair%20has%20previously,crypto%20trading%20and%20lending%20programs>.

*“Runs are problematic for two reasons. First, the entity being run on could fail and cease its intermediating function. Second, to meet liability outflows, the entity would be forced to sell assets at discounted prices, which could trigger a fire sale that impacts the price of the assets being sold and the solvency of other institutions that hold similar assets.”*¹⁷³

Because stablecoins are used for speculation, a run would have no impact on credit or payments intermediation in the real economy. Nor would a run on stablecoins produce a damaging fire sale. The total stablecoin supply is under \$140 billion, with the majority of fiat-backed stablecoin reserves consisting of bank deposits and Treasury securities. The market would easily absorb any sale of these reserves should a run on stablecoins occur.

Rather than force stablecoins into the banking system, Congress can grant the SEC the authority to regulate them like money market mutual funds, with strict requirements that stablecoin reserves be held in cash and Treasury securities. The composition of reserves should be subject to periodic audits and disclosure, which would impose much-needed market discipline.

¹⁷³ Reiners, “Regulators.”

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Statement for the Record

On Behalf of the

American Bankers Association

before the

Subcommittee on Digital Assets, Financial Technology and Inclusion

Of the

House Financial Services Committee

March 9, 2023



Statement for the Record*On Behalf of the***American Bankers Association***before the***Subcommittee on Digital Assets, Financial Technology and Inclusion***Of the***House Financial Services Committee****March 9, 2023**

The American Bankers Association (ABA) appreciates the opportunity to provide a Statement for the Record for this hearing, *Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem*. ABA is the voice of the nation's \$23.6 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard \$19.2 trillion in deposits and extend \$12.2 trillion in loans.

The digital asset marketplace, comprising cryptocurrency and stablecoin and the firms that support the digital asset transactions, is changing rapidly. In November 2021, the total market capitalization of all cryptocurrencies (including stablecoins) peaked at around US\$3 trillion.¹ Since then, in the face of several high-profile events, the digital asset market precipitously collapsed in value (total market cap is ~US\$1.03 trillion as of March 6, 2023),² and many consumers and investors have been adversely impacted. Some crypto companies³ have suspended the ability for consumers to withdraw their funds and ultimately filed for bankruptcy, calling into question whether those consumers will ever be made whole. In at least one insolvency proceeding of a non-bank, the court has made a preliminary decision to treat customer assets as property of the bankruptcy estate available for satisfaction of claims of general creditors. In connection with another insolvency, concerns have been raised with regard to misrepresentation as to whether customer cash deposits were FDIC insured and under what conditions that FDIC insurance would apply. Other crypto companies⁴ have sought emergency loans to stay afloat. What all of these crypto companies have in common is that they are not subject to consolidated federal regulation and supervision. The risks these non-banks' unregulated operations pose to consumers have become clear.

Congress is right to focus on the digital asset ecosystem to better understand how the various entities in the market operate, what risks those operations present, and therefore what

¹ <https://www.statista.com/statistics/730876/cryptocurrency-market-value/>

² <https://coinmarketcap.com/charts/>

³ See, e.g., <https://www.ft.com/content/8d6dee7d-2cc9-4663-a0a2-e469686baca5>;
<https://www.ft.com/content/8e4538cc-e8c5-4cc2-9448-053074f72f67>;

<https://www.washingtonpost.com/business/2022/07/06/voyager-bankruptcy-three-arrows/>

⁴ See, e.g., <https://www.wsj.com/livecoverage/global-stocks-markets-dow-update-06-17-2022/card/crypto-lender-babel-finance-freezes-all-account-withdrawals-cGRgPdUuSJYISZti5dhg>;
<https://www.bloomberg.com/news/articles/2022-07-25/zipmex-aims-to-raise-at-least-50-million-to-mend-balance-sheet>

regulations or legislation is necessary to ensure consumer and investor protection and financial stability without inhibiting innovation.

The digital asset ecosystem encompasses a broad range of entities, assets, and activities. It is important to distinguish among the different aspects as each carries varying levels of risk; however, often digital assets are categorized broadly without regard for the particular characteristics of a specific type of digital asset. At the most foundational level, policymakers must understand that distributed ledger technology (DLT) or blockchain technology is different than cryptocurrencies. While cryptocurrencies operate on DLT, there is potential value in DLT separate and apart from cryptocurrency activity. Blockchain technology has potential for application in financial services that, over time, may lead to enhanced efficiencies, new products, and new ways to deliver traditional products. The fundamental characteristics of blockchain, including immutability and transparency, are relevant and valued in the financial services market, and many banks are exploring potential uses.

Defining important terms and developing a comprehensive and harmonized lexicon for the various types of digital assets and entities active within the digital asset ecosystem, and supporting infrastructures, will help authorities more effectively target the unique risks that each present. Policymakers must distinguish among digital assets, cryptocurrencies, and tokenized assets, as well as the underlying DLT and blockchain infrastructure, which may differ in use across functions and activities, when they apply existing (or develop new) regulatory frameworks for them. Traditional banking products and activities utilizing DLT, blockchain, or other novel technologies provided by federally insured or regulated banks or subsidiaries of bank and financial holding companies do not present the risks presented by non-bank digital asset service providers and non-bank issued cryptocurrencies or related activities because banks and the regulatory structure in which they operate are designed to effectively manage risks. Further, legal instruments are independent from the arbitrary technology used to represent them. For example, a deposit recorded on a traditional ledger today is the same as one recorded on a blockchain.

Regulatory clarity that defines the rules of the road for bank digital asset activity, in cases where the law does not already cover the underlying activity, is critical to ensuring continued financial innovation. Banking regulators have instructed banks to proceed into the digital asset ecosystem with extreme caution, requiring advanced supervisory notice and formal approval⁵, which is an atypical standard for many product and technology implementations. Given the regulatory uncertainty and regulators' concern, banks have moved more carefully to market than many of the less regulated providers of these services. Such non-bank financial institutions are not subject to prudential regulation and examination and are not subject to robust capital and liquidity requirements. As recent events have made clear, this unregulated activity can expose consumers and counterparties to harm.

We strongly recommend Congress and regulators apply the principle of "same activity, same risk, same regulation" to develop a framework for digital asset regulation, seeking to apply existing financial system safeguards to the digital asset ecosystem and filling in gaps with new legislation, as necessary. The United States has a number of existing laws and regulations that may be applicable to activities (e.g., custody, deposit-like accounts, lending, payments) taking place in the digital asset ecosystem. Applying the principle of "same activity, same risk, same

⁵ <https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html>;
<https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf>;
<https://www.federalreserve.gov/supervisionreg/srletters/SR2206.htm>.

regulation” will help ensure that all customers are protected equally, regardless of where they engage with the financial marketplace and that the financial system remains strong, safe, and competitive.

In particular, entities performing bank-like activities should be subject to bank-like regulation that provides for robust consumer protections, anti-money laundering procedures, and capital and liquidity controls. Similarly, entities performing market activities should be subject to relevant and appropriate market regulations. Banks are subject to a comprehensive regulatory framework and consolidated supervision that enables careful implementation of digital asset activities. Backed by a culture of risk management and compliance, and subject to supervision and examination, banks are well equipped to identify risks and mitigate them in a timely manner. Banks are evaluating several ways to responsibly engage in the digital asset ecosystem, and much of their activity can be grouped into three categories:

1. Providing digital asset custody services;
2. Providing traditional banking products and services utilizing DLT, blockchain, or other novel technologies; and
3. Providing banking services for entities in the digital asset ecosystem.

We urge Congress and regulators to clarify that it is generally permissible for banks acting in a safe and sound manner to engage in these activities, which will enable financial innovation to the benefit of US consumers and the broader economy.

Providing digital asset custody services. Banks have long provided safe and well-regulated custody services to investors in securities and other assets. Prudential regulators appear to be taking a case-by-case approach to permitting banks to provide custody services for digital assets. Further, in March 2022, the SEC released Staff Accounting Bulletin 121 (SAB 121) to address perceived risks to publicly-traded companies that safeguard crypto-assets for their customers. SAB 121 requires a company that has perceived technological, legal or regulatory risk to record a liability and asset for the fair value of the crypto-assets. SAB 121 effectively precludes banks from offering digital asset custody at scale, in part because placing value of client assets on balance sheet will trip prudential requirements such as capital, liquidity, and other mandates.

The combination of prudential regulators’ caution and SAB 121 means few banks are currently offering custody services for digital assets, leaving consumers with few options for a safe, well-regulated custody service for digital assets. Many have turned to non-bank market entrants that are not subject to prudential regulation and examination and are not subject to robust capital and liquidity requirements. As recent events have made clear, this unregulated activity can expose consumers and counterparties to harm.

Providing traditional banking products and activities utilizing DLT, blockchain, or other novel technologies. Banks stand ready to innovate, but the banking regulators do not appear to have appropriately distinguished between traditional bank activities using DLT or blockchain, such as tokenizing existing bank liabilities (e.g., deposits) or securities, and non-bank issued cryptocurrencies, which present very different risks given the inherent design of the various activities. The National Credit Union Administration acknowledged the potential benefits from credit unions’ use of DLT and issued a letter in May 2022 clarifying that credit unions may appropriately use DLT as an underlying technology.⁶

⁶ <https://ncua.gov/regulation-supervision/letters-credit-unions-other-guidance/federally-insured-credit-union-use-distributed-ledger-technologies>

The use of DLT for traditional banking activities, such as tokenized deposits, or for infrastructure uses, may result in increased efficiencies and security that benefit consumers. Banks are responsibly evaluating this technology, and we urge Congress and regulators not to throw the proverbial baby out with the bathwater by restricting banks' ability to leverage DLT in a safe and sound manner. Innovation such as the use of DLT for improved internal recordkeeping and trade settlement should not trigger additional regulation that is intended to address risk associated with novel digital asset activity. Under the existing regulatory framework and effective robust risk management function of banks, traditional banking activities using new technology are well-managed by banks with well-established controls for product development, and banks can manage the risks of traditional banking activities using DLT or blockchain.

Providing banking services for entities in the digital asset ecosystem. Banks should be able to bank – or not bank – any legal business so long as they do so in a safe and sound manner and don't discriminate unlawfully. Recent guidance from banking regulators has sought to remind banks of the risk present in a range of digital asset activities, including liquidity risk that may result from holding a high concentration of deposits from crypto entities. The guidance has been clear to note that banks are not prohibited from banking crypto businesses. It is imperative that banks can continue to make the choices that are best for their customers, communities, and business plan.

Banks have a critical role to play in the digital asset ecosystem, which has the potential to be a catalyst for change in traditional financial markets, with significant implications for our financial system, economy, markets, and most importantly for the American consumer. Banks are actively evaluating ways to compete safely and responsibly in the digital asset market, and we look forward to working with all stakeholders to ensure that outcome.



Statement for the Record
House Financial Services Subcommittee on
Digital Assets, Financial Technology, and Inclusion Hearing
“Coincidence or Coordinated? The Administration’s Attack on the Digital Asset
Ecosystem”

March 9, 2023

Chair Hill, Ranking Member Lynch, and Members of the Subcommittee,

Thank you for the opportunity for Chamber of Progress to provide a written statement for the record for the House Financial Services Subcommittee Hearing entitled, “Coincidence or Coordinated? The Administration’s Attack on the Digital Asset Ecosystem.”

Chamber of Progress is a tech industry coalition promoting technology’s progressive future. Our organization works to ensure that all Americans benefit from technological leaps. Our corporate partners include several leading crypto and web3 companies, but our partner companies don’t have a vote or veto over our positions.

After the major collapses of bad actors like FTX and Terra/Luna due to fraud, bankruptcy and improper business models, this industry needs thoughtful regulation that gives companies clear rules of the road and gives consumers more confidence. The SEC has used regulation by enforcement to sow seeds of fear and uncertainty in the digital asset industry, as companies brace to discover new interpretations of securities law via social media and television¹²³.

¹ <https://www.politico.com/newsletters/digital-future-daily/2023/02/13/cryptos-crisis-gets-existential-00082620>

² <https://decrypt.co/121069/sec-gary-gensler-kraken>

³ <https://www.forbes.com/sites/mariagraciasantillanalinares/2022/06/27/sec-chairman-gary-gensler-implies-that-ether-is-a-security-and-falls-under-his-jurisdiction/?sh=6ad8ea0d7775>

In light of recent enforcement actions by the SEC, we continue to call on Congress to direct the SEC and other regulatory bodies to establish clear rules and regulations for the digital asset industry. A public rulemaking process around proposed digital asset regulation is a necessity to ensure that all stakeholders have the opportunity to participate in the public notice and comment period. The coordinated actions by the SEC and other agencies to choke-off⁴ digital assets from the marketplace may have the intention to protect investors, but the lack of regulatory clarity via the proper rulemaking process leaves consumers at risk of being left behind by the rest of the world. Limiting access may spur an increase in American consumers investing abroad, which will leave them with little to no protection if they trade with unregistered firms outside of the US.⁵ Furthermore, banning cryptocurrency in the United States could cause financial harm to the 34 million Americans who own it currently⁶, and the 46 million Americans who are likely to purchase it this year.⁷ An outright ban would make it difficult for Americans to transact using crypto within our borders, and may propel an increase in underbanked populations.

The 117th Congress featured a number of crypto-related bills introduced with the intention of laying a proper framework for the industry. We applaud the bipartisan efforts made by the House and Senate to advance legislation that could positively impact the future of payments and digital assets. With the 118th Congress underway, we encourage continued bicameral collaboration to develop a robust crypto regulatory structure.

We believe that Congress should pass legislation that will provide the proper financial safeguards for the digital asset industry:

- **Clarification of a digital security vs. digital commodity.** Congress should designate a clear line in the sand where a token stops being a commodity. The SEC and CFTC have determined that Bitcoin⁸ and (sometimes) Ether⁹ are commodities; however, this determination has not included the conditions upon which the respective digital asset is considered a commodity or security. Contributing to the lack of clarity is a recent appeal in SEC's case against LBRY, Inc., which revealed the secondary sales of LBRY's token did not qualify as the sale of a security.¹⁰ Congress should also take into account the classification of future

⁴ <https://www.piratewires.com/p/crypto-choke-point>

⁵ <https://www.wsj.com/articles/u-s-crypto-traders-evade-offshore-exchange-bans-11627637401>

⁶ <https://www.insiderintelligence.com/insights/us-adults-cryptocurrency-ownership-stats/>

⁷ <https://www.fool.com/the-ascent/research/study-americans-cryptocurrency/>

⁸ <https://www.coindesk.com/layer2/2022/06/28/secs-gensler-reiterates-bitcoin-alone-is-a-commodity-is-he-right/>

⁹ <https://www.coindesk.com/markets/2019/10/10/cftc-chairman-confirms-ether-cryptocurrency-is-a-commodity/>

¹⁰ <https://finance.yahoo.com/news/judge-rules-secondary-sale-lbry-032057654.html>

cryptocurrencies using other consensus algorithms other than Proof of Work (PoW), which the Bitcoin and Ethereum blockchains were built on.

- **Public disclosures to ensure investor confidence in the cryptocurrency markets.** Congress should require that all crypto exchanges or companies receiving customer deposits to publicly disclose audited financial statements and documents that truthfully represent the company's health. This will help investors and consumers make informed decisions about which exchanges and platforms work best for them.
- **Preventing "bank runs."** Congress can grant jurisdiction to the SEC and CFTC to establish reserve requirements for digital asset exchanges and companies accepting customer deposits. This could avoid sudden delays from companies rushing to satisfy customer withdrawals in response to a market fluctuation. Reserve requirements can be held in an appropriately-backed stablecoin or fiat currency.

In the aftermath of the collapses in the digital asset industry, Congress must not lose sight of the opportunities the digital asset industry is bringing to the table of American innovation. Cryptocurrencies are improving the way payments are processed, cutting down the amount of time consumers wait for payments to clear from days to seconds. Due to the industry being so nascent, people of all generations are investing in digital assets, because they are looking towards a more progressive future.

Congress must work expeditiously to stop future abuses of the digital asset industry by bad actors, and instill secure guardrails for investors to trust the markets once again.

Respectfully,



Janay Eyo
Director, Financial Policy
Chamber of Progress



Statement for the Record
of the
USDF Consortium
for the hearing entitled
Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem
of the
Subcommittee on Digital Assets, Financial Technology and Inclusion
of the
House Committee on Financial Services
March 9, 2023

Chairman Hill, Ranking Member Lynch, the USDF Consortium¹ appreciates the opportunity to submit this statement for the record for the hearing entitled "Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem."

The topic of today's hearing is a timely one; distributed ledger technology holds tremendous promise to improve financial services, offering more efficient products and services that can help promote financial inclusion, drive economic growth, and support the role of the U.S. Dollar as the global reserve currency. We can only realize these benefits when innovation is delivered responsibly and regulatory guidelines are clear, certain, and consistently applied. We believe it is critical that banks and other regulated entities are empowered to deliver safe and responsible blockchain innovation to the market.

To date, most blockchain innovation has occurred outside of the regulated banking sector in novel cryptocurrency markets. These markets have provided testing grounds that have proven the efficiencies that blockchain technology can deliver. However, the volatile nature of these assets and the inconsistent regulation in these markets have limited the real-world impact of this technology and created unacceptable risk and loss.

Today, we see blockchain technology being used by banks of all sizes to improve the delivery of traditional banking services to the real economy. We believe that the best way to leverage the strengths of blockchain as a technology is to use it to support the delivery of safe, responsible, and regulated financial services. In many cases, use of blockchain technology will be transparent to customers, similar to the use of cloud technology today and other infrastructure.

¹ The USDF Consortium is a membership-based association of insured depository institutions. Our mission is to build a network of banks to further the adoption and interoperability of a bank-minted tokenized deposit (USDF™). We believe that blockchain technology can make payments more efficient and improve traditional banking, expanding access to safe and affordable financial services.

To leverage blockchain for real-world transactions, you first need a trusted and reliable way to make payments natively on blockchain. This need is what led to the rise of stablecoins and has driven the policy discussion around the creation of a “digital dollar” or central bank digital currency (CBDC).

As we debate how best to leverage blockchain to create a “digital dollar,” it is important to remember the critical role that digital dollars play in our economy today. While we tend to think of paper money, the reality is that most money in the U.S. is already digital and exists in the form of bank deposits. Today, bank deposits represent 73% of money in our economy.²

Bank deposits are a cornerstone of our monetary and financial systems that support the dominance of the U.S. dollar around the world. They play a critical role in supporting credit availability that drives economic growth and social mobility. As we look to implement blockchain technology to improve payments, we should be careful to maintain the numerous protections and benefits that our banking system provides today.

The USDF Consortium and our member banks are working to build blockchain-based payment infrastructure that ensures banks can continue to play this critical role in a digital economy. USDF allows us to deliver the benefits of blockchain technology from within the established regulatory structure for digital money. USDF operates on a private, permissioned blockchain (the USDF Private Chain). In its initial implementation, bank customers will not engage directly with the blockchain, just as they do not interact directly with wholesale payments rails today.

As recent failures have demonstrated, when innovations are not delivered in a responsible manner, they create risks to consumers and the broader economy. The bank regulatory framework is designed to manage the risks associated with offering digital representations of money. Banks are subject to prudential regulation and supervision and robust consumer protections, which ensure deposits are safe and that consumers receive the appropriate protections.

Unfortunately, there is not currently a clear path for banks to act as the responsible providers of blockchain innovation. As highly regulated institutions, any new offering by banks is subject to scrutiny, but blockchain initiatives are held to a higher standard. Today, any bank wishing to undertake a blockchain project must receive formal regulatory approval, a process that does not exist when utilizing other technologies. Moreover, as the federal banking agencies have moved to address risks emerging from the non-bank crypto ecosystem, they have painted with a broad brush, making it difficult for banks to leverage this promising new technology.

Banks play a critical role in our economy. As more economic activity is supported by blockchain, it is critical that we create a clear and credible path for banks to play this same role on-chain. Failure to do so would push financial services activities outside of regulated markets and risk

² Money as measured by M1 ([Federal Reserve H.6](#)).

undermining the United States' leadership in financial services. Banks are eager to bring responsible innovation to market and look forward to working with Congress and regulators to safely deliver on the promise of blockchain.

1. It is important to separate blockchain from cryptocurrencies

Blockchain and crypto have been imprecisely conflated in the public discourse. While this may be understandable given the important role that blockchain played in facilitating the creation of crypto markets, it is important to clearly distinguish these concepts as policymakers consider appropriate regulation for these novel technologies and assets. By analogy, we do not regulate the internet, but instead regulate the numerous industries that leverage the internet to deliver their services. Similarly, a one-size-fits-all approach to blockchain that seeks to address the risks that have emerged from novel crypto markets may limit its use in other industries.

Policymakers are right to focus on the risks that have emerged from these novel crypto markets. Blockchain facilitated the creation of new financial services products that fall outside the perimeter of existing regulatory and supervisory structures. Many of these services resemble traditional financial services products but are not supervised for the same risks because they are offered by new kinds of businesses that do not fit under traditional licensing and supervisory regimes. Despite this, the risks presented by the use of blockchain are rarely novel. In many cases, existing banking regulation is well suited to manage these risks.

At its core, blockchain is a ledger technology that can facilitate a wide range of activities, each presenting a different risk profile. The risks associated with delivering a novel asset in an unregulated market are very different from the risks associated with a regulated financial institution offering a traditional product.

In banking, we believe that blockchain technology can provide efficiencies that lower the cost of offering financial services, allowing banks to reach more Americans with safe, affordable, and inclusive products. Blockchain on its own is not a silver bullet, but we believe that as a shared system of record, blockchain has a unique ability to break down silos, facilitating real-time collaboration between financial institutions. In particular, we believe that blockchain can facilitate the following activities:

- **Faster, cheaper payments.** As a shared system of record, blockchain can facilitate the near real-time transfer of value. USDF leverages a proof-of-authority model where trust is already established, eliminating the need for participants to undertake costly computing exercises to create skin in the game. This allows for rapid transactions at minimal cost. We believe this can be particularly valuable in supporting business-to-business transactions, which are still largely paper based today.
- **Programmable payments.** Blockchain can integrate smart contracts, enabling banks to automate the execution of complex payments based on real-world conditions. For

example, smart contracts could be used to automate the payments process associated with buying a home. Today, a buyer sends money to escrow, and an escrow agent calls individual banks and confirms wires to all of the various parties that participated in the transaction. With a smart contract, we can deliver each payment to the right party the minute a contract is signed.

- **Shared system of record.** Blockchain adds additional value when it is used as a system of record for other traditional banking assets (like loans). Today, banking infrastructure is a system of siloed proprietary databases. These silos create friction when a transaction requires moving assets in multiple systems at the same time. A buyer will not release funds until they are sure the asset has moved in a separate system of record.

Blockchain allows for both payments and assets to be recorded on the same system of record. This allows a buyer to trade their dollars for an asset in real time without settlement risk because the transfer of money and the purchased asset move in the same block. This is a process often referred to as atomic settlement.

Incorporating atomic settlement into traditional banking assets makes it easier to buy and sell those assets. By making these assets more liquid, we add new funding options that lower the cost of credit, expanding access to affordable financial products.

2. Bank deposits should play a central role in the creation of any digital dollar

Financial innovation only adds value when it helps facilitate real-world economic activity like buying capital goods, hiring employees, or purchasing a home. Before blockchain can make a positive impact on the real world, we need a safe, reliable, and trusted form of payments that exists natively on chain. This has led to demand for blockchain native “cash equivalents” that can be used as a means of payment and a store of value.

Many options that have been presented to meet this need would fundamentally reshape the way money exists in our economy today. While we believe there is room for many forms of digital money in a modern economy, commercial bank money (bank deposits) plays a critical role as the dominant form of money in our economy today.

Bank deposits are subject to a strong and tested regulatory regime and play a prominent role in supporting the availability of credit. Because of these benefits, bank deposits make up 73% of money in the U.S. economy today. We believe they will continue to play a dominant role as money is developed natively on blockchain.

Retail CBDCs have serious drawbacks that limit their utility

Some policymakers have suggested that the government should step in and offer an alternative to stablecoins in the form of a retail CBDC.³ A retail CBDC would be a liability of the Federal Reserve that is widely available to the general public. The issuance of a retail CBDC would present a safer alternative to existing non-bank stablecoins because they would carry no credit risk.

A retail CBDC would undermine critical benefits that our banking system provides today. According to the Federal Reserve, a “widely available CBDC could serve as a close substitute for commercial bank deposits or other low-risk assets such as government MMFs and Treasury bills. A shift away from these assets could reduce credit availability or raise credit costs for households, businesses, and governments.”⁴

Even if delivered through banks, a retail CBDC would ultimately be a liability of the Federal Reserve, not a private institution like a bank. The American Bankers Association estimates that 71% of bank funding is in deposits that would be put at risk by this model.⁵ A flight of deposits to the Federal Reserve would undermine the deposit base that supports lending. Banks across the country rely on these deposits to fund the loans that support small businesses in their community and help families achieve homeownership.

An alternative path would be for the Federal Reserve to explore a wholesale CBDC.⁶ In doing this, they could create modern blockchain-based payment infrastructure while maintaining the same two-tier system that exists today. While there are numerous tradeoffs to consider in this approach, a wholesale CBDC would reduce one of the largest risks of issuing a CBDC and ensure the private sector has the ability to innovate.

Bank deposits are likely to remain the most attractive form of money regardless of technology

The existing U.S. monetary and financial system provides numerous benefits to consumers and the broader economy, and supports the important role that the U.S. dollar plays around the world today. There is little need to change this tested market structure as we implement new technology to upgrade these systems.

³ A “retail” CBDC means a liability of the central bank held directly by a member of the public, unlike a commercial bank deposit, which is a liability of the commercial bank owed to its customer.

⁴ Federal Reserve Discussion Paper, Money and Payments: The U.S. Dollar in the Age of Digital Transformation ([Jan. 2022](https://www.federalreserve.gov/publications/january-2022-cbdc.htm)), <https://www.federalreserve.gov/publications/january-2022-cbdc.htm>.

⁵ American Bankers Association Comments on Federal Reserve Discussion Paper, Money and Payments: The US Dollar in the Age of Digital Transformation (May 20, 2022), <https://www.aba.com/advocacy/policy-analysis/aba-comments-on-fed-discussion-paper-money-and-payments>.

⁶ A “wholesale” CBDC means a CBDC designed for use among financial intermediaries only.

Bank deposits play a central role in our economy today as the dominant form of money. Tokenized deposits (sometimes referred to as deposit tokens or dollar tokens) allow us to bring the benefits of bank deposits on-chain by creating a representation of an existing bank deposit on blockchain. Tokenized deposits can take many forms; some might be held by the customers of the bank while others may only be used by financial institutions to create blockchain-native payments rails. In the initial implementation of USDF, no customers will engage directly with the blockchain just as they do not engage directly with existing payments rails today.

Banking regulation ensures that deposits are safe.

Bank deposits are backed by robust capital and are subject to a regulatory regime that ensures liquidity and solvency. For banks, the implementation of blockchain technology does not fundamentally change the nature of banking or how regulation controls for the risks associated with it. Banks are heavily supervised to ensure they deliver the numerous consumer protections associated with digital payments.

Moreover, the bank regulatory structure is designed to maintain important broader public policy objectives. For example, under the Community Reinvestment Act and other laws, banks have long demonstrated their unique ability to support underserved communities. This law is directly tied to bank deposits; a transition to non-bank deposits would risk undermining these critical objectives.

Bank deposits support credit creation.

Banks play a critical role in our economy, engaging in maturity transformation. Banks take short-term assets in the form of deposits and use those funds to extend long-term assets in the form of loans.

When a bank makes a loan, it creates new money in the form of a deposit in the borrower's account that did not previously exist. That deposit in turn can be used to power additional lending. The amount of deposits that can be used to support additional lending is determined by the capital the bank must hold to support new loans. Today, the core capital (leverage) ratio for FDIC-insured institutions is near 8.7%.⁷ This system, called fractional reserve banking, means that a \$1 deposit can power more than \$10 of lending. These loans allow businesses to invest in new employees or capital goods that create jobs and drive economic growth.

Non-bank instruments like stablecoins or CBDC would eliminate this important function. There are many forms of stablecoins, but the high-profile failure of Terra's UST has led to a push for fully collateralized stablecoins that hold one dollar in assets for every dollar of the stablecoin. This means that a \$1 stablecoin could only ever support \$1 in lending.

⁷ FDIC Quarterly Banking Profile, FDIC QBP Graph Book, <https://www.fdic.gov/analysis/quarterly-banking-profile/graph-book/2022mar/QREGCAP.html>.

There simply isn't enough capital in the system to support fully collateralizing every financial asset. Today, there are nearly \$200 trillion in U.S. financial assets supported by \$18 trillion of commercial bank deposits.

The New York Federal Reserve staff reinforced the importance of this in a post titled *The Future of Payments Is Not Stablecoins*, in which the staff argued in favor of tokenized bank deposits.⁸ The post notes, "The emergence of DLTs has led to a proliferation of new types of money, such as stablecoins.... In this post, we argue that if DLT platforms are the transfer mechanism of the future, then it seems worthwhile to find the best possible money that can be used on that transfer mechanism. We suggest that tokenized deposits might be a fruitful avenue to pursue."

The only scalable way to bring traditional financial assets on-chain is to leverage the banking system to support that by tokenizing existing bank deposits.

3. Congress should ensure there is a clear, credible path for regulated institutions like banks to offer responsible products

If policymakers want to realize the benefits of blockchain technology while maintaining critical protections and promoting efficiencies, they are right to look to the bank regulatory framework. Banks have a long history of bringing new technology to customers through a trusted and regulated channel. Bank regulation is flexible and well-equipped to manage the risks of integrating new technologies such as blockchain.

We offer the following recommendations and stand ready to work with Congress to advance policies that can promote responsible innovation:

Congress should urge the banking agencies to create a clear path for the approval of blockchain-based activities.

Banks are often slower to adopt new technologies than other industries. This is not for a lack of interest or skill but due largely to the fact that banks are so heavily regulated. Technology companies can bring nascent technologies directly to customers, iterating daily and fixing bugs after releases are made. Before releasing new products, banks must perform countless rounds of testing and ensure that their approach is aligned with regulatory expectations.

While caution is warranted given the important role that banks play, the standard for approval for blockchain-based activities is putting banks at a competitive disadvantage. Currently, banks must obtain formal approvals from their regulators prior to offering any blockchain product, a

⁸ Federal Reserve Bank of New York, *The Future of Payments Is Not Stablecoins* (Feb. 7, 2022), <https://libertystreeteconomics.newyorkfed.org/2022/02/the-future-of-payments-is-not-stablecoins/>.

standard that does not exist for any other technology.⁹ To date, no clear set of expectations has been determined for regulatory approval and few approvals have been given.

Since creating these policies, the banking agencies have been careful to highlight that banks are “neither prohibited nor discouraged from providing banking services to customers of any specific class or type,” but have put out a series of statements, rules and reports highlighting the risks when banks engage in crypto-related activities.

- Joint Statement on Crypto-Asset Risks to Banking Organizations (1/3/23): Highlights safety and soundness risks of holding cryptocurrencies or dealing with crypto clients.¹⁰
- Federal Reserve Policy Statement and Final Rule (1/27/23, 2/7/23): The Federal Reserve issued a policy statement,¹¹ which was later published as a final rule,¹² clarifying that banks cannot hold crypto as principal. The Federal Reserve highlights that banks may be able to issue dollar tokens but that they do not believe banks can meet their obligations on a public, permissionless, or decentralized blockchain.
- The Administration’s Roadmap to Mitigate Cryptocurrencies’ Risks (1/27/23): The National Economic Council released a statement highlighting its plan to reduce crypto risk. In the statement, the Council discourages policy that would allow “mainstream institutions” to dive headlong into crypto.¹³
- Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities (2/23/23): Highlights heightened liquidity risks for deposits from crypto platforms involving customer funds or stablecoin reserves.¹⁴

⁹ The OCC’s Interpretive Letter 1179 requires OCC-regulated banks to obtain supervisory non-objection prior to engaging in any permissible crypto-related activity. OCC Interpretive Letter 1179 (Nov. 18, 2021), <https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf>. The FDIC’s FIL-16-2022 requires banks to notify the FDIC for supervisory feedback prior to engaging in any crypto-related activities. FDIC FIL-16-2022 (Apr. 7, 2022), <https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html>. The FDIC’s FIL-16-2022 requires banks to notify the FDIC for supervisory feedback prior to engaging in any crypto-related activities. FDIC FIL-16-2022 (Apr. 7, 2022), <https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html>.

¹⁰ Federal Reserve, FDIC and OCC, Joint Statement on Crypto-Asset Risks to Banking Organizations (Jan. 3, 2023), <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf>.

¹¹ Federal Reserve, Policy Statement on Section 9(13) of the Federal Reserve Act (Jan. 23, 2023), <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230127a1.pdf>.

¹² 88 Fed. Reg. 7,848 (Feb. 7, 2023), <https://www.govinfo.gov/content/pkg/FR-2023-02-07/pdf/2023-02192.pdf>.

¹³ National Economic Council, The Administration’s Roadmap to Mitigate Cryptocurrencies’ Risks (Jan. 27, 2023), <https://www.whitehouse.gov/nec/briefing-room/2023/01/27/the-administrations-roadmap-to-mitigate-cryptocurrencies-risks/>.

¹⁴ Federal Reserve, FDIC and OCC, Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities (Feb. 23, 2023), <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230223a1.pdf>.

These statements focus primarily on the real risks emerging from the broader crypto markets, but few address the use of blockchain for traditional banking. Despite this, the statements could be interpreted by the banking industry to set a tone that discourages banks from exploring these technologies.

We recommend that Congress engage to ensure that there is a clear path for regulated entities like banks to bring responsible blockchain innovation to market.

Stablecoin legislation should not restrict banks' ability to record deposits on blockchain.

Bipartisan stablecoin legislation has emerged in both the House and the Senate. This legislation is a timely response that addresses the risks that have been demonstrated by recent failures. A consistent theme of the legislation is ensuring that stablecoin issuers fully reserve against the stablecoins that have been issued. We believe this is a prudent step to ensure that stablecoins remain backed by high-quality assets.

The definition of stablecoin used in draft legislation is quite broad and risks capturing bank deposits recorded on blockchain. Banks are subject to stringent capital and liquidity standards that allow them to use deposits to fund loans. If banks are required to fully reserve against deposits recorded on blockchain, it would limit their ability to lend into the communities they serve.

We were pleased to see clarifying language in draft legislation that would ensure banks can continue to offer deposit products, but we would urge Congress to explicitly exempt tokenized deposits from any stablecoin legislation.

Congress should urge the FDIC not to restrict banks' ability to use blockchain to record deposits.

The FDIC recently proposed a rule to update the standards for signage and marketing of FDIC insurance.¹⁵ The proposal is overbroad, and we have concerns that language in the proposed rule would limit banks' ability to record deposits on blockchain.

Technology has rapidly changed the way banking services are delivered. Today, most customers access their bank primarily through digital channels and the bank branch is no longer the main source of information in a banking relationship. Technology has also facilitated partnerships that allow for the delivery of banking services through non-traditional channels. With the proliferation of new options, it is more important than ever that customers clearly understand when they receive the protections associated with banking regulation and FDIC insurance.

This need has become particularly apparent in the non-bank cryptocurrency space, where numerous companies have claimed to offer bank-like protections and, in some cases, falsely claimed FDIC insurance. We support the FDIC's work to address these dangerous misrepresentations and ensure consumers remain protected.

¹⁵ 87 Fed. Reg. 78,017 (Dec. 21, 2022), <https://www.govinfo.gov/content/pkg/FR-2022-12-21/pdf/2022-27349.pdf>.

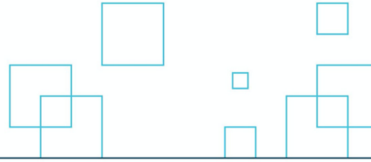
Despite this, we have concerns that the broad definition of “crypto-asset” in the proposal may limit banks’ ability to implement blockchain for traditional banking applications. Specifically, it would inhibit banks from using blockchain as the system of record for recording bank deposits by labeling any asset recorded on a distributed ledger as an “uninsured financial product.”

Like any other technology, blockchain presents risks that must be managed in its implementation. These risks vary greatly depending on the blockchain implementation being used. Existing banking regulation and compliance culture provide for the appropriate management of these technology risks. Blockchain technology does not present any unique risks that would warrant a new regulatory approach to managing this technology risk or inhibit its use in traditional banking applications. Congress should urge the FDIC to take a technology-neutral approach that addresses the risks inherent in any technology implementation, rather than prohibit banks’ use of this technology.

Conclusion

Blockchain technology holds tremendous potential to improve financial services. When delivered responsibly, it has the potential to promote financial inclusion and help ensure that the United States remains a global leader. We believe the bank regulatory structure is well-equipped to manage the risks associated with this novel technology and that tokenized deposits are the best way to realize these benefits.

The USDF Consortium was created as a venue for banks to collaborate as they design blockchain infrastructure that will power the future of financial services. We are committed to delivering these innovations responsibly, ensuring that our customers receive the world-class safety and protections inherent in U.S. banking regulation. We are committed to working with Congress to help ensure an appropriate regulatory framework to enable this critical innovation.



House Committee on Financial Services
Subcommittee on Digital Assets, Financial Technology and Inclusion
2129 Rayburn House Office Building
Washington, D.C. 20515

The Honorable French Hill
Chairman

The Honorable Stephen Lynch
Ranking Member

Chamber of Digital Commerce Statement for the Record

March 9, 2023

Dear Chairman Hill and Ranking Member Lynch:

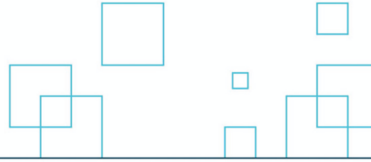
The Chamber of Digital Commerce (Chamber) appreciates the opportunity to submit a statement for today's Subcommittee hearing entitled "Coincidence or Coordinated: The Administration's Attack on the Digital Asset Ecosystem."

For almost a decade, the Chamber has advocated and encouraged U.S. policymakers to fulfill their duty and set a clear legal and regulatory framework for the digital asset industry and investors. The demise of FTX and a string of recent market failures of centralized entities underscores the need for a U.S. legal environment that brings digital assets and blockchain technology further into the regulatory perimeter.

At this moment in time, the U.S. is losing its competitive edge in global financial and technological leadership by failing to propose a legal framework for digital assets to operate securely domestically. In absence of regulatory guidelines, the digital assets and blockchain industry have been met with increased enforcement, prejudicial policy statements, and actions aimed at limiting accessibility to traditional financial services. Through these actions, regulatory agencies have coordinated their message to the industry and it is "you're not welcome in the United States."

To that end, we urge the Full Committee to prioritize passing the legislative proposals considered in today's hearing to preserve American preeminence in fintech innovation and provide much-needed clarity that will allow the United States to lead the exploration of these nascent technologies. Those bills include the **Blockchain Regulatory Certainty Act**, **Keep Your Coins Act**, and **Keep Innovation in America Act**.

Furthermore, we urge the Subcommittee to consider legislative proposals, such as the **Securities Clarity Act** and the **Clarity for Digital Tokens Act**, that aim to create a taxonomy for digital



assets and provide clear guidelines as to the appropriate regulatory body for developers and issuers to follow.

How the Chamber of Digital Commerce Can Help

The Chamber applauds the creation of this Subcommittee and the leadership put forth by Chairman Hill and Ranking Member Lynch to working collaboratively to advance bipartisan solutions for the U.S. advancement of blockchain technology and digital asset innovations.

The U.S. has been the global leader in finance and technology innovation due in part to its robust regulatory regime. For decades, the U.S. regulatory environment has helped to promote competition, encourage investment, and protect consumers in order to create an environment conducive to innovation. However, the U.S. has failed to create a regulatory regime for digital assets leading to consumers, investors, and developers searching off-shore for rules and regulations without protection.

We stand ready to work closely with government officials to ensure that digital asset development remains onshore and is conducted in a safe and sound regulatory environment. We encourage you to read the Chamber's 2023 Policy Agenda¹, which lists ten actions that U.S. policymakers can take immediately to create a legal environment for digital assets that protects consumers and preserves the U.S. as the global leader in financial and technology innovation.

In conclusion, the Chamber hopes to be a valuable resource to the Subcommittee as we develop policy solutions to create a regulatory framework for digital assets.

Sincerely,

A handwritten signature in black ink that reads "Perianne Boring".

Perianne Boring
Founder and CEO
Chamber of Digital Commerce

¹ "Certainty for Crypto & Investors: The Policy Agenda." *Chamber of Digital Commerce*, 10 Dec. 2022, <https://digitalchamber.org/certainty-for-crypto-investors-the-policy-agenda/>.



Statement for the Record of the Club for Growth

for the hearing entitled

Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem

of the Subcommittee on Digital Assets, Financial Technology and Inclusion

of the House Committee on Financial Services

March 9, 2023

Chairman McHenry, Chairman Hill, Ranking Member Waters, and Ranking Member Lynch, the Club for Growth appreciates the opportunity to submit this statement for the record for the hearing entitled "Coincidence or Coordinated? The Administration's Attack on the Digital Assets Ecosystem."

Bitcoin and other digital assets, as well as blockchain technology, represent the most transformational technology since the internet for the U.S. economy, our society, and our fundamental liberties. These technologies carry transformational possibilities to grow our economy by trillions of dollars, and they are our best hope to protect our fundamental liberties to free speech, free association, and the free exchange of ideas, as well as our national security, all of which are increasingly threatened by authoritarian governments and entities, and are now being threatened by the Biden Administration and its regulators. American businesses that utilize digital assets and blockchain technology employ thousands of Americans, contribute significantly to U.S. GDP, and lead the way in American innovation and exceptionalism.

Unfortunately, the Biden Administration and its banking regulators are currently engaged in a coordinated and discriminatory attack upon the digital asset industry, that can be aptly named "Operation Chokepoint 2.0" and which has resulted in the debanking and stifling of the innovation of legal American businesses.

What Banking Regulators Are Doing

A recent policy statement from the Federal Reserve, FDIC, and OCC said that banks who issue or own crypto-assets on public blockchains are likely acting in a way that is "inconsistent with safe and sound banking practices."¹ To bankers, who generally prefer to play things safe, this is a clear statement to stay away from crypto – not just parts of it - but the entire industry. This is clearly discriminatory treatment of Americans that choose to trade, transact or own crypto. They have broken no laws and yet their funds won't be protected by the same FDIC insurance that anyone else's funds would be. This is also discriminatory action against the American businesses.

On April 7, 2022, the FDIC issued a Financial Institution Letter, "Notification of Engaging in Crypto-Related Activities"² requiring that all FDIC-supervised institutions that are engaging in or considering engaging in

¹ <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf>

² <https://www.fdic.gov/news/press-releases/2023/pr23002a.pdf>



crypto-related activities notify the FDIC and provide all necessary information that would allow the FDIC to assess “safety and soundness.” This effectively halts all legal crypto-related activities, while the FDIC

performs an amorphous analysis in an undefined “timely manner”, stifling American innovation and national security as American companies are handcuffed, while other nations, including hostile nations, are free to innovate giving them a technological edge, and also pushing American companies off shore. The government and regulators should not be picking winners and losers.

In the real world – behind closed doors as part of the bank supervisory process – it appears the banking regulators are going well-beyond the issued statements and discouraging banks from providing basic banking services to crypto companies, as well as effectively prohibiting banks from engaging in the safe testing of innovative blockchain technology. If crypto companies are deprived of banking services then they will no longer be able to operate. If consumers can’t convert from crypto to fiat, they are effectively trapped in their investments. That’s the most anti-consumer result possible. If companies are not able to innovate in the United States, they will move off shore. Again, these are legal companies, based in the United States, that employ thousands of employees. The largest and most well-known, Coinbase, is even publicly traded, and just two years ago, the SEC approved its application to become publicly traded.

Why Congress and All Americans Should Care

What the banking regulators are doing to crypto is undemocratic and steps on citizens’ rights to choose what business and investing activities to take part in. It also steps on American businesses’ rights to make their own business decisions, and places the government in the role of making these decisions and picking winners and losers. This is comparable to Operation Chokepoint, which was started by the Obama Justice Department in 2013 to target supposed companies that it believed to be high risk, like firearm dealers. Operation Chokepoint is now seen as a shameful overreach that eroded the public’s confidence in the banking sector. This is also comparable to Canada freezing the bank accounts of truckers who opposed COVID 19 mandates. Law-abiding businesses should be free to build and grow – that is the American way. It is beyond the scope of regulators’ authority to start picking winners and losers among compliant businesses.

Debanking crypto will hurt the millions of Americans who have invested in crypto assets. It would be much better for consumers if crypto was brought into the sunlight and regulated properly, in a way that protects consumers while allowing for innovation. If regulators are worried about risk management, the best approach is to let many banks serve crypto companies – forcing some banks away from crypto has the opposite effect. The Americans who will be most hurt are those who have turned to crypto because the traditional banking system wasn’t meeting their needs – including people of color, low income people, and young people.

Actions being taken by the banking regulators will push an entire industry overseas. This will hurt our economy, national security, and technological competitiveness. The crypto industry is building, and the future use cases are many. Crypto can help improve payments, entertainment, and a host of other industries. But if the start-up founders currently building in their garage aren’t able to open bank accounts, they will never get their businesses off the ground.

Crypto technology isn’t going away. If it matures elsewhere, the U.S. government will not be able to stop the bad actors who try to use crypto, such as those who use it for illicit finance and sanctions evasion. The public, permanent and traceable nature of the blockchain is a huge advantage for preventing illicit financial

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| www.clubforgrowth.org



transactions. Blockchain analytics are a powerful tool. But if the U.S. pushes this tool away, it can't benefit from it.

This isn't just about crypto, it's about the rule of law. Access to basic banking services isn't supposed to be political. If you can meet the typical requirements you should be able to get a bank account. Bank regulators know that they don't have the authority to tell banks to stay away from an entire industry. They've tried this before - last time it was firearms, oil and gas - and this time it's crypto. The playbook is the same, just with a bit more subtlety.

How Digital Asset Innovation can be fostered in the U.S.

There is a social consensus and bipartisan political support for developing new rules for crypto, which protect consumers, while at the same time allow for innovation in a nascent industry that has the real potential to transform the U.S. economy. Congress should chart the course for crypto in this country, not regulatory agencies using arbitrary and non-transparent enforcement actions. Congress must create a regulatory environment where companies are rewarded, not penalized, for doing the right thing and making compliance a priority. This means encouraging crypto to become involved with those institutions, like banks, that are subject to strict oversight and regulatory requirements. It also means there must be clear standards for enforcement, which provide regulatory certainty, not selective enforcement actions. Jurisdictions like the EU, Brazil, Australia, the UK, and Japan are in the process of writing rules for crypto. We do not want other entities gaining an advantage in this new and powerful emerging technology, and we do not want U.S. businesses fleeing to foreign jurisdictions because there is no clear regulatory path forward in the U.S., and thus no certainty for businesses.

Specific Actions that Congress Should Take to Solve the Discriminatory Actions by Banking Regulators:

The Club for Growth respectfully recommends the following specific actions that Congress should take to rein in the discriminatory actions being taken by the Biden Administration and its banking regulators:

1. **House and Senate Committees should exercise oversight authority over banking regulators such as the FDIC, OCC, and Federal Reserve by conducting in-depth oversight hearings to determine the size and scope of the regulatory overreach with respect to debanking and stifling innovation, so that appropriate action may be taken to rein in this regulatory overreach.**
2. **Congress should pass affirmative legislation, akin to the SAFE Banking Act of 2021, to prohibit federal banking regulators from penalizing a depository institution for providing banking services to legitimate businesses, including digital asset and blockchain-related businesses. Suggested provisions are detailed below:**
 - Prohibited penalties include terminating or limiting the deposit insurance or share insurance of a depository institution solely because the institution provides financial services to a legitimate digital-asset related business and prohibiting or otherwise discouraging a depository institution from offering financial services to such a business.



- Proceeds from a transaction involving activities of a legitimate digital asset and blockchain-related business are not considered proceeds from unlawful activity. Proceeds from unlawful activity are subject to anti-money laundering laws.
- A depository institution is not, under federal law, liable or subject to asset forfeiture for providing a loan or other financial services to a legitimate digital asset or blockchain-related business.
- A federal banking agency may not request or order a depository institution to terminate a customer account unless (1) the agency has a valid reason delineated in law or regulation for doing so, and (2) that reason is not based solely on reputation risk. Valid reasons for terminating an account include threats to national security and involvement in terrorist financing, including state sponsorship of terrorism.

3. Congress should add an Appropriations Rider (limitation rider) to the funding of banking regulatory entities specifically prohibiting the use of funds for terminating or limiting the deposit insurance or share insurance of a depository institution solely because the institution provides financial services to a legitimate digital asset or blockchain-related business and prohibiting or otherwise discouraging a depository institution from offering financial services to such a business.

Conclusion

Digital assets and blockchain technology represent the most transformational technology since the internet for the United States. American companies utilizing these technologies are legal American businesses that contribute significantly to the U.S. economy and create thousands of good jobs for Americans. These companies, like any other American company, should have access to the banking services that they need to exist and thrive. The Club for Growth strongly urges Congress to exercise its rightful authority to prevent the Biden Administration's coordinated attack upon and the discriminatory actions towards American citizens and innovative American companies.

Crypto
Council for
Innovation

March 9, 2023

Patrick McHenry
Chairman
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Maxine Waters
Ranking Member
House Committee on Financial Services
4340 O'Neill House Office Building
Washington, DC 20515

French Hill
Chairman
Subcommittee on Digital Assets,
Financial Technology and Inclusion
1533 Longworth House Office Building
Washington, DC 20515

Stephen Lynch
Ranking Member
Subcommittee on Digital Assets,
Financial Technology and Inclusion
2109 Rayburn House Office Building
Washington, DC 20515

Dear Chairman McHenry, Ranking Member Waters, Chairman Hill, and Ranking Member Lynch:

The Crypto Council for Innovation (CCI) appreciates the opportunity to contribute to the important discussion taking place during today's hearing. CCI is a global alliance of industry leaders with a mission to communicate the benefits of crypto/Web3 and demonstrate its transformational promise. CCI members include some of the leading global companies and investors operating in the industry. They span the crypto ecosystem and share the goal of encouraging the responsible global regulation of crypto to unlock economic potential, improve lives, foster financial inclusion, protect national security, and disrupt illicit activity. CCI and its members stand ready and willing to work with the House Financial Services Committee and its members to accomplish these goals and ensure that the most transformative innovations of this generation and the next are anchored in the United States.

Crypto is a broad term that covers a wide range of use cases and applications. The core shift it represents is from the current model of intermediated interactions to an ownership-based, user-centered digital economy. For a long time, we have relied on third parties to facilitate trust in many aspects of our lives, including transactions, identity provision, and governance. In many cases, these third parties

have handsomely profited from intermediation. And in some cases, intermediaries have exacerbated inequalities,¹ sown distrust,² and restricted much-needed access for individuals.³

There is a pressing need for regulatory clarity around cryptocurrency and digital assets that promotes innovation and protects consumers. While digital asset prices have fallen and a number of individual crypto projects have collapsed in recent months, Americans' interest in this market and technology remains robust,⁴ and spans demographics.⁵ As of March 7, 2023, crypto still had a market cap of over \$1 trillion USD.⁶ The number of full-time developers in the crypto space grew 8% year-over-year in 2022, despite a 70% decline in prices.⁷ However, while cryptocurrencies have been held and traded by American consumers for over a decade, U.S. federal prudential and financial market regulators have failed thus far to establish any clear regulatory framework for digital assets.

In early 2022, the Biden Administration provided an encouraging signal to the crypto marketplace when President Biden signed Executive Order (EO) 14067, on "Ensuring Responsible Development of Digital Assets."⁸ Among the Administration's stated objectives in issuing this EO was "establishing a framework to drive U.S. competitiveness and leadership in, and leveraging of digital asset technologies" as well as directing the "U.S. Government to take concrete steps to study and support technological advances in the responsible development, design, and implementation of digital asset systems." However, in recent months and since the issuance of the EO, we have seen multiple federal financial agencies pursue a general approach of regulation by enforcement, which not only discourages innovation, but in many cases also fails to protect investors and consumers. For example, in recent years the Securities and Exchange Commission (SEC) has received a number of public petitions for rulemakings to provide greater clarity as to how existing rules apply to cryptocurrencies and digital asset service providers,⁹ ¹⁰ proposals which have been echoed by current Commissioners.¹¹ However, rather than conducting a formal rulemaking process, the Commission has left investors and market

¹ <https://journals.sagepub.com/doi/pdf/10.1177/000276422211003162>

² https://www.eurofound.europa.eu/sites/default/files/ef_publication/field_ef_document/ef22042en.pdf

³ <https://documents1.worldbank.org/curated/en/552411525105603327/pdf/The-decline-in-access-to-correspondent-banking-services-in-emerging-market%20s-trends-impacts-and-solutions-lessons-learned-from-eight-country-case-studies.pdf>

⁴ <https://morningconsult.com/cryptocurrency-insights-hub/> and <https://crypto4innovation.org/1-in-7-voters-own-crypto-with-support-across-party-lines/>

⁵ Purchasers of digital assets actually vary widely in terms of demographics: Average cryptocurrency buyer is under 40 (mean age is 38); • 55% do not have a college degree; • 44% of crypto traders are not white; • 41% of traders are women; and 35% have household incomes of less than \$60K annually. <https://www.kansascityfed.org/research/payments-system-research-briefings/the-cryptic-nature-of-black-consumer-cryptocurrency-ownership/>

⁶ <https://coinmarketcap.com/>

⁷ <https://www.developerreport.com/developer-report>

⁸ <https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/>

⁹ <https://www.sec.gov/rules/petitions/2022/petn4-789.pdf>

¹⁰ <https://www.sec.gov/rules/petitions/2022/petn4-782.pdf>

¹¹ <https://www.sec.gov/news/statement/peirce-statement-kraken-020923>

participants to try to understand the applicability of SEC rules to digital assets by analyzing a growing number of enforcement actions.¹²

In recent weeks, federal prudential regulators have also spurred uncertainty among crypto market participants and the financial institutions from which they obtain banking services through the issuance of a series of new guidance documents.¹³ On January 3, the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) issued a joint statement warning depository institutions of potential risks to their safety and soundness associated with providing banking services to digital asset service providers and other “crypto-asset sector participants”.¹⁴ While the regulators claim in their guidance that the institutions they regulate “are neither prohibited nor discouraged from providing banking services to customers of any specific class or type,” they also go on to state that “the agencies have significant safety and soundness concerns with business models that are concentrated in crypto-asset-related activities or have concentrated exposures to the crypto-asset sector.” As a result of this guidance, crypto industry market participants have begun to encounter increased challenges, in what was already a challenging environment, in obtaining access to basic and critical banking services, such as deposit accounts for employee payroll.

Additionally, the guidance issued by the agencies highlights concerns regarding “concentration risks for banking organizations with exposures to the crypto-asset sector.” However, the effect of the agencies’ guidance is counter to the ostensible objective. Rather than reducing concentration risk, by discouraging this activity, these regulatory signals will likely reduce the number of financial institutions willing to provide banking services to crypto-related clients even further, resulting in increased concentration risk. High concentration in any one sector – not just crypto – poses risks to an individual financial institution. To decrease these risks, regulators should encourage deposits to be dispersed at a large number of banks of all sizes.

As a result of many of the steps taken by federal financial regulators, the U.S. is becoming an increasingly challenging environment for innovation around crypto, digital assets, and blockchain technology to take place. In the event that digital asset companies cannot conduct their businesses in the United States – because of ongoing regulatory uncertainty, lack of access to the banking system, or both – they will have no choice but to shift their operations to other jurisdictions.

This outcome stands in stark contrast to many of the objectives of EO 14067. It also threatens the position of the United States as a leader in technological innovation and in the global financial system. Many foreign jurisdictions, including the European Union, Japan, United Kingdom, Singapore, Australia, and Hong Kong, have taken significant steps towards establishing new regulatory regimes

¹² <https://www.pionline.com/cryptocurrency/sec-ramped-cryptocurrency-enforcement-2022-report-shows>

¹³ <https://www.reuters.com/business/finance/us-regulators-warn-banks-be-alert-crypto-related-liquidity-risks-2023-02-23/>

¹⁴ <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf>

for the governance of digital asset markets.¹⁵ As other countries seek to harness the benefits of digital assets, the risk of offshoring American innovation poses significant risks to both economic and national security. A cautionary parallel is happening contemporaneously with semiconductor manufacturing, which the United States is now desperately trying to bring back onshore for similar reasons. In addition, small businesses, and populations who have been historically excluded from financial services, stand to lose the most if the crypto industry moves offshore and their ability to deploy their assets as they deem fit is diminished.

The Crypto Council welcomes the efforts of the House Financial Services Committee to explore avenues to establish clear rules of the road that foster innovation, provide critical protections for consumers and our financial system, and preserve the technological cutting edge of the United States.

Sincerely,

A handwritten signature in dark ink, appearing to be 'S' followed by a long horizontal stroke.

Sheila Warren
Chief Executive Officer
Crypto Council for Innovation

¹⁵ <https://www.banking.senate.gov/imo/media/doc/Jeng%20Testimony%202-14-23.pdf>



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National Association of Federally-Insured Credit Unions

March 8, 2023

The Honorable French Hill
Chairman
Committee on Financial Services
Subcommittee on Digital Assets,
Financial Technology and Inclusion
United States House of Representatives
Washington, DC 20515

The Honorable Stephen Lynch
Ranking Member
Committee on Financial Services
Subcommittee on Digital Assets,
Financial Technology and Inclusion
United States House of Representatives
Washington, DC 20515

Re: Tomorrow's Hearing: "Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem"

Dear Chairman Hill and Ranking Member Lynch:

I write to you today on behalf of the National Association of Federally-Insured Credit Unions (NAFCU) to share our thoughts on issues of importance to credit unions ahead of tomorrow's hearing, "Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem." NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve over 135 million consumers with personal and small business financial service products. We would like to thank you for this opportunity to share some thoughts regarding digital assets and stablecoins.

Recent developments in the digital asset and stablecoin space have proven both the enormous potential of these innovations and the need for regulation. Distributed ledger technology and other technologies that support a broad ecosystem of digital assets offer an array of potential operational efficiencies. For example, the ability to facilitate payment transactions integrated with smart contracts, either through use of stablecoins or other digital assets, may help members with specific business needs and potentially reduce credit unions' operational costs. Most importantly, digital assets technologies can be designed with strong auditability features, which can enhance regulatory compliance and reduce instances of human error, fraud, and other misconduct. However, the absence of a clear regulatory environment and appropriate supervisory framework poses risks to the adoption of these otherwise promising technologies. NAFCU supports a competitive framework for digital assets that preserves credit unions' ability to compete with other financial institutions and companies on a level playing field.

A digital assets framework aimed at fostering equitable growth should seek to mitigate the potential for regulatory arbitrage by emphasizing the applicability of transparent prudential oversight, robust safety and soundness protections, and the application of consumer and investor protection laws to entities engaged in providing digital asset services or products to consumers. We urge Congress to explore ways to provide regulatory certainty and parity across the financial services system and ensure a level playing field for all with new and emerging financial technology. As you do so, we urge you to ensure the needs

The Honorable French Hill
The Honorable Stephen Lynch
March 8, 2023
Page 2 of 2

of credit unions and their unique structure as member-owned cooperatives are considered in any legislative approach you undertake in the future.

As the Subcommittee examines recent turmoil in markets for digital assets, NAFCU would like to reiterate its opposition to a central bank digital currency (CBDC), which some have called for as an alternative to unregulated digital assets. Introducing a CBDC is not the appropriate solution for addressing the risks of stablecoins, cryptocurrencies, or other digital assets. The best tool for addressing stablecoin risk is an appropriate regulatory framework developed with the input of relevant federal banking regulators, including the National Credit Union Administration (NCUA). Furthermore, NAFCU believes the vast federal administrative resources needed to develop a CBDC could be put to better use, particularly in the domain of financial inclusion, by prioritizing existing financial sector infrastructure and community development programs. A CBDC could, theoretically, yield greater payments efficiency in a country that currently lacks mature payment systems; however, American consumers already have access to numerous options for making fast, safe, and affordable payments. In this regard, hypothesized improvements to domestic and cross-border payments would likely be marginal, especially when real-time payments can already be made, and the improvements needed to reduce international remittance costs are largely reliant upon legal harmonization efforts which do not depend on the technical infrastructure of a CBDC. Additionally, a direct-to-consumer CBDC would be impossible to implement without some form of consumer accounts being offered at the Federal Reserve, which NAFCU has consistently opposed.

We thank you for the opportunity to share our thoughts and look forward to continuing to work with you on this important issue. Should you have any questions or require any additional information, please contact me or Lewis Plush, NAFCU's Senior Associate Director of Legislative Affairs, at (703) 258-4981 or lplush@nafcuhq.org.

Sincerely,



Brad Thaler
Vice President of Legislative Affairs

cc: Members of the House Financial Services Subcommittee on Digital Assets, Financial Technology and Inclusion



Statement for the Record
House Financial Services Committee
Digital Assets, Financial Technology and Inclusion Subcommittee Hearing
"Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem"

March 9, 2023

Dear Chairman McHenry, Ranking Member Waters, Subcommittee Chair Hill, and Ranking Subcommittee Member Lynch,

On behalf of Americans for Financial Reform and Demand Progress, we submit this letter for the record in connection with House Financial Service Committee's Subcommittee on Digital Assets, Financial Technology and Inclusion Hearing on digital assets taking place today. We urge the Committee to pursue meaningful oversight of and accountability for the crypto industry, and to abandon measures that would instead weaken such efforts, in the name of dubious claims about crypto's potential for financial innovation.

1. The Crypto Industry's Failure is Largely Its Own Fault

Crypto industry representatives and their allies in Congress have been quick to suggest that the massive crypto market failure that began in 2022 and continues today is primarily the fault of a few bad actors within the industry and regulators who did not provide "regulatory clarity" for crypto firms and who also failed to act quickly and decisively enough to prevent the market's collapse.

Some of these claims, which come from not only industry voices but by policymakers in this body, verge on conspiratorial, accusing regulators of collusion with both legacy financial institutions and now infamous players within the crypto space.¹ This is bitterly ironic, given that some of the policy makers making these claims were, at the height of the crypto bull market and just before the crash, actively seeking to impede SEC investigations and oversight into the actions of firms like FTX.²

The lion's share of responsibility for the crash lies with the industry. It seems strange to have to provide a reminder of this point, but the crypto crash has eliminated roughly \$2 trillion in investors' assets; caught up millions of investors in prolonged bankruptcy proceedings with

¹ <https://cointelegraph.com/news/republican-lawmaker-claims-sec-chair-was-coordinating-with-ftx-to-obtain-regulatory-monopoly>

² <https://prospect.org/power/congressmembers-tried-to-stop-secs-inquiry-into-ftx/>

little hope of full redemption; illustrated the poor custody practices – or outright theft – practiced by many crypto platforms; exposed the deeply interconnected relationships between various crypto firms which, in turn, point to rampant conflicts of interest; demonstrated how many firms were overleveraged and under-capitalized; and revealed woeful due diligence on the part of both venture capital, private market and institutional investors exposed to crypto markets – just to name a few issues. The problems raised here are business and financial regulation 101 – traditional financial firms and businesses of many kinds navigate these requirements every day. These are fundamental failures of industry practice.

If that were not enough, however, we only have to look at the ongoing systemic problems in the industry **right now** to once again recognize how deep the governance, compliance and performance problems go in the crypto sector.

Just in the past **two weeks**, more details have emerged pointing to widespread misdeeds by industry leaders.

- The SEC charges filed against Terra founder Do Kwon allege that Terra, the once popular algorithmic stablecoin highly touted by crypto industry players and backers, may have **never actually been** a legitimate stablecoin, and that instead a third party may have helped to prop up the coin to make it look like it was one.³
- An investigative report from the *Wall Street Journal* (WSJ) published this past Saturday alleges that Tether – **the most widely used stablecoin in the crypto industry, with a past record of wrongdoing and suspicious activity** – falsified documents and used shell companies to secure bank accounts, in some cases using third party names and entities linked to money laundering.⁴
- Another recent investigation by the *WSJ* alleges that **Binance** executives created a plan to 'neutralize US authorities' in part to avoid or mitigate regulatory scrutiny. This alleged plan involved the creation of US legal entities, including Binance.US, to create the appearance of an independent business, despite the fact that ownership and control of the entity was deeply intertwined with the parent company.⁵
- Meanwhile, also this past week, a *Forbes* magazine investigation claims Binance moved \$1.8 billion of collateral meant to back its customers stablecoins last year and put those assets to other undisclosed uses, leaving those assets unbacked for a period of months. This was despite claims by the firm that those assets were 100% backed, and observers say this practice is "eerily" similar to similar actions taken by FTX.⁶

³ <https://decrypt.co/121575/sec-files-lawsuit-against-terraform-labs-and-founder-do-kwon>

⁴ <https://www.wsj.com/articles/crypto-companies-behind-tether-used-falsified-documents-and-shell-companies-to-get-bank-accounts-f798b0a5?mod=mhp&s=03>

⁵ <https://www.wsj.com/articles/texts-from-crypto-giant-binance-reveal-plan-to-elude-u-s-authorities-3a17ddeb>

⁶ <https://www.forbes.com/sites/javierpaz/2023/02/27/binances-asset-shuffling-eerily-similar-to-maneuvers-by-ftx/?sh=14d12078bccd>

- Binance is also facing likely fines and penalties from the DOJ as a result of its alleged violations of anti-money laundering laws.⁷ This doesn't come as a surprise; a *Reuters* investigation from June 2022 alleged that for a period of five years from 2017 to 2021, Binance served as a conduit for the laundering of at least \$2.35 billion in illicit funds, stemming from hacks, investment frauds and illegal drug sales.⁸
- Voyager Digital's Unsecured Creditors' Committee filed a report in bankruptcy proceedings this past week that examined Voyager's lending practices. The report asserted that a major reason the company became insolvent was because of a single unsecured loan made to now defunct crypto hedge fund Three Arrows Capital - one that was over a quarter of their loan book. The loan was made March 8, 2022, just two months before the Terra-Luna collapse. Voyager's leadership reportedly knew they were embarking on risky lending strategy, yet the due diligence on 3AC allegedly amounted to a single-sentence statement of 3AC's net asset value and a half hour phone call.⁹
- A profile in *Forbes* magazine of a lawsuit filed by wealthy tech founder Ryan Breslow lays out how Breslow hired a developer previously convicted of federal wire fraud and money laundering charges to engineer a new crypto protect called Movement DAO - a decentralized autonomous organization that Breslow and his co-founders created to be a "community-run platform for funding social impact causes." Breslow is suing developer Mark Phillips - who was given high levels of access to the platform - for the alleged theft of more than two-thirds (\$10 million+) of seed funding invested in the program, which disappeared earlier this year. Phillips has dismissed the allegations and has claimed instead it was Breslow that sought to "pull the rug [e.g., rip off] on Movement."¹⁰

Voyager, Tether, Celsius, FTX, Terra Luna, 3AC, BlockFi, Nexo - these firms are not obscure, fringe elements of an otherwise upstanding crypto industry. These firms arguably are the industry, or at the very least, major stars in its firmament.

For policymakers and other stakeholders to have an effective and reasonable discussion about the proper regulatory response to the problems and failures of the crypto industry, it starts with the industry taking full responsibility for its actions, and not finger-pointing at regulators.

2. The SEC and Banking Regulators Have Approached Crypto Regulation in Sound Manner

Regulatory agencies are fallible and can be slow to respond to fast moving developments, regardless of the context. They also often have competing priorities - in the case of financial

⁷ <https://www.coindesk.com/policy/2023/02/16/binance-bracing-itself-for-fines-from-us-regulators-to-settle-past-conduct-WSI/>

⁸ <https://www.reuters.com/investigates/special-report/fintech-crypto-binance-dirtymoney>

⁹ <https://amycastor.com/2023/03/04/crypto-collapse-silvergate-implosion-continues-signature-bank-tether-lied-to-banks-voyager-celsius/>

¹⁰ <https://www.forbes.com/sites/ianmartin/2023/03/03/ryan-breslow-bolt-convicted-fraudster-movement-dao-lawsuit/?sh=3fc6878b9f70&s=03>

markets for example, market regulators have the dual objective of providing protection for investors while also creating clear rules of the road that facilitate capital formation. Regulators are also often famously underfunded – in part thanks to a decades-long effort by some in Congress to defund and marginalize regulatory agencies’ efforts to provide meaningful and effective oversight and accountability.

Despite these challenges, we would argue that the SEC and banking regulators have taken meaningful and effective steps to protect investors (particularly investors outside of or adjacent to crypto markets, which comprise a much larger pool of investors), financial systems and markets from the obvious risks present with the crypto industry.

A number of organizations and experts have enumerated in detail several steps that the SEC in particular has taken to appropriately and effectively regulate crypto actors, enforce securities laws, and protect investors. We’ve attached links and excerpts to a few of those papers to this statement as an appendix for further review by policy makers. But in short, the SEC:

- As of January 18, 2023, has brought 127 successful enforcement actions (and more since that date) against actors in the crypto space that were out of compliance.
- Issued an Investors Alert on "Ponzi Schemes Using Virtual Currencies" in 2013, and another alert in 2014 on "Bitcoin and Other Virtual Currency-Related Investments."
- In 2017, released a Section 21a report of an investigation into The DAO, concluding the tokens the firm offered met the Howey Test, clearly communicating the agency's understanding that those who would use a DAO (decentralized autonomous organizations) or distributed ledger technology to raise capital should ensure compliance with securities laws.
- In 2019, released a "Framework for Investment Contract Analysis of Digital Assets," providing details on when a digital asset has the characteristics of an investment contract.
- In multiple speeches, testimony, and official Commission statement, SEC Chair Gensler has raised concerns about the risks associated with crypto platforms, and consistently conveyed the Commission’s view that most crypto assets are securities or operating out of compliance with securities law, and that firms should seek to register.¹¹

Moreover, the approach the SEC is taking now has merit. The crypto sector has at one count over 12,000 individual tokens that have been issued and are being traded (and that may be an undercount);¹² to effectively hold each token issuer’s hand as they go through the registration process (assuming that’s even appropriate) would take more than the full roster of employees retained by the SEC overall. In contrast, most crypto trading and investment activity takes place

¹¹ For a more detailed analysis of the SEC’s record on regulatory guidance and enforcement with respect to crypto assets, please see the testimony of Lee Reiners (Policy Director, Duke Financial Economics Center) before the Senate Banking Committee in January 2023 - <https://www.banking.senate.gov/imo/media/doc/Reiners%20Testimony%202-14-23.pdf>

¹² <https://www.fool.com/investing/stock-market/market-sectors/financials/cryptocurrency-stocks/how-many-cryptocurrencies-are-there/>

on a handful of major crypto exchanges. Those exchanges, being mostly vertically integrated, also often provide brokerage services and clearinghouse services as well. The exchanges are the on-ramp and off-ramp for most tokens seeking buyers or products seeking investors. And these exchanges – as we’ve seen with FTX and others – present some of the most potent vulnerabilities when comes to investor protection, disclosure, market fairness and stability risks.

Hence, the ramped-up focus by the SEC on exchanges and firms providing ersatz brokerage services is a more efficient and strategic approach to ensuring system-wide change in the industry. If exchanges are obliged to register and meet existing standards, their adoption of such standards would force token issuers and other crypto market participants to adhere to their standards in return.

3. The industry is measuring itself with a private markets yardstick – not a public markets one

Industry voices claim that the process to become a registered exchange or securities issuer is difficult and onerous. The reality is that, to a certain extent, it should be. The rules governing those listing and registration processes have been hammered out over a century of financial crises and responses. Issuing an investment product to the general public, with the support of financial regulators, SROs and other assistance from the US government, should require rigorous standards to be met.

Meanwhile, many crypto firms are accustomed to operating in a private markets offering context, where standards are less rigorous – and where we and other public interest organizations have warned such less rigorous standards have created conditions that have allowed private market actors to conduct a range of risky and unethical business practices that are harming investors, ordinary Americans and our financial system as a whole.

The reality is that many crypto asset issuers and actors, under current conditions, would struggle to meet the standards required for public listing. The registration requirements alone would require greater disclosures, more financial reporting and auditing, greater details and vetting of issuers’ management and governance practices, and more sober, detailed analysis of a product’s essential value and inherent risks. But, when the industry culture is dominated by products that are created overnight, issued with white papers that are vague, grandiose and replete with industry specific, self-referential jargon (not standardized terms), the problem is not the registration requirements, it’s the industry’s ability to meet them.

4. The Legislative Proposals Considered in the Hearing Are Deregulatory in Nature and Are A Step Backwards for Investor and Consumer Protection and Financial Safety and Stability

On January 23, 2023, Committee Chair McHenry was quoted, in response to questions about the recent crypto crash, “We have a massive number of fraudsters that are acting in this space,

and we have little regulatory clarity, and little clarity under law.”¹³ During a December 2022 hearing to examine the collapse of FTX, in reference to the over one million creditors negatively impacted by that collapse, Subcommittee Chair Hill said, “Americans were hurt. And I want everyone listening to know in today’s hearing that this is just the first step that Congress is taking to get an understanding of what happened and how to create the appropriate regulatory environment.”¹⁴

One could view these statements as recognition that more needs to be done to protect investors from fraud and harm found within crypto markets. Yet, the bills proposed by the Committee’s Republican leadership today seem to move in the opposite direction. Each of these bills appear largely deregulatory in nature. We are deeply concerned that these measures could weaken, not strengthen, oversight for the crypto industry, and enable further harm and abuse in this sector.

The Keep Your Coins Act, sponsored by Rep. Davidson (R-Oh.), would effectively prohibit regulators from overseeing the use of self-hosted crypto wallets for transactions dealing with goods and services. The rationale for this bill is to protect consumers’ privacy when conducting regular business and differentiate ‘ordinary’ transactions from ones associated with investment activity. But it’s possible that if this bill were passed, it would be more difficult for regulators to use consumer protection laws such as the Electronic Funds Transfer Act to protect and assist consumers that are victims of fraudulent transactions or scams that involve such wallets (which in many case perform functions similar to bank accounts, not actual wallets). This is critically important given the high frequency of scams already found in crypto markets. It’s also possible other large non-bank payment platforms such as Venmo or PayPal might use this self-custodied wallet carve-out to avoid compliance with consumer protection laws, which could impact millions of consumers, even those who haven’t even touched crypto. The bill may also allow bad actors to more easily use self-custodied wallets to bypass or undermine anti-money laundering due diligence requirements.

The Financial Technology Protection Act would create an interagency working group to ‘study’ the intersection between financial technology and illicit finance. Such a study presents as a neutral exploration of this intersection, but we fear this is proposal may be more of a stall tactic to delay or diffuse crypto platforms’ compliance with basic anti-money laundering/know your customer rules.

Many actors in the crypto space are or have been found out of compliance with these rules. For example, major US crypto exchange Coinbase recently reached a \$100 million settlement with the New York Department of Financial Services after the agency found the platform let customers open accounts without conducting sufficient AML/KYC background checks.¹⁵ Major

¹³ <https://www.ny1.com/nyc/all-boroughs/politics/2023/01/24/--it-was-a-wild-week---rep--mchenry-recounts-tumultuous-speaker-vote>

¹⁴ Quote from PoliticoPro Transcription of House Financial Services Committee Hearing “Investigating the Collapse of FTX, Part I,” December 13, 2022.

¹⁵ <https://www.nytimes.com/2023/01/04/business/coinbase-settlement-anti-money-laundering.html>

platform Binance is under investigation by the Department of Justice for what may likely be similar violations,¹⁶ and has been accused of more widespread AML violations and failures by a bipartisan group of Senators earlier this month.¹⁷ Our concern is that this study would simply “kick the can down the road” with regard to ensuring crypto platforms are abiding by basic AML requirements, making it easier for bad actors that exploit crypto platforms for the purposes of laundering illicit funds to continue with business as usual.

The Keep innovation in America Act, sponsored by Rep. McHenry (R-N.C.), seeks to rescind tax rules laid out in the recently adopted Infrastructure and Investment Jobs Act, which clarified that anyone acting as a broker involved in the sales or trading of digital assets, including so-called crypto miners, must report the same tax information as brokers dealing in other more traditional assets.

This change in the tax law was both fair and necessary. Crypto miners – largely firms that pool computing resources to ‘validate’ transactions on the blockchain using energy intensive computing processes – often argue that they don’t qualify as ‘financial intermediaries’ because they are simply validating transactions, not acting as brokers or other intermediaries. But those claims don’t hold up well under scrutiny. For example, a June 2022 analysis conducted by the Bank of International Settlements showed that, since miners ‘choose’ which transactions are added to the ledger and in what order (and are sometimes even paid to move certain transactions to the front of the line) they are acting as intermediaries in these financial transactions and sometimes may even be engaging in a form of market manipulation.¹⁸ This and other examples make the case that if miners are facilitating trades that result in taxable income for market participants, like other intermediaries, it’s only fair that they have similar reporting obligations.

What is more, individuals who invest in crypto and earn income or capital gains as a result need reliable information from the third parties that facilitate crypto transactions – just as they would from more conventional financial institutions – or else they risk failing to comply with their own tax reporting obligations.

Lastly, the link between crypto and tax evasion is a strong one. A Barclays analysis from 2022 showed there maybe a \$50 billion a year more tax gap in the U.S. as result of nonpayment of taxes owed on crypto transactions.¹⁹ Better tax reporting would help close this gap, simply by

¹⁶ <https://www.reuters.com/markets/us/us-justice-dept-is-split-over-charging-binance-crypto-world-falters-sources-2022-12-12/>

¹⁷ <https://www.investors.com/news/binance-accused-of-money-laundering-criminal-activity-by-senators-bitcoin-retreats/#:~:text=Binance%20Alleged%20Charges&text=Over%20the%20course%20of%20three,by%20Binance%20CEO%20Changpeng%20Zhao.%22>

¹⁸ <https://www.bis.org/publ/bisbull58.htm>

¹⁹

<https://www.cnn.com/2022/05/18/irs-may-be-missing-out-on-50-billion-dollars-a-year-in-unpaid-crypto->

ensuring that taxpayers who benefit from cryptocurrency investments pay what they owe. Yet, this bill would likely weaken or narrow these definitions and tax reporting obligations, allowing crypto miners and validators to avoid tax reporting obligations, likely making it easier for tax evaders to evade the law and harder for honest crypto investors to abide by it.

The Blockchain Regulatory Certainty Act, sponsored by Rep. Emmer (R-Minn.) would prohibit or restrict financial regulatory oversight of software designers or developers who create blockchain protocols that facilitate crypto finance. We have serious concerns about this legislation, which could amount to a fin reg “get out of jail free” card for decentralized finance. There are certainly serious conversations to be had about the tension between protecting code if or when it amounts to an expression of speech while also ensuring software developers can’t just write code that is directly intended to facilitate potentially risky financial transactions, including illicit ones, and simply wash their hands and pretend they have little or no responsibility for the outcome.

This bill is not grounded in that serious conversation; it appears to be a blanket carve out for the DeFi industry, which faces serious problems with hacks, scams and financial instability despite the industry insisting DeFi can “solve” the problems of centralized finance with technology. Furthermore, it’s possible this bill would undermine existing financial regulations for traditional finance; it’s not hard to see how the bill’s vague language and broad definitions would invite traditional financial companies that use or develop software to conduct hi-frequency trading strategies to seek similar exemption under this law.

Lastly, the proposed **Resolution expressing Congressional support for blockchain technology and digital assets** is breathtaking in its demonstration of selective memory. The ink isn’t even dry on the various indictments levied at Sam Bankman-Fried and his alleged co-conspirators. More criminal actions against other major players in the crypto industry are underway or are likely coming. Millions of investors and creditors have individually lost significant amounts of money as the result of this malfeasance; many have lost it all. Major players in the industry have failed to meet even elementary investor protection standards. None of this should elicit confidence in the crypto industry’s record, yet Members of Congress are introducing this resolution, as if the ongoing crypto collapse is already a distant memory. Imagine if, in early 2009, Members of Congress decided to issue a resolution expressing support for the underlying innovative potential of sub-prime lending?

The technological potential of blockchain is also highly contested. Many of the use cases for crypto have so far failed to deliver on their promises, and there is division in the computer engineering world as to whether blockchain’s structural limitations can be overcome, or are worth investing in, given the existence of products that provide the same benefits without the same drawbacks. As one example, in June 2022 more than 1500 technologists with expertise in

[taxes.html#:~:text=In%20a%20new%20analysis%20released,as%20%2450%20billion%20per%20year.](#)

computer science and engineering sent a letter to Congress expressing serious doubts about the technology's risks and potential:

"By its very design, blockchain technology is poorly suited for just about every purpose currently touted as a present or potential source of public benefit. From its inception, this technology has been a solution in search of a problem and has now latched onto concepts such as financial inclusion and data transparency to justify its existence, despite far better solutions to these issues already in use."²⁰

The crypto industry has thus far largely failed to deliver on its promises to provide a more fair, safe, efficient, and equitable way for people to engage in financial activities, and instead has facilitated widespread fraud and abuse that has harmed millions of investors and consumers. Instead of taking full responsibility for this failure and working constructively with policymakers to pursue fair and consistent ways of complying with existing rules that protect consumers and investors, the industry has for the most part pursued a strategy of laying blame at the feet of everyone else – regulators, a "few bad apples", legacy financial institutions, or policy makers that just don't "get it". Unfortunately, some in Congress are playing the same tune, and if it continues, it will be consumers and investors that will be harmed again by Congress' failure to hold bad actors in this industry accountable and truly address the systemic harms and failures in this industry.

Instead of proposing deregulatory legislative measures that would weaken oversight of this industry, Member of this Committee and Congress in general should support effective efforts by the SEC, major banking regulators and others to hold the line and oblige crypto industry players to come into compliance with existing financial regulatory measures. One means of offering such support would be for Congress to provide significant increased funding for financial regulatory agencies to deal with the fallout of the crypto collapse.

We thank you for taking these comments into consideration and would be happy to respond to any questions or comments Committee members might have in response.

Sincerely,

Mark Hays
Senior Policy Analyst
Americans for Financial Reform
markhays@ourfinancialsecurity.org

²⁰ <https://concerned.tech/>

**Appendix: Selected Resources on Regulatory Response to
Crypto Firms Non-Compliance and Other Themes**

Gensler Got it Right – The American Economic Liberties Project

Synopsis: This piece argues that, while the SEC has been criticized for not taking enough action against the crypto industry, the reality is that they have done more than they are given credit for. Under Chair Gensler, the SEC has attempted to crack down on some of the abuses with the crypto currency space. The crypto industry claims that crypto can serve as a functional currency, but it has been largely used as a speculative investment. However, unlike other securities, crypto's value comes from no real economic activity and faces minimal regulation compared to other securities.

To start, the agency, in coordination with banking regulators, has largely kept crypto out of the banking system, potentially preventing a future financial crisis related to crypto. The SEC has also maintained a consistent requirement for all commodity- trust- exchange traded products, which prevented Greyscale and other crypto companies from creating a Bitcoin spot ETF. Gensler has continued to make crypto enforcement a priority and has gone after its largest players. This includes the prevention of crypto lending products entering the market, and an ongoing investigation into Terra and its Terra/Luna coins, and the company's founder Do Kwon. Since the publication of this article, the SEC has charged Do Kwon in federal court for defrauding investors. The SEC has also prevented crypto companies from entering the public stock market and has fought against light touch regulation of the crypto industry, pointing out that this would undermine securities law and the authority of the SEC.

US Regulators are Cleaning Up the Crypto Industry – The American Economic Liberties Project

Synopsis: This article provides an argument for why, by using existing laws, the SEC and other financial regulators have taken a decisive step in regulating crypto. While the SEC has taken a leading role, they are joined by the Fed, FDIC, and the Office of the Comptroller of the Currency in highlighting the potential risks that crypto has to the financial system. These risks include: fraud, scams, significant volatility, institutional mismanagement, misleading and false advertising, among other claims. The SEC has taken action against multiple crypto firms in the past few months. It shut down Kraken's staking program, as well as Genesis and Gemini for an illegal crypto lending program. The Federal Reserve also issued a policy statement discouraging banks from working with crypto assets and denied a crypto firm membership in the Federal Reserve system.

Why "SEC Regulation by Enforcement" is a Bogus Big Crypto Catchphrase – John Reed Stark:

Synopsis: This extensive piece argues that the phrase "regulation by enforcement" misrepresents the way in which the SEC goes about securities regulation in general, and in particular how the SEC has used existing securities law and regulatory guidance to appropriately

oversee the crypto sector. Securities regulation is principles-based, with broad definitions and has often been formed through litigation. This allows the SEC to be flexible to new technologies and products as they arise and enforce regulation as the financial landscape changes. The crypto industry has decried this practice as “regulation by enforcement” saying that it will stifle innovation and that regulation needs to be created that is specific to crypto. Chair Gensler has pushed back against this claim, saying that crypto firms can come talk to the SEC and has clearly implied he believes most cryptocurrencies are securities and should be regulated as such. The principles-based approach of securities regulation is what allows securities regulation to work, and that, “The flexibility of SEC statutory weaponry is an SEC hallmark, enabling SEC enforcement to keep fraud in check.” The piece then goes on to evaluate in detail some of the legal details of various SEC enforcement actions and litigation, ultimately making a case for why the enforcement actions levied against crypto platforms are an appropriate regulatory response to an industry that is largely out of compliance with existing securities laws and regulations.

[The SEC’s Excellent Record on Crypto: Regulation and Enforcement](#) – Better Markets

Synopsis: This report argues that the SEC has an excellent track record when it comes to regulating the crypto industry. The SEC has consistently worked to enforce laws that all other US financial companies are already required to follow and has issued new guidance related to cryptocurrency and digital assets. Despite these efforts, the SEC has faced criticism from all sides for its actions, both for being overbearing in its enforcement and for not doing enough of it. The SEC has managed to do all this while facing significant challenges including: underfunding, low staffing levels, and fierce opposition from the crypto industry.

[Debunking the Narratives about Cryptocurrency and Financial Inclusion](#) – Tonantzin Carmona, Brookings Institution

Synopsis: This piece analyzes the claims made by the crypto industry regarding its potential for fostering financial inclusion, versus the reality of how many crypto products either fail to address barriers to financial inclusion or mimic the injustices found within the traditional financial sector. Many people, including people and communities of color, as well as those with low-incomes, face a chronic lack of access to affordable and fair financial services and products. This is a major concern that policy makers should work to address, especially since studies have shown that these groups have less trust in traditional financial institutions, due to the endemic racism and other forms of injustice that are found throughout this system.

This state of affairs has created an opening for the crypto industry to try to fill the gaps, presenting themselves and the potential of their technology as a solution for these communities. However, this paper argues that there is a crucial difference between the current state of crypto and its potential. In its current state, crypto could have an outsized negative impact on the communities it purports to want to help and is still largely inaccessible to them.

The crypto industry has two main arguments for its potential: One, that crypto will provide easy access to financial services; and two, that crypto can help marginalized investors and communities build wealth in a more accessible and equitable way.

The problem with the first argument is that crypto's volatile qualities make investments risky for many participants, a poor choice for payment services, and that in most cases investors need access to banking services anyway to engage in crypto related activities. The challenge with the second argument is that crypto's volatility, poor business practices and lack of meaningful regulation means that investors from marginalized communities are being exposed to high levels of risks with less protection and with less financial cushion than more affluent, white investors. This means that crypto may be serving as more of a form of 'predatory' financial inclusion than as a more equitable pathway to wealth. The paper explores these claims in more detail.



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March 9, 2023

The Honorable Patrick McHenry
Chair
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Chair McHenry and Ranking Member Waters:

We write to urge prompt Congressional action on stablecoin legislation and to outline fundamental principles for effective regulation of these important assets.

Over the last year, digital asset markets have experienced significant turmoil, culminating in the now-infamous failure of the Bahamas-based exchange FTX. The blockchain industry has felt the impact of these events far and wide, with even the most rigorous, resilient, and highly-regulated companies suffering commercial and reputational damage due to the carelessness and misconduct of bad actors.

The industry now finds itself in a period of reflection and self-examination. There is no doubt that blockchain technology has the power to fundamentally reshape the global financial system and digital economy to be more innovative, efficient, and inclusive. Yet, many stakeholders are questioning how an industry driven by the desire to eliminate reliance on third parties fell victim to the same risks that characterize traditional finance.

Through this process of self-analysis, the industry is poised to emerge with a renewed sense of purpose and commitment to its mission. Despite the views of some skeptics, crypto is here for good, and blockchain-based digital assets will play a crucial role in the lives of everyday Americans. The industry is convinced that, to achieve its goal of responsible innovation, outdated laws and regulations must be revised to address the unique nature of public blockchains. The time has come for Congress to take action.

Blockchain Association is the leading nonprofit membership organization focused on promoting a pro-innovation policy environment for the U.S. blockchain industry. We represent more than 100 member companies from every sector of this dynamic industry, including software developers, infrastructure providers, exchanges, custodians, investors, and more. Our member companies are strongly committed to regulatory compliance and



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have long requested clear rules of the road from U.S. policymakers so that they can build safe, sound, and successful businesses here in the United States.

Regulatory clarity is essential to ensure that the United States remains the world leader in the development of blockchain technology and to protect digital asset investors and consumers from harm. As a matter of law, only Congress — not the federal agencies — can decide how digital assets should be regulated. We recognize that it will take significant time and careful study to determine how best to regulate many of these novel, complex assets and the applications in which they are used. But one type of digital asset is already ripe for tailored legislation: stablecoins.

A. Congress Must Pass Stablecoin Legislation.

Stablecoins are digital assets that maintain a stable value compared to a reference asset, typically the U.S. dollar. Stablecoins represent a categorical improvement on legacy payment infrastructure, allowing users to transfer any amount of value to any person anywhere in the world nearly instantly and at nearly zero cost. Stablecoins are transmitted on public blockchains, which outperform existing payment rails that are slower, more expensive, and exclusive to incumbent financial institutions.

Unlike traditional payment methods, stablecoins are accessible by anyone with an internet connection, enabling billions of people around the world who lack financial services to join the global economy for the first time. In so doing, stablecoins reinforce the dominance of the U.S. dollar as the global reserve currency at a time when our foreign adversaries, such as China, are actively seeking to undermine that status.¹

Although stablecoins have only existed for a short time, they have already shown a meaningful, positive impact on the global stage. Today, stablecoins are used by the United Nations Refugee Agency (UNHCR) to distribute dollars to internally displaced persons and other war-affected people in Ukraine;² for cross-border remittances between family members working and living abroad;³ by citizens in countries ravaged by

¹ Samantha Hoffman et al., *The Flipside of China's Central Bank Digital Currency*, Australian Strategic Pol'y Inst. (Oct. 14, 2020), <https://www.aspi.org.au/report/flipside-chinas-central-bank-digital-currency>.

² Michael Bodley, *Can Stablecoins Revolutionize Foreign Aid?* *The UN Thinks So.*, Blockworks (Dec. 16, 2022), <https://blockworks.co/news/un-stablecoins-revolutionize-foreign-aid>.

³ Austin Adams et al., *On-chain Foreign Exchange and Cross-border Payments* (Jan. 18, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4328948.



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inflation like Argentina, Turkey, and Zimbabwe;⁴ and to fight for the health and safety of people suffering under authoritarian regimes like that of Nicolás Maduro in Venezuela.⁵

Despite stablecoins' economic and geopolitical importance, the United States lacks a comprehensive federal framework governing existing U.S.-based firms that issue, maintain, and redeem these assets. In November 2021, the President's Working Group on Financial Markets (PWG) published a report recommending that "Congress act promptly to enact legislation to ensure that [stablecoins] are subject to a federal framework on a consistent and comprehensive basis."⁶ In May 2022, Treasury Secretary Janet Yellen reiterated this recommendation during testimony before this Committee, stating that she was "eager to work with [Congress]" on legislation through "a bipartisan effort."⁷

Since the PWG published its report, Congress has made great strides toward well-tailored legislation that maximizes the benefits and mitigates the risks of stablecoins. These extensive efforts have received bipartisan, bicameral support. Last February, Rep. Josh Gottheimer (D-NJ) released a discussion draft of the Stablecoin Innovation and Protection Act of 2022.⁸ Last April, Sen. Patrick Toomey (R-PA) released a discussion draft of the Stablecoin TRUST Act of 2022.⁹ And last fall, we were excited to hear about the progress that this Committee made on stablecoin legislation under your leadership.

We urge the Committee to resume its focus on drafting and introducing stablecoin legislation, if it has not done so already. The opportunity that well-regulated stablecoins

⁴ Sam Lyman, *Stablecoins as Statecraft: How Uncle Sam Could Replace Satoshi as the King of Digital Currency*, *Fortune: Crypto* (Feb. 26, 2023), <https://fortune.com/crypto/2023/02/26/stablecoins-statecraft-uncle-sam-satoshi-digital-currency/>.

⁵ Gideon Long, *Digital Scheme Pays Venezuela Health Workers from Frozen Funds*, *Financial Times* (Dec. 9, 2021), <https://www.ft.com/content/2a271032-35b4-4969-a4bf-488d4e9e3d18>.

⁶ Press Release, U.S. Dep't of the Treasury, President's Working Group on Financial Markets Releases Report and Recommendations on Stablecoins (Nov. 1, 2021), <https://home.treasury.gov/news/press-releases/jy0454>.

⁷ *The Annual Report of the Financial Stability Oversight Council: Hearing Before the H. Comm. on Fin. Servs.*, 117th Cong. 6-7 (2022) (statement of Janet Yellen, Sec'y, U.S. Dep't of the Treasury), <https://www.congress.gov/117/chrg/CHRG-117hhrq47651/CHRG-117hhrq47651.pdf>.

⁸ Press Release, Rep. Josh Gottheimer, Release: Gottheimer Announces "Stablecoin Innovation and Protection Act," Critical New Cryptocurrency Legislation (Feb. 15, 2022), <https://gottheimer.house.gov/posts/release-gottheimer-announces-stablecoin-innovation-and-protection-act-critical-new-cryptocurrency-legislation>.

⁹ Press Release, Sen. Comm. on Banking, Hous., and Urb. Aff. Minority Staff, Toomey Announces Legislation to Create Responsible Regulatory Framework for Stablecoins (Apr. 6, 2022), <https://www.banking.senate.gov/newsroom/minority/toomey-announces-legislation-to-create-responsible-regulatory-framework-for-stablecoins>.



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offer to the United States is substantial, and the consequences of failing to act quickly — losing ground to competing national currencies like China’s digital yuan, losing out on the benefits of a revolutionary upgrade to legacy payment systems, and losing innovators and entrepreneurs to other jurisdictions — are dire. Other countries are forging ahead with comprehensive regulatory regimes, so there is no time to waste.

B. Principles for Stablecoin Legislation.

Effective stablecoin legislation must protect consumers and promote financial innovation. To achieve that goal, stablecoin legislation should account for the risks associated with these assets while also providing a clear path for stablecoin issuers to operate in the United States. Below, we outline five principles for your consideration that we believe are essential components of a balanced bill:

1. Stablecoin legislation should focus on applying tailored regulatory standards to “custodial” stablecoins, meaning those issued, maintained, and redeemed by a firm responsible for holding assets backing the stablecoins in a bank or other financial institution. Other types of stablecoins function in materially different ways that warrant further study and thoughtful analysis before they are ready to be addressed in legislation.
2. Both insured depository institutions and non-bank firms should be allowed to issue stablecoins, subject to regulatory compliance obligations tailored for each category of issuer. Forcing all stablecoin issuers to obtain bank charters would severely restrict innovation without any attendant regulatory benefit, since stablecoins issued by properly-regulated non-bank firms will be equally safe and sound as those issued by banks.
3. Assets held by stablecoin issuers as backing for stablecoins should be limited to specified, high-quality, liquid assets that meet a minimum standard of safety and soundness. The federal regulator authorized to oversee stablecoin issuers should also be allowed to approve other assets at their discretion.
4. Stablecoin issuers should be subject to operational requirements, such as making public disclosures regarding assets held as backing for stablecoins, segregating those assets from corporate funds, implementing clear policies



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and procedures regarding issuance and redemption of stablecoins, and conducting routine audits or evaluations by registered public accounting firms.

5. Stablecoins should be overseen by a prudential regulator such as the Federal Reserve System or the Office of the Comptroller of the Currency, and should be exempt from overlapping regulation by the Securities and Exchange Commission or the Commodity Futures Trading Commission, so as to provide regulatory clarity and clear delineation of responsibility between agencies.

In addition to these principles, we strongly support the view that good stablecoin legislation can only come from a bipartisan effort. How digital assets should be regulated is a major question of national importance and has been the subject of healthy debate among people of all political persuasions for years. We are confident that bipartisanship will yield the best, most durable result for the benefit of all Americans.

* * *

We thank you for your consideration and stand ready and willing to assist the Committee on this critical issue in the coming months.

Sincerely,

A handwritten signature in cursive script, appearing to read 'Kristin Smith'.

Kristin Smith
 Chief Executive Officer

A handwritten signature in cursive script, appearing to read 'Jake Chervinsky'.

Jake Chervinsky
 Chief Policy Officer

cc: The Honorable French Hill
 The Honorable Stephen Lynch
 Members of the House Committee on Financial Services
 Members of the House Subcommittee on Digital Assets, Financial Technology, and Inclusion



Jim Nussle
President & CEO

Phone: 202-508-6745
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99 M Street SE
Suite 300
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March 9, 2023

The Honorable French Hill
Chairman
Subcommittee on Digital Assets, Financial
Technology and Inclusion
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Stephen Lynch
Ranking Member
Subcommittee on Digital Assets,
Financial Technology and Inclusion
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairman Hill and Ranking Member Lynch,

On behalf of America's credit unions, I am writing regarding your committee's hearing entitled, "Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem." CUNA represents America's credit unions and their more than 130 million members.

The significant impact of digital assets on the financial sector and the overall economy cannot be denied. In November of 2021, the cryptocurrency market exceeded a \$3 trillion market cap, and the extreme price volatility of Bitcoin and Ether has sent shockwaves across the economy. The International Monetary Fund (IMF) has established correlation between cryptocurrencies and major stock indices and their analysis has shown that "spillovers between crypto and equity markets tend to increase in episodes of financial market volatility."¹ Additionally, this correlation could pose a significant risk to financial stability as the United States sees increased adoption of cryptocurrencies.²

Surveys have shown that around 16% of adults in the United States are engaged with cryptocurrencies.³ 2022 data showed that number more than doubles to 39% when surveying credit union members as a whole and increases to 59% when evaluating credit union members between 18 and 34 years of age.⁴ Despite the crypto winter triggered by last years' failures, this years' survey maintained above average involvement in cryptocurrencies by credit union members—22% of credit union members are still engaged with cryptocurrencies with 42% of credit union members between 18-34 years of age.⁵

The failure of FTX, and the numerous other digital asset companies over the last year, has made crystal clear the need for a comprehensive regulatory framework to govern the digital assets system. The threat to consumer welfare has been demonstrated time and again by the misrepresentation and false statements presented to consumers regarding the state of their funds, the reserves held by exchanges and lenders, and the insurance status of the companies. Congress and federal regulators must ensure these companies are held to account and are no

¹See <https://blogs.imf.org/2022/01/11/crypto-prices-move-more-in-sync-with-stocks-posing-new-risks/>.

²Id.

³ Fact Sheet accompanying EO: <https://www.whitehouse.gov/briefing-room/statements-releases/2022/03/09/fact-sheet-president-biden-to-sign-executive-order-on-ensuring-responsible-innovation-in-digital-assets/>.

⁴ 2022 CUNA Voter Survey.

⁵ 2023 CUNA Voter Survey.

longer allowed to take advantage of consumers and the lax regulatory environment in which they are currently operating.

Blockchain was introduced in 2008 to be used as the public ledger for Bitcoin, and the first Bitcoin was mined in 2009. Since then, blockchain has expanded beyond digital currency as the novel technology can be used for everything from copyright and royalty protection to real estate and land transfers. This technology is still in its nascent state, and it has the possibility to completely transform industries, but we see no reason why innovation should change the government's role in overseeing an industry that uses blockchain. In fact, there is tremendous innovation currently happening in the credit union space surrounding use cases for blockchain and distributed ledger technology as a result of the National Credit Union Administration's (NCUA) letters to credit unions encouraging innovation because of the significant benefits the technology can provide to members. These letters related to digital assets include:

- (1) In December 2021, the NCUA issued a letter stating that credit unions can “establish relationships with third-party providers that offer digital assets services to the FICU's members, provided certain conditions are met.”
- (2) In May 2022, the NCUA told credit unions they could use distributed ledger technology (DLT) for business uses to enhance their operations and ongoing competitiveness.

Credit unions support appropriate oversight and regulation of the digital assets marketplace to prevent regulatory arbitrage by largely unregulated financial technology companies (fintechs) and other unregulated entities provided financial services to consumers. The industry needs a comprehensive national standard that levels the playing field and protects consumers and the financial system.

Regulation of the crypto industry must be commensurate with the innovation and development occurring, or these systemic failures will persist and infect the larger economic ecosystem. Regulated financial institutions, like credit unions, must have the required authorities to fully engage in the cryptocurrency marketplace—starting with the ability to custody crypto-assets. Credit union members trust their credit union to provide necessary financial services, and the ability to provide new financial services products and delivery channels is needed for credit unions to fulfill their mission. Moreover, credit unions' focus on financial literacy and financial education can be extended to crypto-related products in order to help members use these new products prudently. Furthermore, credit unions must be included in stablecoin legislation on par with our similarly regulated financial institution colleagues. Innovation cannot be effective if it leaves a significant portion of the market behind.

The cryptocurrency boom of 2021 drove consumers to the product in hopes of profiting from the gold rush. Crypto exchanges, like FTX, marketed themselves as easy-to-use platforms for crypto novices to buy, sell, and hold crypto assets. These companies were insufficiently regulated and as the market ebbed and flowed, they encountered liquidity crises and were unable to fulfill customer orders. As a result, these exchanges halted sales and withdrawals—leaving consumers unable to access their funds or coins and most likely left holding the bag. Consumers must be granted a safe, secure, and trusted option through which to engage with this nascent industry—that option is their credit union.

As you know, our member credit unions are highly regulated in their operation and credit union members are protected by a plethora of consumer protection laws. The crypto and digital currency sectors operate largely outside of the traditional financial safeguards and generally without financial intermediaries where the role of stabilizer and protector typically rest. In fact, like fintechs, once one wades through the novel technology, the fundamental innovation of cryptocurrency is the elimination of the financial intermediary. Unfortunately, when there is no financial intermediary, the functions that they provide are also lost. This is the crux of FTX's demise—“...a complete failure of corporate control.”

Treasury Secretary Yellen reinforced this point in the recently when she stated, “[w]hile non-bank firms’ entrance into core consumer finance markets has increased competition and innovation, it has not come without additional risks to consumer protection and market integrity.” The comprehensive regulatory framework and accompanying strict oversight and examination to which credit unions and banks are subject has a proven track record of protecting consumers and ensuring safe and sound operations. This framework also ensures that innovations in the industry are given thoughtful consideration and measured implementation to protect consumers and the financial system from unidentified risks.

Credit unions are concerned that digital assets expand some providers’ ability to offer products and services outside the scope of regulations, and the ease at which they can be used to facilitate criminal activity. Whether from a fintech engaging in regulatory arbitrage or the avoidance of regulation through disintermediation of financial institutions enabled by cryptocurrencies and other digital assets, consumers receive less protection when bank-like services such as deposit taking, lending, and payments are obtained outside of the regulated banking system. We are less concerned with the novel technology used to offer these services than we are with the culture created by fintechs and users of digital currency to avoid regulation of products and services that evolve to look like traditional banking services with none of the protection offered by regulated banks and credit unions.

The business model of “regulatory arbitrage” generally leverages technology and sometimes the misuse of banking charters to skirt laws and regulations designed to protect consumers. Tasked with safeguarding consumers’ money, credit unions and banks are generally regarded to be the most regulated part of the financial system. Because this regulation comes with a cost, entities looking to provide bank like services without regulation can leverage technology to drive down cost and speed up innovation without considering risk or the negative impact of their actions.

Crypto service providers have taken full advantage of this regulatory work-around. The answer must be a comprehensive framework that ensures these companies are subject to regulations, examinations, and oversight commensurate with the services they are providing. This should include, at a minimum, stringent capital and liquidity requirements, a strong proof-of-reserves system, concentration caps, safety and soundness parameters, comprehensive data security and privacy regulations, consistent oversight and examinations. This approach should be coordinated among the prudential regulators to provide clarity, a level playing field that encourages competition, appropriate consumer protections, and responsible innovation. Furthermore, there should be parity among all depository institutions as to their powers and authorities in the crypto assets space and the regulations, or lack thereof, should not disadvantage them to less regulated fintechs and other new market entrants. Regulatory guiderails will allow credit unions to confidently engage with digital assets and provide a trusted entry point for a novel product to their members.

Any digital assets regulatory framework must continue to value privacy of the consumer while complying with applicable Anti-Money Laundering (AML), Combating the Financing of Terrorism (CFT), and Know Your Customer (KYC) obligations. Financial institutions currently adopt and operate under a strict cybersecurity regime imposed by the Gramm-Leach Bliley Act (GLBA), and consumers trust their data is secure at their credit union or bank due to these stringent standards. Additionally, the blockchain is built on tenants of privacy in transactions. Conversely, the retail sector has no such requirements, and the financial institution bears the burden of breaches that occur. Integrating the digital assets marketplace into traditional financial services requires that the same privacy and security obligations are extended to nonbank fintechs and new market entrants. A digital assets framework must also bring nonbank fintechs engaging in equivalent activities under the purview of the Financial Crimes Enforcement Network (FinCEN) to ensure they are actively working to combat financial crime as well as the Consumer Financial Protection Bureau (CFPB) to ensure consumers are protected.

Current Design Proposals for a CBDC Present Acute Risks that Outweigh the Purported Benefits

Credit unions welcome developments that allow them to better serve their communities and to execute their mission: to promote thrift and provide access to credit for provident purposes.⁶ There are currently many open questions surrounding central bank digital currencies (CBDCs), and we have concerns under several proposed scenarios, that the creation of a CBDC could significantly worsen the provision of financial services. Firstly, implementation of a CBDC should not proceed without congressional authorization and a clear structure and novel purpose. Secondly, any CBDC must utilize an intermediated model that preserves the direct relationship between consumers and financial institutions. Thirdly, deposit substitution and its cascading effects must be sufficiently mitigated as to prevent reduction of the credit supply, to maintain affordable credit, and to ensure the safety and soundness of the financial system and overall economy. The Federal Reserve Board's consultation paper, "Money and Payments: The U.S. Dollar in the Age of Digital Transformation," presents a variety of design choices for consideration and comment, yet the overarching discussion centers on a retail CBDC⁷ which would be a direct liability of the Federal Reserve and would transform the role of financial institution to one of custodian or wallet holder, rather than trusted financial partner. In a retail CBDC model, the ability of consumers to transfer balances from commercial bank deposits to central bank currency could have a catastrophic impact on the ability of financial institutions to continue their operations. This would be even more pronounced during times of economy uncertainty when depositors would "run on the bank" and transfer all their funds into CBDC which has no credit or liquidity risk. As with bank runs previously, this could send financial markets and the overall economy into a tailspin and lead to significant institution failures.⁸

The creation of a CBDC would introduce significant privacy and cybersecurity risks into the system. The cybersecurity risks for a system of this magnitude would be substantial because the risk would be concentrated in a digital environment rather than diluted with paper money or distributed with commercial bank money. While some risk could be mitigated with a distributed ledger, Project Hamilton has shied away from its use due to concerns about its payments throughput.⁹

Proponents of the creation of a CBDC cite goals such as encouraging financial inclusion, streamlining cross-border payments, and preserving the dominant international role of the U.S. dollar. These are important aims that credit unions support, but it must be clear that a CBDC will accomplish the objective and that it is the most effective solution. At this point, it does not appear that a CBDC is the most effective solution for these goals due to the many risks outlined above and the design trade offs that must occur to reach various aims. There are solutions in the marketplace and in development through private enterprise and collaboration with public entities that address many of these goals. Credit unions' dedication to financial inclusion and how digital assets could aid those efforts is detailed above. The effects of CBDC implementation on financial inclusion efforts seem to be muted due to the outsized threats CBDCs could have on the financial services industry and the economy as a whole. The prospect for a CBDC to enhance cross border payment capabilities is among the most appealing and relatively tangible use cases. The longstanding pain points impacting cross-border money movements are well documented and include challenges such as aligning regulatory, supervisory, and oversight frameworks, AML/CFT consistency; and payment system access.¹⁰ It is important to recognize the diverse array of US payments improvement initiatives that are already in the works, spearheaded by both private sector consortia (The

⁶ 12 U.S.C. § 1752.

⁷ Board of Governors of the Federal Reserve System, "Money and Payments: The U.S. Dollar in the Age of Digital Transformation" (Jan. 14, 2022) (available at: <https://www.federalreserve.gov/publications/files/money-and-payments-20220120.pdf>).

⁸ See Office of Financial Research, Keister and Monnet, Central Bank Digital Currency: Stability and Information (July 2022).

⁹ See Federal Reserve Bank of Boston and Massachusetts Institute of Technology Digital Currency Initiative, "Project Hamilton Phase 1[.] A High Performance Payment Processing System Designed for Central Bank Digital Currencies," pp. 3-5 (Feb. 3, 2022) (available at: <https://www.bostonfed.org/publications/one-time-pubs/project-hamilton-phase-1-executive-summary.aspx>).

¹⁰ See Central bank digital currencies for cross-border payments, Report to the G20, BIS, CPML, Innovation Hub (July 2021).

Clearing House's Real Time Payments, Nacha's Same Day ACH) and quasi-governmental entities (FedNow). It remains unclear how a CBDC model would deliver a faster, more efficient, more inclusive, and/or less expensive settlement solution than the innovations currently in the market or in development.

At this time, the potential risks of a CBDC are not sufficiently mitigated to be outweighed by the potential benefits a CBDC could provide to consumers and the economy. It is imperative that the discussion and research continue, and that new proposals are considered and evaluated on their merits.

For the reasons above, we think that it is time for Congress and the relevant federal agencies to develop a comprehensive regulatory framework for digital assets that opens the industry to financial institutions and ensures all market participants adhere to the same rules that protect consumers and the U.S. financial system.

On behalf of America's credit unions and their more than 130 million members, thank you for holding this markup and considering our views.

Sincerely,



Jim Nussle
President & CEO



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March 8, 2023

Chairman French Hill
Ranking Member Stephen Lynch
Subcommittee on Digital Assets, Financial Technology and Inclusion
House Financial Services Committee
Washington, DC

Re: Statement for the Record for hearing on "Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem" (March 9, 2023)

Dear Chairman Hill and Ranking Member Lynch,

The National Consumer Law Center, on behalf of its low-income clients, submits this statement for the record on crypto-assets for consideration in the above hearing.

We see little to no legitimate consumer-facing use for crypto-assets and few, if any, potential benefits that are not heavily outweighed by the high degree of risk, harm, and evasion of consumer protection laws. In particular:

- Individual consumers are investing money they cannot afford to lose in speculative assets that will often crater in value and trigger high fees if the consumer attempts to cash out.
- Scams using crypto-assets are exploding off the charts and enabling criminals to steal money anonymously, quickly and irreversibly.
- Stablecoins are not as stable as they claim and exist primarily as a gateway to and support for unstable and dangerous crypto-assets.
- As a payment method, crypto-assets have no protections and do not comply with laws that require protecting consumers from unauthorized use and errors.
- Crypto-assets have no potential to enhance financial inclusion and instead are just the latest in a long series of products that strip wealth from communities of color and push them further behind.

These problems are serious for all consumers. But they are especially dangerous for low-income consumers with no buffer of assets to lose, and for Black and Latino communities, which disproportionately invest in crypto-assets.

Congress and regulators should do as much as possible to discourage expanding use of crypto assets, which are simply unsafe. While the underlying blockchain technology may have legitimate applications, we see few prospects for consumer-facing use of crypto-assets, as the problems are a feature, not a bug.

For more detail on these points, see the comments that we and other consumer organizations submitted to the Department of Treasury in response to its Request for Comment on Ensuring Responsible Development of Digital Assets. Please contact me at csanchezadams@nclc.org with any questions.

Yours very truly,

Carla Sanchez-Adams
Senior Attorney



August 5, 2022

Submitted at regulations.gov

Natalia Li, Deputy Director
Office of Financial Institutions Policy
U.S Department of the Treasury
Washington, DC

Re: Request for comment on ensuring responsible development of digital assets

The National Consumer Law Center (on behalf of its low-income clients), Americans for Financial Reform, Center for Responsible Lending, Consumer Action, Consumer Federation of America, Digital Finance Alliance, and U.S. PIRG Education Fund appreciate the opportunity to respond to your request for comments on ensuring the responsible development of digital assets. In these comments, we focus on the perspective of consumers and consumer protection.

Introduction and Summary

This request for comments covers two different sets of digital assets: cryptocurrencies, including stablecoins, and central bank digital currencies.

We see little to no legitimate use for cryptocurrencies and few, if any, potential benefits that are not heavily outweighed by the high degree of risk, harm, and evasion of consumer protection laws:

- Individual consumers are investing money they cannot afford to lose in speculative assets that will often crater in value and trigger high fees if the consumer attempts to cash out.
- Scams using cryptocurrencies are exploding off the charts.
- Stablecoins are not as stable as they claim and exist primarily as a gateway to and support for unstable and dangerous cryptocurrencies.
- As a payment method, cryptocurrencies have no protections and do not comply with laws that require protecting consumers from unauthorized use and errors.

These problems are serious for all consumers, especially for low-income consumers with no buffer of assets to lose, and for Black and Latino communities, which disproportionately invest in cryptocurrencies. Cryptocurrencies are becoming the latest in a long line of devices used to strip wealth from communities of color and push them further behind.

Regulators should do as much as possible to discourage expanding use, which is simply unsafe. We see few prospects for “responsible” development, as the problems with cryptocurrencies are a feature, not a bug.

While greater regulation is important, it is critical not to do so in a manner that helps cryptocurrencies expand their reach or provide a gloss of legitimacy. Commodities and securities laws should certainly apply to the investment and trading aspects of cryptocurrencies. But we are deeply concerned about measures that help to bring cryptocurrencies within the banking system.

Cryptocurrencies should not be given access to payment rails or allowed to be used to facilitate consumer payments without complying with the Electronic Fund Transfer Act (EFTA). Products that mimic deposit accounts but lack deposit insurance and EFTA protections will put vital consumer funds at risk.¹ Consumer warnings and disclosures are ineffective and can be overshadowed by offers of higher interest or other advantages that are funded by not paying for deposit insurance and not complying with consumer protection laws. If banks, or their subsidiaries or affiliates, offer cryptocurrency products and services, consumers will mistakenly believe these products and services are safe and covered by existing laws. But without EFTA protections, bank adoption of cryptocurrency products and services will inappropriately legitimize them, facilitate their spread, and lead consumers to believe, wrongly, that they are safe. Furthermore, closer ties between bank accounts and crypto accounts will make it easier for scammers to move money fast, with no form of relief for the defrauded consumers.

With respect to a potential United States central bank digital currency (CBDC), we have yet to hear a plausible case for how a CBDC could expand financial inclusion or otherwise have significant benefits for consumers, especially in an intermediated model. On the flip side, a CBDC poses significant potential risks to consumers, including threats to privacy, the potential for surveillance of and control over those who receive government benefits, fraud at greater scale and velocity, and unclear application of consumer protections. A CBDC could also hurt financial inclusion if it became the de facto preferred payment system while many consumers were shut out of or distrustful of it, or if it deprived banks of the capital used to support low-balance accounts, consumer credit, and reinvestment activities. However, we do encourage Treasury to explore other public payment systems or strategies that may have more potential to improve financial inclusion for consumers.

Below we respond to the specific questions posed by the FSOC.

Adoption to Date and Mass Adoption

(1) What explains the level of current adoption of digital assets? Please identify key trends and reasons why digital assets have gained popularity and increased adoption in recent years.

The exploding consumer interest in digital assets appears to be driven primarily by intense marketing and media attention that promote a desire to cash in on a “gold rush” investment opportunity. Promotions of and opportunities to purchase crypto in mainstream nonbank banking apps lend legitimacy to the product and add to the belief that everyone should consider owning crypto.

(2) Factors that would further facilitate mass adoption.

¹ For an example of an article promoting accounts and payment services with no mention of the serious risks, see Coinbase, “Can crypto really replace your bank account? From direct deposit to earning yield, key ways crypto can help you take control of your financial future,” <https://www.coinbase.com/learn/crypto-basics/can-crypto-really-replace-your-bank>.

Factors that would further facilitate mass adoption include:

- Broader access to payment rails, and greater integration of crypto purchase and payment options within existing payment platforms;
- Promotion of, incentives for, and ease of payment by crypto at the point of sale;
- The offer of higher interest rates in an inflationary environment;
- Spread of crypto promotions, availability, and integrations with mainstream banks and credit unions;
- Increasing promotion of crypto by celebrities and others;
- A new run-up in value followed by media stories of fortunes being made.

Access to payment rails and anything else that would encourage broader use as a payment device have particularly strong potential to lead to mass adoption and serious risk to the public. While payments are a marginal to nonexistent use case today, that could change if crypto companies have easier and broader access to the payment rails. Merchants, financial institutions, and payment providers could see broad advantages to moving payments in a manner that allows them to escape complying with consumer protection laws. In turn, that could lead them to heavily promote those types of payments and offer consumers an incentive to use them. In particular, merchants could give consumers discounts to entice them into paying through a method that silently deprives them of their chargeback and error resolution rights.

Similarly, the closer cryptocurrencies are associated with and promoted by mainstream banking institutions, the more legitimacy and reach they will have. Right now, beyond the crypto industry itself, many nonbank banking apps – heavily marketed to lower income and struggling consumers -- prominently feature the opportunity to buy crypto. But most consumers bank at more traditional financial institutions. If they see their trusted institution making it easy to purchase or use crypto, millions more consumers will do so.

Conversely, the distrust of large financial institutions can also feed mass adoption of alternative financial services that claim to be able to meet the same needs.

Opportunities for Consumers, Investors, and Businesses

- (3) What are the main opportunities for consumers, investors, and businesses from digital assets? For all opportunities described, please provide data and specific use cases to date (if any).**

Cryptocurrencies

Some consumers may be able to make significant amounts of money by investing in crypto. But as with any investment, the greater the potential for reward, the greater risk of significant loss.

Despite the unsubstantiated hype about crypto as a potential way of promoting financial inclusion or of addressing inefficiencies in current payment systems, such as in international remittances, we have yet to see credible examples that match these claims. The friction in current systems exists for good reason – such as preventing money laundering or fraud. Moreover, any remittances sent through cryptocurrency still need to be transferred out of and back into fiat currencies and need a network to enable consumers to access the funds, all of which result in costs.

U.S. central bank digital currency

We have a hard time finding any significant benefits of a U.S. CBDC for consumers. Our thoughts on a U.S. CBDC are outlined in our comments in response to the Federal Reserve Board's (FRB) recent discussion paper,² and we will only briefly summarize them here.

The FRB's discussion paper largely ignores consumers and does not explain how a CBDC would benefit them. The paper identifies five theoretical benefits of a CBDC but does not explain how a CBDC would actually provide those benefits or help consumers beyond what FedNow will provide.³

It is difficult to see how a CBDC would promote financial inclusion, especially in an intermediated model (with financial institutions and possibly nonbank entities as the interface), which is the model that the Federal Reserve appears to be considering. A CBDC would pose the same issues that keep people out of banks today: mistrust of banks; not enough money to be worth having an account; cost of accounts; and know-your-customer issues and exclusion due to adverse consumer reports with checking account screening agencies. Mistrust of the federal government and privacy concerns could compound those reasons. We also fail to perceive how a CBDC would meet the need for faster payments in a fashion superior to FedNow.

Despite our skepticism regarding the use case for a CBDC, a CBDC does seem to pose fewer risks than crypto and stablecoins. As such, we urge the Treasury and other agencies to continue exploring whether there might be a model that offers tangible benefits and adequately addresses risks. To the extent that distributed ledger technology may ultimately be used for payment services in some fashion, it's important for public models, systems, or principles to be available to serve as counterweights to private models or systems, which present their own unique array of limitations and risks to consumers.

Additionally, we urge Treasury to explore other public payment systems or strategies that may have more potential to enhance or improve financial inclusion for consumers while also paying close attention to fraud risks.⁴

Risks to Consumers, Investors, and Businesses

- (5) **Please identify and describe potential risks to consumers, investors, and businesses that may arise through engagement with digital assets.**

Risks of Cryptocurrencies.

The request for information accurately identifies a number of very real risks to consumers:

Frauds, scams, and losses associated with interacting with illicit counterparties directly. Since the start of 2021, reports to the Federal Trade Commission describe losses of over \$1 billion in payment scams involving crypto – undoubtedly a vast understatement of the amount of actual fraud, as many fraud

² See Comments of National Consumer Law Center to Board of Gov. of the Federal Reserve System re. central bank digital currency (May 20, 2022), <https://bit.ly/CBDC-comment> ("NCLC CBDC Fed comments").

³ See *id.*

⁴ See [Sept. 2021 comments](#) of 43 groups urging stronger protections for FedNow and more detailed [FedNow comments](#) from National Consumer Law Center, National Community Reinvestment Coalition, and National Consumers League.

losses go unreported.⁵ Crypto accounted for one out of every four dollars of fraud losses reported to the FTC since 2021, more than any other payment method.⁶ Crypto scams are exploding and are likely going to increase. Crypto losses reported to the FTC in 2021 were *sixty times* what they were in 2018,⁷ and even the losses in the first quarter of 2022 were 16% higher than the last quarter of 2021.⁸

The more that crypto spreads, the more fraud will spread. Fraud is rampant today even with funds going through regulated financial institutions. Closer integration of cryptocurrency with traditional bank accounts will make it easier for scammers to quickly move money from one to the other. For example, we recently heard from an attorney representing a consumer because a scammer managed to take control of the consumer's computer, access her bank account, transfer \$100,000 into a newly created Coinbase account fraudulently opened using her identity, and then move the money out. That transaction would be much easier if the scammer did not need to create the Coinbase account and could simply transfer money with access to the bank login alone.

Conversely, there are also severe risks if cryptocurrency enables individuals to transact with counterparties directly, without any institution overseeing the transaction to attempt to ensure its legitimacy. In that case, even the modest protection of our know-your-customer laws and fraud prevention regimes will not be available.

Losses due to theft. Cryptocurrencies are designed with no protection against theft or unauthorized access.

Losses of private keys. People lose or forget passwords all the time. One can only imagine how unacceptable it would be to say that you lose all the money in your bank account if you forget your password, with no method of recovering it.

Losses from the failure/insolvency of wallets, custodians, or other intermediaries. Crypto has no deposit insurance and no other protection if the wallet, custodian, or other intermediary fails, becomes insolvent, or has technical problems that lead to losses. We have already seen examples of the devastating havoc these events can cause.⁹

Disclosures and amount of fees. People do not realize how costly it can be to cash out of crypto into fiat currency, or all the significant risks that crypto entails. No laws beyond the common law and laws against unfair, deceptive, and abusive practices dictate disclosures associated with cryptocurrency, including fee disclosures.

⁵ See Emma Fletcher, FTC, [Data Spotlight: Reports show scammers cashing in on crypto craze](#) (June 3, 2022).

⁶ *Id.*

⁷ *Id.*

⁸ Fraud losses by cryptocurrency reported to the FTC were \$299.1 million in the last quarter of 2021 and \$364.6 million in the first quarter of 2022. See <https://public.tableau.com/app/profile/federal.trade.commission/viz/FraudReports/LossesContactMethods>. Those numbers are vastly understated, as many losses are not reported to the FTC, and most of those reported do not describe the payment methods.

⁹ See, e.g., Sean Stein Smith, Forbes, [Crypto Failures Highlight The Need For Better Accounting Standards](#) (July 17, 2022); Michael P. Regan, Bloomberg Crypto, [Terra Was Too Big to Fail, and It Failed](#) (May 12, 2022).

Authenticity of digital assets, including NFTs. Consumers have little way of verifying if digital assets are authentic, and many are falling for scams.¹⁰

Ability of consumers, investors, and businesses to understand contracts, coding, and protocols.

Consumers have no ability to understand contracts, coding or protocols governing cryptocurrency or to protect themselves from manipulations. They are at the complete mercy of those who design them.

Risks of a CBDC

While a CBDC does not pose all the same risks as cryptocurrencies do, it shares some of them and poses others.¹¹

A CBDC not only seems unlikely to help with financial inclusion, it could actually hurt financial inclusion if it became the de facto preferred payment system while many consumers were shut out of or distrustful of it; or if it deprived banks of the capital used to support low-balance accounts, to provide access to credit, or to engage in community reinvestment.

Other risks with a CBDC include:

- Privacy threats, which cannot be minimized simply by asserting that a CBDC would be privacy protected;
- Misuse of CBDC technology by the government to surveil and control spending by public benefits recipients. Public benefits recipients are already being told how to spend their money,¹² and the broader capacity to monitor and limit spending will be irresistible for some (especially opponents of public benefits) to resist;
- Fraud at greater scale and velocity, with no protection;
- Reduction in access to credit as funds are moved out of the banking system;
- Cost of accounts imposed by financial institution intermediaries needed to access funds held in CBDC;
- Unclear coverage and application of the Electronic Fund Transfer Act (EFTA);
- Unclear application or preemption of other important state and federal consumer protection laws;
- Easier garnishment by debt collectors and the government for debts, with the United States as a “one stop shop” on which to serve garnishment orders. As with many debt collection judgments, garnishments could be for the wrong amount or against the wrong person; and

¹⁰ See, e.g., Ben Kochman, Law360, FBI Warns Fake Crypto Apps Defrauded Investors Out Of \$42M (July 18, 2022); U.S. Attorney’s Office for the Southern District of New York, Press Release, [Manhattan U.S. Attorney Announces Charges Against Leaders Of “OneCoin,” A Multibillion-Dollar Pyramid Scheme Involving The Sale Of A Fraudulent Cryptocurrency](#) (Mar. 8, 2019).

¹¹ For a longer discussion of the risks of a CBDC, see NCLC CBDC Fed Comments, *supra*.

¹² See, e.g., Teresa Wiltz, Pew Charitable Trusts, [Should States Tell Welfare Recipients How to Spend Their Benefits?](#) (April 24, 2015).

- Reduction of community reinvestment activities, with fewer funds held by banks subject to reinvestment obligations.

Impact on the Most Vulnerable

(6) According to the FDIC's 2019 "How America Banks" survey, approximately 94.6 percent (124 million) of U.S. households had at least one bank or credit union account in 2019, while 5.4 percent (7.1 million) of households did not. And roughly 25 percent of U.S. households have a checking or savings account while also using alternative financial services. Can digital assets play a role in increasing these and other underserved Americans' access to safe, affordable, and reliable financial services, and if so, how?

No. As discussed in response to question (3) above, we have not seen any credible explanation for how either cryptocurrencies or a CBDC could increase access to safe, affordable, and reliable financial services.

On the other hand, cryptocurrencies pose a severe threat to the most vulnerable. They are highly volatile and subject to scams and high fees taken from those who can least afford to bear the losses. The "get rich quick" pitch of cryptocurrencies preys on those who lack assets yet cannot afford the risk.

Surveys also suggest that Black Americans and Latinos are more likely to invest in cryptocurrencies.¹³ These communities will also likely bear a disproportionate share of the losses from volatility and scams, further exacerbating inequality and stripping assets from communities that have long been denied the opportunity to build wealth.¹⁴ We simply cannot let this happen.

Thank you for the opportunity to submit these comments. With questions, please contact Lauren Saunders, Associate Director, National Consumer Law Center, lsaunders@nclc.org.

Yours very truly,

National Consumer Law Center (on behalf of its low-income clients)
Americans for Financial Reform
Center for Responsible Lending
Consumer Action
Consumer Federation of America
Digital Finance Alliance
U.S. PIRG Education Fund

¹³ See, e.g., Terri Bradford, Kansas City Federal Reserve Board, [The Cryptic Nature of Black Consumer Cryptocurrency Ownership](#) (June 1, 20212); Andrew Perrin, Pew Research Center, [16% of Americans say they have ever invested in, traded or used cryptocurrency](#) (Nov. 11, 2021) (18% of Black adults had invested in, traded or used crypto, compared to 13% of white adults).

¹⁴ See, e.g., The Economist, [Why the crypto crash hit black Americans hard](#) (May 20, 2022).



March 7, 2023

Chair Patrick McHenry
Ranking Member Maxine Waters
Members
U.S. House of Representatives Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chair McHenry, Ranking Member Waters and Honorable Members,

On behalf of more than 500,000 members and supporters of Public Citizen, we provide the following documents for your consideration that are relevant to the House Financial Services Committee hearing entitled "Coincidence or Coordinated? The Administrations Attack on the Digital Asset Ecosystem."

The first document is a letter signed by 13 organizations applauding the Security and Exchange Commission's (SEC) enforcement efforts in the crypto industry. We believe history will show that SEC Chair Gary Gensler and the SEC are well serving investors by bridling the many crypto schemes; and that those aiding and abetting crypto will be viewed dimly. We believe your hearing characterized as an "attack on the digital asset ecosystem" is not only misguided but will help perpetuate the exploitation of vulnerable populations lured to cryptocurrencies.

The second document we submitted to the Treasury Department outlines Public Citizen's views on cryptocurrency. Generally, we believe that most cryptocurrency projects are thinly veiled Ponzi schemes that squander huge quantities of energy with few actual benefits or protections for retail investors.

The third document we submitted with Americans for Financial Reform to the SEC outlines our more detailed critique of the energy issues.

For questions, please contact Bartlett Naylor at bnaylor@citizen.org, or Yevgeny Shrago at yshrago@citizen.org.

Sincerely,

Public Citizen

March 3, 2023

The Honorable Gary Gensler
Chair
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Dear Chair Gensler,

We, the undersigned, applaud the efforts of the U.S. Securities and Exchange Commission (SEC) under your direction to address widespread fraud, manipulation, deceptive practices, rule evasion, and other corrupt activities that are endemic within the cryptocurrency sector.

We believe that cryptocurrency has failed to prove its value as a currency for widespread legitimate transactions – despite 15 years of effort since publication of the white paper that introduced Bitcoin.¹

In addition, many cryptocurrency (crypto) promoters have effectively perpetrated a massive Ponzi scheme, where the victims are disproportionately persons of color and those with modest incomes. These are the very individuals the crypto industry has claimed would benefit most from the adoption of crypto as a normalized financial instrument.²

We recognize that you and the SEC have stood firm against fierce, ad hominem attacks from crypto proponents, and we want to appreciate your important efforts.

The cryptocurrency balloon has been inflated by influencers, many surreptitiously paid;^{3 4} massive advertising campaigns that we now know were funded, in part, through crypto firms' misuse or theft of customer funds, such as FTX;⁵ and a rogue's gallery of online crypto enthusiasts, some of whom may have a self-interest in elevating the price of tokens.

The crypto industry has faced criticism from a few outspoken critics, such as the indefatigable Molly White,⁶ John Reed Stark (former chief of the SEC's Office of Internet Enforcement), and

¹ Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, BITCOIN.ORG (2008) <https://bitcoin.org/bitcoin.pdf>

² Linda Jeng, *Testimony*, SENATE BANKING COMMITTEE (Feb. 14, 2023) <https://www.banking.senate.gov/imo/media/doc/jeng%20Testimony%202-14-23.pdf>

³ *SEC Charges NBA Hall of Famer Paul Pierce for Unlawfully Touting and Making Misleading Statements about Crypto Security*, SECURITIES AND EXCHANGE COMMISSION (Feb. 17, 2023) <https://www.sec.gov/news/press-release/2023-34>

⁴ *SEC Statement Urging Caution Around Celebrity Backed ICOs* SECURITIES AND EXCHANGE COMMISSION (Nov. 1, 2017) <https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos>

⁵ Tiffany Hsu, *Larry David Doesn't Get Crypto. That's Why He's the Perfect Pitchman*, NEW YORK TIMES (Feb. 13, 2022) <https://www.nytimes.com/2022/02/13/business/media/larry-david-super-bowl-ftx-crypto.html>

⁶ Gerrit De Vynck, *First She Documented The Alt-Right. Now She's Coming For Crypto*, WASHINGTON POST (May 29, 2022) <https://www.washingtonpost.com/technology/2022/05/29/molly-white-crypto/>

others. Additionally, more than 1500 technologists signed a public letter calling for responsible oversight of the sector.⁷ But these public-spirited, uncompensated voices have often been drowned out by well-funded marketing campaigns undergirded by hundreds of millions of dollars in political donations.⁸

Though your efforts have drawn vitriol from crypto's supporters, we believe it is important that you know that many organizations whose members and missions are committed to defending consumers and seeking economic justice for all Americans – including those already marginalized by the existing financial system – sincerely appreciate your steadfast efforts.

We specifically support your enforcement of existing statutory requirements regarding registration and disclosure for crypto firms that are in effect issuing unregistered securities or acting as unregistered exchanges, brokers, or other regulated financial intermediaries. These efforts have led to tens of millions of dollars in fines and have stopped a number of firms from providing risky or harmful products and services.⁹

Ideally, unscrupulous crypto promoters will reform. If not, then the SEC's consistent application of these requirements will continue to ensure those actors who are unable or unwilling to meet these standards will not be allowed to continue with crypto business as usual. You are rightly enforcing regulations, despite claims by critics that you are "regulating by enforcement."

Finally, your newly proposed rule regarding custody safeguards promises further sanity.¹⁰ Segregating customer funds will be vital in preventing the likes of Sam Bankman-Fried from allegedly collecting the investment monies of unwitting investors and using them for risky bets, advertisements, political spending, and more.¹¹ As with your enforcement actions, this rule at a minimum will help weed out the worst of the hucksters.

We strongly support greater funding for the SEC to continue this important work as you strive to combat widespread abuses in the crypto sector.

Again, we appreciate your resolve and your focus on ensuring existing securities laws are applied fairly, consistently and rigorously in order to protect investors and markets.

Sincerely,

⁷ Assorted signatories, *Letter in Support of Responsible Fintech Policy* (June 1, 2022) <https://concerned.tech/>

⁸ <https://www.opensecrets.org/news/2022/06/crypto-industry-executives-spend-millions-on-political-contributions-as-washington-weighs-industry-regulations/>

⁹ David Yaffe-Bellany, *Government Cracks Down on Crypto Industry With Flurry of Actions* *New York Times* (Feb. 18, 2023) <https://www.nytimes.com/2023/02/18/business/crypto-crackdown-regulation.html?smid=nytcore-ios-share&referringSource=articleShare>

¹⁰ *SEC Proposes Enhanced Safeguarding Rule for Registered Investment Advisers* SECURITIES AND EXCHANGE COMMISSION (Feb. 15, 2023) <https://www.sec.gov/news/press-release/2023-30>

¹¹ David Yaffe-Bellany, *How Sam Bankman-Fried's Crypto Empire Collapsed* *NEW YORK TIMES* (Nov. 14, 2022) <https://www.nytimes.com/2022/11/14/technology/ftx-sam-bankman-fried-crypto-bankruptcy.html>

American Economic Liberties Project

Americans for Financial Reform

California Reinvestment Coalition

Consumer Reports

Demand Progress Education Fund

The Institute for Agriculture and Trade Policy

National Association of Consumer Advocates

National Community Reinvestment Coalition

Public Citizen

Revolving Door Project

20/20 Vision

Tzedek DC

U.S. PIRG



August 8, 2022

Departmental Offices
 Department of the Treasury
 1500 Pennsylvania Ave., NW
 Washington D.C. 20220

Re: Ensuring Responsible Development of Digital Assets; Request for Comment per Executive Order 14067

Dear Officers,

On behalf of more than 500,000 members and supporters of Public Citizen we offer the following comments in response to the Treasury Department's effort for "Ensuring Responsible Development of Digital Assets."¹² We applaud the Biden administration's principal policy objectives with respect to digital assets. We look forward to Treasury's scrutiny of the risks posed by digital assets to consumers, investors, financial institutions, democratic principles, and the climate. We also encourage Treasury to consider carefully the purported benefits of digital assets, particularly cryptocurrencies, which are often overstated.

In this request of comment, the Treasury asks: "What explains the level of current adoption of digital assets? Please identify key trends and reasons why digital assets have gained popularity and increased adoption in recent years."¹³

Indeed, the popularity of cryptocurrency has exploded in recent years. From adoption of the first cryptocurrency, Bitcoin, which was introduced in 2008¹⁴ and could initially be purchased for pennies, the market capitalization of all cryptocurrencies peaked in 2022 at \$3 trillion, before falling back to around \$1 trillion during the latest so-called "crypto winter."¹⁵

The crypto boom came with a proliferation of projects trying to draw in new investors with exited promises of riches, democratized finance, and transformational technologies. No doubt, real problems

¹² Department of the Treasury, *Ensuring Responsible Development of Digital Assets*, FEDERAL REGISTER (July 8, 2022) <https://www.govinfo.gov/content/pkg/FR-2022-07-08/pdf/2022-14588.pdf>

¹³ Id

¹⁴ Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, (2008) <https://bitcoin.org/bitcoin.pdf>

¹⁵ Emily Flitter, *How Wall Street Escaped the Crypto Meltdown*, New York Times (July 5, 2022) <https://www.nytimes.com/2022/07/05/business/economy/wall-st-cryptocurrency-prices.html>

make the current U.S. payment system inefficient and expensive. Many understandably hold major banks in low regard. For many, the current economy truly is rigged against them.

But as the recent crypto crash is reinforcing, most of these projects are thinly veiled Ponzi schemes that use huge quantities of energy with few actual benefits or protections for retail investors or users and have grown only in the cracks created by regulatory inattentiveness. The failures of Celsius (now in bankruptcy), Luna and TerraUSD attest to the false claims and Ponzi characteristics of this market.¹⁶

Initially, advocates argued cryptocurrency would make the payment system faster and cheaper. But more than a decade later, few vendors accept cryptocurrency. Generally, cryptocurrency has failed in its initial promise of a decentralized, efficient, less costly, and more equitable financial system especially for those with less access to traditional banking. This failure follows more than a decade of efforts by thousands of experts exploring the potential of blockchain and Bitcoin, which was described in the 2008 white paper by the pseudonymous Satoshi Nakamoto as an alternative payment system.¹⁷ Instead, cryptocurrencies have served mainly as a source of speculation, a vehicle for funding illegal activity including tax evasion, and a massive use of energy that exacerbates climate change.

Most immediately, the prevailing cryptocurrencies are gyrating wildly in price often in a single day. In the last year, Bitcoin traded as high as \$60,000 per token and as low as \$19,000.¹⁸ These swings undermine the case for digital assets as a means of exchange: A customer who believed that Bitcoin would rise in value would not rationally use one for a purchase on that day since they would be over-paying. They would only use the coin if they thought the price would fall. Conversely, a vendor who believed Bitcoin would fall would not accept the coin, since it would be an underpayment, and would only accept the token if they believed the price would rise. In other words, a fluctuating price stifles the use of Bitcoin as a vehicle of market exchange.

Stablecoins promised to answer the problem of volatility in pricing by pegging each token to a specific value, such as the U.S. dollar. However, many sponsors failed to fully back these tokens. The New York Attorney General fined Tether and Bitfinex for such failures.¹⁹ Celsius promised high yields to those who purchased its stablecoin, but allegedly paid those yields with newer investors' money, a basic Ponzi scheme. Its bankruptcy filing noted it owed \$4.7 billion to some 1.7 million investors, and only had \$167 million in assets.²⁰ Voyager allegedly claimed its stablecoin was backed by FDIC insurance, according to the federal agencies.²¹ Voyager declared bankruptcy.²²

¹⁶ Wayne Duggan, *What Is Celsius? Why Is It Crashing the Crypto Market?* FORBES (July 18, 2022) <https://www.forbes.com/advisor/investing/cryptocurrency/what-is-celsius/>

¹⁷ Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, (2008) <https://bitcoin.org/bitcoin.pdf>

¹⁸ *Bitcoin*, COINDESK (website accessed June 11, 2021) <https://www.coindesk.com/price/bitcoin>

¹⁹ *Attorney General James Ends Virtual Currency Trading Platform Bitfinex's Illegal Activities in New York* NY ATTORNEY GENERAL, (Feb. 23, 2021) <https://ag.ny.gov/press-release/2021/attorney-general-james-ends-virtual-currency-trading-platform-bitfinex-illegal>

²⁰ MacKenzie Sigalos, *Homeless, Suicidal, Down To Last \$1,000: Celsius Investors Beg Bankruptcy Judge For Help* CNBC (Aug. 2, 2022) <https://www.cnbc.com/2022/08/02/celsius-investors-owed-4point7-billion-beg-judge-to-recover-life-savings.html>

²¹ FDIC, Federal Reserve, Letter to Voyager Digital, FEDERAL RESERVE *July 28, 2022) <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20220728a1.pdf>

²² Rohan Goswami, *Voyager CEO Made Millions In Stock Sales In 2021 When Price Was Near Peak* CNBC (Aug. 3, 2022) <https://www.cnbc.com/2022/08/03/voyager-ceo-made-millions-in-stock-sales-in-2021.html>

Second, the promise of cost-free transactions has also proven illusory. The cost of transactions for Bitcoin are substantial and vary greatly. In the last year, they have reached \$300 for each transaction.²³ This is hardly democratizing finance. Related to this, the same population that lacks a bank account, and who are most sensitive to financial fees, may also lack the technology to interact with digital currencies.

Third, investment scams involving cryptocurrencies abound. During a recent five-month period, the Federal Trade Commission reported 7,000 cryptocurrency scams covering some \$80 million in reported losses. That is 12 times the number of scams reported during the same period a year earlier, with a 1000 percent greater estimated loss.²⁴ One review found some malicious actors created digital coins that can be purchased but not sold. Others promise enormous returns that proved untrue.²⁵

Fourth, the number of cryptocurrencies is staggering, and growing. In 2021, there were more than 10,000 different cryptocurrencies.²⁶ In the summer of 2022, that number nearly doubled to 19,000, according to one estimate.²⁷ Commodity Futures Trading Commission Chair Rostin Behnam testified before Congress that “there are now hundreds of thousands of unique digital assets in circulation.”²⁸ That is a greater than the number of banks in the United States. Dogecoin, the 10th largest cryptocurrency by value, was created as a “joke,” according to its founders.²⁹ Even if one or a few cryptocurrencies are adopted as common tender, it is inconceivable that the number accepted would be greater than 10, or 100, and certainly not 19,000. Thus, their utility as a tender for goods and services seems limited, at best.

A few retailers have experimented with accepting Bitcoin for payment, but many have stopped.³⁰ Facebook (now called Meta) applied its prodigious muscle to launch a digital currency. In a test of remittances, however, the blockchain validation costs proved exorbitant.^{31 32}

Fifth, the claim that cryptocurrency cannot be stolen has proven untrue. While it may not be as vulnerable to street theft as cash, or to cyber criminals hacking a bank account, a cyber-criminal might be able to hack into a personal computer where Bitcoin codes are kept. In 2021, a ransom paid in digital assets by Colonial Pipeline to hackers that took over their system (which led to a temporary decline in gasoline

²³ *Bitcoin Average Cost Per Transaction*, YCHARTS (website accessed June 11, 2021)

https://ycharts.com/indicators/bitcoin_average_cost_per_transaction

²⁴ Emma Fletcher, *Cryptocurrency Buzz Drives Record Investment Scam Losses*, FEDERAL TRADE COMMISSION (May 17, 2021) <https://www.ftc.gov/news-events/blogs/data-spotlight/2021/05/cryptocurrency-buzz-drives-record-investment-scam-losses>

²⁵ Alexis Goldstein, *Testimony*, HOUSE FINANCIAL SERVICES COMMITTEE (June 20, 2021)

<https://financialservices.house.gov/uploadedfiles/hhrg-117-ba09-wstate-goldsteina-20210630-u1.pdf>

²⁶ *Understanding the Different Types of Cryptocurrencies*, SOFI LEARN (Jan. 15, 2021)

<https://www.sofi.com/learn/content/understanding-the-different-types-of-cryptocurrency/>

²⁷ Arjun Kharpal, *Crypto Firms Say Thousands*

s Of Digital Currencies Will Collapse, Compare Market To Early Dotcom Days, CNBC (June 3, 2022)

<https://www.cnbc.com/2022/06/03/crypto-firms-say-thousands-of-digital-currencies-will-collapse.html>

²⁸ Rostin Behnam, *Testimony*, SENATE AGRICULTURE COMMITTEE (Feb. 9, 2022)

<https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehtnam20>

²⁹ Avi Salzman, *Dogecoin Was Started as a Joke*, BARRON'S (May 5, 2021)

<https://www.barrons.com/articles/dogecoin-started-as-a-joke-now-its-too-important-to-laugh-off-51620229273>

³⁰ Steve Fiorillo, *How to Use Bitcoin for Purchases*, THE STREET (April 18, 2018)

<https://www.thestreet.com/investing/what-can-you-buy-with-bitcoin-14556706>

³¹ Alexis Goldstein, *Stablecoins: How Do They Work, How Are They Used, and What Are Their Risks?* HOUSE FINANCIAL SERVICES COMMITTEE (Dec. 14, 2021)

<https://www.banking.senate.gov/imo/media/doc/Goldstein%20Testimony%202021-14-21.pdf>

³² Open Markets Institute, *Letter to Federal Regulators*, OPEN MARKETS INSTITUTE (Nov. 23, 2021), https://downloads.regulations.gov/CFPB-2021-0017-0089/attachment_2.pdf

supplies on the East Coast), was traced and recovered by the FBI. “Crypto experts say it is at times easier to track than hard currencies such as U.S. dollars,” according to one observer.³³

Many experts question the value of cryptocurrency. Berkshire Hathaway CEO Warren Buffett recently called cryptocurrency “rat poison squared.” His associate Charlie Munger labeled trading in this market as “dementia.”³⁴ Investor Mark Cuban said he’d prefer bananas to Bitcoin, “Because at least as food, bananas have intrinsic value.”³⁵ Bill Gates says cryptocurrencies are “100% based on greater fool theory,” or reliance on a rational assumption of one speculator finding another speculator willing to pay a higher price.³⁶ JPMorgan CEO Jamie Dimon said he’d fire any employee he found investing in Bitcoin. European Central Bank President Christine Lagarde says cryptocurrency is worth “nothing.”³⁷ Other skeptics include Allianz economist Mohamad El-Erian, economist Paul Krugman, and Oaktree Capital Management founder Howard Marks.³⁸ Nassim Taleb, who once considered Bitcoin promising, now says its ultimate worth is “zero.”³⁹

Finally, many experts question the utility of the underlying blockchain technology. In June 2022, 1,500 computer scientists, software engineers, and technologists sent an open letter urging Washington policy makers to “take a critical, skeptical approach toward industry claims that crypto assets (sometimes called cryptocurrencies, crypto tokens, or web3) are an innovative technology that is unreservedly good.” The experts take direct issue with blockchain, which they argue, “by its very design . . . is poorly suited for just about every purpose currently touted as a present or potential source of public benefit.” Further, they write, blockchain technologies facilitate few, if any, real economy uses.⁴⁰ Among the signatories are employees of IBM, Netscape, Google, Microsoft, Apple, MIT, Meta, Columbia, eBay and Amazon--looking only to those signatories whose first name begins with “A.”

Some legitimate use cases for public blockchains may exist. The U.S. government and private sector are evaluating the suitability of blockchain technologies for a variety of industries outside of creating tokens for digital currency. For example, the U.S. Department of Energy just concluded a \$3 million, two-year blockchain for Optimized Security and Energy Management as part of its power grid modernization initiative.⁴¹ Blockchain has been identified as having potential advantages to manage the allocation and distribution of Renewable Electricity Credits (RECs) produced by clean energy project managers. Four

³³ James Uberty, *How the FBI Got Colonial Pipeline’s Money Back*, WALL STREET JOURNAL (June 11, 2021) <https://www.wsj.com/articles/how-the-fbi-got-colonial-pipeline-ransom-money-back-11623403981>

³⁴ James Royal, *Warren Buffet Says to Avoid these Two Types of Hot Investments*, BANKRATE (May 6, 2019) <https://www.bankrate.com/investing/warren-buffett-says-avoid-these-hot-investments/>

³⁵ Taylor Locke, *Mark Cuban: Bitcoin Is ‘More Religion Than Solution’ And Won’t Help In ‘Doomsday Scenarios*, CNBC (Dec. 17, 2020) <https://www.cnbc.com/2020/12/17/mark-cuban-bitcoin-is-a-store-of-value-that-is-more-religion.html>

³⁶ Ryan Browne, *Bill Gates Says Crypto And NFTs Are ‘100% Based On Greater Fool Theory’*, CNBC (June 14, 2022) <https://www.cnbc.com/2022/06/15/bill-gates-says-crypto-and-nfts-are-based-on-greater-fool-theory.html>

³⁷ Ryan Browne, *Christine Lagarde Says Crypto Is Worth Nothing*, CNBC (May 23, 2022) <https://www.cnbc.com/2022/05/23/ecb-chief-christine-lagarde-crypto-is-worth-nothing.html>

³⁸ Trisha Phillips, *Bill Gates and Other Powerful People Who Hate (or Love) Bitcoin*, SHOWBIZ CHEATSHEET (MAY 25, 2018) <https://www.cheatsheet.com/money-career/powerful-people-love-or-hate-bitcoin.html/>

³⁹ Tanaya Macheel, *Black Swan’ Author Nassim Taleb Says Bitcoin Is Worth Zero And Fails As A Currency And A Hedge*, CNBC (July 13, 2021) <https://www.cnbc.com/2021/07/13/black-swan-author-nassim-taleb-says-bitcoin-is-worth-zero.html>

⁴⁰ *Letter in Support of Responsible FinTech Policy*, (June 1, 2022) <https://concerned.tech/>

⁴¹ National Energy Technology Laboratory, *Blockchain for Optimized Security and Energy Management*, NATIONAL ENERGY TECHNOLOGY LABORATORY (website visited July 25, 2022) <https://netl.doe.gov/BLOSEM>

automakers and IBM formed the Mobility Open Blockchain Initiative to share information on how to use the blockchain to allow electric vehicle owners to sell their automobile's stored energy into the grid; help manage transportation congestion; vehicle emissions testing; and supply-chain management. Law firms and real estate transactions are using contract automation technology based on the blockchain to utilize "smart contracts" that replace multiple (and often time-consuming and expensive) counterparties.

If cryptocurrency does not seem useful as a currency, why did the market capitalization reach \$3 trillion? We believe, simply, perhaps obviously, that those who buy cryptocurrency hope to make money—they are speculators. (We leave aside for now those using cryptocurrency for illicit activities.) Presumably, most investors who might purchase stock in a jet manufacturer or pharmaceutical firm may have little personal expertise in aerospace technology or biochemistry. Similarly, few who purchase cryptocurrencies are likely familiar with Merkle Trees, nonces, or other technical features of blockchain. But these speculators can see that some who purchase stock in a jet maker have made money, and that's been the case with cryptocurrency as well.

The sad reality is that about 46 million Americans now own Bitcoin alone.⁴² Why do so many people invest in Bitcoin and other cryptocurrencies? We assume, as with a stock or other traditional asset, these speculators believe the price will rise and that they will profit. To date, that has been the case. Bitcoin's market capitalization has occasionally exceeded four times that of JP Morgan Chase.⁴³ Speculators who purchased at lower prices are, indeed, sitting on a profit. Bitcoin sold for \$1,000 in 2017, before peaking at \$60,000 in 2021.⁴⁴ Would-be speculators saw these winnings and likely were attracted to the arena.

Bolstering the stories of success, mainstream institutions and public influencers are affirming the legitimacy of cryptocurrencies as investments. Well known brokers, including large firms catering to small investors such as Schwab, now offer cryptocurrencies.⁴⁵ Wells Fargo offers the product to its elite clients.⁴⁶ Fidelity Investments announced it would provide cryptocurrency options for sponsors of 401(k) plans.⁴⁷ Cryptocurrencies legitimized by large institutions naturally invites otherwise rational people to consider allocating at least some of their portfolio to this sector.

Cryptocurrency sponsors have spent extravagantly on advertising, relying conspicuously on influencers. Crypto.com spent \$15 million in advertising in November 2021.⁴⁸ CoinDesk reportedly mounted a \$100 million advertising campaign in 2021.⁴⁹

⁴² *About 46 Million Americans Own Bitcoin*, NASDAQ (May 14, 2021) <https://www.nasdaq.com/articles/about-46-million-americans-now-own-bitcoin-2021-05-14>

⁴³ *JP Morgan*, YCHARTS (website accessed June 11, 2021) https://ycharts.com/companies/JPM/market_cap

⁴⁴ James Royal, *Best online brokers for buying and selling cryptocurrency in June 2021*, BANKRATE (June 1, 2021) <https://www.bankrate.com/investing/best-online-brokers-cryptocurrency-trading/>

⁴⁵ James Royal, *Best online brokers for buying and selling cryptocurrency in June 2021*, BANKRATE (June 1, 2021) <https://www.bankrate.com/investing/best-online-brokers-cryptocurrency-trading/>

⁴⁶ *Wells Fargo: US Bank Set to Offer Crypto to Rich Clients*, BBC (May 19, 2021) <https://www.bbc.com/news/business-57147386>

⁴⁷ Rob Wile, *Fidelity Lets Companies Offer Bitcoin In A 401(K), But Financial Advisers Warn It's A Risky Bet*, NBC (May 22, 2022) <https://www.nbcnews.com/business/consumer/bitcoin-401k-fidelity-financial-advisers-warn-risk-cryptocurrencies-rcna29099>

⁴⁸ Jet Encela, *Crypto Companies Slash Ad Spending By 90% Amid Market Jitters*, BITCONIST (website visited July 15, 2022) <https://bitcoinist.com/crypto-companies-slash-ad-spending/>

⁴⁹ Jamie Crawley, *Crypto.com Looks to Cash In on Bull Market With \$100M Advertising Campaign*, COINDESK (Oct. 2021) <https://www.coindesk.com/business/2021/10/28/cryptocom-looks-to-cash-in-on-bull-market-with-100m-advertising-campaign/>

For those who believe there is little future as a currency, and that blockchain holds little promise, speculation may be based on the “greater fool” theory.⁵⁰ Such sponsors are effectively promoting a Ponzi scheme, with new investors paying a higher price than previous investors. (A sponsor is an individual or firm that creates and promotes the cryptocurrency. Bitcoin has no sponsor.)

Some cryptocurrency sponsors may be exploiting this “greater fool” theory with those who believe they’ve been shut out of the traditional financial system. We are especially dismayed by reports that of the U.S. individuals who own cryptocurrencies, 40 percent of people of color. According to one report, the average cryptocurrency trader is under 40 (mean age is 38) and does not have a college degree (55 percent). Forty-one percent are women. More than one-third (35 percent) have household incomes under \$60k annually.⁵¹ After centuries of exploitation of people of color, after nefarious bankers targeted Black borrowers with abusive mortgages leading to the 2008 financial crisis,⁵² it is tragic that predatory cryptocurrency sponsors may have targeted the Black community with this Ponzi scheme. Derrick Hamilton of the New School noted, that crypto has a “low barrier to entry with a promise of high returns. . . . [The industry] preys on people’s desire to make something of themselves.”⁵³

Digital asset markets are rife with scams and other manipulative financial practices. Several federal regulators, including the Consumer Financial Protection Bureau (CFPB), Securities and Exchange Commission (SEC), and Federal Trade Commission (FTC), among others, have issued regular alerts warning consumers and investors about the prevalence of scams, hacks and manipulative activities found within the digital asset markets, and have collected data to back up these warnings. Numerous media articles, academic studies and even industry reports have documented the large sums of money lost through these scams and exploitative practices. For example, a recent study by crypto analytics firm Chainalysis found there were \$14 billion in losses in 2021 alone due to malfeasance, and that there had been a 79% increase in crypto related crime during that same year.⁵⁴

These scam-related losses may be the tip of the iceberg; a Better Business Bureau report profiling crypto schemes noted that the FTC claims that only about 5% of fraud victims end up reporting their losses or victimization.⁵⁵ Tellingly, the FTC has also historically found that Black and Hispanic or Latino Americans are more likely than white Americans to be victims of scams or fraud and are more likely to under-report such experiences as well.⁵⁶ This suggests that, even as digital assets are being promoted (via sophisticated marketing campaigns) as vehicles for financial inclusion for communities traditionally

⁵⁰ Nolan Whitcomb, *The Greater Fool Theory*, OXFORD BUSINESS REVIEW (Dec. 30, 2020)

<https://oxfordbusinessreview.org/the-greater-fool-theory/>

⁵¹ *More Than One in Ten Americans Surveyed Invest in Cryptocurrencies* University of Chicago (July 22, 2021)

<https://www.norc.org/NewsEventsPublications/PressReleases/Pages/more-than-one-in-ten-americans-surveyed-invest-in-cryptocurrencies.aspx>

⁵² Ylan Q. Mui *Ex-Loan Officer Claims Wells Fargo Targeted Black Communities For Shoddy Loans*, WASHINGTON POST (June 12, 2012) https://www.washingtonpost.com/business/economy/former-wells-fargo-loan-officer-testifies-in-baltimore-mortgage-lawsuit/2012/06/12/gJQA6EGtXV_story.html

⁵³ William Pierre-Louis Jr, *Why Crypto is not the Solution to Financial Inclusion*, AMERICANS FOR FINANCIAL REFORM (website accessed July 18, 2022) <https://ourfinancialsecurity.org/2022/07/blog-why-crypto-is-not-the-solution-to-financial-inclusion/>

⁵⁴ *The Chainalysis Crypto Crime Report*, CHAINALYSIS (website accessed July 22, 2022)

<https://go.chainalysis.com/2022-Crypto-Crime-Report.html>

⁵⁵ Better Business Bureau, *Cryptocurrency Scams Study*, BETTER BUSINESS BUREAU (website accessed July 22, 2022) https://www.bbb.org/all/scamstudies/cryptocurrency_scams/cryptocurrency_scams_study

⁵⁶ Federal Trade Commission, *Combating Fraud in African America & Latino Communities*, FEDERAL TRADE COMMISSION (June 15, 2016) <https://www.ftc.gov/system/files/documents/reports/combating-fraud-african-american-latino-communities-ftcs-comprehensive-strategic-plan-federal-trade/160615fraudreport.pdf>

excluded from or exploited by traditional financial actors, these same communities may be bearing the brunt of the losses generated by fraud and scams.

Cryptocurrencies also serve as a medium of payment for illicit activities. One study found that “approximately one-quarter of Bitcoin users are involved in illegal activity” and that an estimated \$76 billion in illegal activity per year involve Bitcoin (46% of Bitcoin transactions), “which is close to the scale of the U.S. and European markets for illegal drugs.”⁵⁷ Many avoid paying taxes on cryptocurrency profits.⁵⁸

Regulatory Options

The Treasury should advise the various financial regulatory agencies to remedy negative impacts that happen in the crypto ecosystem through fraud, financial crisis, energy consumption, waste, and carbon emissions.

Regulators must prevent crypto firms from engaging in fraud on their customers and must not allow crypto infrastructure to be used to perpetuate fraud. *Caveat emptor* is not an appropriate guiding principle for firms with access to retail investors. The people who digitally mint and promote the coins need to be liable for fraudulent statements, fraudulent transactions, rug pulls, abandoned projects, and self-dealing.⁵⁹ (In a “rug pull” predators lure investors into a project, then abandon the project and take the money.) We welcome announcements of greater staffing at the Securities and Exchange Commission (SEC) and urge the Federal Trade Commission (FTC) to increase its enforcement efforts as well. We also welcome the enforcement efforts of the Commodity Futures Trading Commission (CFTC). This agency polices fraud, false reporting, and manipulation over commodity cash markets in interstate commerce. Since 2014, the CFTC has brought 50 enforcement actions involving digital assets. In 2021, it brought 20 enforcement actions alleging digital asset-related misconduct.⁶⁰ Authorities are prosecuting “rug pulls” in several non-fungible token (NFT) cases.^{61 62} In one rug pull case, the durable wire fraud law proved reliable in arresting two suspects.⁶³ The FTC signaled it will better scrutinize “gatekeepers,” where rug pulls are

⁵⁷ Sean Foley, et al, *Sex Drugs and Bitcoin*, THE REVIEW OF FINANCIAL ECONOMICS, (May 2019) <https://academic.oup.com/rfs/article/32/5/1798/5427781>

⁵⁸ Greg Iacurci, *Cryptocurrency Poses A Significant Risk Of Tax Evasion* CNBC (May 31, 2021) <https://www.cnbc.com/2021/05/31/cryptocurrency-poses-a-significant-risk-of-tax-evasion.html>

⁵⁹ *SEC Signals Ramp-Up in Crypto Enforcement by Nearly Doubling Its Crypto Assets Cyber Unit Staff* BAKERHOSTETLER (May 5, 2022) <https://www.bakerlaw.com/SEC-Signals-Ramp-Up-in-Crypto-Enforcement-by-Nearly-Doubling-Its-Crypto-Assets-Cyber-Unit-Staff>

⁶⁰ Rostin Benham, *Address*, BROOKINGS INSTITUTION, (July 25, 2022) <https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam24>

⁶¹ Kevin Roose, *What are NFTs?* NEW YORK TIMES (website visited July 21, 2022) <https://www.nytimes.com/interactive/2022/03/18/technology/nft-guide.html>

⁶² *FYI on NFTs: Consumer Protection and Privacy Considerations* WILSON SONSINI (March 9, 2022) <https://www.jdsupra.com/legalnews/fyi-on-nfts-consumer-protection-and-5976517/>

⁶³ U.S. Attorney’s Office, *Two Defendants Charged In Non-Fungible Token (“NFT”) Fraud And Money Laundering Scheme* DEPARTMENT OF JUSTICE (March 24, 2022) <https://www.justice.gov/usao-sdny/pr/two-defendants-charged-non-fungible-token-nft-fraud-and-money-laundering-scheme-0>

prominent.⁶⁴ We welcome the Department of Justice's decision to establish a National Cryptocurrency Enforcement Team.⁶⁵

The SEC should regulate cryptocurrency as a security. The SEC defines a security with the Howey Test. The Howey Test consists of four prongs, all of which must be satisfied for the SEC to classify a transaction as a security. The four elements are as follows: [1] An investment of money [2] in a common enterprise [3] with expectations of a profit [4] to be derived from the efforts of others⁶⁶ (The "effort of others" derives from the promotion by the sponsor.) Given that sponsored cryptocurrencies satisfy all of these elements, they should be regulated by the SEC. And, in fact, in a recent case of alleged insider trading, the SEC declared several cryptocurrencies as "unregistered securities."⁶⁷

Once cryptocurrencies status as securities is clarified, the SEC's climate disclosure rule, if adopted, could provide a comprehensive, verified view of the emissions generated by digital assets and trading, especially if the rule requires registrants to disclose the emissions released in their value chain, also known as Scope 3 emissions. Along with the immediate benefits to investors, such disclosures would also provide important inputs to systemic financial risk monitoring conducted by the Office of Financial Research and the Financial Stability Oversight Council, which has highlighted both climate and digital assets as emerging risk areas. To realize these benefits, it's important that the SEC clarify the reach of its proposed Scope 3 reporting requirement, which currently only requires disclosure if those emissions are "material." Ideally, the SEC would recognize the importance of Scope 3 emissions disclosure for all companies. But, at a minimum, it should clarify that for large firms that own or trade significant quantities of cryptocurrency, their Scope 3 emissions would be material and subject to disclosure for the reasons discussed above. Due to their importance, those emissions should also be subject to the level of assurance required for Scope 1 and 2 emissions.

Stablecoins should be regulated along the lines established recently by the European Markets in Crypto Assets (MiCA).⁶⁸ When implemented, European authorities will require stablecoin sponsors to hold liquid assets on a 1-1 basis with the tokens and provide for refunds with no charge. (Because stablecoin transactions require decentralized "miners" for verification, and they are paid in that stablecoin, then stablecoin sponsorship may be inherently unprofitable.⁶⁹) Sponsors will also need to disclose their climate footprint. Crypto asset service providers must register with the European Securities and Markets Authority. We believe U.S. stablecoin sponsors should publish audits of their reserve monthly. Exchanges need margin requirements and stress tests; stablecoins need a liquid assets requirement and money market mutual fund-style protections to prevent runs and death spirals; banks and other traditional financial

⁶⁴ Lina Khan, *Vision and Priorities for the FTC*, FEDERAL TRADE COMMISSION (Sept 22, 2021) https://www.ftc.gov/system/files/documents/public_statements/1596664/agency_priorities_memo_from_chair_lina_m_khan_9-22-21.pdf

⁶⁵ Department of Justice, *Justice Department Announces First Director of National Cryptocurrency Enforcement Team* DEPARTMENT OF JUSTICE (Feb. 17, 2022) <https://www.justice.gov/opa/pr/justice-department-announces-first-director-national-cryptocurrency-enforcement-team>

⁶⁶ *Framework for "Investment Contract" Analysis of Digital Assets* SEC (website accessed August 3, 2022) <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>

⁶⁷ Press Release, *SEC Charges Former Coinbase Manager, Two Others in Crypto Asset Insider Trading Action* SECURITIES AND EXCHANGE COMMISSION (July 21, 2022) <https://www.sec.gov/news/press-release/2022-127>

⁶⁸ European Council, *Digital finance: agreement reached on European crypto-assets regulation (MiCA)* EUROPEAN COUNCIL (June 30, 2022) <https://www.consilium.europa.eu/en/press/press-releases/2022/06/30/digital-finance-agreement-reached-on-european-crypto-assets-regulation-mica/>

⁶⁹ *The Stablecoin Cryptocurrency System* JDSUPRA (Dec. 1, 2020) <https://www.jdsupra.com/legalnews/part-2-the-stablecoin-cryptocurrency-78223/>

institutions must hold adequate capital to reflect the riskiness and volatility of crypto assets. Banks that hold crypto should post 1250 percent risk capital, as described by the Basel Committee.⁷⁰

The Financial Stability Oversight Council (FSOC) should use its authority (under Dodd-Frank Section 120) to recommend that primary financial regulatory agencies move quickly to address these issues.

Regulators must look at the impacts of crypto operations and financial footprint on groups who have been excluded from financial markets because of racial discrimination. Crypto purportedly permits access to the financial system for those groups, but those claims rarely amount to more than marketing.

The Department of Labor (DOL) should instruct fiduciaries that crypto is not a responsible investment. We welcome DOL guidance that notes that “Fiduciaries may not shift responsibility to plan participants to identify and avoid imprudent investment options, but rather must evaluate the designated investment alternatives made available to participants and take appropriate measures to ensure that they are prudent.” The DOL notes a U.S. Supreme Court explanation that “even in a defined-contribution plan where participants choose their investments, plan fiduciaries are required to conduct their own independent evaluation to determine which investments may be prudently included in the plan’s menu of options.” The failure to remove imprudent investment options is a breach of duty, the DOL states.⁷¹

Regulators must account for the energy and emissions impacts of crypto, particularly given the lack of underlying economic value of the assets. Both the direct emissions from mining and the broader effects of a mining ecosystem can have serious consequences for energy prices, the environment, and the climate. Crypto firms must adopt practices and protocols that mitigate these impacts in line with science-based targets for emissions and waste reduction.

Crypto’s anonymity must not enable avoidance of legal obligations or illicit behavior. Regulators must make crypto firms comply with Know Your Customer rules, not facilitate sanctions avoidance, and issue tax docs for sale of coins (including swaps into other cryptocurrencies). Agencies must better ensure that gains from the sales of cryptocurrencies are properly taxed, including an increased focus on this issue by enforcement officials at the IRS. We support greatly increased funding to the agency to help tackle this type of enforcement.

In addition to cryptocurrencies, other digital assets such as NFTs may require no additional regulation. We are astounded at some of the prices, such as the \$69 million paid for a digital collage called “Everyday: the First 5000 Days,” by an illustrator known as Beeple.⁷² The bidding, conducted by Christies, started at \$100, suggesting that this expert auction house itself had no accurate understanding of what the market value might be. The purchaser owns this digital asset, but not the copyright. Anyone can enjoy the identical digital image as the purchaser by searching for it on the internet. We are aware that

⁷⁰ Basel Committee on Banking Supervision, *Prudential Treatment Of Cryptoasset Exposures*, BANK OF INTERNATIONAL SETTLEMENTS (Sept. 10, 2021) <https://www.bis.org/bcbs/publ/d519.pdf>

⁷¹ Department of Labor, *401(k) Plan Investments in “Cryptocurrencies”* (March 10, 2022) <https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/compliance-assistance-releases/2022-01>

⁷² Abram Brown, *Beeple NFT Sells for \$69 million*, FORBES (March 11, 2021) <https://www.forbes.com/sites/abrambrown/2021/03/11/beeple-art-sells-for-693-million-becoming-most-expensive-nft-ever/?sh=402d6d0c24>

NFT promotions may involve scams to exploit a consumer's digital wallet. But these take place outside the question of whether NFT have value that any reasonable investor would assign.⁷³

Improving the Payment System

As noted, the cryptocurrency promised to improve the payment system. We welcome efforts to broadly make the payment system more efficient and less costly for consumers and businesses alike.

Many U.S. residents are underbanked. More than six percent of American households, or some 33 million citizens are without a traditional bank account. Some do not trust banks, while others lack the funds that financial institutions require to open and maintain an account.⁷⁴

Even for those lucky people with deposit accounts, the payment system is slow. Overdraft fees can be substantial. Checks and credit card payments can take two days or more to clear, meaning that vendors are without these funds during that time. It is also costly. Checks and particularly wire transfers can include substantial fees. Banks charge interchange fees for credit cards, a substantial burden for retailers.⁷⁵ And it is complex, with thousands of banks with idiosyncratic ledger systems communicating with one another and the Federal Reserve.

We note the apparent success of the Pix payment system in Brazil, sponsored by the Central Bank of Brazil.⁷⁶ This uses QR codes (or two-dimensional bar codes, formally known as a quick response code) that appear in the customers' cell phones. After a year of operation, this electronic system, free of fees to customers, represented some 6 percent of electronic commerce in the country.⁷⁷ During the pandemic, adoption of Pix led to a 73 percent decline in the unbanked population.⁷⁸ The Brazilian Central Bank requires Brazilian banks to participate. Banks reportedly discovered that while they lost some revenue from fees, they saved money from the reduced use of checks.⁷⁹

⁷³ Amanda Hetler, *Eight Ways to Avoid NFT Scams*, TECHTARGET (May 26, 2022)

<https://www.techtartget.com/whatis/feature/8-ways-to-avoid-nft-scams>

⁷⁴ Mehra Baradaran, *How the Other Half Banks*, HARVARD UNIVERSITY PRESS (2015)

<https://www.hup.harvard.edu/catalog.php?isbn=9780674983960>

⁷⁵ Aaron Klein, *A Few Small Banks Have Become Overdraft Giants*, BROOKINGS INST. (Mar. 1, 2021)

<https://www.brookings.edu/opinions/a-few-small-banks-have-become-overdraft-giants/>

⁷⁶ Pix, CENTRAL BANK OF BRAZIL (website accessed July 18, 2022)

https://www.bcb.gov.br/en/financialstability/pix_en

⁷⁷ *The Pix Revolution in Brazil*, EBANK (website accessed July 18, 2022)

https://business.ebanx.com/hubfs/ABM/APMs/Pix/English/PIX-Revolution-EBANX-EN.pdf?utm_medium=email&_hsenc=p2ANqtz-9rbll_fYtYx3FDsbh-srlZgbl8Xm3IC1j2G5w_c2Zc8YqlVgzOSnCMB8XLdkCn06suimlTD9pQ8gwIs4SdfcW3iIyIQ&_hsmi=206763316&utm_content=206763316&utm_source=hs_automation&hsCtaTracking=5529a87a-3179-4fcd-94eb-bf706937d921%7Cf2d4b972-00a6-4acd-a46a-3d880e2cf259

⁷⁸ *A Year of PIX in Brazil: What Does the Future of Real-Time Fraud Look Like?* ACI WORLDWIDE (Dec. 10, 2021)

<https://www.aciworldwide.com/blog/a-year-of-pix-in-brazil-what-does-the-future-of-real-time-fraud-look-like>

⁷⁹ Maxnaun Gutierrez, *Why Pix is the Revolution of Consumer Experience in Brazil* PAYMENTS JOURNAL (Feb. 24, 2021) <https://www.paymentsjournal.com/why-pix-is-the-revolution-of-consumer-experience-in-brazil/>

The 28 countries of the European Union, along with several others, are experimenting with Single Euro Payments Area, an electronic transfer system that promises transaction completion within 10 seconds. (European regulators, however, do not require banks to participate.⁸⁰)

At the same time, Public Citizen does support exploration of a Central Bank Digital Currency (CBDC). This federal digital coin, in one form dubbed a FedAccount, holds the promise to address some of the problems with the payment system reviewed above. Currently, depository institutions maintain accounts with the Federal Reserve.

Conceived by Lev Menand of Columbia Law School in June 2018, the CBDC would be a Federal Reserve account. It would be available to “any U.S. resident or business in digital wallets operated by the Federal Reserve, the Post Office, or one of the country’s several thousand community banks,” he explains.⁸¹ “The digital wallets would charge no fees and have no minimum balances. They would come with debit cards, direct deposit, and bill pay. They would have customer service, privacy safeguards, and fraud protection—if for example one lost their password. And these accounts would earn interest at the same rate that the Fed pays to banks.”

Lack of profitability for the banks represents one of the reasons that banks fail to service roughly six percent of the population. The FedAccount would be available regardless of any balance and would be streamlined with immediate clearing. There would be no fees. With such an account, delivery of federal payments such as Covid relief or other government benefits, would be immediate.

Noting though that before such a system is implemented, important questions must be answered. For example, many bank account holders are subject to garnishments because of unpaid debt. Debt collectors would have a simple way to garnish funds through the CBDC. That also means the Federal Reserve would need to engage with debt collectors in addition to individual Federal Reserve account holders. There may be political issues. For example, the CARES Act might have more effectively delivered needed rescue funds to needy Americans via a FedAccount system. However, some of the individuals who received relief may have been subject to garnishment, meaning the Federal Reserve would be in a position of deciding whether, in times of extraordinary need, it would protect or release these funds.

Conclusion

From a non-existent market in 2008 to a recent market capitalization of \$3 trillion, cryptocurrency has mushroomed to the point where it now threatens to become a source of systemic risk. If regulators worried that more forceful intervention in this giant Ponzi scheme might concuss through broader markets, such concerns should be allayed by the recent collapse, where the market value has now declined by about \$2 trillion in a matter of months. If erasing two thirds of market capitalization has not caused tremors, we believe the final \$1 trillion will not either.

We urge the Treasury to recommend to agencies a robust regulatory scheme without fear of sparking systemic risk, and with support from consumer protection advocates when it comes to protections for consumers contemplating an investment in assets without true value.

⁸⁰ Andrew Singer, *Brazil’s PIX Payments System Has the Same Spirit, but Not a Blockchain Structure* COINTELEGRAPH (Feb 28, 2020) <https://cointelegraph.com/news/brazils-pix-payments-system-has-the-same-spirit-but-not-a-blockchain-structure>

⁸¹ Lev Menand, *Testimony*, U.S. SENATE BANKING COMMITTEE (June 9, 2021) <https://www.banking.senate.gov/imo/media/doc/Menand%20Testimony%206-9-21.pdf>

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Sincerely,

Public Citizen

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

June 17, 2022

Re: The Enhancement and Standardization of Climate-Related Disclosure for Investors
Attention: 87 FR 21334; Docket ID: SEC-2022-06342; File No. S7-10-22

Dear Ms. Countryman,

Americans for Financial Reform Education Fund and Public Citizen appreciate the opportunity to comment on the above referenced Proposed Rule (the “Proposal”) by the Securities and Exchange Commission (the “SEC” or the “Commission”) to require mandatory, standardized climate-related disclosures from public companies. In conjunction with other comments submitted by our organizations, we write separately to address the importance of requiring disclosure for the transition risks that registrants face from exposure to digital assets. The response is intended to address Questions 19, 20, 97, 98, and 101.

Digital assets pose serious, poorly understood transition risks to registrants and markets.

Over the last decade, the market for digital assets has exploded, with a total market capitalization of nearly \$3 trillion at its height in Fall 2021, before recently falling by almost two-thirds to under \$1 trillion.⁸² These volatile, poorly regulated assets pose a range of risks to investors and markets. Along with the well-documented volatility and fraud that pervades many of these assets is the risk created by the energy-intensive protocols and activities that support many of them. As the White House Office of Science and Technology Policy explained in a recent request for information on the climate impacts of digital assets (“OSTP Request”):

The explosive growth of the digital asset ecosystem may contribute to greater energy use and negatively impact the climate. Many digital assets, including cryptocurrencies, use decentralized consensus mechanisms as opposed to a central authority to verify transactions. While different

⁸² CoinMarketCap, “Total Cryptocurrency Market Cap,” available at <https://coinmarketcap.com/charts/> (last accessed June 13, 2022).

digital asset systems use different consensus mechanisms, many use “proof of work” based systems that require significant amounts of computing power and electricity, often derived from carbon-intensive sources. Some researchers estimate that cryptocurrencies use more electricity each year than many individual countries in the world, including some industrialized nations.⁸³

Because of their energy intensive nature, these assets are subject to what the Commission describes in the Proposal as transition risk: “the actual or potential negative impacts on a registrant’s consolidated financial statements, business operations, or value chains attributable to regulatory, technological, and market changes to address the mitigation of, or adaptation to, climate-related risks.”⁸⁴ Digital assets are heavily exposed to transition risks. For instance, the OSTP Request mentions that many digital assets are looking into less energy-intensive consensus mechanisms than proof of work.⁸⁵ If investors come to prefer these other mechanisms, then registrants with significant financial investment in mining or owning proof-of-work based cryptocurrencies may see unexpected losses or need to shift their business strategy.

Investors in registrants with exposure to digital assets lack standardized, comparable information about their climate impacts and transition risks. To the extent that ownership of digital assets becomes widespread and the industry becomes embedded in public markets in new and complex ways, it exposes investors and market participants to a largely unmonitored source of transition risk. The Proposal, if adopted with the recommendations below, could provide a comprehensive, verified view of the emissions generated by digital assets and trading, especially if the rule requires registrants to disclose the emissions released in their value chain, also known as Scope 3 emissions. Along with the immediate benefits to investors of understanding the emissions and other climate risks generated as a direct result of cryptocurrency mining and which firms are exposed to those risks, the Proposal could also illuminate the transition risks from the e-waste generated by mining operations, as well as the need for disclosure to help investors understand attempts to use digital assets to trade carbon offsets.

To adequately monitor the climate risks posed by digital assets, the Commission should adopt robust emissions disclosure requirements, including of Scope 3 emissions.

The decentralized and semi-anonymized characteristics of blockchain-based applications are factors that make it difficult to develop a systematic understanding of the overall energy usage or climate risks of any given digital assets, much less the entire ecosystem. What information exists today is often based on academic modeling that employs a wide range of estimates and simplifying assumptions regarding the energy mix used to power the consensus mechanism.⁸⁶ Some estimates of energy mix come from surveys

⁸³ Request for Information on the Energy and Climate Implications of Digital Assets, 87 Fed. Reg. 17105, 17106 (Mar. 25, 2022).

⁸⁴ Proposal at 21350.

⁸⁵ See [Request for Information on the Energy and Climate Implications of Digital Assets](#), 87 Fed. Reg. at 17106.

⁸⁶ [Cambridge Bitcoin Electricity Consumption Index](#); [The carbon footprint of bitcoin](#) at 12.

of participants, which are not subject to rigorous external verification.⁸⁷ Indeed, there is a clear incentive for stakeholders to withhold this information or underestimate emissions and risks and overestimate climate benefits. Purposeful obfuscation is the present norm.⁸⁸

The transition risks posed by cryptocurrency are becoming increasingly concrete. Recently, some governments have begun to advance proof of work pauses or bans.⁸⁹ If this trend continues, it could abruptly threaten the value and utility of digital assets that still use that protocol. The mining space is also full of bold claims about climate friendliness, even from miners powering their operations with coal refuse or flared natural gas.⁹⁰ This mismatch between words and deeds could result in additional transition risks as the public learns more about the sector's climate and environmental impacts.

Unfortunately, registrants who own or use digital assets are not required to account for these sorts of transition risks. The rapid growth of digital assets makes this a particularly dangerous blind spot. Many mainstream Wall Street firms are increasingly trading and lending digital assets,⁹¹ and large miners like Stronghold Digital Mining and exchanges like Coinbase have been publicly listed on US stock exchanges. Investors and other market participants lack the information to fully assess the climate risks posed by these assets.⁹² Retail and institutional investors who purchase digital assets, sometimes with the assistance of registrants like Coinbase, are not being properly appraised of these risks, which threatens the orderly and efficient functioning of the capital markets.

The Proposal provides an important avenue for giving investors and other market participants, including regulators, the information they need to assess this risk. Digital asset miners, exchanges, and owners that are publicly traded would all need to assess their business and publicly disclose the way their business could be affected by the energy transition. Of particular importance is the Proposal's requirement for registrants to disclose GHG emissions from their activities (Scope 1 and 2 emissions), and, in some cases, from the activities in their value chain and investments (Scope 3).

Disclosure of Scope 1 and 2 emissions would provide information about the emissions of publicly traded miners and other direct participants in proof of work protocols. This would provide investors and other market participants with a picture of the heterogeneity of energy use and emissions by different miners and protocols, and help substantiate or debunk claims about the emissions generated by their activities.

⁸⁷ See [3RD GLOBAL CRYPTOASSET BENCHMARKING STUDY](#) at 29.

⁸⁸ [How Crypto Is Failing Spectacularly to Greenwash Itself: Zombies on the blockchain – CarbonPlan](#)

⁸⁹ [NY State Assembly Bill A7389C](#)

⁹⁰ [Crypto Mining Company Welcomes SEC Environmental Reporting Proposal; Exxon is mining bitcoin in North Dakota as part of its plan to slash emissions](#)

⁹¹ [Wall Street Reluctantly Embraces Crypto - WSJ](#)

⁹² [Crypto Miners Struggle to Cut Carbon Emissions - WSJ](#)

Investors could choose how to allocate their capital with full information about the potential transition risks faced by a set of miners involved in each protocol. These emissions disclosures would be subject to outside assurance requirements and attestation by management.

Perhaps even more important for assessing the emissions of digital asset protocols would be the Scope 3 disclosures. Major exchanges hold a near oligopoly on the trading of some cryptocurrencies.⁹³ Coinbase, one of the largest, is publicly traded, and others may follow suit as regulation of digital assets continues to develop. As part of their business, these exchanges own some of the digital assets they offer for trade.⁹⁴ Requiring disclosure of the emissions from their investments would make those exchanges assess and report the emissions impacts of each protocol they trade in.

Requiring disclosure of Scope 3 emissions would also require publicly traded financial institutions, which have been adding digital assets to their portfolios, to conduct the same assessment. This is particularly important because many of these large financial institutions have made pledges to align their investments with science-based emissions targets, in part to manage the transition risks they face. Disclosure of the emissions attributable to cryptocurrency investments will help investors in these institutions and other market participants assess the credibility of these net zero claims.

To appropriately capture this information, exchanges and financial institutions would need to establish processes for assessing the emissions from the main miners and protocols, regardless of their location or ownership status. Such processes would illuminate the level of transition risk embedded in digital assets, providing both investors and regulators with the picture they need to choose whether to invest in specific digital assets or in the firms that own or trade them.

To realize these benefits, it's important that the SEC clarify the reach of its proposed Scope 3 reporting requirement. The current Proposal only requires disclosure if those emissions are "material" and does not provide additional clarity on what such an assessment entails. The SEC should recognize the importance of Scope 3 emissions disclosure for all companies and require all registrants to disclose their emissions, rather than adopting a "materiality" threshold. For large firms who own or trade significant quantities of cryptocurrency, their Scope 3 emissions would undoubtedly be important to investors and subject to disclosure for the reasons discussed above. Yet adopting a materiality standard would create opportunities for large holders of crypto to avoid such disclosures by claiming they are immaterial. The SEC should avoid this possibility by requiring disclosure of Scope 3 emissions for all registrants. Because of the importance of these disclosures the Commission should also require them to receive the same level of reasonable assurance required for Scope 1 and 2 emissions, and require their disclosure on a similar timeline for all but the smallest registrants.

⁹³ [Crypto Oligopoly Imminent as Top Exchanges Grab 96% Market Share](#)

⁹⁴ [Coinbase's crypto holdings jumped ninefold last year to over \\$300 million as bitcoin surged](#)

Along with illuminating the emissions attributable to energy use by cryptocurrency protocols, the Proposal, if it adopts the recommendations above, could also help shine light on other sources of transition risk to investors and other market participants. Two examples, discussed below, are the emissions embedded in the waste produced by digital assets, and the forays by cryptocurrency firms into carbon offset markets.

The Proposal should help investors understand how the impacts of digital assets extend past the direct emissions generated by their operations, including to the waste they produce.

Requiring disclosure of Scope 3 emissions could help investors understand the emissions resulting from mining operations' dependence on the manufacturing and supply of electronic equipment. Crypto mining and proof of work verification methods generate disproportionately high volumes of electronic waste (or "e-waste") for the type of 'meaningful' economic activity that crypto mining purports to represent. The emissions resulting from the manufacture of this equipment may match or even exceed the emissions directly attributable to mining. One study has estimated the annual e-waste generated globally by mining for Bitcoin alone as roughly 30.7 metric kilotons in 2018, roughly equivalent to the amount of small IT equipment e-waste generated by the Netherlands.⁹⁵ One average Bitcoin generates 272 grams of e-waste per transaction, the equivalent of throwing away an iPad for every two Bitcoin transactions.⁹⁶ At peak price levels, Bitcoin mining could produce up to 64.4 metric kilotons of e-waste annually.

The main driver of this e-waste is that the typical ASIC processor used for Bitcoin mining can operate at an intensity sufficient to be profitable for only 1.29 years. This planned obsolescence on steroids will, barring both fundamental changes in mining technology and an incentive structure to change this approach, virtually guarantee a steady stream of electronic waste so long as crypto currencies exist and use processing intensive verification methods such as proof-of-work.

Noted digital technology developer and digital historian David Rosenthal has estimated that the carbon footprint of bitcoin mining, when taking into account released carbon emissions from the manufacture and use of these electronics, could be two times or even ten times larger than estimates that focus primarily on mining's energy use alone.⁹⁷

For broader context, the creation, collection, disposal of electronic waste is a decades long global resource and environmental health concern that poses risks to investors and market participants that are akin to transition risks. The US generates a significant amount of e-waste – 6918 kilotons in 2019 alone, which works out to approximately 21 kilograms of e-waste generated per capita annually. Of that, only 15% is recycled.⁹⁸ Given this high volume of waste and the challenges that come with managing it, the economic and operational costs of collecting e-waste have historically put undue strain on local waste management facilities. Improper disposal, handling, disassembly, or incineration of e-waste can also release toxic

⁹⁵ [Bitcoin's growing e-waste problem - ScienceDirect](#)

⁹⁶ [E-waste from every two bitcoin transactions is the equivalent of throwing away an iPad](#)

⁹⁷ [DSHR's Blog: Cryptocurrency's Carbon Footprint Underestimated](#)

⁹⁸ [The Global E-waste Monitor 2020](#)

metals and chemicals into the local environment, which can have significant negative health impacts on waste management workers and local communities, as well as local air and water quality.

Roughly half of US states have some sort of e-waste recovery laws to establish producer responsibility for the end of life of their products, but these laws vary widely in scope, coverage, and incentivization.⁹⁹

Although the volume of e-waste generated by crypto mining to date is likely modest in comparison to the overall volume generated in the US, this may change should crypto assets achieve mainstream use, either as a tool for investment or speculation. The volume of waste would no doubt achieve new levels of magnitude. Local and state waste recovery and recycling programs would face significant operational and financial strain managing such waste. State laws could be amended to ensure crypto mining operations fall under the scope resource recovery laws that deal with e-waste – or, in states where no such rules exist, entirely new requirements might be created to deal with this new waste stream. Such changes would impose significant costs throughout the crypto value chain, in ways that will likely affect the financial condition of firms that are embedded within it. Investors need information about emissions, as well as qualitative disclosures of climate risk, to assess how prepared registrants are for this risk.

Blockchain based carbon offset credits cannot address the issues with carbon credits and indeed create new challenges.

One strategy that some registrants intend to rely on to manage transition risk is the use of carbon offsets. As the Proposal acknowledges, offsets pose their own set of risks to registrants who would rely on them, and require separate disclosures so investors can evaluate a registrant’s strategy.¹⁰⁰ Recent developments seeking to combine offsets and digital assets reinforce the wisdom of this approach.

In recent months, Decentralized Finance (DeFi) projects have launched, claiming to employ the blockchain to create a forum for trading carbon offset credits and to improve transparency and liquidity in those markets.¹⁰¹ The largest project, known as Toucan, claims it has put more than 17 million tons of CO2-equivalent avoided emissions “on chain.” But recent research by the climate solutions watchdog Carbon Plan shows that while this project has apparently been lucrative for its backers and partners, there is little evidence that it has effectively reduced emissions.¹⁰² The offsets it puts on chain are subject to well-documented problems, which mean that the verified credits are unlikely to actually reduce emissions. And because the protocol denies responsibility for further verifying credits, it actually revives projects that have previously been unable to find buyers or that are no longer eligible for trading on off-chain markets.

⁹⁹ [The Global E-waste Monitor 2020](#)

¹⁰⁰ Proposal at 21355.

¹⁰¹ [Cryptocurrency Traders Move Into Carbon Markets - WSJ](#)

¹⁰² [Zombies on the blockchain – CarbonPlan](#)

The stated goal of Toucan is to create liquidity and increase price discovery through transparency in voluntary carbon markets, which would raise prices for credits from voluntary emissions reductions. If successful, proponents claim it would incentivize greater emissions reductions in the physical world. The protocols operate by allowing anyone who currently holds emissions credits with the Verra offsets registry to move those credits onto the blockchain.

But using blockchain for carbon offset trading is a solution in search of a problem: neither liquidity nor price discovery are current problems in the functioning of the carbon markets; the overarching problem is poor offset quality.¹⁰³ Most voluntary emissions reduction projects struggle to demonstrate that they actually reduce emissions. Instead, they often pay managers of forests or other carbon sinks to continue doing what they were already doing.¹⁰⁴ At best, this approach means a project has no effect on carbon emissions. Worse, in some cases it actually justifies increased emissions. This is because when business-as-usual management of a carbon sink is treated as an “offset,” it increases the pool of allowable emissions without any corresponding real-world offset or reduction. A recent effort by global financial leaders to improve the integrity of these markets has become bogged down in these challenges.¹⁰⁵

The garbage in - garbage out problem that this state of affairs creates is only exacerbated by Toucan’s expansive eligibility criteria. Carbon Plan has documented that, rather than incentivizing production of new, high quality offsets, the Toucan protocol largely gives new life to “zombie projects” that have been unable to sell credits for years, likely due to their low quality standards. 99.9 percent of credits on Toucan reflect projects that were credited before 2016, making them ineligible for trading in most conventional markets. Rather than taking responsibility for these negative consequences, Toucan has insisted they are not responsible for judging the quality of carbon credits on their blockchain.¹⁰⁶ Naturally, Verra has disclaimed any responsibility for any trading that happens on Toucan. The result is that buyers of credits get to claim non-existent emissions reductions, while sellers make a quick profit on previously worthless carbon credits.

The blockchain may yet prove to have benefits for tracking emissions and reductions. But registrants who rely on offsets purchased on such an exchange may find that the quality does not reflect their or their investors’ expectations. This risk is why it is critical for disclosure about the use of offsets to include information about whether credits were purchased from a blockchain based registry and the diligence done to assess the quality of the credit. Without this information, investors and other market participants will not have what they need to assess the risks registrants face from purchasing offsets of dubious quality.

¹⁰³ [Public Citizen Comment on Office of the Comptroller of the Currency’s Principles for Climate-Related Risk Management for Large Banks](#), pp 10-13

¹⁰⁴ [Rethinking forest carbon offsets; JPMorgan, Disney, Blackrock Buy Nature Conservancy’s Useless Carbon Offsets](#).

¹⁰⁵ [Mark Carney’s Bid to Boost Carbon Market Scaled Back Amid Controversy - Bloomberg](#)

¹⁰⁶ [Toucan’s Huge Crypto Effort to End Useless Carbon Offsets Is Backfiring - Bloomberg](#)

Conclusion

The Proposal is an important step forward for protecting investors and other market participants from the transition risks posed by digital assets. The Commission could build on this protection by moving quickly to finalize the Proposal, including a requirement for all registrants to disclose their Scope 3 emissions, subject to reasonable assurance.

Thank you for your time and attention to these important issues. To discuss them further, please contact Yevgeny Shrago, Policy Director at Public Citizen's Climate Program (yshrago@citizen.org) and Mark Hays, Senior Policy Analyst at Americans for Financial Reform Education Fund (markhays@ourfinancialsecurity.org).

Sincerely,

Public Citizen and Americans for Financial Reform Education Fund

**Questions for the Record from Ranking Member Maxine Waters
Digital Assets, Financial Technology and Inclusion Subcommittee Hearing entitled,
“Coincidence or Coordinated? The Administration’s Attack on the Digital Asset
Ecosystem”
March 9 at 2pm ET**

Mr. Jonathan Gould

1. **Mr. Gould**, which of the following options best describes your self-identified race? (you may choose more than one)
 - a. White or Caucasian
 - b. Black or African American
 - c. Hispanic/Latinx
 - d. Asian
 - e. Middle Eastern/North African
 - f. Choose not to answer
 - g. Prefer to self-describe (please specify)

2. **Mr. Gould**, which of the following options best describes your gender identity?
 - a. Woman
 - b. Man
 - c. Non-binary
 - d. Transgender man
 - e. Transgender Woman
 - f. Choose not to answer
 - g. Prefer to self-describe (please specify)

**Questions for the Record from Ranking Member Maxine Waters
Digital Assets, Financial Technology and Inclusion Subcommittee Hearing entitled,
“Coincidence or Coordinated? The Administration’s Attack on the Digital Asset
Ecosystem”
March 9 at 2pm ET**

Mr. Lee Reiners

1. **Mr. Reiners**, several major crypto firms, such as FTX, Genesis, the Celsius Network, and Voyager Digital, filed for bankruptcy in the last year for a variety of reasons. The reverberation of FTX’s collapse continues to be felt and contagion remains a concern for much of the public and investors.
 - a. Was there any common theme you have found in these bankruptcies?
 - b. Have you uncovered signs that FTX’s contagion will continue to spread for the foreseeable future?

Of course, the most obvious theme is that all these entities were exclusively engaged in crypto asset activities. Once the value of crypto assets declined precipitously in the wake of the Terra/Luna collapse in May 2022, these firms’ business models came under pressure. After the crypto hedge fund Three Arrows Capital collapsed due to its Terra/Luna exposure, the contagion spread to Voyager and Genesis, as both firms had lent to Three Arrows. In addition, all these firms suffered from severe risk management failures and in some cases, executives at these firms engaged in alleged illegal conduct. Perhaps most importantly, none of these firms were regulated or supervised at the federal level, either by the CFTC or the SEC. After their failures, the SEC filed civil charges against FTX and Genesis for alleged offerings of unregistered securities (the SEC and CFTC also brought charges against FTX executives for various securities and commodities laws violations.) Furthermore, the outcomes for these firms’ users have been the same; they have all become unsecured creditors in the bankruptcy estate.

- a. Have you uncovered signs that FTX’s contagion will continue to spread for the foreseeable future?

Crypto assets and crypto firms are deeply interconnected. As we’ve seen repeatedly over the years, problems in one corner of the crypto market quickly spread throughout the crypto economy. Unlike in the traditional financial system, there is no central bank to step in as lender of last resort to stop the hemorrhaging in the crypto economy. This means that contagion can spread very quickly in the crypto system, and as we’ve seen throughout history, when the market cannot tell the weak from the strong, they treat everyone as though they are weak. Because crypto firms are largely unregulated and are not required to disclose audited financial statements – publicly traded companies aside – the market has an even harder time distinguishing between solvent firms and insolvent firms.

All that said, crypto prices have stabilized over the past month, and as long as prices remain stable, the risk of further contagion is limited. However, crypto assets lack fundamental value and trade entirely on sentiment. Therefore, prices could decline at any minute for a multitude of reasons, at which point we would likely see further failures in the crypto sector.

2. **Mr. Reiners**, up until recently only a few banks were willing to significantly deal with cryptocurrency companies and lend to leveraged cryptocurrency participants. The failure of Silvergate Bank, which had half of the global market for cryptocurrency-related banking services, suggests the wisdom of this behavior. The general firewall between the banking system and the cryptocurrency world has largely held.
 - a. Can you elaborate on the lessons learned from the recent bank runs?
 - b. What was crypto's role in these collapses?

There are many lessons to be learned from the recent bank runs. I would argue that the most important lesson is the risk associated with concentrated business and funding models. Another important lesson, which the federal banking agencies were thankfully already aware of, is the necessity of keeping crypto out of the banking system. At the time of FTX's failure, the federal bank regulators, such as the Board of Governors of the Federal Reserve System (the Federal Reserve), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC), each had outstanding guidance in place expressing concerns over banks' ability to engage in crypto-asset activities in a safe and sound manner and requiring banks to notify their appropriate regulator before engaging in such activity.¹ This stance limited crypto's integration into the banking system and did not threaten financial stability or the broader health of the banking system. However, despite regulators' warnings, FTX's failure revealed that several banks were more exposed to crypto-asset activities than previously realized. Three notable examples are Silvergate Capital Corporation, Moonstone Bank, and Signature Bank. I do believe these banks had distinct business models compared to similar-sized banks and I do not believe there are other banks within the system that have such a concentrated exposure to crypto.

- a. What was crypto's role in these collapses?

Crypto was the main cause of Silvergate's collapse. Silvergate positioned itself as the leading bank for cryptocurrency exchanges (including FTX) and investors.² At the end of September 2022, deposits from crypto clients comprised 90% of the bank's overall deposit base, leaving the bank highly exposed to a volatile sector.³ This risk became manifest post-FTX collapse when the bank experienced \$8.1 billion in deposit outflows during the fourth quarter of 2022, more than 60% of its total deposits.⁴ Silvergate was forced to sell assets to meet deposit outflows,

¹ Mike Winters, 'Contagion risk': After the FTX Collapse, Top U.S. Regulators Warn Banks About Crypto, CNBC (Jan. 6, 2023, 8:30 AM), [https://perma.cc/YUQ7-XPQ5]; see also Pete Schroeder, U.S. Banks Must Seek Regulatory Permission Before Engaging in Certain Crypto Activities—Regulator, REUTERS (Nov. 23, 2021, 4:42 PM), [https://perma.cc/9V7S-P4KG].

² SILVERGATE, [https://perma.cc/663S-R693] (last visited Mar. 7, 2023).

³ Marc Rubinstein, *These Banks Were Left Holding the Bag in Crypto Implosion*, WASH. POST (Nov. 23, 2022, 7:07 AM), [https://perma.cc/XMT3-2QZW].

⁴ David Benoit, *Silvergate's Deposit Run Is Worse Than Great Depression-Era Runs*, WALL ST. J. (Jan. 5, 2023, 1:30 PM), [https://perma.cc/L6DM-C6P2].

resulting in a loss of \$718 million, which exceeded “the bank’s total profit since at least 2013.”⁵ Silvergate also borrowed \$4.3 billion from the Federal Home Loan Bank of San Francisco in an unsuccessful effort to stay afloat.⁶ On March 8, 2023, Silvergate’s holding company announced they were voluntarily liquidating the bank.⁷

Crypto played a role in the demise of Signature Bank as well, but its exact role is subject to some debate. Following the SVB collapse—the biggest bank failure since the global financial crisis of 2008 and the second biggest bank failure in U.S. history – attention turned to Signature Bank, which had a similarly high percentage of uninsured deposits (more than 93 percent of SVB’s deposits were uninsured, and 89 percent of Signature Bank’s deposits were uninsured).⁸ Unlike SVB, Signature had heavy exposure to the crypto industry, which created additional concerns about the bank’s health; it operated a “24/7 payments network for crypto clients and had \$16.5 billion in deposits from digital-asset-related customers.”⁹ Signature was put into FDIC receivership on Sunday, March 12, 2023, prompting bank board member and former congressman Barney Frank to claim that “regulators wanted to send a very strong anti-crypto message.”¹⁰ However, the New York Department of Financial Services – they took possession of Signature and appointed the FDIC as a receiver – said that the decision to close Signature “had nothing to do with crypto.”¹¹ On March 20, 2022, the FDIC entered into a purchase and assumption agreement with Flagstar Bank for most deposits and certain loan portfolios of Signature.¹² Flagstar did not bid on Signature’s crypto deposits and the FDIC announced they would send roughly \$4 billion of Signature Bank deposits held by crypto businesses back to its

⁵ David Benoit, *Silvergate Raced to Cover \$8.1 Billion in Withdrawals During Crypto Meltdown*, WALL ST. J. (Jan. 5, 2023, 4:30 PM), [https://perma.cc/B47L-SHG7].

⁶ Kate Berry, *Silvergate Bank Loaded Up on \$4.3 Billion in Home Loan Bank Advances*, AM. BANKER (Jan. 10, 2023, 1:56 PM), [https://perma.cc/W48Q-PNNR].

⁷ https://ir.silvergate.com/news/news-details/2023/Silvergate-Capital-Corporation-Announces-Intent-to-Wind-Down-Operations-and-Voluntarily-Liquidate-Silvergate-Bank/default.aspx

⁸ David Hayes, *SVB, Signature Racked Up Some High Rates of Uninsured Deposits*, S&P GLOBAL MARKET

INTELLIGENCE (Mar. 14, 2023) [https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/svb-signature-racked-up-some-high-rates-of-uninsured-deposits-74747639].

⁹ Hugh Son, *Why Regulators Seized Signature Bank in Third-Biggest Bank Failure in US History*, CNBC (Mar. 13, 2023) [https://www.cnbc.com/2023/03/13/signature-bank-third-biggest-bank-failure-in-us-history.html]

¹⁰ Id.

¹¹ Hannah Lang and Pete Schroeder, *Signature Bank’s Closure Had ‘Nothing to Do with Crypto’ – New York Regulator*, REUTERS (Mar. 14, 2023) [https://www.reuters.com/business/finance/signature-banks-closure-had-nothing-do-with-crypto-new-york-regulator-2023-03-14/].

¹² [FDIC: PR-21-2023 3/19/2023](#)

customers.¹³ As of this writing, the FDIC is still attempting to find a buyer for Signature's crypto payments network.¹⁴

In their recent report on their supervision of Signature Bank, the FDIC attributes a larger role for crypto in Signature's failure than the NYDFS.¹⁵ The FDIC notes that Signature's liquidity position deteriorated in late 2022 in large part due to stress in the crypto industry and that the bank was not prepared for the shock of an uninsured deposit run. The FDIC also notes that Signature's reputation as a crypto-friendly bank led to its stock price declining precipitously along with crypto prices in 2022.

Crypto did not play a meaningful role in the demise of SVB.

3. **Mr. Reiners**, which of the following options best describes your self-identified race?
(you may choose more than one)
 - a. **White or Caucasian**
 - b. Black or African American
 - c. Hispanic/Latinx
 - d. Asian
 - e. Middle Eastern/North African
 - f. Choose not to answer
 - g. Prefer to self-describe (please specify)

4. **Mr. Reiners**, which of the following options best describes your gender identity?
 - a. Woman
 - b. **Man**
 - c. Non-binary
 - d. Transgender man
 - e. Transgender Woman
 - f. Choose not to answer
 - g. Prefer to self-describe (please specify)

¹³ [FDIC Gives Deadline of Next Week for Crypto Depositors Stranded by Signature Failure \(yahoo.com\)](#)

¹⁴ [FDIC to Sell Signature Bank's Crypto Payment Network \(wsj.com\)](#)

¹⁵ [FDIC'S SUPERVISION OF SIGNATURE BANK](#)

The SEC Has Issued Approximately 130 Enforcement Actions on Crypto Assets

That includes:

- SEC v. Bankman-Fried (FTX)
- SEC v. Singh (FTX)
- SEC v. Ellison and Wang (FTX)
- EMAX tokens (NBA player Paul Pierce)
- SEC v. Terraform Labs (Terra USD)
- Payward Ventures (Kraken)
- SEC v. Eisenberg (MNGO token)
- SEC v. Genesis Global Capital, LLC and Gemini Trust Company, LLC
- SEC v. Thor Technologies, Inc. and Chin
- EMAX Tokens (Kim Kardashian)
- SEC v. Chicago Crypto Capital LLC, et al.
- SEC v. Dragonchain, Inc., et al.
- SEC v. Ryn and GexCrypto
- SEC v. Wahi, et al. (former Coinbase product manager)
- SEC v. Block Bits Capital, LLC, et al.
- SEC v. Barksdale, et al.
- BlockFi Lending LLC
- SEC v. Ripple Labs, Inc., et al
- and more....

The Honorable Patrick McHenry
Chairman
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

From:
Dr Nicholas Weaver, Ph.D.
2150 Shattuck Ave, Ste. 250,
Berkeley, CA 94704
nweaver@icsi.berkeley.edu

3/7/2023

Dear Chairman McHenry, Ranking Member Waters and members of the Committee,

I am a researcher at the International Computer Science Institute in Berkeley, where for over a decade one area of my research included the cryptocurrency ecosystem. I am also a lecturer in Computer Science at the University of California at Berkeley. I received my Ph.D. in Computer Science from UC Berkeley in 2003.

I am also the author of the recently published ISP Digital Future Whitepaper from Yale University School of Law entitled "The Death of Cryptocurrency: The Case for Regulation", which is available at:
https://law.yale.edu/sites/default/files/area/center/isp/documents/weaver_death_of_cryptocurrency_final.pdf

As an expert in the cryptocurrency space I am in a fairly unique position. Most experts have significant financial interests in the cryptocurrency space, which likely has an effect on their judgements. As an academic, I am able to turn research in this space into academic papers, which is a business model that allows me to study the space without being financially invested.

I hold no cryptocurrency, and the only cryptocurrency I held (1.05 Bitcoin) I donated in 2015.

I. There Is No "Innovation" To Stifle with Regulation

The question the committee is pondering, whether the "The Administration's Attack on the Digital Asset Ecosystem" is coincidence or coordinated, needs to first address the issue of whether a sudden interest in regulation might actually harm an "innovative" industry or is instead targeting old economic behavior with well tested regulations.

Although cloaked in a veneer of technobabble, the underlying economic behaviors within the cryptocurrency space mostly recapitulate a millennia of financial history, creating a field generally devoid of meaningful innovation, and a large fraction of repeating history is repeating

historical failures. But by repeating a long litany of previous failures, the systems are already covered by existing regulation. That the field is finally being forced to abide by such regulation should not be looked on as an “attack” but rather the natural response to the many harms caused by the cryptocurrency field and the billions already lost by the investing public in various collapses..

Almost every cryptocurrency, when issued, should already be considered a security under US law because individuals are encouraged to invest with a promise of gain due to the activity of others. Indeed there is often a strong resemblance to an investment in “an undertaking of great advantage, but nobody to know what it is”, a flashback to the 1820s and the South Sea Bubble.

The NFTs (Non Fungible Tokens), when not sold as a security in disguise¹, are highly reminiscent of the tulip mania from 1634, as the value of a CryptoKitty (the original NFT game), a particularly fine Beany Baby, and a *Semper Augustus* tulip are the same: what will someone else pay for this thing in the future.

The primary stablecoins, Tether and Circle, recapitulate the “free bank era” model from the mid 19th century where banks issued their own banknotes. The proliferation of “wildcat banks”, and subsequent consumer losses when unbacked paper bills turned out to be worthless, is why banks are no longer allowed to engage in this activity. The other historical analogy they resemble is “Liberty Reserve”, a criminal money transmitter shut down by the Department of Justice in 2013.

“Decentralized Autonomous Organizations” (DAOs), when legally constituted, are simply joint stock corporations. This is an idea that dates back a thousand years to the Song dynasty in China. And if not integrated into existing legal frameworks they are just general partnerships, complete with joint and several liability.

And finally, the cryptocurrency exchanges present to consumers that they are just like normal stock exchanges and brokerages, yet they seem to repeatedly fail in ways much more reminiscent of the Great Depression through a combination of mismanagement and outright fraud, from Mt Gox in 2014 to QuadrigaCX in 2019 to FTX in 2022.

II. Regulatory Action Protects Honest Participants

The recent regulatory activity by the SEC and other regulators seems largely driven by the realization that the underlying economic behavior is not new and falls squarely within the regulators’ existing authority and that the digital assets space is full of dishonest participants that harm both investors and honest participants.

Recently, the SEC began being more proactive against the issuers of “Initial Coin Offerings” and other unregistered securities. If the issuers of ICOs or other tokens actually believe they are offering legitimate investment opportunities, they should welcome the clear application of existing rules.

¹ Many high profile NFTs are driven by the promise that the NFT issuer will build a “metaverse” or some other NFT requiring service that NFT holders can profit from by selling the NFT to someone who may want access later, so the profit is supposed to be gained from the subsequent activities of the issuer.

The current cryptocurrency space is a “Lemons market”, a market where the buyers can’t tell whether products are good or bad and therefore must treat all products as bad. Any legitimate company or venture firm wishing to release an ICO should actually embrace the SEC’s enforcement of existing regulations as such regulations are specifically designed to allow investors separate sound securities from outright frauds, and the only real cost for the company is that involved in completing the paperwork required of all other investment vehicles. This would disrupt the lemons market, enabling honest purveyors of legitimate investments to receive significantly more investor interest.

Similarly, the moves to treat cryptocurrency exchanges like any other market system should be welcome to the markets as well as consumers. Requiring these exchanges to properly maintain custody of assets is a huge benefit to consumers, as it protects consumers from harm when the exchanges fail. This would not only benefit consumers but the exchanges themselves.

There is a saying amongst cryptocurrency skeptics that “all exchanges are FTX”: customers can’t know whether they are legitimate or fraudulent. If the cryptocurrency industry wishes to attract customers in the future, it is critical that customers be able to tell the difference between FTX and their exchange of choice. And the only way that can happen is through the application of mostly existing regulations.

Indeed, countries which have applied such regulations after a major failure have escaped the damage of future failures. Japanese and Canadian customers were mostly isolated from the fallout of FTX’s failure, as the prior major failures (MtGox in Japan and QuadrigaCX in Canada) caused these countries to apply regulations that are proven to protect consumers. Yet these regulations didn’t prevent Coinbase or other exchanges from operating in Canada (where they still operate) or Japan (where they recently closed operations not due to regulations but simply market conditions).

Coinbase and others should be delighted that the SEC wants to require cryptocurrencies to be held by qualified custodians and otherwise treat them as broker/dealers, as it would allow them to clearly explain to customers the significant protections this grants customers. This is especially true compared to the current world where Coinbase customers, in the event of a bankruptcy, will find their holdings part of the bankruptcy estate just like FTX-us customers.

After all, numerous cryptocurrency companies (such as the now bankrupt Voyager Digital) have shown the marketing benefit of falsely claiming FDIC protection. Reputable cryptocurrency companies should embrace the opportunity to participate in systems like SIPC and structures with proper custodianship. Embracing regulation would enable them to both better protect their customers and be able to market themselves as more trustworthy entities.

Regulating stablecoin issuers is also well within the ambit of existing law if it is acknowledged that the stablecoin issuer’s customers are not just those who buy or redeem the stablecoin but all those who use the stablecoin. This would make it clear that the stablecoin issuers are money transmitters and need to perform the Know Your Customer/Anti Money Laundering (KYC/AML) checks that all other money transmitters need to do.

This would incur a cost for the stablecoin issuers, but the cost is the same experienced by all other money transmitters. And although the code tracking ownership of the stablecoins is running in a distributed fashion, the stablecoin issuers can update the code itself to only allow transfers between registered users of the stablecoin.² Otherwise, these stablecoins are simply “Liberty Reserve with a Blockchain”.

Finally, banking regulators have properly focused on firewalling off cryptocurrency from the rest of the financial system. Up until recently only a few banks were willing to significantly deal with cryptocurrency companies and lend to leveraged cryptocurrency participants like Microstrategy or various cryptocurrency mining firms. These regulatory moves were never about attacking cryptocurrency but ensuring that regulated banking remains sound and isolated from the inherent problems in the cryptocurrency space.

The current failure of Silvergate Bank, which had half of the global market for cryptocurrency-related banking services, shows the wisdom of this behavior. Not only is Silvergate likely insolvent, but the general firewall between the banking system and the cryptocurrency world has largely held, and there does not seem to be any contagion effect.

III. Conclusion

Overall, regulators need to avoid being distracted by the “how” cryptocurrency works. As a technologist I can spend hours talking about hash chains, public key signatures, zkSNARKs, distributed computation, the use of random sampling and metastability in consensus algorithms, and the effect of quantum-flux inhibitors on the warp drive manifold³.

But we need to focus on “what it does”, and what it does falls squarely within existing regulation. And the reason for this is that so many of the problems are not new, but are instead replaying half a millennia of various financial failures. That regulators are finally seeking to proactively address those harms can’t be an “attack” on any honest participants within the digital assets ecosystem.

If you or your staff have any questions, do not hesitate to ask.

Sincerely Yours,

/s/Nicholas Weaver
Nicholas Weaver, Ph.D.

² Stablecoin issuers regularly block addresses involved with high profile thefts, clearly demonstrating their ability to control transfers.

³ Only one phrase has nothing to do with cryptocurrency systems

