

THE FUTURE OF DIGITAL ASSETS: PROVIDING CLARITY FOR THE DIGITAL ASSET ECOSYSTEM

HEARING BEFORE THE COMMITTEE ON FINANCIAL SERVICES U.S. HOUSE OF REPRESENTATIVES ONE HUNDRED EIGHTEENTH CONGRESS FIRST SESSION

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CONTENTS

	Page
Hearing held on:	
June 13, 2023	1
Appendix:	
June 13, 2023	59

WITNESSES

TUESDAY, JUNE 13, 2023

Allaire, Jeremy, Co-Founder, Chairman, and CEO, Circle	5
Garrison, Coy, Partner, Steptoe and Johnson LLP, and former Counsel to SEC Commissioner Hester M. Peirce	6
Kaplan, Aaron, Co-CEO and Founder, Prometheus, Inc.	12
Sexton, Thomas W., President and CEO, National Futures Association (NFA)	8
Sirer, Emin Gun, Founder and CEO, Ava Labs, Inc.	10

APPENDIX

Prepared statements:	
Allaire, Jeremy	60
Garrison, Coy	65
Kaplan, Aaron	72
Sexton, Thomas W.	114
Sirer, Emin Gun	124

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Davidson, Hon. Warren:	
Written responses to questions for the record submitted to Aaron Kaplan	134
Waters, Hon. Maxine:	
Written responses to questions for the record submitted to Jeremy Allaire	135
Written responses to questions for the record submitted to Coy Garrison ..	135
Written responses to questions for the record submitted to Thomas W. Sexton	136
Written responses to questions for the record submitted to Emin Gun	
Sirer	136

THE FUTURE OF DIGITAL ASSETS: PROVIDING CLARITY FOR THE DIGITAL ASSET ECOSYSTEM

Tuesday, June 13, 2023

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 2:42 p.m., in room 2128, Rayburn House Office Building, Hon. Patrick McHenry [chairman of the committee] presiding.

Members present: Representatives McHenry, Lucas, Posey, Luetkemeyer, Huizenga, Wagner, Barr, Williams of Texas, Hill, Emmer, Loudermilk, Mooney, Davidson, Rose, Steil, Timmons, Norman, Meuser, Fitzgerald, Kim, Donalds, Flood, Lawler, Nunn, De La Cruz, Ogles; Waters, Velazquez, Sherman, Meeks, Scott, Lynch, Green, Himes, Foster, Beatty, Vargas, Gonzalez, Pressley, Horsford, Tlaib, Torres, Garcia, Williams of Georgia, Nickel, and Pettersen.

Chairman MCHENRY. The Financial Services Committee will come to order.

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

Today's hearing is entitled, "The Future of Digital Assets: Providing Clarity for the Digital Asset Ecosystem."

I will now recognize myself for 4 minutes for an opening statement.

Nearly 15 years since the Bitcoin White Paper, an idea has become the new internet architecture with ownership, digital identity, and value storage native to technology. Digital assets are no longer a new technology. They are used all over the world, and America has always led technology invention, and if not invention, implementation, and today we are at risk of falling behind competitors around the globe.

This bipartisan hearing has been years in the making. Over the past several months, this committee has engaged in an unprecedented joint effort with our colleagues on the House Agriculture Committee. Earlier this month, Agriculture Committee Chairman Thompson and I, along with Subcommittee Chairs, French Hill and Dusty Johnson, released a discussion draft that would close the gaps between our securities and commodities laws and provide much-needed clarity for digital assets. We adhered to the time-tested principle of same risk/same regulation, while modernizing our regulatory framework to better match this innovative technology.

In fact, requirements set out in the draft bill are much more onerous than the requirements for traditional financial intermediaries.

As I have said in all of our markups, I have an open door. This should be a bipartisan process, and I intend it to be, so please share your input. This is a draft bill. There is plenty of time for Members to find common ground on how we legislate here, but be advised that I intend for this committee to mark up some form of this legislation when we return from the July 4th recess.

Let's start with where I know we all agree: consumer protection. The draft bill would require trading platforms to comply with strict requirements regarding the segregation of customer assets, similar to most traditional intermediaries. We also address how digital asset issuers raise capital for their projects. The U.S. has the deepest and most-liquid capital markets in the world, and we intend to keep it that way. We want to keep that strategic advantage here in the United States to the best of our ability.

We know informed disclosures are critical to helping investors make informed decisions. By making disclosures fit for purpose, the draft bill will ensure that issuers provide users with necessary information, including the number of tokens in circulation, the concentration of assets held by affiliates, and much, much more.

Additionally, we enhance the SEC's ability to detect and punish fraudulent actors and activity. Today, traditional financial intermediaries are registered with a Federal regulator. Digital asset trading platforms should be no different. The draft legislation will establish requirements for digital asset trading platforms to ensure that Americans and their assets are protected. The draft bill will provide a workable path for trading platforms to register with the SEC and/or the CFTC. It will provide clarity to those assets that are offered as part of an investment contract and, therefore, security.

And I would submit that the central part of this bill is a workable timeframe and a workable time period for assets, started as part of an investment contract, to transition to a digital commodity if the network is functional and decentralized. I think that is the central piece of this legislation on which our discussion should be focused.

Let me close with this: We are at a critical moment for American dynamism. We can choose the side of financial freedom, innovation, inclusion, and American competitiveness, and important consumer protections at the same time, or we can let this moment pass us by and surrender our leadership of the global financial system to other countries. I hope we will choose the former. I yield back.

I will now recognize the ranking member of the committee, who as Chair last Congress, started this long arc for stablecoin legislation and the discussion that we are centering on today on this market structure bill. With that, I recognize Ranking Member Waters for 4 minutes for her opening statement.

Ms. WATERS. Thank you very much, Mr. Chairman. Good afternoon. Last week, Republicans posted a bill that would rewrite our nation's security and commodities laws. Committee Democrats are taking a serious and thoughtful look at this piece of legislation. However, the bill is 160 pages long, highly complex and was only made public about a week ago. Any bill that would so dramatically

overhaul our nation's capital markets must be worked on collaboratively with the Minority. We also need the analysis and views of our independent regulators, the Administration, and the stakeholders on the implications of this legislation.

With that said, I have some initial concerns I would like to discuss today. For starters, I am particularly worried that the Republican bill would allow crypto firms that are currently being sued for violating our securities laws to continue doing business through provisional registration. We witnessed this last year when disgraced FTX CEO, Sam Bankman-Fried, defrauded millions of customers, and now the SEC has taken actions against firms like Binance and other firms for potentially similar behavior. This bill appears to halt any enforcement actions by the SEC against crypto firms, even when they have committed fraud. This provisional registration could reward bad actors with a get-out-of-jail-free card and allow them to continue harming consumers and investors.

We also know that FTX illegally commingled customers' funds to make undisclosed investments and to trade against its own customers. The SEC has ramped up its enforcement against other crypto firms for the same misconduct. Broker-dealers today are and have been for decades prohibited from commingling customer assets, so I wonder why Republicans would legitimize this illegal practice for crypto firms and allow customer funds to be put at risk?

Another point I would like to raise is that three crypto firms recently received approval to operate legitimately under our securities laws. Franklin Templeton received approval to offer a money market fund on the blockchain, OTC Markets received approval to trade crypto securities, and Prometheus, whose CEO is one of our witnesses today, received approval to custody and trade crypto assets. As SEC Chair Gensler has repeatedly said, the door is always open for crypto companies to register with the SEC. Despite the claims of some in the industry, our securities laws, which have worked for every other industry for 90 years, can also work for crypto firms.

Turning to the stablecoin bill that was also noticed for this hearing, I am encouraged by the legislative progress that is being made. That said, while Republicans have heeded a few of our concerns, there are still major red flags, including the bill's lack of diversity and inclusion protections, weak consumer protections, and wholly-insufficient oversight by the Federal Reserve or State-chartered stablecoin issuers. So, I look forward to returning to the negotiating table to finish what we started last Congress.

I do believe that Mr. McHenry and I had gotten a long way in dealing with stablecoins, and I am sorry that it got interrupted somehow, but I am looking forward to getting back and negotiating to see if we can move stablecoins forward.

Chairman MCHENRY. I look forward to those continued conversations, and I appreciate you starting this long discussion on digital assets under your leadership. And my intention is to utilize those conversations we have had and come to some reasonable conclusion that we both can support, and I want to thank the former Chair and current Ranking Member for that.

The Chair now recognizes the gentleman from Arkansas, Mr. Hill, who is also the Chair of our Subcommittee on Digital Assets, Financial Technology, and Inclusion, for 1 minute for an opening statement.

Mr. HILL. I thank the chairman. Good afternoon. Thank you all for joining us on our panel, particularly for the 6th hearing that we have had in this committee on digital assets.

For months, the Digital Assets Subcommittees of the House Financial Services and the House Agriculture Committees have been working on legislation to establish a functional regulatory framework with strong consumer protections. The two proposals noticed at the hearing are the result of that good work.

Importantly, the market structure bill would prevent another FTX from happening by ensuring that customer assets are protected, by providing robust guardrails to mitigate conflicts of interest, and by establishing clear oversight and supervisory authority for Federal regulators to ensure that market participants like dealers, exchanges, and custodians are compliant with our securities and related commodity laws. Like then-Chair Waters said in November, after FTX, we need legislative action to ensure that digital asset entities cannot operate in the shadows, and that is exactly what we have done.

I want to be clear: We want feedback from our Members and we look forward to that during the course of the hearing today. I yield back.

Chairman MCHENRY. The Chair now recognizes the ranking member of our Subcommittee on Digital Assets, Financial Technology, and Inclusion, the gentleman from Massachusetts, Mr. Lynch, for 1 minute.

Mr. LYNCH. Thank you, Chairman McHenry, and Ranking Member Waters. I must say I continue to have grave concerns with key elements of both of these bills under consideration, which I believe will serve to fundamentally undermine our broader financial system. By creating a whole new regulatory carveout dedicated to digital assets, these bills create a loophole that will allow any non-bank security issuer to digitize or tokenize its products so it will be able to avoid compliance with existing investor protections and financial stability regulations.

I am also deeply concerned about the new roles defined for the SEC and the CFTC. These bills are both targeted at greatly reducing the SEC's authority and would hinder its ability to conduct adequate enforcement. Our financial system, which is the envy of the world and the source of U.S. primacy in global finance, is in its essence built on trust and the investor protections afforded by the rule of law. I would urge my colleagues to take a critical view of these bills and consider how the insecurity and volatility that these changes will inject into our traditional financial system will endanger the trust and confidence in that system. Thank you, and I yield back.

Chairman MCHENRY. The gentleman yields back. Today, we welcome the testimony of a great panel: Jeremy Allaire, the co-founder, chairman, and CEO of Circle; Coy Garrison, a partner at Steptoe and Johnson, and a former Counsel to SEC Commissioner Hester Peirce; Thomas Sexton III, the president and CEO of the

National Futures Association; Emin Gun Sirer, the founder and CEO of Ava Labs, Incorporated; and Aaron Kaplan, the founder and co-CEO of Prometheus, Incorporated.

We thank each of you for taking the time to be here. Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. And without objection, your written statements will be made a part of the record.

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

**STATEMENT OF JEREMY ALLAIRE, CO-FOUNDER, CHAIRMAN,
AND CEO, CIRCLE**

Mr. ALLAIRE. Chairman McHenry, Ranking Member Waters, and members of the committee, it is an honor to be here today. I am Jeremy Allaire, chairman and CEO of Circle. I co-founded Circle 10 years ago with the vision that digital currency would transform how value was exchanged. Five years ago, we launched USDC. Today, USDC has grown to become one of the largest dollar digital currencies in the world. USDC powers tens of thousands of applications and has handled over \$10 trillion in transactions.

The core of Circle's day-to-day mission is expanding the role of the dollar on the internet. The demand for safe and secure dollars on the internet is real and growing. Stablecoins and blockchain networks will likely become strategic infrastructure for the future of the internet. It is a profound moment for the dollar in the world today. Currency competition is real and is increasingly defined by technological competition. No nation understands this better than China with its own state-controlled digital yuan, complete with embedded surveillance. The steps the U.S. Government takes now will have a significant impact on dollar competitiveness in the decades that follow. Failing to take the appropriate steps could have devastating consequences for America. As a nation, we need to ensure that the dollar is the most-competitive currency on the internet.

There also needs to be universal access to the safest and most-secure digital dollars possible. These digital dollars must be backed by the safest assets. The world must have the safety and assurance needed to exchange value without fears of bank runs. Access and safety are cornerstones of keeping the dollar competitive, but at the heart of dollar competitiveness must be technological superiority. That means unleashing the innovation made possible by software, the internet, and free market competition.

We are here today to consider and discuss proposed stablecoin legislation. I appreciate the substantial and bipartisan work you have all done. Delivering a stablecoin bill to President Biden's desk should be a national priority. Already, other major nations are enacting laws to regulate the use of dollar stablecoins. Rather than let other countries define our future, the United States needs to lead the development of global rules that will determine how our currency moves around the world. The broad parameters of this bill are strong, providing for robust supervision, strict reserve requirements, redemption, custody, and reporting requirements that protect consumers. The bill also provides roles for both State and Federal regulators and supports both bank and non-bank issuers.

At the same time, there are several issues on which I would like to comment. The first is the respective roles State and Federal

banking regulators should play. We need to ensure an important and continuing role for States in the growth of well-regulated stablecoin adoption. To start, we need nationally-established standards that set a high bar for all issuers and that can be enforced by Federal regulators where appropriate.

A second issue is related to reserves. Circle believes issuers should only hold reserves that are even safer than for banks, where fractional reserves put the safety of money used for payments at risk. A simple solution would be to afford issuers limited rights to basic Fed services, facilitating more-timely redemptions, and protecting consumers and financial stability, without needing to provide access to the discount window.

Finally, are questions around custody and safekeeping. The harsh lessons of 2022 teach us that we need stronger protections around the custody of digital assets. A common-ground solution would be to require that any stablecoin intermediary be required to hold them with either a State- or federally-chartered qualified custodian.

Back in the late 1990s and early 2000s, we went through an intense hype cycle and then a dramatic crash in the development of the web. There were total losses, scams, and frauds. A combination of proactive policy and private-sector development led to a period that made America the uncontested technology leader. We are in a similar moment today, but we don't have the luxury of time. The tech capability gap that existed then has now been closed by China. The dollar is at a crossroads, and currency competition is now technology competition.

I ask all of you as Members of Congress to consider this moment. Ask what value system we want to enshrine in law and how do we safely and deliberately unleash the creative forces of U.S.-led technology innovation?

Thank you again for the opportunity to be here today. I would happy to answer any questions you may have.

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

Chairman McHENRY. Thank you. Mr. Garrison, you are now recognized for 5 minutes.

STATEMENT OF COY GARRISON, PARTNER, STEPTOE AND JOHNSON LLP, AND FORMER COUNSEL TO COMMISSIONER HESTER M. PEIRCE

Mr. GARRISON. Thank you, Chairman McHenry, Ranking Member Waters, and members of the committee, for inviting me here today. My name is Coy Garrison. I am a partner at Steptoe and Johnson where I advise participants across the digital asset industry on securities laws compliance. Prior to a year ago, I was an attorney at the SEC where I had the honor of serving as Counsel to Commissioner Hester Peirce. I am testifying today on my own behalf and not on behalf of my firm or any client of my firm.

My message to you today is simple: Congress must act to bring sensible regulation to the digital asset industry. Today's discussion draft is thoughtful and measured. It would create a workable regulatory framework for the industry with much-needed investor pro-

tections. Before highlighting the positive aspects of the draft, I would like to discuss why congressional action is needed.

First, the application of securities laws to digital assets is not always clear. Sweeping statements that nearly all digital assets are securities or are not securities ignore the complexity of the analysis and distract from finding a workable solution to the issues at hand. Congress defined, “security,” in 1933 by referencing more than 30 instruments. Unsurprisingly, digital assets are not included in this list. Generally, the question becomes whether a digital asset is sold pursuant to an investment contract.

Under the *Howey* case, an investment contract is a contract, transaction, or scheme where you have an investment of money in a common enterprise that leads to a reasonable expectation of profit from the efforts of others. The application of this test is not always straightforward. Indeed, the SEC staff issued guidance on the subject in 2019, and it identified over 60 factors to consider. Additionally, even if a digital asset is sold pursuant to an investment contract, the digital asset itself is not the security. Rather, it is the digital asset plus the promises of the third party that constitute the transaction, the contract, or the scheme that is the security.

Further, as of today, there simply is no case law addressing the application of the *Howey* Test to a secondary market transaction in an investment contract. And if that is not enough, adding to the complexity, the SEC staff has taken the position that a digital asset that at one point in time may represent a security, may over time no longer represent the security if the network becomes sufficiently decentralized. There is no clear guidance on how this happens.

Second, congressional action is needed because the SEC has refused to create a workable regulatory framework. Digital asset trading platforms cannot register under existing rules because those rules are not designed with the realities of how digital assets trade or operate. Existing equity market structure rules do not contemplate concepts made possible, such as instantaneous settlement, the potential for trading of securities and non-securities on the same platform, and the lack of a need for intermediaries for various functions.

The SEC has shown little interest in considering changes to existing rules. The Commission is instead relying on enforcement actions, some of which will take years of litigation and appeals to result in any binding judicial precedent. Absent a congressional directive to the SEC to engage in rulemaking, the status quo will likely persist for the foreseeable future.

Third, congressional action is needed because the lack of regulation harms investors, responsible industry participants, and the U.S. economy. The status quo fails to protect people who are trading digital assets. While there are a number of responsible platforms appropriately safeguarding customer assets and monitoring against fraud and manipulation, some platforms have notoriously put their customers’ assets at dramatic risk and caused significant loss. While enforcement actions are important tools to hold wrongdoers accountable, they simply cannot replace sensible market regulation that can help deter, identify, and mitigate wrongdoing.

Fortunately, the market structure draft provides a foundation for a responsible regulatory framework and addresses a number of the regulatory uncertainties I have just highlighted. The bill forces the SEC to turn its focus to producing a more-workable regulatory regime and to also responsibly divide responsibility of the digital asset spot markets between the SEC and the CFTC.

First, the bill would create a new exemption where a digital asset can be sold pursuant to an investment contract to non-accredited investors with important investor protections in place. Second, the bill would require the SEC to modernize its secondary trading rules to permit the trading of digital assets. Third, the bill would also provide the first framework for how a network can become decentralized, and it creates a formal process to transfer regulatory responsibility from the SEC to the CFTC. Fourth, the bill gives the CFTC authority to regulate the spot markets and digital asset commodities in a responsible manner.

In conclusion, the discussion draft would provide the regulatory certainty that is needed to ensure that the digital asset industry can innovate and grow the U.S. economy. Thank you for your tremendous work on this important legislation, and I look forward to your questions.

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

Chairman MCHENRY. Thank you, and I recommend to the panel that you bring the microphones closer. This is the best technology that we can bring to you from the 1940s.

[laughter]

Chairman MCHENRY. Mr. Sexton, you are now recognized.

**STATEMENT OF THOMAS W. SEXTON, PRESIDENT AND CEO,
NATIONAL FUTURES ASSOCIATION (NFA)**

Mr. SEXTON. Thank you, Chairman McHenry, Ranking Member Waters, and committee members for inviting the National Futures Association (NFA) to appear before you today. My name is Tom Sexton, and I am the president and CEO of NFA. We applaud this committee's and the House Committee on Agriculture's joint work. The committees' June 2nd discussion draft contains the critical customer protections that Congress should adopt as it moves forward with developing a statutory framework for spot digital asset commodities.

Congress in 1974 authorized the creation of registered futures associations. NFA is the only one. Congress and the CFTC in 1982 gave us the responsibility to regulate firms engaging in exchange-traded derivatives. Over the years, Congress expanded the CFTC's jurisdiction, and we were entrusted with additional responsibilities over spot retail forex and swaps.

NFA is solely a regulator, and we partner closely with the CFTC to perform our work. We currently have approximately 3,000 global member firms that the CFTC requires to be members of NFA, and 42,000 individual associate members. We have approximately 520 employees, and our budget is approximately \$140 million, all paid for by the industry. Our seven primary areas of responsibility are described in my written testimony. Let me highlight two.

First, we monitor and examine our members for compliance with NFA's rules. One key oversight area relates to customer funds. Futures Commission Merchants (FCMs), by rule, must hold these funds in segregated accounts at qualified depositories, which are separate from the FCM's proprietary and operational funds. Each day, we receive reports directly from depositories holding these funds to ensure that an FCM holds sufficient money to cover the amount owed to customers.

Second, we investigate possible rule violations and vigorously enforce our rules. Our enforcement efforts are coordinated closely with the CFTC and, if necessary, law enforcement. Over the past 10 years, nearly 25 individuals have gone to prison due to criminal misconduct, many involving retail customers initially investigated by NFA.

My written testimony describes our strong track record in two areas and how we partner with the CFTC to protect retail customers and prosecute retail trading abuses and fraud. In both cases, our enforcement actions and customer-filed arbitrations drop precipitously due to our actions.

Let me highlight how we tackle customer abuses in the spot retail forex market. Forex dealers appear to function similar to firms that offer digital asset commodities. They solicit retail customers, accept customer funds, operate an electronic trading platform, and may take the other side of the trade with customers. In 2008, Congress gave the CFTC anti-fraud and regulatory jurisdiction over spot retail forex transactions and their dealers. Congress prudently placed a fence around these spot forex transactions within the Commodity Exchange Act and created a separate registration category for forex dealers, whom Congress required to be members of a Regional Financing Arrangement (RFA.) Today, NFA and the CFTC impose extensive customer protection rules upon these dealers.

Let me now turn to our involvement with spot digital asset commodities. Member firms engaging in spot digital asset commodities are already within our doors. NFA has proactively acted to oversee members engaged in this activity. In 2018, we required members to provide enhanced disclosure requirements and an investor advisory to customers. More recently, we filled a jurisdictional hole by adopting a rule that imposes anti-fraud and supervision requirements on members engaged in this activity. NFA's rule currently covers Bitcoin and Ether.

Retail customers have suffered significant monetary harm in schemes involving digital asset commodities and deserve protection. Only Congress can create a Federal registration and regulatory regime. Therefore, we encourage you to provide the CFTC with the regulatory authority to complement its current anti-fraud authority over spot digital asset commodities. Only then, can the CFTC adopt the discussion draft's critical customer protections, including those relating to customer assets, business conduct and disclosures, minimum capital requirements, and trade practices.

Finally, I want to voice our strong support for the critical role as provided in the discussion draft that an RFA should play to partner with the CFTC to regulate this area. NFA has always been willing to take on the additional responsibilities entrusted to it by

Congress and the CFTC, and we would do so again to the extent requested. Thank you, and I am happy to answer any questions.

[The prepared statement of Mr. Sexton can be found on page 114 of the appendix.]

Chairman McHENRY. Thank you. Dr. Sirer, you are now recognized for 5 minutes.

STATEMENT OF EMIN GUN SIRER, FOUNDER AND CEO, AVA LABS, INC.

Mr. SIRER. Chairman McHenry, Ranking Member Waters, and members of the committee, it is an honor to be here with you today. I thank you for the opportunity to appear before you as a computer scientist to discuss blockchain technology, its innovative uses, why it is impactful to our economy, and why it must thrive in the United States.

I am the founder and CEO of Ava Labs, a blockchain software company headquartered in Brooklyn, with the mission to digitize the world's assets. We have developed some of the most-significant recent technological innovations in blockchain, including the biggest breakthrough in consensus protocol since Bitcoin. I was previously a professor of computer science at Cornell University for almost 20 years. I consulted with various U.S. Government agencies and made fundamental contributions to distributed systems, operating systems, and networking. I am also currently a member of the CFTC's Technology Advisory Committee.

We are living through a period of unprecedented technological progress and transformation. Computers initially set the strand in motion with isolated mainframes and personal computers that lacked network connectivity. The emergence of the internet marked a pivotal shift from isolated local computing to global-scale computing using what we call client-server architectures. This new paradigm, which enabled us to connect to services operated by others, gave rise to systems that cater to the entire world, created millions of jobs, and solidified the United States' position as a global economic leader.

Blockchains represent the next phase of networked computer systems. Whereas client service systems rely on point-to-point communication, blockchains facilitate many-to-many communication, allowing multiple computers to collaborate, achieve consensus, act in unison, and share services under adverse network conditions. This enables the development of unique digital assets, more-efficient financial services, programmable assets in computer games, and digital identity solutions, among many other innovative applications. My full written testimony contains examples of blockchain applications that tangibly improve people's lives.

The implications of this breakthrough are far-reaching because blockchain and the digital uniqueness it creates allows us to redefine trust, ownership, commerce, recreation, and communications, ultimately transforming how we interact with digital systems and each other. The determination of the regulatory regime for blockchains must start and end with the functionality and features of the digital assets and not the technology used to create them. At Ava Labs, we call this a sensible token classification.

Blockchains have the ability to build into their technological fabric any set of rules that are then automatically applied to all relevant transactions. This enables us to build efficient, self-enforcing networks. For example, the Ava Labs software allows anyone to build custom blockchains with creator-defined rule sets, including financial regulations. Other blockchains are working on their own equivalent solutions.

Now, let me be clear on three key points. First, decentralized networks are a desirable goal for many reasons that have nothing to do with regulations governing use cases. In fact, they are more resilient, secure, auditable, and available than traditional systems. Blockchain builders did not set out to develop technology to evade loss. We set out to solve hard computer science problems.

Second, tokenization also was not created to evade laws. It is the natural product of blockchains and an improvement over traditional systems, just like computer databases were an improvement over paper filing cabinets.

Third, as we enter this new era, we must support this revolutionary technology. By doing so, we can ensure that the United States remains at the forefront of innovation, propelling the next generation of internet technologies and ushering in great economic growth.

The U.S won the first wave of internet revolution precisely because it enabled the freedom to innovate responsibly. The United States must follow the same path of enabling free but responsible growth of blockchain technology through sensible regulation of blockchain applications and tokens based on implementation and use case. Otherwise, there are two critical paths of failure for any regulatory framework.

First, the blockchain platforms themselves should not become regulated at the protocol layer. This would be the equivalent of regulating internet services and internet routers, which would have doomed the vibrant internet we have today.

Second, the tokens and smart contracts created with blockchains should not be lumped into homogeneous and incompatible categories. This would be the equivalent of regulating a social media application the same way we regulate a consumer healthcare application. Instead, tokens and smart contracts must be regulated based on their function and features.

Finally, it is essential to remember that just as good people are committed to public service, there are also good people committed to building technologies to improve lives. By working together, we can lay the groundwork for trustworthy, efficient, and self-enforcing systems that serve as the foundation for our modern economy. I thank the committee for the opportunity and look forward to your questions.

[The prepared statement of Dr. Sirer can be found on page 124 of the appendix.]

Chairman MCHENRY. Thank you, Dr. Sirer. And Mr. Kaplan, you are recognized for 5 minutes.

**STATEMENT OF AARON KAPLAN, CO-CEO AND FOUNDER,
PROMETHEUM, INC.**

Mr. KAPLAN. Chairman McHenry, Ranking Member Waters, and esteemed members of the committee, thank you for the opportunity to testify at today's hearing on, "The Future of Digital Assets: Providing Clarity for the Digital Asset Ecosystem."

My name is Aaron Kaplan, and I am the founder and co-CEO of Prometheus. As an attorney, my background is in securities laws. Since 2013, I have dedicated my career to the application of distributed ledger technology to the securities industry and the related regulatory issues.

Prometheus and its subsidiaries are building a public market and custodial infrastructure for digital asset securities pursuant to the Federal securities laws. Prometheus has developed proprietary technology in the United States, integrating the requirements and investor protections of securities regulation and the efficiencies of distributed ledger technology. Prometheus's subsidiaries are Securities and Exchange Commission registered broker-dealers and Financial Industry Regulatory Authority (FINRA) members. Prometheus ATS is an SEC-registered alternative trading system that matches orders for buyers and sellers of digital asset securities under the Federal securities laws. Prometheus Capital was recently approved as the first Special Purpose Broker-Dealer, meaning it is the first SEC-registered custodian for digital asset securities under the Federal securities laws.

By operating under the SEC's established regulatory frameworks through registered entities overseen by the SEC and FINRA, Prometheus provides Americans participating in the crypto and Web3 space with the investor protections of the Federal securities laws. Through this, Prometheus is developing a fair and orderly market, ensuring customers' assets are properly segregated, secured, and custodied.

In the vast majority of cases, crypto is a financial instrument offered to the public as an investment. Intermediaries are required to be regulated by the SEC based on the services they provide to the public. Properly regulating crypto trading, clearing, settlement, and custody under the securities laws provides a proven mechanism which allows and encourages responsible participation and innovation, while at the same time ensuring that investors are protected.

There has been much discussion lately about the need for greater regulatory clarity for digital assets. The essential point at hand is not about more or less regulation or even new regulation, but rather, the application of the existing regulatory frameworks to digital assets. The Federal securities laws have been tried and tested for almost 90 years and have allowed the United States to establish the world's most-trusted and advanced financial markets.

The SEC is by far the most-capable financial markets regulatory agency in the world. The SEC relies on FINRA, a self-regulatory organization whose mission is market integrity and investor protection, to regulate the securities markets. Together, the SEC and FINRA employ approximately 8,000 employees to oversee these vital securities functions. Put simply, the Federal securities laws and oversight from the SEC and FINRA have proven to be the

most-effective system to protect investors, operate fair and orderly markets, and protect customers' funds and assets.

As early as July 2017, the SEC put the industry in the DAO Report, stating that digital assets and related financial services could (and likely did) implicate the Federal securities laws. Subsequently, the SEC created a marketplace framework with the release of the four-step process on July 8, 2019, and the three-step process on September 25, 2020. Thereafter, the SEC created the framework for the clearance, settlement, and custody of digital asset securities through the Special Purpose Broker-Dealer release on December 23, 2020. These releases provide the framework for a compliant path forward for crypto in the United States.

I want to stress that point: There is a compliant path forward for crypto in the United States, that the SEC has clearly laid out. Those who argue for new laws are simply not willing to comply with existing applicable securities laws and regulations. New legislation is not in the best interest of the investing public or the blockchain industry. Legislative efforts will take years to implement while the American public will continue to operate on reckless, unlawful platforms.

In conclusion, the United States fosters innovation through the vibrancy of our capital markets. U.S. capital markets flourish under the established regulations of the Federal securities laws overseen by the SEC and FINRA. In order for innovation to continue to thrive in the digital asset space, the protections afforded by the Federal securities laws need to be in place. Proper regulation under the Federal securities laws is not a hindrance to innovation, but rather, a prerequisite that will allow innovation to flourish.

Thank you again for the opportunity to testify at this hearing, and I look forward to answering any questions.

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

Chairman MCHENRY. I will now recognize myself for 5 minutes for questions.

Mr. Garrison, how many foreign regulators have proposed new regulatory frameworks for digital assets?

Mr. GARRISON. You are looking at about half a dozen to a dozen.

Chairman MCHENRY. Okay. Including Europe?

Mr. GARRISON. Including Europe.

Chairman MCHENRY. And Europe is far more advanced than we are?

Mr. GARRISON. Yes.

Chairman MCHENRY. Okay. We see venture capitalists now deploying offices—American venture capital firms going there to seek to invest. Are other countries implementing new regulations around digital assets, specifically digital assets?

Mr. GARRISON. They are. Whole cloth new regulations.

Chairman MCHENRY. Okay. And do you think consumers are protected here in the United States by our lack of clear rules?

Mr. GARRISON. No, they are not.

Chairman MCHENRY. Okay.

Dr. Sirer, how does the threat of enforcement action stymie innovation and hold back developers from new projects here in the United States?

Mr. SIRER. Lack of clarity around regulations involving the issuance of tokens holds back quite a few innovators from actually residing in the United States, and we are actually seeing people who are active in this field move wholesale out of our borders to other jurisdictions.

Chairman MCHENRY. And that is putting pressure on you to develop your technology overseas, not here in the United States?

Mr. SIRER. Well, I am very happy to be in the United States myself, but I can see the pressure on other people.

Chairman MCHENRY. Okay.

Now, Mr. Garrison, in terms of the cost structure of potential enforcement action by the SEC, what does that look like for a firm? I don't want to get into what they charge, but it is not cheap, right?

Mr. GARRISON. It is not. Hundreds of thousands of dollars, and into the millions, depending on the charges.

Chairman MCHENRY. Okay. As I said, we want a purpose-built regime for digital assets, right? We want same risk/same regulation, that is the focus.

Mr. Sexton, in the draft here, we have said that decentralization is the key. If a digital asset is associated with a decentralized and functional network, they would be treated as commodities. Would the CFTC and your organization be able to serve as primary regulators over the digital commodity spot market?

Mr. SEXTON. Chairman McHenry, if that is the definition as far as a commodity is concerned, then the CFTC and NFA would be able to implement that definition within and regulate that in the spot market, yes.

Chairman MCHENRY. Okay. Over here in the Financial Services Committee, we have securities law protections for consumers. We have consumer protection. That is a key part of our discussions. Is there similar consumer protection in the world of commodities?

Mr. SEXTON. Absolutely, everything from segregation, capital requirements, risk disclosure. You monitor the trading that occurs, the exchanges do on the exchanges. Very similar type of customer protections are in place with regard to retail participants.

Chairman MCHENRY. Dr. Sirer, about decentralization, what are the features? What is the end goal state of a functional decentralized network? What are the attributes of it? Give us some sort of, not your 401 class, maybe your 201 class from your college days?

Mr. SIRER. Simply put, a decentralized network aims to provide a service wherein, even though some of the actors in the system might be what we call, "Byzantine," and they might be acting in an adversarial fashion, the system is still able to maintain its safety and integrity guarantees for all of its users. These networks are more resilient than other computer network systems.

Chairman MCHENRY. When we see the Securities and Exchange Commission ramping up their enforcement action, it's time for hearings. I would think there has to be some contemplation from our friends over there. What we are trying to build is consensus around changes in law, around a new object, a new asset, a new digital architecture.

Mr. Garrison, if you have an innovator who wants to set up shop here in the United States in the world of digital assets, how would you advise them?

Mr. GARRISON. I tell them that the laws, the regulations are very uncertain, and often those conversations end with the entrepreneur deciding to either launch offshore or to drop the idea altogether.

Chairman MCHENRY. Let's pivot to stablecoins. Mr. Allaire, where are you currently regulated? Where is Circle currently regulated?

Mr. ALLAIRE. Circle is regulated in a number of jurisdictions. We are regulated across the United States by State payments and banking supervisors. We are regulated in Singapore as a major payment institution. We are in registration with the French government, and we are also regulated by the Financial Conduct Authority (FCA) in the UK.

Chairman MCHENRY. Do you comply with any money laundering rules here in the United States?

Mr. ALLAIRE. Yes, absolutely, comprehensive Bank Secrecy Act/Anti-Money Laundering (BSA/AML) programs, which we have had in place for a very long time.

Chairman MCHENRY. Okay. Are you licensed in the State of New York?

Mr. ALLAIRE. We have a BitLicense in New York, and we are also licensed as a money transmitter in the State of New York.

Chairman MCHENRY. Okay. Thank you all for your testimony. I appreciate the wide-ranging panel we have here.

I will now recognize the ranking member, Ms. Waters, for 5 minutes.

Ms. WATERS. Thank you so much, Mr. Chairman. I did not anticipate that we would have such strong advocacy for the CFTC and for the SEC, so this is interesting.

Mr. Kaplan, while Democrats are taking a serious look at the Republicans' market structure bill, I am deeply concerned that some of the most-basic investor protections are missing from the bill. First, any commingling of investor funds must be strictly prohibited. We saw with the collapse of FTX that much of the fraud and investor harm came from the commingling of customer funds, which enabled the CEO, Sam Bankman-Fried, to steal his customers' property. The bill also seems to permit trading facilities to trade against their own customers and engage in other activities prohibited by today's security laws. Do you agree that commingling of customer funds should be prohibited? Will your firm commingle customer assets, Mr. Kaplan?

Mr. KAPLAN. Our firm will not commingle customer assets with that of the firm. Our model does not have proprietary trading or market-making activities. Thus, customer assets will not be commingled with firm assets because, in that sense, there are no firm assets. And customer assets will be properly segregated as outlined by Securities Exchange Act Rule 15c3-3.

Now, when it comes to the investor protections of the Federal securities laws, we saw the dangers with FTX, of what happens when they are not in place. The Federal securities laws would have done the most in terms of preventing an FTX-like situation. They ensure fair and orderly markets. They ensure that markets are not manip-

ulated. They ensure that you can't trade against your customers' accounts necessarily. They also ensure proper segregation of customer funds and assets from that of the firm.

These were major issues when it came to FTX, and they could have been prevented had there been proper regulation and oversight with the SEC. So, in order for the best route going forward, I think the best way to protect the American public is with the application of the Federal securities laws, which are built to protect investors. There is literally no need to recreate the wheel here.

Ms. WATERS. Thank you very much. As a Special Purpose Broker-Dealer (SPBD), are there activities you are prohibited from doing but that are permitted for crypto brokers in the Republican bill, and can you describe why the securities laws prohibit those activities and how changing the prohibition would affect investors?

Mr. KAPLAN. The Special Purpose Broker-Dealer is capable of custodial digital asset securities under the Federal securities laws. Pursuant to the Federal securities laws, there are filings and disclosures that must be submitted to the SEC, and these disclosures and filings include firm financials, possession and control reports, and it goes as far as requiring disclosures about firms' affiliates. Having these systems in place with the ongoing reporting, the proper oversight, and the investor protections of the Federal securities laws will ensure market participants are properly protected and are the best way to protect the American public, going forward.

Ms. WATERS. Mr. Kaplan, I also have concerns with what the bill refers to as, "provisional registration." Specifically, I am concerned that this gives crypto firms that are violating our securities laws a get-out-of-jail-free card. This provision seems particularly harmful, because firms like Binance or even FTX, which have both been accused of fraud, could effectively block the SEC from continuing its investigation. Are you concerned by this provision of the bill? What impact do you see this having on investors?

Mr. KAPLAN. I am very concerned by that provision of this bill, as the provisional safe harbor would essentially prevent a system where the American public is still exposed to the dangers that they were previously exposed to while that safe harbor goes to full registration. Furthermore, when you look at the best way forward, the best way forward has to be to use the most-robust system to protect the American public, and the most-robust system to protect the American public is the Federal securities laws.

I would like to point out that the American public was left holding the bag when it came to the FTX violations, or the alleged violations, when it comes to Binance and Coinbase. And essentially, the best way to protect them going forward is to establish the most-robust regulatory regime. The SEC and FINRA combined have 8,000 employees. The CFTC and the NFA combined have approximately 1,300 employees. The best way forward that is pretty clear and logical is the application of the Federal securities laws.

Ms. WATERS. Thank you very much. I yield back.

Mr. HILL. [presiding]. The ranking member yields back. I now recognize myself for 5 minutes.

Last week, the House Agriculture Committee heard testimony from CFTC Chair Behnam and former SEC General Counsel Berkovitz, who served under Chairman Gensler, and it was strik-

ing to see how both of those witnesses called for congressional action to address the gap in Federal regulation of digital assets, and this mirrored the Financial Stability Oversight Council's (FSOC's) report last October.

And this morning, for those of you who are not glued to C-SPAN here at the House, we had Treasury Secretary Yellen here for a very interesting morning, and she also suggested that she stood by that FSOC report calling for a comprehensive regulatory framework for digital assets. And she said, "We would like to see your regulatory framework over those markets and their gaps and regulations. I would point out specifically stablecoins, and I do believe we need a comprehensive Federal prudential framework, and I would be pleased to work with you and the Congress to develop such a framework." In my view, the CFTC thinks that this is the right direction to take because there are gaps in the system, notwithstanding the comments from Mr. Kaplan, and our Treasury Secretary seems to agree as well.

Mr. GARRISON, I want to start with you, because I think the ranking member brought this subject up. She had a good interchange with Mr. Kaplan about this provisional registration issue. It is very important. This was also discussed in the House Agriculture Committee hearing last week. It is a tricky area to get right, and we want to make sure we draft it in the best way possible. This is a temporary provision, as I understand it, meant to bring digital asset firms into the remit of the SEC and the CFTC before rules of this comprehensive framework can be stood up, and this was similar to how we approached swap dealers after Dodd-Frank. Is that your understanding?

Mr. GARRISON. Yes.

Mr. HILL. And we patterned this drafting based on that. The last time the committee worked ably with the Agriculture Committee was in the Dodd-Frank Act, on looking at swap rules, which was a tough debate. I think Mr. Lucas and Ms. Waters would agree with that. Why is a process like this needed, and how it can be structured to provide actual customer protection in the digital asset markets in the interim before those rules are ready? Is it possible that we can do that?

Mr. GARRISON. It certainly is. The provisional registration or provisions, I think are designed to acknowledge the reality that these markets exist now, that these trading platforms exist now, and that customers, consumers are using them. And until the new rules are written, there are no rules of the road. So by requiring them to raise their hand, to signal an indication of seeking full registration when the rules are provided by committing to certain undertakings of meeting certain standards—

Mr. HILL. Those standards might include books and record-keeping, customer disclosure, segregation of customer funds, right? No one is letting somebody off the hook for those responsibilities, even under provisional rules. Isn't that right?

Mr. GARRISON. Correct.

Mr. HILL. Do you have any suggestions on further refining provisional registration that would be best for both the regulators and the market participants?

Mr. GARRISON. Sure. I think there is a provision exempting any actions relating to fraud, and it sounds like there might be some confusion on that point. So, I would recommend really drilling down and making sure that during that provisional period, obviously, that shouldn't cover any fraudulent acts that would occur during that provisional period. So to the extent there is uncertainty on that, it seems like a good area on which to focus.

Mr. HILL. Good. Thank you. Last week, the Commission issued an enforcement action against Binance for failing to register as a national securities exchange broker-dealer or clearinghouse. More concerning was also the allegation that they were commingling customer assets with house assets and misrepresenting the controls to investors. This absolutely cannot be allowed to happen. We need clear rules of the road to prevent that kind of thing or another FTX. You have looked at our draft. Do you think that we have a good bill, with provisions on prohibiting commingling?

Mr. GARRISON. I think it does, both on the SEC side and the CFTC side.

Mr. HILL. Would it allow conflicts of interest to persist if we have the new framework in place?

Mr. GARRISON. It would not.

Mr. HILL. Mr. Garrison, Mr. Kaplan made a very good comment about his success in becoming a registrant of the Commission. Are there things you saw that took place there that we should change in our bill about registering broker-dealers?

Mr. GARRISON. No. I believe the Special Purpose Broker-Dealer is limited to a certain universe of digital assets.

Mr. HILL. My time has expired. You can answer in writing if you would.

The gentleman from Georgia, Mr. Scott, is now recognized for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. Mr. Kaplan, 90 years ago, Congress created our Federal securities laws to protect our investors and to establish robust regulation against misrepresentation and fraud in our securities market. However, since then, we have seen decades of legal precedent established that consistently yielded benefits to our consumers and our investors in the long run. Unfortunately, I believe that under this misguided digital asset market structure bill we are dealing with now, the fundamental approach to securities laws is effectively undermined, to the detriment of the American investor.

I am particularly referencing sections of the bill which give much of the authority over digital assets, previously with the SEC, to the CFTC, and the bill would also exclude digital commodities and payments stablecoins from the definition of a "security" under the securities laws. This is antithetical to current law where an asset can be both a commodity and a security. So by creating an entirely new regime for so-called digital commodities, the bill eliminates the SEC's ability to determine what is or is not a security.

Mr. Kaplan, what consequences may arise from this? Make it plain to us. This is the heart of the matter. Could this potentially result in less protection for our investors than is currently provided?

Mr. KAPLAN. I anticipate that it would. Essentially, as you mentioned, the Federal securities laws are tried and tested over generations. There is not just case law; there is follow-on legal precedent, and additional regulations, and basically continuing actions thereafter. And essentially, the concept of creating a new regulatory regime that would make a determination of whether a digital commodity will exist would create sort of a void in between what we have now and when that is fully in place. It would take maybe half a decade to a decade for those laws to be flushed out such that they might be viable. And in the meantime, we have an existing framework that is purpose built, meant to protect investors, meant to ensure there are proper disclosures, and meant to ensure that there are fair and orderly markets, and basically, that customer funds and assets are properly segregated and secured.

Essentially, in the meantime, while all of this is sort of flushed out in the legal system, and basically the digital commodity is operating in a semi-security capacity because it has always arguably been a security, the investors participating in that space will not have proper disclosures, and proper protections, and also not proper oversight to ensure they are properly protected.

I also want to circle back to the provisional registration. The provisional registration really provides a get-out-of-jail-free card because, essentially, when an entity registers or provisionally registers, the SEC cannot go after their previous actions. So in theory, if Binance, or if FTX was still around, were registered, once they became provisionally registered, those who suffered at the hands of the malfeasance of those entities would not have legal recourse. How is that in the best interest of the American public? It is not.

Mr. SCOTT. Mr. Kaplan, I agree with you 100 percent. What do you think we should do about this?

Mr. KAPLAN. Follow the existing Federal securities laws, which have been tried and tested over generations and are literally meant to protect the retail investing public. It is a clear and logical pathway forward.

Mr. SCOTT. Thank you, Mr. Kaplan.

Mr. HILL. The gentleman from Georgia yields back.

The gentleman from Oklahoma, Mr. Lucas, is recognized for 5 minutes.

Mr. LUCAS. Thank you, Mr. Chairman, for holding this hearing and for your work, and I thank the Chairman McHenry for his work on the digital market structure legislation. Both this Financial Services Committee and the House Agriculture Committee have had many hearings, and many roundtables in the lead-up to this draft, and this hearing gives us another opportunity to examine the underlying legislation and discuss why it is important for Congress to provide a clear regulatory framework.

And I will begin with this: If the United States wants to be a leader in the future of digital assets, it is essential that Congress act. Other jurisdictions, such as the European Union and Japan, have frameworks for digital assets, and countries like the U.K. are crafting their own rules. At the same time, our regulators here in the U.S. are at odds. We have the Chairman of the SEC telling Congress that legislation is not needed, while the Chairman of the CFTC says legislation is needed. Congress should settle this by

passing much-needed regulatory clarity for digital assets, not jurisdictions abroad like the EU, and not the SEC through a chaotic enforcement approach.

Mr. GARRISON, could you discuss how it makes our job passing meaningful legislation more difficult, the longer we wait?

Mr. GARRISON. The longer that it takes to get legislation together, the more the trading public in digital assets are put at risk, where there are no rules in place. The longer that industry participants do not have certainty, the more difficult it is for them to continue to operate, and the greater the risk that they move offshore.

Mr. LUCAS. Mr. Allaire, could you further underscore the missed opportunity of allowing other countries to create a workable digital asset environment, while here in the United States we allow the SEC to take the lead?

Mr. ALLAIRE. Thank you for the question, Congressman Lucas. Very specifically, we are seeing governments around the world—the EU, the U.K., Japan, Hong Kong, Singapore, and others—actually defining the rules for how dollars, digital dollars, are issued and operate in those markets, which is astounding. The United States is responsible for the dollar, and the United States does not yet have clear regulation for payment stablecoins and digital dollar issuance. And with respect to the different need for clarity, I think as recommended by Secretary Yellen and the entire President's Working Group, who have also led an effort internationally to establish stablecoin rules, we need to adopt stablecoin rules so that other markets are not actually regulating the dollar.

Mr. LUCAS. Many of the consumer protection concerns that we see today in the crypto market are reminiscent of the forex markets of the 2000s, which were rife with get-rich-quick schemes under an unclear regulatory framework. In 2008, granting the CFTC jurisdiction over retail forex transactions provided tangible consumer protection results.

Mr. Sexton, drawing upon your experience and tenure at the NFA, how important is it for Congress to act if we truly want to protect consumers?

Mr. SEXTON. Mr. Lucas, thank you for the question and thank you for meeting with us yesterday. As a member of the Agriculture Committee, you worked with us on retail forex issues, and it is extremely important in light of the similar type of retail customer fraud that occurs with regard to spot digital asset commodities that a similar framework be built.

We know that the CFTC has anti-fraud jurisdiction over these products currently. We need to complement that with regulatory jurisdiction, as we did in the retail forex space. As we have often said, it is far better to prevent fraud than to prosecute fraud because retail customers have been hurt after that has occurred.

Mr. LUCAS. Mr. Sexton, I understand you are still reviewing applications of the market structure discussion draft, but could you discuss broadly how the National Futures Association would amend its compliance rules to account for Congress creating a classification for digital commodities? What would the process look like?

Mr. SEXTON. The process would be very similar to what we have done in the past when we have taken on additional responsibilities in the retail forex and the swaps markets. The first thing that we

would do is—as I said, we currently have an anti-fraud rule for digital asset commodities that covers Bitcoin and Ether. Depending upon what Congress derives as far the definition for those products, we would amend our rules to cover those products. We also would amend our rules to permit digital asset commodity brokers and dealers to be members of an NFA if we are participating in this, and then afterwards, we would adopt compliance rules in the areas that are identified in the discussion draft, working closely with the CFTC in doing so, from customer seg to capital disclosures, you go down the line, as to the elements of the discussion draft.

Mr. LUCAS. Thank you for those insights. My time is about to expire, Mr. Chairman.

Mr. HILL. The gentleman yields back.

The gentlewoman from New York, Ms. Velazquez, is recognized now for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Allaire, as you know, the New York Department of Financial Services has developed its own regulatory regime providing for the legal issuance of stablecoins in the State of New York. There has been significant conversation on this committee about whether the Federal Government or the States should be the primary regulatory authority regarding stablecoin issuance. What is your view? How do you view the role of the Federal Reserve vis-a-vis the States?

Mr. ALLAIRE. Thank you for the question, Congresswoman Velazquez. This is a critical issue which I know is central to ultimately getting stablecoin legislation done here in the United States. We believe there needs to be a strong role for both States and the Federal regulators. I think that the bill, as noticed as of this Friday, makes very significant progress in establishing the very strong Federal floors on the reserve requirements, reporting requirements, redemption disclosures, co-minglings, not allowing that. And then, very specifically, it allows the Fed and the Federal banking regulators to deal with the rules around capital advocacy, core risk management rules, safety and soundness requirements, the kind of fitness of management, many of the fundamental things, and that becomes the floor that any State regulator needs to meet. But States would be allowed to issue payment stablecoin licenses and to supervise firms under that Federal floor, and I think that is a good compromise for States like New York, which have really led the way in stablecoin regulation in the United States.

Ms. VELAZQUEZ. Thank you for that answer.

Mr. Kaplan, what is your view? How do you view the role of the Federal Government vis-a-vis the States when it comes to regulation of stablecoin issuance?

Mr. KAPLAN. Under the draft bill, I think there are potential issues when it comes to the fragmentation and the different regulatory regimes. Essentially, a stablecoin could be licensed at a State level, but what happens if that stablecoin is used outside the State? Isn't it used in interstate commerce then, and therefore shouldn't there be Federal oversight?

I think the most-appropriate way to ensure that investors and the public are properly protected, particularly when it comes to

stablecoins, which arguably pose the largest and most systemic risk, is to have proper Federal oversight that is uniform, that would prevent any sort of regulatory arbitrage where issuers would choose one State versus another because they are more friendly towards the approval process.

Ms. VELAZQUEZ. Okay. Thank you for that answer.

Mr. Allaire, and Mr. Kaplan, if you both believe Federal oversight is important, do you believe it is important to have ongoing supervisory and examination authority for the State license issuers at the Federal level?

Mr. ALLAIRE. I believe that the Fed needs to be able to continue to enhance rules over time. In particular, the bill stipulates core areas around capital adequacy, risk management, and safety and soundness. The importance of those is paramount, and Federal regulators need to be able to look at what is evolving in the market and evolving on the whole and be able to make recommendations around that.

So, this is not a static, one-time thing. I think that these are going to be dynamic markets and technology changes, and that will require that we be able to look at those on an ongoing basis.

Ms. VELAZQUEZ. Very short answer, Mr. Kaplan?

Mr. KAPLAN. I think that there is specifically, on the State level, potential issues when it comes to the idea that the State can unilaterally expand the list of eligible reserve assets without restriction at any time. Expanding the underlying assets that could basically stabilize the stablecoin, and to include and introduce additional risks which will increase the chance of that stablecoin losing its peg.

Ms. VELAZQUEZ. Thank you. Mr. Kaplan, one of the central tenets of our banking system is the separation of banking and commercial activity. The Republican-led stablecoin legislation we are discussing here today seems to fail to recognize this separation for stablecoin issuers, which would allow non-commercial businesses to own a stablecoin issuer. Can you explain the harm to both consumers and perhaps financial stability that could arise from failing to clearly define this separation?

Mr. KAPLAN. Consolidation of consumer and banking activities can lead to conflicts of interest and potential systemic risk. Essentially, the lack of a strong framework with proper regulatory oversight for the entities involved, particularly when they are comingling consumer- and financial-based activities, presents additional levels of conflict and potential exposure to the underlying customers either on the consumer side or—

Mr. HILL. Thank you. The gentlewoman's time has expired.

Ms. VELAZQUEZ. Thank you. I yield back.

Mr. HILL. Thank you.

The gentleman from Florida, Mr. Posey, is now recognized for 5 minutes.

Mr. POSEY. Thank you, Mr. Chairman.

Mr. Allaire, you began your testimony today talking about China's currency. Do you see any comparison between that and the central bank digital currency that the President has proposed in his Executive Order?

Mr. ALLAIRE. I'm sorry. I could not hear the last part of your question because the door opened.

Mr. POSEY. I said, do you see any similarity between the Chinese program and the central bank digital currency that President Biden included in his Executive Order?

Mr. ALLAIRE. Thank you for the question, Congressman Posey. I think what the Chinese government has pushed forward with is an entirely state-run and state-administered digital currency program. It has with it significant embedded surveillance capabilities, and it is clearly something that the Chinese government seeks to export around the world as part of its desire to grow the role of the yuan internationally.

I believe your reference to the Executive Order from President Biden was around studying a central bank digital currency in the United States. Our view is that a similarly-designed retail government-run and government-administered central bank digital currency is not needed in the United States. But we do believe that there are critical improvements to be made in the core infrastructure of the dollar itself, within the Federal Reserve System, what people sometimes refer to as wholesale infrastructure for this, and clearly, central banks around the world are all exploring that.

But I think this separation between those institutions that are delivering financial services directly to end customers and the government is a kind of air gap that is important to preserve for privacy, security, and market competition reasons.

Mr. POSEY. You can understand the concern of some people that if private digital is competing with government digital, guess who is going to win? It is never going to be a level playing field, and more levels of regulation is not going to help. We know that for 10 years, the SEC was informed about the biggest fraud in history. So, more regulation is not going to fix the fraud that we endured.

And there is also concern that when you have a central bank digital currency, like China has, the government knows every penny that you spend. They can slow down your flow of funding, they can cut it off, or they can take everything that you have. And I can understand the legitimate concerns that some people have about that.

How should investors evaluate the liquidity risk of digital assets compared to banks?

Mr. ALLAIRE. Specifically on stablecoins, what this bill does is specify a very narrow base of important, high-quality liquid assets that must be held on a fully-reserved basis, the most-liquid dollar instruments in the world. And a digital dollar that is held to those reserve standards is dramatically safer than bank deposits. Bank deposits hold one-twelfth of the deposits, and the remainder is lent out. We see risks from fractional reserving. And the mixing of that lending behavior and payment system behavior has, let's just say, bitten American consumers and businesses many, many times historically.

This bill, I think, helps to define and create the safest digital dollar in the world, which is what the American government should be getting behind and making that an important export product on the internet.

Mr. POSEY. How should the regulations for stablecoins compare to the capital regulations for banks and money market funds?

Mr. ALLAIRE. In the stablecoin bill, there are recommendations for Federal regulators to look at capital adequacy, to evaluate key activities around the risks of an issuer, and I think that is appropriate. There should be capital buffers to deal with it. But unlike a bank, which is rehypothecating and lending and fractionally reserving, these are very, very narrowly held, so the liquidity requirements, and therefore the capital buffer requirements, are likely going to be significantly lower. That is left to regulators to determine as opposed to being highly prescriptive in the bill, but I think it is a very important and necessary piece for this to ultimately go into effect.

Mr. POSEY. Thank you. Mr. Chairman, my time has expired, so I yield back.

Mr. HILL. The gentleman yields back.

The gentleman from California, Mr. Sherman, is recognized now for 5 minutes.

Mr. SHERMAN. Thank you. This seems like the 12th hearing we have had on crypto this year. I am still waiting for a hearing on diversity, equity, and inclusion in this room this year. But all of these hearings seem to start with the idea that we are falling behind. But America is behind Peru in cocaine cultivation, and we are behind the Cayman Islands in nefarious hidden financial transactions; we do not always need to catch up.

We are told that we now have a 160-page bill, and I am sure a lot of work has gone into that bill, but it comes down to the one sentence, and the one reason why Sam Bankman-Fried prowled the halls of this building, and that was to get the SEC out and put a patina of regulation in.

Then, there is the proposed stablecoin bill that goes to the lowest State denominator. And what State, if they could have \$1 billion to provide health care for their own citizens who might die, would not cut that deal and just provide whatever patina of regulation the industry wanted? And if North Dakota will not do it, South Dakota will.

So, we will have achieved Sam Bankman-Fried's objectives. The least we could do is let him out of jail to come here and celebrate this legislative success.

When billionaires tell you that they are working to hurt your country, you should believe them. The head of Coinbase, Brian Armstrong, tells us that he views crypto as a new global reserve currency. And we see from others that this is the way major figures in the crypto industry see crypto: as a way to undermine American sanctions.

The role of the U.S. dollar allows us to have the, "Know Your Currency," rules. Crypto says it is hidden money. It is in the name. Undermine our sanctions rules, provide a tool for tax evaders, but most importantly is what Mr. Brian Armstrong, CEO of Coinbase says, and that is to displace the dollar partially or completely as a reserve currency.

We are told that we need clarity. We have clarity. The SEC realizes it is a security, as Mr. Kaplan does as well. The industry is here to: first, they are in court spending tens of millions of dollars to undermine that clarity; and then, they are in Congress spending God knows how much to undermine the clarity that we could have

with tough regulation from the SEC, which is what is currently called for in our laws

I have a question for Ava Labs. Avalanche Labs attempts to highlight their use of technology to focus on innovation, but still peddles unregistered securities to retail investors. The Avalanche token went from a market cap of \$40 billion to \$4 billion.

Mr. Sirer, did Ava Labs file a registration statement with the SEC? Has Ava Labs sold unregistered Avalanche tokens or a future right to Avalanche tokens in order to raise capital?

Mr. SIRER. Congressman, we have complied with every regulation to the best of our abilities, and we are——

Mr. SHERMAN. Did you file a registration statement or not?

Mr. SIRER. When we did our token sale, we filed an appropriate——

Mr. SHERMAN. Did you file a registration statement or not?

Mr. SIRER. I do not know the correct answer to that. I am a technologist, so I do not know the answer to that. I don't believe that we did.

Mr. SHERMAN. That would certainly surprise me. I mean, Taylor Swift turned down millions of dollars and responded to the community by saying that crypto is an unregistered security, and she would turn down millions of dollars to not be associated with it. Some people in this room are not willing to make that statement.

Mr. Kaplan, are you able to comply with SEC regulation and carry on your business?

Mr. KAPLAN. Yes, sir.

Mr. SHERMAN. You filed a registration statement?

Mr. KAPLAN. We filed through the licensing process.

Mr. SHERMAN. Through the licensing, so, you got a license from the SEC?

I would just say that we have had a lot of witnesses come before us, but I don't believe we have had one who came here to talk about how, if this works, it undermines the power of the American people.

Mr. HILL. The gentleman's time has expired.

Mr. SHERMAN. I yield back.

Mr. HILL. I thank the gentleman from California.

The gentleman from Missouri, Mr. Luetkemeyer, who is also the Chair of our National Security Subcommittee, is recognized for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

I want to quote from an article in the Wall Street Journal last week entitled, "Crypto communism' Has a New Meaning: China seeks to infiltrate the U.S. financial system, and the SEC and FINRA seem oblivious." In this article, it talks about Prometheus as an American company, but according to SEC filings it is a, "strategic partner and joint venture with Shanghai Wanxiang Blockchain Inc., and its affiliate, HashKey. The former company is a spinoff of Wanxiang Group, which has deep ties with the Chinese Communist Party."

Wanxiang Group was founded in 1969, and the founder passed away recently, and an official press release commented that, "the comrade always listened to the party and followed the party." That group is now led by that gentleman's son, Lu Weiding, and the

press release goes on to say that, “he will carry forward the practices of the deceased founder and always listen to the party and follow the party.” I can tell you from being on the House Select Committee on the Chinese Communist Party, that that is a chilling statement, when we have an American company that is in bed with the Chinese.

Mr. Kaplan, what percentage of your company is owned by a Chinese entity?

Mr. KAPLAN. I think, approximately 20 percent.

Mr. LUETKEMEYER. Twenty percent of it. How much influence do they have over your company?

Mr. KAPLAN. They have the same rights as other shareholders.

Mr. LUETKEMEYER. How much access do they have to intellectual property?

Mr. KAPLAN. Wanxiang has no access to any Prometheus code or technology or systems service or customer data.

Mr. LUETKEMEYER. If they are on the board of directors and have access to all of your data, from the standpoint of being an investor, how do you answer that question like that?

Mr. KAPLAN. The bylaws were changed in the filing that was filed with the SEC in November 2021, and they basically limit who has access to data, including directors.

Mr. LUETKEMEYER. Okay. Where is the data stored right now?

Mr. KAPLAN. In the United States.

Mr. LUETKEMEYER. So, your headquarters is here, and your data is stored here. It is not stored anywhere in China?

Mr. KAPLAN. Not at all, sir.

Mr. LUETKEMEYER. Okay. You have a designation as a digital asset security broker-dealer, and as such, you have a lot of personally identifiable information on your clients, do you not?

Mr. KAPLAN. Correct.

Mr. LUETKEMEYER. Okay. Do the Chinese have access to any of that information or any other technology at this point?

Mr. KAPLAN. Absolutely not, sir. I want to point out that Prometheus is an American-born, American-bred, and American-controlled company, and there is basically no foreign influence or control over Prometheus or any of its systems, its code, its servers, or its customers’ data.

Mr. LUETKEMEYER. I am glad you could read that, but that does not impress me because I sit on the Committee, and I can tell you any company that is either owned by or involved with the Chinese Communist Party and/or government is influenced by them. That is the only way they operate.

What safeguards do you have in place to make sure they do not get access to anything in your company?

Mr. KAPLAN. Sir, we have had both a Committee on Foreign Investment in the United States (CFIUS) inquiry and an SEC investigation where we were required to give all communications—

Mr. LUETKEMEYER. To what benefit do the Chinese then involve themselves in your company? If they cannot access information, if they cannot access your technology, what is the benefit to them of investing in your company?

Mr. KAPLAN. The belief in the business idea that digital assets are securities and need to be properly regulated as such and traded

on intermediaries that are properly registered under the securities laws.

Mr. LUETKEMEYER. Do you think that perhaps they are getting some information just by being around your business that could be helpful to them?

Mr. KAPLAN. I do not believe so, sir.

Mr. LUETKEMEYER. Why did you take them on as a partner? Why can you not have an American partner instead of a Chinese partner? What is the benefit of having a Chinese partner in this business?

Mr. KAPLAN. As anyone who has started a startup knows, when you are young and small as an entity and a large, established entity seeks to have a relationship with you, you look for the opportunity. If there had been an American opportunity, we probably would have taken it.

Mr. LUETKEMEYER. That is troubling because, you see, this is exactly how the Chinese work their way into our various companies in this country. They see an opening, because there is a need there for the company to grow, for money, for expertise, for technology, and they are standing there with their hands out being willing to add that to the portfolio or give to whatever you want to do here. And as a result, then they have their hands on you. It is very disturbing to see that is what is going on here.

I am just worried that this is a situation where we have the SEC giving you one of the first digital asset security broker-dealer's licenses, and where is the SEC on this, I wonder?

But anyway, I see my time is getting short, so with that, Mr. Chairman, I will yield back.

Mr. HILL. The gentleman yields back.

The gentleman from New York, Mr. Meeks, who is also the ranking member of the House Foreign Affairs Committee, is recognized for 5 minutes.

Mr. MEEKS. Thank you, Mr. Chairman. I think most of you know I am from New York, and I think you are all aware that the New York Department of Financial Services (DFS) has created what I believe is a best-in-class licensing regime for virtual currency businesses, and I am very, very proud of that. The New York DFS is the only prudential regulator with virtual asset-specific authority in these United States of America. Under the leadership of Superintendent Adrienne Harris, DFS ensures that consumers and markets are protected, and New York continues to be the financial center of the entire world. They have assembled the largest team of expert virtual currency regulators in the nation and have taken the strongest supervisory and enforcement actions of any regulator.

Mr. Allaire, whom would you consider to be Circle's primary regulator?

Mr. ALLAIRE. Thank you for the question, Congressman Meeks. We are regulated similarly to virtually every other major electronic payment innovator in the United States. We are regulated by many different State regulators throughout the U.S., similar to PayPal, Apple Pay, Venmo, Cash App, and others. So, we are an electronic stored value money transmission application, which requires us to be licensed in a filing with the Treasury Department, with Bank Secrecy Act (BSA) and mail requirements with the U.S. Treasury,

as well as licensing and supervision throughout the United States. We also have international supervisors that are central banks and market supervisors.

We are also a BitLicense company. In fact, we were the very first company in the world to receive the New York BitLicense. In 2015, we contributed to the development of that licensing regime. And we follow New York's reserve and disclosure requirements for stablecoins, which we would agree are some of the best available to the market today.

Mr. MEEKS. I just want to make sure that I am clear—does Circle currently possess any type of virtual currency license in the domestic jurisdictions?

Mr. ALLAIRE. Yes. We have a BitLicense, the New York virtual currency license which they pioneered in 2015. Other States also have specific enhancements to their money transmission statutes that deal with virtual assets and interactions between the banking system and virtual assets. A number of large States do that already today. We are also supervised by international banking regulators such as the Monetary Authority of Singapore, the UK Financial Conduct Authority (FCA), and others.

Mr. MEEKS. So, you acknowledge that States like New York have been leaders in this space, and you agree that they have a vital role to play. Is that correct?

Mr. ALLAIRE. I absolutely agree.

Mr. MEEKS. Can you speak to why the existence of a State pathway is not a race to the bottom?

Mr. ALLAIRE. I believe payment stablecoins, as identified by the Presidential Working Group and by the G20 as well, have the potential to be very large scale, much larger scale in use than many other payment technologies. And for that reason, it has been recommended by the U.S. Treasury, the White House, and others that there be national standards set for payment stablecoins. And I think that is exactly what, on a bipartisan basis, we are seeing happen here in Congress.

And what is really key there is that there is a federally-defined floor, that we do have the ability for Federal regulators to define what that floor is so that there cannot be a race to the bottom. I believe the best States should be able to issue licenses and supervise firms according to this Federal floor. And I think that is exactly what the legislation in front of us considers today.

Mr. MEEKS. Thank you. Let me jump to Mr. Garrison. Mr. Garrison, your assessment that the lack of clear rules of the road puts the United States at a competitive disadvantage deeply resonates with me. It is something that I have been talking about a lot. Like you, I hear regularly from U.S. companies that the lack of regulatory clarity at the Federal level is causing them to consider moving out of the United States and seek to be regulated in other jurisdictions around the world.

So, I would like to give you an opportunity to expand on this and share some of your observations in this area, and what are some of the potential near-term and longer-terms impacts of industry participants leaving the United States?

Mr. GARRISON. The regulatory uncertainty is tremendously difficult for people as they want to grow businesses. And when they

seek legal counsel and when they come to people like me, they are willing to spend money to comply with the law. They just simply need to know what the rules of the road are, so it becomes incredibly frustrating when there are no clear rules of the road, and all you know is that an enforcement action may be hanging over your head, but there is no actual way to comply.

Mr. HILL. The gentleman's time has expired. I thank the gentleman from New York.

The gentlewoman from Missouri, Mrs. Wagner, who is also the Chair of our Capital Markets Subcommittee, is now recognized for 5 minutes.

Mrs. WAGNER. Thank you, and I want to thank Chairman McHenry and our Chair of the Digital Asset Subcommittee, Mr. Hill, for their efforts to develop a much-needed framework that provides clarity to market participants, promotes innovation, and protects investors.

This hearing is timely, and the legislation that we are discussing today is critical to ensuring the United States remains the leader in technological and financial innovation. While Congress has been working toward developing a legislative framework, SEC Chair Gensler continues to regulate by enforcement. The SEC is actively policing digital asset markets through enforcement without clear authority from Congress and without providing a clear regulatory roadmap for digital asset firms.

Meanwhile, the Commodity Futures Trading Commission (CFTC) has brought enforcement actions as well, including with regard to digital assets over which the SEC claims jurisdiction.

Mr. Allaire, although the collapse of FTX did not involve payment stablecoins, one of the most-egregious stories to come out of it was the co-mingling of customer and firm assets. Following your review of the draft legislation, does this draft fix the problems that we saw in FTX, so that we can provide increased protections to Main Street investors?

Mr. ALLAIRE. Thank you for the question, Congresswoman Wagner. In both the payment stablecoin bill and in the draft market structure bill, I do believe that those co-mingling issues are absolutely addressed, and I think that is a critical issue that you have identified, and obviously a core to whether you are holding funds backing a stablecoin or you are holding digital assets that are on behalf of investors and users.

Mrs. WAGNER. Absolutely. Last week, the SEC issued an enforcement action against Coinbase, alleging that they were operating as an unregistered broker-dealer exchange and clearinghouse. This action came after several requests from Coinbase, including a petition for rulemaking to amend the securities laws so that they could actually come in and register with the agency.

Mr. Garrison, in your view, does this inaction on valid requests from the SEC, followed by harsh penalties against Coinbase, inhibit companies making good faith efforts to register, thus preventing job creation and economic growth within the stablecoin market, sir?

Mr. GARRISON. It certainly does. The lack of a regulatory framework makes operating a digital asset business in the U.S. very difficult, so allowing digital asset markets to operate within the ac-

knowledge of certain realities such as instantaneous settlement of trading of digital assets that may be represented by securities alongside non-securities at the same time are important things to acknowledge, and I think this bill does a good job of identifying that and telling the SEC to start putting a regulatory framework in place.

Mrs. WAGNER. Okay. Mr. Garrison, the proposed legislation requires the SEC to modernize a number of its rules to account for the realities of digital assets, including rules governing alternative trading systems and broker-dealers. Would you describe how these rules could be updated to accommodate digital assets and what impact these modernizations will have on the digital asset ecosystem?

Mr. GARRISON. The secondary trading rules need to be updated to acknowledge that not all intermediaries are necessary, which is one thing that digital assets make possible. So, those are rules that, by the way, even at the end of these enforcement actions, if the SEC is successful, these rules still have to be updated to allow for these realities of the technology to occur.

So, it is something that the SEC can do now, and the good thing about this bill is it requires them to act now as opposed to waiting until after the enforcement action—

Mrs. WAGNER. My time is short, Mr. Garrison. Development in the blockchain space is accelerating rapidly, yet existing regulations make it difficult for everyday investors to participate in initial offerings. The new exemption in the bill allows participation of non-accredited investors, up to a certain limit. How will this access benefit retail investors?

Mr. GARRISON. Improving investor choice is an important part of investor protection, as well as the key characteristics here of—

Mrs. WAGNER. Are there protections too, sir?

Mr. GARRISON. Yes. The disclosure requirements are included in the bill, the individual investment limits, the aggregate offering limits. There are limits on secondary trading from insiders as well.

Mrs. WAGNER. My time has expired, but I would be interested in any other protections that you think should be added to the legislation.

I thank the Chair, and I yield back.

Mr. HILL. The gentlewoman yields back.

The gentleman from Massachusetts, Mr. Lynch, who is also the ranking member of our Digital Assets Subcommittee, is recognized for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

Mr. Kaplan, I am going through the bill itself, and it is remarkable that the Commodity Exchange Act actually reads out of the law four major pieces of legislation that have been intrinsic to strengthening our markets—the Securities Act of 1933, gone; the Securities Exchange Act of 1934, gone; Investment Company Act of 1940, gone, does not apply; the Investment Advisors Act of 1940, does not apply; the Sarbanes-Oxley signoff of annual reports, gone. As a matter of fact, annual reports are gone.

All of these bills were put in place right after the stock market crash in 1929, and because we had 9,000 banks in this country go out of business, fail, Congress, with the support of Wall Street, amazingly, at the time, came back and said, how do we restore the

trust of investors in Wall Street, in the stock market, in our banks? And we came up with this menu of bills that tried to restore confidence, since our financial system is built essentially on trust. And we got trust by providing public information to those investors right up front, to build confidence in their investments.

You have been able to follow those rules in establishing Prometheus. What do you think the consequences will be if new companies have the choice of either being regulated or, as SEC Chair Gary Gensler has pointed out, operating like the Wild West? And especially if it is a State-by-State model, where you can go to a State like New York, which has an established regime and somewhat of a regulatory framework, or you can go to some other State that is very loosely regulated. What do you think the consequences of those choices will be on the markets?

Mr. KAPLAN. The American public will be harmed. Essentially, what we have seen is that the Wild West crypto financial services ecosystem focused on revenues at the expense of customers' best interests. The way forward, the best way, really, the only way forward is the application of the Federal securities law to ensure that investors are protected.

As you mentioned, sir, the major Acts when it came to the securities laws were passed after the 1919 crash. We learned our lessons then. Regretfully, we did not understand them in 2022. But now, in hindsight, it is totally clear that the best way forward and the best way to protect the public is literally the application of the Federal securities laws.

I want to point out that there has been discussion about a lack of regulatory clarity, and that is just not true. The SEC put the industry on notice in July 2017, in the DAO Report. The SEC has released compliant frameworks for the trading and custody of digital assets. Those who argue that there is a lack of regulatory clarity, need a lack of regulatory clarity because they cannot be compliant under the existing clarified regulations.

Mr. LYNCH. Mr. Kaplan, the SEC has brought 130 enforcement actions and has won every single one of them. After each and every one of those enforcement actions, there is a written decision as to why that individual company was found to be in noncompliance. Is that instructive to the next company coming along? Is that instructive to you as a new startup?

Mr. KAPLAN. There has been clear indication, whether it is on the release, the enforcement side, or the statements coming out of the SEC, that the Federal securities laws applied and that those seeking to operate compliantly in the space when it comes to digital asset financial services need to comply with them. Basically, there is no confusion here. Essentially, the industry has chosen to ignore the clear statements, the enforcement actions, and the releases by the SEC because they were best-served by not being regulated under the Federal securities laws.

Mr. LYNCH. Thank you. We have a few seconds left. What are the steps for registering and coming into compliance under existing laws? Is it onerous or is it balanced?

Mr. KAPLAN. The steps are difficult, they are a little complex, and they take time, but they need to, because when you are dealing with customer funds and assets—

Mr. HILL. The gentleman's time has expired. I thank the witness. I appreciate my ranking member and his questions.

And I will now recognize the gentleman from Kentucky, Mr. Barr, for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman. Let me start with Mr. Garrison and follow up with Mr. Kaplan's testimony. It seems that Mr. Kaplan is making the argument that everything except Bitcoin is a security. I want you to amplify your testimony in reference to this, what I think is Mr. Kaplan's testimony. In your written testimony, you talk about how the application of existing security laws—which Mr. Kaplan says are perfectly applicable in this new, innovative marketplace—to digital assets is not always clear. And amplify your analysis of how *Howey* does not really cover everything in the current modern world.

Mr. GARRISON. Yes. We always start with the statute on the analysis of, what is a security? The statute is quite clear in the list of instruments. Digital assets are not there. Then the question becomes, is it an investment contract? The Supreme Court, in the *Howey* case, put forth a test. It said a contract, transaction, or a scheme where there is an investment of money and a common enterprise with a reasonable expectation of profit from the efforts of others is the security.

Now a digital asset, at times, can, in fact, be sold pursuant to an investment contract, which does not mean that the digital asset itself evidences the security for all of time. That set of promises that may have been launched as a project is getting off the ground and developing the network for the first time, and raising money to do that, that is selling a token pursuant to an investment contract. But over time, tokens operate differently. They are not equity securities. They are not your traditional stocks or bonds or notes. People purchase them for a number of different reasons, but one of the reasons is they want to use it on the platform itself, on the network itself.

At some point in time, when the network is fully decentralized and fully functioning, that digital asset does not bear the characteristics of the security, and the application of securities laws would be so overly burdensome that it would render the use of the network moot.

Mr. BARR. In summary, what do you make of Mr. Kaplan's argument that existing securities laws are all we need?

Mr. GARRISON. I disagree with the position. I think securities laws are a piece of the puzzle, but I think there is a large piece of the puzzle that is missing.

Mr. BARR. Let me follow up with a question about custody. It is essentially for any market structure legislation to set rules for the custody of digital assets so that consumers can have confidence that their digital assets actually are where an intermediary says they are. Digital assets raise several novel issues when it comes to custody that must be addressed.

Mr. Garrison, would you discuss some of the key questions when it comes to the application of the SEC's requirements for custody of digital assets?

Mr. GARRISON. With respect to custody of digital assets and the SEC, there are a number of different questions relating to the

intermediaries that may hold digital assets, typically broker-dealers, sometimes investment advisors.

Generally, one of the questions that comes up, and the core becomes, how do you demonstrate exclusive possession of a digital asset? The way digital assets work is you have private keys, and of course, the private key may be shared with others and may be charted and put into different groups, so a lot of the securities regulations or debates going on in securities regulation is how do you actually show exclusive control.

Now, the industry has a number of solutions that they think are sufficient, and the SEC has been talking about it and refusing to come to a conclusion since, I want to say, about 2018, on the subject.

Mr. BARR. Here again, the status quo is unacceptable. It is stifling innovation. The banks tell us that not just the SEC but also the bank regulators are discouraging State custody of digital assets, and that is stifling innovation here in the United States. We have to fix that.

My final question to Mr. Allaire is related to China. Can you touch on how the United States can build out our stablecoin regime to elevate the United States' leadership in this space without jeopardizing Americans' access to freedom, privacy, and apolitical private capital, and talk about that in contrast to what we see in China with the Chinese digital yuan, which has embedded surveillance features?

Mr. ALLAIRE. Thank you for the question, Congressman Barr.

Mr. BARR. And could you also touch on how a regulatory framework for a dollar-denominated stablecoin is an effective alternative to a CBDC or a digital dollar that would preserve the dollar's dominance globally?

Mr. ALLAIRE. My time is very short. In short, I believe private sector innovation with strong regulation at the national level for digital dollars, which is what this bill provides, is the best path to compete with China right now.

Mr. BARR. Thank you. And it is a longer answer, but I appreciate the answer. I yield back.

Mr. HILL. The gentleman's time has expired.

The gentleman from Texas, Mr. Green, is recognized for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I thank the ranking member as well. And I thank the witnesses for appearing.

I think a good many topics have been covered quite thoroughly, so I would like to go into another area that I am interested in, and that is diversity. I believe that this industry ought to have diversity, and I would like to ask you if you agree with me. If you think that this industry should be diversified in terms of people who are involved, at all levels, if you think it should be diversified at all levels would you kindly extend a hand into the air?

[Show of hands.]

Mr. GREEN. Okay. Let the record reflect that all of the witnesses believe that we should have diversity at all levels.

Are there women who are capable, competent, and qualified to testify at a hearing like this one today? If you think so, raise your hand, please.

[Show of hands.]

Mr. GREEN. Let the record reflect that all of the witnesses believe that there are women who are capable, competent, and qualified to testify at a hearing such as this.

If you identify yourself as a person who is not—N—O—T—not a male, raise your hand.

[Pause.]

Mr. GREEN. Let the record reflect that no hands have been raised, so I assume that all of the witnesses identify themselves as males.

I must tell you, I find it quite amazing that as far as we have come, we still have a way to go. I do not fault you. I really do not. But I do fault my colleagues. Not one female among the persons who are on this panel, not one. I am amazed because they know that I am going to point it out, because I do this quite regularly.

I am also amazed because this could end if the news media would make an issue of it, and just note that we are not allowing women to have the opportunity to demonstrate that they are capable, competent, and qualified.

Do any of you have children? If you have children, raise your hand, please.

[Show of hands.]

Mr. GREEN. If you have a daughter, raise your hand, please.

[Show of hands.]

Mr. GREEN. Okay. Let's start with the gentleman at the far end. Sir, would you like to see a female on this panel?

Mr. ALLAIRE. Absolutely.

Mr. GREEN. Do you think your daughter would benefit from having a female on this panel?

Mr. ALLAIRE. I do.

Mr. GREEN. When you came in and noticed that you had all what facially appear to be men, did it give you any degree of consternation?

Mr. ALLAIRE. I would like to see more diversity in all of these panels.

Mr. GREEN. So would I. We have come so far, yet we have so far to go, it seems.

Mr. Kaplan, do you have any women in your business?

Mr. KAPLAN. Yes, sir.

Mr. GREEN. Are women as smart as men?

Mr. KAPLAN. Arguably smarter.

Mr. GREEN. I agree.

What about you, Mr. Sexton? Any women in your business?

Mr. SEXTON. Absolutely, sir. NFA is 40 percent women, 60 percent men. I have two women behind me who are fully capable of testifying at this hearing, who helped prepare me for this hearing. I also have a daughter who would, I am sure, thoroughly enjoy testifying before you.

Mr. GREEN. Thank you. Just to validate what you said about two women behind you, would you feel it an imposition to just have them raise their hands? Would that be an imposition?

Mr. SEXTON. I am certainly sure that they could raise their hands, sir. Thank you.

Mr. GREEN. All right. Ladies, women, if you would, raise your hands.

[Show of hands.]

Mr. HILL. I'm sorry. The gentleman's time has expired.

Mr. GREEN. Okay. My time always expires, but I will be back.

Mr. HILL. Not always. The 5 minutes goes by fast.

The gentleman from Minnesota, Mr. Emmer, who is also the Majority Whip of the House, is recognized for 5 minutes.

Mr. EMMER. Thank you, Mr. Chairman. I want to thank Chairman McHenry for holding this important hearing today, and I want to thank all of the witnesses for your testimony.

We are convening to discuss a remarkable piece of draft legislation on digital asset market structure. It is a product of joint committee collaboration, which, here in Congress, does not happen often, and it is drafted thoughtfully and intelligently. I want to commend Chairman McHenry, Chairman Thompson of the Agriculture Committee, and both of their teams for all of their hard work.

Crypto will thrive with or without the United States. What we seek to do today in discussing this draft is to establish if the next iteration of the internet is going to be designed by Americans, and for Americans, or if it is going to emulate the values of some other country. It must be the former, not the latter.

American digital asset innovators and entrepreneurs desperately need regulatory clarity, regulatory certainty, regulatory confidence, and regulatory competitiveness, the four C's. Instead, as a product of Congress ceding its power to the administrative state since the mid-1990s, this Administration has been able to abuse its regulatory powers toward the digital asset ecosystem to the detriment of the American people.

We have an SEC Chair who flip-flips before Congress, telling us last year that he needs legislation to regulate the digital asset industry, and telling us this year that he has changed his mind. He actually does have the authority, in his own mind, the statutory authority to regulate this space. I would disagree. But obviously this sends mixed signals.

The SEC and the CFTC, the two primary regulators, are constantly at odds on whether digital assets are commodities or securities. This sends, again, mixed signals to stakeholders. This Administration weaponized the recent bank crisis to de-bank the digital asset community, deploying an Operation Choke Point-style assault on this legal industry.

We have enforcement actions almost every week alleging that different tokens are securities or different actions fall under SEC jurisdiction. Yet, the SEC has failed to produce a single rule or regulation to help the unique digital asset industry come into compliance, a failure of the administrative state.

Congress needs to step into the driver's seat and pass a bill that provides regulatory clarity, certainty, confidence, and competitiveness. I believe the McHenry-Thompson bill could get us there. It would set up a dual registration framework that would allow projects to crowdfund and give tokens a mechanism to move from issuance to decentralization.

However, the way it is currently drafted conflicts philosophically with how I consider this asset class. Fundamentally, I do not believe digital assets themselves are ever securities. Instead, I believe digital assets can be obtained through a securities contract. The distinction between an investment contract and the asset of the investment contract underpins my 8 years of legislative work in this space, and it is a basis of my bill, the Securities Clarity Act, which I was fortunate to have Mr. Thompson on as a co-sponsor last Congress.

Primarily, while I know this is not the author's intention, my concern is that the McHenry-Thompson bill, as drafted, currently sets up a framework where one fungible digital asset can be both a security and a commodity at the same time. On its face, that is not possible. For one thing to have two distinct classifications, that is not possible. That is because the SEC does not clearly distinguish the asset from the investment contract. In current law, securities inherently include commodities.

Let's go back to *Howey*. The orange groves themselves were obviously a commodity, but they were obtained through a securities contract. Nonetheless, the SEC considered those orange groves a security rather than the asset of a security, but it did not consider all other orange groves a security.

The SEC does this today with digital assets, which, if continued, makes it impossible for digital assets to be in compliance with the law and to be used for their utility. Chair Gensler gave a speech just last week discussing his belief that the asset of the investment contract is itself the investment contract, which is completely bogus.

For the text to achieve what the authors wanted to achieve, which is to enable a framework in which a project can crowdfund and still create an asset that can be used for its utility, then the text needs to clearly assert concepts established in the Securities Clarity Act, that a token is separate and distinct from an investment contract. This will allow the bill to provide the necessary regulatory clarity, regulatory certainty, regulatory confidence, and regulatory competitiveness to ensure that the next iteration of the internet is designed by Americans, for Americans.

Again, thanks to our witnesses for being here, and thanks to Chairman McHenry and Chairman Thompson for your work in this framework. I yield back.

Mr. HILL. The gentleman yields back.

The gentleman from Connecticut, Mr. Himes, who is also the ranking member of the House Permanent Select Committee on Intelligence, is recognized for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman, and thank you to our witnesses. I would like to thank Chairman McHenry and Ranking Member Waters for starting down this path. It is evident that we have a bunch of work in here, and that we have a bunch of work yet to do.

I am going to use my time just to try to elucidate one issue that has come up a lot today and that is the issue of comingling. There is a lot that needs to be done in this bill but we are all pretty attuned to comingling, given the fact pattern around FTX. I was told that the bill permitted comingling.

Mr. Garrison, you said the bill did not permit commingling. So, I went back to the language of the bill and what I find when I look at it is on page 105, "commingling prohibited. Money, assets, and property of a customer described in Clause One shall be separately accounted for and shall not be commingled."

Then, we move down a few lines to, "Exceptions," where it reads, "Notwithstanding subparagraph (a), money, assets, and property of customers of a digital commodity exchange described in subparagraph (a) may for convenience, be commingled." Elsewhere in the bill there is an exactly parallel construction where it says that all assets shall be segregated unless they cannot be segregated if separately accounted for.

It would appear that as written, the language is that there can be commingling provided that it is done for convenience. I can't find anywhere in the bill that defines for whose convenience or what convenience means.

Mr. Garrison, since you made the statement earlier, and because of your experience, I am wondering, does that language give you confidence that there will not be commingling?

Mr. GARRISON. If I remember correctly, and I don't have the exact language of the bill in front of me, I think there was a specific carveout for a very limited activity. So, to the extent that there was a carveout for a very specific activity that it is very clear there is a purpose for, then I think that would make sense.

Mr. HIMES. I don't mean to provoke here, but I have read this 10 times now and it says that, "for convenience," is the one condition that must be met for commingling to occur. That is pretty clear here.

I am not a lawyer but that troubles me. You are a lawyer. Does it trouble you?

Mr. GARRISON. I would agree. "For convenience," should be tightened up.

Mr. HIMES. Okay.

Mr. Kaplan, I wonder if you have any views on this, since you have been seeing things slightly differently than Mr. Garrison?

Mr. KAPLAN. Commingling is a fundamental issue that is necessary to deal with and to regulate properly in order for crypto innovation to continue to occur in the United States. The best way to prevent against commingling is the application of the Federal securities laws, which have reporting mechanisms, ongoing reporting mechanisms, proper oversight, and a plethora of other devices to ensure that the entities that are holding customers' assets do not commingle them with the assets of the firm, particularly Rule 15c3-3, the customer protection rule which has been established and has essentially led to the capital markets on the custody side being able to continue to thrive and grow.

Mr. HIMES. Okay. Just to drive this point home, I think we have agreed that perhaps the language as written is a bit broad or the exceptions are a bit broad.

Do any of our witnesses have any objections if we use the language associated with prohibitions on commingling and custody accounts and that sort of thing to prevent commingling inside this bill?

Would there be an objection to that as a concept?

[No response.]

Mr. HIMES. Okay. I hear none. Thank you very much. And I yield back, Mr. Chairman.

Mr. HILL. The gentleman yields back.

The gentleman from Georgia, Mr. Loudermilk, is recognized for 5 minutes.

Mr. LOUDERMILK. Thank you, Mr. Chairman.

Mr. Garrison, in your written testimony you point out that SEC staff has taken a position that digital assets may or may not be securities, depending on the condition of their underlying network, but do little more to clarify the thresholds of which a network is decentralized enough for the asset to be a digital commodity.

Given that almost every market participant has asked for clarity as to when digital assets are commodities or securities, why do you think it is important to look at the underlying network as opposed to the digital asset itself?

Mr. GARRISON. I believe that looking at the underlying network is important because it will show the regulator, and it will show anybody using the network, who actually is in charge.

If the network is decentralized and everybody comes on equal terms and the rules are being built by a decentralized group, a number of people outside of just a core number of folks who started the program, then that should give you more comfort that this is a decentralized network, not something that is simply run by a centralized group of people.

Mr. LOUDERMILK. Okay. Thank you. Do you think it is important that there are clear thresholds of decentralization that could be used to make this security vs commodity distinction?

Mr. GARRISON. Yes, I do.

Mr. LOUDERMILK. What do you believe is a good measure of network decentralization to help in making that distinction?

Mr. GARRISON. I think there are a number of factors that you can look at, one being, does any person or group of persons have unilateral authority to change the code itself? I think that is something that jumps out. Can they block or prohibit people from interacting with the code on their own?

Another is concentration of ownership of tokens. If there are governance rights associated with a token, and a central group or a central entity can always decide the outcome, then that would indicate centralization as well.

Mr. LOUDERMILK. Okay. Thank you for that.

Mr. Kaplan, your company recently received the first-ever approval as a Special Purpose Broker-Dealer (SPBD) for digital assets. Since then, you have publicly proclaimed that there is obviously a way forward for crypto in the United States. However, while your company was approved, most of your would-be competitors are still waiting for their approval.

You have already begun discussing Prometheum as an, "SEC-registered platform," even though, respectfully, your firm does not command the same recognition as countless other platforms that are more familiar to consumers.

It seems that you are keenly anticipating the increase in market share that will come with SPBD approval. Given that you are the

only SPBD for digital assets around, do you really think experience can speak for market participants as a whole?

Mr. KAPLAN. I do think it can. Previously, they were frameworks for the compliant trading and custody of digital assets under the securities laws. But until someone was approved, you can argue that there was no pathway forward, that there was no clear path.

But that argument is now moot, and essentially others, I believe, in the industry can follow that example of compliance under the securities laws, and understand that there can be success at the end of that endeavor and basically put those practices into place in order to achieve compliance.

Mr. LOUDERMILK. Okay. In your written statement for this hearing you claimed that it was clear that a joint development agreement with Shanghai, if I pronounce this right, the Wanxiang Blockchain, a company that has known ties to the Chinese Communist Party, was not viable as early as December of 2018.

You also claimed that after that realization, you began independently developing your platform. However, in June of 2021 SEC filings, you claimed that you were still conducting development activities with these Chinese strategic partners. If you realized you needed to stop working with them in 2019, why did it take you until October or November 2021 to formally terminate the agreement?

Mr. KAPLAN. I would have to check the exact statement, sir, but my understanding is that the investment occurs at the end of 2018 and maybe early 2019 and, therefore, the year time period thereafter is not in 2019, in my understanding.

Mr. LOUDERMILK. Okay. As you know, an alternative trading system cannot facilitate trading for unregistered securities unless they have a valid exemption. To date, how many tokens have received these exemptions and how many of these are major tokens?

Mr. KAPLAN. I believe a significant number of the top 50 market cap tokens have gone the exceptive route.

Mr. LOUDERMILK. Okay.

Mr. Chairman, I see that I am running out of time, so I will submit my remaining questions for the record, and I yield back.

Mr. HILL. The gentleman yields back.

The gentlewoman from Massachusetts, Ms. Pressley, is recognized for 5 minutes.

Ms. PRESSLEY. Thank you. This hearing is billed as a chance to make progress on cryptocurrency but I would like to know, progress for whom? In my opinion, Congress should not be doing the work of wealthy investors in advancing toothless and feeble legislation that can make the problem of an unregulated crypto industry worse.

Mr. Kaplan, can you give an estimate of approximately how many cryptocurrencies exist?

Mr. KAPLAN. Thousands.

Ms. PRESSLEY. Okay. According to a recent Forbes article, there are over 22,000, and many more are bound to be created. While there are differences among them, crypto tokens do share similarities. For example, cryptocurrency generally has a low barrier to entry. If someone has a smart phone, they can simply download an app, connect a bank account, and become a crypto investor. This

helps explain why cryptocurrency has become so popular, because it is so accessible.

While a lot of folks want to highlight the innovation and opportunity that crypto offers, I am laser-focused on making sure that the innovation and opportunity does not come at the expense of financial ruin for those who do not have MBAs or Wall Street experience or generational wealth to invest.

Data shows that low-income Black and Latino adults invest in crypto at higher rates than White adults.

Mr. Kaplan, for years experts have warned of bad actors in the crypto market. Do you agree a seemingly normal crypto investment can really be nothing more than a scam?

Mr. KAPLAN. I think that a lot of platforms utilize the advantages of the internet with the association of innovation in order to democratize scams to the general public because they were not properly regulated and did not have proper disclosures and often had nefarious—

Ms. PRESSLEY. Reclaiming my time, I will take that as a, yes.

Mr. KAPLAN. Yes, ma'am.

Ms. PRESSLEY. Okay. Congress has learned important lessons on how to regulate our economy and complex investments to protect investors from scams. When regulating something as high-risk and volatile as cryptocurrency, we should be comprehensive, not restrained. Public disclosure which clearly establishes investor rights, and stringent administrative oversight are critical aspects of our securities laws but they are overwhelmingly lacking in proposals put forth by my colleagues across the aisle.

Comprehensive regulation matters. Just look at the recent economic turmoil. When FTX crashed late last year, billions of dollars, not millions, not thousands, but billions of dollars were lost, and earlier this year, Signature Bank, which had deep ties to the crypto industry, collapsed, putting more than \$100 billion at risk.

In order to protect investors in crypto, it simply does not make sense to start from scratch or create a weak regulatory system. We need to use best practices and further empower the SEC and Federal watchdogs to oversee this industry. If we don't, the consequences can certainly go far beyond crypto.

Mr. Kaplan, in your opinion, if there is a loophole created where non-crypto firms could take advantage of lax regulation on a secondary market to sell stock under the guise of blockchain, would they do it? Yes or no?

Mr. KAPLAN. I anticipate they would.

Ms. PRESSLEY. Okay. So if Congress is going to regulate cryptocurrency, we must make sure the solution is not worse than the problem. Thank you. I yield back.

Mr. HILL. I now recognize the gentleman from Ohio, Mr. Davidson, who is also the Vice Chair of our Digital Assets Subcommittee and the Chair of our Housing Subcommittee, for 5 minutes.

Mr. DAVIDSON. Thank you, Mr. Chairman. Thank you to our witnesses, and I am excited, because it took a long time to get to this hearing. It has taken a long time to get to draft text and I wish everyone could understand all of the legislation. We can explain it to everybody, but we can't understand it for everybody. But I appreciate that so much innovation is happening in our country. I

hope we can keep some of it here and that we can get this legislation done.

I have had bipartisan legislation on this subject since 2018, the Token Taxonomy Act. It has been fully bipartisan for years, and I just think how many of the calamities that people point to could have been prevented or solved if we had done our job as Congress and provided legal clarity.

Mr. GARRISON, there is a saying that beauty is in the eye of the beholder. But should whether something is a security or not be in the eye of the beholder or should it be pretty clear to everybody that this is a security, and that is not?

Mr. GARRISON. It should be very clear and that would provide certainty that would allow businesses to operate and investors to do so in a protected manner.

Mr. DAVIDSON. And I think the point of a bright-line test is incredibly important and it should be clear for the investors, for the innovators, it should be clear for the regulators, too, and even SEC Chairman Gensler can't decide, after all this time, whether or not it is a security. We just had him here in April for hearings, and he couldn't answer the question.

So if the existing framework and existing laws are fully adequate, why can't the Chair of the SEC answer that? It will tell you it is not clear enough, and we spend a lot of time here talking about how things could be treated as not securities. But could it be that somebody wants to create a token that does represent a security?

Mr. GARRISON. Yes, and that does occur today.

Mr. DAVIDSON. Right. So, when you think about the framework that we are putting together, even if, in the cases, oh, with the existing law, you could possibly find a way to do it, couldn't we create a market structure that would be more clear for everybody? How would you register a token and make it a security and be fully regulated as a security?

Mr. GARRISON. Absolutely. There is nothing preventing the SEC from updating the regulations to allow for tokenized equity securities or stock or bonds.

Mr. DAVIDSON. Yes. I would add there is nothing preventing Congress from doing that either, so one of the things that we talk about is the importance of self-custody.

Dr. Sirer, some of your observations that you have made include that privacy is an important protection, but when you look at the people who looked at FTX, there was clear fraud. The people who had self-custody used the platform to be able to conduct a transaction. Then, they offloaded the custody of that. They were protected. So, could you highlight how important self-custody is?

Mr. SIRER. Absolutely. The failure of FTX was a failure not of crypto but of traditional custodians, and the decentralized exchanges that performed much of the same functionality as FTX did not fail and in fact survived quite well through market up and downs.

Mr. DAVIDSON. Thank you. I think it is just incredibly important that we protect self-custody. The Keep Your Coins Act does that, and I hope that we can get to that kind of principle in both the stablecoin bill and the market structure bill.

I want to get to stablecoins, but I think it is important to address something Mr. Himes said.

Mr. Sexton, the commingling limitations, I don't think he actually applied correctly, because there are, in current law due to Dodd-Frank, differences in how we treat futures versus swaps in terms of funds; you can't commingle with house funds but you can commingle with the funds of customers. When you think about legally separate operating commingling frameworks provided for swaps under Dodd-Frank, would you please explain how that works?

Mr. SEXTON. There are different frameworks with regard to assets and the protections of those assets with regard to swaps and the segregation accounts that we have in the futures world.

So, it is very complex. It is pursuant to the CFTC's regulations, and when you have a customer segregated account on the futures side, generally, we say that you cannot commingle the house. But the house could top that off with sufficient funds to have excess funds in that segregated account also to make sure that they at all times have sufficient funds to pay off liabilities to customers.

Mr. DAVIDSON. Yes. That is existing law; it is not like this is some loophole that creates some exception. It is just meant to capture the existing law and existing framework.

And as much as I would love to get to the stablecoin market and the importance of it, I will have to submit some questions for the record on that.

My time has expired, and I thank you all.

Mr. HILL. The gentleman's time has expired. I appreciate that.

The gentlewoman from Texas, Ms. Garcia, is now recognized for 5 minutes.

Ms. GARCIA. Thank you, Mr. Chairman, and thanks to all the witnesses who are here today.

As we all know, then-Chairwoman Waters led meaningful, productive, and truly bipartisan negotiations on stablecoin legislation last Congress. I would like to start by highlighting my frustration with the stripping of some very important provisions from those earlier negotiations, working against the bipartisan progress that then-Chairwoman Waters and other Members of Congress worked on last year.

With that said, I am relieved that some of the more-radical proposals by my Republican colleagues were not offered and are no longer in play, and I hope that this hearing can lead to a productive discussion on this very important issue.

I was just discussing with the ranking member when we all got started, what, now 3 years ago, maybe 4, that this has been a long journey, and it is great that we are here today to hopefully put a ribbon on the whole thing.

Mr. Kaplan, I would like to begin by asking you about an issue that I have been engaged on for a long time and have some very strong concerns about. The Democratic compromise draft of the stablecoin bill includes language preserving the separation of banking and commerce, which protects from unhealthy consolidation of economic power.

In simpler terms, it would prohibit non-financial commercial businesses like Facebook or Wal-Mart from owning a payment

stablecoin issuer, which would ultimately prevent massive private companies from being able to control even more of their consumers' lives.

In the 116th Congress, I introduced a bill to address exactly this problem because I believe that allowing private companies to be stablecoin issuers is very dangerous. This protection, however, is notably absent from the bill that the Republicans are proposing today.

Mr. Kaplan, can you please highlight the kinds of customer harm that could come from huge companies issuing their own coins? Why is this separation important?

Mr. KAPLAN. The potential for conflicts of interest when a company has both commercial and financial interests both offered to the same customers is significant. Furthermore, the systemic risk and potential contagion risk associated with an entity that has a stablecoin is significant. The potential implications of a stablecoin losing its peg could have knock-on effects and contagion risks that would affect the larger financial market, and it is essential that we hold those who are issuing stablecoins to the highest standards and that we properly segregate those activities from other business activities.

Ms. GARCIA. Thank you.

In carrying on with important provisions that the Republicans stripped from Chairwoman Waters' version of this bill, I would like to touch on the importance of diversity and financial inclusion in the crypto space, which this bill fails to even mention. This nation has a long history of building financial institutions and systems that are accessible and exciting for the wealthy and mostly White consumer, and inaccessible and exclusionary for everyone else.

This nation continues to deal with credit inequity, lending inequity, banking inequity, and financial literacy inequity, and as was clearly pointed out by my colleague and friend from Houston, there is also witness inequity.

And still, in front of our eyes, it appears that we are repeating our mistakes of the past and building a financial system that only makes the rich and privileged richer and more privileged.

Mr. Kaplan, can you please speak about the importance of building financial inclusion language into regulatory legislation?

Mr. KAPLAN. It is essential for any industry to make sure that it is able to be afforded and available to all segments of society, and as such, it is important that there is diversity and inclusion.

Ms. GARCIA. Can you give us an example of what you think we need to add to make sure that happens within this legislation?

Mr. KAPLAN. I don't have a specific example off the top of my head. I think that it is essential that there is a mention such that the policy of diversity and inclusion is made sure to be understood and integrated into the crypto industry and the larger financial industry as a whole.

Ms. GARCIA. Thank you. How can crypto-based companies work to better include low-income and minority communities in the crypto space? How can they best reap the benefits of a functional, well-regulated crypto industry for which we are all striving?

Again, Mr. Kaplan?

Mr. KAPLAN. What we saw with FTX and the like was that they used the internet under the guise of innovation in a speculative new investment instrument in order to basically allow the general public and certain segments of society on——

Mr. HILL. The gentlewoman's time has expired.

I recommend that the witness expand on his answer in writing. And I now turn to the gentleman from Tennessee, Mr. Rose, for 5 minutes.

Mr. ROSE. Thank you, Mr. Chairman, and thanks to our witnesses for taking the time to be with us today.

I want to dive right in. The Democratic talking point that Chair Gensler's approval of this one Special Purpose Broker-Dealer license does not mean that the current system is working. Why? Because an alternative trading system (ATS) cannot facilitate trading for any unregistered securities not offered under a valid exemption.

Additionally, Chair Gensler, and the Democrats, and apparently, Mr. Kaplan, allege that nearly all tokens are unregistered securities. This approval does nothing for retail investors and the general public.

Mr. Garrison, isn't it correct that there currently aren't any registered digital asset securities with real customer demand and liquidity? For example, can an ATS offer Solana or Cardano, which the SEC has recently alleged are unregistered securities, to retail non-accredited investors on its ATS today?

Mr. GARRISON. No, they cannot.

Mr. ROSE. And, Mr. Garrison, would the outcome be different under the market structure legislation that we have coming forward?

Mr. GARRISON. Yes. The legislation would allow an ATS to list and trade structured digital assets alongside payment stablecoins, alongside digital commodities. Each of those would be regulated under different regimes but an ATS regulated by the SEC would allow all those products to trade.

Mr. ROSE. Thank you.

Mr. Garrison, can an ATS currently offer both digital asset securities and digital asset commodities alongside each other on the same platform for retail trading?

Mr. GARRISON. No, they cannot.

Mr. ROSE. And would the outcome be different under the market structure legislation?

Mr. GARRISON. Yes, it would be.

Mr. ROSE. Thank you.

Mr. Garrison, Prometheus has been approved to custody digital assets under a Special Purpose Broker-Dealer framework that the SEC issued in 2020. Under current law, digital assets may be classified as securities or commodities.

Can a Special Purpose Broker-Dealer custody both digital asset securities and digital asset commodities on behalf of retail investors?

Mr. GARRISON. No.

Mr. ROSE. Mr. Garrison, given this fact, what impact, if any, does the SEC's approval of this Special Purpose Broker-Dealer license have on retail traders?

Mr. GARRISON. Not a significant impact.

Mr. ROSE. And, Mr. Garrison, the SEC has indicated that they expect digital assets to be registered by a promoter or, “a promoter sponsor or other third party,” that, “provides essential managerial efforts that affect the success of the enterprise.”

The problem is that certain digital assets are open source peer-to-peer digital currencies that are transferred through a decentralized public ledger that is maintained by a network of computers operated by individuals who, apart from possibly transferring digital assets to one another at some point in their lives, may never interact.

Take Dogecoin. Mr. Garrison, who exactly is the SEC expecting would come in and register Dogecoin?

Mr. GARRISON. I do not know.

Mr. ROSE. Mr. Garrison, in 2021 SEC Chair Gensler said regarding the regulation of digital assets, “There are some gaps in this space. We need additional congressional authorities to prevent transactions, products, and platforms from falling between regulatory cracks.”

He now says the securities laws are clear, that he doesn’t need additional authority from Congress.

Mr. Garrison, do you agree with Chair Gensler version one, whom we might call, “Dr. Jekyll,” that he needs more authority from Congress to regulate crypto?

Or do you agree with Chair Gensler version two, “Mr. Hyde,” that the Federal securities laws are 100 percent clear and no relief is necessary to regulate digital assets, securities, and crypto platforms seeking to support them?

Mr. GARRISON. I am not sure that I agree with either version. I believe the SEC has the authority to regulate digital assets that are sold pursuant to investment contracts in a clearer way than they have. But I do also disagree that the securities laws’ application to the sale of digital assets is certainly not clear.

Mr. ROSE. And shifting gears, Mr. Allaire, given the Federal Reserve’s incompetence during the most-recent turmoil in the banking sector, are you confident that they will be able to regulate stablecoin issuers under this bill?

Mr. ALLAIRE. Thank you for the question, Congressman Rose. I believe that the bill does a very good job of very clearly establishing the core standards that are important for a stablecoin to function, so I believe Congress is doing its job in identifying that and——

Mr. HILL. The gentleman’s time has expired.

Mr. ROSE. Thank you. I yield back.

Mr. HILL. The Chair now recognizes the gentleman from New York, Mr. Torres, for 5 minutes.

Mr. TORRES. Thank you, Mr. Chairman.

Before we get to the substantive question of what to do with crypto, we as a country have to answer a more fundamental question: Who among us should get to decide the future of emerging technologies like crypto and blockchain? Should it be Chair Gary Gensler, an unelected bureaucrat who answers only to himself, or should it be the United States Congress, whose Members are elected by and therefore accountable to the people?

Mr. Allaire, do you believe as I do that an Act of Congress would be the most-democratic means by which to decide the future of digital assets?

Mr. ALLAIRE. Thank you for the question, Congressman Torres.

I do agree, and in fact, the Presidential Working Group specifically asked Congress to act urgently on this matter over a year-and-a-half ago. So, I believe it is critical that Congress does take control here.

Mr. TORRES. There are crypto companies like Circle that strive to be compliant with the law, and then there are crypto companies that seem intent on willfully evading the law. And, yet, Chair Gensler appears to see no difference at all between the two. He treats them all as one and the same. His enforcement has been indiscriminant in nature, which brings me to the lawsuit against Coinbase.

Mr. Garrison, if the SEC sincerely thought that Coinbase was operating an unregistered securities exchange, then why on earth would the SEC approve Coinbase as a public company?

Why would the SEC not, at a minimum, require Coinbase to disclose its status as an unregistered securities exchange as a material risk to the investing public? Do you see a contradiction between the SEC's 2021 approval of Coinbase as a public company and the 2023 enforcement action against Coinbase?

Mr. GARRISON. I do see a contradiction. As part of the filing review process, making a filing effective under the securities rules requires a public interest finding. Typically, a public interest finding is a very loosely defined term but you might argue that an act by the company that is inconsistent with securities laws might be not in the public interest.

Mr. TORRES. And I want to interject. The SEC made the following statement in the Coinbase lawsuit. It said that declaring effective a Form S-1 registration statement does not constitute an SEC staff opinion on endorsement of the legality of an issue as underlying business. When it comes to S-1 registration, the SEC is asserting that it has no opinion on whether an issuer is complying with the very laws that the SEC is charged with enforcing.

That strikes me as strange. It is almost as if, suppose the SEC would approve the Mafia as a public company, and then say, but we have no opinion on the underlying legality of the business. As a lay person, that just strikes me as absurd. So, am I missing something or—

Mr. GARRISON. No, I think that is where the public interest finding comes in, and I think perhaps the other side of that coin is that—

Mr. TORRES. No pun intended, right?

Mr. GARRISON. —you don't want the SEC to take responsibility for what is in any filing, which is what I think some of that language is getting at as well.

Mr. TORRES. In an interview with New York Magazine, Chair Gensler said that everything but Bitcoin is a security. Of the more than 200 listings on the Coinbase exchange, the SEC lawsuit only identifies 13 as unregistered securities, and 13 out of more than 200 seems to contradict the Gensler doctrine that everything but Bitcoin is a security.

Do you see a contradiction there?

Mr. GARRISON. Yes. It would be nice to have clearer insights into what tokens, what digital assets the SEC believes are securities instead of seeing them piecemeal through enforcement actions.

Mr. TORRES. The digital market structure discussion draft provides for a safe harbor and I see the need for a safe harbor that protects good-faith crypto companies from arbitrary and capricious enforcement actions.

But what about bad-faith crypto companies? How do we prevent bad-faith crypto companies from exploiting the safe harbor to prevent legitimate enforcement actions?

Mr. GARRISON. Included in the market structure bill are the typical anti-fraud protections that exist in both the securities and commodities laws. So whether a digital asset is sold through the new SEC exemption, the SEC's robust anti-fraud authority would also apply there, and on the CFTC side, if a digital commodity was sold or manipulated in a fraudulent way, the anti-fraud provisions of the Commodity Exchange Act would apply as well.

Mr. TORRES. And then, a quick question about the applicability of securities law to secondary market transactions. Has there ever been a single statute or a single rule or regulation or a single court case that expressly affirms that the Howey Test applies to secondary market transactions?

Mr. GARRISON. No.

Mr. TORRES. Are you sure?

Mr. GARRISON. To the best of my knowledge, yes.

Mr. TORRES. Are you positive?

Okay. My time has expired.

Mr. HILL. The gentleman's time has expired. As you can see, there is a vote on the House Floor. It is the Chair's intention to continue until there are approximately 200 on the non-voting screen. We will then recess and reconvene immediately after votes.

I now recognize the gentleman from South Carolina, Mr. Timmons, for 5 minutes.

Mr. TIMMONS. Thank you, Mr. Chairman.

Mr. Garrison, getting back to the exemption that Congresswoman Wagner covered earlier, the new exemption in the bill allows participation of non-accredited investors in primary issuances of digital assets.

You started talking about the protections that the market structure bill provides for retail investors in primary offerings. The exemption as I read it provides that a non-accredited investor is permitted over a 12-month period to purchase digital assets issued in a primary sale that equal 5 percent of the person's net worth or 5 percent of their annual income. Rough math—for a person with \$990,000 of net worth or \$190,000 in annual income would be \$49,000 or \$9,500 of annual investment, depending which is greater.

My question is, in your view, is the exemption as laid out in the discussion draft a good balance of retail investor access to this new asset class and traditional consumer protections?

Mr. GARRISON. I believe it is a good balance. Personally, I am opposed to individual limitations on investments generally, but I recognize that reasonable people can disagree on that, and I think this

approach in the market structure bill really borrows from Regulation Crowdfunding, which has these individual investor limits, as does Regulation A, and I think that has proven to be a protection that can be valuable in these exemptions.

Mr. TIMMONS. Thank you for that. A common way for a project to distribute digital assets to its users is through broad distributions in order to support the development of its network.

Mr. Garrison, again, how does this proposed legislation treat digital assets distributed in this manner and why does this treatment more accurately correspond to how the digital asset markets operate?

Mr. GARRISON. Sure. The market structure bill acknowledges that some digital assets are created through the normal functioning of the network itself, whether that is through a validating transaction or staking or anything like that, and it just makes clear that the securities laws are not needed to protect those activities. Those activities are separate. They are not securities transactions. And it more clearly separates the transactions that are in need of consumer investor protections from those that are not in need.

Mr. TIMMONS. Thank you for that.

Mr. Garrison, again, in the proposed legislation there are tests for decentralization in functionality of the blockchain network. Would you share your views on this construct in the legislation?

Mr. GARRISON. Yes. I think this is a really great first effort in trying to put a construct around how decentralization can occur. It is an issue that has really been difficult for those in the industry to come to terms with because there are no third-party standards that we can look at to say, this is how networks are decentralized.

For example, when I worked for SEC Commissioner Peirce, and she created her token safe harbor proposals, there were a lot of ideas in there of, how do you show decentralization, and a lot of different ideas came to the foreground. Some of them include looking at the ownership of the tokens of the network, are they concentrated in any one particular group or not?

Another is just the functionality of the network, who is contributing to the code. I think in the early days of a lot of networks, you see some key contributors that are responsible or perhaps have a key they can write and change code as needed on an emergency basis.

Over time, those things typically go away. Those are good indicators of decentralization. What is the number of participants in the network, both end users of validators, miners, whatever the protocol may be?

There are a lot of different factors you can consider, and I think this bill does a good job of really drilling down and saying, what are the key ones that matter, and it really keeps coming back to this idea of unilateral control: Does a person or a group of persons have control over this network.

Mr. TIMMONS. Thank you. One last question, Mr. Garrison. Some have alleged that the proposed legislation creates light touch regulation for digital assets. However, the bill seeks to apply the same rules for current SEC- and CFTC-registered intermediaries with adjustments as needed for the unique characteristics of digital assets.

In some instances, the requirements of digital asset firms are more onerous than traditional intermediaries. Would you discuss how the bill applies equal or stronger standards to digital asset firms?

Mr. GARRISON. The bill brings digital assets into the SEC- and CFTC-regulated universes. Currently, digital asset transactions are not covered here, so the SEC would oversee the initial issuance in certain situations through the new exemption, and the SEC would also oversee normal securities trade through ATSS. So, all of the protections from an ATS would also apply here.

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

Mr. HILL. The gentleman yields back.

It is a pleasure to recognize the gentleman from Illinois, Dr. Foster, for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman, and thank you to our witnesses.

I would like to start with what I consider the two foundational questions in this that are not, I don't believe, really addressed in this draft.

The first one is to answer the simple question, if we wish to prevent ransomware and all kinds of illicit activities, is there any way to do that if we allow self-custody of assets or is it pretty much a binary thing? Either we are going to allow self-custody and live in a world with ransomware and so on or not. Is there any alternative to that third path?

Mr. SIRER. Congressman, it is entirely possible to control these systems at the ingress and egress points. So, it is entirely possible to preserve self-custody and all the benefits that come with it.

Mr. FOSTER. But how does that work actually? If you go and take your dollars and you put them into the systems you are developing, then they go off and become self-custody. They are used for human trafficking or you name it, ransomware, you name it, and then someone comes back after having passed this through anonymous currencies that are better than Bitcoin for avoiding truly anonymous alternatives that are being developed and actually exist to some degree today, and then they pass it through these anonymizing techniques, and then they present something that has been self-custodied to your system.

It seems like you are just the last leg in a complicated money laundering scheme, and tell me why that is not really technically the case?

Mr. SIRER. That is technically not the case because the sets of tools we have for tracking and tracing money flows are incredibly sophisticated. Chainalysis and TRM Labs-type companies are quite able to trace even those anonymizing transactions and trace the flow of funds. If you look at the recoveries that law enforcement has done in recent years with the aid of these increasing—

Mr. FOSTER. Yes, but those are Bitcoin-type things that they are tracking. And you rapidly get into declassified discussions in briefings that I have had on this.

But a bunch of smart people are working very hard and effectively to really make these anonymous. I think they are more likely to succeed than the mouse is likely to not survive the cat in this case. And I don't think that today, you can guarantee that won't

be the case, so I think that's the first thing, and we should continue this technical discussion offline.

The second thing is that if we wish to prevent market abuses, things like front-running or wash trades, there are estimates that more than half of all Bitcoin transactions are actually wash trades, for example.

If we wish to prevent that, is there any alternative to having some regulator somewhere that sees the true identity behind the participants on both sides of every trade? How do you prevent wash trades if there is not such a regulator somewhere?

Mr. SEXTON. How this has been handled with the Trader ID mechanism and the like?

Mr. SEXTON. It has, and it is key that if you are going to prevent those types of trading abuses, you have to know who is on both sides of a trade.

Mr. FOSTER. A trusted regulator must know, must be able to see who is on both sides of the trade?

Mr. SEXTON. Correct.

Mr. FOSTER. Right. The traders don't need to know who is on the other side. In fact, it is not good for them to know who is on the other side in the typical instance.

But when you see something that looks abusive, you have to go and, first off, know who the people are, and you also have to make sure that the Trader ID is, for example, biometrically, so you don't have one person operating multiple Trader IDs. That is a major no-no in your industry.

Mr. SEXTON. If you bring this into a regulated environment under the National Futures Association (NFA) and the CFTC intermediaries need to know who their customers are, and if you have exchanges or trading platforms, they need to know who is going to be on the opposite side of those trades. That is the bedrock of the regulated environment that we have today under the CFTC.

Mr. FOSTER. Yes. But if you have, for example, the ability to make derivative bets and have a spot market over here, a regulator has to see the True IDs of both the spot market participants and everyone who is making derivative bets on the basis of those spot prices. It seems as though this is something that spans the current jurisdictions of the SEC and the CFTC.

Mr. SEXTON. You have to have cooperation between regulators so that they know what a market user is doing in both the spot markets and in the futures markets.

Mr. FOSTER. Right, and this actually has to work internationally if you are talking about crypto assets that are traded internationally as well. So, it is an even more complicated thing. You have some sort of solution internationally in the options market.

Mr. SEXTON. International cooperation is also essential.

Mr. STEIL. [presiding]. The gentleman's time has expired. The witness can provide additional comments in writing for the record. I now recognize myself for 5 minutes for questions.

Mr. Garrison, I want to follow up on Congressman Emmer's comments earlier. According to SEC Commissioner Hester Peirce, a digital asset may be offered and sold initially as a security because it is wrapped in a transaction involving an investment contract.

But the asset may later be emphasized and sold outside of an investment contract.

I think a key point is to think about how our legislation should categorize different types of digital assets regardless of their classification when first issued.

Can you elaborate on this principle and then comment on how the proposed legislation addresses this?

Mr. GARRISON. A digital asset, when it is sold pursuant to an investment contract, does not constitute the security. Under the *Howey* Test and 77 years of case law, courts have come up with an analysis to determine when a transaction contract or scheme may be sold in a manner that is, in fact, a securities transaction.

This is very different than the test for what is an equity security, what is a stock, what is a bond, and the case law makes it quite clear that the object of the investment contract, whether it be the orange groves in the original *Howey* case or there are some fun exotic cases about chinchillas and whiskey receipts.

The chinchillas themselves are not securities, so in applying that logic to the digital asset space, the distinction becomes even more important as one learns more about digital assets and understands why one holds a digital asset to operate or to function and participate on a network, and once those functionalities are realized for the digital asset, you start to realize that there is no actual central party that maybe was making promises at the time of the initial sale for fundraising but later in time a fully decentralized functioning network.

There is no central party. There is no one that would be the equivalent of an issuer in a securities offering.

Mr. STEIL. Thank you for providing that distinction. Let me shift gears to you, if I can, Mr. Kaplan. There is a little bit of confusion around the circumstances and disclosures associated with Prometheus, their filings for the alternative trading system and Special Purpose Broker-Dealers.

In your testimony, you noted that you terminated all co-development work and strategic relationships with your Chinese affiliate in late 2021. When did Prometheus take full control of the product development?

Mr. KAPLAN. Prometheus realized that its endeavors with Wanxiang were not going to bear fruit, and that, in conjunction with the ongoing decoupling that was occurring in the larger geopolitical sphere, led to the decision to terminate that relationship. I believe the termination agreement is October 2021.

Mr. STEIL. October 2021. Thank you.

Did the SEC or FINRA at any point raise a concern about the relationship between Prometheus and the Chinese firm?

Mr. KAPLAN. We had both a CFIUS inquiry and an SEC investigation where we were required to submit all communications with any foreign entity for review to the SEC, and basically, we were told that after a period of time, the SEC closed the investigation.

Mr. STEIL. Thank you.

Has Prometheus ever had to adjust its policies and procedures at the request of HashKey or representatives of the Chinese government?

Mr. KAPLAN. No.

Mr. STEIL. Okay. I appreciate your testimony there. I want to just echo the concerns raised by some of my colleagues. Our regulators have done everything in their power to push digital asset business overseas. They seem to be quite comfortable giving a stamp of approval to a firm with the relationships back to China.

To me, this underscores the need for clarity and consistent regulation in the industry structure. Cognizant of my time, I am going to come back to you if I can, Mr. Garrison, just for a second.

Mr. Rose brought this up a little bit, but I think it is worth hitting the point home before we go into recess. There has been some hyperbole in particular about how the bill is described. Do the modifications upend securities law, as some have suggested?

Mr. GARRISON. No, it does not. It borrows from existing provisions and securities laws.

Mr. STEIL. Okay. And I have 40 seconds, so I am going to jump back to Mr. Allaire.

Stablecoin legislation attached to this gives the Fed a backstop authority over State-chartered payment stablecoin issuers. Can you describe why the backstop is important and what the Fed can and can't do with it?

Mr. ALLAIRE. Thank you for the question, Congressman Steil.

I think it is critical. I think the first is really the fundamental standards around what can be in reserves, the reporting and disclosure requirements, the need to separate these assets. Those are part of that kind of Federal framework.

Additionally, setting standards under Section 4 around capital adequacy, risk management, safety and soundness, and others they can, obviously, also enforce against those.

Mr. STEIL. Thank you.

Cognizant of the time, and cognizant that we are now under 200 votes, pursuant to the Chair's previous announcement, the committee will stand in recess until the conclusion of votes.

[recess]

Mr. FLOOD. [presiding]. The committee will come to order. The Chair now recognizes Mr. Nickel for 5 minutes.

Mr. NICKEL. Thank you so much to our chairman and ranking member. Thank you so much, Congressman Flood, as well, for being here today, and thank you to our witnesses. I know it has been quite a long day, so thanks for joining us.

I am happy with the progress our committee is making on stablecoin legislation. The most recent draft includes many of my suggestions like protecting State regulators, adding consumer protections, and ensuring banks can safely hold digital assets in their custody.

I hope that we can all come together and put politics aside and reach bipartisan agreement on this legislation. Not only is passing a stablecoin bill essential to protecting consumers and encouraging innovation, but it is also vital to providing much-needed regulatory clarity.

The SEC's regulation by enforcement, which we have seen ramp up in the last week, is going to send digital asset companies offshore to places like the Bahamas, where Americans will have no protections. Additionally, as I have said before, stablecoin legislation can reinforce the dominance of the U.S. dollar as the global re-

serve currency, all while making it stronger, more accessible, and more competitive.

Mr. Allaire, my first question to you. Can you please describe the privilege the U.S. is afforded because the dollar is the dominant global reserve currency?

Mr. ALLAIRE. Thank you for the question, Congressman Nickel. As is often referenced, the dollar presents the United States with an exorbitant privilege, and that is in many forms, I think that privilege is around low borrowing costs for the government, for households, and for businesses. I think strong preference in commerce and trade internationally helps grow opportunities for people and businesses here, as well as the execution of soft power around the world. And in an environment today, where that is being challenged, it is more important than ever that the U.S. make every effort to strengthen dollar competitiveness, and I would agree with you that the stablecoin bill is a significant step towards increasing dollar competitiveness.

Mr. NICKEL. Thanks so much. And in your testimony you said, "Currency competition is real and is increasingly defined by technological competition. Perhaps, no nation understands this better than China."

Mr. Allaire, as we are designing stablecoin legislation, how should we think about currency competition? Would the most-recent draft of the stablecoin bill ensure that the U.S. dollar remains competitive, safe, and accessible?

Mr. ALLAIRE. I think it would be a huge step forward in that. The United States competes with highly competitive technology companies, financial companies, and open, free, and fair markets in a rules-based system. That has served us incredibly well in the development of the internet. It has served us incredibly well in the realm of payment technology innovation. And I think for an innovation like stablecoins, it can also be the leader globally.

Critically, stablecoin legislation, as currently submitted to the committee, does, in fact, create, I believe, the safest digital dollar in the world. It creates a mechanism to ensure that there is a competitive market for the issuance of that by banks and nonbanks, and that those firms can compete in that technological competition with constantly-upgradeable blockchain infrastructure and be competing with state-driven actors such as China.

Mr. NICKEL. Thanks so much.

Mr. Garrison, moving on to you, I would like to talk about the Majority's market structure bill, which I am still reviewing. I am encouraged to see that we are making progress, but I do have some concerns with this current version of the bill, which I understand is just a starting point. Whether you love crypto or hate crypto, you should support market structure legislation. It is what safeguards consumers while updating our securities laws to work with modern technological innovations. And frankly, burying our heads in the sand just is not an option here.

Mr. Garrison, can you please explain the dangers of congressional inaction on digital asset market structure? Specifically, how would consumers be harmed without clear regulations that encourage companies to remain here in the United States?

Mr. GARRISON. If the status quo were to continue, I think it would harm investors and consumers, it harms the participants in the digital asset ecosystem, and it ends up harming the U.S. economy. There is a lack of a Federal regulator over the spot markets for digital assets right now, as we speak, so anyone trading on a digital asset platform in the U.S. is at the mercy of the platform's own controls and procedures and processes and compliance with other laws——

Mr. FLOOD. The gentleman's time has expired.

Mr. NICKEL. I yield back.

Mr. FLOOD. Thank you, Mr. Nickel.

I now recognize myself for 5 minutes.

I would like to start by reading a question from a comment letter that Prometheus sent in response to the SEC's December 2020 Special Broker-Dealer Framework: "The definition of a digital asset security, as used in the proposal, is a digital asset that meets the definition of a security under the Federal securities laws. This definition puts a burden on the industry to determine which digital assets are securities. As a result, we believe that clarity is needed to understand the regulatory framework they must comply with."

That was in a letter dated April 26th, from Prometheus, specifically signed by Benjamin S. Kaplan, co-CEO of the company. I offer this into the record, without objection.

[This letter can be found as an appendix to the written testimony of Mr. Aaron Kaplan, on page 00 of the appendix.]

This concern, which Prometheus themselves raised in 2020, probably sounds familiar for those who track this committee closely. It is the exact same concern we have heard from witnesses in front of this committee before. Can a broker-dealer register if they do not know which assets are a security and which are not? Further, it makes the same argument that other firms have made, that the lack of clarity from the SEC puts an undue burden on the industry.

Mr. Kaplan, in your testimony you were very confident that no new legislation is needed in the digital asset space to clarify this question. What has changed between the date of this letter, in 2021, when your firm called for clarity, and now? What has changed?

Mr. KAPLAN. Over the 2-plus years since that time, there have been additional enforcement actions and statement by the SEC, which have clarified any questions that we had in regard to the designation of a digital asset as a security.

Mr. FLOOD. Mr. Kaplan, Prometheus's website says that Prometheus's ATS supports, "many tokens that mostly trade on crypto exchanges." I would like to dig in on that just a little bit. Can Prometheus customers trade in Ether? If your answer is yes, please explain how?

Mr. KAPLAN. Not currently.

Mr. FLOOD. Can Prometheus customers trade in Bitcoin? And if your answer is yes, please explain how.

Mr. KAPLAN. No.

Mr. FLOOD. Just for the audience at home's benefit, Ether and Bitcoin make up more than 60 percent of the digital asset market.

Mr. Kaplan, given that Ether and Bitcoin make up more than 60 percent of the digital asset market, if the current system is working, why can't your customers trade the most-popular and widely-used digital assets?

Mr. KAPLAN. Regulation and new ATSs and custodians should take a, "crawl, walk, run," approach, and essentially they will proceed to add additional assets and abilities as time goes on. I would like to point out when the——

Mr. FLOOD. I am going to reclaim my time. Mr. Kaplan, did Prometheus receive any additional exemptive relief from the SEC that has not been publicly shared?

Mr. KAPLAN. No.

Mr. FLOOD. Thank you, Mr. Kaplan.

Prometheus's Special Purpose Broker-Dealer license does not address the core issue. There is not a consistent definition of a digital asset security within current law. This point was made obvious when Chair Gensler could not say definitively whether Ether is a digital asset security, when asked by Chairman McHenry in this very room a couple of months ago. In other words, that same question that Prometheus themselves raised in their 2021 comment letter is still unanswered. That is why legislation is needed. That is the problem that the chairman's bill works to solve.

To testify in front of our committee that your company's charter, which only allows for trading in a very small subset of assets, is evidence that no legislation is needed just does not make sense. If anything, the fact that Prometheus's customers cannot trade some of the most-popular digital assets is an illustration of the broader problem, Mr. Kaplan.

I yield back.

With that, the gentleman from Iowa, Mr. Nunn, is recognized for 5 minutes.

Mr. NUNN. Thank you, Mr. Chairman, and I think we are well said on the rule of having clarity in this space, which is what Chairman McHenry is aiming to do.

I want to thank the Chair for the comments here. I sit on a second committee, the House Agriculture Committee, and it also has oversight of digital assets. I had the pleasure of talking with CFTC Chair Benham about his thoughts on market structure and what we are discussing today. His thoughts on this legislation were that a much-needed change was in order to give clarity to the digital asset ecosystem.

Right before CFTC Chairman Benham testified, however, we saw his counterpart, SEC Chair Gary Gensler, charge Coinbase with listing digital tokens he deemed to be securities. Chair Gensler went so far as to say that, "We do not need more digital currency. We already have digital currency. It is called the U.S. dollar. It is called the euro. It is called the yuan."

Let's make one thing very clear, that the rest of the world is already attuned to: Chair Gensler's blockchain innovation and technology is here to stay. It is thriving, and the U.S. market needs to be able to appreciate it. This lack of consensus among our Federal regulators, however, on the appropriate regulatory treatment of digital assets is what we need to discover and why we are here today.

The inconsistent treatment by Federal regulators underscores the urgent need for Congress to pave clear rules of the road for both market participants and investors. If Congress does not act, and lets Federal agencies continue to engage in territorial disputes and empire building, this will have a grave national impact, both on our trade as well as our national security.

From this sentiment, Europe, the UK, and Singapore have all marched out as leaders in this space. They have worked effectively within their jurisdiction. In fact, the Markets in Crypto-Assets Regulation (MiCA) is real. Venture capital investment in Europe in crypto projects is up to 1,000 percent in 1 year alone, investments that could have been happening in U.S. markets. To my home State of Iowa, these represent real tangibles. They are American jobs. They are future investment. To America, it means innovation that is fleeing offshore. That is why this legislation that the chairman has brought forward, I believe, is highly important.

Mr. Garrison, your former boss, SEC Commissioner Hester Peirce, explained how a digital asset may be offered as a sold initial security based on the initial transactions offered in, but the digital asset may later be offered outside this investment contract. You spoke with my colleague here earlier today. Highlight specifically how this proposed legislation would address that?

Mr. GARRISON. The market structure bill would address that by providing a clear exemption for issuers that would like to sell a digital asset pursuant to an investment contract. So if you want to build a network and sell the digital asset that is required for the network, this bill would allow an exempt transaction for up to \$75 million within a 12-month period. It would allow for individual investment limitations for non-accredited investors to purchase them. There would be robust disclosure requirements. The disclosure requirements would be tailored to the needs of token purchasers of digital asset purchasers. And it would place restrictions around activities that people want to engage in, in the U.S., but currently cannot.

Mr. NUNN. This would provide a clear framework. Absent this legislation, we would be like Coinbase, and have to come to Chairman Gensler on a, "come and register," approach, meaning that everyone would have no clear guidance but would have to go and have a sniff test done by the SEC, which at this point has been only punishing—no carrot, no incentive, no guidance. Is that correct?

Mr. GARRISON. Yes.

Mr. NUNN. Mr. Sexton, the proposed legislation that we have been discussing imposes significant consumer protections, requirements that all digital commodities intermediaries register with the CFTC would have to be met, most notably, the segregation of customer assets. What are your thoughts on customer protections provided for in this legislation?

Mr. SEXTON. Thank you for your question. The customer protections provided in this proposed legislation mirror the customer protections that have been in place for years with regard to the regulated futures markets. Customer assets, capital disclosures, Congressman, you can go down the list within the bill, but those have been in place for years.

Mr. NUNN. Would the NFA have the ability to implement these new standards for the CFTC?

Mr. SEXTON. We totally have that ability to work the CFTC to do so.

Mr. NUNN. So for the consumer, for the process, for the providers, and for the national security of the United States, this legislation makes very good sense.

Mr. FLOOD. The gentleman's time has expired.

Mr. NUNN. Mr. Chairman, I yield back.

Mr. FLOOD. The gentleman yields back.

The gentleman from South Carolina, Mr. Norman, is now recognized for 5 minutes.

Mr. NORMAN. I thank each of you for your testimony and for a long day, so I will be brief.

Mr. Kaplan, in your testimony you state that, "Prometheum provides Americans participating in the crypto Web3 space with the investor protections of the Federal securities laws." What assets do you plan to offer?

Mr. KAPLAN. Digital asset securities.

Mr. NORMAN. But you have a limited offering on that, do you not?

Mr. KAPLAN. I believe that a certain number of the top tokens qualify as digital asset securities.

Mr. NORMAN. What percentage?

Mr. KAPLAN. Thirty? Forty?

Mr. NORMAN. Which would be—

Mr. KAPLAN. Possibly a lot more. And as Chairman Gensler has said, the overwhelming majority of digital assets, arguably everything besides Bitcoin, is potentially a security.

Mr. NORMAN. But you would have a pick of 60 percent that would be not regulated under the—

Mr. KAPLAN. Those numbers are guesses, at best. I would have to look into it more deeply. It is my belief that almost every smart contract-based network token was issued with the intention to raise capital from the general public, with the intention of the investor to make money in the common enterprise from the efforts of that common enterprise.

Mr. NORMAN. I get that. I guess I just—your claims that you are providing investor protections really would not be all-inclusive, at all.

Now with your company, what bothers me about Prometheum is the Chinese 25-percent ownership. I think I heard when you were questioned by another Congressman that there is no Chinese investor with 25 percent that sits on your board. Is that right?

Mr. KAPLAN. There is no Chinese investor in our company that has 25 percent, sir. I said, 20 percent.

Mr. NORMAN. So, they have 20 percent.

Mr. KAPLAN. Correct.

Mr. NORMAN. Currently?

Mr. KAPLAN. Correct.

Mr. NORMAN. Is that not a problem for this country to open up the type of information that you would be giving? It shocked me that FINRA and the SEC approved this.

Mr. KAPLAN. Prometheus went through a series of SEC inquiries and CFIUS investigations. We changed our bylaws. We terminated any agreement. There is no code, nothing done from China that is involved in Prometheus in any capacity.

Mr. NORMAN. But they sit on your board, with a vote, that owns 20 percent.

Mr. KAPLAN. Sir, I believe there are many Chinese who sit on boards of certain companies in America.

Mr. NORMAN. I am talking about Prometheus, that just got approval from the SEC and from FINRA.

Mr. KAPLAN. And there was a full examination by CFIUS into our interactions, plus the SEC. We had to send all communications in to any foreign investor. Essentially, they examined everything we had previously done, and based on their examination, they thought it was okay. They closed that investigation.

Mr. NORMAN. Okay. Well, I doubt your claim is true. That would not qualify for protection from the Federal securities law that you are offering, with this type of an investment group.

Mr. GARRISON, you are, I think, an SEC alum?

Mr. GARRISON. Yes.

Mr. NORMAN. Are you aware of the bicameral bill that Senator Tillis has, and I think it is Senator Gillibrand, that prohibits Chinese entities from acquiring U.S. digital asset companies? You worked at the SEC. What is your opinion of this bill?

Mr. GARRISON. I am not familiar with that exact bill.

Mr. NORMAN. It stops Chinese companies from investing in Prometheus.

Mr. GARRISON. I believe the national security concerns should be taken into account in any digital asset legislation and regulation.

Mr. NORMAN. Do you agree with the bill or not? Is that something you would—

Mr. GARRISON. Yes, in general broad terms. Again, I have not read the bill. But yes, that is—

Mr. NORMAN. Okay. It just prohibits Chinese—

My time is about up, but if we do not realize now what China is doing to this country, and the information that is divulged, being on a board of the size of this company and the private information, for a company that is pretty much overtaking this country, or attempting to, I think it is a sad day in this country that this is what is happening. And the protections are not there, and you basically know it.

I yield back.

Mr. FLOOD. I would like to thank all of our witnesses for being here and for their testimony today.

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.

I will ask our witnesses to respond no later than July 10, 2023.

This hearing is adjourned.

[Whereas, at 6:46 p.m., the hearing was adjourned.]

A P P E N D I X

June 13, 2023

Written Statement of Jeremy Allaire
Before the United States House Committee on Financial Services,
"The Future of Digital Assets: Providing Clarity for the Digital Asset Ecosystem"
June 13, 2023

Chairman McHenry, Ranking Member Waters, and Members of the Committee, it is my honor to submit my testimony to you today.

My name is Jeremy Allaire, and I am the Co-Founder, Chairman and CEO of Circle, a leading global financial technology firm.

I come to the Committee having spent the past 30 years building important infrastructure on the internet. I have been both a principal in shaping technology development and a witness to the power of open networks, open software and competitive markets to transform how the world operates by building on the internet.

I co-founded Circle 10 years ago with the vision that digital currency could transform how value was exchanged, bringing to our global financial system many of the same benefits the internet has brought to software, media, communications and commerce. For Circle, the core of our day-to-day mission is expanding the role of the dollar on the internet. In pursuing that mission, we have embraced a regulatory-first path, becoming licensed and supervised by payments and banking supervisors in the US, Europe and Asia.

Five years ago our founding vision became a reality when we launched USD Coin, or USDC, one of the first regulated payment technologies for digital dollars on the internet. Now, several years later, USDC has grown to become one of the largest dollar-based digital currencies in the world and the largest US-domiciled and regulated dollar stablecoin. Circle has issued \$333B USDC since inception, and has redeemed \$305B. USDC powers thousands of applications that benefit from a blockchain-based digital dollar, and has handled over \$10 trillion in transactions. USDC is also the most transparent payment stablecoin in the world, backed by 100% liquid dollar-denominated assets that are subject to monthly independent attestations by major public accounting firms and published on our website since launch.

The Future of the Dollar

The demand for safe and secure dollars on the internet is real and growing. With the right regulatory framework, stablecoins and blockchain networks could scale to support billions of users and tens of trillions of dollars in payment activity. Indeed, advancements in blockchains are accelerating, and Web3 technology is widely viewed as strategic infrastructure for the future of the internet.

At the same time, it is a profound moment for the dollar in the world today. Rapidly evolving geo-economic and geo-political blocs are putting enormous pressure on the post-WWII

dollar-based global financial system. The dollar's share in global foreign reserves has been declining by about one percentage point every year on average for the past 8 years.

Alternative payment systems, often anchored in internet-based technologies, are also accelerating. Currency competition is real and is increasingly defined by technological competition, often with multiple compounding exponential technologies driving the velocity of change – 6G networks, quantum computing, blockchains and AI, as a few key examples. Perhaps no nation understands this better than China, which has created its own state-controlled, digital yuan, complete with embedded surveillance. Ultimately, there are designs for the yuan to compete with and erode the dominance of the dollar in the years ahead.

All eyes are on the US dollar, and the steps that the US government takes in the coming years will have a significant impact on dollar competitiveness in the decades that follow. Failing to take the appropriate steps could have devastating consequences for our country.

The dominance of the US dollar affords us what has long been described as an “exorbitant privilege” that has enabled Americans to benefit from low borrowing costs for our government, businesses, and households. Moreover, this dollar primacy allows the US to weather economic and financial shocks (as the dollar strengthens in times of crisis) and exert global influence far more than other countries.

As a nation, therefore, we need to ensure that the dollar is the most competitive currency on the internet, and that there can be universal access to the safest and most secure digital dollars possible. The stakes are simply too high to ignore.

Access to dollars is not only about America's economic competitiveness and international stature, but also about deepening the role of the dollar as a store of value and reliable medium of exchange in a global economy powered by smart devices and software. Digital dollars should freely and widely circulate on the internet for all lawful uses.

In order for that to happen, those digital dollars must be backed by the safest assets in the world. Full reserve money, backed by the highest quality liquid assets, and without embedded investment and lending risk, can provide the world with the safety and assurance needed to transact and exchange value without fears of bank runs or credit defaults.

Access and safety are cornerstones of keeping the dollar competitive. But at the heart of dollar competitiveness must be technological superiority, unleashing the innovation made possible by software and the internet, and open, free-market competition, which have been the drivers of American technology competitiveness for decades.

The Stablecoin Bill

We are here today to consider and discuss the merits of and issues with stablecoin legislation and the regulation of digital assets markets. The stablecoin bill is a crucial piece of legislation

that should be the first step in creating a regulatory framework that builds the conditions for a vibrant and safe digital assets market. It would also have significant ramifications that go far beyond the digital assets market to the global role of the US dollar. The stablecoin bill would enable dollar access, safety and competitiveness in the digital currency age. I appreciate the substantial work that has gone into drafting this law, and the genuine bi-partisan effort to reach common ground and pass sensible legislation that addresses the most pressing issues.

Delivering a bill to President Biden's desk should be a national priority. As we speak, significant governments globally are establishing their own stablecoin laws. Indeed, today, emerging laws in the European Union, Japan and Hong Kong are establishing new rules for US-issued dollar stablecoins. That is a point worth repeating – other nations are enacting laws to regulate the use of the US dollar. The time has come for the United States to lead the development of global rules that will determine how our own currency moves around the world.

The broad parameters of this bill are strong. Critically, it provides for:

- Robust bank-grade supervision and risk management of stablecoin issuers
- Strict requirements on the assets that can be held to back digital dollars
- Redemption and custody requirements that protect consumers
- Strong transparency, audit and reporting requirements
- Measures to bar the circulation of counterfeit digital dollars by issuers that operate offshore and that do not play by US rules
- Roles for both state and federal regulators in supervising issuers, building on our robust dual-banking system

In addition, the bill permits both banks and nonbanks to responsibly issue payment stablecoins. It likewise clarifies that prudential supervisors rather than market regulators are best-suited to oversee this payment system innovation.

At the same time, there are four unresolved issues on which I would like to comment. I believe this Committee can find an agreeable solution to each.

The first is the respective roles state and federal banking regulators should play. In the US, the states have been the laboratory of fintech innovation for the past 25 years, and we should celebrate that fact. Indeed, the innovations that we are addressing today became possible only through our broad-based state regulatory system. We need to ensure an important and continuing role for states in the growth of well-regulated stablecoin adoption in the US.

We can learn from and adopt lessons from the dual-banking system to resolve this issue. Given the strategic nature of issuing digital dollars on the internet, we need nationally-established standards that set a high bar for both state and federally-licensed issuers. Those standards should be enforced by federal regulators where appropriate. This solution would not only effectively address federalism concerns but also ensure US standards set the floor for dollar-denominated digital currency innovations around the world.

A second issue is related to reserves. Circle believes stablecoin issuers should be as safe and sound as possible. In fact, reserve requirements should be even safer than for banks, where placing only a fraction of their deposits in the form of reserves while the rest is loaned out can interfere with the safety of money used for payments. The bill recognizes this point by requiring stablecoins be backed 1:1 by liquid, dollar-denominated assets, but it deprives payment stablecoin issuers of the ability to hold even a small portion of their cash assets at the Federal Reserve. As a consequence, payment stablecoin issuers will have little choice but to deposit all of their cash with banks and other depository institutions that could fail and ultimately undermine public confidence in digital dollars. Moreover, requiring that payment stablecoin issuers access Fedwire through intermediary banks could lead to unnecessary customer concentration risk within our nation's uninsured deposit base.

The appropriate solution is to afford payment stablecoin issuers tailored and limited rights for accessing basic Federal Reserve account services. This would facilitate more timely satisfaction of redemption requirements, enhance financial stability, and protect consumers without providing access to the discount window or other financing programs afforded only to banks.

A third crucial issue is the question of how financial institutions should be required to hold payment stablecoins. Both the history and precedence for cash custody under US banking law, as well as the harsh lessons learned in 2022 from the waves of digital asset exchange and brokerage failures teach us that we need stronger consumer protections around the custody of digital dollars and other digital assets.

A reasonable common-ground approach to this issue would be to require that any company acting as a financial intermediary for payment stablecoins be required to hold those stablecoins with either a state or federally chartered qualified custodian, including trust banks. Such measures are an important part of ensuring digital dollar safety.

Finally, the bill aims to clearly define what is and is not deemed to be a legitimate digital dollar, but falls short of the mark in terms of preventing illegitimate digital dollars from proliferating in the US and world economy. Today, the internet is plagued with dollar stablecoins that purport to be dollars, but where the operators are opaque, the risk management and financial integrity uncertain, and in some cases where the stablecoins are specifically designed to be resistant to US national interests and law. At best, these so-called stablecoins are counterfeiting the dollar, at worst, they are actively undermining US national interests and security.

Just as the bill mandates criminal penalties for US stablecoin issuers whose officers knowingly issue false certifications, the bill should impose criminal penalties on stablecoin firms that knowingly issue false digital dollars into the US, to US persons, or around the world. Simply put, I believe civil penalties alone are woefully insufficient to dissuade those who will have tremendous economic incentives to flout US law and undermine the dollar's credibility at home and abroad.

The Arc of Internet History

Having lived through multiple generations of internet technology disruption, it is helpful to look back at similar times and learn from how the US government and industry responded.

Back in 1999-2001, we were in a period of intense interest and hype around the promise of the Web. Thousands of companies were formed and even went public with little more than a whitepaper. There were total losses, scams and frauds. The technology was not living up to the promise, with the "World-Wide-Wait" being the user experience of the time due to tedious dial-up connections.

But a combination of proactive policy decisions in the late 1990s, and persistent technology development and private-market investment led to a period immediately following that established the US as the uncontested leader of internet-based technology and businesses. Americans are still benefiting from those policy decisions through high-paying jobs and everyday access to the most advanced and useful technology the world has to offer.

We are at exactly that same moment today. But unlike that period, we do not have the luxury of time. In the 1990s, a massive tech capability gap existed between the US and the rest of the world. Today, other nations, most notably China, have closed that gap considerably if not eliminated it all together.

The dollar is at a crossroads. And currency competition is now technology competition on the internet. I ask all of you as members of Congress to consider this moment, and ask what value system we want to enshrine in law, and safely and deliberately unleash the creative forces of US-led technology innovation.

Thank you again for the opportunity to share my testimony with you today. I would be happy to answer any questions you may have.

Testimony of Coy Garrison
Partner, Steptoe and Johnson LLP
Before the U.S. House of Representatives Committee on Financial Services
“The Future of Digital Assets: Providing Clarity for the Digital Asset Ecosystem”
June 13, 2023

Thank you, Chairman McHenry, Ranking Member Waters, and members of the Committee for the invitation to testify on the urgent need for legislation to bring clarity to the digital asset ecosystem.

My name is Coy Garrison. I am a partner in the Washington, D.C. office of Steptoe & Johnson LLP. As a member of Steptoe’s Blockchain & Cryptocurrency practice, I advise a range of participants in the digital asset ecosystem on securities law compliance and how to navigate the challenging legal and regulatory issues facing the industry. Prior to joining Steptoe one year ago, I was an attorney for the U.S. Securities and Exchange Commission (“SEC” or the “Commission”), first working in multiple roles within the Division of Corporation Finance until I had the honor of serving as counsel to Commissioner Hester M. Peirce for nearly three years. My testimony today is a product of my experiences in both government and in private practice, but I appear before you on my own behalf and not on behalf of my firm or any client of the firm.

I. Congress must act to bring appropriate regulation to the digital asset industry.

My message to you today is simple: Congress must act to bring sensible regulation to the digital asset industry. The Digital Asset Market Structure Discussion Draft is a thoughtful and measured approach, and would create a workable regulatory framework for the industry. Before addressing the details of the draft, I’d like to explain the circumstances that necessitate congressional action.

a. Currently, there is no meaningful federal regulation of the digital asset markets, which harms investors, responsible industry participants, and the U.S. economy.

The status quo fails to protect people who trade or hold digital assets on centralized exchanges. While there are a number of responsible trading platforms appropriately safeguarding customers’ assets and monitoring against fraud and manipulation, some trading platforms have put their customers’ assets at dramatic risk and caused significant loss.¹ Enforcement actions are tools to hold wrongdoers accountable, but they cannot replace sensible market regulation that can help deter, identify, and mitigate wrongdoing.

The status quo also creates a business environment where responsible actors in the digital asset industry are hindered in their potential to innovate, add jobs to the economy, and realize the benefits of their technology. They are also limited in their ability to compete against traditional

¹ United States Attorney’s Office Southern District of New York, United States Attorney Announces Charges Against FTX Founder Samuel Bankman-Fried (Dec. 13, 2022), <https://www.justice.gov/usao-sdny/pr/united-states-attorney-announces-charges-against-ftx-founder-samuel-bankman-fried>.

institutions. Most digital asset industry participants simply want clear rules of the road and will pour tremendous resources into compliance if those rules are provided.

Further, the status quo puts the U.S. at a competitive disadvantage. The European Union, Canada, Dubai, and Hong Kong are examples of jurisdictions that in recent months have implemented new legislation or regulations for digital assets, which create attractive destinations for entities that are made to feel increasingly unwelcome by regulators here in the U.S. This is not empty rhetoric: I have travelled to two of these jurisdictions in the past six months to explore business opportunities under these new foreign regulatory regimes, and I have regular conversations with industry participants in the U.S. actively considering moving to new jurisdictions.

b. The application of existing securities laws to digital assets is not always clear.

Blockchain technology, like nearly any new innovation, does not fit nicely into existing regulatory regimes. The foundational question of whether any digital asset is a security or commodity is therefore not easily answered. As a preliminary matter, to the extent a digital asset fits within the broad definition of a commodity under the Commodity Exchange Act, the Commodity Futures Trading Commission (“CFTC”) currently has enforcement authority in the spot market for digital assets, but does not have regulatory authority.²

The SEC has increasingly asserted its authority over digital asset trading platforms in recent weeks.³ The legal analysis of whether any particular digital asset is sold pursuant to a security in any particular transaction requires a facts-and-circumstances consideration of the economic realities of the transaction, which involves nuance and judgment. Sweeping statements that nearly all digital assets are securities, or are not securities, ignore the complexity of the analysis and distract from finding a workable solution to the numerous legal and regulatory issues involved in this context.

To determine whether a digital asset is sold as a security, a proper analysis requires one to start with the statute: the Securities Act of 1933 (“Securities Act”). In Section 2(a)(1) of the Securities Act, Congress defines “security” by referencing more than thirty specific instruments, including stocks, bonds, and notes. Each instrument listed in the statutory definition is subject to its separate legal analysis as explained by the relevant case law. Unsurprisingly, digital assets are not included in the list of securities.

The concept of an “investment contract,” however, is included in the statute as a type of security. In 1946, in the *Howey* case, the Supreme Court first defined an investment contract as a “contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”⁴ While the

² 7 U.S.C. § 6(c); 17 C.F.R. § 180.1.

³ SEC Files 13 Charges Against Binance Entities and Founder Changpeng Zhao (June 5, 2023), <https://www.sec.gov/news/press-release/2023-101>; SEC Charges Coinbase for Operating as an Unregistered Securities Exchange, Broker, and Clearing Agency (June 6, 2023), <https://www.sec.gov/news/press-release/2023-102>.

⁴ SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

Howey case related to the sale of orange groves in conjunction with service contracts for the cultivation and sale of the oranges, seventy-seven years of case law on the subject has found securities transactions relating to schemes involving the sale of items ranging from chinchillas to whiskey receipts.⁵ In the 2017 DAO Report, the SEC first asserted that digital assets may be sold pursuant to investment contracts under the *Howey* test.⁶

The application of the *Howey* test to digital assets is not always a straightforward exercise. As a preliminary matter, determining whether an investment contract exists in any digital asset transaction involves a complex analysis of the particular facts and circumstances. The SEC staff issued guidance on the subject in 2019 and identified more than sixty factors to be considered, which underscores the complexity of the analysis.⁷

Additionally, even if it is determined that an investment contract is present in a digital asset transaction, the digital asset itself is not the investment contract.⁸ Rather, the digital asset plus the promises and efforts of the promoter or the third party constitute the contract, transaction, or scheme that is the investment contract. There is no case law addressing the application of the *Howey* test to a secondary market transaction in an investment contract.⁹ This creates tremendous uncertainty in seeking to determine whether the securities laws apply to secondary trading of digital assets that were sold pursuant to investment contracts. The SEC has recently begun to shift its focus in enforcement actions to arguing that secondary transactions in certain digital assets constitute investment contracts,¹⁰ but courts have not had an opportunity to assess the SEC's arguments regarding the applicability of securities laws to such transactions.

Further adding to the complexity, the SEC staff has taken the position that a digital asset at one point in time may represent the investment contract, but that the same digital asset may no longer represent the investment contract over time if the network is sufficiently decentralized.¹¹ There is no clear guidance from the SEC on how to determine whether a network is sufficiently decentralized and how a digital asset can transition from a security to a non-security.

⁵ See *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974); *Glen-Arden Commodities, Inc. v. Costantino*, 493 F.2d 1027, 1034–1035 (2d Cir. 1974).

⁶ SEC, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (Jul. 25, 2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

⁷ SEC Staff, Framework for “Investment Contract” Analysis of Digital Assets (Apr. 3, 2019), <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>.

⁸ See *SEC v. Telegram Group Inc.*, No. 1:19-cv-09439-PKC (S.D.N.Y. Mar. 24, 2020) (“While helpful as a shorthand reference, the security in this case is not simply the Gram, which is little more than alphanumeric cryptographic sequence.”)

⁹ For an excellent discussion of the application of *Howey* to digital assets, see Cohen, Lewis and Strong, Greg and Lewin, Freeman and Chen, Sarah, The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets Are not Securities (November 10, 2022). Available at SSRN: <https://ssrn.com/abstract=4282385>.

¹⁰ See *supra* note 3. See also SEC Charges Former Coinbase Manager, Two Others in Crypto Asset Insider Trading Action (Jul. 21, 2022), <https://www.sec.gov/news/press-release/2022-127>; SEC Charges Crypto Asset Trading Platform Bittrex and its Former CEO for Operating an Unregistered Exchange, Broker, and Clearing Agency (Apr. 17, 2023), <https://www.sec.gov/news/press-release/2023-78>.

¹¹ William Hinman, then-Director of Division of Corporation Finance, Digital Asset Transactions: When *Howey* Met Gary (Plastic) (June 14, 2018), <https://www.sec.gov/news/speech/speech-hinman-061418>. See also Framework *supra* note 7 (describing factors to consider when evaluating whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales).

Nevertheless, the desire to be sufficiently decentralized under the securities laws drives a significant number of decisions for persons working on digital asset networks.

These difficult, unresolved legal issues surrounding the proper application of the *Howey* test to primary and secondary transactions in digital assets underscore the uncertainty facing the digital asset industry and investors.

c. The SEC has refused to create a workable regulatory framework for digital assets.

The securities markets function well for capital raising activities through traditional instruments such as stocks and bonds. For example, when a company grows to the size that it needs additional capital and can afford the costs of being a public company, it will file a registration statement with the SEC to sell shares to the public and include disclosures of material business and financial information to allow investors to make informed investment decisions. On an ongoing basis, public companies are required to provide periodic and current disclosures so that investors have sufficient information to make informed investment and voting decisions. Secondary transactions of shares in public companies are executed through a host of intermediaries: broker-dealers, clearing agencies, national securities exchanges, alternative trading systems (“ATS”), transfer agents, and others. The SEC oversees an intricate set of rules and regulations designed to ensure that these intermediaries treat investors fairly and honestly.

However, to the extent digital assets are sold pursuant to securities transactions, they are not traditional securities like stocks or bonds. As previously discussed, digital assets may be sold pursuant to investment contracts. The SEC’s rules and regulations, however, are not designed for investment contracts. Nor are the SEC’s rules and regulations designed for digital assets that permit holders to participate in the functioning of a blockchain network. Generally, unlike common stock, investment contracts are not sold pursuant to registered offerings.¹² Many of the existing disclosures that would be required in a registration statement do not provide useful information in the digital asset context. Additionally, under the existing regulations, there is no such thing as an exchange for investment contracts where buyers and sellers can trade.

The problem, therefore, with demands from SEC officials that digital asset trading platforms register with the SEC under existing equity market structure rules is that those rules are not designed with the realities of how digital assets trade or operate. Existing equity market structure rules do not contemplate concepts made possible by digital asset trading, such as instantaneous settlement, the potential for the trading of securities and non-securities on the same platform, and the lack of a need for intermediaries for various functions. Reasonable regulation of digital assets would consider changes to the existing rules to address these new capabilities. However, the SEC has shown little interest in such rulemaking, or even in providing actionable guidance to the industry. For example, despite years of engagement with the industry, the SEC has yet to provide clarity on how broker-dealers and investment advisers are permitted to custody digital assets in a compliant manner.

¹² To my knowledge, there is only one context in which an issuer has registered the sale of investment contracts: in the marketplace lending industry where the investment contracts were non-separable from the notes also being registered and had no separate value from the notes being registered.

d. *The SEC's special purpose broker-dealer concept is not a sufficient solution.*

The limited efforts by the SEC to date to permit broker-dealers to interact with digital asset securities have, regrettably, not been effective. In September 2020, the SEC staff issued a no-action letter to FINRA outlining two non-custodial models for ATSs to facilitate secondary transactions in digital asset securities.¹³ Notably, the no-action position permits trading of digital asset securities for a tiny corner of the digital asset market. Only digital assets that are offered or sold pursuant to a registered offering or a valid exemption are eligible. As most digital assets are not sold pursuant to registered offerings or a valid exemption, the vast majority of digital assets are not eligible for this no-action position. While there are some ATSs that rely on this no-action letter to facilitate transactions in digital asset securities, the universe of digital assets permitted to trade on these ATSs is very small and the trading volumes are relatedly low. The attractiveness of these business models is hampered by the uncertainty of determining whether a digital asset is offered as a security.

The SEC also issued a statement in December 2020 outlining a new special purpose broker-dealer, whereby broker-dealers could seek approval to provide custody of digital asset securities if they comply with nine specific requirements.¹⁴ For nearly three years, no broker-dealer was approved to operate as a special purpose broker-dealer despite numerous applicants. Last month, FINRA approved a member to operate as a special purpose broker-dealer. Under the SEC's statement, there are two significant limitations for any special purpose broker-dealer. First, just as with the September 2020 no-action letter, only a tiny corner of the digital asset market will be permitted to be custodied by the special purpose broker-dealer. The vast majority of digital assets will not be able to be custodied under this program. Second, the special purpose broker-dealer no-action position is only good for five years and thus will expire in February 2026 absent further Commission action. The limited scope and duration of the special purpose broker-dealer license renders the license not well-suited for most market participants.

e. *The SEC needs direction from Congress to engage in meaningful rulemaking.*

The SEC has the ability to use its rulemaking and exemptive authorities to bring clarity on these issues and to provide a workable regulatory framework for digital assets sold pursuant to investment contracts. Indeed, SEC Commissioner Peirce proposed token safe harbor proposals in 2020 and 2021, which would have relied on these agency authorities to create a temporary regulatory regime for digital assets.¹⁵ Unfortunately, the Commission did not move forward with the ideas, and there have been no new proposals for a tailored regulatory framework since. Rather than using its rulemaking and exemptive authorities, the Commission

¹³Division of Trading and Markets, SEC, ATS Role in the Settlement of Digital Asset Security Trades (Sept. 25, 2020), <https://www.sec.gov/divisions/marketregr/mr-noaction/2020/finra-ats-role-in-settlement-of-digital-asset-security-trades-09252020.pdf>.

¹⁴ SEC, Custody of Digital Asset Securities by Special Purpose Broker-Dealers, Rel No. 34-90788 (Dec. 23, 2020), <https://www.sec.gov/rules/policy/2020/34-90788.pdf>.

¹⁵ Hester Peirce, Commissioner, SEC, Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization (Feb. 6, 2020), <https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06>; see also Hester Peirce, Commissioner, SEC, Token Safe Harbor Proposal 2.0 (Apr. 13, 2021), <https://www.sec.gov/news/public-statement/peirce-statement-token-safe-harbor-proposal-2.0>.

is instead relying on enforcement actions to articulate its application of the securities laws to the digital asset ecosystem. Some of these cases will likely take years of litigation and appeals to result in any binding judicial precedent. Absent a congressional directive to the SEC to engage in rulemaking, the status quo will likely persist for the foreseeable future.

II. The Digital Asset Market Structure Discussion Draft creates a responsible regulatory framework for the digital asset industry.

The discussion draft provides the foundation for a responsible regulatory framework for the digital asset ecosystem and addresses a number of the regulatory uncertainties I have previously highlighted. The draft reflects a thoughtful, balanced approach that is rooted in existing securities and commodities laws concepts. First, the discussion draft creates a new exemption from registration for the sale of digital assets pursuant to an investment contract with important investor protection provisions: an aggregate offering limit, individual investment limits for non-accredited investors, bad actor disqualification, tailored initial and on-going disclosure requirements, and limitations on resales by insiders. These provisions are modeled after familiar securities laws and regulations, including Regulation A, Regulation Crowdfunding, and Rule 144. The tailored disclosure requirements for digital assets are an improvement from the existing disclosure requirements for registered offerings.

Second, the discussion draft provides for the secondary trading of these restricted digital assets on ATSs, and directs the SEC to modernize Regulation ATS in key ways. The current issue of digital asset securities not being permitted to trade against non-security digital assets would be resolved by requiring ATSs to be allowed to trade restricted digital assets, digital commodities, and payment stablecoins on the same platform. Additionally, Regulation ATS would be amended to accommodate the benefits of blockchain technology by permitting disintermediated trading and real-time settlement of digital assets, with appropriate safeguards. These measures would address the shortcomings of the special purpose broker-dealer regime and the current, limited ATS functionality permitted by the September 2020 SEC no-action letter.

Third, the discussion draft tackles the problem of when a digital asset that is sold pursuant to a securities transaction can become a digital asset that is no longer part of a securities transaction because the network is sufficiently decentralized. A certification process would be established at the SEC, providing the agency the ability to rebut a presumption of certification and providing the applicant due process both in the agency and through the courts. A potential area for improvement on this section would be to clarify the standards by which the SEC considers and reviews such certifications.

Fourth, the discussion draft provides the CFTC with authority to regulate the spot markets for digital commodities. Digital commodity exchanges, dealers, brokers, and qualified custodians would have to register with the CFTC, become members of the National Futures Association (“NFA”), and be subject to significant oversight. The CFTC would impose regulations concerning the monitoring of trading activity, the treatment of customer assets, recordkeeping and reporting, and conflicts of interest, which would provide much-needed protections in spot market trading of digital commodities.

Digital asset trading platforms would have the ability to register as both an ATS and a digital commodity exchange, and the SEC and CFTC would be instructed to work together to remove any duplicative requirements. This will help ensure that the trading of digital assets, whether restricted digital assets on an ATS, or digital commodities on a digital commodity exchange, are subject to similar, but not overlapping or duplicative requirements. Moreover, the draft legislation creates processes for determining which agency has jurisdiction over which assets, providing a clear roadmap for determining the legal status of any digital asset.

The discussion draft gives both the SEC and the CFTC the ability to put their stamps on the appropriate regulatory regime through rulemakings. The two agencies would be instructed to engage in joint rulemakings to implement the bill and to establish a joint advisory committee to address ongoing matters. While the CFTC gains significant new jurisdiction in overseeing the spot digital commodity markets, the SEC is granted a significant role in regulating digital assets, and is directed to modernize a variety of its rules in this context, including the Customer Protection Rule and Market Access Rule for broker-dealers, Regulation NMS, and Regulation SCI.

Finally, the discussion draft is limited to the problem at hand: the lack of federal regulation of spot market trading of digital assets. Importantly, the draft clarifies that certain ancillary activities involving digital assets, such as validating, that do not require the securities or commodities laws are not covered by the statutes. Additionally, the agencies are instructed to study DeFi and NFTs, which should lay the groundwork for more responsible, thoughtful regulation of those areas of the digital asset ecosystem.

III. Conclusion

Throughout my career, I have sought to bring regulatory clarity to the digital asset industry. Not surprisingly, I did not always see eye-to-eye with my colleagues at the SEC on issues relating to digital assets. My experience in private practice has reaffirmed my belief that most market participants want to comply and will do so when provided with clear rules. I also know from my time at the agency that the SEC staff is filled with capable and dedicated securities lawyers that could provide the industry a workable regulatory framework, if the SEC staff were empowered to do so. I hope you will allow them the opportunity through this legislation. Thank you for your unprecedented work on this important legislation with the Agriculture Committee.

Hearing on:

The Future of Digital Assets:
Providing Clarity for the Digital Asset Ecosystem

Tuesday, June 13, 2023

Testimony of:

Aaron Kaplan
Co-CEO and Founder, Prometheus, Inc.
Before the U.S. House of Representatives Financial Services Committee

I. Committee Chairman McHenry, Ranking Member Waters, and esteemed members of the committee:

Thank you for the opportunity to testify at today's hearing on The Future of Digital Assets: Providing Clarity for the Digital Asset Ecosystem. My name is Aaron Kaplan, and I am a founder and Co-CEO of Prometheus Inc. ("Prometheus"). As an attorney, my background is in securities law. Since 2013, I have dedicated my career to the application of distributed ledger technology to the securities industry and the related regulatory issues.

Prometheus and its subsidiaries are building a public market and custodial infrastructure for digital assets securities ("DAS")¹ pursuant to the Federal Securities Laws ("FSLs"). Prometheus has developed proprietary technology in the United States, integrating the requirements and investor protections of securities regulation and efficiencies of distributed ledger technology. Prometheus's subsidiaries are Securities and Exchange Commission ("SEC") registered broker-dealers and Financial Industry Regulatory Authority ("FINRA") members. Prometheus ATS is an SEC registered alternative trading system ("ATS") that matches orders for buyers and sellers of DAS under the FSLs. Prometheus Capital was recently approved as the first special purpose broker-dealer ("SPBD"), meaning it is the first SEC registered custodian for DAS under the FSLs.

By operating under the SEC's established regulatory frameworks through registered entities overseen by the SEC and FINRA, Prometheus provides Americans participating in the crypto/Web3 space with the investor protections of the FSLs. Through this, Prometheus is developing a fair and orderly market, ensuring customers' assets are properly segregated, secured, and custodied.

In the vast majority of cases, crypto is a financial instrument offered to the public as an investment. Intermediaries (e.g., crypto exchanges, custodians, Etc.) are required to be regulated by the SEC based on the services they provide to the public. Properly regulating crypto trading, clearing, settlement, and custody under the securities laws provides a proven mechanism through which to

¹The SEC defines a "digital asset security" to mean "a digital asset that meets the definition of a "security" under the federal securities laws." The SEC further defines a "digital asset" as "an asset that is issued and/or transferred using distributed ledger or blockchain technology ('distributed ledger technology'), including, but not limited to, so-called 'virtual currencies,' 'coins,' and 'tokens.'" <https://www.sec.gov/rules/policy/2020/34-90788.pdf>

allow and encourage responsible participation and innovation while at the same time ensuring that investors are protected.

There has been much discussion lately about the need for greater regulatory clarity for digital assets. The essential point at hand is not about more or less regulation or even new regulation, but rather the application of the existing regulatory frameworks to digital assets.

The FSLs have been tried and tested for almost 90 years and have allowed the United States to establish the world's most trusted and advanced financial markets.

The SEC is the most capable financial markets regulatory agency in the world. The SEC relies on FINRA, a self-regulatory organization ("SRO"), whose mission is market integrity and investor protection to regulate the securities markets. Together, the SEC² and FINRA³ employ approximately 8,000 employees to oversee these vital securities functions.

Put simply, the FSLs and oversight from the SEC and FINRA have proven to be the most effective system to protect investors, operate fair and orderly markets, and protect customers' funds and assets.

As early as July 2017, the SEC put the industry on notice in the DAO Report⁴, stating that digital assets and related financial services could (and likely did) implicate the FSLs. Subsequently, the SEC created a marketplace framework with the release of the Four Step Process on July 8, 2019⁵, and the Three Step Process on September 25, 2020.⁶ Thereafter, the SEC created the framework for the clearance, settlement and custody of DAS through the Special Purpose Broker-Dealer release ("SPBD Release") on December 23, 2020.⁷ These releases provide the framework for a compliant path forward for crypto in the United States.

I want to stress that point: There is a compliant path forward for crypto in the United States that the SEC has clearly laid out.

Those who argue for new laws are simply not willing to comply with existing applicable securities laws and regulations. New legislation is not in the best interest of the investing public or the blockchain industry. Legislative efforts will take years to implement while the American public will continue to operate on reckless, unlawful platforms.

In conclusion, the United States fosters innovation through the vibrancy of our capital markets. U.S. capital markets flourish under the established regulations of the FSLs overseen by the SEC and FINRA. In order for innovation to continue to thrive in the digital asset space, the protections

²<https://www.sec.gov/strategic-plan/about#:~:text=The%20Chair%20is%20responsible%20for,headquarters%20and%2011%20regional%20locations.>

³<https://www.finra.org/careers/working-at-finra#:~:text=Visualize%20yourself%20as%20one%20of,employees%20%E2%80%93%20what%20do%20you%20see%3F>

⁴<https://www.sec.gov/litigation/investreport/34-81207.pdf>

⁵<https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities>

⁶<https://www.sec.gov/divisions/marketreg/mr-noaction/2020/finra-ats-role-in-settlement-of-digital-asset-security-transaction-09252020.pdf>

⁷<https://www.sec.gov/rules/policy/2020/34-90788.pdf>

afforded by the FSLs need to be in place. Proper regulation under the FSLs is not a hindrance to innovation, rather a prerequisite that will allow innovation to flourish.

Thank you again for the opportunity to testify at this hearing. I look forward to answering any questions.

II. Prometheus Inc. Origin

The founders of Prometheus⁸ initially became interested in the digital assets space in 2013, when Bitcoin was the only digital asset. After researching how the retail public was interacting with the asset, i.e. mainly speculatively investing, and how the markets were developing for the trading of such assets, Prometheus's founders realized that this was possibly the biggest capital markets opportunity since paper trading went electronic. Beyond the interesting question of crypto as a store of value or speculative instrument, the transition from electronic trading with multiple-day settlement cycles, counterparty risks, bloated inefficiencies, Etc., to trading of digital native blockchain-based assets had and has monumental implications for the future of markets.

As the industry blossomed with the initial coin offering ("ICO") boom, it was apparent that tokens issued in ICOs and thereafter were securities, and retail investors needed to be properly protected. In other words, the activities surrounding the issuance, trading, clearance and settlement, and custody of digital assets needed to be properly regulated in order for the potential of the crypto/blockchain industry to be truly realized in the United States.

Regulation requires two (2) elements to work, tested regulatory frameworks and the ability to enforce such frameworks on an ongoing basis. The FSLs have been tried and tested for almost 90 years and have allowed the United States to create and maintain the most developed financial markets in the world. The SEC's long-standing three-part mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.⁹

The founders of Prometheus realized there was no need to reinvent the wheel. The FSLs are meant to protect primarily retail investors, require trading venues to follow established rules, and ensure customer assets are segregated, secured, and protected. Based on this analysis, it has always been the Prometheus founders' belief that the FSLs were the best framework to regulate digital asset activities (i.e. issuance trading, clearance, settlement, and custody) as well as the intermediaries/financial service providers in the space.

Driven by this thesis, Prometheus's founders saw an opportunity to adopt the FSLs to create an ecosystem that allows for the American public to responsibly participate in the space. When the DAO Report was issued in July 2017, and the industry was put on notice that digital assets and related financial services can (and likely did) implicate the FSLs, Prometheus started the business shortly thereafter with the intention of creating an FSL compliant ecosystem for the issuance trading clearance settlement and custody of digital assets.

⁸ The founders of Prometheus are Martin, Aaron and Benjamin Kaplan

⁹<https://www.sec.gov/our-goals#:~:text=The%20SEC%E2%80%99s%20long%20standing%20three, capital%20formation%E2%80%94remains%20its%20touchstone.>

III. Prometheum Digital Asset Subsidiaries

Prometheum Inc. and its subsidiaries are building a public market and custodial infrastructure for DAS licensed with the SEC and FINRA and compliant with the FSLs. In our effort to service the lifecycle of a DAS, Prometheum has secured two (2) SEC registered and FINRA member broker-dealers, with each broker-dealer serving a critical role in our efforts to vertically integrate all aspects of trading, clearing, settlement, and custody.

i) Prometheum Capital LLC (CRD #312784/SEC # 8-70739) is the first and only SEC registered and FINRA member firm to become a SPBD, permitted to custody DAS pursuant to the SEC's SPBD Release.

ii) Prometheum ATS (CRD # 311636/SEC # 8-70624) is a broker-dealer and SEC registered ATS licensed pursuant to the Three Step Process. As an ATS, Prometheum ATS matches retail and institutional buy and sell orders for DAS.

IV. SPBD Application Process

Prometheum Capital recently became the first and only SEC registered and FINRA member firm to become a SPBD, permitted to custody DAS pursuant to the SPBD Release.

Prometheum's team instantly realized the implications of the SPBD Release when it was published in December 2020, and submitted a comment letter¹⁰ during the comment period associated with the SPBD Release. Prometheum spent approximately one (1) year creating the application and significant time thereafter going through numerous iterations and demonstrations pursuant to FINRA Rule 1014.

The application and membership process is complex, challenging, timely, and expensive. When a company receives a license to custody any form of asset, and particularly digital assets, the threshold for licensing and the complexity of the necessary systems and procedures are purposefully high to protect the American public.

Satisfying the protection of the public interest is critical to maintaining America's leadership in innovation and financial markets. Establishing a high bar for licensing for market intermediaries, and particularly SPBDs, will ensure the American investing public is insulated from events similar to the debacles of 2022.

V. Benefits of FSLs and SEC Regulatory Oversight

As SEC registered broker-dealers, Prometheum ATS and Prometheum Capital must comply with the FSLs, which require ongoing filings, disclosures, and controls. As evidenced during the debacles of 2022, regulatory oversight and proper enforcement mechanisms are needed to ensure investor protection and market integrity. Requiring disclosures, filings, and control frameworks are primary ways of achieving these FSL protections. Ongoing regulatory oversight provides

¹⁰<https://www.sec.gov/comments/s7-25-20/s72520-8734178-237104.pdf>

confirmation of FSL compliance.

A. ATS Reporting/Oversight

ATS filings, disclosures, and controls include, but are not limited to, the following:

1. Form ATS - A form filed by an ATS that explains components of their organization, business, and operations. This form is filed with the SEC i) 20 days prior to commencing initial operations and ii) when a material change occurs to the ATS' business as filed in the initial Form ATS filing.
2. Form ATS-R - A form filed with the SEC disclosing an ATS' quarterly activities —both the unit volume and dollar volume of trades in every type of security it handles.
3. Trade Reporting Facilities - Established trade reporting rules require firms to report transactions to FINRA. Multiple facilities exist - OATS, CAT, TRACE, ORF.
4. Exchange Act Rule 15c3-5 (Market Access Rule) - requires broker-dealers with market access or that provide market access to their customers to "appropriately control the risks associated with market access so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system."¹¹
5. FOCUS reports - (Financial and Operational Combined Uniform Single report). These reports are similar to financial statements and also provide key SEC customer protection and financial responsibility reporting, i.e. SEA 15c3-1 net capital information, reserve formula, and related operational information.
6. SEA Rule 15c3-1 - Proscribes required net capital requirements for broker-dealers.
7. SEA 17a-5(c) - Requires sending customers: i) year-end Audited Statement of Financial Condition and Financial Disclosure statement; ii) Mid-year unaudited Statement of Financial Condition and Financial Disclosure statement.

B. SPBD Reporting/Oversight

SPBD filings, disclosures, and controls include, but are not limited to, the following:

1. SEA 15c3-3 Customer Protection Rules - Requires proper segregation of customer funds and securities from the firm's assets.
2. SEA Rule 15c3-1 - Proscribes required net capital requirements for broker-dealers.
3. FORM 17-H RISK ASSESSMENT REPORT FOR BROKERS AND DEALERS - requires broker-dealers who custody customer assets to disclose information on its affiliates' activities (i.e. parent, subsidiaries, holding companies, Etc.)

¹¹<https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program/market-access#:~:text=Exchange%20Act%20Rule%2015c3%2D5,participants%2C%20the%20integrity%20of%20trading>

4. SEA 17a-5(c) - Requires sending customers: i) year-end Audited Statement of Financial Condition and Financial Disclosure statement; ii) Mid-year unaudited Statement of Financial Condition and Financial Disclosure statement.

5. FOCUS reports - (Financial and Operational Combined Uniform Single report). These reports are similar to financial statements and also provide key SEC customer protection and financial responsibility reporting, i.e. SEA 15c3-1 net capital information, reserve formula, and related operational information.

6. Form Custody - Identifies custody location of customer cash and securities positions held by broker dealers, including special purpose broker-dealers.

VI. Compliant Crypto in the United States

As set forth in the SEC's various complaints, the trading, distribution, clearing, and settlement of DAS without compliance with the FSLs violates the law. Technology is no substitute for investor protection and the integrity of markets.

The SEC has released regulations on how to compliantly trade and custody DAS with the Three Step Process and SPBD releases and therefore laid out how compliance with the FSLs is achieved.

There is a pathway forward for crypto in the United States. It literally requires following the law.

Innovation and the future of markets have been addressed by the SEC, and Prometheus ATS and Prometheus Capital are examples of how compliance can be achieved under the FSLs.

VII. In Response to Foreign Investor Concerns

On June 5, 2023, in a letter to SEC Chairman Gensler and FINRA's President and CEO, Mr. Robert Cook, Senator Tuberville raised concerns over Prometheus's previous investment from foreign investors with alleged ties to the Chinese Communist Party. Prometheus would like to take this opportunity to state clearly and on the record these concerns are unfounded and without merit.

Prometheus commenced its operations in September 2017, having been conceived and built in the United States by a group of securities lawyers whose years of experience formed the predicate for Prometheus's existence, that all ICOs were securities and subject to the FSL.

While seeking capital and assistance in developing Prometheus's proposed ecosystem for the compliant trading of tokens, now known as DAS, Prometheus was introduced to Shanghai Wanxiang Blockchain Inc. ("Wanxiang") as a leading entity in the crypto industry. In December 2018, Wanxiang's subsidiary Haskey Digital Asset Group Ltd. ("Hashkey") made its investment into Prometheus, and Prometheus and Wanxiang entered into a development agreement.

In December 2018, as part of the investment from Hashkey into Prometheus, Prometheus and Wanxiang agreed to jointly develop a blockchain trading system. Thereafter, in approximately one (1) year, it became clear to Prometheus that joint development was not viable. Upon such realization, Prometheus started to independently develop its own platform. All servers, code, data,

and proprietary technology were created independently of Wanxiang and its affiliates. Prometheus does not use any resource, code, or other assets from Wanxiang or its affiliates in any of its systems.

Prometheus formally terminated all co-development work and strategic relationships with Shanghai Wanxiang Blockchain and its affiliates in October 2021 in an Omnibus Agreement, which was filed with the SEC in November 2021.

The October 21, 2021, Omnibus Agreement terminated the Purchase Agreement, the Joint Development Agreement, the Technology Agreement, and the Rights Agreement (the "Prior Agreements"). As a result, HashKey's right to purchase Prometheus's Series A Preferred was terminated. Further, under the terms of the Omnibus Agreement, HashKey has the right to designate one (1) person to be elected to Prometheus's board of directors, and Prometheus's founders have the right to designate the remaining six (6) directors. The Omnibus Agreement also provides for a general mutual release of the parties to the Prior Agreements, and confidentiality and non-competition covenants. The Omnibus Agreement is attached hereto.

On June 22, 2021, Prometheus received a request for information from the Committee on Foreign Investment in the United States ("CFIUS") seeking information regarding Prometheus's agreements with foreign entities, including Wanxiang and its affiliates. Prometheus submitted multiple responses which seemed to satisfy CFIUS as a formal case has not been opened. Prometheus has had no further inquiries from CFIUS.

On July 12, 2021, Prometheus received a subpoena from the SEC seeking historical information regarding Prometheus and its affiliates. As part of the investigation, the SEC requested all communications with any foreign entity, all vendors, and financial information relating thereto. Prometheus provided all information requested. Prometheus was advised by its SEC counsel that the SEC closed its investigation.

To further protect the confidentiality of Prometheus's intellectual property, Prometheus adopted new bylaws in 2021. The revised bylaws include provisions that ensure that Prometheus's confidential intellectual property and proprietary information remain confidential. Under the revised bylaws, each of Prometheus's officers is responsible for (i) the protection and preservation of the confidentiality of Prometheus's intellectual property and (ii) required to take all necessary actions to ensure that all disclosure or access to intellectual property will be limited to Prometheus's employees and the employees of its subsidiaries that require such disclosure or access. The revised bylaws also provide that no use, disclosure, or access to any of Prometheus's intellectual property shall be provided to any person that is not one of its employees, including non-employee directors, without the express prior written approval of a majority of the board of directors and that any, such use, disclosure or access shall be made pursuant to the terms of a written agreement.

Prometheus's current systems have been created internally and are the sole intellectual property of Prometheus, and all the rights relating thereto belong to Prometheus. Prometheus has implemented advanced cybersecurity tools and controls to ensure that its systems and information contained within are secure.

Terminating its relationship with Wanxiang and its affiliates resulted in Prometheus writing down its

assets by \$2.475 million.

All of the above was included in the November 4, 2021, Prometheus filing with the SEC.¹²¹³

Wanxiang and its affiliates have no access to any Prometheus code, technology, software, or to the Prometheus ecosystem. Furthermore, all Prometheus code has been developed internally.

Prometheus is proud to be an American-born, bred, and controlled company.

¹²<https://www.sec.gov/Archives/edgar/data/1718271/000101905621000572/offeringcircular.htm>

¹³Any allegations that Prometheus is anything but an American born, bred and controlled company are false and specious as the historical record reflects. See the Appendix attached hereto.

Appendix:

XIII. November 4, 2021 Reg A filing with SEC:

<https://www.sec.gov/Archives/edgar/data/1718271/000101905621000572/offeringcircular.htm>

IX. Omnibus Agreement dated October 20, 2021

X. Prometheus comment letter re Custody of Digital Asset Securities by Special Purpose Broker-Dealers (17 C.F.R. Part 240, SEC Rel. No. 34-90788, File No. S7-25-20)

OMNIBUS AGREEMENT

THIS OMNIBUS AGREEMENT (this “**Agreement**”) is made and entered into as of October 20, 2021 (the “**Effective Date**”) by and among PROMETHEUM, INC., a Delaware corporation (the “**Company**”); HASHKEY DIGITAL ASSET GROUP LIMITED, a company organized under the laws of Hong Kong (“**HashKey**”), SHANGHAI WANXIANG BLOCKCHAIN INC., a PRC corporation (“**Wanxiang**”), and solely for purposes of Sections 2.01(d) and 2.02 hereof, the shareholders signatory hereto (the “**Shareholders**”). The Company, HashKey, and Wanxiang are collectively referred to herein as the “**Entity Parties**” and may each be referred to as an “**Entity Party**.”

RECITALS

The following recitals are a material part of this Agreement.

1. The Company and HashKey are parties to that certain Securities Purchase Agreement dated as of December 14, 2018 (the “**Securities Purchase Agreement**”).
2. The Company, HashKey and Wanxiang are parties to that certain Technology Agreement, made and entered into as of December 14, 2018 (the “**Technology Agreement**”).
3. The Company, HashKey, the Management Group (as defined below) and the other signatories thereto as Founders (as defined below) are parties to that certain Investor and Founders Rights Agreement, effective as of December 14, 2018 (the “**Investor and Founders Rights Agreement**”).
4. The Company, and Wanxiang are parties to that certain Strategic Partnership and Joint Development Agreement made and entered into as of December 14, 2018 (the “**Strategic Partnership Agreement**”).
5. The Entity Parties (and for purposes of the Investor and Founders Rights Agreement, the Founders (defined below)) deem it in their respective best interests to terminate the Securities Purchase Agreement, the Technology Agreement, the Investor and Founders Rights Agreement and the Strategic Partnership Agreement (collectively, the “**Prior Agreements**”) effective as of the date hereof and replace the Prior Agreements with this Agreement for the purpose of setting forth the rights and duties of the Entity Parties and to provide for the corporate governance of the Company.

NOW, THEREFORE, in consideration of the mutual covenants contained in this Agreement, and for other good and valuable consideration the receipt and adequacy of which are hereby acknowledged, the Entity Parties agree as follows:

**ARTICLE I.
DEFINITIONS**

1.01 Capitalized Terms. The following capitalized terms used in this Agreement have the meanings set forth below:

“Affiliate” means any Person that, directly or indirectly, through one or more intermediaries, controls, is controlled by or is under common control with a Person, and as used in this definition, the term “control” means the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of a Person, whether through ownership of voting securities or other ownership interest by contract, or otherwise.

“Board” means the board of directors of the Company.

“Bylaws” means the third amended and restated bylaws of the Company, dated October 1, 2021 and all subsequent amendments thereto and restatements thereof.

“Certificate” means the certificate of incorporation of the Company, filed in the office of the Secretary of State of Delaware on September 18, 2017, as amended on November 22, 2017 and on January 28, 2021 and all subsequent amendments thereto and restatements thereof.

“Common Stock” means the common stock of the Company, par value \$0.00001 per share and any other capital stock of the Company into which such stock is reclassified or reconstituted and any other common stock of the Company.

“Company” has the meaning set forth in the Preamble of this Agreement.

“Digital Asset” means an asset that is issued and/or transferred using distributed ledger or blockchain technology, including, but not limited to, virtual currencies, coins, tokens and digital assets that meet the definition of a security under the US federal securities laws.

“Director” means any member of the Board.

“Exchange Act” means the Securities and Exchange Act of 1934, as amended.

“Founders” means the Persons set forth on Schedule I hereto.

“Governmental Authority” means any nation or government, any state or other political subdivision thereof, and any entity exercising executive, legislative, judicial, regulatory or administrative functions of or pertaining to government.

“HashKey Director” has the meaning set forth in Section 3.01(a)(ii).

“HashKey Group” means HashKey, Wanxiang and each of their Affiliates.

“Holder” means any Person that is or becomes a party to this Agreement.

“Law” means any statute, law, regulation, ordinance, rule, injunction, order, decree, governmental approval, directive, requirement, or other governmental restriction or any similar form of decision of, or determination by, or any interpretation or administration of any of the foregoing by, any Governmental Authority.

“Management Group” means Martin H. Kaplan, Aaron L. Kaplan and Benjamin S. Kaplan.

“Person” means any individual, partnership, corporation, limited liability company, association, joint stock company, trust, joint venture, unincorporated organization, or other form of business organization, whether or not regarded as a legal entity under applicable Law, or any Governmental Authority or any department, agency or political subdivision thereof.

“Prior Agreements” has the meaning set forth in the recitals to this Agreement.

“Securities Act” means the Securities Act of 1933, as amended.

“Shares” means shares of Common Stock now or hereafter issued to or acquired by a Holder and all shares of capital stock of the Company, including the Common Stock and all or other securities of the Company or any successor of the Company issued or issuable as a result of any stock dividends on, or stock split or reclassification or conversion of, or in exchange for, any such Common Stock or issued or issuable with respect to such Common Stock in connection with any merger or reorganization or similar transaction involving the Company.

“Voting Shares” shall mean the Common Stock and any and all other Shares, by whatever name called, which carry voting rights which are now owned or subsequently acquired by a Holder or an Affiliate of such Holder, however acquired, including, without limitation, through stock splits, stock dividends, reclassifications, recapitalizations and other similar events.

ARTICLE II.

TERMINATION OF PRIOR AGREEMENTS; GENERAL RELEASE

2.01 Termination of Prior Agreements.

(a) The Company and HashKey agree that, on the Effective Date, the Securities Purchase Agreement is terminated and of no further force and effect and that this termination does not effect the shares or warrants for Ember Tokens that have been issued to HashKey through the date hereof. The Entity Parties agree that, as of the Effective Date, HashKey is the owner of 11,479,167 shares of restricted Common Stock and 101,500,000 restricted warrants to purchase 101,500,000 restricted Ember Tokens, in each case, fully-paid and non-assessable and free and clear of all liens and obligations.

(b) The Company and HashKey agree that, on the Effective Date, the Technology Agreement is terminated and of no further force and effect.

(c) The Company and Wanxiang agree that, on the Effective Date, the Strategic Partnership Agreement is terminated and of no further force and effect.

(d) The Company, HashKey and each of the Founders agree that, on the Effective Date, the Investor and Founders Rights Agreement is terminated and of no further force and effect.

2.02 General Release.

(a) HashKey/Wanxiang Release. HashKey and Wanxiang, individually and on behalf of their respective Affiliates, agents, officers, directors, employees, representatives, attorneys, heirs, successors and assigns, hereby fully and finally discharge, covenant not to sue, and forever release any and all actions, claims, causes of action, suits, charges, complaints, demands, debts, dues, sums of money, accounts, contracts, controversies, agreements, promises, obligations, damages, judgments, executions, rights, remedies and liabilities of any kind or character, in law or equity, suspected or unsuspected, past or present, known or unknown, that they may have had (the "**HashKey/Wanxiang Release**") against the Company, the Shareholders and each of their respective affiliates, subsidiaries, parent companies, predecessors, and successors, and all of their respective past and present officers, directors, stockholders, partners, members, employees, agents, representatives, plan administrators, attorneys, insurers, and fiduciaries (each in their individual and corporate capacities)(the "**Released Company Parties**"). For the avoidance of all doubt, the HashKey/Wanxiang Release includes any and all claims arising out of or relating in any way to any of the Prior Agreements, from the beginning of time up through and including the Effective Date.

(b) Company/Shareholders Release. The Company and the Shareholders, individually and on behalf of their respective Affiliates, agents, officers, directors, employees, representatives, attorneys, heirs, successors and assigns, hereby fully and finally discharge, covenant not to sue, and forever release any and all actions, claims, causes of action, suits, charges, complaints, demands, debts, dues, sums of money,

accounts, contracts, controversies, agreements, promises, obligations, damages, judgments, executions, rights, remedies and liabilities of any kind or character, in law or equity, suspected or unsuspected, past or present, known or unknown, that they may have had (the "Company/Shareholders Release") against the HashKey, Wanxiang and each of their respective affiliates, subsidiaries, parent companies, predecessors, and successors, and all of their respective past and present officers, directors, stockholders, partners, members, employees, agents, representatives, plan administrators, attorneys, insurers, and fiduciaries (each in their individual and corporate capacities)(the "Released HashKey Parties"). For the avoidance of all doubt, the Company/Shareholders Release includes any and all claims arising out of or relating in any way to any of the Prior Agreements, from the beginning of time up through and including the Effective Date.

(c) Bar to Future Suit. The Entity Parties and the Shareholders agree and warrant that they shall not bring, commence, institute, maintain, or prosecute, or allow any person, entity or organization to bring, commence, institute, maintain, or prosecute in her name, any other action at law or in equity or any legal proceeding, claim, or counterclaim whatsoever, against any of the Company Released Parties or the HashKey Released Parties, as the case may be, arising out of or relating in any way to the Prior Agreements other than to enforce this Agreement or based on an alleged breach of this Agreement. The Entity Parties agree that this Agreement may be pleaded as a full and complete defense to, and may be used as a basis for injunctive relief against, any action, suit, or other proceeding that may be instituted, prosecuted, or attempted in breach of this Agreement. To the extent allowable by law, the Entity Parties agree to waive the requirement of a bond or security to pursue injunctive relief.

ARTICLE III. MANAGEMENT OF THE COMPANY

3.01 Board of Directors.

(a) Number of Directors. As of the Effective Date, the Company's Board consists of seven (7) members. The number of directors may thereafter be increased or decreased in accordance with the Certificate and the Bylaws and the provisions of this Agreement.

(b) Term. Each such Director shall hold office until the next annual meeting of the shareholders of the Company (or a special meeting of shareholders held in lieu thereof) and until his or her successor is duly elected and qualified or until his or her earlier resignation or renewal.

(c) Voting. Each of the Holders agrees to vote all of the Voting Shares owned by such person and otherwise to use such person's best efforts to elect to the Board at the next annual meeting of shareholders of the Company and subsequent annual meetings or at any special meeting at which directors are to be elected as follows;

(i) One (1) director designated by HashKey (the “**HashKey Director**”) who shall initially be Dr. Xiao Feng; and

(ii) Six (6) directors designated by the Management Group. One of the directors designated by the Management Group shall also be appointed Chairman of the Board. Martin H. Kaplan shall be Chairman of the Board.

(d) Notices. Each person entitled to designate one or more directors pursuant to the provisions of this Section 3 shall furnish written notice of its director-designees to the other Holders prior to any election of directors. In the absence of such notice, the director-designees then serving and previously designated shall be reelected if still eligible to serve as provided herein.

(e) Vacancies.

(i) Any vacancy on the Board created by the resignation, removal, incapacity or death of any Person designated under this Section 3 shall be filled by another person designated by the original designating party and consented to by the Management Group (which consent shall not be unreasonably withheld). The Holders shall vote their respective Voting Shares in accordance with such new designation, and any such vacancy shall not be filled in the absence of a new designation by the original designating party or by each of the other members of the Board, as the case may be.

(ii) Any vacancy on the Board created by an increase in the number of directors pursuant to the Certificate and the Bylaws shall be filled by a Person designated by the Management Group. The Holders shall vote their respective Voting Shares of Common Stock in accordance with such new designation.

(f) Removal. The Holders who are entitled to appoint a Director hereunder may remove such Director at any time and from time to time and, subject to consent (which shall not be unreasonably withheld) of the Management Group, designate his or her successor by written notice to the Company and the other Holders. Provided the Management Group has approved the successor, the other Holders agree to vote their Voting Shares for such removal and for the election of the successor so designated.

(g) Covenant to Vote. Each Holder shall appear in person or by proxy at any meeting of Shareholders for the purpose of establishing a quorum and shall vote the Voting Shares owned by such Holder upon any matter in a manner so as to be consistent and not in conflict with, and to implement, the terms of this Agreement. Each Holder also agrees to execute and deliver unanimous or majority written consents of shareholders of the Company in lieu of attendance at a meeting of shareholders meeting if required to implement the terms of this Agreement or to approve or authorize corporate action consistent with the terms hereof.

(h) Termination of Rights. The right of the HashKey to appoint a HashKey Director shall terminate at such time as HashKey no longer owns at least ten (10%) percent of the issued and outstanding Voting Shares.

**ARTICLE IV.
RIGHTS AND OBLIGATIONS OF HOLDERS**

4.01 Schedule 13D Filing.

(a) The Entity Parties agree to comply with all obligations under the Exchange Act, including but not limited to, Section 13 thereof.

4.02 Non-Competition, Non-Disclosure and Non-Solicitation Covenants.

(a) Covenants. Each of HashKey and Wanxiang, on behalf of itself and its respective subsidiaries, covenants and agrees that during the term of this Agreement, and for a period of five (5) years after the Effective Date, it shall not, for its own account or jointly with another, directly or indirectly, for or on behalf of any other Person (except for the Company or an Affiliate of the Company), as a principal, agent or otherwise:

(i) own, control, manage, be employed by, perform consulting services or otherwise knowingly participate in, any business engaged in the clearance, trade, settlement or custody of digital asset securities in the Trade Area (as defined below) which competes with the digital asset securities business of the Company or its Affiliates, including, but not limited to, a Person which is directly or indirectly engaged in, or seeking to engage in (i) the business of operating, developing or offering venues or platforms for Persons to engage in transactions in digital asset s, including but not limited to issuance of and secondary trading, clearing, and settlement of digital asset transactions, and/or (ii) the provision of custody and control of digital assets (the “**Restricted Business**”); for the avoidance of doubt, HashKey, Wanxiang and their respective subsidiaries shall not license directly or indirectly to anyone in the Trade Area the software developed with the Company;

Notwithstanding the above, making a passive investment into any Person which has its business in the Trade Area by HashKey, Wanxiang or their respective subsidiaries solely as a financial investor will not constitute an activity that is prohibited as a Restricted Business pursuant to this section.

(ii) solicit or attempt to solicit any Person who is an employee, consultant or advisor of the Company or its Affiliates (or who has served in such capacity during the twelve (12) months preceding the solicitation) by the Company or any of its Affiliates to terminate its services to the Company or its Affiliates, whether or not such services are pursuant to a written contract; or

(iii) solicit, contact or deal with any Person who is or was a Customer or prospective Customer of the Company or any of its Affiliates in the Trade Area for the purpose of providing Restricted Business which are competitive with the services or products provided by the Company or its Affiliates (for purpose of this provision, a Customer or prospective Customer is any Person to whom the Company or its Affiliates provides or provided products or services, or with whom the Company or its Affiliates had or has material contacts for the purposes of soliciting business, at any time during the one-year period prior to termination of Agreement).

(b) Trade Area. As used herein, the term "Trade Area" means the United States of America including its territories and provinces and Canada.

(d) Enforcement. Each of HashKey, Wanxiang and their respective subsidiaries acknowledges that the covenants contained in this Article IV are reasonable in scope and in all other respects, do not constitute a material restraint of trade and are essential to protect the Company's business. Each of HashKey, Wanxiang and their respective subsidiaries further acknowledges that if it breaches any covenant contained in this Article IV, the Company would suffer immediate and irreparable injury for which no remedy at law would be adequate. Accordingly, the Company will be entitled to an injunction restraining any breach or threatened breach of any covenant in this Article IV and need not post any bond or other security or show actual damages. The exercise by the Company of its rights under this Section 4.02 does not limit any other rights or remedies that the Company may have. No failure by the Company to pay compensation to any of the entities comprising the HashKey Group nor any claim or cause of action that any of the entities comprising the HashKey Group may have against the Company, whether predicated on this Agreement or otherwise, will be an excuse or defense for any failure by any of HashKey, Wanxiang and their respective subsidiaries to abide by this Article IV or constitute a defense to the enforcement of this Article IV by the Company. The Company's rights and remedies under this Article IV are cumulative and do not limit any other rights or remedies it may have.

(e) Blue Pencil. If any court of competent jurisdiction determines that any of the covenants set forth in this Article IV, or any part thereof, is unenforceable because of the scope or duration of such provision, such court shall have the power to modify any such unenforceable provision in lieu of severing such unenforceable provision from this Agreement in its entirety, whether by rewriting the offending provision, deleting any or all of the offending provision, adding additional language to this Article IV or by making such other modifications as it deems warranted to carry out the intent and agreement of the parties as embodied herein to the maximum extent permitted by applicable law. The parties hereto expressly agree that this Agreement as so modified by the court shall be binding upon and enforceable against each of them.

ARTICLE V.
RESTRICTIONS ON TRANSFER

5.01 Rule 144 Acknowledgment. Each Holder acknowledges that such Person is familiar with Rule 144 of the rules and regulations of the Commission, as amended, promulgated pursuant to the Securities Act ("Rule 144"), and that such Person has been advised that Rule 144 permits, only under certain circumstances, the resale of restricted securities such as the Shares now held or being acquired by such Person contemporaneously with the execution of this Agreement, but that Rule 144 is not currently, and may not in the future become, available to permit resales by such Person of any Shares. Each Holder understands that, to the extent that Rule 144 is not available, such Person will be unable to sell any Shares without either registration under the Securities Act or the existence of another exemption from such registration requirement, and that the Company has no obligation whatsoever to any Holder to register any Shares.

5.02 Further Restrictions on Transfer. Until December 14, 2021, no Holder or any transferee of a Holder's Shares, shall directly or indirectly or by operation of Law, (a) offer, pledge, sell, assign, exchange, pledge, gift, transfer, contract to sell, grant, lend, or make any other disposition (collectively, "Transfer"), any Shares or any securities convertible into or exercisable or exchangeable for Shares, whether now owned or hereafter acquired by the undersigned or with respect to which the undersigned has or hereafter acquires the power of disposition (collectively, the "Lock-Up Securities"); (b) enter into any swap or other arrangement that transfers to another, in whole or in part, any of the economic consequences of ownership of the Lock-Up Securities, whether any such transaction described in clause (a) or (b) above is to be settled by delivery of Lock-Up Securities, in cash or otherwise; (c) make any demand for or exercise any right with respect to the registration of any Lock-Up Securities; or (d) publicly disclose the intention to make any offer, sale, pledge or disposition, or to enter into any transaction, swap, hedge or other arrangement relating to any Lock-Up Securities.

5.03 Permitted Transfers. Notwithstanding Section 5.01, but subject to any restrictions under the US federal securities laws and any securities laws of any State of the United States of America, the Lock-Up Securities of each Holder may be Transferred under the following circumstances:

- (a) any Holder who is an individual may Transfer all or any of his or her Lock-Up Securities to a trust, family limited partnership or limited liability company for the benefit of such Holder, his or her spouse, lineal descendants or ancestors, provided that such Holder retains the sole right to control the exercise of all rights under this Agreement with respect to such Lock-Up Securities;
- (b) any Holder who is an individual may Transfer all or any of his or her Lock-Up Securities, upon his or her death, by will or the laws of descent and distribution;

(c) any Holder who is an individual may Transfer all or any of his or her Lock-Up Securities to any entity Person in which the Holder owns and retains all of the outstanding equity interests provided such transferee becomes a party to this Agreement;

(d) any Holder who is an entity may Transfer all or any of its Lock-Up Securities to any entity Person in which the Holder owns and retains at all times while this Agreement is in effect 100% of (i) the issued and outstanding equity interests, and (ii) the voting securities of such entity Person transferee provided such transferee becomes a party to this Agreement; and

(e) any Holder may Transfer all or any of such Holder's Lock-Up Securities with the prior written consent of at least a majority of the Board, which shall also require prior written consent of at least one (1) Founder Director if HashKey is making such Transfer and the HashKey Director if a Founder is making such Transfer.

5.04 No Transfers to Bad Actors. No Holder shall, directly or indirectly, Transfer any Lock-Up Securities to any Person (other than the Company) unless and until the proposed transferee confirms to the reasonable satisfaction of the Company, which shall not be unreasonably withheld, that neither the proposed transferee nor any of its directors, executive officers, other officers that may serve as a director or officer of any company in which it invests, general partners or managing members, nor any Person that would be deemed a beneficial owner of those Lock-Up Securities (in accordance with Rule 506(d) of the Securities Act) is subject to any of the "bad actor" disqualifications described in Rule 506(d)(1)(i) through (viii) under the Securities Act ("**Bad Actor Disqualifications**"), except as set forth in Rule 506(d)(2)(ii) or (iii) or (d)(3) under the Securities Act and disclosed, reasonably in advance of the Transfer, in writing in reasonable detail to the Company. Each Holder will promptly notify the Company in writing if the Holder or, to the Holder's knowledge, any Person specified in Rule 506(d)(1) under the Securities Act becomes subject to any Bad Actor Disqualification.

5.05 Market Standoff.

(a) In the event of a public offering by the Company (or any successor to the Company) of its Equity Securities (defined below), pursuant to an effective registration statement filed under the Securities Act, or a qualified offering statement filed pursuant to Regulation A, promulgated under the Securities Act, the Shareholders, Wanxiang and HashKey, each covenant and agree, that they will not sell, make any short sale of, loan, hypothecate, pledge, grant any option for the purchase of, or otherwise dispose of or transfer for value or otherwise agree to engage in any of the foregoing transactions with respect to any Equity Securities of the Company however or whenever acquired (except for those being registered or qualified) without the prior written consent of the Company. Such limitations shall be in effect for such period of time as may be requested by the Company; provided, however, that in no event shall such period exceed 180 days after the effective date of the registration statement, or qualification date of the offering statement, for such public offering, plus such additional period as may be requested by the

underwriter or placement agent for such public offering, if any, as is necessary to comply with regulatory restrictions on the publication of research reports (including, but not limited to, FINRA Rule 2241, or any amendments or successor rules). If requested, each of the Shareholders, Wanxiang and HashKey will execute an agreement reflecting the limitation of this Section 5.04 as may be requested by the Company, or if applicable, the underwriter or placement agent for such public offering.

(b) For purposes hereof, “**Equity Securities**” means (a) the common and preferred stock of the Company; (b) any securities conferring the right to purchase common or preferred stock; (c) any securities directly or indirectly convertible into, or exchangeable for (with or without additional consideration) common or preferred stock; (d) smart security tokens of the Company, including the Company’s ember tokens, when and if created (collectively, with any other blockchain based securities of the Company, “**Digital Securities**”); and (e) any securities directly or indirectly convertible into, or exchangeable for (with or without additional consideration) Digital Securities.

5.06 Stop-Transfer Instructions. In order to enforce the limitations of this Article V, the Company reserves the right to impose stop-transfer instructions with respect to any Equity Securities subject to the foregoing provisions until any applicable restrictions on transfer expire.

ARTICLE VI. CONFIDENTIALITY

6.01 Confidentiality Obligation. In connection with providing services to the Company pursuant to the Prior Agreements, each Entity Party, and their respective officers, directors employees and Affiliates, and the respective officers, directors and employees of such Affiliates (the “**Receiving Party**”) may have been provided or had access to certain information, including Confidential Information (as defined below) of any other Entity Party (the “**Disclosing Party**”). At all times during the term of this Agreement, and for a period of three (3) years following the termination of this Agreement, the Receiving Party shall hold all Confidential Information in strict confidence and not to disclose any Confidential Information to any third party, except as required by law, regulation or legal or judicial process. The Receiving Party shall not use any Confidential Information for their benefit, or for the benefit of any their Affiliates, or any other third party. The Receiving Party shall take the same degree of care that they use to protect their own confidential and proprietary information and materials of similar nature and importance (but in no event less than reasonable care) to protect the confidentiality and avoid the unauthorized use, disclosure, publication or dissemination of the Confidential Information. No Receiving Party shall make any copies of the Confidential Information. No Receiving Party shall decompile, disassemble or otherwise reverse engineer any Confidential Information or any portion thereof, or determine or attempt to determine any source code, algorithms, methods or techniques embodied in any Confidential Information or any portion thereof.

6.02 Confidential Information. For purposes of this Agreement, “**Confidential Information**” means any and all information, technical and non-technical data, know-how, trade secrets,

intellectual property, ideas, inventions, processes, techniques, methodologies, algorithms, programs (whether in source code or object code form), hardware, devices, and all other confidential or proprietary information, including without limitation, information relating to past, present or proposed business plans, strategies, projects, services, customers, potential customers, partners, potential partners, product development efforts, the marketing or promotion of any product or services, business policies or practices, financial forecasts or results, and other information relating to the business, operations and affairs of the Disclosing Party or any of its Affiliates, whether in writing, or in oral, graphic, electronic or any other form, regardless of whether marked confidential or proprietary, the manner or form in which it is provided, or whether tangible or intangible, furnished by or on behalf of the Disclosing Party prior to the Effective Date or after the Effective Date. Confidential Information shall not include information that (i) is or becomes generally available to the public other than as a result of an act or omission by the Receiving Party, (ii) was within the Receiving Party's possession prior to it being furnished to it by the Disclosing Party or any of its representatives, provided that the source of such information was not otherwise prohibited from transmitting the information by a contractual, legal, fiduciary or other obligation, or (iii) becomes available to the Receiving Party on a non-confidential basis from a source other than the Disclosing Party or any of its representatives, provided that the source of such information was not otherwise prohibited from transmitting the information by a contractual, legal, fiduciary or other obligation.

6.03 Ownership. All Confidential Information (including, without limitation, all copies, extracts and portions thereof) is and shall remain the sole property of the Disclosing Party. No Receiving Party acquired (by license or otherwise, whether express or implied) any intellectual property rights or other rights under the Prior Agreements or this Agreement, except the limited right to use such Confidential Information in accordance with the express provisions of the Prior Agreements.

6.04 Remedies. Each Entity Party agree that, due to the unique nature of the Confidential Information, the unauthorized disclosure or use of the Confidential Information may cause irreparable harm and significant injury to the Disclosing Party, the extent of which may be difficult to ascertain and for which there may be no adequate remedy at Law. Accordingly, each Entity Party agree that the Disclosing Party, in addition to any other available remedies, shall have the right to seek an immediate injunction and other equitable relief enjoining any breach or threatened breach of this Agreement. The Receiving Party shall notify the Disclosing Party in writing immediately upon either of them becoming aware of any such breach or threatened breach.

6.05 Return of Materials. If requested by the Disclosing Party, (a) the Receiving Party shall promptly return to the Disclosing Party or destroy all materials (in written, electronic or other form) containing or constituting Confidential Information, including any copies and extracts thereof, and (b) the Receiving Party shall not use such Confidential Information in any way for any purpose.

6.06 Protective Arrangements. In the event that any Receiving Party either determines on the advice of its counsel that it is required to disclose any information pursuant to applicable Law or receives any request or demand under lawful process or from any Governmental Authority to disclose or provide information of the Disclosing Party (or any of the Disclosing Party's Affiliates) that is subject to the confidentiality provisions hereof, such Receiving Party will notify the Disclosing Party (to the extent legally permitted) as promptly as practicable under the circumstances prior to disclosing or providing such information and will cooperate, at the Disclosing Party's cost and expense, in seeking any appropriate protective order reasonably requested by the Disclosing Party.

ARTICLE VII. RIGHTS OF HASHKEY

7.01 Definitions. For the purpose of this section, the following terms shall have the following meanings:

- (a) A "Qualifying Offer" means a bona fide written offer from an un-Affiliated third (3rd) party (a "**Proposed Transferee**") to purchase Shares then held by a member of the Management Group or the HashKey Group. A Qualifying Offer must be contained in a binding written agreement and be accompanied by evidence which reasonably demonstrate the ability of the Proposed Transferee to purchase such Shares.
- (b) Selling Group means either the Management Group or the HashKey Group, that has received a Qualifying Offer that it wishes to accept.
- (c) Tag-Along Notice means a notice sent by the Selling Group, to either the Management Group or the HashKey Group, as applicable. Any Tag-Along Notice shall be in writing and shall include all of the material terms of the Qualifying Offer and the identity of the Proposed Transferee.
- (d) Tag-Along Group shall mean the recipient of a Tag-Along Notice.

7.02 Tag-Along Rights.

- (a) In the event that a member of a Selling Group receives a Qualifying Offer from a Proposed Transferee which the Selling Group in its sole discretion, wishes to accept, the Selling Group shall deliver Tag-Along Notice' to the Tag-Along Group which will have the right to participate proportionately as set forth below in the sale to the Proposed Transferee,
- (b) In the event that the Tag-Along Group elects to participate in the sale, the Tag-Along Group will send written notice to the Selling Group that it is exercising its Tag-Along rights. After delivery of such notice, the Tag-Along Group will participate in the

sale to the Proposed Transferee on the same price, terms and conditions as the Selling Group,

(c) If the Proposed Transferee will not purchase all of the Shares which the Selling Group and the Tag-Along Group wish to sell, the percentage of Shares which each of the members of the Selling Group and Tag-Along Group will be permitted to sell to the Proposed Transferee will equal to the product of (i) the number of Shares which the Proposed Transferee desires to purchase, multiplied by (ii) by a fraction, (a) the numerator of which is the number of Shares owned by the Selling Group or the Tag-Along Group as applicable, and (b) the denominator of which is the aggregate number of Shares owned by the Selling Group and the Tag-Along Group.

(d) The Tag-Along Group may exercise its rights under Section 7.01(a) above by providing written notice to the Selling Group within ten (10) days after the date of delivering the Tag-Along Notice.

(e) The Tag-Along rights pursuant to this Section 7.01 shall not apply to any Transfer made pursuant to any merger and/or acquisition, in which 100% of the Company's issued and outstanding Common Stock and preferred stock (if any) are acquired.

7.03 Preemptive Rights. HashKey shall have a one-time preemptive right to purchase up to \$5 million of any Company Securities upon the entry into a binding letter of intent by the Company with a third-party investor to purchase no less than \$5 million of Company Securities on the same terms and conditions. HashKey will have 5 days following written notice by the Company to it to exercise this right. Such notice by the Company shall include the price and terms and conditions upon which the Company proposes to issue the Company Securities.

ARTICLE VIII. GENERAL PROVISIONS

8.01 Notices. Any notices, consents, waivers or other communications required or permitted to be given under the terms of this Agreement must be in writing and will be deemed to have been delivered: (i) upon receipt, when delivered personally; (ii) upon receipt, when sent by facsimile or electronic mail (provided confirmation of transmission is mechanically or electronically generated and kept on file by the sending party); or (iii) two (2) Business Days after deposit with a reputable international courier service with 2nd day delivery specified, in each case, properly addressed to the party to receive the same. The addresses, facsimile numbers and e-mail addresses for such communications shall be:

If to the Company or any Founder:

Prometheum, Inc.

120 Wall Street, 25th Floor
 New York, NY 10005
 Telephone: (212) 514-8369
 Facsimile: (212) 809-4147
 Attn: Benjamin S. Kaplan, Co-Chief Executive Officer
 Email: bkaplan@prometheum.com

If to HashKey/Wanxiang:

HashKey Digital Asset Group Limited
 614-615, Level 6, Cyberport 3
 100 Cyberport, Hong Kong
 Telephone: (852) - 3598-3078
 Facsimile: (852) - 8343-0950
 Attn: Ben El-Baz
 Email: ben.elbaz@hashkey.com

8.02 Governing Law. This Agreement and the terms and conditions set forth herein, shall be governed by and construed solely and exclusively in accordance with the internal laws of the State of New York without regard to the conflicts of laws principles thereof. The parties hereto hereby expressly and irrevocably agree that any suit or proceeding arising directly or indirectly pursuant to or under this Agreement shall be brought solely in a federal or state court located in the City, County and State of New York. By its execution hereof, the parties hereto covenant and irrevocably submit to the in personam jurisdiction of the federal and state courts located in the City, County and State of New York and agree that any process in any such action may be served upon any of them personally, or by certified mail or registered mail upon them or their agent, return receipt requested, with the same full force and effect as if personally served upon them in New York, New York. The parties hereto expressly and irrevocably waive any claim that any such jurisdiction is not a convenient forum for any such suit or proceeding and any defense or lack of in personam jurisdiction with respect thereto. In the event of any such action or proceeding, the party prevailing therein shall be entitled to payment from the other parties hereto of all of its reasonable counsel fees and disbursements.

8.03 Specific Performance. Each party hereto acknowledges and agrees that in the event of any breach of this Agreement by any of them, the other parties hereto would be irreparably harmed and could not be made whole by monetary damages. Each party accordingly agrees to waive the defense in any action for specific performance that a remedy at law would be adequate and that the parties, in addition to any other remedy to which they may be entitled at law or in equity, shall be entitled to specific performance of this Agreement without the posting of bond.

8.04 Headings. The Article and Section headings of this Agreement are for convenience only, do not form a part of this Agreement, and will not in any way affect the interpretation hereof.

8.05 Parties in Interest. Nothing in this Agreement will be construed to be for the benefit of or enforceable by any Person not a party to this Agreement, including, but not limited to, any creditor of the Company, other than the Persons entitled to indemnification.

8.06 Further Assurances. The parties will execute and deliver such further instruments and do such further acts and things as may reasonably be required to carry out the intent and purposes of this Agreement.

8.07 Remedies Cumulative. Except as otherwise provided herein, no remedy conferred upon or reserved to the Company or any other party by this Agreement is intended to be exclusive of any other remedy. Except as otherwise provided herein, each and every such remedy will be cumulative and will be in addition to any other remedy given to the Company or any other party hereunder or now or hereafter existing at law or in equity or by statute.

8.08 Successors and Assigns. Subject to the restrictions on Transfer set forth in this Agreement will bind and inure to the benefit of the parties hereto and their respective successors and assigns.

8.09 Legal Fees. In the event that any party should commence legal proceedings with respect to the rights and duties of the parties to this Agreement, the prevailing party in such legal proceedings will be entitled to reimbursement from the non-prevailing party of all legal fees and expenses incurred in such proceedings.

8.10 Counterparts. This Agreement may be executed in any number of counterparts, each of which will be deemed to be an original and all of which will constitute one and the same agreement.

8.11 Entire Agreement. The terms and conditions of this Agreement constitutes the entire agreement between the parties concerning the subject matter hereof, and will supersede all previous communications, either oral or written, between the parties hereto, and no agreement or understanding modifying this Agreement will be binding upon any party unless such modification is in writing and signed by such party.

8.12 Waivers and Amendments. This Agreement, and any and all provisions of this Agreement, may be waived, modified or amended from time to time with the prior affirmative vote of at least a majority of the Board and the prior written approval of the HashKey and Wanxiang, provided that the HashKey Group owns no less than ten (10%) percent of the Company's issued and outstanding Common Stock at such time, except that any waiver, modification or amendment that adversely affects the rights of HashKey Group or additionally increase the obligations of HashKey Group shall require the consent of HashKey and Wanxiang.

8.13 Interpretive Principles. Unless the context otherwise clearly requires, as used in this Agreement, the masculine pronoun shall include the neuter and the feminine and the neuter pronoun shall include the masculine and the feminine. This Agreement shall be construed

without regard to any presumption or rule requiring construction against the party causing an instrument or any portion thereof to be drafted. For purposes of this Agreement, except as otherwise expressly provided or unless the context otherwise requires (a) the words “herein,” “hereof” and “hereunder” and other words of similar import refer to this Subordination Agreement as a whole and not to any particular provision; (b) the terms “include” and “including” mean without limitation by reason of enumeration; and (c) the term “or” has, except where otherwise indicated, the inclusive meaning represented by the phrase “and/or.”

8.14 Termination of this Agreement. This Agreement shall terminate and have no further force and effect upon the closing of the IPO of the Common Stock (or of the common stock of a successor entity and/or a parent thereof to the Company), except that Section 2.02, Section 3.01, Article IV, Article VI, and this Section 8.14 all of which shall survive an IPO.

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EXECUTION COPY

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first above written.

COMPANY:

PROMETHEUM, INC.

By: 

Name: Martin H. Kaplan
Title: Chairman

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first above written.

HASHKEY DIGITAL ASSET GROUP LIMITED

By: 
Name: Dr. Xiao Feng
Title: Director

SHANGHAI WANXIANG BLOCKCHAIN INC.

By: 
Name: Dr. Xiao Feng
Title: Chairman

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first above written.

SHAREHOLDERS:



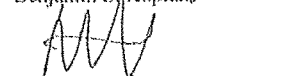
Martin H. Kaplan



Aaron L. Kaplan



Benjamin S. Kaplan



Lawrence G. Nusbaum

Junichi Watanabe


Jonathan Braun

Jerry Schneider

Alex Shapiro

Gareth Jenkins

EXECUTION COPY

SCHEDULE I

Founders

Founder Name
Martin H. Kaplan
Aaron L. Kaplan
Benjamin S. Kaplan
Lawrence G. Nusbaum
Junichi Watanabe
Jonathan Braun
Jerry Schneider
Alex Shapiro

April 26, 2021

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: Custody of Digital Asset Securities by Special Purpose Broker-Dealers (17 C.F.R. Part 240, SEC Rel. No. 34-90788, File No. S7-25-20) (the “Proposal”)

Prometheus, Inc. (“Prometheus”) appreciates the opportunity to provide comments on the Proposal and recognizes that it is an effort by the Securities and Exchange Commission (the “Commission”) to seek a comprehensive approach to the regulation of digital asset securities. We recognize that it is the Commission's goal to ensure that the level of investor protection related to the custody of digital asset securities is equal to or greater than the protection currently offered in the traditional securities (non-digital securities) clearing, settlement and custody model. We also believe, that as is the case with traditional securities, there should be a securities industry alternative for the custody location of digital asset securities.¹ We have prepared this letter in response to the Commission seeking comments from the public in order to gain information and insight relating to potential industry standards and best practices to ultimately determine the rules and policies for the custody and control of digital asset securities.

Prometheus applauds the Commission's effort to create a framework for becoming a Special Purpose Broker-Dealer. While we endeavor to answer the Commission's request for comments in the Proposal, we also seek certain points of clarification as we believe the Proposal creates material unknowns that are critical to the clearing, settlement and custody of digital assets securities.

In the Proposal, the Commission takes the position that a Special Purpose Broker-Dealer must limit its business operations to digital asset securities. The definition of a digital asset security, as used in the Proposal, is “a digital asset that meets the definition of a “security” under the federal securities laws.” This definition puts a burden on the industry to determine which

¹ See *OCC Interpretive Letter No. 1170* from July 22, 2020, opining that national banks can provide custody services for crypto securities pursuant to already established provisions of custody of traditional securities.

It is important to note that regardless of how the Commission defines digital asset securities, we believe the securities industry won't realize the many benefits of using blockchain technology without including stablecoins in the settlement process. Stablecoins are digital assets that are generally pegged to stable assets such as fiat currency, thereby making them a blockchain native solution for performing asset to "cash" settlement. Allowing a Special Purpose Broker-Dealer to settle digital asset securities with stablecoins will result in further settlement efficiencies such as instantaneous and direct settlement. In consideration of the important role stablecoins can play in the digital asset securities settlement process, we respectfully request the Commission clarify whether Special Purpose Broker-Dealer will be able to settle transactions using stablecoins.

In furtherance of the Proposal's collection of information and of the industry's need for clearly defined practices, Prometheus provides comments herein to the following questions: 1) What are industry best practices with respect to protecting against theft, loss, and unauthorized or accidental use of private keys necessary for accessing and transferring digital asset securities; 2) What are industry best practices for generating, safekeeping, and using private keys? Please identify the sources of such best practices; 3) What are the processes, software and hardware systems, or other formats or systems that are currently available to broker-dealers to create, store, or use private keys and protect them from loss, theft, or unauthorized or accidental use?; 6) What differences are there in the clearance and settlement of traditional securities and digital assets that could lead to higher or lower clearance and settlement risks for digital assets as compared to traditional securities?; and 7) What specific benefits and/or risks are implicated in a broker-dealer operating a digital asset alternative trading system that the Commission should consider for any future measures it may take?

I. Proposal Questions 1 and 3: Question 1) What are industry best practices with respect to protecting against theft, loss, and unauthorized or accidental use of private keys necessary for accessing and transferring digital asset securities? What are industry best practices for generating, safekeeping, and using private keys? Please identify the sources of such best practices; Question 3) What are the processes, software and hardware systems, or



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other formats or systems that are currently available to broker-dealers to create, store, or use private keys and protect them from loss, theft, or unauthorized or accidental use?

Questions 1 and 3 are best addressed together as they go hand-in-hand. The Commission has stated that a Special Purpose Broker-Dealer custodial digital asset securities must comply with the Customer Protection Rule by establishing that the digital asset security is in “the exclusive physical possession or control of the broker-dealer”. The creation, protection and safe storage of private keys are critical to establishing the exclusive physical possession or control by the broker-dealer of digital asset securities.

A. Current Industry Best Practices

Cyber security industry best practices, such as automated control systems, information security, and existing digital financial services and enterprise encryption systems, are the first line defense mechanisms for protecting private keys. Another strategy, more specific to blockchain to secure keys, includes strictly automated key management systems, extensive logging and auditing of key use, role-based access, and key rotation. In addition to the above measures, the combined use of Multisignature Wallets (“MultiSig Wallets”), hardware key/wallet systems and offline use of keys and signatures (“cold storage”) provide the highest level of security, and in our opinion, exceeds the level of security offered by databases, cloud, and other hosting solutions currently used to custody non-digital securities.

Digital asset securities are generally created on a blockchain as smart contract “tokens”, which means that best practices for the management of keys can include enforcing or expecting certain best practices in the smart contracts themselves (including MultiSig Wallets described below). This is unlike most cryptocurrencies where the options for key management are hard-coded into the underlying blockchain and provide limited options, particularly for multi-signature use.

Multisig Wallets are normally implemented as smart contracts whose access is cryptographically secured via the use of private keys and require at least two cryptographical private keys to access, and by extension, initiate or “call” a transaction. A smart contract is both the means of representing the digital asset on the blockchain and also controls access to the use of the digital asset. The number of keys required to access a wallet can vary depending on the protocols of the smart contract (e.g., a simple majority, 2 out of 3, 3 out of 5), commonly known as “N or M approvals”.

Smart contract enabled Multisig Wallets are a simple yet effective solution to solving two major problems inherent to digital assets: 1) losing them due to the loss of a person's private key and 2) theft by another person or entity. Multisig Wallets are a viable solution for ensuring that investors don't lose assets on a blockchain supported clearing, settlement, and custody solution because different required private keys can be entrusted to different persons at the broker-dealer so no one person has complete control. Essentially, the sum of the “pieces” will ensure the whole is not lost.





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An “N” of “M” protocol requires authentication of a certain number of keys. Each key would be distributed amongst different authorized persons, each of whom must authenticate using different mechanisms (e.g., different hardware systems). As an illustration, a “3 of 5” system allows for any three (3) of a total of five (5) keys to be used to confirm a transaction.

In the context of the Special Purpose Broker-Dealers holding the digital asset security, two to three of the five (5) keys would be held by different appropriately-authorized associated persons. Each of these persons would use a different hardware key system to authenticate their respective code. All of the hardware systems would be integrated and under the control of the broker-dealer.

In addition to “N of M” threshold systems for multiple keys, smart contract wallets can also be programmed to provide a key rotation or replacement system. For example, in a system that regularly uses specific keys, those keys should be replaced or, in the case of a significant security breach, replaced by less-frequently used keys. Such a system can be engineered to either require all other keys to confirm a replacement key or use of a separate key that is held in a different structure or with a different entity. In an example “3 of 5” system where 1 key is lost, stolen or unavailable it could be expected that three (3) of the remaining four (4) keys will be used to sign a transaction. Therefore, policies for key rotation or key replacement are important to ensure secure systems.

Hardware key/wallet systems are specially designed hardware that store private keys. Such systems often resemble USB memory sticks with a small screen. The advantage of these devices is that they do not connect to the internet permanently (i.e., are normally considered some form of “cold storage”) and thus provide a simple mechanism for keeping keys away from internet-connected computers that may be running (or susceptible to running) malicious software. Normally hardware key systems produce the required digital signatures on the devices itself and don’t allow for the private key itself to be obtained easily. Multiple types of hardware signing devices from different vendors is critical to maintaining the safety of the “N” of “M” protocol. This protects against potential failure of the protocol should one hardware signing device be compromised, as only one of the “N” of “M” keys would be lost.

Lastly, offline (“cold”) use of keys and signatures refers to keys that are stored in an electronic device that is not connected to the internet (a/k/a “air gapped”) which is also a strongly recommended best practice.

Ultimately, we believe the above processes and tools are a good foundation for industry best practices.





II. Proposal Question 6: What differences are there in the clearance and settlement of traditional securities and digital assets that could lead to higher or lower clearance and settlement risks for digital assets as compared to traditional securities?

The comparison of clearing and settlement for traditional securities and digital asset securities centers on the systems utilized in the clearing and settlement process, the procedures

(both automated and manual), as well as the overhead and personnel required. Clearance and settlement of traditional securities is complicated, time consuming, and is cost, infrastructure and labor intensive. It is highly dependent on a blend of new and legacy technologies, numerous interconnected entities and organizations, and continuous human/manual procedures related to redundancy and reconciliation that by default introduce some risk. While we have prepared a detailed comparison below, we believe it's important to note that after the execution of traditional securities transactions, they need to be reconciled at the broker dealer level, at the clearing firm level, and at the DTC level where they are ultimately settled by an exchange of securities for cash. Again, significant portions of the process are not automated and involve people entering data and/or comparing files, and as a result, settlement finality takes 2 days. Blockchain technology represents an elegant solution to many of the traditionally manual processes we have described herein.

In the traditional markets, data from many different sources is often manually combined and compared during reconciliation resulting in a critical inefficiency. In comparison, the use of a blockchain to clear and settle digital asset securities is based on self-executing protocols through smart-contracts, and simultaneous books and records updates via the ledger. As discussed herein, there are risks inherent in both systems, however, clearance and settlement of digital asset securities over a blockchain has significantly less risk because it greatly reduces the number of intermediaries involved, the exchange of redundant data and messaging, and removes the possibility of human errors. Ultimately ensuring faster and more accurate verification of transactions, identification of change in beneficial ownership, and clear and contemporaneous books and records of transactions and ownership.

Set forth in Section II(A) below is the typical life cycle of a trade in a traditional security. Section II(B) addresses clearance and settlement of a digital asset security on the blockchain. A summary table of the comparison of traditional clearance and settlement steps and the corresponding blockchain utility is attached as Appendix A hereto.

A. Traditional Clearance and Settlement Cycle

As acknowledged in the Proposal, traditional clearance and settlement (hereinafter, "TCS") is a multi-layered system of separate Participants (as defined herein) performing distinct essential functions for the transfer of beneficial ownership of traditional securities. Broker-dealers, clearing firms, and market centers ("Participants") work with each other and with transfer agents, the Depository Trust and Clearing Corporation ("DTCC") and the National Securities Clearing Corporation ("NSCC"), self-regulatory organizations ("SRO") and banks





throughout the clearing and settlement process to ensure settlement finality. Generally, the timeframe for complete clearance and settlement is trade date + two (2) days (“T+2”).

An equity trade life cycle begins when an order to buy and/or sell a US equity security is submitted to a market center (e.g., exchanges, ATS) by a broker-dealer identified by its unique Market Participant Identifier (“MPID”) as well as its unique DTCC number. The order is then matched, and the transaction is executed at which point, the market center sends confirmation of

the trade to the counter-brokers involved in the transaction via a proprietary API or messaging format or standardized electronic message protocol (“FIX”). Simultaneously, the market center sends a confirmation to the NSCC via NSCC’s Universal Trade Capture (“UTC”) system which “locks-in” the trade to the respective brokers by their DTC number. The broker-dealers then send the confirmations they receive to their clearing firms by FIX, as well as, sending an end-of-day (“EOD”) file after the close of each trading day.

The transaction is then reconciled, cleared and settled amongst the Participants. During and after the trading day, clearing firms must perform trade reconciliation, and reviews of the trading activity executed by their correspondents. Clearing firms compare their real-time drop copies with EOD reports they receive from their correspondents, exchanges, ATS and the NSCC. Trade reconciliation involves extensive automated and manual labor. Processing systems compare the multitude of aforementioned files and generate alerts and reports. Clearing firm employees must then review these reports for errors, mismatches and other possible trade breaks. Trade breaks must be resolved manually by clearing firm employees by contacting the trade desks, executing brokers, other clearing firms and other market centers. Once a trade break is resolved, new trade data must be uploaded to the clearing firm’s systems in order to update the records for correct reports to be submitted to DTCC and NSCC, custodian banks and broker-dealers for the account holders.

Book Entry Only (“BEO”) is the accounting system that enables the DTCC to electronically transfer beneficial ownership records for traditional securities. As is the practice, DTCC holds the securities in its nominee name, Cede & Co, for the beneficial owner of the traditional security. The account holder’s broker-dealer is responsible for tracking its customers, i.e., the beneficial owner’s holdings in the customer’s brokerage account.

This fragmented structure creates many points of potential failure and vulnerability. The lack of standardized technology between intermediaries and the high degree of human involvement exposes equities clearing and settlement to significant risk. As discussed below, smart contracts and the blockchain offer a more secure and efficient system for clearing and settling digital asset securities.

B. Clearing and Settlement on the Blockchain

Prometheus believes that settlement of digital asset securities must occur using appropriate and audited smart contracts and network verification in order to take full advantage of blockchain technology. Blockchain technology increases operational efficiency and provides





faster reconciliation, clearing and settlement cycles. The result is a more streamlined and effective path to custody finality, accurate and transparent record keeping, and direct auditing functionality.

1. Smart Contracts

Smart contracts are established to automatically enact a series of predetermined changes according to a technology protocol when a specific act occurs. Smart contracts are used in every

step of the digital asset security trade-cycle to verify the accuracy of information, ownership rights, trade details and the ultimate change in beneficial ownership with significantly less intermediaries and information redundancies than traditional securities clearing and settlement.

Smart contracts enforce protocols for automatically facilitating the transmission of shareholder communications, enforcement of blue-sky qualifications and required protections for jurisdictional limitations. They can also facilitate payment of interest or dividends electronically and enforce limits on trading for restricted securities.

Smart contracts mitigate settlement risks because: 1) no transfer/transaction can be completed without the seller meeting specific conditions established in the smart contract; 2) smart contracts execute without human interaction on the blockchain thereby eliminating intermediaries relaying different parts of trade information which, will result in less trade breaks; and 3) all trades settle on a same day basis.

2. System and Data Security

Current market infrastructure is centralized and is secured by utilizing advanced hosting facilities, security hardware and applications, redundancies, and backup systems. However, the very nature of the centralized system makes it extremely vulnerable to widespread harm through hacking, ransomware and other network attacks.

The blockchain's distributed nature eliminates the potential for a hack, ransomware or other attacks to bring down the whole network. Blockchain technology, governance models and consensus mechanisms have the potential to be substantially more secure than the current central database supported market infrastructure. Additionally, because most of the independent components and manual processes of the traditional securities model can be recreated as Participants or functions on a blockchain, a consistent level of defense can be maintained across the whole ecosystem

3. Operations Efficiency

Today, using blockchain technology, payments can be processed, and debits/credits applied within seconds. The T+2 settlement cycle is inefficient and archaic.





In connection with the post trade settlement process, a blockchain, even with some level of manual oversight, will streamline the current model. MultiSig Wallets are very good at providing secure settlement finality. Smart contracts allow for “intelligent” algorithms to automate clearing level reconciliation between exchanges and BDs.

4. Accurate Recordkeeping and Data Transparency

One of the most fundamental risks in the TCS process is the constant exchange of data being generated and transmitted between intermediaries for execution, reconciliation and recording of changes in beneficial ownership. This section outlines the inefficiencies and redundancies of the TCS process resulting in significant systemic risk.

A digital asset security on a blockchain is the solution to an efficient and accurate record of transactions. A blockchain is made up of distinct, sequential, and time-stamped records of asset ownership resulting from settlement (“Block”). The underlying distributed ledger technology, and smart contract verifications enforces the accuracy of each new Block consisting of the settled transaction and the previous Block. This technologically enforced sequential recordkeeping provides certainty that settlements recorded on a blockchain are accurate and independently confirmed in real-time by the network Participants. The network is responsible for updating the blockchain through the addition of new Blocks, the contents of which can be reviewed by Participants upon distribution, in real-time.

For each Participant, the copy of the blockchain provides data regarding the clearance and settlement status of the Participant’s transactions and resulting securities and cash positions. Over time, this would allow each Participant to use the blockchain in lieu of maintaining a separate internal ledger. This has the potential to eliminate the need to reconcile differences in settlement records, either with trading counterparties, or with the omnibus position in an account at the clearing firm and/or at a central securities depository like DTC/NCSS.

Additionally, each Participant could allow its customers (including the end investors) to have direct and individually permissioned access to the blockchain. Thus, the beneficial owner of the security could rely on the blockchain’s technologically enforced data for his/her positions. This accountability would eliminate DTCC’s nominee holding practice. Moreover, investor access has the potential for enhanced investor protection as it would allow investors to independently confirm their ownership and possession of assets recorded to the blockchain.

5. Regulatory Reporting and Auditing Functionality

The data visibility and accuracy could also be extended to regulators for the fair and consistent enforcement of market rules and regulations. In the traditional securities model, Participants must provide daily reports, requested information, and real-time drop copies to regulators/self-regulatory organizations. Participants are also required to provide access to regulators for auditing purposes. The blockchain solves the transfer of mass volumes of data by using a read-only node on a blockchain. By building in such a node and utilizing a blockchain explorer, Participants can obtain direct uneditable data at any time and in real-time.





Ultimately, performing clearance, settlement and custody on a blockchain presents many clear advantages that allow for greater efficiencies, protections and less mistakes.

III. *Proposal Question 7: What specific benefits and/or risks are implicated in a broker-dealer operating a digital asset alternative trading system that the Commission should consider for any future measures it may take?*

Based on regulatory precedence, it is clear that only a registered broker-dealer can operate an alternative trading system, regardless of whether the asset traded is a traditional security or a digital asset security. A broker-dealer already has compliance requirements related to record keeping, customer protection, security, risk, AML/KYC, and financial stability. An ATS must meet all of these requirements, as well as maintain a fair and orderly market. Specifically, blockchain, and related technology like smart contracts, public/private key cryptography, and digital wallets can and should be adapted and used to the advantage of the capital markets. We firmly believe that broker-dealers will realize clear and important benefits from operating a digital asset alternative trading system. Clear and important benefits include, but are not limited to:

1. Faster settlement finality;
2. Immediate reconciliation;
3. Real-time balances;
4. Accurate short sell (stock loan/borrow);
5. Ability to always track stock locates on-chain;
6. Streamlined reporting;
7. Real-time auditing;
8. Lower fees;
9. Less overhead cost;
10. Decreased counterparty risk;
11. Eliminates need for central clearinghouse;
12. Eliminates need for NSCC to take on risk; and
13. Automated risk controls (pre-trade).

IV. *Conclusion*

In conclusion, we would like to thank the Commission for the opportunity to share our thoughts and provide comments on the Proposal. To reiterate, we strongly support the creation of the Special Purpose Broker-Dealer to custody digital asset securities, and believe it is a critical step towards incorporating digital assets into the capital markets. We firmly believe that blockchain represents the “next” technological evolution for capital markets, and that innovation must be compliant with the federal securities laws to ensure the security of investors and the markets.





Prometheum would welcome the opportunity to meet with the Commission to further contribute to the ongoing regulatory progress.

Sincerely,

Benjamin S. Kaplan
Co-CEO, Prometheum Inc.

[REDACTED]



Appendix A

Traditional Clearance and Settlement	Blockchain Clearance and Settlement
T+2 final settlement of transaction	Immediate and direct clearance and settlement
Multiple unique identifiers for each Participant entering securities transactions (e.g., MPID, DTCC number, etc.)	Information provided to appropriate parties to be able to identify Participants is inherently digitally and automatically added to each side of the transaction.
Transaction terms creates a contract required to be verified and confirmed over T+2	The execution on the blockchain through the use of smart contracts is the final simultaneous verification and confirmation.
Correspondent/clearing firm relationship	Blockchain technology removes the need for separate verification of transactions amongst the multiple participants in the clearing process.
Multiple steps and messages between trade Participants for one transaction	Limited messages to post a transaction based on automated and real-time writing of transaction to the blockchain
Non-uniform messaging protocols	Uniform protocol on the blockchain
Clearing firm trade reconciliation based on reports from multiple entities and human review.	Smart contracts aggregate data from multiple parties and provide immediate and consistent outputs for reconciliation and other purposes based on pre-agreed and tested protocols.
Clearing firm must resolve trade breaks by humans contacting the multitude of trade Participants	Smart contracts execute transactions in digital asset securities by automating protocols for verification of the terms of the transactions prior to execution, preventing erroneous transactions.
Clearing firms regenerate corrected reports and disseminate to all trade Participants	The blockchain automatically retains all smart contract actions and serves as the standard basis for reporting.
Book Entry Only accounting records the change in beneficial ownership once a transaction is confirmed as settled and holds it in nominee name for the beneficial owner.	The blockchain is the real-time accounting system for smart contract verified digital asset transactions.



Prometheum

DTCC holds the traditional security in nominee name for the beneficial owner.	Digital asset securities are held in wallets that represent both the immediate custodian and the beneficial owner. The blockchain is the ultimate source of truth for beneficial ownership regardless of whether those digital asset securities are held directly by the beneficial owner or on their behalf.
Broker-dealers that hold beneficial owner accounts track the positions.	Beneficial owners typically access positions via their broker-dealer, but those positions are also verifiable via publicly viewable blockchain information.

**TESTIMONY OF THOMAS W. SEXTON
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL FUTURES ASSOCIATION**

**BEFORE THE COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES**

***THE FUTURE OF DIGITAL ASSETS: PROVIDING CLARITY FOR THE DIGITAL
ASSET ECOSYSTEM***

JUNE 13, 2023

Chairman McHenry, Ranking Member Waters and Committee members thank you for inviting National Futures Association (NFA) to appear before you today. My name is Thomas Sexton, and I am the President and Chief Executive Officer of NFA. At the outset, we applaud this Committee's and under Chairman Thompson's and Ranking Member Scott's leadership, the House Committee on Agriculture's collaborative work to develop potential legislation governing spot digital assets, including those that are commodities. We strongly believe that retail customers should be protected from wrongdoers engaging in spot digital asset commodity activities and continue to support Congress's efforts to enhance the current regulatory framework to offer greater protections to customers.

Today, I want to discuss the following with this Committee:

- NFA's role and regulatory responsibilities in the derivatives industry;
- NFA's record of success addressing retail trading abuses;
- NFA's strong partnership with the CFTC; and
- NFA's oversight of its Members engaging in spot digital asset commodity activities.

We recognize that this Committee and the House Committee on Agriculture issued a *Discussion Draft* on June 2, 2023 that provides a regulatory framework for digital assets. While we are still fully evaluating the *Discussion Draft*, I thought it may be helpful for us to offer our views about some of the critical customer protections contained in the *Discussion Draft* that Congress should adopt if it moves forward with developing a statutory framework for digital asset commodities.

NFA's Role in the Derivatives Industry

NFA is a registered futures association (RFA) pursuant to Section 17 of the Commodity Exchange Act (CEA), and the industrywide independent self-regulatory organization

(SRO) for the derivatives industry. Our global membership includes CFTC registered futures commission merchants (FCMs), swap dealers (SDs), commodity pool operators (CPOs), commodity trading advisors (CTAs), introducing brokers (IBs), retail foreign exchange dealers (RFEDs) and the registered associated persons of these entities. NFA membership is mandatory as the CFTC requires these registered firms to be NFA Members. We currently have approximately 3,000 Member firms and 42,000 individual Associate Members.

NFA is solely a regulatory body—we partner with the CFTC to regulate our Members' derivatives activities. Further, due to retail customer protection concerns, we have asserted jurisdiction over Members' activities with respect to two specific spot markets—retail forex in the early 2000s and, more recently, digital asset commodities. We do not operate a market nor are we an industry trade association. As a regulator, NFA is a resolute customer protection organization, and we are committed to developing rules and regulatory programs designed to ensure Member firms and industry professionals deal fairly with their customers and counterparties. We are funded by the derivatives industry—primarily from membership dues and an assessment fee on public volume for listed futures contracts. Our FY 2024 operating budget is approximately \$140M and we perform our work with nearly 520 employees. We are headquartered in Chicago, Illinois and have a significant New York City presence.

NFA began operations in 1982 when Congress and the CFTC gave us the responsibility to regulate firms engaging in activities with customers in the exchange-traded derivatives markets. As Congress expanded the CFTC's jurisdiction over the years to include the retail forex spot and swaps markets, Congress and the CFTC also entrusted NFA with additional regulatory oversight responsibilities for these markets.¹ NFA worked very closely with the CFTC to develop rules and regulatory programs to effectively oversee these areas.

NFA's Primary Responsibilities

NFA currently has seven primary functions—registration, rulemaking, monitoring Members, enforcement, market regulation, investor protection and education and dispute resolution. Each are described briefly below:

Registration. Congress via the CEA requires certain firms and individuals that conduct business in the derivatives industry to register with the CFTC. Close to forty years ago, the CFTC delegated its registration responsibilities to NFA. On behalf of the CFTC, NFA registers firms and market professionals after a thorough investigation of their background to determine if they meet specified fitness standards. As part of the registration function, NFA also requires

¹ Congress originally gave the CFTC anti-fraud jurisdiction over the retail forex markets and expanded its jurisdiction to include regulatory oversight in 2008. Congress gave the CFTC jurisdiction over the swaps markets (except for security-based swaps) after the enactment of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.

associated persons to successfully complete applicable proficiency examinations developed by NFA.

Rulemaking. The essence of self-regulation involves identifying industry best practices in certain areas and then mandating those practices for the entire industry. NFA's Board of Directors reviews and approves the adoption of and changes to all NFA Requirements, which are subsequently subject to the CFTC's review and/or approval. Whether enhancing customer/counterparty protections, addressing fraud, or tailoring rules to specific regulatory issues and markets, NFA has worked with its Members and the CFTC to develop practical and effective regulatory responses for over forty years.² In times of market crisis, NFA's ability to respond quickly and decisively—in weeks not months—to developments is key to restoring or maintaining market participants' confidence.

Monitoring Members. NFA monitors Members for compliance with NFA's rules, which may adopt by reference applicable CFTC regulations, and investigates possible rule violations. Our key monitoring efforts include risk-based examinations, analysis of Members' financial and operational data, the investigation of customer complaints, the review of retail forex trade data, and the review of swap valuation dispute, swap data repository and key market and credit risk data.

Importantly, the CFTC and NFA have rules in place that prohibit customer funds from being commingled with an FCM's proprietary/operating funds. An FCM must maintain in a customer segregated account or accounts money, securities and property in an amount at least sufficient in the aggregate to cover its total obligations to all customers. To further enhance this critical customer protection, NFA and CME Group, Inc. require every FCM to report daily its customer segregated, secured and cleared swap collateral funds' balances, and we also receive daily reports from the depositories holding these funds to ensure that the accounts' balances are sufficient to cover the amount owed to customers.

Enforcement. Adopting stringent rules and monitoring for compliance with those rules does little good if NFA does not vigorously enforce them when appropriate in disciplinary actions against Members.³ NFA's disciplinary panels may impose penalties against Members that include expulsion or suspension from NFA membership, fines, or any other appropriate penalties or remedial actions. Given mandatory membership, a firm or associated person expelled or suspended from NFA membership is effectively barred from the derivatives industry. NFA works

² Further, before implementing a new or amended rule, NFA develops and delivers education to Members to help them understand their regulatory requirements.

³ Over the years, for example, NFA's enforcement efforts have focused on serious types of misconduct including Ponzi schemes, misleading and/or high-pressure sales practices, improper loans and advances from commodity pools, retail forex electronic trading platform manipulative practices, abusive trading strategies and supervisory failures.

very closely with the CFTC's enforcement division so that we can properly coordinate and allocate our regulatory resources, which is critical in emergency situations. Importantly, we also work cooperatively with law enforcement agencies when we observe or suspect criminal activity. Over the years, NFA and the CFTC have brought many cases to quickly close down Ponzi and fraud schemes. Subsequent criminal prosecution of the individuals involved has often resulted in significant prison sentences.

Market Regulation. As permitted by the CEA, NFA's Market Regulation Department performs trade practice/market surveillance functions for certain electronic designated contract markets (DCMs) and Swap Execution Facilities (SEFs). Each SEF and DCM enters into an agreement with NFA to perform these regulatory functions for which they remain ultimately responsible under the CEA.

Investor Protection and Education. Protecting investors has been part of the CFTC's and NFA's mandate since inception and is a critical component of NFA's mission. NFA offers a variety of resources to help investors learn how the derivatives markets work and about the firms and individuals offering investment opportunities in the derivatives markets. We want investors to make informed decisions and avoid dealings with bad actors. Importantly, NFA offers a website tool, BASIC, that investors, the general public and NFA Members can use to research the background of industry professionals.⁴

Dispute Resolution. NFA offers an affordable and efficient arbitration program to help customers resolve futures-related and forex-related disputes with Members.

Addressing Retail Trading Abuses

We recognize that this past year is replete with examples of fraud schemes involving digital asset commodities that have caused significant monetary harm to retail customers. Our experience shows that robust requirements and stringent monitoring that make it difficult for potential fraudsters to carry out their schemes are essential to protect customers.

NFA has a strong track record over the years of closely working with the CFTC to effectively develop regulatory oversight programs targeted to protect retail customers and to prosecute retail trading abuses and fraud. Our collective efforts working with the CFTC, the industry's other SROs and industry participants have yielded significant results—customer complaints and single-event customer arbitrations filed at NFA, as well as CFTC's reparations cases, remain near all-time lows. The following illustrates our commitment to eradicating wrongdoers and protecting retail customers:

⁴ BASIC contains information relating to firms' and individuals' CFTC registration and NFA membership, regulatory actions, FCM financial information and dispute resolution information.

The 1990s—Options Sales Practices

In the 1990s, NFA and the CFTC cracked down on the boiler rooms in South Florida and California that utilized fraudulent sales practices to pitch retail customers on the sale of exchange traded options. These boiler rooms were NFA Member firms that utilized misleading radio and television advertisements to reel in their unsuspecting customers. NFA and/or the CFTC would take an enforcement action and close down one of these firms only to see a related firm open shortly under a new name with many of the same brokers. To address this situation, NFA augmented its sales practice and supervision rules by adopting more enhanced regulatory requirements, which were approved by the CFTC, to make it difficult for these firms to ply their trade.

Specifically, we placed restrictions on Members' use of radio and television advertisements, banned practices that presented a distorted and misleading view of the likelihood of customers earning dramatic profits and those that constituted high-pressure sales. Importantly, if a Member firm had brokers who were previously associated with a firm that had been shut down for sales practice fraud, we imposed enhanced requirements upon it relating to higher capital, tape recording of sales solicitations and the pre-approval by NFA of its promotional material. Therefore, once NFA and the CFTC took enforcement actions, we largely eliminated the incentive for firms to simply reopen under a different name. Due to NFA's and the CFTC's efforts, the large-scale boiler rooms that preyed on retail customers are a thing of the past.

The Early 2000s—Retail Spot Forex

In the late 1990s and early 2000s, an OTC retail forex market aimed at retail customers grew rapidly and many customers were victimized in a completely unregulated market. In the early 2000s, Congress passed legislation providing that off-exchange retail forex transactions were permitted if the counterparty to the retail customer was a regulated entity (e.g., an FCM). As a result, many entities that had no intention of doing on-exchange futures business became registered FCMs solely to act as counterparties to retail forex transactions. These FCMs performed several functions that traditionally had been performed, in part, by separate entities—they solicited customers, accepted customer funds, operated an electronic trading platform via an Internet interface and acted as counterparty (took the other side of the trade) of retail customers. At one point, there were over forty of these firms and fraud and mismanagement were rampant. Even though these firms made up less than 1% of our total Members, they accounted for 20% of our arbitration cases and over 50% of NFA's emergency actions.

Congress gave the CFTC anti-fraud authority over these FCMs' retail forex activities. However, although the firms were CFTC registered FCMs, Congress did not initially give the CFTC authority to regulate these firms' retail forex activities. Equally significant, the CFTC's anti-fraud enforcement efforts were jurisdictionally frustrated with respect to these retail forex transactions after Federal Appeals Courts found that these

transactions were not futures contracts but spot transactions that were outside of the CFTC's jurisdiction.⁵

Although the CFTC's hands were tied both from an anti-fraud and regulatory oversight standpoint, because these FCMs were NFA Members, we were able to step in and fill this regulatory gap until Congress acted in 2008 to give the CFTC the necessary authority. To regulate Members' spot retail forex activities, NFA adopted an anti-fraud provision and rules to establish enhanced capital requirements⁶ and business conduct rules for forex dealers, and we began to weed out the worst offenders. NFA specifically requires, in part, these forex dealers to disclose to customers the risks and inherent conflicts of interest associated with these transactions (e.g., when the customer loses money, the dealer makes money). Moreover, NFA requires forex dealers to inform customers that their customer funds are not segregated and, therefore, are unlikely to be protected in the event of the dealer's bankruptcy. Further, we receive transactional data from these firms' trading platforms to, in part, ensure that retail customers obtain fair prices, and we have taken several enforcement actions against these firms for abusive trading practices.

Due to our continuing customer protection concerns, NFA worked closely with the Congressional Agriculture Committees, the CFTC and the derivatives industry to grant the CFTC the necessary jurisdiction over leveraged spot retail forex transactions. In 2008, Congress amended the CEA to add Section 2(c)(2)(C) to give the CFTC anti-fraud and regulatory jurisdiction over these leveraged spot transactions provided they aren't securities or result in actual delivery within two days.⁷

Given that these spot forex dealers combine several functions⁸ within their business operations, Congress created a new CFTC registration category, Retail Foreign Exchange Dealer (RFED), for firms engaged solely in these spot retail forex transactions. Congress further required these firms to be Members of an RFA. In 2010, the CFTC adopted specific rules to govern spot retail forex transactions, which

⁵ The CFTC brought enforcement actions against several of these firms and lost these actions after federal courts found that these transactions were not contracts of sale of a commodity for future delivery. The courts recognized the leveraged and two-day rolling nature of these transactions but held they were spot contracts after deciding that the retail customers had no guaranteed right of offset and there was allegedly no standardization to the transactions' sizes. Consistent with the CFTC's position, NFA took the position that these transactions were futures contracts.

⁶ Specifically, NFA adopted capital requirements that over a five-year period increased from \$250,000 in 2005 to \$20,000,000 in mid-2009.

⁷ Excluded transactions also include those that create an enforceable obligation to deliver between a buyer and seller that have the ability to deliver and accept delivery, respectively, in connection with their line of business.

⁸ As noted above, these entities solicited customers, accepted customer funds, operated an electronic trading platform via an Internet interface and acted as counterparty (were on the other side of the trade) with retail customers.

extensively mirrored NFA's existing rules. Importantly, when NFA and the CFTC adopted rules in this area, we drew from our experience and the existing regulatory framework for futures intermediaries, making adjustments as needed to address the differences in these markets.

Today, there are four RFED NFA Members.⁹ Over the past several years, they account for very few of our disciplinary and customer arbitration cases.

The Regulation of Spot Digital Asset Commodities

Let me preface my remarks in this area by stating that, as a regulator, NFA does not advocate for specific markets or products and, therefore, will not do so in the case of spot digital assets. Further, our role is not to define what digital assets are securities or commodities.

Our primary responsibility is to regulate our Members' derivatives activities and, in limited instances, their spot market activities (e.g., retail forex and digital asset commodities) when they pose a risk to retail customers. Over five years ago, we had growing concerns with our Member firms engaging in spot digital asset commodity activities and decided to impose requirements upon our Members that have evolved over time in this area.

NFA's Oversight of its Member Firms Engaging in Spot Digital Asset Commodity Activities

Specifically, we were concerned that investors may not fully understand the nature of virtual currencies and virtual currency derivatives, the substantial risk of loss that may arise from trading these products and the limitations of NFA's regulatory authority over spot market virtual currencies. Given these concerns, in 2018, we adopted enhanced disclosure requirements that Members are required to provide customers. Moreover, we required Members engaging in these activities to provide customers with an NFA Investor Advisory – *Futures on Virtual Currencies Including Bitcoin* and the CFTC Customer Advisory: *Understand the Risk of Virtual Currency Trading*.

More recently, NFA extended its jurisdiction over Members' spot digital asset commodity activities. Candidly, we have not observed significant issues with Members engaging in these activities. However, we currently have well over 100 NFA Member firms that reported to NFA that they engage in business activities related to digital assets in the derivatives and/or spot markets. While our rules covered these Members' derivatives activities, they did not generally apply to spot digital asset commodity activities. If an NFA Member firm committed fraud or similar misconduct with respect to its spot digital asset commodity activities, NFA would have been in an untenable position because we would have lacked jurisdiction to prosecute the Member either in an emergency action or disciplinary case.

⁹ Additionally, two FCMs engage in retail forex activities.

Therefore, to proactively ensure that we have jurisdiction to discipline a Member and, in part, regulate Members' activities in this area, we adopted NFA Compliance Rule 2-51. This new rule imposes anti-fraud, just and equitable principles of trade and supervision requirements on NFA Members and Associates engaged in spot digital asset commodity activities. NFA Compliance Rule 2-51 became effective on May 31, 2023 and covers those digital assets that are commodities (e.g., Bitcoin and ether). These two digital assets have related futures contracts listed for trading on CFTC regulated exchanges. If Congress, federal regulators or the courts identify other digital assets as commodities in the future, then NFA would amend the Rule to cover them.

NFA's oversight programs and rules will continue to evolve in this area as we continue to monitor and examine our Members engaged in spot digital asset commodity activities. We recognize, however, that our ability to adopt critical customer protections is limited. We only have jurisdiction over our Members. We cannot create a federal registration and regulatory regime for spot digital asset commodity market participants, including segregated funds and bankruptcy protections for retail customers.

As previously noted, we recognize that this Committee and the House Committee on Agriculture issued a *Discussion Draft* on June 2, 2023 that provides a regulatory framework for digital assets. While we are still fully evaluating this *Discussion Draft*, our initial review found that it contains many of the critical customer protection principles that we believe Congress should adopt if it moves forward with developing this statutory framework for digital asset commodities.

Critical Customer Protections

NFA strongly believes that a customer protection regime for digital asset commodities can be drawn with adaptation from the CFTC's and NFA's foundational rules for exchange traded derivatives and retail forex, as applicable. Congress should provide the CFTC with regulatory authority to complement its current anti-fraud authority over market participants engaged in spot digital asset commodity activities. In doing so, Congress could amend the CEA to adopt a federal registration regime for spot digital asset commodity market participants and trading platforms and provide the CFTC with the authority to adopt critical customer protection rules. As previously noted, the *Discussion Draft* contains many of the key customer protections that we believe Congress should consider if it moves forward with developing a statutory framework for digital asset commodities, including but not limited to:

- Anti-Fraud and Anti-Manipulation;
- Business Conduct Standards (e.g., solicitation and advertising);
- Conflicts of Interest (e.g., prohibitions, management and disclosures);
- Customer Asset Protections (e.g., segregated funds; qualified third-party custodians hold customer assets/property and acknowledge they are

holding customer assets/property; limitations on how customer funds may be invested; and bankruptcy protections);¹⁰

- Disclosures to Customers (e.g., risk of loss, the nature and functionality of digital asset commodities and fees);
- Maintenance of Books and Records;
- Minimum Capital Requirements;¹¹
- Risk Management Procedures; and
- Trade Practice Surveillance (e.g., detect abusive and manipulative trading practices).

These robust customer protections have served the derivatives industry extremely well over the years and will provide digital asset commodity customers with similar regulatory protections, which these customers do not have today. We encourage Congress to allow the CFTC to adopt these critical customer protections if it moves forward with developing a statutory framework for digital asset commodities.

Last, since the *Discussion Draft* proposes a significant role for an RFA, I would be remiss if I did not touch upon the vital role that an independent SRO could assume to partner with the CFTC as it develops a regulatory regime to regulate the digital asset commodity market's participants. For an SRO to operate effectively with the CFTC, two key features are necessary. First, Congress and/or the CFTC must adopt a requirement to mandate membership in the RFA for registrants. As apropos to the derivatives industry, the CFTC has rules requiring mandatory membership in an RFA, which ensures that NFA can discipline, and when appropriate, bar registrants that do not abide by NFA's rules. Without mandatory membership, firms would be able to relinquish their NFA membership if they did not want to follow a rule or were being disciplined for failing to follow NFA's rules. Second, effective government oversight is essential to self-regulation, and this oversight should cover all aspects of the SRO's regulatory activity. Today, while we may partner with the CFTC to regulate our Members, the CFTC closely reviews and monitors our activities to ensure that we fulfill our regulatory responsibilities.

¹⁰ Part 190 of the CFTC's Regulations provides customers with priority in the event of an FCM bankruptcy.

¹¹ An FCM is required to maintain a minimum amount of capital designed to ensure that the FCM has "liquid assets" in excess of the firm's liabilities to provide resources for the FCM to meet its financial obligations as a market intermediary. The CFTC's regulations set forth detailed requirements on how an FCM calculates this amount, which takes into consideration the risks of the FCM's business. FCMs are required to comply at all times with these requirements and notify the CFTC and NFA immediately if they are not in compliance.

Over the years, as Congress expanded the CFTC's jurisdiction to include the retail forex spot and swaps markets, Congress and the CFTC also entrusted NFA with additional regulatory oversight responsibilities for these markets. We have always been willing to take on these additional responsibilities and worked closely with the CFTC to do so. If Congress moves forward with legislation in this area, we stand ready once again to assist the CFTC to the extent requested.

In conclusion, thank you again for the opportunity to appear before you today. We are pleased that this Committee and the House Committee on Agriculture are working collaboratively to develop a regulatory structure to govern spot digital assets, including those that are commodities. We look forward to engaging with this Committee, the House Committee on Agriculture, your Senate counterparts, as well as the CFTC and SEC to create a meaningful regulatory framework with strong customer protections to oversee market participants engaged in the digital asset commodity market.

Fostering Responsible Growth Of Blockchain Technology

**Testimony of Dr. Emin Gün Sirer
Founder & CEO, Ava Labs, Inc.**

**Before the United States House of Representatives, House Financial
Services Committee**

Chairman McHenry, Ranking Member Waters, and Members of the Committee,

It is an honor to be here with you today. I thank you for the opportunity to appear before you as a computer scientist to discuss blockchain technology, its innovative uses, why it is impactful to the economy, and how to understand the use cases that blockchain will support. With an understanding of these key concepts, it is possible to develop sensible regulatory frameworks and ensure the technology will thrive in the United States.

There have been several testimonies before this Committee regarding blockchain, but they have been primarily provided by lawyers and business people. To that end, I hope this testimony will provide a helpful overview of blockchain and tokenization from a technology and computer science perspective. I will focus on blockchain's ability to transform society by making digital services more efficient, reliable and accessible to all.

The collective goal is that the United States should seek to enable the free, safe, and responsible proliferation of blockchain technologies and their many applications so that, as a country, the United States and its citizens can benefit greatly from the economic growth that blockchain technologies will enable.

My Background

I am the founder and CEO of Ava Labs, a software company founded in 2018 that is headquartered in Brooklyn, New York, whose mission is to digitize the world's assets. Ava Labs is a software company that builds and helps implement technologies on the Avalanche public blockchain and other blockchain ecosystems. We have developed some of the most significant recent technological innovations in blockchain, including the biggest breakthrough in consensus protocols following Bitcoin. Before founding Ava Labs, I was a professor of computer science at Cornell for almost 20 years, advancing the science of blockchains with a focus on improving their scalability, performance, and security. During that time, I consulted with various U.S. government agencies and departments on a range of topics. I have made fundamental contributions to several areas of computer science, including distributed systems, operating systems, and

networking, with dozens of peer-reviewed articles (among other things, I am one of the most cited authors in the blockchain space after Satoshi Nakamoto). I hold a National Science Foundation CAREER award and previously served on the DARPA ISAT Committee. I serve as a member of the Commodity Futures Trading Commission's Technology Advisory Committee. But I am perhaps most proud of having helped write a parody of the blockchain space with John Oliver.

The Big Picture

We are living through a period of unprecedented technological progress and transformation. The computer revolution set this trend in motion, initially with mainframes and later with personal computers. However, these early systems were limited by their "stand-alone architecture," capable only of processing local data and executing local computations. Although they made existing tasks more efficient, they failed to create a multiplier effect due to their lack of network connectivity.

The emergence of the internet and, subsequently, world wide web marked a pivotal shift from isolated, local computing to global-scale computing. Architecturally, we transitioned from standalone computers to a "client-server architecture," which enabled us to connect to remote services operated by others to leverage their programs and capabilities. This new paradigm gave rise to digital services that catered to the entire world, created millions of jobs, and solidified the U.S.'s position as a global economic leader.

Blockchains represent the next phase in the evolution of networked computer systems. Whereas the client-server systems that power the web today rely on point-to-point technologies to connect clients to servers, blockchains facilitate many-to-many communication over a shared ledger. This allows multiple computers to collaborate, achieve consensus, and act in unison. Blockchain technologies allow us to build shared services in the network. In turn, this enables the development of unique, secure digital assets, more efficient financial services systems, tamper-proof supply chain tracking, digital identity solutions, and transparent voting systems, among many other innovative applications. By harnessing the power of blockchain technology and the digital uniqueness it allows us to create, we can redefine trust, ownership, commerce, recreation, and communications, ultimately transforming how we interact with digital systems and each other.

The implications of this breakthrough are far-reaching. Blockchain technology allows us to create systems that reduce costs, increase efficiencies, and gain more control over our digital lives and the virtual world. Additionally, we can establish new kinds of

marketplaces, novel digital goods, and services that empower individuals and communities to foster economic growth and social impact.

The advancements from blockchain technology will result in leaps forward, just like the internet itself, because they will improve the internet itself. This technology creates a new kind of public good, namely, a shared ledger that can be purposed for a wide range of applications. As we enter the era of customizable blockchains and smart contracts, the fine-tuning of this software will further enhance and improve what the technology delivers today while empowering compliance with relevant regulations.

Blockchains and Smart Contracts: Impact Across Applications

Blockchains solve a long-standing challenge in computer science: enabling a diverse set of computers worldwide to reach consensus (agreement) on a piece of data and the larger dataset to which it belongs. While it may appear obscure at first glance, this is a crucial building block for solving complex problems that traditional internet systems struggle to address, such as creating digitally unique assets, tracking their ownership, and safely executing business and other processes. In doing so, this technology does not have to rely on humans or intermediaries for its security properties; in fact, it typically provides strong integrity guarantees even in the presence of (partial) system failures.

Let me be clear: this ability to leverage distributed or decentralized networks is a desirable goal for many reasons that have nothing to do with securities laws, financial services regulation, or the laws and rules governing other areas of commerce, recreation, and communications. Distributed networks are more resilient, secure, auditable, and available for builders. Blockchain builders did not set out to develop the technology to evade laws and rules. We set out to solve computer science problems.

The potential applications for blockchain technology are vast and varied in contrast to the client-server model where many functions are expensive or impossible. Below, I will discuss just some of the key applications and innovations blockchains enable.

Blockchains are evolving rapidly

Blockchain technology has evolved rapidly in the 14 years since Satoshi Nakamoto introduced Bitcoin to the world.

The Bitcoin blockchain pioneered a consensus mechanism – the way that the data is agreed upon by participating computers – popularly and inaccurately known as “proof-of-work.” Bitcoin has demonstrated to the world that public, permissionless blockchains are possible. The topic of consensus was known in computer science

literature as “byzantine fault tolerance” and research into creating such systems had been funded by the National Science Foundation and DARPA, and involved hundreds of academics, myself included, for multiple decades. Bitcoin solved the problem and proved to the world that this technology could create and maintain a digital asset, as well as establish and transfer ownership over it. Bitcoin has remained up and accessible, even as it weathered numerous attacks throughout its 14 years, without a central authority or controller maintaining its health. In contrast, even the best client-server services built by Microsoft, Google, Amazon, and Facebook have experienced numerous outages during the same timeframe.

Computer scientists did not stop there. Subsequent blockchain technologies have expanded this core functionality. Most notably, Ethereum introduced the concept of smart contracts, self-executing programs encoded on blockchains. Smart contracts can facilitate all manner of applications, including currently popular ones like peer-to-peer lending, social networks, digital collectibles such as NFTs and gaming skins, and the tokenization of real-world (traditional) assets on a single chain governed by a uniform set of rules.

The latest breakthrough in blockchain architecture is known as multichain blockchains. In these systems, developers can create chains with custom rule sets, execution environments, and governance regimes tailored to their needs. Not only does this level of customization unlock use cases previously not possible on blockchains with single rule sets, but it also isolates traffic and data into environments purpose-built for a task or application. Examples of these systems include Avalanche and Cosmos, which enable the creation of specialized blockchains, sometimes referred to as subnets or app-chains, that can be compliant by design.

For instance, SK Planet, a company in South Korea, recently created a specialized blockchain on Avalanche that onboarded more than 58,000 fully identified customers in its first few days. Additionally, Ava Labs is working with Wall Street firms to create a specialized institutional blockchain. With a multichain architecture, operators have complete control over who can access the chain, who secures it, what token, if any, is used for transaction fees, and more.

There is a general trend here. Blockchain technology is evolving rapidly and naturally progressing towards making itself more flexible and secure. In other words, it has been through code that many challenging issues have already been addressed.

The lesson from these developments is clear: Policymakers should enunciate clear objectives based on the particular implementation of the technology (that is, the activity it is used for), while leaving the mechanisms of achieving those objectives up to experts

to determine. Because we can customize blockchain implementations, it is easier than ever to regulate the implementation rather than the technology, and achieve neutrality of regulation.

Regulation in The Token World

Blockchains are technologies that allow us to build resilient and fault-tolerant applications. They are, in effect, openly programmable platforms that their users can interact with as if they are a public commons. This powerful construct naturally gives rise to many different kinds of applications and, consequently, tokenization, the creation of digital representations of bundles of rights, assets, and other things.

All tokens are not equivalent in their implementation or function – they must be treated differently according to their essential nature. Tokens cannot simply be lumped together under a single set of regulations because they vary so widely in function and features. A good analogy is paper; we regulate the bundle of rights, assets, or things created by the words, numbers and pictures on the page.

Types of tokens include but are not limited to:

- *A real-world asset*: A token can be the direct or indirect representation of a traditional asset. For example, one could tokenize land ownership such that each token corresponds to a uniquely identifiable piece of land. In many cases, real-world assets are already regulated, and their digitization into a blockchain format should not necessitate wholesale new regulation.
- *A virtual item*: A token can represent a piece of digital art, a collectible, a gaming skin, and more. These can be varied in function and form as well. They can range from simple non-programmable pictures, a common use of NFTs, to complex assets, some used in games, that can encode all sorts of functions and features of the asset directly inside the asset itself.
- *Pay-for-use*: Public blockchains constitute shared computing resources that must be allocated efficiently. A token is the perfect mechanism to meter resource consumption and prioritize important activities. Such tokens are sometimes known as “gas tokens.” For example, BTC is the gas token of the Bitcoin blockchain, ETH for Ethereum, AVAX for Avalanche, and so on. Without gas or transaction costs, a single user or small group of users could potentially overwhelm the blockchain, similar to a denial of service attack, making the blockchain unusable.

The list above covers expansive categories, but remains just a snapshot of what is happening and what is possible. I encourage you to review our [Owl Explains](#) educational

initiative for more information. As a matter of first principles, the determination of the regulatory regime must start and end with the functionality and features of the token, not the technology used to create it. At Ava Labs, we call this sensible token classification.

Let me be clear again: Tokenization was not created to evade laws. It is the natural product of blockchain technology and an improvement that blockchains offer over traditional systems, just like computer databases were an improvement over paper filing cabinets.

In addition to sensible token classification, regulations that pertain to tokens must be devised in a manner that can be enforced at a layer that has access to the necessary information for enforcement. In the same way that we do not expect internet routers to check the verity of content sent on social media applications, we cannot impose a regulatory burden on technology layers that are unaware of the content or operations carried out on-chain. The platforms already provide features, such as lockups and transfer restrictions, that can assist in coding these limitations.

Enhancing Market Efficiency, Transparency, and Oversight

Blockchains and smart contracts can be the foundation of a more transparent and efficient financial system that enables all participants to share a level playing field. This includes regulators, who can have greater visibility than ever before into the actions and activities of all market participants. Privacy remains an important component of any system. Developing these new ways of providing and regulating financial services should incorporate personal privacy. These improvements can only come with the support and collaboration of regulators and policymakers by providing sensible laws and regulations that allow for the responsible growth of the technologies.

How has this played out in the wild? A perfect example is the trustworthiness of exchanges.

Last year saw the failure of several crypto-asset exchanges, most notably FTX. Make no mistake: these failures were not failures of blockchain technology. They were failures of traditional custodians who were supposed to secure user deposits. Not a single major decentralized exchange was affected by a similar failure. Blockchain technology is purpose-built to eliminate this reliance on centralized intermediaries, who can jeopardize user funds, market integrity, and other desired features of a well-functioning system.

In addition to on-chain custody and transacting, a more recent breakthrough known as enclaves enables new marketplaces where code severely constrains what even the owner and operator of the marketplace can do. This innovation can rule out unwanted behaviors like front-running, stop-loss hunting, and breaches of privacy that challenge market integrity. Ava Labs's own [Enclave Markets](#) is at the forefront of this innovation, which we call fully encrypted exchanges.

Another example that points up the benefits of engaging in activities on-chain as opposed to with centralized parties comes in the lending context. Last year saw major failures of lenders and borrowers who conducted their activities off-chain, while the major on-chain lending platforms weathered the stormy markets mostly unscathed. These protocols adeptly navigated liquidations and collateral calls in rapidly falling markets, due to their reliance on over-collateralization and automated systems.

While there is no panacea, the evidence so far points to the success of decentralized networks in managing stress conditions much better than centralized counterparties. These results are in line with what blockchain design predicts.

Stablecoins as the Digital Gateway for the U.S. Dollar

Stablecoins, which are predominantly denominated in United States Dollars, are expanding globally because they are a superior way of holding dollars. Stablecoins not only enhance the user experience—by increasing the velocity of capital and reducing the cost of transferring it—but also cater to a growing demand for stablecoin dollars among those facing economic uncertainty and hyperinflation in their local economies.

By transforming the dollar's capacity to retain value into an accessible product outside the U.S., stablecoins help individuals protect their life savings from fluctuations in the value of their local currencies and from being stolen by criminals and other rogue actors.

This potential can be realized with appropriate regulation, which allows for the responsible growth of stablecoins through new technologies and configurations.

Blockchains Can Accelerate Recoveries from Climate Disasters with Insurance

Consider the emerging property insurance crisis catalyzed by more frequent and extreme climate events. State Farm, the largest property insurer in California, announced it will no longer provide insurance due to the risk of wildfires. Insurers in Texas, Florida, Colorado, and Louisiana have felt the same pressure to stop provisioning insurance, increase rates, or find backstops for insolvency.

Who will communities in these states, and in the U.S. as a whole, rely on to insure their homes and economic futures? If the industry consolidates as bankruptcies hit smaller regional insurers, how will that risk be managed?

Using smart contracts and the Avalanche network, Lemonade Foundation is now providing insurance to more than 7,000 farmers who previously only had access to products with unaffordable premiums or delays in payout that had lasting, multi-season impacts. These premiums were not economically feasible for the organization due to the manually-intensive processes now condensed into a single smart contract.

As another example, in 2019, the U.S. government completed the accounting for Hurricane Katrina disbursements, a full 14 years after its catastrophic impact in 2005. The delays stemmed partly from the difficulty of achieving agreement among the many stakeholders participating in this process.

In 2012, Superstorm Sandy damaged almost half a million homes and incurred roughly \$50B in damages. The same gaps in insurance payouts stifled urgent recovery efforts across the East Coast. Families who had paid their premiums for years were given pennies on the dollar to rebuild their lives. By the time their lawsuits led to action and more financial payouts, the damage had been done, and scars set on these communities.

Blockchain-based distributed ledgers can significantly streamline such processes, and our company is collaborating with Deloitte under a FEMA contract to develop and implement this technology.

Supply Chain and Fighting Counterfeiting

Global supply chains are facing challenges relating to the expedited demand for goods and pandemic-driven strains, including our most security-critical infrastructure. When supply chain problems hit, they can be especially problematic, and when there is fraud, the problems are exacerbated. Blockchains and smart contracts can help secure and validate supply chains for various global sectors.

Blockchains can perform supply-chain management to provide a reliable and transparent record of a product's origin and authenticity. The Tracr platform from De Beers has shown how to accomplish this for diamonds, while other deployments have addressed fields ranging from luxury goods to concert tickets. Blockchains can be vital tools to fight the counterfeiting of medical supplies, pharmaceuticals, food products, and consumer technologies that directly affect our communities and your constituents.

Upcoming Technological Improvements

While there have been highly-publicized exploits of smart contracts, the space has significantly matured since its early days, and new technologies stand poised to improve the safety of on-chain assets and applications.

The potential risks relating to smart contract-based systems have centered around flaws in implementation, such as poor coding and negligence in following best practices, rather than fundamental issues inherent to smart contracts or blockchain technology. Just as the internet software stacks were weak in the 1990s, smart contract programming tools are in their infancy.

The space has rapidly evolved to use code audits and other techniques to certify that smart contracts uphold safety standards, giving rise to a burgeoning field of software threat analysis, certification, and verification services. In addition, we are seeing the emergence of automated tools for program verification and model checking to help find bugs that human eyes cannot easily locate. These techniques operate even before programs are deployed to root out bugs before they can affect anyone.

Finally, there are new mechanisms, such as run-time integrity checks, smart contract escape hatches, and automated limits on money flows that operate in real-time to help contain the effects of any unintended errors that might pass through to production.

Systems that have employed best practices, such as lending platforms and well-designed bridges, such as the ones Ava Labs has built, have seen billions of dollars pass through their contracts without compromise.

Given my background in academia and research, I am confident that the space will develop even stronger techniques for ensuring the correctness of smart contract software. One of the spillover effects of this activity will be better integrity and safety for *all* software, including software not related to blockchains.

Technological Competitiveness and Risk of Inaction

As we stand at the precipice of this new era, it is imperative that we nurture and support the development of this revolutionary technology. By doing so, we can unlock its full potential and ensure that the United States remains at the forefront of innovation, propelling the next generation of internet technologies and ushering in great economic growth.

Responsible actors in the blockchain space want sensible laws and regulations that incentivize growth and good behavior, punish bad actors, and elevate the users of blockchain networks. The community stands ready to provide guidance to policymakers to achieve those aims. However, without sensible frameworks and collaboration, there is a clear path to losing technological leadership to other countries.

The United States won the first wave of the internet revolution precisely because it enabled responsible freedom to innovate. The United States must follow the same path of enabling free but responsible growth of blockchain technology while carefully and intelligently classifying and regulating blockchain applications and tokens. Otherwise, there are two critical paths of failure for any regulatory framework.

First, the blockchain platforms themselves become regulated at the protocol layer. This would be the equivalent of regulating internet protocols, which would have doomed information technology and the vibrant internet we have today. Second, the tokens and smart contracts created with blockchains are lumped into homogenous and incompatible categories. This would be the equivalent of regulating a social media application like we regulate a consumer health care application. Instead, tokens and smart contracts must be analyzed case-by-case and regulated carefully based on their function and features.

As we move towards a more digitally-native world, aided by AI, virtual reality, and a work-from-home society, we will have to rely increasingly on digitally-native transfer and programmability of value. Blockchains are the clear technological answer to these needs and are definitively synergistic with the global economy. The addressable market for digitizing the world's assets and transferring value safely across the internet is greater than the sum of all the value of all existing assets. Failure to see the power of blockchain technology – whether due to a lack of understanding or misplaced fears of the technology – will have disastrous consequences. Failure to rapidly provide sensible regulatory frameworks will not only undermine economic growth but also make it easier for bad actors to conduct illicit activities.

Finally, it is essential to remember that just as there are good people committed to public service, there are also good people committed to building technologies to improve lives. By working together, we can lay the foundation for trustworthy, efficient, and self-enforcing systems that serve as the foundation for our modern economy.

- **Did Prometheus work with the SEC directly on their approval versus FINRA only? How long did the process take from start to finish?**

Response: Prometheus ATS Inc., was formed in February 2018 and submitted its FINRA application in November 2020. It was approved as a FINRA member on July 16, 2021. As part of becoming an ATS, Prometheus ATS made filings with the SEC. Prometheus Capital LLC was formed in January 2021. It submitted its application to become a special purpose broker-dealer in May 2022 and was approved as a FINRA member on 5/17/23. Prometheus did not directly work with the SEC on becoming a special purpose broker-dealer.

- **Can Prometheus list on its ATS any of the tokens that the SEC has alleged are securities in recent litigation such as the SOL token?**

Response: Yes.

- **If their ATS doesn't support decentralized tokens like SOL, then do all tokens need to be traded solely on their ATS and solely be custodied with Prometheus custody?**

Response: Respectfully, we do not understand the question.

- **How does clearing and settlement take place (e.g., do both buyer and seller have to set up a custody account with Prometheus)?**

Response: Once approved for such business, clearance and settlement occurs at Prometheus Capital between a buyer and seller. Clearance and settlement occurs as prescribed by and in compliance with the Federal Securities Laws.

- **Can a user of the Prometheus ATS or custody services take his or her tokens into their own wallet (self-custody)?**

Response: Yes.

- **None of these "securities" were sold in a registered offering and were issued without relying on an exemption. How can Prometheus facilitate resales of them in compliance with the '33 Act?**

Response: Prometheus ATS and Prometheus Capital can support both registered or exempt digital asset securities. Many digital asset securities have filed Form Ds, which are filings declaring a sale of an exempt security via a Regulation D offering. By filing a Form D, these entities declared they were offering securities. A digital asset sold via a Regulation D offering is by definition an exempt digital asset security that has trading restrictions. Those trading restrictions can be removed. Thus, lifting the restrictive legend under certain circumstances is proper. When the restrictive legend is removed, that digital asset can trade freely on a properly licensed digital asset ATS. A digital asset security held by a non-affiliate for 1 year, regardless of the availability of current public information, qualifies under SEC Rule 144(b)(1) for the lifting of the restrictive legend, allowing it to trade on an open retail market.

Assuming a non-affiliated individual/entity holds a digital asset issued via Reg D offering for one year under Rule 144(b)(1), the digital asset security is no longer restricted and may be held and traded on retail markets by both retail and institutional investors.

- **Will there be any market makers? If so, how would those market makers comply with Rule 15c2-11, as the information required by that rule to be held by the broker-dealer and publicly available would not seem to be known or knowable?**

Response: There will not be market makers.

Questions for the Record from Ranking Member Maxine Waters
Subcommittee Hearing, entitled “The Future of Digital Assets: Providing Clarity for the
Digital Asset Ecosystem”
June 13, 2023, 2pm

Mr. Jeremy Allaire

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)

Mr. Coy Garrison

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 specify)

Mr. Emin Gün Sirer

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 specify)

Mr. Thomas Sexton, III

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)
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 - a. Woman
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 - d. Transgender Man
 - e. Transgender Woman
 - f. Choose not to answer
 - g. Prefer to self-describe (please specify)

