THE FUTURE OF DIGITAL ASSETS:
IDENTIFYING THE REGULATORY GAPS
IN THE DIGITAL ASSET MARKET STRUCTURE

HEARING
BEFORE THE
SUBCOMMITTEE ON DIGITAL ASSETS,
FINANCIAL TECHNOLOGY,
AND INCLUSION
OF THE
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THE FUTURE OF DIGITAL ASSETS: IDENTIFYING THE REGULATORY GAPS IN THE DIGITAL ASSET MARKET STRUCTURE

Thursday, April 27, 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 2:02 p.m., in room 2128, Rayburn House Office Building, Hon. French Hill [chairman of the subcommittee] presiding.

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

Ex officio present: Representatives McHenry and Waters.

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 now recognize myself for 4 minutes for an opening statement.

Thank you for joining us at today’s hearing. We have an unique opportunity as members of this subcommittee to be on the cutting edge of crafting an effective, functional regulatory system for the digital assets ecosystem.

At this very moment, Chair Johnson and other members of the House Agriculture Committee are also holding a similar hearing discussing this same issue. That means that more than 40 Members of the U.S. House have an opportunity to work together to ensure that our regulatory framework embodies the key principles of the same activity, with the same risk, and the same regulation.

Moreover, we will be holding a joint hearing next month with the House Agriculture Committee to explore these issues together. Two committees working hand in hand on a joint legislative product like this is unprecedented, and I believe it vastly increases our chances of getting it right.

Why is legislation needed? The U.S. Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) have created an impossible situation where the same
firms are subject to competing enforcement actions by the two different agencies. Asset legislation and our regulators are only pushing entrepreneurs, developers, and job creators offshore and out of the U.S. system.

We have a responsibility to protect our constituents. There are glaring gaps in consumer and investor protections, and regulation by enforcement does nothing to fill that gap. And contrary to arguments by some that the problem is simply nonconformity or noncompliance, it is much more complicated than that. Also, money transmission licenses—as one of today’s witnesses, Mr. Gorfine, points out—are insufficient in scope.

So today, we are going to dive into the current rules that govern our securities and commodity markets and assess how we can address these potential gaps. First, we will examine the current test to determine if a digital asset is offered as a part of an investment contract and therefore a security. Currently, the SEC and the CFTC disagree on the classification of many digital assets, which is unworkable for entrepreneurs and consumers. The agencies need direction from Congress.

Second, the current disclosure regime does not produce information that a reasonable consumer would need to know before considering the purchase of a digital asset. The information that is relevant to the purchaser of a digital asset is different from the information that is relevant when an investor considers purchasing a stock of a public company.

Third, we will explore whether digital asset trading platforms perfectly fit under existing laws and regulations and the rules applicable to digital asset trading platforms.

We have a diverse, knowledgeable panel before us today. Their experiences will help us understand how we can fill these gaps and build a better, more-functioning framework. I implore members of this subcommittee to be thoughtful and open-minded with their questions as we seek to take a deep dive into the current regulatory requirements.

I look forward to working together on both sides of the aisle to craft a digital asset market structure framework and to lead in the right way.

I now recognize the ranking member of the subcommittee, Mr. Lynch, for a 4-minute opening statement.

Mr. Lynch. Thank you very much, Mr. Chairman.

And today is Take Your Child to Work Day, so some of our staff—

Chairman Hill. Did you bring Bill Foster?

Mr. Lynch. No. He is much younger than my son. My dad was an iron worker, so he did not take me to work, thankfully.

But anyway, I want to thank you, Mr. Chairman, for holding this hearing. And I thank our witnesses for your willingness to share your expertise and to help this committee with its work.

As we consider the future of digital assets, I believe that this is an important opportunity to really understand the intended and unintended impacts on our traditional financial system that might come about as our collective efforts combine to change the regulatory landscape for some of these digital products.
This hearing focuses on possible gaps in regulation and the need for legislation to fill those gaps, which is a fair and legitimate topic. I do have some concerns, however, that we may be feeding into a narrative that has been shaped by the digital assets industry itself, and it will turn into a tax on the regulatory structure and those individuals leading the regulatory institutions.

Digital asset companies often claim that their technology is incompatible with existing laws and regulations, when in reality, it may be simply that their business models are incompatible with existing law.

Over the last of couple of years, as the digital asset space has matured, there have been ongoing questions about the ways in which digital assets should be regulated. The industry continues to claim that it lacks regulatory clarity and that its products are so innovative that they require their own regulatory regime.

The financial services industry has innovated for decades and will likely continue to do so. The U.S. has a comprehensive and long-standing framework of securities law and rules designed to protect investors, promote market integrity, and facilitate capital formation.

As I have stated before, I align with SEC Chair Gensler’s assertion that most crypto assets are indeed securities and should be regulated as such. Chair Gensler has called for cryptocurrency intermediaries to register with the SEC, warning that they may be subject to enforcement action if they do not do so. My hunch is that companies do not do so because they know that they would not meet the standards required, and that these rules are not compatible with their individual business models.

Securities laws exist for a reason. They prevent many of the issues we have seen from failed crypto companies, and they cover a multitude of products and services. The SEC has important requirements to protect investors in markets, including the segregation of customer funds and voiding commingling and capital requirements, customer protection rules, Know Your Customer (KYC) supervision and compliance, and transparency and disclosure.

Rather than complying with existing rules, various crypto firms have engaged in legal battles against the SEC, and often argue that they lack guidance on their products. Additional criticism of the SEC appears to conflict. On one hand, the industry and some of my Republican colleagues argue that the SEC has not provided adequate guidance, but, on the other hand, they complain that the SEC pursues too many rulemakings and enforcement actions designed to remove that lack of clarity.

As we consider legislation, it is important to note that neither the Administration, investors, the SEC, or financial regulators have called for any. It seems unnecessary to reinvent the rules when we already have a regulatory regime that is indeed effective. Our financial system is the envy of the world because of investor confidence, which comes from these rules. And we could easily become the envy of the world in the digital asset space if we simply had digital asset companies comply with existing laws.

So, I look forward to the debate and discussion and to learning more from our experts. And Mr. Chairman, I yield back.

Chairman Hill. I thank the ranking member.
And I now recognize the Chair of the full Financial Services Committee, Mr. McHenry of North Carolina, for 1 minute.

Chairman McHENRY. Thank you, Mr. Chairman. I want to thank you for how you have conducted this subcommittee and the collegial efforts you are trying to lead to build consensus here.

Digital assets are here to stay. This ecosystem has been denied legal clarity for too long, and both market participants and consumers are worse off because of it. We have a market that lacks clarity, and we have a duty to create a regulatory environment that allows responsible innovation and responsible consumer protection to sit side by side with appropriate legal clarity. We need that innovation here in the United States.

If Congress doesn’t act, the rest of the world will. The Europeans are ahead of us in a market structure bill. The U.K. regime is ahead of us. They have provided legal clarity, while we have not. We need to do our work, and it starts here in this subcommittee with these members.

And I want to thank this panel for their expertise in bringing forward ideas on how to protect consumers and ensure that innovation happens here.

I yield back.

Chairman HILL. Thank you, Chairman McHenry.

And now, it is my pleasure to call on the ranking member of the Full Committee, Ms. Waters of California, for 1 minute.

Ms. WATERS. Thank you very much.

Last week, I questioned SEC Chair Gensler about whether the agency has the authorities it needs to bring crypto companies and exchanges into compliance with our securities laws, which have served investors and the markets for the past 90 years. His response was unequivocally, yes, and the SEC’s success in the courts proves his point.

Despite what those across the aisle may say, we do not need to create an entirely new and special framework for crypto; we already have one. Rather, crypto firms, like other tech companies before them, must recognize that they are not exceptional. They need to comply with the laws of the land. To the extent that there are actual gaps in our laws, such as limitations on the SEC’s reach overseas, we should focus on those and not on creating more complexity through a whole new regulatory framework.

Later on, I hope I will be able to ask some questions. I yield back. And thank you very much.

Chairman HILL. I thank the ranking member.

Today, we welcome the testimony of a great panel of witnesses. First, Ms. Marta Belcher is the president and chair of the Filecoin Foundation, as well as the general counsel and head of policy for Protocol Labs.

Second, Mr. Daniel Gorfine is an adjunct professor of law at Georgetown Law School, as well as the founder and CEO of Gattaca Horizons LLC. Previously, he was the CFTC’s first Chief Innovation Officer and the Director of LabCFTC.

Third, Mr. Joshua Rivera serves as general counsel of Blockchain Capital, a leading venture capital firm in the industry.
Fourth, Mr. Zachary Zweihorn is a partner at Davis Polk & Wardwell LLP, where he specializes in financial institutions, fintech, and digital assets.

And finally, Ms. Hillary Allen is a professor of law and associate dean for scholarship at American University Washington College of Law, where she teaches courses on banking, securities regulation, and business associations.

We thank each of you for taking the time to be with us today. 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 our record.

Ms. Belcher, we will start with you. You are now recognized for 5 minutes.

STATEMENT OF MARTA BELCHER, PRESIDENT AND CHAIR, FILECOIN FOUNDATION

Ms. Belcher, Thank you, Subcommittee Chairman Hill, Subcommittee Ranking Member Lynch, Full Committee Chairman McHenry, and Full Committee Ranking Member Waters for inviting me to testify today.

I am Marta Belcher, president and chair of Filecoin Foundation, one of many organizations working on a cryptocurrency called Filecoin.

While this hearing is being held by the Committee on Financial Services, I want to emphasize today that cryptocurrency is about so much more than finance. Cryptocurrency is already creating a better internet, providing an alternative to Big Tech that puts people in control of their own data. This technology is also preserving some of the world’s most important information, including government data, evidence of human rights abuses, and critical scientific datasets. Today, I would like to explain how.

Today’s internet is centralized. The vast majority of data is stored by three companies: Amazon, Microsoft, and Google. This creates single points of failure. When these companies suffer blackouts, large swaths of the web go down for hours. This also means that we live our lives through a handful of corporations. We have no choice but to trust them with our data, and they have unilateral control over what we can do and say online.

Cryptocurrency provides an alternative. Cryptocurrency creates the ability to program money, to send value across the globe instantly and automatically with no intermediary when a condition is met. For example, you can write a computer program that says for every second of a song I play, automatically transfer a millionth of a cent from me to the songwriter. Filecoin uses programmable money to create a decentralized file storage network.

It is like Airbnb for file storage. You can rent out your digital storage space to people who pay you to store their files or pieces of their files. A computer program regularly checks that you are still storing the files, and you are automatically paid in Filecoin. Using the Filecoin token enables the network to operate in a way that is peer-to-peer, instant, automatic, and trustless.

Filecoin is a foundational technology for the next generation of the Web. Filecoin puts users in control of their data, finally giving them an alternative to Big Tech. It also allows users to store many
copies of their files so that data remains accessible even if some devices fail. There are thousands of individuals and small businesses serving as Filecoin storage providers, some of them in the audience today. They are contributing more than 15 billion gigabytes of capacity to the Filecoin network, which is enough to store all written works since the beginning of recorded history 10 times over. That storage space is being used to preserve humanity's most-important information.

For example, Filecoin is storing copies of open datasets created by NASA, NIH, and the National Weather Service. Filecoin is also important for government documents because it can solve the problem of link rot, the fact that over time, many links and important documents like congressional records no longer work. Harvard’s Library Innovation Lab is exploring how these technologies can ensure that links work permanently.

Human rights defenders leverage Filecoin to help collect, verify, and preserve data. For example, Starling Lab, a project of Stanford and USC, recently submitted evidence of Russian war crimes in Ukraine. They submitted that to the International Criminal Court, and used Filecoin to both preserve this digital evidence and also verify that it was authentic and had not been tampered with.

Filecoin also stores important scientific generation like genomic, satellite, and climate datasets from institutions like the ATLAS Experiment at CERN. Filecoin Foundation is also working with Lockheed Martin on a satellite launch to demonstrate how the technology underlying Filecoin can speed up communications in space.

As these examples show, cryptocurrency is about so much more than financial services, and regulating cryptocurrencies like financial services could undermine these valuable use cases. Regulations that insert intermediaries and add friction are incompatible with these technologies.

It is critical that any cryptocurrency regulation protects users' ability to transact directly with each other. It is critical to recognize the open source decentralized nature of this technology and to acknowledge our country's free speech protections for writing computer code. And it is critical to provide clarity, safe harbors, and compliance on-ramps so that innovators can continue to operate in the United States.

In drafting cryptocurrency regulation, I urge the committee to consider the many valuable use cases of cryptocurrency beyond financial services to ensure this innovation can continue to thrive. I look forward to your questions. Thank you.

[The prepared statement of Ms. Belcher can be found on page 55 of the appendix.]

Chairman Hill. Thank you.

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

STATEMENT OF DANIEL S. GORFINE, FOUNDER & CEO, GATTACA HORIZONS LLC; ADJUNCT PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER; AND FORMER CHIEF INNOVATION OFFICER AND DIRECTOR, LABCFTC, U.S. COMMODITY FUTURES TRADING COMMISSION (CFTC)

Mr. Gorfine. Thank you, Subcommittee Chairman Hill and Ranking Member Lynch, Full Committee Chairman McHenry and
Ranking Member Waters, and members of the subcommittee for the opportunity to testify before you today.

My name is Daniel Gorfine. I am the founder and CEO of Gattaca Horizons, an adjunct professor at Georgetown Law, and the former Chief Innovation Officer at the CFTC. The testimony presented here today reflects my own views.

The topic of today’s discussion has featured prominently both during and after my time in government. Nevertheless, the fundamental regulatory landscape for digital assets in the U.S., especially at the Federal level, has not changed significantly since the inception of Bitcoin in 2009.

The current landscape remains one where spot or cash digital commodity trading activity, which means the buying and selling of an asset for immediate delivery, is largely regulated at the State level. Notably, under the status quo, spot market digital commodity exchanges are not subject to comprehensive Federal market oversight and supervision. This would require new and explicit authorization from Congress.

But let me step back and unpack the current landscape a bit further. The Financial Crimes Enforcement Network (FinCEN) determined in 2013 that digital asset exchanges are money services businesses. Following FinCEN, many States have required exchanges to secure a money transmission license pursuant to each State’s respective laws. Some States have gone further and created tailored crypto regulatory frameworks, including, for example, the New York BitLicense.

State frameworks do impose meaningful requirements on intermediaries. These frameworks do not, however, uniformly impose the same types of markets and trading oversight as is common with Federal market regulation. For example, State money transmitter regulation would typically not impose market surveillance requirements intended to detect fraudulent or manipulative trading activity, including wash trading and spoofing.

Beyond FinCEN and the States, the CFTC, the SEC, and the Federal banking regulators apply their respective rules depending on the type of digital asset intermediary and the involved activity.

The CFTC’s jurisdiction over digital assets was established in 2015 when the Commission determined that Bitcoin met the definition of, “commodity.” However, the CFTC’s jurisdiction over spot commodity markets is quite limited. While the CFTC does have enforcement authority to police for fraud and manipulation, this authority is backward-looking and is invoked only when wrongdoing is suspected. And this authority is not oversight authority, which entails rulemaking and the registration and regular examination of intermediaries.

This key point is commonly confused because the CFTC does have authority over derivatives products that may be predicated on an underlying commodity, for example, oil, gold, or even Bitcoin futures contracts. Involved intermediaries are then subject to CFTC requirements, including with respect to registration, trade surveillance, and customer education and protection.

Since 2018, the CFTC has overseen well-regulated, robust, and transparent Bitcoin futures in options markets. These products were offered under the CFTC’s tailored heightened review frame-
work in order to address unique digital commodity characteristics, including their high degree of retail participation and unique custody considerations.

The CFTC accordingly established the basis for differential treatment of digital commodities and ensured that Americans have access to well-regulated markets. This outcome is far preferable to seeing investors lured to offshore, illegal derivatives exchanges that are prone to fraud and financial crime.

With respect to the SEC, it has broadly asserted its enforcement authority and suggested that many cryptocurrencies are securities. While many enforcement actions—especially during the ICO mania—targeted clear cases of an issuer selling tokens to raise capital or defraud investors, there remains a lack of clarity in determining when an asset is a security. This ambiguity has implications, since market participants and regulators alike may struggle in determining which rules apply.

Looking ahead, while some States like New York have developed mature regulatory frameworks, there is no current Federal market regulator overseeing spot digital commodity markets. By statute, the CFTC is a principles-based regulator established by Congress to deter and prevent price manipulation, uphold market integrity, protect market participants, and promote responsible innovation. The CFTC, however, would need specific statutory authority to oversee spot digital commodity markets.

Additionally, even if the CFTC were granted such authority, it would still be necessary to increase definitional clarity regarding when a token is or is not a security. This is an area where more work needs to be done, whether by the courts, regulators, or Congress.

Today’s panel, as well as many others before us, have identified existing gaps and opportunities to create a more efficient and comprehensive national regulatory framework. Against this backdrop, I think there is a great opportunity for policymakers to work collaboratively to craft that framework in order to ensure the responsible development of digital assets and markets in the United States.

Thank you, and I am happy to answer any questions you may have.

[The prepared statement of Mr. Gorfine can be found on page 58 of the appendix.]

Chairman Hill. Thank you very much.

Mr. Rivera, you are now recognized for 5 minutes for your oral presentation.

STATEMENT OF H. JOSHUA RIVERA, GENERAL COUNSEL, BLOCKCHAIN CAPITAL

Mr. Rivera. Thank you, Subcommittee Chairman Hill and Ranking Member Lynch, Full Committee Chairman McHenry and Ranking Member Waters, and the members of the subcommittee for inviting me to testify today.

My name is Joshua Rivera. I serve as general counsel of Blockchain Capital, a venture capital firm focused on digital assets technology. I am a lawyer by training and practice and have represented traditional global financial institutions in various finan-
cial transactions, including capital markets, financings, mergers and acquisitions, and asset management.

I also have the great privilege of sitting on our investment committee of Blockchain Capital and participating in the critical investment decisions we make on behalf of our limited partners.

Blockchain Capital manages approximately $2 billion in assets and has invested in more than 100 portfolio companies, protocol teams, and projects in the digital assets industry. Our team fields approximately 1,500 proposal decks and pitches each year from entrepreneurs building in the industry, providing us with an unique macro perspective on industry developments.

Thank you for allowing me to testify about the incredible opportunities as well as the challenges the digital assets industry presents to an innovative American marketplace. My message for you today is that the industry wants to work with you, the members of this subcommittee, other Members of Congress, and regulators on developing appropriate market structure regulation for addressing the novel challenges and opportunities this technology presents.

First, I will explain pain points in our current financial system and how blockchain technology can enhance our society. The current financial system is overly-reliant on centralized intermediaries. This is a paradigm that constrains innovation.

The U.S. consumer credit rating system provides a prime example of the inefficient and flawed systems that can arise out of overly-intermediated value systems. Monopolized by three ratings bureaus, this system is often ineffective, and excludes those who need safe and affordable access to credit, while also creating immense privacy and security concerns.

It is not only legacy financial systems that suffer from intermediaries. Social media enterprises like Facebook and Twitter, as well as content platforms like Spotify and YouTube, have all leveraged the free and instantaneous transfer of data originally pioneered by the internet, not to democratize participation in value creation, but rather to monopolize it. They do this by commoditizing their own users and preventing actual content creators from realizing more value from the content they create. Blockchain technology creates alternative solutions to the services and infrastructure controlled by these intermediaries.

In the case of financial ecosystems, blockchain networks can be accessed anywhere in the world by anyone with an internet connection. Using these networks, participants can transfer any amount of value to virtually any location in the world 24 hours a day, 7 days a week, 365 days a year with instantaneous settlement at much lower cost to the user.

So the question is, how should we engage with this innovation? The fundamental innovation of blockchain networks is to allow anyone, anywhere, to participate in commerce or other systems of value without an intermediary. This is novel, and a fundamental shift from the traditional ways in which finance and commerce are both organized and regulated. It requires a new approach.

There is an unfortunate perception that participants, investors, and founders in the digital assets industry do not want to be regulated. This is false. A great number of participants, myself included, have sought over many years to engage with regulators in
a collaborative attempt to set out clear and workable rules of the road. While there have been some rulemaking efforts, these efforts have not come early or often enough, and unfortunately have been made with almost no meaningful industry engagement. The undesirable result has been rule proposals that are largely unworkable, both in technical implementation and policy outcomes. We should work with this innovation, not against it.

According to data from PitchBook, the share of venture capital funding from blockchain start-ups in the European Union surpassed the allocation for U.S. firms for the first time ever in the first quarter of this year. This may signal a potentially devastating outcome, one from which the U.S. may not be able to recover. It is something that every member of this subcommittee should actively seek to correct.

In closing, the world-changing innovations introduced by the digital assets industry have only scratched the surface of their potential. We are on the cusp of the next wave of technological change, but the United States must act quickly to ensure it develops here and not abroad.

Tailored, fit-for-purpose rules for this nascent ecosystem are critical, and must protect consumers, while also promoting innovation. Industry stands ready to work with you on this balanced approach to ensuring that the U.S. remains a leader, as it often is, in all vanguard fields of innovation, especially blockchain technology.

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

[The prepared statement of Mr. Rivera can be found on page 68 of the appendix.]

Chairman Hill. Thank you very much.

Mr. Zweihorn, you are now recognized for 5 minutes for your presentation.

STATEMENT OF ZACHARY J. ZWEIHORN, PARTNER, DAVIS POLK & WARDWELL LLP

Mr. Zweihorn. Chairman Hill, Ranking Member Lynch, and members of the subcommittee, thank you for inviting me to testify today. My name is Zach Zweihorn, and I am a partner at the law firm of Davis Polk & Wardwell. My legal practice focuses on the regulation of the securities markets, and in particular, laws and rules that govern the activity and conduct of market intermediaries, such as securities exchanges and broker-dealers.

I have worked with many industry members, both in traditional finance as well as those that are crypto native, to consider their digital asset activities and the potential securities law compliance obligations.

It has been a challenging landscape to navigate due to the regulatory uncertainty and some legal dead-ends. There is much debate on the question of whether a particular digital asset is or should be considered to be a security. This is a critical question, and one that Congress needs to clarify.

What I would like to highlight today is that if a digital asset is a security, not only is the initial sale subject to registration, but secondary market trading must occur through a web of registered
and regulated market intermediaries: brokers, dealers, exchanges, transfer agents, and clearing agencies.

We have all heard the siren’s call that trading platforms should come in and register. It sounds enticingly attractive, but it is an oversimplification that conflates registration, which may theoretically be possible, with compliance, which really is not.

Registration is not simply a matter of filling out forms and sending them in. Instead, it is a substantive exercise of showing the regulator how a firm’s proposed activities will comply with the existing laws and rules. Because these existing laws and rules were designed for traditional securities such as debt and equity, compliance for trading in digital assets securities is challenging or virtually impossible.

To point out a couple of examples, under current law and rules, a registered exchange can generally only facilitate trading in a security if that security is registered. Similarly, broker-dealers are prohibited from facilitating trade in a security unless the issuer has taken steps to register it or otherwise make certain disclosures.

This results in a catch-22. The intermediary is required to register with the SEC in order to facilitate trading, but if it has registered with the SEC, it is prohibited from facilitating trading unless the issuer—somebody different than the intermediary that it can’t control—has taken further steps and actions.

As another example, in order for centralized trading platforms to operate, someone needs to hold securities for investors. But SEC accounting and custody guidance has made it legally or economically infeasible for either banks or broker-dealers to provide custody services for digital assets. So, again, if a firm were to register, there would be no way for it to facilitate trading, because there is nobody that can provide custody.

In light of these and other challenges, and absent a litany of exceptions or new guidance from the SEC, a digital asset security that did seek to register with the SEC would have its application rejected.

There are also differences in market structure that raise unnecessary legal challenges. Digital asset trading platforms operate under a model that allows end-users to directly trade on a platform, with the platform maintaining custody of the digital assets of the user, matching buyers and sellers and settling transactions. This is different from how our traditional securities markets work, where separate firms provide exchange, broker services, and clearing.

Because the securities laws and rules were developed to regulate the heavily-intermediated structures that are already involved in the securities market, that model has been baked into the laws. As a result, current law assumes that there would be a high level of intermediation, and effectively requires intermediation if an asset is a security, regardless of whether new innovations mean that model is not necessarily practical or better for investors.

It may be popular in the crypto community to blame the SEC for bringing enforcement actions while failing to adopt a regulatory regime that is compatible with digital assets, but the SEC is a creature of statute, created by Congress in charge of administering the Federal securities laws that Congress has adopted. While the SEC
has authority to provide exemptions, wholesale changes and entirely new regulatory regimes should come from Congress and not from the Commission.

The only real solution is for Congress to establish a regulatory framework under which digital asset market structure can exist, giving the SEC a mandate to implement and facilitate it. Congress has amended the laws to address changes to the securities market before. Congress could and should take the same approach today.

Thank you, again, for the opportunity to participate today, and I look forward to your questions.

[The prepared statement of Mr. Zweihorn can be found on page 72 of the appendix.]

Chairman Hill. Thank you very much.

And Professor Allen, you are now recognized for 5 minutes for your oral presentation.

STATEMENT OF HILLARY J. ALLEN, PROFESSOR OF LAW, AMERICAN UNIVERSITY WASHINGTON COLLEGE OF LAW

Ms. Allen. Thank you, Chairman Hill, Ranking Member Lynch, and members of the subcommittee. Thank you for inviting me to testify at today's hearing.

My name is Hillary Allen, and I am a professor of law at the American University Washington College of Law, and the author of the book, "Driverless Finance: Fintech's Impact on Financial Stability."

We are here to talk about regulation of the digital asset markets, and the other witnesses here have urged legislative and regulatory reform in order to let crypto business models thrive.

The main point I would like to make today is to urge you to be very wary of peeling back laws designed to protect the public from harm. In my research, I have explored in detail the financial stability and investor harms associated with the crypto markets. And in connection with the latter, I would like to read you a quote from Congress in 1933.

"During the postwar decade, some $50 billion of new securities were floated in the United States. Fully half or $25 billion worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise.

"Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High-pressure salesmanship rather than careful counsel was the rule in this most dangerous enterprise."

I think this statement would resonate very much with those who have lost money with Celsius or FTX or any of the other failed crypto intermediaries. I believe it would also resonate with those
exposed to the DeFi platform, Terra LUNA, or any number of other DeFi scams.

I read this statement here to illustrate that with crypto, not much has changed since 1933. Of course, the technology used is different now, but technology is only a tool, and the impacts of any technology are inextricably intertwined with the people who use it.

With crypto, the existence of blockchain technology does nothing to change the economic incentives of those deploying it, and those incentives have not changed significantly since 1933.

The crypto industry often demands that lawmakers and regulators understand the intricacies of blockchain technology before creating or enforcing law or rules. But I would submit that the crypto industry needs to learn some basics about economics and finance before they argue that the rules shouldn't apply to them.

If they understood even a little bit about economics and finance, they would understand that technological decentralization and decentralized economic control are two very different things. A system can have lots of nodes, but if someone controls a lot of those nodes, they will control the system.

Of course, it is possible that some members of the crypto industry already do understand these things, and their rhetoric about decentralization is entirely disingenuous because there is nothing economically decentralized about the crypto markets where we see concentrations of economic power that sometimes rival or exceed what we would see in traditional finance. The technological decentralization achieved through blockchain technology, that is far less efficient than centralized systems, has all been for naught.

While I see little of value in blockchain technology, I want to make it clear that enforcement of existing law is not incompatible with blockchain technology. It is entirely possible for a business using blockchain technology to comply with existing investor protection and financial stability regulation.

However, for many crypto businesses, it may be true that existing regulation is incompatible with the economics of their business model, especially if their business model depends on doing things that we have learned over the years tend to harm people, like a hedge fund that profits by trading against the customers of an affiliated exchange without those customers knowing, or an exchange that profits by commingling its own assets with customer assets and then using those commingled assets to trade, or an issuer that profits by making up assets out of thin air at almost zero cost engaging in some wash trades to inflate their market price, hyping the assets on social media, using them as collateral for loans, and then dumping them on unsuspecting investors.

As my written testimony explains, existing financial law and regulations are already well-suited to dealing with these kinds of harms associated with crypto business models. We shouldn't dispense with those protections lightly in any circumstances, and we really shouldn't dispense with them for the sake of letting business models based on speculation and predation thrive and become too-big-to-fail.

Remember that laws make markets, and bespoke crypto legislation could create a market for business models that don't have
enough utility to survive on their own. More robust enforcement of existing laws and regulations would certainly be desirable.

In particular, Congress should support the SEC’s enforcement in securities registration and broker-dealer registration requirements with increased funding and with increased political support, but the legal fundamentals are by and large there.

I look forward to your questions.

[The prepared statement of Ms. Allen can be found on page 38 of the appendix.]

Chairman Hill. Thank you very much.

We will now turn to Member questions. And the Chair now recognizes himself for 5 minutes for questioning.

I will just start out by saying that I appreciate, Professor Allen, your talk about the securities markets, and I think you have made many, many good points.

Let me say that between March of 2000 and October of 2002, the insider regulatory framework, with all of their surveillance and people involved in overseeing it, and following every 1933 and 1934 Act, we lost $5.5 trillion from investors in the United States. Silicon Valley Bank, just a few weeks ago—super-regulated, over-regulated, massively-regulated, inside the regulatory framework, but due to a lack of supervision and a terrible business policy, people lost a lot of money there.

So what we are talking about today is crafting a regulatory framework that is fit for purpose and that fits the activity and absolutely doesn’t undercut any fraud or anything whatsoever about consumer-investor compliance.

I don’t think anybody here is suggesting that. No one on this panel supports fraud and misbehavior, a lack of compliance, not following the rules, et cetera. But we definitely have the need for a regulatory framework that fits the purpose and protects investors to the best that Federal regulation can do so.

Although some digital assets will fall under the definition of a security or a commodity—and we have heard testimony today about both—there are digital assets like a digital sports card or a digital collectible or maybe a token connected to an activity like a game or Filecoin that we have had described today pretty thoroughly, I think, that make a use case for precisely what that company is doing that is distinguishable from a security or a commodity. And these assets merit, in my view, being classified in a third category altogether, which is why the existing regulatory framework does not work.

So, Mr. Gorfine, would you agree that there is a third bucket of digital assets that need oversight, need clarity, need all of the investor and security protections, but they don’t fit in the bucket of either Mr. Rivera’s background at the CFTC or Chair Gensler’s world at the SEC?

Mr. GORFINE. Yes. It is a good question. And I would actually suggest that the problem with the term, “digital asset,” is that it is incredibly broad. And I would say we have even more than three buckets. The reason I say that is you can effectively tokenize any asset, especially if you are tokenizing the ownership interest in that asset. You could tokenize a car title. You could tokenize a title
to a home. You could tokenize an actual item of digital art or ownership over existing artwork.

So, I think we have to be careful because the reality is that regulation looks at things through the lens of what type of an asset or an instrument is it, and we apply certain rules based on what the asset actually is. So in that sense, the term, “digital asset,” is incredibly broad, and there certainly may be items, collectibles, that fall outside of at least the securities law definition, and potentially even the way that the CFTC, for example, would view, “commodity,” because the term, “commodity,” under the Commodity Exchange Act is incredibly broad. That doesn't mean that the CFTC is seeking to at least police the spot market for every conceivable commodity or instrument that can transact in society. It is a broad topic.

Chairman Hill. Thank you. I like the idea of a gaming company that raises money to create a new game; let's say they have to raise $10 million to create a game. It is clearly a security. It is a private placement to create the game. But if you invest in the game, you also get some tokens that are going to be used in the game, if the game ever works. If the game is unveiled and nobody comes to play and it is a flop, then those tokens are useless. But if the game is up and running a year later, those tokens have value.

Are those tokens securities, or are those tokens just things in the game?

Mr. Gorfine. That is where we are going to need some clarity around the potential for something to transition from being in one state, maybe down the line to something else. If people purchase a token in order to help the company raise money—

Chairman Hill. But that wasn't my example.

Mr. Gorfine. Right. This is something that is actually being used functionally within the game.

Chairman Hill. Yes. We will dumb it down and make it for a broader audience, perhaps.

So, $10 million to create a new musical. You are going to star in it on Broadway. And if the musical goes from off-Broadway to Broadway and is successful, everybody who put $100,000 in my $10 million-offering gets 25 tickets to the show that they could use for the whole run of the show.

So, it's clearly a security. The Broadway show is a success. I am earning a return on my investment, I hope. But I now have 25 tickets that are just a thing to go to this show. I can keep them. I can give them to my kids. I can sell them. Are those tickets a security?

Mr. Gorfine. It sounds like it is a perk as being part of that—

Chairman Hill. A perk. Yes. It is an offshoot of it. And if the play was a flop, then those tickets would have no value.

I think this is why we need to really carefully think about this. I appreciate your responses.

Now, let me yield to my friend, the ranking member of the subcommittee, Mr. Lynch, for 5 minutes.

Mr. Lynch. Thank you, Mr. Chairman.

Professor Allen, the SEC first warned investors of the dangers of investing in crypto back in 2013, when the Office of Investor Education and Advocacy issued an investor alert on, “Ponzi schemes involving cryptocurrencies.” Then in 2014, the same office issued an-
other investor alert on Bitcoin and other virtual currency-related investments.

In 2019, the SEC issued a Framework for Investment Contract Analysis of Digital Assets. And that was to provide clarity on when a digital asset has the characteristic of a security and when the sale of a digital asset is a securities transaction.

And in addition, there had been 130 enforcement actions brought by the SEC against crypto firms that have engaged in marketing securities without providing the necessary disclosures, audited financials, or investor protections that would allow investors to make a meaningful and informed decision regarding the value of a crypto product or the viability of the underlying business.

Two points are notable. One, the SEC has won every single one of those 130 cases that they have brought under existing law. And two, each of those cases went through a legal process which culminated, in every case, in a written regulatory decision, and many had judicial decisions or administrative opinions written on appeal that actually do provide clear and unambiguous guidance to the crypto industry and provide clarity and lay out the rules of the road that should guide our crypto firms.

So the claims that there is no direction, there is no clarity, in at least that part of it, can you speak to that?

Ms. Allen. I do think it is quite clear. And it ties back to the investor harms that I mentioned earlier. The Howey test is all about protecting people who have invested their money in a common enterprise with the expectation of profits to come predominantly from the efforts of others.

That offers scope for harm, and I think that probably accurately reflects why most people are investing in these crypto things. I think there is the clarity. But if we wanted more, Congress could pass legislation that inserted crypto assets into the definition of security in both the 1933 Act and the 1934 Act, and that would settle it for all time.

Mr. Lynch. Let me ask you, the fact that—and others have said here this morning that you can basically tokenize anything. If you did have a system for crypto that was—that didn’t—so all of those rules that apply to traditional finance don’t apply, okay? Because they are all acting right now in noncompliance.

If there was another whole system that is set up where there is no compliance requirements for disclosure or commingling of funds, which is happening rampantly in the crypto world, what would that do to the traditional finance system where you have financial firms that are under the burden and have to observe the protections that are provided to investors and to the public?

Ms. Allen. This is really important. A bespoke crypto regime would be a massive regulatory loophole for all of financial services. I don’t actually use the term, “digital assets,” in this space because I think all our assets are already digital, right? So, I talk about crypto as being something that is associated with the blockchain, because all of our assets are already digital.

It is very easy, as we have heard, to tokenize them and put them on the blockchain. So if you create a special bespoke crypto regime that has fewer protections than the existing regulatory regime, it doesn’t take a genius to see what is going to happen to traditional
finance. They are going to put it all on the blockchain and take advantage of that lighter touch regime.

Mr. LYNCH. Right. And with the commingling of funds—many of the crypto firms don't provide audited financials. They don't make those necessary disclosures. If we held the crypto industry to the same standards, would that be one way of legitimizing or protecting the public even in the crypto realm?

Ms. ALLEN. Yes, that is right. We have to thread the needle where we protect the public without giving special treatment to crypto. And I think by applying existing registration requirements for the securities themselves and also for the broker-dealer regulation and exchange regulation—just to take one example, that would mean that the current crypto exchange model with all of the conflicts of interest that is just rife in that model couldn't continue to exist. And so, customers would be protected from all of those conflicts of interest by requiring those exchanges to register.

Mr. LYNCH. Thank you.

Mr. Chairman, I yield back.

Chairman HILL. I thank my friend.

I now turn to Mr. Rose of Tennessee for 5 minutes.

Mr. ROSE. Thank you, Chairman Hill, and thank you, Ranking Member Lynch, for holding this hearing.

And thank you to our distinguished witnesses for being here and sharing your time with us.

Mr. Rivera, AI-linked blockchain products include payment systems, trading, models, machine-generated nonfungible tokens, and blockchain-based marketplaces for AI applications. As we think through how to play catch-up in the broader crypto regulatory landscape, what are some of the unique regulatory gaps created by AI-linked crypto projects?

Mr. RIVERA. The question on AI is a difficult one. It is still a very burgeoning and growing industry. It is moving extremely rapidly with the recent rise of ChatGPT. Its application to crypto is something that we are looking at very closely, and how that will be regulated, I think, is extremely important.

But I think the focus needs to be on regulating entities that we understand how they work, intermediaries—exchanges, custodians—who provide services in a centralized way to the digital asset ecosystem. And making sure that regulation is focused, and not so broad that it stifles innovation for things that we understand less, like how AI is going to interplay with digital assets in the next 3 to 5 years.

There surely will be a large number of innovations that will come from the interplay of those two things, and many of them will be extremely useful. They will be extremely beneficial to society, and we should give space for those innovations to happen, and in the meantime, really focus on providing targeted regulation for entities that we understand.

Mr. ROSE. Thank you.

Shifting to Mr. Gorfine, SEC Chair Gensler has insisted that digital assets’ legal status depends on, “individual facts and circumstances,” and that projects should, “come in and talk to the SEC,” to identify a path towards compliance.
Only about four crypto projects have been able to come into compliance as defined by the SEC.

Mr. Gorfine, at your former agency, the CFTC, is there a path towards compliance, specifically for exchanges, and what does that look like?

Mr. GORFINE. Yes. To level set, remember that spot commodities are not directly regulated by the CFTC. So, exchanges that are engaging in spot activity do not register with the CFTC. But the CFTC has registered and oversees a number of exchanges that do offer Bitcoin or ether futures and options products, and those can be both physically settled and cash settled.

So, there is a robust, well-regulated marketplace regulated by the CFTC where registrants have been able to come in and offer those types of products.

Mr. ROSE. Thank you.

Mr. Zweihorn, Chair Gensler has said—and I am going to give you about four of his quotes. In August of 2021, he said that the SEC needs additional authorities to prevent transactions, products, and platforms from falling between regulatory cracks. In December of 2022, he said that he feels that the SEC has enough authority in this space. In May of 2021, he said that, right now, there is not a market regulator for crypto exchanges. And then, in December of 2022, he said that exchanges can come into compliance by appropriately working with the SEC.

So, Mr. Zweihorn, do you believe that these comments provide regulatory clarity and promote stability in digital markets?

Mr. ZWEIHORN. Thank you, Congressman Rose.

I think those comments, depending on whether he is referring to a digital asset as a security or as not a security, could mean different things. There is a lot of lack of clarity about that. But the SEC admittedly, by its own admission, doesn’t regulate Bitcoin or Bitcoin exchanges. So, I don’t think he could mean that Bitcoin exchanges would need to register.

But as he has said, he believes—and the market does not agree with this—that many other digital assets are securities. But there is certainly some lack of clarity in terms of which ones and therefore what obligations they have.

Mr. ROSE. Thank you.

Mr. Rivera, SEC Commissioner Peirce has noted that there has been a reluctance on the part of the SEC to, “provide additional guidance about how to determine whether a token is being sold as part of the securities offering or which tokens are securities.”

In your view, would additional guidance from the SEC on this issue be helpful?

Mr. RIVERA. Yes. I think it is pretty telling when one of the Commissioners of the SEC has directly stated that there is reticence in the agency to provide guidance. We have been asking for this with the SEC for a long time. As they say, everything is facts and circumstances, so it is hard to say that whether something is a security is based on facts and circumstances, but everything is a security.

Mr. ROSE. Thank you.

My time has expired. I yield back.

Chairman HILL. I thank the gentleman.
And I now recognize my friend from Illinois, Dr. Foster, for 5 minutes.

Mr. Foster. Thank you, Mr. Chairman.

Ms. Belcher, how does Filecoin handle anonymity and censorship? For example, if someone steals the designs of nuclear weapons and posts them on Filecoin, can you find out who did it, remove the material, and take it down and identify the person?

Ms. Belcher. Thank you so much for that question.

Filecoin is an open source technology, and many people are building tools on top of the Filecoin network—

Mr. Foster. My question is, can you do it today? As it is set up right now, if someone tomorrow posts the designs of nuclear weapons, can you identify the person, haul them into court, and remove the material?

Ms. Belcher. Yes. We have content moderation tools that are built on top of the Filecoin network by—

Mr. Foster. And do you have a governing structure that allows you—let’s say that taking down material is disputed. What court system do you go to to resolve that?

Ms. Belcher. The way that it works is basically the same content moderation rules apply.

Mr. Foster. Which court system ultimately has jurisdiction?

Ms. Belcher. Again, the same rules that would apply to content—

Mr. Foster. Are you saying no court system has jurisdiction to ultimately decide if there is a disputed takedown of material?

Ms. Belcher. I am saying the same rules apply to content moderation on the Filecoin network that apply to Facebook or any other protocol.

Mr. Foster. What jurisdiction are you registered in that allows the court to say, I’m sorry, I order you to take that down?

Ms. Belcher. Just like with Facebook, there isn’t registration for content moderation. The way that it works is you can go to any individual node or storage provider, and we actually have tools that provide for decentralized content moderation.

Mr. Foster. Okay. That is an important question that we have to think through, because it will happen and maybe already has.

Mr. Gorfinen, there are estimates from Forbes and other places that more than 50 percent of all Bitcoin transactions are fakes, mostly wash trades between anonymous participants.

So, how can you possibly have a well-regulated market in, say, Bitcoin futures, when the majority of transactions in the underlying assets are fraudulent?

Mr. Gorfinen. When the CFTC allowed the self-certification in Bitcoin futures, it did so under a heightened review framework where there were requirements for the derivatives exchanges to have information-sharing relationships with the underlying exchanges being used to create—

Mr. Foster. But there are a lot of trades that are not on underlying exchanges. How do you get the information to know that this is a wash trade?

Mr. Gorfinen. The underlying exchanges were U.S.-based exchanges participating in the index formation. But to your point, that is the gap in the underlying spot market, is there is no Fed-
eral market supervision of spot trading activity as you would typically see with market regulation.

Mr. Foster. Right. Yes, when trading derivatives, you need a trader ID so you know exactly who—there is a regulator that sees the true identity of both participants of all trades, and they can identify wash trades and other market abuses.

Mr. Gorfine. That is right.

Mr. Foster. That is not present in Bitcoin, correct?

Mr. Gorfine. That is right. The same is the case, though, for many other commodities. Precious metals like gold-based futures, you don’t have—spot markets tend to operate differently than the regulated markets. But in the context of digital commodities, there are these characteristics around the trading activity, the retail facing aspect, which could warrant this type of market—

Mr. Foster. Right. Which are much more surveilled than Bitcoin, I guess is the point.

Mr. Rivera, one of the fundamental rules of the road is that you cannot drive a car on the road without a license plate and without a licensed driver. The automobile industry would never have gone anywhere without that convention.

And for the same reason, it seems to me that all crypto wallets must require a verifiable driver’s license, that can be anonymous under most circumstances, but when a crime has been committed, you have to use that to deanonymize the true owner.

In addition, for commodities or any item which has a market defined value, we have to prevent wash trades and other front-running market abuses like that. So, is there any alternative in this case to have a regulator somewhere that sees the true identity between all participants of all crypto transactions? Is there any alternative to that?

Mr. Rivera. We are investing in companies that are building something called zero knowledge—

Mr. Foster. I understand there is a dream. Is there anything that works today, that will allow you to prevent wash trades, for example?

Mr. Rivera. Crypto networks are extremely transparent. And Federal regulators actually—

Mr. Foster. But there are ones, like Monero and more advanced ones, that have deliberate and very effective efforts to make it impossible to identify the true participants.

My question is, does the technology exist today to prevent wash trades unless there is a regulator that sees the true identity?

And if you can respond. My time is up. If you can respond—

Mr. Rivera. Yes, it is developing, sir.

Mr. Foster. I understand. But this question is for everyone, and I would like you all to respond for the record. Does the technology exist today that does not require having a regulator see the true identities behind both sides of any crypto transaction if we wish to prevent wash trades and other market abuses?

My time is up. I yield back.

Chairman Hill. Yes. You can respond in writing if you would like to on that. Thank you very much.
The gentleman from Ohio, Mr. Davidson, who is the Vice Chair of this subcommittee, and also the Chair of our Housing and Insurance Subcommittee, is recognized for 5 minutes.

Mr. DAVIDSON. I thank the chairman, and I thank our witnesses. I also thank my colleagues who are taking the time to continue to study this issue. As someone who has tried to get regulatory clarity for this since I got on the committee in 2017, it has been painful. You just see people ask questions that you explain over and over and over and over and over again, and that is why it means a lot that people do take time to understand the issue.

It seems that even then, you will have people who draw different conclusions. For example, that the only reason you would want to own these things is to evade the law.

The reality is people have been pleading for this ever since I got here, ever since the Initial Coin Offering (ICO) market. The people with good use cases have come here saying, please solve this problem. They are asking to be regulated, and not the way a lot of people are being asked to be regulated. They are saying, basically, hey, could you protect our market share by making it illegal for people to actually compete with us? They are saying, let’s compete.

I think the challenge is that people think of this space in the same—if they can’t get rid of Bitcoin altogether, they at least want to make it account-based, because they don’t actually trust you with custody. Just like they haven’t actually outlawed cash, but almost, right?

Mr. Rivera, as you’re aware, the European Union recently passed the Markets in Crypto-Assets Regulation, which puts them well ahead of us; they actually passed a law. But alongside this proposal, the EU also passed a Transfer of Funds Regulation, which imposes a strict Know Your Customer (KYC) regime whenever more than 1,000 euros is transferred between self-custody wallets. If I move more than $1,000 of value to someone else in any form, cash or something else of worth, you have to get a third party. We don’t trust our citizens. They can’t do permissionless transactions. Everything has to be permissioned.

It seems like some of my colleagues actually think that is a good thing. I think it is kind of dystopian, personally, but the reality is, how do you have DeFi without the, “de” part, the “decentralized?”

Mr. Rivera. Yes, the Transfer of Funds Regulation is the European Union’s effort to clarify the existing travel rule. I think the rule itself is not perfect, but, importantly, what it does is it limits the application of the rule to institutions communicating with each other and making transfers of value to each other. While doing so, it aims to protect the privacy of individuals who want to self-custody their assets.

So, the objective of the rule is to actually allow individuals to participate in decentralized systems without having to divulge personal information about themselves and the financial activities that they engage in, while still regulating institutions that send that information, like our travel rule.

It is unclear how it is going to be implemented, as it has just been passed, but it does make the right efforts, at least initially.

Mr. DAVIDSON. That is encouraging, and it is a little more narrow than I had understood it to be, if not in law, in intent, maybe.
But how important is custody to the concept of market structure? When some of the same people in the room helped in 2018 to craft what became the base text for the 100-percent bipartisan Token Taxonomy Act, we wanted to define a bright-line test that translates the Howey test into language that people can understand, including the regulators. But it also dealt with custody.

So, we have custody challenges in our T+2 trading of actual securities, but since you have a real-time 24/7, in theory, permissionless peer-to-peer transaction capability, how important is custody to market structure? And I will open that up to the panel.

Mr. RIVERA. Custody is extremely important, and it is extremely important to understand the differences between traditional custody, which is paper-based and ledger-based and relies on an intermediary that is keeping track, and digital assets custody, which actually relies on a decentralized blockchain to identify who has what. In order to ensure protection of client funds under a custodial regime, digital asset custodians have to have incredible technical expertise, and it is technical expertise that they have developed over the course of the last 10 years.

Mr. DAVIDSON. Can more than one person have custody of something at the same time?

Mr. RIVERA. No. But someone can gain access to funds in the same way that someone could kind of steal funds in a bank, but the way you do that is very different.

Mr. DAVIDSON. Right.

I think the important point when you look at some of the markets where you will see asymmetry in naked short selling and derivatives contracts and so on and so forth, is that the idea is really solved with the custody rules here.

I wish I had more time to get into this. But my time has expired, and I yield back.

Chairman HILL. I thank the gentleman.

The gentleman from New York, Mr. Torres, is now recognized for 5 minutes.

Mr. TORRES. Thank you, Mr. Chairman.

If the United States continues driving crypto offshore, there will be more offshore companies, more companies in the offshore deregulated mold of FTX, so it seems to me that it would be in the interest of consumer and investor protection to bring crypto into a workable but rigorous regulatory regime here in the United States.

FTX fraud has no greater friend than the status quo, and no greater friend than congressional inertia.

New York State has shown that it is possible to create a rigorous regulatory regime for crypto without causing the apocalypse for 9 decades of securities law. There is a question of whether Congress should create a new regulatory framework for crypto, as New York State has successfully done, or whether Congress should seek to fit crypto within the existing Federal framework for regulating financial assets, which strikes me as the more-probable outcome.

If Congress elects to adapt the existing framework rather than create an entirely new one, the question then becomes, which digital assets qualify as securities and which qualify as commodities or something else? But if an asset qualifies as a security, then
there is a question of registration, and that is where blockchain technology has run into a buzz saw.

Even if Congress were to pass a law that provides perfect regulatory clarity as to which assets are securities, none of it matters if there is no workable path to registration and compliance. And under the status quo, SEC registration is little more than a mirage for blockchain businesses. The number of blockchain businesses that have found a workable path to registration is close to zero. One observer put it cogently: “The SEC has created a world where project founders are required to register as ice cream while making freezers illegal. Good luck.”

Mr. Zweihorn, how can Congress best tailor registration to accommodate blockchain technology without compromising investor protection?

Mr. Zweihorn. Thank you, Congressman Torres. I think that is a very good way of thinking about it.

My client, certainly, and nobody I know who is respectable in the blockchain space believes that it should be unregulated, that we need fewer regulations. They want a system that sort of gives them an out. I think they want tailored regulations.

As I said in my testimony, there are a lot of SEC rules and part of the Federal securities laws that are sort of round peg and square hole when it comes to digital assets, because digital assets are just different. And if you compare the White Papers that came out during the ICO boom and compare them to a prospectus, they are, obviously, a lot shorter. There is a lot less information, but there is also a lot of information that is not in SEC prospectuses because digital asset purchasers are interested in other topics that are not ones that the SEC has asked about in its forums.

Mr. Torres. And as I understand it, Chair Gensler himself has said that the SEC has tailored disclosure requirements to accommodate the particularities of industry. So, there is nothing unprecedented about the notion of tailoring.

Mr. Zweihorn. That is correct. The SEC has adopted particularized disclosure regimes for certain assets. But they have not yet done so for digital asset securities.

Mr. Torres. The SEC, statutorily, is designed to be a merit-neutral regulator, but it hardly requires a suspension of disbelief to imagine a regulator who has a personal or ideological antipathy for crypto and, therefore, seeks to regulate the industry out of existence.

But even if you are a critic of crypto, the fact remains that regulatory sabotage of crypto is the antithesis of merit-neutral regulation, which is the kind of regulation that Congress contemplated for the SEC.

So, how can Congress ensure that the SEC is, in fact, a merit-neutral regulator? And how do you prevent the use of the registration process to punish or sabotage an industry that has fallen out of political favor?

Mr. Zweihorn. Thank you.

I don’t want to impugn the motives of anybody at the SEC. They are hardworking and well-meaning people, and I think they are acting in good faith, but they are subject to the securities laws. Congress has mandated that they apply the securities laws as Con-
gress has written them. I think their incentive is to make sure that the securities laws are followed, at least as they interpret them. I think if Congress wanted to make it more likely that there would be a workable path, Congress would need to mandate that the SEC adopt something that is actually functional and possible for the market to comply with.

Mr. TORRES. A distinction has been drawn between regulating financial activity and regulating the technology that underlies the activity. Some people call it regulating applications versus regulating protocols. When crafting a regulatory framework, how should we think about that distinction? Should financial regulators be limited to their core competency of regulating financial activity rather than the underlying technology?

Mr. ZWEIHORN. Of course. The one challenge with digital assets, as I think Mr. Gorfine said earlier, is that you can have a car title, or you can have a home title in NFT or a security or a commodity, and they are all a digital asset of some sort or another. And I think we, in this country, do regulate different items and different assets differently depending on what the risks are because the risks of buying a house are different than the risks of buying a security. So, there would need to be a way to differentiate in terms of whether this asset is an investment product, it is—

Chairman HILL. The gentleman’s time has expired.

The gentleman yields back.

Mr. TIMMONS. Thank you, Mr. Chairman.

And I want to thank all of our witnesses for taking the time to come and testify before us here today.

In 1946, the Justices of the United States Supreme Court could not have fathomed the internet, nevertheless digital assets. It seems absurd that the future of digital assets will be decided using such an archaic test. Nevertheless, the Howey test has dominated the conversation around how to classify digital assets.

Mr. Zweihorn, can you talk about any other classification frameworks that exist?

Mr. ZWEIHORN. A case subsequent to Howey, the Forman case, questioned whether a sheriff’s stock in a co-op, a residential apartment co-op, was a security, and the court said, well, a co-op is used to live in. There is a functional purpose for it, and if something has a functional purpose, and it is not just an investment, then it is not a security.

So there is this tension there, particularly with digital assets, of whether the asset is just an investment or it actually has a functional purpose, such as Filecoin that the other member of the panel has talked about.

Mr. TIMMONS. What suggestions would you have if we were to create a test from scratch to classify digital assets?

Mr. ZWEIHORN. It is a challenging question, Congressman, because a lot of these assets are dual purpose, and while Filecoin, as an example, is useful and has utility to use for purchasing storage space, there are plenty of people who speculate on it. But that is true with lots of commodities. You go buy gold as an investment. You go buy a property as an investment.
I think there has to be some kind of threshold for utility where if this thing actually is just a share of interest in a company, and it is a claim on its debtor equity, then it is a security, and if there is actual utility, then it is not a security.

Mr. Timmons. Thank you for that.

Turning back to Howey, Mr. Rivera, can you talk about the need for a definition for when a digital asset is or has become sufficiently decentralized to fall out of Howey? How should we think about this?

Mr. Rivera. Yes, that is a very good question. It is going to take a lot of collaboration from Congress to think through principle-based legislation that will allow regulators to make specific applications for different assets. Facts and circumstances isn’t incorrect, like the SEC likes to say, but it does mean that we need to have more principled legislative approaches to make that determination.

There are thousands of digital assets. Some of them are securities, but many of them are not, and understanding the ways in which they are used, whether they have use case, understanding both the technical and the economic decentralization in the networks that they operate on, are key principles that Congress really needs to understand well and think about implementing.

So, it is going to take some time and require some collaboration.

Mr. Timmons. Thank you.

Ms. Belcher, what about when blockchain technology is used, say, in the business-to-business (B2B) process solution? I have met with many companies which are utilizing blockchain technology to trim hours, and in some cases days, off the B2B processes in the financial services world. The efficiency and cost savings presented by these companies is incredibly compelling.

Are there any risks of getting in the way of blockchain innovation by not considering this important use of blockchain technology while we are working on the market structure legislation?

Ms. Belcher. Absolutely. Filecoin is really just one example of so many protocols that are enabling a huge number of businesses, including small businesses, to thrive. For example, many of our thousands of storage providers are small businesses in the United States.

In fact, as one example, Lucky Storage converted a former Lucky Strike tobacco factory in North Carolina into a data storage facility. They are actually here today. They have 65 employees in North Carolina; and that is one of thousands of storage providers on just one cryptocurrency network.

And, in addition, we have many applications that are built on top of the Filecoin network that are business-to-business and that also are themselves small businesses.

One example is Audius. I mentioned in my testimony the ability to say, for every second of a song I play, automatically transfer a millionth of a cent to the songwriter. And they are actually doing that, building on top of the Filecoin network.

These are things that are really revolutionizing the way that small businesses work, and it is very important not to get in the way of that innovation in order to ensure that these businesses continue to thrive.

Mr. Timmons. Thank you for that.
One final question, Ms. Belcher. Just broadly speaking, do you believe that blockchain technology can deliver on the industry’s promise of efficiency, decentralization, and financial inclusion?

Ms. BELCHER. Absolutely. All you have to do is think about what happened within hours of Russia invading Ukraine. Within hours, Ukraine had posted their wallet address and millions and millions of dollars were donated via cryptocurrency. Why? Because it was the most efficient way to do it.

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

Chairman HILL. Thank you.

I now yield to the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. Billions and billions of dollars have been transferred to Ukraine using traditional currencies, and lots of money has gone to Russia, evading our sanctions, using cryptocurrency.

Fear of missing out. Somebody else may get ahead of us in this technology. The Bahamas is ahead of us. Peru is ahead of us in cocaine cultivation. China is ahead of us in organ harvesting, and the Cayman Islands is ahead of us in financial crime. We don’t need to catch up.

Fentanyl is a new, innovative technology. We don’t need a regulatory system that rewards those who created that innovation.

There are gaps in our regulatory system because Congress fails to pass a law prohibiting Americans from buying cryptocurrency. There are gaps in our law because we have not, in the alternative, passed a law saying that cryptocurrency is clearly a security. So, we are going to leave it to the courts to decide, based on the Howey test.

And there are gaps because the crypto industry cannot prosper unless much of it is underwater, immune from familiar currency, familiar customer anti-money laundering statutes. That doesn’t mean everybody who invests in cryptocurrency is trying to hide money, although, “cryptocurrency,” literally means, “hidden money.”

Sometimes, they think they can just make a profit investing in cryptocurrency and selling it to someone else who needs to hide their money, just as you can make money by investing in a burglary tool factory without actually being a burglar.

Sam Bankman-Fried is out on bail, unfortunately, living in my State, and living much better than most of my constituents, but his ghost is still in this room. He haunts the halls of Rayburn. But let’s remember why he was here, for one reason: To prevent the SEC from having jurisdiction over cryptocurrency and to give cryptocurrency the baby regulation, the patina of regulation that would be provided through the CFTC.

If you want to know whether crypto is a currency or whether crypto is a security, just ask yourself: Are those in the crypto business engaged in the financial services business or the agriculture business? It is clear that they weren’t the Agriculture Committee regulator on this to provide a patina of regulation.

All of the money and power in this town is in the crypto side because crypto bros make money literally by making money, and they have made over a trillion dollars out of thin air. They will accuse the U.S. Government of making money out of thin air. Maybe we
do, but we are the U.S. Government. What we are able to do benefits the American people in a democratic system. Nobody elected Sam Bankman-Fried.

But I want to pursue one other area and that is taxation. We have this capital gains allowance, very low tax or, if you hold it until you die, no tax on your gain, and we justify that on the basis that we are trying to encourage people to invest in something that will create jobs and build the American economy.

Professor Allen, can you think of a reason why we allow gains on cryptocurrency, when they are reported, to be taxed under a favorable rate, a lower tax rate than is paid by our staff?

Ms. Allen. I think you have hit on something important in your remarks, which is that we are talking about crypto as something it actually isn’t, so let me demystify the blockchain a little bit. A blockchain is a database, right? That is what it is. It has no magical powers. The thing that makes it a blockchain is that there is no, “centralized technological node,” that controls that database, who updates it, et cetera. But there are economic forces that centralize control of that database, so we have created something that is really replicating what we already have.

Now, I am not an apologist for traditional finance. There are a lot of problems with traditional finance, but what we have here is all of those problems being replicated or exacerbated. And when we talk about sort of giving capital gains treatment or tailored regulation, et cetera, to this space, we have to ask the question: Why are we doing this?

Traditional finance, with all of its flaws, facilitates capital formation and credit allocation. Crypto does neither, so I think we need to keep that in mind as we think about how we regulate this space.

Mr. Sherman. Thank you.

Chairman Hill. I thank the gentleman. He yields back.

Mrs. Houchin is now recognized for 5 minutes.

Mrs. Houchin. Thank you, Chairman Hill, and Ranking Member Lynch.

I appreciate the opportunity to talk to the witnesses, and thank you for being here.

There has been talk today about FinHub’s guidance. In 2019, the SEC’s FinHub released guidance regarding how an issuer of a digital asset can determine whether it would fall under the definition of an investment contract and, thus, be required to comply with securities laws. The guidance consists of a list of factors and subfactors that digital assets projects should consider.

Mr. Zweihorn, in your view, is this guidance useful for projects in determining whether or not they will be classified as a security by the SEC?

Mr. Zweihorn. Thank you for the question.

I think when the guidance first came out, the industry was very excited to have some guidance, and it was useful in terms of showing what the SEC was thinking and was a good-faith effort by the SEC to tell the industry.

But in time, it has turned out to not be all that helpful. It consists of 50-plus factors, none of which is determinative. It is a question of weighing and, therefore, resulting in how likely something
will be, so it leaves people sort of not with a definitive answer on any particular token they are considering.

Mrs. HOUCHIN. As a follow-up to that, how does a purchaser determine how many factors it needs to meet and how to weigh the factors against each other under this current structure?

Mr. ZWEIHORN. It is a difficult question. A colleague of mine referred to it as a ruler with no lines, so you can't really tell where on the ruler you are. You kind of get a feeling of how many factors and how important those factors are, but there is not a way to answer that.

Mrs. HOUCHIN. During Chairman Gensler's term, has the SEC provided any other guidance on how the Commission will determine whether a digital asset is offered as part of an investment contract?

Mr. ZWEIHORN. I am not aware of them putting out further guidance as such. Chairman Gensler obviously speaks his mind openly before Congress and in other venues, and the SEC has brought a number of enforcement actions where the SEC sets out its view of whether particular assets are or are not securities and explains it to some degree. They haven't turned back to the framework in those enforcement actions as far as I am aware to evaluate it against the framework. And in some ways, some of the enforcement actions of late have been inconsistent with the framework, where the enforcement action says this asset was sold as a security initially many, many years ago, whereas, the framework looks to what is it today. What are its uses today? Is it decentralized?

So, it looks like there has been a bit of a shift in thinking.

Mrs. HOUCHIN. What has been, in your opinion, the result of the SEC's failure to provide guidance on this issue?

Mr. ZWEIHORN. It is very challenging for members of the industry and clients of mine because they really are at the whim of, are they going to get an enforcement action if they do something here? They can have very strong views, very strong legal views, opinions, or guidance from counsel, but at the end of the day, if they are doing anything in this space, they have to worry that the regulator may disagree with them.

Mrs. HOUCHIN. Switching gears a little bit here, one of the problems with the current regulatory framework is that digital asset projects have a disincentive to register, as they are less likely to be listed on a trading platform if they are classified as a security.

Mr. Zweihorn, would you discuss the perverse incentives that this dynamic creates and how our market structure legislation can ensure that firms are not penalized for complying with the law?

Mr. ZWEIHORN. Yes. I think the firms that are not listing on exchanges are not doing so because they don't believe that the asset involved is a security, and the disincentive is that if the asset is a security, those exchanges, which are not registered with the SEC, would not list it.

So if they want to have a liquid market for the asset, they need to take steps to ensure that, in their view, they are comfortable that it is not a security. The SEC may or may not agree with that, because if it is a security, it won't be listed.
I think market structure regulation would be to create a viable market structure where if it finds that these are securities, make it so that exchanges can actually list them, which they really can’t today. Or if it finds them as not securities, create a market structure where exchanges can exist that do list them and trade them in such a way that consumers are protected.

Mrs. HOUCHIN. Thank you.
From the financial sector to alternative uses and applications, digital assets and the underlying technologies are here to stay. It is important that we create clear rules of the road to stop the threat of regulation by enforcement and establish a field where anyone who wants to play by the rules has the ability to do so.

Thank you, Mr. Chairman. I yield back.
Chairman HILL. The gentlewoman yields back.
The gentleman from Illinois, Mr. Casten, is recognized for 5 minutes.

Mr. CASTEN. Thank you, Mr. Chairman. And thanks to all of our witnesses.

Ms. Belcher, I want to start with you. In your testimony, you described some of your customers as being musicians who have to put their music on Spotify or something like that and get paid in fractions of a penny for every listen. And I want to first say that I completely agree that there is an enormous value of the blockchain technology, distributed ledger, as a way to monetize the digital asset.

You said fractions of a cent, which is not a cryptocurrency. For people who are engaging in that transaction, is what they are putting on the blockchain, essentially, an invoice to be repaid in U.S. currency? Or is it an invoice to be repaid in a token that is separate from the dollar? I just didn’t quite follow from how you explained that distinction.

Ms. BELCHER. Thank you for the question.
It is a token, but the point I was trying to make is that it can be micro, micro amounts.

Mr. CASTEN. No, no. Sure. Why? Why is it a token? Because I don’t have any need for rapid settlement of 3/10 of a penny.

Ms. BELCHER. Sure. A couple of things. First of all, that enables us to program money, to send it instantly and automatically across the world with no intermediary, as though I am handing a fraction of a cent to someone.

Mr. CASTEN. So, it is primarily a settlement time issue?

Ms. BELCHER. No, it is a programmability issue.

Mr. CASTEN. But I could program an invoice. If you and I have—if I want to have a legal contract that you owe me money, I can program it and have a blockchain that you owe me money, right?

Ms. BELCHER. Yes. Basically, to give you an example from Filecoin, it is important that we use a bespoke token, as opposed to a stablecoin or the traditional financial system, because that is actually what allows us to operate the way that the Filecoin token does operate.

Mr. CASTEN. Okay. We are going to get wonkier here than we have time for, but it seems to me that a token could be an invoice that is dollar-denominated. I don’t have to retokenize.
And the reason that I mention it is, Mr. Chairman, I would like to enter for the record an article from last week’s New Yorker entitled, “Crooks’ Mistaken Bet on Encrypted Phones.”

Chairman Hill. Without objection, it is so ordered.

Mr. Casten. I would encourage everybody to read this article because it is fascinating and has nothing and everything to do with crypto. It is, essentially, a lot of our international financial regulators hacked into the bad guys’ cell phones that they thought were encrypted and have unearthed these massive financial fraud networks where you can go take a picture of a low denomination $5 bill and then send that serial number through an encrypted cell phone network to somebody in the Netherlands or Mexico or wherever you are moving money. Take it to the bank or the illicit bank. Get $30 million with a cell phone.

Mr. Rivera, you mentioned that, sort of, rapid settlement was an innovation of the crypto industry. I would submit to you that encrypted tokenization was invented a long time before by a lot of shady characters.

The value—

Mr. Rivera. You mean the U.S. Government.

Mr. Casten. The value—the U.S. Government is not trying to break the law. This has tremendous value for people who want to break the law. I am not saying that every crypto user is trying to break the law, but encrypted tokenization—because I really want to separate the value proposition of the blockchain from the value proposition of an encrypted token that can get around KYC laws.

Professor Allen, are you aware of anyone in the crypto space, anywhere within the system, who is tracking enough information about buyers and sellers on either side of the trade so that they are capable of complying with Know Your Customer/Anti-Money Laundering (KYC/AML) laws and are doing so?

Ms. Allen. I do not know if that is happening. I do know that avoiding the anti-money laundering regulation is, in many respects, a feature rather than a bug of this business model.

The problem with the blockchain is that it is actually quite inefficient when compared with centralized alternatives because if you think about it, if you have a database where you have to create some kind of proof of work consensus or proof of state to deter bad actors, that is going to be more computationally expensive than just having a centralized person add things to the blockchain.

So because it is more expensive, the way that you usually see efficiency gains is from doing end runs around AML and KYC—

Mr. Casten. I want to get into other things, because I do think there is a case to be made. Again, if I am—people often confuse me with Jay-Z. If I write a song, sell it to you, like the digital transaction, that is a value for the blockchain there because it is a digital thing that I can’t get around.

I want to introduce one more thing for the record, but, Professor Allen, you had mentioned I think in your testimony that a lot of the profits in the crypto industry are made by founders in Wales. We have had a tremendous number of people here who say this is about closing the racial wealth gap.
Mr. Chairman, I would like to introduce a Washington Post article, “Crypto is not the key to Black generational wealth,” which notes that from 2017 to 2022, the median cryptocurrency declined by 46 percent, and the average stock market index rose by 56 percent, and that the losers are disproportionately Black and Brown communities who got in late.

Chairman Hill. Without objection, that will be included in the record.

Mr. CASTEN. Thank you. I will yield back to you, Chairman Hill.

Chairman HILL. I thank my friend.

Mr. Flood is now recognized for 5 minutes.

Mr. Flood. Thank you, Mr. Chairman.

Let’s briefly take a step back and identify why we are here. The SEC and Chair Gary Gensler have forced this committee’s hand. There is simply no way that the digital assets ecosystem within the United States will survive without some kind of action from Congress to combat the regulatory deluge we have seen in the past few months.

We have all heard from firms like Coinbase that they will move offshore. The reality is that in this environment, it is hard to blame them.

In February, the SEC issued a proposed rulemaking that would severely restrict the ability of current custodians for registered investment advisors to continue to hold custody of those assets.

Mr. Rivera, I would like you to briefly speak to some of the challenges associated with the proposed rulemaking from the SEC for qualified custodians and how it would affect your firm. Specifically, as it stands, how many options does your firm have to custody digital assets, and would you expect this rulemaking to reduce your firm’s options for providing custody services of digital assets?

Mr. Rivera. Our firm has a very limited number of digital asset custodians. There are three, perhaps four; there are three that we trust. This rulemaking effectively reduces that to maybe zero. It seems like the intent is to make it extremely difficult to comply with the rule as proposed, which would mean that we could effectively be disenfranchised from being able to invest in the ecosystem.

Mr. Flood. Thank you.

Next, I would like to pivot to how broker-dealers work in the digital asset space and whether today’s securities rules could possibly apply to the digital asset space as written. Broker-dealers that work with equities typically custody securities for their customers. However, with the current SEC custody rules, there is no way for a broker-dealer to directly custody customer assets.

Mr. Zweihorn, can you describe what kinds of challenges this presents for broker-dealers within the digital asset space?

Mr. Zweihorn. Sure. Thank you for the question, Congressman.

As you said, broker-dealers typically will custody their investor securities on their behalf, and that is part of the services they provide that facilitates the customer trading. The SEC has a rule that regulates how broker-dealers do so in order to protect customers, called the Customer Protection Rule, to ensure that those brokers don’t mishandle or lose or steal those assets.
That rule was adopted in the 1970s originally, and it has been amended over time, and, not surprisingly, it doesn't refer to holding a crypto private key as one of the ways that a broker-dealer can permissibly hold a customer's assets.

The SEC has struggled with determining what would be a safe mechanism for broker-dealers to hold crypto assets for customers, and the most recent step they took was to put out guidance that was time-limited; it expires, actually, 3 years from today. It would allow broker-dealers to hold custody if they have reasonable policies and procedures, but then, there is a list of other conditions that brokers, essentially, can't meet because it would mean they couldn't do any other business.

Mr. FLOOD. Thank you.

Let's move on to clearing and settling. Within the securities market, you need some sort of entity which ensures that a trade placed by an investor is ultimately settled between the buyer and the seller. The Depository Trust and Clearing Corporation is the clearing agency that fills that role for securities.

The current model, which requires a clearing agency to clear and settle trades, just doesn't really make sense for digital assets operated on a blockchain. Transactions clear in real time, and there is no need for one centralized intermediary.

Continuing with this question, you mentioned in your testimony the perils of applying the definition of clearing agency under the Securities Exchange Act to validators and miners on a blockchain that participate in the settlement process. Can you just elaborate on that a little bit for me?

Mr. ZWEIHORN. Sure. The definition of, “clearing agency,” under the Securities Exchange Act is very broad, and it includes anyone that is facilitating a settlement of a securities transaction without the physical delivery of paper security certificates. That definition made sense in its context where it was regulating the securities market, the traditional securities market, and trying to bring a higher level of safety and security to the market where paper certificates were moving or where they were becoming dematerialized.

Everyone in digital assets is facilitating the transfer of the asset without physical delivery, whether they are securities or not. But if they are securities, then, arguably, the definition would encompass a lot of different parties.

Now, if a firm, like a digital asset trading platform, holds all the assets itself so that it can update its books in real time with every trade, it doesn't really seem like you need a separate clearing agency to just add an intermediation that is not actually technically necessary.

Mr. FLOOD. Thank you for your answer.

The final point I will make is this: Legislation is needed to fix this.

Thank you.

Chairman HILL. Thank you.

Mr. FLOOD. I yield back.

Chairman HILL. Thank you, Mr. Flood.

And I will turn to my friend from North Carolina, Mr. Nickel, for 5 minutes.
Mr. Nickel. Thank you. I would like to thank Chairman Hill for holding today's hearing on digital asset market structure. I am looking forward to working together in a bipartisan way to learn more about this issue and pass meaningful legislation.

Mr. Rivera, you write in your testimony that you are worried there is a growing sentiment that crypto technology will, “go away if we don't create new regulations.” I am concerned that if this is the case, and all the trading venues were to exit the U.S. market, that any American looking to trade digital assets would find themselves having to use an offshore exchange.

As we learned with the failure of Bahamas-based FTX.com and others, foreign firms are not always well-regulated.

It is my priority to protect my constituents.

Mr. Rivera, do you have any concerns that a decline in the number of U.S. trading venues might produce new risks for American consumers?

Mr. Rivera. I do. I think that this is an example of a really unfortunate policy outcome resulting from the enforcement actions that have happened from regulators, particularly the SEC. If there are trading venues that move offshore and U.S. persons want to trade in those venues, they will probably try to find ways to trade them, and the U.S. Government will have much less of an ability to regulate the activity on those venues, and that would be unfortunate.

Mr. Nickel. And I have to apologize. I forgot to thank and acknowledge Ranking Member Lynch for his outstanding leadership on this subcommittee and, most specifically, thank him for keeping us all fed last night on this side of the aisle, with some very well-timed pizza. We were here until 11:30 last night for a markup. So, I am grateful for your leadership on well-timed pizza.

Back to Mr. Rivera. In March of 2022, the SEC released Staff Accounting Bulletin (SAB) 121, which effectively precludes banks from offering a digital asset custody at scale by requiring them to include on their balance sheets crypto assets that are custody on behalf of their clients. This is a shift in historical practices. Custody assets have always been treated as off-balance sheet assets. If crypto companies don't have access to safe and security banking, U.S. investors will be at risk.

Mr. Rivera, if banks can't provide this service, who would? Are you concerned that some may turn to offshore solutions?

Mr. Rivera. Indeed. There should be meaningful engagement with custodial providers in the ecosystem, and banks, to the extent that they want to provide custody to digital assets, they should have avenues that they can pursue to do that. SAB 121 effectively limits their ability to do that in any meaningful way. It would be entirely too costly for them to have to over-collateralize the digital assets they hold as liabilities on their balance sheet.

Mr. Nickel. Thank you.

Ms. Belcher, some have claimed that digital asset market structure legislation would only legitimize an industry seeking to facilitate illicit activities. Some have also claimed that digital assets are unnecessary and fail to add any new, real value to our financial and technological systems.
I am doing my best to try to understand this issue and dig in. Could you provide us with some background on the use cases for Filecoin and the service that it is helping to provide?

Ms. Belcher. Absolutely. Thank you so much for the question. Filecoin is just one example of cryptocurrency, but it is enabling hundreds of applications and use cases. Those include human rights applications. In addition to Starling Lab’s international criminal court evidence verification, they are also storing the USC Shoah Foundation’s genocide survivor testimony archives.

We also have with us here today the Prelinger Archives, which is using decentralized technologies to store rare films. We have the Freedom of the Press Foundation that is exploring using decentralized technologies for secure document exchange between journalists and anonymous sources. And the Guardian Project, which is building a mobile app for eyewitnesses that authenticates content captured on smartphones.

And the Human Rights Data Analysis Group, which is exploring how this storage can be useful for accessing sensitive human rights data. We also have investigative journalists using this technology with enterprise use cases.

There is an organization called the Decentralized Storage Alliance that uses these technologies, which includes EY, Seagate, and AMD. Scientific data, not only stored by the ATLAS Project at CERN, but also the University of Maryland, the University of Utah, and Berkeley’s Underground Physics Group.

And government datasets, an absolutely enormous amount of open datasets, not just the ones that I mentioned, but also the National Library of Medicine, the National Oceanic and Atmospheric Administration, the National Center for Atmospheric Research, et cetera, et cetera.

So, there are just an enormous number of use cases, and all of those are enabled by the Filecoin network.

Mr. Nickel. Thank you so much.

And I yield back.

Chairman Hill. I appreciate that. The gentleman yields back.

Mr. Donalds is now recognized for 5 minutes.

Mr. Donalds. Thank you, Mr. Chairman.

And I am actually glad I get to go last. I heard a lot in today’s hearing. Obviously, we have some serious questions that Congress is going to need to address. And let’s just be very clear: The SEC, or the CFTC, or frankly, any other agency has not been empowered by Congress to just decide this stuff on the fly. Sorry, relative Commissioners and Chairmen that exist around this town. We have not authorized you to do that yet.

A couple of things. One, I found it interesting that Sam Bankman-Fried is now the ghost of Christmas past. What happened at FTX is unconscionable, never tolerated, but that is accounting fraud, which is something that was contemplated under the Sarbanes-Oxley Act after the Enron scandal. So, you have that.

If we are going to talk about Russia avoiding our sanctions regime using cryptocurrency, then maybe the Administration should have paid attention to Russia’s military buildup on the Ukrainian border after the debacle that was the withdrawal from Afghanistan.
If we are going to talk about the fentanyl crisis, maybe the Administration should actually secure the border, as opposed to just complaining about fentanyl all the time.

And with respect to Filecoin or anything else, I think one of the most fundamental problems we have in this building is Members of Congress trying to justify why an American would choose to buy a product that they want to acquire. We are not talking about narcotics here. We are not talking about food that you ingest. We are not talking about contact lenses that go in your eye. We are talking about a digital currency or assets or token that they might choose to buy with their own U.S. dollars. I thought that was okay in the U.S., but I see that not all is reality here on Capitol Hill.

Mr. Gorfine, is the CFTC, or the Federal Government, for that matter, currently equipped to serve as a market regulator for digital assets?

Mr. GORFINE. The CFTC, by virtue of overseeing futures, swaps options that are predicated on commodities gains very good understanding of commodities and the underlying markets and the asset. They currently don't have that authority to regulate the spot market, but as I noted earlier, there are some unique characteristics of digital commodities that may make it reasonable to say we need to have Federal market supervision.

Mr. DONALDS. I like your answer, but I am also under 2 minutes and 36 seconds. I want to hone in on one thing. The operative word in your sentence is, “may.” Does the CFTC, if this is the agency that looks to be the closest to be able to do so, have the manpower, the technical knowledge, and the expertise to adequately be a market regulator of digital assets?

Mr. GORFINE. Yes. They already are, and they do have that expertise. They do have that knowledge. Chairman Behnam has been testifying as such, so this is something for which they may need additional resources, given the size and scope of digital commodity markets, but they do have that expertise, and the professional staff there is well-equipped to understand the underlying commodity market.

Mr. DONALDS. Okay.

Mr. Zweihorn, can you elaborate on some of the incompatibilities between the digital asset marketplace and the traditional financial structure marketplaces?

Mr. ZWEIHORN. Sure. As we have talked about many times in this hearing, there are lots of digital assets that have functional uses. In order to use Filecoin, for example—I don't believe Filecoin is a security, but if Congress was to say that Filecoin is a security, then everybody who touches Filecoin would need to be a regulated intermediary.

Mr. DONALDS. Quickly, let me just say, as a Member of Congress, that Filecoin is not a security. But go ahead.

Mr. ZWEIHORN. Better you than me.

If you were to buy Filecoin because you want to use it, you want to store files, you can only buy it through a registered broker-dealer. The system through which it gets transferred to you would be through a registered exchange to actually find the buyer and seller and a clearing agency in order to actually send it to you. And those
basically make it impossible to use for its intended purpose, because you are not going to have all of the entities involved in facilitating storage of data be SEC-regulated for financial services activities.

Mr. DONALDS. Okay.

Last question. Mr. Rivera, given that Congress is already behind the curve regarding blockchain technology, how do we ensure that what is proposed today applies down the road?

Mr. RIVERA. Applies what?

Mr. DONALDS. How do we ensure that some of the topics in conversations that are being talked about today in this committee can apply down the road? What do you think is the best course of action for this?

Mr. RIVERA. Yes, we want collaboration by Congress, and by members of this committee, to take a very good look at the industry and understand all of the different issues at play and come up with constructive legislation that regulators can then apply meaningfully to multiple different use cases and different types of assets. So, we need principles-based legislation that is bipartisan and effective.

Mr. DONALDS. Okay.

I yield back. Thank you, Mr. Chairman.

And thank you, witnesses.

Chairman HILL. Thank you. Thank you, Mr. Donalds.

I want to thank the panel today. It has been a very informative hearing. I look forward to comparing notes with our colleagues over in the House Agriculture Committee’s Digital Assets Subcommittee today and see what they learned. Again, I repeat, we have 40 Members of Congress engaging right now on trying to understand the digital asset marketplace or the cryptocurrency marketplace and understanding how best the U.S. Government should be engaged.

What I heard today was that we have a real need for fit-for-purpose regulatory tools at the SEC and the CFTC. I have heard in the spot market, in dealing, in registering something that is not a security, clarifying how the laws work and, of course, custody. So it was a very good discussion.

I thank my friend, Mr. Lynch, the ranking member of the subcommittee, for our collaboration in listening to your testimony and working on potential legislation.

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 now adjourned.

[Whereupon, at 3:50 p.m., the hearing was adjourned.]
APPENDIX

April 27, 2023
Hearing on The Future of Digital Assets:
Identifying the Regulatory Gaps in Digital Asset Market Structure

Before the U.S. House of Representatives Committee on Financial Services
Subcommittee on Digital Assets, Financial Technology, and Inclusion

Thursday, April 27, 2023

Prepared Statement

Hilary J. Allen, Professor of Law
American University Washington College of Law

Chairman Hill, Ranking Member Lynch, and Members of the Committee:

Thank you for inviting me to testify at today’s hearing. My name is Hilary Allen, and I am a Professor of Law at the American University Washington College of Law. I am also a member of the CFTC’s Technology Advisory Committee, although I have prepared this testimony on my own behalf and not on behalf of either of these organizations. I teach courses in corporate law and financial regulation, and my research focuses on financial stability regulation and financial technologies. I have authored several articles for law reviews and the popular press about fintech and financial stability, and I have also written a book, Driverless Finance: Fintech’s Impact on Financial Stability, that explores the threats that crypto and other fintech innovations pose to our financial system. Prior to entering academia, I spent seven years working in the financial services groups of prominent law firms in London, Sydney, and New York. In 2010, I worked with the Financial Crisis Inquiry Commission, which was appointed by Congress to study the causes of the financial crisis of 2007-2008.

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1. Executive Summary

We regulate financial services to protect investors and our broader financial system from harm. Our existing body of financial regulation reflects hard-earned knowledge about how financial service businesses can inflict these kinds of harm, and we should not dispense with that financial regulation lightly. The emergence of blockchain technology has not meaningfully altered the economic incentives of the people using that technology to provide financial services. These people still have incentives to centralize economic control, and once centralized, they have the same incentives that providers of financial services have always had to exploit and profit from that control. While the idea of decentralizing finance is certainly very appealing, we would need to find a way to decentralize economic power in finance in order to achieve that ideal – blockchain’s technological decentralization cannot achieve that.

Many in the crypto industry, however, either misunderstand or are willfully blind to the fact that economic incentives will impact how blockchain technology is used. There is a stereotypically Silicon Valley mindset that perceives everything as a pure technology problem, and ignores the incentives of the people who use that technology and the broader context of the problem to be solved. Lawmakers and financial regulators, however, are better attuned to this broader context. While we often hear that lawmakers and regulators need to learn more about blockchain technology, I would submit that the crypto industry needs to learn about the fundamentals and history of finance and economics. I do recommend, though, that lawmakers and regulators learn more about blockchain technology so that they can critically interrogate whether it is even possible for blockchain innovation to deliver on the crypto industry’s promises of efficiency, decentralization, and financial inclusion. I would submit that it is not possible, and that is important context for lawmakers deciding how to proceed.

Members of the crypto industry often claim that existing regulation is incompatible with their technology. This is a misdirection: it is entirely possible for a blockchain-based technology business to comply with existing investor protection and financial stability regulation. However, for many crypto businesses, it may be true that existing regulation is incompatible with the economics of their business model, especially if their business model depends on doing things that we have learned, over the years, tend to harm people.

Most of the crypto-specific legislation that has been proposed so far in the United States is designed to peel back protective laws in order to let these crypto business models thrive. Because the crypto industry, rather than the public, is likely to be the primary beneficiary of this type of legislation, these bills are inferior to the regulatory status quo. As this testimony will explain, existing financial regulation is already well-suited to dealing with many of the harms associated with crypto business models. More robust enforcement would certainly be desirable: in particular, Congress should support the SEC’s enforcement of securities and broker/dealer registration requirements with increased funding and political support. But many of the fundamentals are already there. If Congress wishes to explore other legislative possibilities, this testimony recommends a ban as the most effective way of protecting investors and our financial system from the harms associated with crypto business models. Short of a ban, this testimony suggests the following desirable legislative reforms: a “Glass-Steagall 2.0” separation of banking and crypto; an amendment to the definition of “security” to clarify that all crypto assets are subject to the SEC’s jurisdiction; and a legislative direction for increased focus on technology-related operational risks.
2. Why we regulate financial services

While blockchain provides a new kind of technological infrastructure for delivering financial services, it is important to note that this technology does not operate in a vacuum. The impacts of technology are inextricably intertwined with the people who use it, and the existence of blockchain technology does nothing to change the economic incentives of those deploying it. If the primary motivations of the people and businesses deploying blockchain technology are rent-seeking, predation, or externalization of costs, then those are harms that the law must address. The crypto industry often demands that lawmakers and regulators understand the intricacies of blockchain technology before creating or enforcing law or rules, but many in the crypto industry lack basic domain knowledge about economics and finance. Silicon Valley historian Margaret O’Mara has observed that “[t]he Valley’s engineering-dominated culture... often paid little attention to the rest of the world... Why care about history when you were building the future?”

The crypto industry needs to learn more about the history of harms that financial regulation seeks to protect against.

We have decades, sometimes centuries, of experience with financial predation and destabilizing crises, and financial regulators are often much better versed in this kind of knowledge than the technologists are. Our existing body of financial regulation reflects hard-earned knowledge about how financial services businesses can harm people, and we should not dispense with that regulation lightly. Following SEC Chair Gary Gensler’s testimony before the House Financial Services Committee last week, the CEO of the Blockchain Association commented that the SEC is “ultimately blind to the harm its regulation by enforcement strategy is doing to lawful companies in this country.” But the primary purpose of financial regulation is to protect the public from harm, not the crypto industry — and the crypto industry is (at best) blind to the harm its business models are inflicting on the public.

The securities laws were created in the wake of the stock market collapse of 1929. In adopting the Securities Act of 1933, Congress outlined the kinds of harms that the legislation sought to protect against:

*During the postwar decade some 50 billion of new securities were floated in the United States. Fully half or $25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor’s attention those facts essential to estimating the worth of any security. High*

pressure salesmanship rather than careful counsel was the rule in this most dangerous enterprise.⁵

These harms, outlined by Congress almost one hundred years ago, resonate today. People losing their life savings after investing in worthless assets supplied by unscrupulous dealers who did not provide any meaningful disclosure – that would sound very familiar to those who invested using centralized crypto platforms like Celsius and FTX, and using DeFi platforms like Terra/Luna. And while these are the most catastrophic crypto failures we’ve seen so far, losses have been widely distributed among other crypto investors as well. For example, recent research by the Bank for International Settlements on bitcoin, which is widely viewed as a “blue chip” crypto investment, has found that “[i]n nearly all economies in our sample, a majority of investors probably lost money on their bitcoin investment,”⁴ and that a few large investors tended to profit at the expense of smaller investors.⁶

Securities regulation is primarily focused on protecting investors from harm. Financial regulation also seeks to protect the stability of the financial system, which in turn protects everyone. Because the broader economy relies on the financial system for payments services, to manage risks, and to amass and allocate capital, financial system failure has significant implications for the people and businesses that make up the broader economy, as we saw in 2008.

Recent research from the Bank for International Settlements has concluded that “while the crypto collapse may have affected individual investors, the aggregate impact on the broader system was limited.”⁵ This is good news, and it was not an inevitable outcome. Despite the narrative of crypto “disrupting” traditional banks, it is quite possible that crypto and banking would already have integrated had regulators permitted it – and if crypto had integrated with the traditional financial system prior to 2022, then the fallout from the failures of Terra/Luna, Celsius, FTX might not have been limited to investors. All of us would have been harmed if there had been a crypto crash-inspired financial crisis.⁷

I note that this Subcommittee is charged with considering financial inclusion, as well as digital assets and other financial technologies. Financial inclusion is a real and pressing problem in the United States, in large part because of a persistent racial wealth gap.⁸ Ultimately, people lack access to financial services and means for building wealth for structural and political reasons, not because we lack the necessary technological tools. If the root causes of financial exclusion are not resolved, then the economic incentives that have resulted in “predatory inclusion” like payday

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⁷ “[L]arger investors probably cashed out at the expense of smaller holders. The data reveal that owners of large wallets, the “whales”, reduced their holdings of bitcoin in the days after the shock episodes... Medium-sized holders, and even more so small holders (“knif”), increased their holdings of bitcoin. The price patterns suggest that larger investors were able to sell their assets to smaller ones before the steep price decline. As discussed in Auer et al (2022), large holders thus profited at the expense of smaller investors.” Id. at 3.
⁸ Id. at 4.
⁹ However, if crypto were more intertwined with the real economy and the traditional financial system, the aggregate impact of a shock in the crypto world could have been much larger. Id.
⁰ See, for example, Mehar Baradaran, HOW THE OTHER HALF BANKS: EXCLUSION, EXPLOITATION, AND THE THREAT TO DEMOCRACY (2018).
lending and exploitative subprime mortgages will continue to manifest in new business models, including crypto business models.9

Unfortunately, excitement about new technologies can sometimes distract us from focusing on or addressing their harms, or the harms of the business models built using those technologies. This is particularly likely to happen in the early days of a technology, where regulators and lawmakers may want to wait and see how the technology plays out before taking any action. In the early days, the technology is all shiny potential and any attendant harms have yet to materialize, which can make regulation that restrains the technology challenging as a matter of political economy. We are well past the early days of blockchain technology, though, and we have seen crypto’s harms in vivid detail during the first ICO bubble and again during 2022’s “crypto winter.”

It seems clear that the crypto industry is not generating win-wins: because there is no productive capacity behind crypto assets, it is inevitably a zero-sum game where any profits that the crypto industry and crypto “whales” make are at smaller investors’ expense.10 The most recent investors are likely to be the ones left holding the bag, and recent survey results from Pew suggest that Black and Hispanic investors are disproportionately likely to have entered the crypto markets in the last year.11

And so the crypto industry’s harms are no longer hypothetical. We have abundant evidence that the economic incentives of crypto entrepreneurs ensure that the use of the technology will never match its idealist rhetoric. To be sure, that idealist rhetoric can sometimes be tempting. Given the sometimes dubious track record of traditional financial institutions, the idea of eliminating reliance on these institutions by decentralizing finance is certainly a very appealing one. To achieve that ideal, though, we would need to find a way to decentralize economic power in finance – but blockchain technology cannot alter the economic incentives of the people using it.

Unfortunately, all of blockchain’s technological decentralization (and all the unavoidable inefficiencies and limitations that stem from that technological decentralization) are for naught if the various nodes in the system conglomorate together for economic reasons – and that is precisely what has happened with Bitcoin, Ethereum and other blockchains. As leading crypto cybersecurity experts Trail of Bits have found, even when the cryptography used is robust, “a subset of participants can garner excessive, centralized control over the entire system.”12 In fact, the Trail of Bits, Are Blockchains Decentralized? Unintended Centralities in Distributed Ledgers, 3 (Jun. 2022), available at https://blog.trailofbits.com/wp-content/uploads/2022/06/Unintended_Centralities_in_Distributed_Ledgers.pdf.

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10 Cornelli et al., supra Note 4 at 3.
11 “Black users (27%) are more likely than White users (12%) to say they first used cryptocurrency within the past year. Roughly two-in-ten Hispanic users (21%) say the same. (There were not enough Asian American cryptocurrency users to be broken out into a separate analysis.) And about three-in-ten users from lower-income households report first investing in cryptocurrency within the past year, compared with about one-in-ten adults from middle- or upper-income households.” Michelle Faverio and Olivia Sidoti, Majority of Americans aren’t confident in the safety and reliability of cryptocurrency, PEW RESEARCH CENTER (Apr. 10, 2023), available at https://www.pewresearch.org/short-reads/2023/04/10/majority-of-americans-arent-confident-in-the-safety-and-reliability-of-cryptocurrency/.
of Bits report (which was completed before Ethereum’s shift to a proof-of-stake consensus mechanism) found that “the number of entities sufficient to disrupt a blockchain is relatively low: four for Bitcoin, two for Ethereum, and less than a dozen for most PoS networks.” Nodes get paid for the transactions they verify, so it’s not surprising that control over nodes has concentrated in just a few hands. To repeat, blockchain technology does nothing to change the economic incentives of the nodes, who are understandably seeking to maximize their profits from verification. Proof-of-stake blockchains “allow validators to stake more of their own coins so that they have a higher chance of winning” the next block and receiving compensation. Since the associated operational costs are mostly fixed, this setup naturally leads to concentration.” The costs of engaging in “proof-of-work” mining have also become prohibitive for most people: while anyone can participate in theory, “unless you have access to powerful computers known as ASICs (that’s “application-specific integrated circuits”), your chances of winning a Bitcoin reward are pretty low.”

No less than internet pioneer Tim O’Reilly has noted that “history teaches us that there will always be new avenues for power to become centralized”, and that “Blockchain turned out to be the most rapid recentralization of a decentralized technology that I’ve seen in my lifetime.” And so these blockchains are economically centralized, but the computational cost associated with their technological decentralization has made them inefficient and impedes their ability to scale up. In many ways, they offer the worst of all worlds.

Centralization of control repeats throughout the crypto industry. We see centralization of control among those who maintain the software that runs the blockchains,17 we see it in the many centralized crypto exchanges that have proliferated in the crypto ecosystem, we see it in the control of so-called “decentralized autonomous organizations” that operate on blockchains.18 As I have written previously, crypto users “have to trust in some combination of ISPs, core software developers, miners, wallets, exchanges, stablecoin issuers, oracles, providers of client APIs used to access distributed ledgers, and concentrated owners of governance tokens”.19 An “inescapable need for centralized governance” arises because it is very challenging for decentralized services to scale up,20 and because it is impossible for software to address all possible eventualities in advance (and so an intermediary is often needed to resolve unanticipated situations).  

13 Id. at 4.
16 Dan Patterson, Internet gurus Tim O’Reilly on Web3: “Get ready for the crash”, CBSNEWS (Feb. 10, 2022).
18 “DeFi’s voting rights are highly concentrated, and the exercise of these rights is very low”; “minority rule is the probable consequence of tradable voting rights plus the lack of applicable anti-concentration or anti-monopoly laws.” Tom Barberan et al., Decentralized Finance’s Unregulated Governance: Minority Rule in the Digital Wild West (Feb. 8, 2022), https://issuu.com/abstractr-700191.
20 Aramonte et al., supra Note 14 at 22.
21 In its discussion of drawbacks to Dapps, Ethereum notes that “scaling is really hard” and that “When one dapp uses too many computational resources, the entire network gets backed up.” Ethereum Explanatory Document, Introduction to Dapps, https://ethereum.org/en/developers/docs/dapps/.
22 Aramonte et al., supra Note 14 at 27.
Streamlining unwieldy decentralized services for users provides opportunities to profit, and so the evolution of centralized intermediaries is inevitable. Because this centralization is ultimately an economic issue, and not a technological one, it is not something that further technological innovation can eliminate. While software itself has no motivations, those who program, maintain, and implement the software do. When we are told, for example, that DeFi doesn’t involve intermediaries and therefore doesn’t need regulation, we are essentially being asked to believe that those who participate in DeFi are simply more altruistic and better behaved than other participants in financial markets. Instead of focusing our attention on whether traditional intermediaries are being eliminated, we should be asking whether users of DeFi are susceptible to the same kinds of harms they can suffer at the hands of traditional intermediaries. If the answer is yes (which it clearly is, as amply demonstrated by Terra/Luna’s failure and many other DeFi scams), then we can “follow the money” to find those who actually control DeFi apps and platforms (be it the founders, their funders, or a “whale”), and require them to operate in a way that minimizes harm to the public.

In sum, when we hear from the crypto industry that existing regulation is incompatible with their technology, I believe that that is a misdirection. It is entirely possible for a blockchain-based technology business to comply with existing investor protection and financial stability regulation. However, for many crypto businesses, it may be true that existing regulation is incompatible with the economics of their business model, especially if their business model depends on doing things that we have learned, over the years, tend to harm people. Like a hedge fund that profits by trading against the customers of an affiliated crypto exchange without those customers knowing. Or an exchange that profits by commingling its own assets with customer assets, and using those commingled assets to trade. Or a stablecoin that has some kind of undisclosed quid pro quo relationship with an affiliated exchange that looks like payment for order flow. Or an issuer that profits by making up assets out of thin air at almost zero cost, engaging in some wash trades to inflate their market price, hyping the assets on social media, and then dumping them on unsuspecting investors. To use this last scenario as an example, while securities registration requirements can be complied with for any crypto asset, they would concededly be economically prohibitive for the crypto assets colloquially referred to as “sh*tcoins,” which have limited demonstrable value and can currently be produced at almost zero cost. But we have little to lose as a society from limiting the profitability of this kind of business model.

3. Bespoke crypto legislation as Trojan Horse

As the Subcommittee is well aware, the legislative process is always a compromise. However, the end result will be very different (and inevitably more crypto-industry friendly) if legislators start from the position that blockchain innovation is inherently beneficial, rather than asking preliminary questions about whether blockchain technology can ever accomplish what crypto lobbyists say it can. Given the industry’s demonstrated harms, I would humbly submit that this Subcommittee should start its legislative process by interrogating whether it is even possible for blockchain innovation to deliver on the crypto industry’s promises of efficiency,

24 For a running catalogue of DeFi scams, see Molly White’s blog Web3 is Going Just Great, https://web3isgoinggreat.com.
decentralization, and financial inclusion. The European Union may have skipped this step in formulating its Markets in Crypto Assets regulation (known as MiCA), which will become effective in 2024. MiCA’s Explanatory Memorandum includes statements like: “One of the strategy’s identified priority areas is ensuring that the EU financial services regulatory framework is innovation-friendly and does not pose obstacles to the application of new technologies.”23 The Explanatory Memorandum also refers to a joint declaration from the European Commission and the Council that they “are committed to put in place a framework that will harness the potential opportunities that some crypto-assets may offer.”24 But because blockchain technology cannot adjust people’s economic incentives, and because blockchain technology is inherently less efficient than available centralized alternatives, the industry’s promises of increased efficiency, decentralization, and financial inclusion seem destined to remain unfulfilled.

Most of the crypto-specific legislation that has been proposed so far in the United States is predicated on a misunderstanding of these preliminary matters as a result, it proposes to peel back laws designed to protect the public from harm in order to let crypto business models thrive. Take the example of two bills introduced in the Senate last session, the Lummis-Gillibrand Responsible Financial Innovation Act, and the Digital Commodities Consumer Protection Act (“DCCPA”) proposed by Senators Stabenow, Boozman, Booker, and Thune. Both of these bills sought to make the CFTC the crypto industry’s primary regulator, instead of the SEC. The CFTC is widely regarded to be the crypto industry’s preferred regulator.27 It is a much smaller agency with a much smaller budget than the SEC, and unlike the SEC, it has no statutory investor protection mandate and limited experience regulating retail-dominated markets.28 Section 4 of the DCCPA would also have implemented a new Section 5(d) of the Commodity Exchange Act that expressly authorized the CFTC to allow self-certification for crypto assets (in a self-certification regime, the exchange is permitted to certify to the CFTC that an asset complies with the Commodity Exchange Act, rather than putting the onus on the CFTC to ensure compliance).29 The SEC does not allow for self-certification.

In short, these bills were designed to offer fewer investor protections than the existing securities laws, and they were intentionally designed in this way in order to accommodate existing crypto business models. These kinds of bills, intentionally or not, will also give crypto assets a veneer of legitimacy, making it easier for fiduciaries operating pension funds and 401k plans to invest in them. Also, the deregulation facilitated by these kinds of bills can run both ways: by providing the crypto industry with “lighter touch” regulation than traditional finance, they encourage traditional financial institutions to refashion their services as crypto services in order to be able to take advantage of the lighter touch regime.30 However, as already discussed, there are

23 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52020PC0593
24 Id.
26 Id.
27 For more on the CFTC and self-certification, see Lee Reiners, Bitcoin Futures: From Self-Certification to Systemic Risk, 23 N.C. BANKING INST. 64 (2019).
28 For more on this issue, see Hilary J. Allen, Beware the proposed US crypto regulation — it may be a Trojan horse, FINANCIAL TIMES (Nov. 17, 2022).
no compelling justifications for accommodating or legitimizing crypto and its attendant harms with a lighter-touch, bespoke regulatory regime. This is a particular concern with regard to stablecoin legislation, as I will discuss in the next Section.

Because the crypto industry – rather than the public – is likely to be the primary beneficiary of bespoke crypto legislation, this kind of legislation is inferior to the regulatory status quo. I am concerned that the European Union may have set a trap for itself in this regard with MiCA. Just as FTX’s Sam Bankman-Fried supported the adoption of bespoke crypto legislation in the United States, Binance’s Changpeng Zhao (better known as CZ) has praised MiCA as a potential “global standard for the industry.” Some European policymakers have already expressed concerns about MiCA’s inadequacy, and MiCA’s loopholes may attract unscrupulous crypto businesses seeking legitimacy to the EU. Because crypto-specific legislation can be a Trojan horse for deregulation and legitimization, the next Section will identify existing regulation that can help contain the harms associated with crypto business models within the United States. The following Section will go on to consider types of new legislation that would be helpful in reducing harms associated with crypto business models.

4. Coverage by existing financial regulation

A. Banking regulation

Banking regulation is designed to promote the safety and soundness of individual banks and the financial system as a whole. It aims to do so by managing the risks that banks take on ex ante and providing ex post support should things go poorly, in the form of emergency lending from the central bank, deposit insurance, and special resolution mechanisms. By and large, banking regulation has succeeded in preventing banks from being exposed to the crypto industry’s risks ex ante. In a Joint Statement issued on January 3, 2023, banking regulators confirmed their position that:

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 transferred on an open, public, and/or decentralized network, or similar system is highly likely to be inconsistent with safe and sound banking practices. Further, 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.

31 Id.
32 “I have serious doubts that Mica would have prevented what happened” [i.e. FTX] said Spanish MEP Ernest Urtasun during a hearing held by the European parliament’s economic and monetary affairs committee in late November.” Scott Chipolina and Laura Noonan, EU frets over crypto rules after FTX blow-up, FINANCIAL TIMES (Jan. 12, 2023). Mica’s limitations include that it does not cover DeFi, crypto lending or staking – this allows for significant arbitrage opportunities. Geographical arbitrage opportunities may also arise as the result of different treatment of crypto assets in different countries with the European Union. Id.
Although banking regulation with regard to crypto has by and large been a success, *ex post* government support from the Deposit Insurance Fund was made available to uninsured Signature Bank depositors upon its March 12, 2023 failure. Silvergate Bank had voluntarily liquidated four days earlier:

Like Silvergate Bank, Signature Bank had also focused a significant portion of its business model on the digital asset industry. Signature Bank began onboarding digital asset customers in 2018, many of whom used its Signet platform, an internal distributed ledger technology solution that allowed customers of Signature Bank to conduct transactions with each other on a 24 hours a day, 7 days a week basis. As of year-end 2022, deposits related to digital asset companies totaled about 20 percent of total deposits, but the bank had no loans to digital asset firms. Silvergate Bank operated a similar platform that was also used by digital asset firms. These were the only two known platforms of this type within U.S. insured institutions.34

Investigations into potential supervisory failures with respect to Silvergate and Signature Banks are ongoing. Given the known volatility of the crypto markets, it may turn out that supervisors should have been more alert to the safety and soundness risks associated with these banks’ business models. Critically, though, US banks do not have direct exposures to crypto assets.

In the normal order of things, financial investments should be allowed to fail. Banking regulation, however, is the exception that seeks to prevent the failure of certain kinds of investments – including through *ex post* measures like emergency lending from the central bank, deposit insurance, and special resolution mechanisms. The availability of these *ex post* measures creates moral hazard (i.e. it gives banks incentives to engage in riskier behavior in order to multiply their profits in good times, knowing that there is a government safety net that will absorb the losses in bad times), but this moral hazard is deemed worthwhile because the economy depends on keeping banks stable to facilitate broad-based growth. Ultimately, banking regulation entails a kind of *quid pro quo* relationship, but crypto assets are primarily used for speculation rather than investment. Crypto assets should therefore not be the subject of government guarantees or otherwise be made “too big to fail.” Policymakers should be mindful of how fragile the crypto system is – as a result of its leverage, interconnectedness, and underlying technological complexity – which means that it may need rescuing regularly. Policymakers should be particularly mindful of the possibility that if banking regulation were applied to crypto assets, people could potentially fabricate crypto assets out of thin air and then have them bailed out by the Federal Reserve.

Bespoke crypto legislation that confers access to such government safety nets could create a market for crypto assets that the industry cannot create on its own. That is one of my concerns about proposed stablecoin legislation. Stablecoins are rarely used for payments, in part because there isn’t significant market demand for payments infrastructure that doesn’t allow mistaken or fraudulent transactions to be reversed, or for payments infrastructure that cannot scale up because it needs to involve wasteful computations in order to discourage attacks. As Banking Member Lynch noted at this Subcommittee’s hearing last week, stablecoins are instead used to facilitate

speculative cryptocurrency trading and investments, and they are fragile because of their susceptibility to runs. Recent survey evidence indicates that the vast majority of Americans are skeptical of crypto assets, but specialized laws could legislate a position for these fragile and inefficient stablecoins in our economy. Each of the stablecoin legislative proposals that I have seen would extend stablecoins some form of government safety net, bringing crypto closer to the core of our financial system and making it highly probable that the Federal Reserve would feel compelled to bail out a failing stablecoin (which would operate as an indirect bailout of the crypto speculation the stablecoins are used for). Such an approach seems ill-advised, particularly since we have already seen that stablecoins can “break the buck” (for example, Tether broke the buck in May 2022, and USDC did so in March 2023). Because crypto assets should be allowed to fail, the crypto industry should not be regulated like banks.36

B. Investor protection regulation

The securities laws have long been applied to an odd array of investments—ranging from orange groves to payphones37—without bringing them into the core of the financial system or making them too big to fail. The securities laws have always eschewed merit regulation, and so are designed to limit the legitimacy they confer on the securities themselves.38 People generally understand that corporate stock, for example, can lose a lot of value and even become worthless.

The SEC administers regulation that pertains to anything that satisfies the definition of a “security.” The SEC does so in accordance with its statutory mandates: to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. Not only does the SEC regulate the offer and sale of the securities themselves, it also oversees a number of key participants in the securities markets, including broker/dealers and securities exchanges. SEC Chair Gary Gensler has made clear that the SEC considers the vast majority of cryptoassets to be securities, and therefore subject to this regulatory framework.39 Unfortunately, the securities laws have so far been underenforced in the United States. This is partially attributable to the SEC’s limited resources: members of Congress seeking to strengthen investor protections should therefore ensure that the SEC is adequately funded through the appropriations process. This is not just a resource issue, though. The extent of the SEC’s jurisdiction over crypto assets in the US has often been called into question, and the SEC has faced political pressure in the past to refrain from cracking down on the crypto industry. Given that the crypto industry offers little by way of financial inclusion or efficiency to counterbalance the increased potential for consumer harm,

35 “Roughly four-in-ten adults who have heard about cryptocurrency (39%) say they are not at all confident and an additional 36% are not very confident in the reliability and safety of cryptocurrencies. On the other end of the spectrum, few of these adults are extremely (2%) or very (4%) confident in cryptocurrencies. About one-in-five (18%) say they are somewhat confident.” Favero and Sideri, supra Note 11.
36 For further discussion of issues related to regulating stablecoins, see Hillary J. Allen, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Hearing on Stablecoins: How Do They Work, How Are They Used, and What Are Their Risks? (Dec. 14, 2021).
39 “Of the nearly 10,000 tokens in the crypto market, I believe the vast majority are securities. Offers and sales of these thousands of crypto security tokens are covered under the securities laws.” Gary Gensler, Kennedy and Crypto, Remarks at SEC Speaks (Sept. 8, 2022), available at https://www.sec.gov/news/speech/gensler-sec-speaks-090822.
Congress should throw its support behind the SEC’s enforcement efforts, particularly its enforcement of registration requirements.

**Securities registration requirements**

Section 5 of the Securities Act of 1933 prohibits the offer or sale of a security without first registering with the SEC, unless an exemption from registration is available. The most widely-used exemptions in the Securities Act restrict who is eligible to purchase the securities in question, and restrict resales of those securities. However, crypto assets (which aren’t backed by any real-world productive capacity) need significant amounts of demand and liquidity to support their value. Restricting the pool of eligible investors, as well as limiting the liquidity of the crypto assets through resale restrictions, is therefore unlikely to be an appealing avenue for crypto issuers. Issuers of crypto assets who wish to access retail investors will need to register their offering in accordance with Section 5.

In 1933, Congress chose disclosure as the primary means of protecting investors from harm. The securities registration process requires a significant amount of disclosure on the part of the issuer, including the provision of audited financial statements. It takes time and money to prepare these disclosures, which changes the cost-benefit calculus for issuers of crypto assets. Right now, there are virtually no costs involved in creating most crypto assets. If the registration requirement is enforced, it will discourage the creation of crypto assets unless they have some long-term value creation potential that justifies the expense of the registration process. The required audit of financial statements and review of the registration statement by the SEC will also help weed out any fraud. This will further the SEC’s investor protection mandate; an incidental financial stability benefit is that the reduced supply of crypto assets will also reduce the amount of leverage in the crypto ecosystem. While some might worry that limiting the supply of crypto assets might be inconsistent with the SEC’s mandate to promote capital formation, the reality is that the crypto markets are largely speculative and self-referential, and do not contribute significantly to capital formation. Any crypto asset that can meet the same registration requirements as other securities would be allowed into the market.

The application of Section 5’s registration requirement can also encourage better private sector due diligence. Details emerging from the FTX collapse suggest that the venture capitalists who helped fund the expansion of FTX did not engage in even basic due diligence or insist on basic principles of good governance at FTX (FTX’s bankruptcy filing described FTX’s “unprecedented” “concentration of control in the hands of a very small group of inexperienced, inexperienced, inexperienced” investors). 

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40 Rule 506, for example, restricts investor eligibility and resales. The Regulation A exemptions have fewer such restrictions, but require the filing of an Offering Statement with the SEC. The crowdfunding exemption also requires an initial filing with the SEC (as well as ongoing annual disclosure requirements), and resales are restricted for the first year.

41 “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.” Todd H. Baker, *Let’s Stop Treating Crypto Trading as If It Were Finance*, THE CLS BLUE SKY BLOG (Nov. 29, 2022), available at https://blue skyblog.columbia.edu/2022/11/29/lets-stop-treating-crypto-trading-if-it-were-finance/

unsophisticated and potentially compromised individuals.43 And noted that many entities had never even held board meetings.44 Given that venture capitalists lend reputational capital to the projects they fund, they serve a kind of gatekeeper function that seems to have been abdicated with respect to FTX.45 It is therefore worth considering how the securities laws, if properly enforced with respect to crypto, might impact venture capital firms and improve the performance of their gatekeeping function.

First, venture capitalists who fund crypto projects are often able to “exit” their investments much more quickly than if they had made a traditional equity investment in a start-up. Venture capital firms typically receive tokens in connection with their crypto investments, and they often sell these tokens to the public as soon as their contractual lock-up expires.46 However, this practice is predicated on the assumption that the tokens are not securities: if the tokens are securities, then any token sales to the broader public will first need to be registered with the SEC. Venture capital firms will not be able to exit so quickly. In short, enforcing Section 5 against venture capital firms will likely result in their holding their crypto investments longer, reorienting their incentives to perform diligence because they will have “skin in the game” longer.

Second, individuals who have purchased a security that was offered or sold in violation of Section 5 have a remedy under Section 12(a)(1) that is essentially a put right: so long as the statute of limitations has not expired, investors can demand their money back. This remedy under Section 12(a)(1) is not just available against the issuer of the security; it is also available against any “statutory seller” that “successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner.”47 Depending on how the relationship between a venture capital firm and a crypto founder is structured, the venture capital firm may satisfy the definition of statutory seller and therefore be liable to refund purchasers of unregistered securities. The threat of such a possibility should encourage venture capital firms to both perform due diligence and ensure that the crypto projects they fund meticulously comply with the securities laws.

Broker/dealer regulation

Many crypto exchanges perform brokerage, exchange, and clearing services for their customers, and some marry these services with proprietary trading activities. As a result, these exchanges must register as exchanges, market-makers, and broker/dealers under existing

44 Id. at 16.
45 Parallel can be drawn here with the Terra/Luna collapse. As one reporter details, “One very senior risk analyst at a crypto VC fund told me he held grave reservations regarding the “algorithm stablecoin” but his team was assuaged by the cap table having some big names in crypto capital…” Max Paradell, The risks and benefits of VCs for crypto communities, COINTELEGRAPH (Jul. 8, 2022).
46 “VCs often buy a huge chunk of tokens at an early stage at a very low price, and these tokens are often time-locked, so they can’t be sold for one or two years. When the time is up, VCs face the dilemma of dump[ing] their tokens — which makes them a fortune but tanks the price of the community’s holdings — or hanging on. Typically, VCs are perceived to choose the former.” Id.
securities laws. My testimony will focus on the application of broker/dealer regulation. Securities broker/dealers are subject to registration requirements under the securities laws, and registered broker/dealers are subject to a multitude of regulatory requirements. Relevantly, these include requirements relating to affiliations and to the custody of customer assets. Robust enforcement of these laws against crypto exchanges would confer protections on US investors.

More specifically, many crypto exchanges are likely to satisfy the definition of a “broker” in Section 3(a)(4)(A) of the Securities Exchange Act of 1934, and as such be required to comply with the broker registration requirements in Section 15(a)(1) of that Act. Once registered, a broker is required to comply with many rules, including Rule 15c3-3 (which “prevents a broker-dealer from using customer funds to finance its business”). A broker/dealer is also subject to a duty of fair dealing which requires full disclosure of any conflicts of interest, and when dealing with retail customers, to Regulation Best Interest. Regulation Best Interest not only requires disclosure of any potential conflicts of interest, it also includes an affirmative obligation to “[i]dentify and mitigate any conflicts of interest associated with such recommendations that create an incentive for the broker-dealer’s associated persons to place their interest or the interest of the broker-dealer ahead of the retail customer’s interest.”

As with securities registration requirements, it is possible that robust enforcement of broker/dealer registration requirements against crypto exchanges will keep some of those exchanges out of the markets – not because it is technologically impossible for those exchanges to comply with the law, but because the economics of their business models depend on trading with customer funds or aggregating functions that must typically be disaggregated to prevent conflicts of interest. Once again, if exchanges are only economically viable because they exploit their consumers, then the public will not suffer if they disappear. For those exchanges that do register, investors will have more information about conflicts of interest, and their assets will be segregated and therefore more secure.

49 The definition identifies “any person engaged in the business of effecting transactions in securities for the account of others” as a broker, the SEC has provided the following guidance on interpreting this definition:

“Here are some of the questions that you should ask to determine whether you are acting as a broker:

- Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?
- Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal? Do you receive trailing commissions, such as 12b-1 fees? Do you receive any other transaction-related compensation?
- Are you otherwise engaged in the business of effecting or facilitating securities transactions?
- Do you handle the securities or funds of others in connection with securities transactions?

A “yes” answer to any of these questions indicates that you may need to register as a broker.”

50 Id.
51 Id.
C. Consumer protection regulation

If there are crypto-related products and services that are not otherwise covered by the securities laws, then the Consumer Financial Protection Bureau may have a role to play. The CFPB has authority to regulate a broad variety of consumer financial products and services, including authority to make rules and bring enforcement actions relating to unfair, deceptive, or abusive acts or practices. As with investor protection regulation, what is critical is that the CFPB use its authority to bring the crypto industry in line with existing regulatory standards, rather than lowering standards to accommodate the industry.

5. Possible legislative reforms

As the previous Section demonstrated, existing financial laws and regulations provide financial regulators with tools that can effectively address many of the harms associated with crypto business models. Robust enforcement of these laws and regulations is key to curbing the crypto industry’s harms. If lawmakers are contemplating new legislation, however, there are some reforms that would further assist in this regard.

A. Banking regulation

As discussed above, banking regulation has performed reasonably well in protecting the traditional financial system from the fallout of crypto industry implosions. However, legislation that formally recognizes the separation of banking and crypto – a type of “Glass-Steagall 2.0” – would be helpful. Such legislation should prohibit banks from investing in any crypto assets, or accepting them as collateral for loans. Banks should also be prohibited from holding stablecoin reserves in a deposit account, as those funds could disappear in the event of the run on the stablecoin, exposing the bank to the risk of a run itself. For the reasons articulated above, insured depository institutions should also be prohibited from issuing their own stablecoins. Congress may also wish to reconsider the wisdom of allowing banks to custody crypto assets, or to perform trades on permissionless blockchains.

With regard to banks providing traditional banking services to crypto businesses, I do not believe that it is appropriate for a statute to prohibit banks from doing so. For a point of comparison, after the enactment of Glass-Steagall, commercial banks were still able to make loans to unaffiliated investment banks. However, any services that banks provide to crypto businesses must be provided in a safe and sound way. Following the failure of Silvergate and Signature Banks, it should be abundantly clear to bank supervisors that relying too heavily on crypto industry deposits is an unsafe and unsound practice for banks, and there may also be other reputational concerns for supervisors to consider when banks work with crypto businesses. To be clear, no legislative reform is needed in this regard: banking regulators already have sufficient authority to address unsafe and unsound practices.

53 Dodd-Frank Act, Title X, Subtitle C, Secs. 1031; 1036 (July 21, 2010).
55 Brayden Lindrea, JPMorgan executes first DeFi trade on public blockchain, COINTELEGRAPH (Nov. 2, 2022).
B. Investor protection regulation

If new crypto legislation is adopted, it should reaffirm the SEC’s jurisdiction over crypto assets. Legislation that amends the definition of “security” in the Securities Act of 1933 and the Securities Exchange Act of 1934 to categorically provide that all crypto assets are securities would mean that the Howey test would no longer be relevant to determining whether a crypto asset is a security. The crypto industry would know with absolute certainty that the securities laws apply to them, and that the SEC is their regulator. In particular, these definitions could clarify that stablecoins are also “securities,” recognizing the reality that stablecoins serve a speculative investment rather than a payments function.

C. Operational risk regulation

This testimony has focused on regulating the economic incentives of those using blockchain-based technologies. However, if these technologies are used to provide financial services, then there are some novel technology-specific operational risks that any applicable regulatory regime should also address. As part of its “BitLicense” framework, the New York Depart of Financial Services has identified a number of blockchain-associated operational issues that should be addressed, including cybersecurity risk, and “[r]isks relating to code defects and breaches and other threats concerning any new coin and its supporting blockchain, or the practices and protocols that apply to them.” Indeed, financial regulation in general would be improved by a legislative direction to focus more specifically on the potential systemic dimensions of technological problems, and by a Congressional commitment to providing the resources needed for financial regulators to hire more software engineers and data scientists.

D. A ban

The legislative reforms outlined so far seek to utilize and improve existing regulatory frameworks to curb the harms associated with crypto business models. However, the most effective way to protect both the stability of our financial system and individual investors would be to ban the issuance and trading of crypto assets. As this testimony has already explored, we have much to gain and little to lose from a ban on crypto (and the gains would go beyond investor protection and financial stability – they would also include limiting environmental damage and preventing ransomware attacks). It is sometimes said that such a ban would be impossible to enforce.

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57 New York Department of Financial Services, Guidance Regarding Adoption or Listing of Virtual Currencies, available at https://www.dfs.ny.gov/industry_guidance/industry_letters/l20200624_adoption_listing_vc
59 For more on building the technological capacity of financial regulatory agencies, see Hilary J. Allen, Resurrecting the OFR, 47 J. Corp. L. 1 (2021).
60 “If crypto cannot deliver on its promises or is even unlikely to deliver, there must be strong regulation to rein in the negative consequences of crypto experimentation. Among its negative impacts, the rise of crypto has spurred
because of the decentralized nature of crypto. However, this testimony has already identified many people against whom such a ban could be enforced. Most obviously, centralized exchanges serve as important gateways to the crypto markets. If they were banned from listing crypto assets, then the market for those assets would most likely diminish significantly. Alternative exchanges do exist that are operated by DAOs rather than a single entity, but a ban could still be enforced against such exchanges. As already explored, DAO governance tokens are held by real people and those real people could be prohibited from holding governance tokens in a DAO operating a prohibited business. Practically speaking, ownership of these tokens tends to be reasonably concentrated with founders, venture capitalist funders, and crypto whales, so enforcement efforts would only have to target a limited number of holders to be effective.\footnote{Barbera et al., supra Note 18} A ban is therefore feasible, and can be effective even if not 100\% impermeable.
Testimony of Marta Belcher
President and Chair, Filecoin Foundation

Before the U.S. House of Representatives Committee on Financial Services
Subcommittee on Digital Assets, Financial Technology, and Inclusion


April 27, 2023, 2 p.m. ET

Thank you, Chairman Hill, Ranking Member Lynch, Chairman McHenry, Ranking Member Waters, and Subcommittee members, for inviting me to testify today.

I’m Marta Belcher. I’m President and Chair of Filecoin Foundation, one of many organizations working on a cryptocurrency called Filecoin.

While this hearing is in the Committee on Financial Services, I want to emphasize today that cryptocurrency is about so much more than finance.

Cryptocurrency is already creating a better Internet—providing an alternative to big tech that puts people in control of their own data. This technology is also preserving some of the world’s most important information, including government data, evidence of human rights abuses, and critical scientific datasets. Today, I would like to explain how.

Today’s internet is centralized. The vast majority of data is stored by three companies: Amazon, Microsoft, and Google. This creates single points of failure; when these companies suffer blackouts, large swaths of the Web go down for hours. This centralized model also means that we live our lives through a handful of corporations. We have no choice but to trust them with our data, and they have unilateral control over what we can do and say online.

Cryptocurrency provides an alternative. Cryptocurrency creates the ability to program money—to send value across the globe instantly and automatically, with no intermediary, when a condition is met. For example, you can write a computer program that says, for every second of a song I play, automatically transfer a milliionth of a cent from me to the songwriter.

Filecoin uses programmable money to create a decentralized file storage network. It’s like Airbnb for file storage: you can “rent out” your extra digital storage space to people who pay you to store their files (or pieces of their files). A computer program regularly checks that you’re still storing the files, and the file owner automatically pays you in filecoin. Using the filecoin token enables the network to operate in a manner that is peer to peer, instant, automatic, and trustless.
Filecoin is a foundational technology for the next generation of the Web. Filecoin puts users in control of their data—finally giving them an alternative to big tech. It also allows users to store many copies of their files on hardware around the world, so data remains accessible even if some devices fail.

There are thousands of individuals and small businesses around the world serving as Filecoin storage providers. Together, they are contributing more than 15 billion gigabytes of capacity to the Filecoin network. That’s enough to store all written works since the beginning of recorded history, 10 times over.

That storage space is being used to preserve humanity’s most important information. For example, Filecoin is storing copies of open datasets created by NASA, NIH, the National Weather Service, and US Geological Survey, and Filecoin Foundation is exploring working directly with some of these institutions.

Filecoin is also important for government documents because it can solve the problem of “link rot”—the fact that, over time, many links in important documents like Supreme Court decisions or Congressional records no longer work. Harvard’s Library Innovation Lab is working to explore how these technologies can ensure that links work permanently.

Human rights defenders leverage Filecoin to help collect, verify, and preserve data. For example, Starling Lab—a project of Stanford and USC—recently submitted evidence of Russian war crimes in Ukraine to the International Criminal Court. Starling used Filecoin to both preserve this digital evidence and also verify that it was authentic and had not been tampered with.

Filecoin also stores important scientific information, like large genomic, geospatial, satellite, and climate datasets, from institutions like the University of Maryland, the University of Utah, Berkeley’s Underground Physics Group, and the ATLAS Experiment at CERN. Filecoin Foundation is also working with Lockheed Martin on a satellite launch to demonstrate how the technology underlying Filecoin can speed up communications in space.

As these examples demonstrate, cryptocurrency is about so much more than financial services. And regulating cryptocurrencies like financial services could undermine these valuable use cases. These technologies only work if you can instantly and automatically send value across the world, directly from one person to another, as easily as attaching a file to an email. Regulations that insert intermediaries and add friction are incompatible with these technologies.

It is critical that any cryptocurrency regulation protects users’ ability to transact directly with each other, without the constraints, risks, and costs that intermediaries impose. It is critical to recognize the open source, decentralized nature of this technology and to acknowledge our country’s free speech protections for writing computer code. And it is critical to provide clarity, safe harbors, and compliance onramps so that innovators can continue to operate in the United States.
In drafting cryptocurrency regulation, I urge the Committee to consider the many valuable uses of cryptocurrency beyond financial services, to ensure this innovation can continue to thrive.

I look forward to your questions. Thank you.

Marta Belcher is president and chair of Filecoin Foundation as well as its sister charitable organization, Filecoin Foundation for the Decentralized Web. She also serves as general counsel and head of policy at Protocol Labs, and special counsel to the Electronic Frontier Foundation. Marta is a member of the Board of Directors of the Zcash Foundation and the Blockchain Association, and is a member of Paradigm’s Crypto Policy Council. Marta was previously an attorney at Ropes & Gray LLP focusing on blockchain and emerging technologies. Marta received a B.A. in Rhetoric from the University of California, Berkeley, and a J.D. from Stanford Law School.
WRITTEN STATEMENT OF

DANIEL S. GORFINE

CEO, GATTAÇA HORIZONS LLC; ADJUNCT PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER, FORMER CHIEF INNOVATION OFFICER AND DIRECTOR, LABCFTC AT THE U.S. COMMODITY FUTURES TRADING COMMISSION (CFTC)

BEFORE THE U.S. HOUSE FINANCIAL SERVICES COMMITTEE, SUBCOMMITTEE ON DIGITAL ASSETS, FINANCIAL TECHNOLOGY, AND INCLUSION


Thursday, April 27, 2023
2:00p EST
Thank you, Committee Chairman McHenry and Ranking Member Waters, Subcommittee Chairman Hill and Ranking Member Lynch, and members of the Subcommittee for the opportunity to testify before you today. I am the founder and CEO of Gattaca Horizons LLC, an advisory firm, an adjunct professor at the Georgetown University Law Center, and a co-founder of the non-profit Digital Dollar Project, which is focused on exploring a U.S. central bank digital currency (CBDC). I am also the former chief innovation officer and director of LabCFTC at the U.S. Commodity Futures Trading Commission (CFTC). The testimony presented here today reflects solely my own personal views, and not the views of any client or organization with which I am affiliated.¹

The topic of today’s discussion is “The Future of Digital Assets: Identifying the Regulatory Gaps in the Digital Asset Market Structure.” This is an important topic and one that has featured prominently since my time in government more than four years ago. Despite significant policymaker, regulatory, and market participant interest, the fundamental regulatory landscape for digital assets in the United States, especially at the federal level, has not changed significantly since the inception of Bitcoin in 2009.

As I will discuss, the current landscape remains one where spot or cash digital asset trading activity, which means the buying and selling of an asset for immediate delivery, is largely regulated at the state level under money transmission frameworks (or those tailored to cryptocurrencies, as in New York), while federal regulators apply various rulesets depending on the specific digital asset and activity involved. Notably, under the status quo, digital asset exchanges that mirror the activities of traditional exchanges and facilitate the matching of trades for digital assets that are commodities are not subject to comprehensive federal market oversight and supervision.

**Understanding Digital Assets & Underlying Infrastructure**

Before delving deeper into the current regulatory landscape for digital assets, it is important to underscore some important points regarding the involved assets, technology and nature of innovation. As a threshold matter, digital assets can be distinguished from the underlying infrastructure used to transfer such assets from one computer to another without the need for a trusted, central party traditionally needed to verify that each party to a transaction has – and does – what it promises.² Differentiating digital assets from the underlying infrastructure or rails transacted upon is conceptually helpful for two reasons.

First, the nature and characteristics of the digital asset itself, along with the particular activity, frequently determine which set of financial rules or regulations are applicable. For example, regardless of the underlying transaction rails, if the digital asset is a security, then we would apply

¹ My professional associations are set out in my biography attached as Appendix A.
² See Written Testimony of Daniel S. Gorringe before the House Committee on Agriculture, Cryptocurrencies - Oversight of New Assets in the Digital Age (July 18, 2018), available at https://agriculture.house.gov/uploadedfiles/07_18_18_gorringe_testimony.pdf
the securities law to transactions involving that asset. And if the digital asset is a commodity, then we apply the commodities laws.

In my view, some of the problems we have observed in the crypto space over the past year are a result of too much focus on novel digital assets rather than real-world applications that yield productive gains and improve lives. If there is a silver-lining in the significant market correction we have witnessed over the past months, including a number of tokens that have gone to zero, it is that for any token to survive in the long run, it will need to have a clear value proposition and differentiating characteristics. This could be, for example, that it is true competition to other forms of payment, is an effective hedge against fiat currencies (like gold), preserves privacy, and/or includes unique and desired programmability and coding features. My expectation is that in the medium-to-long-term, we will see a significant reduction in the number of outstanding tokens.3

A second reason to differentiate the asset from the underlying infrastructure is that it can help us better understand the benefits of that underlying infrastructure—which can also be thought of as new, automated transaction rails. While a native cryptocurrency like Bitcoin cleverly provides an incentive for validators to participate in the network, the fundamental innovation in this space is the ability to transact a digitally scarce asset on the Internet from one computer to another with relatively few intermediaries, at relatively low cost, and with near-instant settlement. Such systems may also bring compelling privacy and decentralization benefits as compared to a traditional accounts-based system.

Before Bitcoin, the only way to transfer certain assets or tokens (commonly referred to as “bearer instruments”) directly from one person to another without relying on an intermediary was in the physical world. Now, with digital tokens and automated transaction rails, we can do so in cyberspace. This computing advance is notable in that it allows individuals halfway around the world to use computers to send unique items of value directly from one to another similar to the way the Internet has enabled the sending of information through email with relatively few intermediaries, at low cost, and with great speed. In the context of economic activity, this digital advance in infrastructure holds promise in unlocking decentralized computing, increasing access and efficiency, driving competition and lower costs, and allowing for increasingly programmable and automated economic activity.

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3 It has been reported that there are near 23,000 cryptocurrency tokens and the website CoinMarketCap lists pricing for more than 9,000 tokens—most of which are not available on the largest U.S. exchanges. See also Daniel Gorfine, “Using Cryptocurrencies As... Currencies?”, Medium (Mar. 26, 2019) (discussing the economics and market realities of tokens), available at https://medium.com/@CFTC_Using-cryptocurrencies-as-currencies-c57af6659234.
The Existing Regulatory Landscape

As noted above, the overall regulatory landscape for digital assets has not changed significantly since Bitcoin first traded in 2009—which means that there is no comprehensive market oversight framework. FinCEN was the first financial regulator to specifically address the regulatory status of cryptocurrency (referred to then as “virtual currency”) by determining in 2013 that exchanges and certain other cryptocurrency intermediaries meet the 2011 definition of money transmitter and are money service businesses (MSBs) under the BSA regulations. Such MSB’s are required to register with FinCEN and report suspicious activity potentially indicative of crime.

Following FinCEN’s analysis, many states have required exchanges and related intermediaries to secure a money transmission license (MTL) pursuant to each state’s respective law; some states have gone further and created tailored and even more robust regulatory frameworks for cryptocurrency businesses, built on the foundation of MTL regulation (e.g. the NY BitLicense).

The state MTL framework and related state-based oversight do impose meaningful requirements on payments companies and money transmitters, frequently including implementation of AML and financial crime compliance programs, permissible investments standards, and minimum net worth and related security requirements. These frameworks do not, however, uniformly impose the same types of markets and trading oversight as is common with federal market regulators, such as the CFTC and the SEC. For example, state money transmitter regulation would typically not impose market surveillance requirements and supervision intended to detect fraudulent or manipulative trading activity, including practices such as wash trading (where a market participant executes counteracting buy and sell orders in order to manipulate trade data) and spoofing (where a market participant places an order but then rapidly cancels it, never intending to execute the trade in the first place). They would also not include certain trading conflict of interest and self-dealing prohibitions as would typically be found in capital markets regulation.

Beyond FinCEN and state licensure requirements, various federal regulators apply their respective rules to digital assets depending on the categorization of the asset and the involved activity. As noted above, the CFTC has certain statutory and regulatory authorities to the extent an asset is a commodity, the SEC applies the securities laws to the extent an asset is a security, and the federal

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banking regulators will apply banking regulations to the extent that a bank seeks to engage in certain digital asset activities, including custody or providing banking services to digital asset firms.

The CFTC’s jurisdiction related to digital assets was established in 2015 when the Commission determined that certain “virtual currencies,” such as Bitcoin, met the definition of “commodity” under the Commodity Exchange Act (CEA). The definition of commodity under the CEA is very broad and the CFTC has indicated that other cryptocurrencies beyond Bitcoin, including Ether and Litecoin, are commodities. The CFTC’s determination that certain digital assets fall under the CEA’s commodity jurisdiction have subsequently been upheld by a number of federal courts.

Under the CEA, however, the CFTC’s jurisdiction over activity involving spot or cash trading in a commodity is relatively limited. More specifically, the CFTC does have limited enforcement authority provided under Dodd Frank to police for fraud and manipulation in underlying spot digital commodity markets, but this authority is backward-looking and invoked only when wrongdoing is suspected. The CFTC has used its enforcement authority to help police digital commodity markets since 2014, having brought more than 50 cases since that time. The CFTC’s authority over cash or spot markets, however, is not oversight or supervisory authority, which entails rulemaking and the registration and regular examination of involved intermediaries, including exchanges.

It is important to underscore this last point: the CFTC does not currently have market oversight authority over spot or cash trading in digital commodities (nor, for that matter, in any other commodity, including precious metals or agricultural commodities). This point is commonly confused because the CFTC does have oversight authority over futures and derivatives products that may be predicated on an underlying commodity—for example, oil, gold, or even bitcoin futures contracts—and the exchanges and intermediaries that facilitate trade in such contracts. Exchanges and related intermediaries that facilitate trading in regulated derivatives products are subject to robust CFTC requirements, including with respect to registration, trade surveillance and monitoring, transaction reporting, compliance with personnel conduct standards, customer education, conflicts of interest, custody, capital adequacy, platform and trading system safeguards,

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10 The CFTC does also have oversight authority over certain leveraged or financed retail commodity transactions where actual delivery of the commodity does not occur within 28 days.
and cyber security examinations. Similarly, the market participants (e.g., dealers, pool operators, and trading advisors) that engage in these activities are subject to oversight by the CFTC, the exchanges where they transact, and, in some instances, by the National Futures Association (NFA), a delegated self-regulatory organization (SRO).

With respect to the SEC, its jurisdiction is implicated when an asset is deemed to be a security; in this case, both the offering and the involved intermediaries, including exchanges, are required to comply with the securities laws and may be subject to registration with the SEC and/or FINRA. To date, the SEC has broadly asserted its enforcement authority and suggested that many cryptocurrencies are securities. As discussed below, however, a lack of clarity in determining when an asset is a security remains a key challenge in this space—this ambiguity has profound implications since market participants and regulators alike may struggle in determining which rules apply to a particular asset and the involved intermediaries.

Finally, to round out the financial regulatory landscape related to cryptocurrencies, it is important to note the role of state and federal banking regulators. Banking entities involved in digital asset activities, including with respect to custody or providing banking services to digital asset firms and exchanges, must satisfy requirements imposed by their respective regulator. Since the end of last year, the federal banking regulators have been increasingly active in publishing guidance concerning how banks should approach and mitigate risks related to digital asset activities.

Looking Ahead & Addressing Gaps

As discussed above, while some states have developed mature and robust regulatory frameworks for supervising digital asset activities, there is no current federal market regulator overseeing spot digital commodity markets. Financial market regulators are empowered by Congress to develop and apply rules that promote market integrity, transparency, and investor protection, as well as “prevent fraud and manipulation, provide adequate disclosure and reporting, ensure proper handling of investor assets, prevent conflicts of interest, and ensure operational resiliency.”

11 See Behnam Testimony: Testimony of Chairman J. Christopher Giancarlo before the U.S. Senate Agriculture Committee (Feb. 15, 2018) (hereinafter “Giancarlo Testimony”), available at https://www.agriculture.senate.gov/imo/media/doc/Testimony_Giancarlo_02.15.18.pdf.
For this reason, as CFTC Chairman Behnam testified last year, “[the] CFTC is well situated to play an increasingly central role in overseeing the cash digital asset commodity market.” By statute, the CFTC is a principles-based regulator established by Congress “to deter and prevent price manipulation or any other disruptions to market integrity; to ensure the financial integrity of all transactions subject to [its jurisdiction] and the avoidance of systemic risk; to protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets; and to promote responsible innovation and fair competition among boards of trade, other markets and market participants.” Absent congressional authorization, however, the CFTC does not have the current authority to directly oversee and supervise spot digital commodity markets.

The CFTC, however, is familiar with supervising large and complex markets traditionally focused on facilitating risk transfer between parties. Indeed, U.S. derivatives markets are the envy of the world and include financial instruments with notional values totaling in the trillions of dollars. The Agency also maintains a robust enforcement division focused on policing its markets, protecting investors, and ensuring market integrity. In 2022 alone, the CFTC brought 82 enforcement actions—with 18 related to digital assets—and “obtained orders imposing over $2.5 billion in restitution, disgorgement and civil monetary penalties either through settlement or litigation.”

The CFTC has historically leveraged its framework and congressional mandate to adapt to constantly changing markets and to gain a deep understanding of the commodities that commonly underpin regulated derivatives products. Whether the asset be a precious metal, natural resource, agricultural product, or a digital commodity, the CFTC studies underlying markets to help inform its enforcement authority over potential fraud and manipulation and its oversight of derivatives products and intermediaries. To this end, I was proud to have had the opportunity during my time at the CFTC to lead LabCFTC and support the Commission’s mission of promoting market integrity, customer education, and innovation. We spent considerable time studying digital asset markets, identifying risks, and advancing sound policy – efforts that continued upon my departure and continue to this day through the recently renamed Office of Technology Innovation.

Since 2018, and specific to digital assets, the CFTC has overseen well-regulated, robust, and transparent bitcoin futures markets facilitated by CFTC regulated exchanges and intermediaries. The initial self-certification of these products were subject to the CFTC’s tailored “heightened review” framework in order to address unique characteristics related to digital commodities, including their high degree of retail participation, unique custody considerations, and the nature of

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their underlying spot markets. To this end, the CFTC differentiated between digital commodities and traditional commodities and established the basis for their differential treatment.

Since that time, these well-regulated markets have continued to grow and are subject to important reporting, market surveillance, investor protection, and customer education requirements. NFA, the CFTC’s delegated SRO, which plays a similar role to that of FINRA with the SEC, has also implemented certain disclosure requirements on intermediaries involved in spot markets and proposed new standards of conduct. And, the CFTC’s enforcement division has remained vigilant, working to actively police CFTC markets and pursue bad actors. It is worth noting that under Chairman Gary Gensler, the SEC has approved a number of exchange traded products predicated on CFTC regulated bitcoin futures contracts given the robust CFTC supervisory framework in place around those contracts.

A takeaway from this discussion is that digital asset futures and derivatives markets are well-regulated and are working as expected. It should further be noted that the existence of these markets provides policymakers with transparency and insights into digital asset instruments, and provides Americans with well-regulated opportunities to participate in futures and options markets. This outcome is far preferable to seeing investors lured to offshore, unregistered, and illegal derivatives markets prone to fraud and financial crime violations, as we have seen.

Similar to the CFTC, the SEC has rules and requirements for intermediaries involved in facilitating trading in securities. As we have also seen over the years, especially during the prior ICO mania, many crypto tokens were developed and sold to retail investors in order to raise capital for the development of an enterprise or simply to defraud investors. In either case, the SEC appropriately has applied the securities laws and its enforcement authority to pursue such unregistered offerings.

It is important to note, however, that outside of clear-cut and established examples of when a token may be a security, there are ongoing marginal and ambiguous cases. This lack of definitional clarity is highly problematic since jurisdictional determinations are based on whether an asset is or is not a security. This is an area where more work needs to be done, whether by the courts, regulators, or Congress.

To this end, it is worth noting that part of the reason we regulate commodities differently from securities is that they are not subject to the same information asymmetry inherent in security investments, whereby a specific management team holds critical information about the enterprise

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18 See Giancarlo Testimony.
19 One of the largest bitcoin and ether futures and options exchanges, CME, publishes robust market data. CME reported that a record number of bitcoin options traded on a recent day in March of this year and that open interest hit a record at the end of the month. Over 2.8 million ether futures contracts have traded since the product’s launch in February 2021. See CME Group, Cryptocurrency futures and options (last visited Apr. 25, 2023), available at https://www.cmegroup.com/markets/cryptocurrencies.html.
that the public must be aware of to inform and facilitate price discovery. In this way, owning shares in McDonald’s is quite distinct from owning a gold bar—and the nature of information regarding each asset and how one might access that information is similarly distinct. With at least some digital assets, we seem to have agreement that they are more akin to the gold bar, but we lack broader and generalized consensus with respect to many others.

For this reason, it is worth exploring ways to address this ambiguity. A potentially viable path would be invoking the spirit of the original JOBS Act legislation that created tailored frameworks for certain capital-raising efforts subject to SEC oversight and disclosures and that are intended to leverage the democratizing impact of the Internet. One could imagine a scenario where digital ecosystem developers avail themselves of a similar, but properly tailored, framework to facilitate initial sales of a token subject to SEC regulation and then revisit registration if an ecosystem has developed to the point it looks more like Bitcoin than a share of McDonald’s stock—meaning sufficiently decentralized to the point that no set of managers hold key valuation information about the token or whose ongoing efforts are essential to the value of such token. This is but one solution worth considering, but by no means the complete universe. The key takeaway, however, is that developing appropriate regulatory frameworks for digital assets will remain incomplete if it remains unclear when such frameworks apply.

*      *      *

Thank you for your time and inviting me to speak with you today. As detailed above, aside from the development of particular, tailored regimes in select states, the regulatory landscape in the U.S. has remained fairly constant since the first Bitcoin was mined in 2009. A particular gap in this landscape remains the lack of a coherent and comprehensive market regulatory framework aimed at ensuring trade surveillance, market integrity, and certain baseline investor protections common in trading environments. The CFTC and SEC have experience establishing such requirements in their respective markets and more can be learned from states, like New York, with experience regulating digital assets. Ultimately, I have confidence in the professional staff and capabilities of our market regulators. Today’s panel—as well as others before us—have identified existing gaps and opportunities to create a more efficient, uniform and comprehensive national regulatory framework. Against this backdrop, I think there is a great opportunity for policymakers to work collaboratively to craft that framework in order to ensure the responsible development of digital assets and markets in the United States.

Thank you. I am happy to answer any questions that you have.
Appendix A

Daniel Gorfine Biography

My name is Daniel Gorfine, and I am the founder and CEO of Gattaca Horizons LLC, a boutique advisory firm. I am also a co-founder and director of the non-profit Digital Dollar Project, which focuses on exploration of a U.S. central bank digital currency (CBDC), and I am an adjunct professor at the Georgetown University Law Center. I am honored to have previously served as chief innovation officer at the U.S. Commodity Futures Trading Commission (CFTC) and Director of LabCFTC.

In my advisory capacity, I work with a range of clients, including financial firms, technology companies, fintech and digital asset-related firms, and startups. My work with the non-profit Digital Dollar Project includes publishing white papers and opinion pieces on the potential designs and merits of a digital dollar. And as an adjunct professor at Georgetown, I teach a course titled “Fintech law and policy.”

I am a graduate of Brown University (A.B.), hold a J.D. from the George Washington University Law School and an M.A. from the Paul H. Nitze School for Advanced International Studies (SAIS) at Johns Hopkins University.
April 27, 2023

WRITTEN TESTIMONY OF
H. Joshua Rivera
General Counsel, Blockchain Capital

BEFORE THE
United States House of Representatives Committee on Financial Services Subcommittee on Digital Assets, Financial Technology and Inclusion

IN A HEARING ENTITLED

Chairman Hill, Ranking Member Lynch, and Members of the Subcommittee:

My name is Joshua Rivera and I serve as General Counsel of Blockchain Capital, a venture capital firm focused on digital assets technology. I am a lawyer by training and practice, and have represented traditional global financial institutions in various financial transactions including capital markets, financings, mergers and acquisitions and asset management. I have also represented eSports and gaming, life sciences, media and advertising and technology firms in various capital markets and venture transactions, both in the traditional financial sector and the digital assets industry. Upon learning about Bitcoin and Ethereum in early 2017, I began to study how blockchain technology could facilitate value creation and value transfer in open ecosystems that do not rely on intermediaries for their viability. This was new; something traditional financial ecosystems were not capable of. Technology like this could powerfully democratize access to financial and other types of value generation and retention while providing new platforms for innovation. Since then, I have worked exclusively on legal issues related to blockchain technology and the digital assets industry.

Thank you for the opportunity to testify about both the incredible opportunities — and immense challenges — that the digital assets industry, and the blockchain technology that underpins it, presents to an innovative American marketplace. My message for you today is that the industry wants to work with you, our elected representatives in Congress, and regulators on developing appropriate market structure regulation for addressing the novel challenges and opportunities of this technology. This regulation should be narrowly-tailored, a top legislative priority and focused initially on the business models that we currently understand well, such as centralized service providers. This will allow innovation to flourish and give the United States the ability to compete for global leadership in a burgeoning industry.

Blockchain Capital manages approximately $2 billion in assets and has invested in more than 100 portfolio companies, protocol teams and projects in the digital assets industry. Our team fields approximately 1,500 proposal decks and pitches each year from entrepreneurs building in the industry, providing us with a unique macro perspective on industry developments. We have a 30,000-foot view of all parts of the digital assets ecosystem, including the infrastructure supporting the foundation of the industry, the increasingly sophisticated applications facilitating new use cases and the critical compliance solutions being developed to aid institutions and agencies to engage with this industry responsibly.

The U.S. proudly maintains the world’s most liquid, fair and efficient financial markets. The venture capital industry plays an integral role in facilitating these robust and deep markets,
particularly infunneling funding to promising enterprises with high growth potential, creating
market efficiencies for investors in more mature markets, such as public equities markets. As
you would expect, America leads the world in venture financing, which has also provided a
critical source of capital and jobs. A recent study shows that job creation at venture
capital-funded companies grew 960% between 1990 and 2020. This job growth outpaced
non-venture capital-backed companies by eight times. This job creation benefits the entire
country (not just major financial centers), as 62.5% of employment at these venture
capital-backed companies occurs outside of the states of California, New York and
Massachusetts, where venture funding is most concentrated.

Venture investors have the great privilege of creating opportunities for entrepreneurs and
innovators to take risks in new fields from agriculture to public health to environmental tech. The
freedom to explore innovation via venture financing has led to enormous advancements,
positioning the United States as an innovation leader across myriad sectors over the past 50
years. In this position, venture capitalists have the very first perspective on innovations that hold
great promise and those that may not work out or those that may require additional time and
resources to develop further. The knowledge and expertise that venture investors gain over time
provide greater certainty to later stage market participants, including fully mature public markets.
As venture capitalists, it is our job to understand how a burgeoning industry is developing better
than anyone else, and we take that responsibility seriously.

How Blockchain Technology Enhances Our Society

The current financial system is overly reliant on intermediaries, a paradigm that constrains
innovation. It is sometimes subject to conflicts of interest, creates central points of attack or
failure and provides continued examples of mismanagement or outright breaches of bedrock
fiduciary duties. While these centralized entities do provide important services and
infrastructure, including allowing strangers to transact safely with each other, the net benefit to
society is limited by their sclerotic control over market access, consumer-facing innovation and
role in suppressing efficient solutions to current market frictions. The U.S. consumer credit rating
system provides a prime example of the inefficient and flawed systems that can arise out of
overly intermediated value systems. Monopolized by three ratings bureaus, this system is often
ineffective and exclusionary to people who need safe and affordable access to credit.

It is not only legacy financial systems that suffer from centralization. Social media and content
creation platforms demonstrate the vast dangers of centralized intermediation. Social media
enterprises like Facebook and Twitter have leveraged the free and instantaneous transfer of
data pioneered by the internet, not to democratize participation in value creation, but to
monopolize it, commoditizing the users of these platforms themselves and extracting value from
them. Similarly, artistic platforms like Spotify and YouTube have successfully scaled access to
music and video content from millions of creators globally only to retain the lion’s share of value
generated on those platforms away from the very same creators, artists and musicians.

Blockchain technology creates alternative solutions to the services and infrastructure controlled
by these intermediaries. In the case of financial ecosystems, blockchain networks can be
accessed anywhere in the world, by anyone with an internet connection. Using these networks,
participants can transfer any amount of money to virtually any location in the world, 24 hours a
day, 7 days a week, 365 days a year, with instantaneous settlement, at much lower cost to the
user. An immediately obvious use case leveraging this broad-reaching and inexpensive
characteristic is global remittance payments. Under traditional payments infrastructure,
remittances can be up to two to three times the costs that are achieved utilizing digital assets.
Even beyond remittances, we have backed entrepreneurs leveraging the efficiency of value transfer on blockchain networks to provide blue collar workers with affordable earned wage access, allowing them an alternative to predatory payday lenders while also granting them unique opportunities to build credit.

For musicians seeking to build communities around the music they create, we have backed builders that allow artists to publish their content to decentralized networks where fans of their music can contribute to their financial success and enjoy access to the value their music generates rather than forfeiting financial gain to a centralized platform, like Spotify. We have also engaged with builders democratizing access to decentralized video streaming protocols which allow video content creators more efficient means of producing and earning income from their artistic endeavors.

These examples form only a fraction of the vast innovations benefitting existing financial and social structures in our society. Such open access and cost-efficient utility stand in stark contrast to the barriers to entry that our legacy financial institutions and centralized social structures erect, disenfranchising many would-be participants in the process. These institutions continue to rely on systems that were built for an earlier era of commerce, ponderous technology that often does not fit with the global, always-on nature of the 21st century economy. In contrast, blockchain technology is such a technology for this moment in time.

**How Should We Engage with this Innovation?**

The fundamental innovation afforded by blockchain networks — to allow anyone, anywhere to participate in commerce or other systems of value, without an intermediary — is a novel and fundamental shift from the traditional way in which financial markets are organized and regulated. Never before have we been able to, at scale, facilitate disintermediated transactions, obviating the hazards of centralized intermediation. While some are critical of the notion that new concepts, new rules, and new regulations are needed to address this shift, it is clear that legacy methods of financial regulation, which focus primarily on the actions of intermediaries, do not adequately address this new paradigm.

Clinging to rules that were designed around centralized actors in hopes that they will also regulate decentralized actors is an ineffective regulatory strategy and stifles innovation. Value ecosystems where transactions are facilitated by open-source software in transparent and verifiable actions, where discretionary decision-making is not entrusted to a person or a firm, require new regulatory frameworks that both promote the novel benefits and opportunities of this technology while carefully addressing the unique risks it presents. Rather than fear this new ability, we suggest that policymakers meet the challenge of designing new regulations that are fit-for-purpose and avoid applying traditional modes of thinking.

Unfortunately, some regulatory agencies have largely ignored this fundamental innovation and instead suggested that existing frameworks are both appropriate and easily accessible to the digital assets industry. We have heard time and again that blockchain companies need only “come in and register.” However, this call rings hollow as these regulators have failed to offer thoughtful pathways to compliance and have chosen instead to rely predominantly on a campaign of enforcement. Innovators have a right to rely on regulators to do the hard work of understanding and adapting to new technologies, and many firms have engaged with regulators in good faith only to be met with silence, or worse, enforcement actions. Enforcement against a fledgling industry should not be that industry’s primary expectation. Because it is in this case,
the vast majority of the law-abiding American citizens building in the digital assets industry are dissuaded from innovating in the U.S.

**A Better Way Forward**

We often hear the perception that participants, investors and founders in the digital assets industry do not want to be regulated. This is false. A great number of participants, myself included, have sought to engage with regulators for years in a collaborative attempt to set out rules of the road that will provide appropriate regulation while also allowing for continued innovation. While there have been some rulemaking efforts, particularly recently, these efforts have not come early or often enough, and unfortunately have been made with almost no meaningful industry engagement. The undesirable outcome has been rule proposals that are largely unworkable both from the perspective of technological implementation and desired policy outcomes. Apart from these infrequent efforts, we are concerned that there is a growing sentiment among many of expressly preferring not to to create regulation in the hopes that the technology will “go away” (offshore) or “die” (cease being developed) if it is not legitimized by regulation. But we are convinced that this technology will not go away or die: it is, by design, operationally resilient and expansive, and the innovators creating it are sincerely passionate to continue their work. We must work with this innovation, not against it.

Other jurisdictions, including major global financial and commercial centers like the United Kingdom, Singapore, the European Union and Japan have taken a drastically different approach towards blockchain technology, making space for the industry to grow in these respective countries while implementing reasonable safeguards to protect users. Indeed, with the recent passage of the EU’s landmark Markets in Crypto-Assets licensing regime, the bloc is now better positioned to attract digital assets startups and investors compared to the increasingly hostile environment in the United States. While many U.S. regulators have remained dismissive of this technology and the markets it has produced, other countries’ regulatory agencies have leaned in, engaging businesses in good faith efforts to understand how progress can be made.

According to recently published data from PitchBook, the share of venture capital funding for blockchain startups in the EU surpassed the allocation for U.S. firms for the first time in the first quarter of this year. This is, sadly, not a surprise. Why would an investor commit to a country that has seemingly harbored a posture of disregard for the technology, at best, or outright hostility, at worst? In stark contrast to the warnings of some in the U.S. regarding the contagion potential wrought by crypto markets, other countries are welcoming would-be U.S innovators with a greater willingness to provide clarity and opportunity. This is a devastating policy outcome, one that the United States may not be able to recover from, and something every member of this subcommittee should actively seek to avoid.

**Tailored Regulation is Critical for the Digital Assets Industry**

The world-changing innovations provided by digital assets have only scratched the surface of innovative potential. We are on the cusp of the next wave of technological change, but the United States must act quickly to keep it here at home.

Tailored, fit-for-purpose rules for this nascent industry are critical — and must protect consumers while also promoting innovation. Industry stands ready to work with you on this balanced approach, ensuring that the U.S. remains a leader — as it often is — in all vanguard fields of innovation, especially the blockchain industry.
Written Statement of
Zachary J. Zweihorn
Partner, Davis Polk & Wardwell LLP

Before the U.S. House Financial Services Committee
Subcommittee on Digital Assets, Financial Technology, and Inclusion

hearing on


April 27, 2023

Chairman Hill, Ranking Member Lynch, and Members of the Subcommittee, thank you for inviting me to testify today. My name is Zach Zweihorn. I am a partner at the law firm of Davis Polk & Wardwell LLP, based in our Washington, DC office. I am a member of the firm’s Financial Institutions Group and our Trading & Markets practice. I have been with Davis Polk for over 15 years, where I began my career. I am testifying today in my personal capacity, and not on behalf of my firm or any client.

I. Background and Practice

My legal practice has focused on the regulation of the securities markets and, in particular, on the federal securities laws and the rules of the Securities and Exchange Commission (the “SEC” or “Commission”) that govern the activities and conduct of securities market intermediaries such as brokers, dealers, national securities exchanges, and clearing agencies, as well as those of the Financial Industry Regulatory Authority (“FINRA”) regulating its member broker-dealers. My clients include well-known U.S. and international banking and securities firms, retail and institutional brokers, and exchanges. They consist of major existing firms and new entrants seeking to develop new competing business models. I have advised firms throughout their life cycle, from initial business planning, formation, registration and licensure, ongoing compliance obligations, and consideration of new products and services, to regulatory examinations and enforcement. I am deeply familiar with the way these market participants are organized, operate, and are regulated.

With the rise of the digital asset markets, questions about the status and regulation of digital assets and its market structure have become prominent. I have worked with both traditional financial institutions and “crypto-native” firms to consider their digital asset activities and potential securities law compliance obligations. It has been a challenging landscape to navigate due to the legal and regulatory uncertainty and related risks.
II. But First: Is a Digital Asset a Security?

Much has been said, and more certainly will be, on the question of whether a given digital asset (or all of them) is or should be considered a security under the federal securities laws. Reasonable people can endlessly debate this question. The uncertainty stems from the simple fact that most digital assets are not simply the digital equivalent of conventional stocks or bonds, but something different in kind—an instrument with both functional and speculative uses. Indeed, the Commission staff’s “framework” for analyzing the security-status of a digital asset consists of a non-exclusive list of over 60 characteristics to be considered and weighed to analyze how likely a digital asset is to be a security. This is not a formula that results in any level of certainty.

If a digital asset is a security, then what? A public offering of a security must be registered with the Commission under Section 5 of the Securities Act of 1933 (the “Securities Act”). But the sorts of disclosures called for by the registration forms do not contemplate the novel attributes of digital assets, resulting in the disclosure requirements being both over- and under-inclusive. Digital asset purchasers tend to have less interest in an issuer’s balance sheet or details about its board of directors (each of which is required), and more interest in the digital asset’s emission schedule and on-chain governance (which are not specifically called for). Few issuers have taken the view that their digital assets are securities, and because of his mismatch, even those that have attempted to register under Section 5 have typically not been successful.

III. Secondary Market Registration and Compliance Issues

How and where to draw the lines around when a digital asset is or is not a security is a critical question—and one that Congress needs to clarify. But for purposes of examining market structure regulation, if any digital asset is a security (which I refer to as a “digital
asset security,” without taking a view on any particular digital asset), the current securities market structure regulatory scheme simply does not work.

This problem is, in my experience, why the question of whether a digital asset is a security has taken on so much importance. It is not merely about registration and disclosure—though those are important and raise the challenges noted above. But the legal and regulatory consequences that flow from an asset’s designation as a security are existential even after its initial sale. Our existing securities market structure and its regulation were designed for traditional debt and equity securities. If an asset is a security, then all the securities laws apply. We’ve all heard the siren’s call to “come in and register.” It sounds enticingly attractive. But this is an oversimplification that conflates registration, which may theoretically be possible, with compliance, which is not.

The word “registration” is used often in the securities laws. And much of the SEC’s enforcement activity in the digital asset space flows from allegations of a failure to register in one manner or another. But there are many different types of registration obligations. Many of the SEC’s actions in this space, particularly before the last few months, were focused on whether promoters of a given digital asset had engaged in an offering to the public of an “investment contract” without registering that offering as required with the Commission under the Securities Act.

But the regulatory challenges only begin there. The federal securities laws, and in particular the Securities Exchange Act of 1934 (the “Exchange Act”), impose numerous other types of registration—and more critically, compliance—obligations on parties that facilitate secondary market transactions in securities. To name a few:

- Brokers who effect securities transactions between others, by arranging or facilitating them;
- Dealers who trade in securities to provide liquidity to the market, such as a market maker;
- Exchanges who bring together buyers and sellers and operate a platform that matches these purchase and sale orders;
- Transfer agents who register the transfer of certain securities on behalf of issuers; and

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• Clearing agencies who facilitate book-entry settlement of securities transactions.

And so, if a digital asset is a security, not only must its initial sale be registered or qualify for an exemption from registration under the Securities Act, but its secondary market trading must occur through a web of registered and regulated market intermediaries. This is the source of much of the incompatibility.⁶

Quite reasonably, before our federal securities regulators grant registrations, they closely examine each applicant and require that it demonstrate that its proposed business activities will comply with applicable law and rules.

• The process for a firm that wishes to register as a broker-dealer generally involves seeking membership in FINRA. Under FINRA rules, a firm’s membership application must demonstrate that it is “capable of complying with applicable securities laws and regulations, and with applicable FINRA rules.”⁷

• A firm that wishes to register as a national securities exchange is required to submit a Form 1 with the SEC. Before granting registration, the Commission must affirmatively determine, among other requirements, that the applicant is “so organized and has the capacity” to carry out the purposes of the Exchange Act and can comply, and can enforce compliance by its members and persons associated with its members, with the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the exchange.⁸

• Similarly, the process for a firm seeking registration as a clearing agency involves the submission of a Form CA-1 with the SEC, and the SEC making various affirmative determinations, including that the applicant’s proposed structure and business activities meet the requirements of the Exchange Act and the rules thereunder.⁹

As a result, registration in these capacities is not simply a matter of filling out the forms and sending them in, but a substantive exercise showing how proposed activities would comply with existing securities laws and rules.

Because digital assets are held, traded, custodied, and settled differently from traditional securities, applying the existing regulatory regime raises many legal issues of first impression. And there are many ways in which compliance with existing secondary

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⁷ FINRA Rule 1014(a)(3).

⁸ Exchange Act § 6(a)(1).

⁹ Exchange Act § 17A(b)(3).
market regulations for trading in digital asset securities is challenging, or virtually impossible.

I would like to highlight several of the ways in which existing securities market structure laws and regulations do not align with digital asset securities, leading firms to find that registration as a securities intermediary is not a viable path under current law.

a. Market Intermediary Responsibility for Issuer Compliance

Today, a broker-dealer or an exchange that seeks to facilitate trading in digital asset securities would be able to lawfully deal in few, if any, assets. This is because our securities laws impose gatekeeping functions on brokers, dealers, and exchanges that prevent them from facilitating trading in securities that do not meet certain standards. These include:

- Brokers cannot facilitate trading in a security if that security cannot lawfully be sold by the seller pursuant to registration or an exemption from the Securities Act.\(^\text{10}\)

- Dealers generally are prohibited from publishing quotations to offer to transact in a non-exchange-listed security unless various specified pieces of information about the security and its issuer are “current and publicly available.”\(^\text{11}\) SEC regulations specify the pieces of information required, which contemplate what an investor would need in order to evaluate an investment in a debt or equity security.

- A national securities exchange may not facilitate trading in any security that is not registered under Section 12 of the Exchange Act, a separate registration from that required for initial distribution under the Securities Act.\(^\text{12}\)

Only a handful of digital asset security offerings have been publicly sold in an offering registered under the Securities Act. Most digital assets have instead been offered under a

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\(^{11}\) Exchange Act Rule 15c2-11.

\(^{12}\) Exchange Act § 12(a). Unlike registration under Section 5 of the Securities Act, which is required for a distribution of a security, registration under Section 12 of the Exchange Act is required for certain widely held equity securities, Exchange Act § 12(g), and exchange-listed securities, Exchange Act § 12(b). Once registered under Section 12, an issuer is required to file ongoing public reports, such as Forms 8-K, 10-K and 10-Q, Exchange Act § 13(a).
view that they are not securities, and that the securities registration and disclosure requirements—let alone the ongoing compliance obligations—do not apply.

The result is a Catch-22: It is unlawful for a firm to intermediate trading in a digital asset that is a security unless the firm is appropriately registered. But if registered, it is unlawful for the firm to facilitate trading in a digital asset security, unless the purported issuer of the security has taken some other action to register or otherwise make information available. A firm is required to register to facilitate trading, but if registered, it is prohibited from facilitating trading—unless the issuer of the security takes steps that are entirely outside the control of the intermediary.

b. Broker-Dealer Custody

For any centralized securities market to function and ensure transactions are settled, someone needs to hold custody of customers’ securities. 13 In traditional securities markets, broker-dealers and banks provide these custody services to their customers. This critical function comes with significant risks to customers. Custodians could fail to properly safekeep customers’ securities, as a result of recklessness, negligence, or misconduct (such as theft or fraud).

The SEC’s Customer Protection Rule14 is designed to manage and limit these risks for registered broker-dealers. A broker-dealer that holds a security on behalf of a customer is required to maintain “physical possession” or “control” of that security in a manner that the rule deems satisfactory.15 “Physical possession” typically refers to holding and protecting an actual paper certificate—something that is rarely done today in securities markets as most securities exist only in electronic form. To satisfy “control” under the rule, the broker-dealer must hold the security only through specified methods, such as through a registered clearing agency or a regulated bank.16 Not surprisingly, possessing the private key to a blockchain entry is not one of the options enumerated in the rule. As a result, the SEC staff initially took the position that there was effectively no way for a registered broker-dealer to custody digital asset securities on behalf of customers, and permitted only non-custodial models.17 Later, the Commission provided guidance that

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14 Exchange Act Rule 15c3-3.

15 Exchange Act Rule 15c3-3(b)(1).

16 Exchange Act Rule 15c3-3(e).

would permit so-called “special purpose” broker-dealers to maintain custody of digital asset securities if many conditions were met. This guidance was time-limited and so narrow—imposing extreme limitations on the types of activities permitted—that no firms have been able to rely on it.

Aside from the inability of broker-dealers to maintain possession of customer digital asset securities under the Customer Protection Rule, the interaction of Staff Accounting Bulletin 121 (“SAB 121”) and the broker-dealer capital rules also make broker-dealer custody of digital assets economically infeasible—similar to concerns raised with regard to custody by banks.

Under SAB 121, a firm that custodies digital assets on behalf of customers must recognize a liability on its GAAP balance sheet equivalent to the value of those assets, along with an offsetting asset. While the GAAP liability counts as a liability for broker-dealer regulatory capital purposes, the offsetting GAAP asset is likely not an “allowable asset” for regulatory capital purposes. Thus, a broker-dealer holding custody of digital asset securities for customers would have to obtain dollar-for-dollar additional capital to offset the SAB 121 liability. This makes broker-dealers providing material digital asset custody services, and still maintaining compliance with regulatory capital obligations, essentially impossible.


19 See, e.g., Proposed Rule: Regulation Systems Compliance and Integrity, Exchange Act Release No. 97143 (Mar. 15, 2023) (“[T]here are currently no special purpose broker-dealers authorized to maintain custody of crypto asset securities.”); Supplemental Information and Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 Regarding the Definition of “Exchange,” Exchange Act Release 97309 at n.54 (Apr. 14, 2023) (“To date, no person has been approved to act as a special purpose broker-dealer custodying crypto asset securities.”).


22 Under Rule 15c3-1 under the Exchange Act, the Net Capital Rule, “assets not readily convertible into cash” are deducted when computing a broker-dealer’s net capital. Exchange Act Rule 15c3-1(c)(2)(iv). The stub accounting entry to offset the liability imposed under SAB 121 would likely not be considered readily convertible into cash.
c. Clearing Agency Status

The term “clearing agency” is defined broadly under the Exchange Act to cover persons who perform a number of clearing and settlement activities, including a person who “facilitates the settlement of securities transactions ... without physical delivery of securities certificates.” Clearing agencies are required to register with the SEC and operate as self-regulatory organizations.

Digital asset securities are not certificated and thus settle without the physical delivery of securities certificates. As a result, anyone involved in any way in the process of facilitating settlement could conceivably be a “clearing agency,” with potentially absurd results. The blockchain itself (if it is deemed a “person”), the miners or validators on the blockchain, and the digital asset trading platform all participate in settlement in some way.

Of course, the concept and definition of a “clearing agency” predates blockchain technology. When Congress added it in 1975, it could not have contemplated automated, public infrastructure carrying out key settlement functions. In the traditional markets, clearing agency regulation is critical to ensure that transactions settle properly and credit and other risks inherent in settlement are appropriately managed. As digital asset transactions are generally fully pre-funded and typically settle in real-time, many of these risks are less salient, leaving the definition potentially overbroad and much of existing clearing agency regulation unnecessary.

d. Differences in Market Structure

Digital asset trading platforms have developed in a direct-to-user manner that typically involves a single service provider. They typically allow end-users to trade directly on the platform, with the platform maintaining custody of the user’s digital assets, matching buyers and sellers, and effecting (instantaneous) settlement of executed transactions. This model is quite different from the more diffuse provider model in which traditional securities markets operate.

National securities exchanges do not, and legally cannot, allow end-users to trade directly on the exchange. By statute, exchanges may only admit registered broker-dealers as


24 While the Exchange Act defines a “person” as a “natural person, company, government, or political subdivision, agency, or instrumentality of a government,” Exchange Act § 3(a)(9), the Commission may take the view that a blockchain only operates through the activities of a group of persons. Cf. Supplemental Information and Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 Regarding the Definition of “Exchange,” Exchange Act Release 97309 at 17–18 (Apr. 14, 2023).

members to trade directly on the exchange. National securities exchanges also do not have the regulatory authority to custody assets of persons trading through the exchange, as generally only broker-dealers, banks, and similar entities can provide securities custody services. Transactions executed on a national securities exchange clear through separate securities depositories that operate as registered clearing agencies, of which the custodian broker-dealers and banks are participants. Each of these functions involves a separate registration under a separate regulatory regime. Indeed, in a recent enforcement complaint, the SEC claimed that, because certain digital assets traded on a platform were allegedly securities, a trading platform was each of an (i) unregistered exchange, (ii) unregistered broker-dealer, and (iii) unregistered clearing agency.

While digital asset trading platforms offer a consolidated service, and the traditional securities markets operate with several intermediaries on each transaction, it is not clear that one market structure model is inherently better than the other. The traditional securities model may be less prone to conflicts of interest and may benefit from an increased likelihood that potential misconduct will be noticed by an unaffiliated third party. At the same time, the digital asset model may have advantages from fewer intermediaries that otherwise increase the overall cost of the service, as well as the speed and efficiencies that arise from a single, integrated provider. Each model developed over time based upon the economics, technology, and user preferences for the market. Because the securities laws and rules were developed to regulate the market structure that had already taken hold in traditional securities markets, that infrastructure has been codified in the Exchange Act and SEC rules. It therefore is the legally required model for intermediaries offering services in any type of security—even if new innovations mean the model is not always practical, necessary, or better for investors than other alternatives.

IV. Square Pegs, Round Holes, and Sledgehammers

As the examples above illustrate, there are many ways in which the traditional securities market structure and the related statutes and rules are incompatible with, or at least impractical, when it comes to digital asset securities. The SEC’s current approach has been that the laws and rules are what they are, and so they must be complied with. The SEC’s view appears to be that if the activity cannot be conducted in compliance with existing laws and rules, the activity—rather than the SEC’s application of the laws and rules—should adjust accordingly.

It may be popular in the crypto community to blame the SEC for failing to adopt a regulatory regime that is compatible with digital assets. One can disagree with the SEC’s enforcement agenda and the digital asset-related cases that it has brought, and I certainly

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26 Exchange Act § 6(c).

27 Complaint, SEC v. Bitvex, 2:23-cv-00580 (W.D. Wash. Apr. 17, 2023). Under the Exchange Act, national securities exchanges and clearing agencies are also self-regulatory organizations, charged with overseeing and enforcing their members and participants compliance. See Exchange Act § 19(g). Digital asset trading platforms, of course, have not viewed themselves as regulators.
do in many cases. But the SEC is a creature of statute, created by Congress and charged with administering the federal securities laws that Congress has adopted. While the SEC has authority to provide exemptions, conditionally or unconditionally, from various securities law obligations, wholesale changes or entirely new regulatory regimes should come from Congress, not the Commission.  

The status quo leaves us in an unfortunate position: the SEC acts as an enforcement sledgehammer, insisting that the square peg of digital asset securities be forced into the round hole of traditional securities market structure. I do not believe that this is the best policy position, as the law should not lock in a structure that prohibits innovation. But unless and until Congress gives the SEC an explicit mandate to do otherwise, the SEC is likely to enforce the existing securities laws in the manner that it believes they apply. Adopting a different regulatory structure for digital asset securities is a major question, and one that Congress should speak to. The SEC cannot be expected, and it may indeed not be appropriate for the SEC, to take it upon itself to fashion a different market structure without Congress’s explicit directive. 

But the inability to conduct digital asset securities activities under existing federal securities laws in the United States does not mean that these assets simply disappear or that U.S. investors lose interest in them. Rather, U.S. investors will find ways to access

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28 Exchange Act § 3(a); Securities Act § 28.
29 This is not the first time that a market not previously contemplated by the securities laws and rules suddenly became subject to the full litany of those requirements. In adopting Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), “security-based swap” (“SBS”) was added to the definition of “security” under the Exchange Act. Dodd-Frank Act § 761(a)(2). But Congress and the Commission recognized that the market in SBS, and the risks that SBS present, are significantly different from traditional securities, notwithstanding the definitional expansion. With a congressional mandate to appropriately regulate the SBS market, the Commission undertook a years-long effort to adopt rules as well as determine which provisions of the otherwise applicable securities laws and rules did not fit for SBS. The result is a set of extensive regulations that govern the SBS market, along with broad exemptions from traditional securities market rules that the Commission determined were not compatible with or necessary for SBS. See, e.g., Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of “Security” to Encompass Security-Based Swaps, and Request for Comment, Exchange Act Release No. 64795 (Jul. 1, 2011) (granting wide-ranging temporary exemptive relief from compliance with certain provisions of the Exchange Act in connection with the expansion of the definition of “security” to encompass SBS, pending further Commission rulemaking); Order Granting Exemptions from Sections 8 and 15(a)(1) of the Securities Exchange Act of 1934 and Rules 3b-13(b)(2), 8c-1, 10b-10, 15a-1(c), 15a-1(d) and 15c2-1 Thereunder in Connection with the Revision of the Definition of “Security” to Encompass Security-Based Swaps and Determining the Expiration Date for a Temporary Exemption from Section 29(b) of the Securities Exchange Act of 1934 in Connection with Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants Exchange Act Release No. 90308 (Nov. 2, 2020) (providing various exemptions from same on a permanent basis).
these services through other means,\textsuperscript{30} often through offshore providers that are less regulated, supervised, or trustworthy—with predictably calamitous results.\textsuperscript{31}

If American investors wish to invest in digital asset securities, they should not be pushed to offshore venues because no legal market structure exists at home. For those who believe a market structure different from the traditional securities markets is appropriate for digital assets, myself included, the solution is for Congress to establish a framework under which this market structure can exist. Congress has addressed the need to accommodate market structure changes before. In 1975, recognizing how technology and the securities markets had developed, Congress adopted Section 11A of the Exchange Act, directing the SEC to facilitate the establishment of a “national market system” for securities, specifying the criteria that the SEC should consider in developing that system, and the steps that it should take in doing so. The SEC responded to that mandate, adopting Regulation NMS and other rules that govern the current market structure for traditional securities.

Congress could and should take the same approach today. Once Congress establishes a clear, workable test to determine which assets should be appropriately regulated as securities (itself a difficult task, to be sure), Congress should find that facilitating a transparent and well-regulated market in the United States for these assets is in the public interest, and direct that an appropriate regulatory regime be implemented to ensure that a trustworthy, transparent, and well-supervised American digital asset securities market can develop and thrive.

Thank you again for the opportunity to participate today, and I look forward to your questions.

\textsuperscript{30}See, e.g., Complaint, CFTC v. Changpeng Zhao, 1:23-cv-01887 (N.D. Ill. Mar. 27, 2023) (alleging that U.S. investors accessed the non-U.S. Binance digital asset trading platform through the use of virtual private networks, or “VPNs”).

\textsuperscript{31}See, e.g., Superseding Indictment, USA v. Samuel Bankman-Fried, 1:22-cr-00673-LAK (S.D.N.Y. Feb. 23, 2023) (alleging, inter alia, that the defendant operating an offshore digital asset exchange “misappropriated billions of dollars in customer funds”).
April 27, 2023

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 commends this effort by the Committee to examine the unique structure of U.S. and global digital asset markets, as well as to consider regulatory frameworks for digital assets that will conserve critical innovation while also providing robust investor protections. 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 support efforts to establish a clearly defined regulatory regime to govern digital asset markets here in the United States.

Now more than ever, it is critically important that cryptocurrency investors, blockchain developers, crypto exchanges, and other intermediaries be provided clarity as to how existing market regulations apply to digital assets. Over the past year digital asset markets have experienced periods of volatility and declining prices, as well as a number of high profile failures among market participants. However,
since the start of this year, the total combined global value of cryptocurrencies has risen by 50 percent since reaching a low of $793 billion at the end of 2022.\(^1\) A recent Pew Research Center survey also found that nearly 70 percent of Americans who have ever purchased cryptocurrency continue to hold crypto, despite the market turbulence of last year.\(^2\) And yet, while U.S. investor interest in digital assets remains strong, the U.S. has fallen behind in proactively developing a regulatory framework to provide clear rules of the road as to how market participants can operate here safely and legally. Unlike the U.S., many major foreign jurisdictions, including the European Union, United Kingdom, China, Hong Kong, and Australia, have all taken significant steps towards establishing regulatory frameworks tailored to address the unique characteristics of digital assets and the markets in which they trade.

This should be an area of grave concern for policymakers because, not only does legal uncertainty stifle innovation, it also threatens to create an environment in which American investors must turn to off-shore crypto exchanges and intermediaries to participate in digital asset markets.\(^3\) The collapse of a number of foreign firms last year, including Singapore-based Terraform Labs and its affiliated algorithmic stablecoin, terraUSD, and Bahamas-based FTX.com, provide stark examples of the very real consequences American investors will face if digital asset market activity increasingly takes place outside of the United States. These risks were recently acknowledged by Securities and Exchange Commission (SEC) Chair Gary Gensler who stated while testifying before this Committee, “U.S. investors are accessing the crypto markets, both onshore companies and offshore.” Chair Gensler went on to highlight the challenges associated with taking enforcement actions against foreign firms stating “[i]t takes longer sometimes in cooperation with offshore enforcement authorities to pursue that and it is, frankly, more challenging to actually get subpoenas compiled with, and so it takes longer in time.”

There are a number of areas of legal and regulatory uncertainty which have presented significant challenges for digital asset market participants in determining when and how existing Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) rules apply to this market. A key area of uncertainty is the specific criteria by which the SEC, and to a lesser extent the CFTC, deem a digital asset to meet the legal definition of a security or commodity respectively. There are currently over 22,000 unique digital assets being traded among users here and abroad with a total combined market value of nearly $1.2 trillion.\(^4\) While Bitcoin (BTC) is widely recognized as a commodity, including by Chair Gensler, and not subject to SEC regulation, it is not clear which other digital assets meet the legal definition of a “security,” as determined by the Howey test.

Chair Gensler has repeatedly asserted that the law is clear and the SEC has all of the authority that it needs to regulate digital assets. He has claimed that digital asset market participants, including crypto

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\(^1\) https://coinmarketcap.com/charts/


\(^3\) https://cointelegraph.com/news/the-crypto-industry-has-already-started-moving-outside-of-the-us-says-ripple-ceo

\(^4\) Most US-based trading platforms offer a tiny fraction of this number, usually a few hundred tokens.
developers and trading venues, can simply “come in and register” with the SEC. Unfortunately, registration for digital assets companies is not that simple. By and large, existing U.S. securities laws were originally designed nearly 100 years ago and thus did not contemplate the technological advances available today, including the ability for transactions to move at the speed of the internet. Today, securities transactions still settle in an analog world, typically two days later, because existing rules require a chain of intermediaries to perform a variety of functions, including custody, brokerage, order matching, clearing, and settlement. All of these steps and intermediaries, which were designed to reduce risk, come at a steep cost to consumers. Blockchain technology has the ability to reduce many risks without the use of so many intermediaries, which provides a cost and time savings to investors. Insisting on the involvement of certain intermediaries that add costs for customers and have been rendered obsolete by this 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.

Additionally, despite multiple petitions for formal rulemaking, the SEC has failed to provide clarity on how a digital exchange could comply with current requirements while listing both securities and non-securities (e.g., Bitcoin). Since 2013, the SEC has brought over 127 enforcement actions against individuals and firms related to cryptocurrencies, but the SEC has not carried out a single rulemaking targeted at addressing ambiguity in regulations around their application to digital assets. This regulation by enforcement approach fails to (1) protect consumers and investors, (2) prevent bad actors from taking advantage of the interest in this market, and (3) provide any clarity to startups and existing companies who want to operate responsibly, develop innovative products, and serve users here in the United States.

The U.S. can and should regulate the trading of digital assets, but without clear rules of the road, innovators cannot operate here in the United States, and Americans cannot effectively use the technology. Inaction creates the risk of offshoring the development of the tech, leading to geopolitical, national security, and economic security risks. As was succinctly stated in a recent decision by Judge Michael Wiles, of the New York Southern District Bankruptcy Court, “[r]egulators themselves cannot seem to agree as to whether cryptocurrencies are commodities that may be subject to regulation by the CFTC, or whether they are securities that are subject to securities laws, or neither, or even on what criteria should be applied in making the decision … [t]his uncertainty has persisted despite the fact that cryptocurrency exchanges have been around for a number of years.”

The Crypto Council welcomes the efforts of the House Financial Services Committee to explore avenues to establish a clear regulatory framework for digital asset markets that fosters innovation, provides critical protections for consumers, investors, and our financial system, and preserves the technological cutting edge of the United States.

Sincerely,
Sheila Warren
Chief Executive Officer
Crypto Council for Innovation
Fact Sheet: Crypto Regulation
April 27, 2023

Introduction

The threat of harm to investors and markets is huge. The cryptocurrency market has exploded and imploded dramatically over just the past few years, costing investors trillions of dollars in losses. Many of those victims are individual retail investors swept up in the hype. Making sure that these financial products are properly regulated is critical.

Securities regulation is the first line of defense. As SEC Chairman Gensler has repeatedly said, the "vast majority" of cryptocurrency offerings are securities. Yet few of the issuers and promoters are complying with the securities laws like every other law-abiding financial firm in the U.S. The solution is first and foremost to aggressively enforce all of the available laws and regulations that apply to securities even if they are in the crypto space, including the registration requirements and the antifraud provisions set forth in the securities laws. And the SEC should be adequately funded to do the job. This is essential for protecting investors and the overall stability and integrity of our securities markets. In fact, the US global leadership in the capital markets depends on this strong regulatory framework and those investor protections. Claims that compliance with the securities laws is too difficult or even impossible, now heard from some in the cryptocurrency industry, are simply unfounded. Moreover, yielding to those claims would create an unlevel playing field and unfairly advantage crypto over all other law-abiding firms.

The CFTC also has a role to play in crypto derivatives regulation, as well as basic antifraud authority over commodities. The CFTC has full regulatory authority over crypto-based derivatives, including futures, options, and swaps. To the extent a cryptocurrency is considered a "commodity" under the Commodity Exchange Act, the CFTC also has authority to police that market for fraud and manipulation.

Any regulatory gaps are narrow and do not justify an overhaul of the regulatory framework. To the extent there are any gaps in the regulatory and enforcement tools applicable to cryptocurrencies, they are narrow, and they do not warrant an overhaul of the current system of financial regulation or special carve-outs from the current framework. Above all, it would be a mistake to deprive the SEC of securities jurisdiction over cryptocurrency offerings or weaken its authority, or to transfer that authority to an agency such as the CFTC. Other policy solutions to the challenge of cryptocurrency regulation that have surfaced are also unwise and unwarranted because they would dangerously legitimate a risky and largely lawless sector without providing genuine safeguards that would protect investors and markets.

Crypto Poses a Huge Threat to Investors While Failing to Deliver on Promised Benefits

The most significant aspect of the cryptocurrency market is the prevalence of fraud and manipulation. In a 2021 white paper, Deloitte estimated that up to 90% of the trading volume in cryptocurrency could be subject to manipulation.¹ The schemes used to manipulate cryptocurrency markets run the gamut, from pump-and-dump schemes, spoofing, and layering to wash sales.² Fraud and outright theft are also prevalent in the cryptocurrency market.

² Deloitte, Market Manipulation in Digital Assets (Mar. 2021), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Financial-Services/px-design-market-
markets, with Chairman Gary Gensler of the Securities and Exchange Commission referring to it as the “Wild West.” Crime and fraud have always been a characteristic of the cryptocurrency market given its promised anonymity; it is therefore no surprise that Bitcoin rapidly evolved into “the preferred currency for criminal activities.”  

Now, with the significant attention cryptocurrencies have attracted, the “lack of regulation and the anonymity of digital money have created a ripe environment for fraudsters.” In 2021 alone, cryptocurrency frauds and scams resulted in $14 billion in losses. 

At the same time, crypto has utterly failed to produce the benefits so often proclaimed with this supposed “innovation.” Supporters and promoters have zealously argued that cryptocurrencies offer the potential to revolutionize the financial system, largely by eliminating the need for intermediaries to facilitate financial transactions. Doing so, according to enthusiasts, will not only make financial transactions more efficient but will also enable greater access to the financial system, and the wealth-building opportunities it provides, for the unbanked and underbanked. 

Further, they argue, by purportedly helping the poor gain access to wealth-building opportunities in the financial system, cryptocurrency will serve as a tool of social justice by helping reduce inequality, allowing marginalized communities, such as Black and Latino Americans and the LGBTQ communities, “to build wealth in communities that have been left out of the discriminatory banking system that we have today.”

Yet, like the other claims, none of these benefits have materialized, nor do they appear on the horizon. In fact, the evidence is to the contrary as communities of color in particular appear to have been targeted by crypto predators and therefore have suffered disproportionate losses from the “crypto carnage.”

**What it Means to Comply with Securities Laws**

“No honest business need fear the SEC” – Joseph Kennedy, First Chairman of the SEC

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6. See Better Markets, Fact Sheet: Cryptocurrencies—The Next Big Thing Or The Next Gold Rush? (Mar. 9, 2022) (explaining that the claim of cryptocurrency enthusiasts is “if an algorithm can be relied upon to provide a financial product or service securely and verifiably, then there is no need for the infrastructure and personnel of the traditional financial system, and individu providers of financial products or services can interact directly with individual consumers. For example, stocks could be bought and sold without the presence of a broker-dealer, or a loan could be made without a bank or even a dedicated peer-to-peer lending platform.”) https://bettermarkets.org/wp-content/uploads/2020/03/BetterMarkets_FactSheet_Cryptocurrencies_3-9-2022.pdf

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Full and honest disclosure is the cornerstone of securities regulation, and the SEC's primary mission is investor protection.

The $31 trillion U.S. capital markets are premised on the fundamental idea that when you raise capital from the investing public, those investors are entitled to full and fair disclosures necessary to make informed investment decisions. Section 5 of the Securities Act prohibits the sale of securities, unless an exemption applies, prior to:

- filing a registration statement with the SEC;
- making available a prospectus to prospective investors including information relating to operations, financial condition, results of operations, risk factors, and management.

These disclosures are designed to provide basic, material information to the SEC and prospective investors about the enterprise, and they are subject to antifraud and materially false or misleading statement liability. All of these requirements and prohibitions are ultimately designed to protect investors and the integrity of the markets. Importantly, every single legitimate financial firm in the country that offers, trades, clears, or deals with securities complies with these foundational investor protection laws.

Intermediaries are subject to registration and oversight.

All of the intermediaries and gatekeepers are subject to oversight in the securities markets, including broker-dealers, investment advisers, auditing firms, and others. Consider broker-dealers. Broker-dealers serve multiple functions in the securities markets, including soliciting potential investors, handling customer funds and assets, and charging fees for those services. Section 15(a) of the Securities Exchange Act requires persons acting as broker-dealers to register with the SEC and join a self-regulatory organization. Broker-dealers are required to comply with SEC and SRO rules, including recordkeeping and reporting obligations, regulatory examinations, and important rules against conflicts of interest.

Specifically, to ensure that broker-dealers avoid conflicts of interest, Section 11(a) of the Securities Exchange Act prohibits broker-dealers that are members of an exchange from making transactions on that exchange for their own account. Additionally, broker-dealers are subject to various duties, including the duty of fair dealing; duty of best execution; regulation best interest; customer protection rules; and net capital rules to name a few. Broker-dealers are also subject to various antifraud provisions of the Securities Exchange Act prohibiting manipulative or deceptive practices.

Exchange regulation is another key component.

Exchange regulation dates back to the passage of the Securities Exchange Act of 1934 and the establishment of the SEC. Exchanges are “any organization, association, or group of persons...which constitutes, maintains, or provides a marketplace or facilities for bringing together purchases and sells of securities...” and they must register as a national securities exchange with the SEC. Under Section 6 of the Securities Exchange Act, exchanges must enact rules to govern their members (which are subject to review by the SEC); ensure fair access for its members; comply with rules designed to protect systems, capabilities, and integrity; discipline members for violations; establish rules to prevent fraud and manipulative acts or practices; and deny membership to non-registered broker-dealers.
Like every other law-abiding, legitimate financial firm in the U.S., the crypto industry can and must comply with the securities laws, and crypto’s complex, conflict-ridden, and overlapping business models cannot obscure that fact.

Since publication of the Bitcoin whitepaper in 2008, one of the premises of cryptocurrencies has been the claimed decentralized nature of peer-to-peer financial transactions without the need of a third-party financial intermediary. However, the largest players in today’s cryptocurrency ecosystem, the cryptocurrency exchanges, are far removed from this decentralized philosophy. In fact, they have gone in the opposite direction and centralized all of the roles of traditional financial intermediaries into one entity while claiming this model represents desirable “innovation” in finance. These crypto firms have become the issuer, broker-dealer, exchange, and clearing agency all under one roof and in some instances they also have a hedge fund engaged in principal proprietary trading on their platforms, often against their own customers.

As objectively proved over many decades, there are inherent conflict of interests between these different roles and that is why the securities regulatory framework does not allow such combinations. Imagine if Robinhood, Citadel’s market-making business and hedge fund, the New York Stock Exchange, and clearing agencies were all wrapped up within one entity with little regulation and less transparency. That is precisely the role being played by centralized cryptocurrency exchanges in today’s crypto markets, which they want exempted from meaningful oversight and investor protections.

Centralized cryptocurrency exchanges have made billions of dollars by serving traditional financial roles—issuer, broker-dealer, exchange, and clearing agency—within the cryptocurrency ecosystem. If these centralized cryptocurrency exchanges are going to serve as traditional issuers, broker-dealers, exchanges, and clearing agencies, then they need to be held to the same standards that apply to similar entities performing similar functions in traditional finance. To exempt them from this framework would be to hold them to a much lower standard than we hold financial intermediaries in other areas of our securities markets. That would not only legitimize and institutionalize unfair competition but also pose unacceptable risks to investors and the stability and integrity of our markets.

The laws and rules applicable to securities and related securities activities have been clear, black letter law and rules for many decades. Those laws and rules have been consistently applied to financial products of all types regardless of claims that they are somehow unique or imbued with a distinguishing type of innovation. The courts have largely agreed with this assessment. It is important to remember that of the more than 100 enforcement cases brought against cryptocurrency companies and actors, we are not aware of the SEC losing any such case.

**How Commodities Regulation Fits In**

The CFTC’s primary mission is to regulate the derivatives markets, which means the trading of futures, options, and swaps contracts. Thus, to the extent that any cryptocurrency-based derivative is being offered and traded, such as the Bitcoin futures contracts, the CFTC has the authority to regulate those activities. That includes registration, books and records, capital and margin, anti-fraud, and other requirements.

The CFTC also has the authority to police fraud and manipulation in the underlying commodities markets, not
just the derivatives markets.\textsuperscript{29} While that does not represent a comprehensive regulatory framework for any cryptocurrency that might in fact be a “commodity,” it is nevertheless another existing enforcement tool that can be brought to bear on certain illegal activities involving cryptocurrencies.

**Filling Claimed Gaps: First, Do No Harm to the Time-Tested Securities Regulatory Framework**

**Preserve the SEC’s jurisdiction.**

To the extent policymakers believe that measures are necessary to fill regulatory gaps in the crypto market, the first order of business is not to weaken the time-tested investor and market protections that the securities laws and rules have provided for nearly 90 years. This framework has led to the most liquid, broadest, and deepest capital markets in the world. Comparatively, it is important to remember that the global cryptocurrency industry is only roughly 1% of the U.S. capital markets. It would be unwise to upend our $100 trillion capital markets and our traditional securities regulatory framework to bend to a nascent and unproven industry that has yet to confer economic utility or benefits. Amending our securities regulatory framework with special carveouts for cryptocurrency actors would undermine the strength of the U.S. capital markets by treating entities performing similar functions—such as issuers, broker-dealers, exchanges, clearing agencies—differently based not on their activity but on the type of industry in which they claim to be conducting business. In short, landmark legislation for this nascent and unproven industry would likely confer legitimacy and access to institutional investments for companies like FTX, without providing adequate investor and market integrity protections or countervailing benefits.

The problem is not, as the industry has claimed, that complying with the law and, for example, registering with the SEC, “is not possible.” It is entirely possible; depending on whether it was registering securities for sale to investors or registering as an exchange, broker-dealer, custodian, or clearing house, that would require crypto to, for example:

a) ensure disclosures and representations were fully accurate and materially complete;

b) establish systems and controls to protect customer assets, prevent internal theft (like commingling or embezzlement) and external hacks;

c) eliminate conflicts of interests or mitigate them while fully disclosing them;

d) maintain accurate books and records;

\textsuperscript{29} CEA § 6c(a)(1) makes it illegal “to use or employ, or attempt to use or employ, in connection with any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate . . . .” CEA § 6c(a)(3) makes it illegal “directly or indirectly, to manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity . . . .” CEA § 6c(a)(2) makes it a felony “to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or of any swap, or to cause or attempt to cause any such commodity . . . .”
e) implement robust and effective management, risk, legal, and compliance programs;
f) submit to routine examinations and supervision by the SEC and SROs like FINRA; and
g) institute margin, liquidity, capital, and related protections to fulfill their obligations and prevent contagion in the event of severe volatility, significant losses, and crashes as we’ve been seeing for almost a year now.

Complying with those rules is entirely possible and done every day by hundreds if not thousands of legitimate financial firms, companies, and individuals. However, such compliance with basic, foundational rules would interfere with crypto’s profit-maximizing predatory business model. It should not be controversial to require the crypto industry to follow the same investor protection and financial stability rules that all other legitimate businesses already follow.

Do not legitimize crypto and allow it to expand its reach into the financial system.

An overarching peril in carving out special rules and safe harbors for crypto is the risk of legitimizing crypto and increasing its interconnectedness with the broader financial system, while at the same time failing to provide adequate protections for investors. Virtually any legislation will endow crypto with an aura of legitimacy, which crypto will market relentlessly as a seal of approval if not endorsement. That will spark another wave of enthusiasm among retail investors, who stand to lose yet more in addition to the trillions of dollars in capital that has evaporated in just the last couple of years. Yet after fourteen years of promises, Bitcoin and other digital commodities still have no independently verifiable use case to support any actual, legitimate economic activity.

In fact, just the opposite is true: the industry has proven itself full of charlatans and criminals relentlessly engaging in predatory, illegal, and criminal conduct. Furthermore, conferring legislative legitimacy will expand the shadow banking system. That will invite, if not guarantee, regulatory arbitrage where yet more risk migrates from the more regulated financial system into the shadows.

There is also the likelihood that, if digital commodities have legislative and regulatory legitimacy, banks will do more business with crypto firms, and bank holding companies might even create crypto subsidiaries that will engage directly in crypto activities as well as create, trade, and hold innumerable crypto-related derivatives. As a result, the core of the banking system will likely become increasingly interconnected with the crypto industry, which makes contagion much more likely and poses a direct threat to the stability of the financial system. With no legitimate use case or any economic productive value, it does not make sense to confer legislative legitimacy on such an industry and financial activity.

Other traps and pitfalls.

Finally, any changes in the law to accommodate the crypto industry must carefully avoid a host of other missteps. For example, it would be a grave mistake to:

- expressly define the nature of any specific crypto asset identified by name, thus in effect creating a permanent safe haven that would be mimicked by other crypto promoters and ultimately reengineered under the same label to circumvent regulation;
- allow a self-certification regime for crypto offerings or platforms, which side-steps thorough and
independent regulatory review and approval;

- fail to establish a primary mandate for investor protection and thus fail to ensure that the regulator’s principal obligation in rulemaking, oversight, and enforcement is to protect investors;
- preempt the authority of state authorities to regulate crypto, and thus repeat the same mistake made prior to the 2008 financial crisis when the states were barred from addressing abuses in the subprime mortgage market;
- fail to adequately fund any agency, including especially the SEC, so it can meet the huge challenges posed by crypto, which, as an industry, has engaged in an unprecedented level of predatory, illegal, and criminal conduct;

For More Information

For more resources and information about the regulation of crypto, see the collection of materials that Better Markets has prepared and collected on its webpage: “Everything You Need To Know About FTX, Sam Bankman-Fried, Crypto, The SEC, CFTC, The Revolving Door And The Influence Industry.”

To talk to one of our experts, contact Anton Becker, Communications Director, at 201-675-8049 or abecker@bettermarkets.org.
Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street’s biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside and protect investors and consumers.

For press inquiries, please contact us at press@bettermarkets.com or (202) 618-6430.
April 27, 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 hearing entitled, “The Future of Digital Assets: Identifying the Regulatory Gaps in Digital Asset Market Structure.” CUNA represents America’s credit unions and their more than 135 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 a 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.” Additionally, this correlation could pose a significant risk to financial stability as the United States sees increased adoption of cryptocurrencies.

Surveys have shown that around 16% of adults in the United States are engaged with cryptocurrencies. 1 2022 data showed that 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. 2 Despite the crypto winter triggered by last year’s failures, this year’s 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 18-24 years of age. 3

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 asset 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 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

CUNA.org
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.

This is why credit unions support the “whole-of-government” approach to regulation outlined in President
Biden’s Executive Order to ensure appropriate oversight and regulation of the marketplace and to prevent
regulatory arbitrage by fintechs and other unregulated entities providing financial services to consumers. The
development of a comprehensive national standard will level the playing field, protect consumers and the
financial system, and promote the policy objectives contained in the Executive Order:

(a) Protection of consumers, investors, and businesses in the United States;
(b) Protection of United States and global financial stability and the mitigation of systemic risk;
(c) Mitigation of illicit finance and national security risks posed by misuse of digital assets;
(d) Reinforcement of 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;
(e) Promotion of access to safe and affordable financial services; and
(f) Support of technological advances that promote responsible development and use of digital assets.

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. 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.

Treasury Secretary Yellen reinforced this point in the recently when she stated, “While 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 guidelines 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.

On behalf of America’s credit unions and their more than 135 million members, thank you for holding this hearing and considering our views.

Sincerely,

Jim Nussle
President & CEO
April 26, 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


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 on gaps in the current regulatory framework for digital assets. 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.

NAFCU appreciates the continued work of the Subcommittee in examining the integration of digital assets into traditional financial products, including the creation of stablecoins—digital assets pegged to the value of another asset. As we have previously shared, we appreciate that the draft noticed for this hearing uses the Federal Reserve definition of an insured depository institution (IDI) instead of other definitions that exclude credit unions. Establishing barriers to credit union engagement with digital assets would also undercut many of the financial inclusion benefits that may be realized through related technologies given that the credit union industry has a long history of prioritizing the needs of underserved and low-income communities. NAFCU also supports enforcement and examination being left up to existing regulators—in the case of credit unions, the National Credit Union Administration (NCUA)—as well as establishing a basic framework for oversight of non-depository stablecoin issuers. We are supportive of your efforts in this draft legislation and appreciate your engagement with us on it.

We thank you for the opportunity to share our thoughts and look forward to continuing to work with you on including emerging technologies into financial services. 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@nafcu.org.

Sincerely,

Brad Thaler
Vice President of Legislative Affairs

cc: Members of the Subcommittee on Digital Assets, Financial Technology, and Inclusion
April 26, 2023

Chair French Hill
Ranking Member Stephen Lynch
Honorable Members of the Subcommittee
U.S. House Committee on Financial Services, Subcommittee on Digital Assets
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chair Hill, Ranking Lynch, and Members of the Subcommittee,

On behalf of more than 500,000 members and supporters of Public Citizen, we offer the following comments for the hearing entitled “The Future of Digital Assets: Identifying the Regulatory Gaps in Digital Asset Market Structure” before the Subcommittee on Digital Assets, Financial Technology and Inclusion April 27, 2023.

Generally, we believe current law can address the scams and other ills associated with digital assets. We attach a letter written to the Treasury Department following its request for information similar to that which the subcommittee considers in this hearing. We except from that letter here:

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. Crexev empyor 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.¹

¹ 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.

¹ SEC Signals Ramp-Up in Crypto Enforcement by Nearly Doubling Its Crypto Assets Cyber Unit Staff
actions alleging digital asset-related misconduct. Authorities are prosecuting "rug pulls" in several non-fungible token (NFT) cases. In one rug pull case, the durable wire fraud law proved reliable in arresting two suspects. The FTC signaled it will better scrutinize “gatekeepers,” where rug pulls are prominent. "We welcome the Department of Justice’s decision to establish a National Cryptocurrency Enforcement Team."

The SEC should regulate cryptocurrencies 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 others. The "effort of others" derives from the promotion by the sponsor. Given that sponsored cryptocurrencies satisfy all 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."

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 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 stablecoins failed to fully back these tokens. The New York

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7 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
Attorney General fined Tether and Binance for such failures.\textsuperscript{10} 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.\textsuperscript{11} Voyager allegedly claimed its stablecoin was backed by FDIC insurance, according to the federal agencies.\textsuperscript{12} Voyager declared bankruptcy.\textsuperscript{13} FTX is bankrupt, and its founders have either pleaded guilty to fraud, or are under indictment.\textsuperscript{14, 15}

Stablecoins should be regulated along the lines established recently by the European Markets in Crypto Assets (MiCa).\textsuperscript{16} 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.\textsuperscript{17}) 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 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.\textsuperscript{18}

Public Citizen believes any stablecoin bill should contain the following:

- Assets backed on a 1-1 basis.
- The assets must be safe and highly liquid, restricted to U.S. Treasury securities.
- The sponsor must maintain capital of 5 percent. (Sponsors must maintain assets that are 5 percent greater than the value of outstanding stablecoins.)
- Sponsors may not be affiliated with any commercial firm, or that is not a bank. (This means that firms such as Facebook or WalMart could be sponsors.)

\textsuperscript{10} Attorney General James Ends Virtual Currency Trading Platform Binance’s Illegal Activities in New York
\textsuperscript{11} MacKenzie Sigalos, Homeless, Suicidal, Down To Lose $1,000: Celsius Investors Beg Bankruptcy Judge For Help
\textsuperscript{13} Rohan Guintani, Voyager CEO Made Millions In Stock Sales In 2021 When Price Was Near Peak
\textsuperscript{15} Vicki Ge Huang, FTX Tapped Into Customer Accounts to Fund Risky Bets, Setting Up Its Downfall
\textsuperscript{17} Phil Helset, An FTX Co-Founder and The Former CEO At Alameda Research Plead Guilty To Fraud
\textsuperscript{19} European Council, Digital finance: agreement reached on European crypto-assets regulation (MiCA)
\textsuperscript{22} 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
• Sponsors must disclose their climate footprint.
• Sponsors must register with the Securities and Exchange Commission (SEC).
• Registration must include:
  o A list of any criminal conviction, deferred prosecution agreement, and pending
    criminal proceeding in any jurisdiction against all of the following: (i) The applicant;
    (ii) Any executive officer of the applicant; (iii) Any responsible individual of the
    applicant; (iv) Any person that has control over the applicant; (v) Any person over
    which the applicant has control.
  o A list of any litigation, arbitration, or administrative proceeding in any jurisdiction in
    which the applicant or an executive officer or a responsible individual of the
    applicant has been a party for the 10 years before the application is submitted
    determined to be material in accordance with generally accepted accounting
    principles and, to the extent the applicant would be required to disclose the litigation,
    arbitration, or administrative proceeding in the applicant’s audited financial
    statements, reports to equity owners and similar statements or reports.
  o A list of any bankruptcy or receivership proceeding in any jurisdiction for the
    10 years before the application is submitted in which any of the following was
    a debtor: (i) The applicant; (ii) An executive officer of the applicant; (iii) A
    responsible individual of the applicant; (iv) A person that has control over the
    applicant; (v) A person over which the applicant has control.
  o A set of fingerprints for each executive officer and responsible individual of the
    applicant.
• Sponsors must publicly disclose monthly their assets, liabilities, capital, income, and
  expenses of the licensee, and an independent audit of this financial data quarterly.
• Sponsors shall maintain a surety bond or trust account in United States dollars in a form and
  amount as determined by the SEC for the protection of those who engage in digital financial
  asset business activity with the registrant.
• Banks that hold stablecoins must post 1250 percent risk capital, as described by the Basel
  Committee.19
• Penalties for infraction of any of these terms shall be one percent of the outstanding value of
  the stablecoin on the first infraction, and termination of the stablecoin on the second.

The bill recently introduced by the committee lacks many of these features.

The bill allows that the reserve may include repurchase agreements. Instead of a fully audited reserve, the bill only requires management attestation as to its value. The bill requires a monthly disclosure of the composition of the portfolio, which is good, but an unaudited monthly statement invites dishonesty. Further, this bill requires no surety bond.

Instead of a robust examination of the integrity of the stablecoin sponsor, the bill establishes a 45-day review period. The application is automatically approved if the regulator has not already approved it. Firms with problem stablecoins “may” be prevented from sponsoring another one. Certainly, a prohibition on a second stablecoin should be mandatory.

19 Basel Committee on Banking Supervision, Prudential Treatment Of Cryptoasset Exposures, Bank of
There is no requirement for additional capital backing the stablecoins. Compounding this problem, the bill opens the Federal Reserve’s Discount Window for the stablecoins, to be used when the stablecoin’s sponsor runs into trouble.

While the bill does limit stablecoin affiliates to those of a “financial” nature (meaning that Facebook or WalMart would be barred), it would allow the likes of mutual fund giant Fidelity to compete and promote this wasteful product. Further, the bill allows the use of contractors. These could be foreign entities where US supervision could be frustrated.

We support the bill’s prohibition of FDIC insurance for stablecoins, and the requirement that stablecoin sponsors make that clear to customers.

Penalties amount to $1 million, instead of one percent of the outstanding value of the stablecoin on the first infraction, and termination of the stablecoin on the second.

Finally, the bill requires no disclosure of climate footprint.

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.

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.

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20 Department of Labor. 401(k) Plan Investments in Cryptocurrencies (March 10, 2022)
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.21 The bidding, conducted by Christie’s, 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 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.22

Improving the Payment System

Cryptocurrency promised to improve the payment system. We welcome efforts to 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.23

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.24 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.25 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.26 During the pandemic, adoption of Pix led to a 73 percent decline in the unemployed population.27 The Brazilian Central Bank

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26 The Pix Revolution in Brazil, BIAKNA (website accessed July 18, 2022) https://business.ebacci.com/hb46/ABM/APAmX/Pix/English/Pix-Revolution-ERANX-EN.pdf?utm_medium=email&utm_source=p2ANqtz-9blf_FY1Yx3FDshb-srfZqBL8xM3CIj2G5w_xcZc8YjVzgO5nCMBNXLkCh60saim1TDPpOQgw1siSdfcW3ilyCQ%_hmi=206763316&utm_campaign=206763316&utm_source=he_automation&hsCtaTracking=5529u87a-3179-4cfd-94e8-bf7800372f72-%CTD4f772-00at=4ced-s4f6s-5B90wCzCZ59
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.²⁵

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.)²⁶

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.²⁷ “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 Cidovid 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.

We attach a letter submitted to the Department of Treasury in response to its request for comment on digital assets.

In conclusion, we appreciate the committee’s efforts to address digital assets. But we believe that cryptocurrency has failed to prove its worth and instead has demonstrated that it’s sponsors often seem consumers, provide a vehicle for money laundering, drug trafficking and other misconduct; and exacerbates climate change. Stablecoins exist and the committee should enact strong protections. It would be better if this so-called innovation withered away.

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²⁶ 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
For questions, please contact Bartlett Naylor at bmnaylor@citizen.org.

Sincerely,

Public Citizen
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.” 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.”

Indeed, the popularity of cryptocurrency has exploded in recent years. From adoption of the first cryptocurrency, Bitcoin, which was introduced in 2008 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.”

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

32 Id
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.33

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.34 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 $19,000.37 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.39 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.38 Voyager allegedly claimed its stablecoin was backed by FDIC insurance, according to the federal agencies.39 Voyager declared bankruptcy.31

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. 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 1,000 percent greater estimated loss. One review found some malicious actors created digital coins that can be purchased but not sold. Others promise enormous returns that proved untrue.

Fourth, the number of cryptocurrencies is staggering, and growing. In 2021, there were more than 10,000 different cryptocurrencies. In the summer of 2022, that number nearly doubled to 19,000, according to one estimate. Commodity Futures Trading Commission Chair Rostin Behnam testified before Congress that "there are now hundreds of thousands of unique digital assets in circulation." 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. 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. 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.

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

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45 Understanding the Different Types of Cryptocurrencies, SoFI LEARN (Jan. 15, 2021) https://www.soфи.com/learn/content/understanding-the-different-types-of-cryptocurrency/
47 Rostin Benham, Testimony, SENATE AGRICULTURE COMMITTEE (Feb. 9, 2022) https://www.crlc.gov/PressRoom/SpeechesTestimonies/opub/190209
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.\textsuperscript{12}

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.”\textsuperscript{13} Investor Mark Cuban said he’d prefer bananas to Bitcoin. “Because at least food, bananas have intrinsic value.”\textsuperscript{14} 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.\textsuperscript{15} 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.”\textsuperscript{16} Other
skeptics include Allianz economist Mohamed El-Erian, economist Paul Krugman, and Oaktree Capital
Management founder Howard Marks.\textsuperscript{17} Nassim Taleb, who once considered Bitcoin promising, now says its ultimate worth is “zero.”\textsuperscript{18}

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.”\textsuperscript{19} 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 coins
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.\textsuperscript{20} 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

\begin{itemize}
\item \textsuperscript{12} James Uberi, \textit{How the FBI Got Colonial Pipeline’s Money Back}, \textit{Wall Street Journal} (June 11, 2021)
\item \textsuperscript{13} James Royal, \textit{Warren Buffett Says to Avoid These Two Types of Hot Investments}, \textit{Bankrate} (May 6, 2019)
https://www.bankrate.com/investing/warren-buffett-says-avoid-these-hot-investments/
\item \textsuperscript{14} Taylor Locke, \textit{Mark Cuban: Bitcoin Is ‘More Religion Than Solution’ And Won’t Help In ‘Doomsday Scenarios’},
\item \textsuperscript{15} Ryan Browne, \textit{Bill Gates Says Crypto And NFTs Are ‘100% Based On Greater Fool Theory’}, \textit{CNBC} (June 14, 2022)
\item \textsuperscript{16} Ryan Browne, \textit{Christine Lagarde Says Crypto Is Worth Nothing} \textit{CNBC} (May 23, 2022)
\item \textsuperscript{17} Trisha Phillips, \textit{Bill Gates and Other Powerful People Who Hate (or Love) Bitcoin}, \textit{Showtime CheatSheet} (May 25, 2018)
https://www.cheatsheet.com/money-career/powerful-people-love-or-hate-bitcoin.html/
\item \textsuperscript{18} Tanaya Macheel, \textit{Black Swan’ Author Nassim Taleb Says Bitcoin Is Worth Zero And Fails As A Currency And A
Hedge} \textit{CNBC} (July 13, 2021) https://www.cnbc.com/2021/07/13/black-swan-author-nassim-taleb-says-bitcoin-is-
worth-zero.html
\item \textsuperscript{19} Letter in Support of Responsible FinTech Policy, (June 1, 2022) https://concerned.tech/
\item \textsuperscript{20} National Energy Technology Laboratory, \textit{Blockchain for Optimized Security and Energy Management, NATIONAL
\end{itemize}
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) counterparts.

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 own Bitcoin alone. 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. 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. 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. Wells Fargo offers the product to its elite clients. Fidelity Investments announced it would provide cryptocurrency options for sponsors of 401(k) plans. 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. CoinDesk reportedly mounted a $100 million advertising campaign in 2021.

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63 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/
64 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/
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. 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. After centuries of exploitation of people of color, after nefarious bankers targeted Black borrowers with abusive mortgages leading to the 2008 financial crisis, 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.”

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 analysts 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.

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. 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. This suggests that, even as digital assets are being promoted (via sophisticated marketing campaigns) as vehicles for financial inclusion for communities traditionally

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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.79 Many avoid paying taxes on cryptocurrency profits.79

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.77 (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.78 Authorities are prosecuting “rug pulls” in several non-fungible token (NFT) cases.78 79 In one rug pull case, the durable wire fraud law proved reliable in arresting two suspects.79 The FTC signaled it will better scrutinize “gatekeepers,” where rug pulls are

prominent. 89 We welcome the Department of Justice’s decision to establish a National Cryptocurrency Enforcement Team.90

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 others.91 (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.” 92

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).93 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.94) 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...

90 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
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.\(^9\)

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.\(^9\)

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.\(^9\) The bidding, conducted by Christie’s, 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


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.  

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.  

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.  

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. 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. During the pandemic, adoption of Pix led to a 73 percent decline in the unbanked population. 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.  

References:

54 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/
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.)

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. 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.

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99 Andrew Singer, Brazil’s PIX Payments System Has the Same Spirit, but Not a Blockchain Structure

100 Lev Menand. Testimony, U.S. Senate Banking Committee (June 9, 2021)
For questions, please contact Yevgeny Shrago at yshrago@citizen.org, Tyson Slocum at tslocum@citizen.org, Alan Zibel at azibel@citizen.org, and/or Bartlett Naylor at bnaylor@citizen.org.

Sincerely,

Public Citizen
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Questions for the Record from Ranking Member Maxine Waters
Thursday, April 27, 2023 2:00 PM

Ms. Marta Belcher

1. 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

2. 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)

Ms. Hillary Allen

1. 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. 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