

**DAZED AND CONFUSED:
BREAKING DOWN THE SEC'S POLITICIZED
APPROACH TO DIGITAL ASSETS**

HEARING
BEFORE THE
SUBCOMMITTEE ON DIGITAL ASSETS,
FINANCIAL TECHNOLOGY,
AND INCLUSION
OF THE
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U.S. HOUSE OF REPRESENTATIVES
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DAZED AND CONFUSED: BREAKING DOWN THE SEC'S POLITICIZED APPROACH TO DIGITAL ASSETS

Wednesday, September 18, 2024

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

The committee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. French Hill [chairman of the subcommittee] presiding.

Present: Representatives Hill, Lucas, Davidson, Rose, Steil, Timmons, Lynch, Waters, Foster, Gottheimer, Torres, Sherman, Green, Casten, and Nickel.

Chairman HILL. To the chattering classes, this is your 10-second warning.

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

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

This hearing is entitled: "Dazed and Confused: Breaking Down the SEC's Politicized Approach to Digital Assets."

Without objection, all members will have 5 legislative days within which to submit extraneous materials to the chair for inclusion in the record.

I now recognize myself for 5 minutes to give an opening statement.

OPENING STATEMENT OF HON. FRENCH HILL, CHAIRMAN OF THE SUBCOMMITTEE ON DIGITAL ASSETS, FINANCIAL TECH- NOLOGY AND INCLUSION, A U.S. REPRESENTATIVE FROM ARKANSAS

Welcome to this important end to our digital assets work for this Congress and the 118th session of the Congress. I have been privileged to lead our Digital Assets Subcommittee, which was established only last year but has already made history legislatively with the clarity for payment, stablecoins, legislation, and our fit-for-purpose regulatory framework bill, the Financial Innovation and Technology for the 21st Century Act (FIT21). Despite this legislative progress on a bipartisan basis, we have been troubled by the fact that the Securities and Exchange Commission (SEC), as chaired by Chairman Gensler, has instead chosen to front-end the

work of Congress and insert politics instead of being an independent regulator. He even took the unusual step of releasing his own statement, opposing FIT21 on the morning of the House vote, despite refusing to provide technical assistance as requested by the committee, and, I might add, also in contrast to the Biden White House, which did not issue a veto statement on that bill. With over 70 Democrats voting “yes” on the bill just hours later, it is clear that Chairman Gensler is stuck on an island of his own making.

The Commission has a statutory mandate to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation instead of providing legal clarity so that those who want to follow the law can do so. The Gensler SEC’s approach has injected even more confusion and uncertainty into the markets and for market participants and consumers alike. How is this protecting the public? Whether it is through politicized enforcement actions or by refusing to share its analysis around the legal classification of digital assets, the SEC has created a lose-lose-lose situation for consumers, founders, investors, and everyone in between.

On one hand, the Agency has pursued enforcement cases against companies for activities that were not clearly defined as securities violations, leaving investors and businesses in a heightened state of uncertainty. On the other, the SEC’s proposed rulemakings and guidance have often been overly broad and difficult and frequently impossible to implement for digital market participants. At best, these rules fail to provide any clarity on how to comply with the law, while imposing significant compliance burdens on digital asset firms that do not make a lot of sense, in other words, not fit for purpose. At worst, they represent a de facto ban on the use of digital assets and blockchain technology in the United States.

Nowhere has the SEC’s prejudice against digital assets been more apparent than in the Staff Accounting Bulletin 121, which upends decades of legal precedent in the custody business and creates an impermeable hurdle for those financial institutions seeking to provide digital asset custody services for their clients, particularly banks and bank trust departments that have the authority, the talent, the compliance procedures to do just that. This kind of politicized, unworkable, and inconsistent approach by Chairman Gensler has made it challenging for business to operate in the United States, and has driven many in the blockchain community not to write more letters of complaint to the SEC, but to buy plane tickets, make hotel reservations, and make lease decisions for Singapore, the United Kingdom, and the EU. One report estimates that the U.S. has lost around 14 percent of blockchain developers since 2018.

Even the SEC’s approval of the exchange-traded product for Bitcoin and Ether earlier this year only happened because Chairman Gensler tried to overplay his hand but could no longer explain to the courts while the SEC approved a Bitcoins Future Exchange-Traded Fund (ETF) but not proposed spot Bitcoin products. While this was a positive development, it took countless hours of manpower, millions of dollars in legal fees, and a full SEC faceplant in the D.C. Court of Appeals to achieve. Important questions still remain about the precedent that sets for future Commissions to follow.

I would like to close by reiterating that the pro-FIT21 and pro-regulatory framework are views of the majority, and the bipartisanship does not mean we are against the SEC going against bad actors or modernizing existing rules to incorporate digital asset securities and other unique instruments. We are against SEC enforcement abuse and making it hard for legitimate actors who are trying to follow the rules to do a fine job and bring innovation and technology to our markets. I want to thank our witnesses for being with us today and look forward to your testimony.

I now recognize the ranking member of the Subcommittee on Digital Assets, Financial Technology Inclusion, the gentleman from Massachusetts, Mr. Lynch, for 4 minutes for an opening statement. Mr. Lynch.

OPENING STATEMENT OF HON. STEPHEN F. LYNCH, RANKING MEMBER OF THE SUBCOMMITTEE ON DIGITAL ASSETS, FINANCIAL TECHNOLOGY AND INCLUSION, A U.S. REPRESENTATIVE FROM MASSACHUSETTS

Mr. LYNCH. Thank you, Mr. Chairman. I want to thank you for holding this hearing in the first place, and thank you to our witnesses for your willingness to help this committee with its work.

The title of this hearing appears to preface another attempt by my colleagues to attack the SEC for its actions taken against digital asset companies. Industry advocates continue to push a false narrative that the SEC is politicizing the regulatory framework by picking winners and losers, and unfairly targeting crypto firms. I find this deeply ironic, given that \$119 million was used by the crypto corporations to contribute and influence Federal elections just this year alone. If anyone is playing politics, it is the crypto industry, and it appears they are playing it well. As I have said many times since this subcommittee was established, this country has a longstanding history of robust securities laws designed to protect investors and keep our markets stable. Unfortunately for the crypto world, the crypto companies, these laws are not conducive to their business models, which is why they continue this crusade to remain unregulated.

We have clear rules that investment companies, including exchanges, brokers-dealers, and clearing agencies, must follow to avoid conflicts of interest and to protect investors and consumers. The digital assets industry continues to push for exemptions to all those legal obligations and bring lawsuit after lawsuit against the SEC. A string of legal victories through the courts validates the SEC's conclusions and proves that these litigious efforts are fruitless. The SEC has consistently won enforcement cases against companies like Telegram, Kik, BlockFi, and Liberty, with judges ruling that certain digital assets were indeed securities.

While most of the digital assets space has collapsed, it is well known what remains is used to facilitate illicit finance or illegal activity. The lack of appropriate oversight due to noncompliance has made this space a safe haven for bad actors. Companies do not get to pick and choose which rules they follow, and certainly should not be allowed to design laws that provide them with favorable outcomes. By enacting legislation like the FIT21 Act, which I oppose strenuously, which would open the floodgates to mass consumer in-

vestor harm, this committee would be the one picking winners and losers. We should not be undermining the good work of the SEC by moving forward with legislation that makes it easier for crypto criminals to do harm. Even Donald Trump is now championing an ill-conceived crypto venture.

Just weeks before the election, he has already pledged to make the U.S. the crypto capital of the planet via light-touch regulation and removing the SEC chair. The crypto industry has been responsible for insolvency crises, mishandled user funds, rampant market manipulation, rug pulls, hacks, and turmoil in the market and these are dangers that investors will continue to be exposed to if we allow this industry to continue to go unchecked. Despite the clear dangers, the army of crypto lobbyists remains strong in their mission to achieve favorable rules for the market.

I am also disappointed to see legislation attached to this hearing that would prohibit regulators from requiring financial institutions to record crypto assets held in custody as liabilities on their balance sheets. This bill attempts to codify opposition to nonbinding staff guidance and goes far too far. According to a report by the Federal Reserve, in 2023, only 7 percent of American adults bought or held crypto as an investment. We have spent almost 2 years arguing over a small sliver of our financial sector, when we could have been exploring ways technology can improve access to financial services. I urge my colleagues to refrain from being a mouthpiece for the crypto industry and attacking regulators that are simply enforcing the law.

Thank you, Mr. Chairman, and I yield. One minute to—

Chairman HILL. She is not here.

Mr. LYNCH. Okay. So I yield back.

Chairman HILL. Thank you. The gentleman yields back.

We welcome the testimony today of Michael Liftik: Mr. Liftik is a partner with Quinn Emanuel Urquhart & Sullivan, where he co-chairs the SEC enforcement practice, and co-managing partner of the Washington, DC. Office; the Honorable Dan Gallagher: Mr. Gallagher is chief legal, compliance and corporate affairs officer at Robinhood Markets, and a former SEC commissioner; Teddy Fusaro: Mr. Fusaro was the president of the Bitwise Asset Management; Jennifer Schulp: Ms. Schulp is the director of financial regulatory studies at Cato and Lee Reiners: Mr. Reiners is a lecturer at Duke Financial Economics Center and a lecturing fellow at Duke Law School.

We are so pleased to have all of you here, and we will start out with you, Mr. Liftik. You are recognized for 5 minutes.

**STATEMENT OF MICHAEL LIFTIK, PARTNER, QUINN EMANUEL
URQUHART & SULLIVAN, LLP**

Mr. LIFTIK. Chairman Hill, Ranking Member Lynch, and members of the subcommittee, thank you for inviting me to speak today. My name is Michael Liftik. I am a partner at Quinn Emanuel Urquhart & Sullivan, where I co-chair our SEC enforcement practice and our blockchain practice. Before joining Quinn Emanuel in 2017, I spent nearly a decade at the SEC in various roles, starting as a line enforcement attorney, then as counsel to the enforcement director, and then as Chair Mary Jo White's senior adviser on en-

forcement. I concluded my tenure at the Agency as the deputy chief of staff, working on all aspects of the SEC's mandate. I have worked at all levels of the Agency and have seen the issues from many angles. I have been on the front lines of digital asset regulation since 2013, when I spearheaded the Agency's first interagency group focused on understanding crypto and blockchain technology. In private practice, I have represented many clients in the blockchain industry, from layer one companies, to exchanges, to investors in crypto projects. I have experienced firsthand the challenges of advising clients in this uncertain regulatory environment.

I am here today on my own behalf and not on behalf of my law firm or any client of the firm. I come before you as someone who worked at the SEC, respects the Agency, and believes in its mission, but the SEC has missed an opportunity to become the leading global regulator of digital assets and blockchain technology. Instead, the SEC has refused to issue new rules or meaningful guidance relating to digital assets and at the same time has engaged in whack-a-mole enforcement that the SEC holds up as a replacement for rulemaking. Rather than be an epicenter of financial innovation as it should be and as it is in other contexts, the U.S. has turned itself into a crypto no-fly zone. This approach has stifled innovation, caused companies to move offshore, and ultimately harms U.S. consumers' ability to engage reliably with the industry.

My observations today are focused on four points. First, we must ask whether framing the debate over crypto through the lens of the Howey Test even makes sense. Put bluntly, Howey does not work well for digital assets. It is an outdated decision about a catch-all term investment contract that imposes a facts and circumstances inquiry on every single transaction at issue. Thus, Howey provides no predictability or certainty. Whether a digital asset is a security is perhaps a statutory question best left for Congress. Second, the SEC's enforcement approach has allowed the law to develop in a haphazard way. Different judges from different Federal districts reach different conclusions on critical questions, such as whether secondary market transactions satisfy the Howey Test, so the industry and U.S. consumers lurch from decision to decision.

Third, the SEC's refusal to engage in rulemaking in the crypto space means that areas that cry out for appropriate regulation to clarify a workable path for digital assets go unaddressed. Fourth, the SEC's approach results in it picking winners and losers for all U.S. consumers. For example, the SEC previously put its thumb on the scale by its long delay in approving the registration of a spot-exchange-traded product for Bitcoin. The effect of this delay was to drive demand outside the U.S. where spot Bitcoin ETFs were available.

How then do we move forward? I believe the answer lies in regulatory innovation. The SEC can apply the time-tested regime that has existed for decades, modified to fit this new industry. For example, the SEC can try out different approaches to potential rule-making frameworks through a sandbox led by its FinHub office. The SEC has broad exemptive authority under Exchange Act, Section 36. It can use that authority to selectively and carefully craft pathways to registration for securities, exchanges, and others. With regards to enforcement, I believe that our markets are stronger

with vigorous and vigilant law enforcement. The SEC's Division of Enforcement must continue to root out fraud and pursue other violations of the Federal securities laws that threaten the U.S. investing public, but at the same time, the Division must ask itself, how does the current program and priorities help investors?

Perpetual investigations and lengthy litigation into potential registration violations consume vast amounts of SEC resources and can harm, rather than help, the very people the SEC is charged with protecting. There must be a better way to address digital assets, encourage innovators and market participants to operate within a defined regulatory regime, while preserving safe access for U.S. consumers.

Thank you, and I look forward to answering your questions.

[Prepared statement of Mr. Liftik follows:]

Testimony of Michael E. Liftik

Partner and Co-Chair of the SEC Enforcement Defense Practice and Co-Chair of the Blockchain and Digital Asset Practice, Quinn Emanuel Urquhart & Sullivan LLP

“Dazed and Confused: Breaking Down the SEC’s Politicized Approach to Digital Assets”

September 18, 2024

Chairman Hill, Ranking Member Lynch and members of the Subcommittee, thank you for inviting me to speak today on the topic of the SEC’s approach to regulating digital assets.

Background

My name is Michael Liftik. I am a partner at Quinn Emanuel Urquhart & Sullivan LLP, where I co-chair both our SEC Enforcement Defense and our Blockchain and Digital Asset practices. I am also the co-head of our Washington DC office. My practice focuses on defending SEC investigations and litigated matters, and complex private securities litigation. A significant portion of my practice involves the cryptocurrency industry.

Before joining Quinn Emanuel in 2017, I spent nearly a decade at the U.S. Securities and Exchange Commission in various roles, as an Enforcement staff attorney, then as counsel to Enforcement Director Rob Khuzami, and then as Chair Mary Jo White’s Senior Advisor on Enforcement. I concluded my tenure at the SEC as the agency’s Deputy Chief of Staff, advising the Chair on all aspects of the agency’s operations, regulatory policy, exams and enforcement programs. I have worked at all levels of the agency and have experience with the enforcement and policymaking divisions from all angles.

I have been on the front lines of digital asset regulation since 2013, when the SEC first began grappling with blockchain technology. In private practice, I have represented blockchain platform companies; layer one and layer two developers; leading digital asset venture and investment funds; digital asset exchanges; founders of and investors in digital asset companies; creators and platforms in the NFT space; and cryptocurrency miners. I have experienced firsthand the challenges of advising clients in an evolving and uncertain regulatory environment.

My remarks today are based on my experiences both at the SEC as well as in private practice. I appear before you on my own behalf and not on behalf of my law firm or any client of the firm.

Introduction

Over the last few years, the SEC has missed an opportunity to become the leading global regulator of digital assets and blockchain technology. Instead, the SEC has refused to issue new rules, regulations, or meaningful guidance relating to digital assets and, at the same time, has engaged in a “whack-a-mole” enforcement approach that the SEC holds up as a replacement for rulemaking. This approach has stifled innovation, caused companies to move offshore and out of

the SEC's reach, and ultimately harms U.S. consumers' ability to engage reliably with this industry.

For digital asset platforms, the SEC widely advertised offers to market participants to "come in and register," but this was a false promise, because the SEC has remained inflexible in its approach to registration, failing to offer real solutions for real companies and market participants. Cryptocurrency is a 21st century asset that deserves 21st century regulation. The innovators in this space need certainty and predictability, as do their customers and the public. The United States has the deepest and most sophisticated capital markets in the world and leads innovation worldwide. Regulators outside the U.S. have looked to the U.S. for guidance, but finding none, have pushed forward where the U.S. has faltered. They have embraced digital assets by adopting frameworks such as ESMA's Markets in Crypto-Assets Regulation (MiCA), which institutes uniform EU market rules for digital assets or the UK's Financial Conduct Authority's rules for "cryptoasset financial promotion."

The SEC has not seized the moment. Rather than being an epicenter of financial innovation, as it should be and is in other contexts, the U.S. has turned itself into a crypto "no fly zone," where "stay outside the U.S." has become a common refrain among digital asset market participants. There must be a better way to address digital assets, encourage innovators and market participants to operate within a defined regulatory regime, while preserving safe access for U.S. consumers and markets participants.

A Chronology of the SEC's Crypto Enforcement Agenda

The global focus and regulation of cryptocurrency has changed dramatically since I first began working on issues related to digital assets over ten years ago. I am a securities lawyer, not a technologist. My interest in cryptocurrencies and blockchain technology then, and still today, stems from its promise and capacity as a new asset class, as a novel way to settle financial transactions securely and permanently, and for its potential to expand access to the mechanisms of finance to those without access to the traditional financial institutions and services.

To understand how the SEC has let the public down through its response to the proliferation of digital assets and blockchain technology, it is important to review how the SEC has reacted over time to various "phases" of the crypto industry's evolution.

In 2013, while serving as Chair White's Senior Advisor on Enforcement, I spearheaded the agency's first intra-agency group focused on digital assets as the SEC began working on understanding cryptocurrency and blockchains. At that time, the agency was wrestling with understanding Bitcoin and focused most of its efforts on the then-elusive question whether Bitcoin transactions should be considered investment contracts under the federal securities laws.¹

¹ Although it is common parlance to talk about whether a digital asset is "a security," the Securities Act of 1933 regulates securities *transactions*. See Securities Act Section 5(a) and Section 5(c). Thus, in the context of cryptocurrencies, the relevant legal question is whether transactions in digital assets are securities transactions. This is where the now-infamous *Howey* enters the analysis. As cryptocurrency tokens do not fit in any typical category of "security" as defined in Section 3(a)(1) of the Securities Act (e.g. stock, bond, convertible note, etc.), the only

At the same time, the SEC was learning about blockchains (or “distributed ledger technology” as commonly referred to at the time). This was a period of learning and analysis. The public record reveals that the agency chose a path of letting the technologies evolve before making any definitive pronouncements. The Division of Enforcement focused its efforts on protecting the investing public against fraud. And, indeed, the first few “crypto cases” were fraud-based.² These early cases were traditional investment fraud schemes, with a “bitcoin wrapper,” rather than cases about the nature of the bitcoin transactions themselves.

In 2017, in response to the Initial Coin Offering (or “ICO”) boom, the SEC started staking out more wide-ranging positions, pulling more crypto tokens and transactions within the SEC’s enforcement ambit. The SEC issued the DAO Report on Investigation,³ which was the first time the agency publicly explained its rationale for how a token offering could meet the *Howey* test.⁴ Shortly after the DAO Report, the SEC’s Division of Enforcement brought a series of enforcement cases in which the SEC asserted that digital asset (or “tokens”) transactions were “investment contracts” under *Howey*, and that these projects therefore violated Section 5 of the Securities Act’s prohibition on issuances of securities in unregistered transactions.⁵ Early on, the defense bar reacted to the SEC’s new focus by seeking to engage with the agency, to explain that—in many cases—a blockchain project’s token minting did not meet the elements of *Howey*. Examples include tokens given away as part of a free airdrop, projects that were not promoted as intending to generate profit for participants, and tokens with utility and consumable purposes.

These efforts were greeted by a series of ever-shifting SEC staff speeches and non-binding, informal staff guidance, and a wave “regulation by enforcement” to which the industry struggled to respond. For example, in response to the SEC’s allegation that tokens were issued primarily to appreciate in value (akin to equity in a company), some blockchain projects emphasized the consumptive use, or “utility,” component of the token. The industry also sought to explain to the SEC that a cryptographically secure token is essential to a functional blockchain—in other words, there cannot be a distributed blockchain project without a token—and, accordingly, that

possible statutory term on which the SEC can claim tokens could fit is “investment contract.” The Supreme Court’s decision in *Howey* and an extensive progeny of case law define whether a transaction creates an “investment contract” under the Securities Act.

² See *SEC Charges Texas Man With Running Bitcoin-Denominated Ponzi Scheme*, SEC Press Rel. No. 2013-132 (Jul. 23, 2013), available at <https://www.sec.gov/newsroom/press-releases/2013-132>; see also *Homero Joshua Garza*, SEC Litig. Rel. No. 23415 (Dec. 1, 2015), available at <https://www.sec.gov/enforcement-litigation/litigation-releases/lr-23415>.

³ Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, SEC Rel. No. 81207 (July 25, 2017) (“DAO Report”), available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

⁴ In *SEC v. W.J. Howey Co.* the Supreme Court explained that under the Securities Act an investment contract is (i) an investment of money in (ii) a common enterprise, with (iii) a reasonable expectation of profits that are (iv) to be derived through the entrepreneurial efforts of others. 328 U.S. 293, 299-301 (1946).

⁵ See, e.g., *SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds*, SEC Press Rel. No. 2017-185 (Sep. 29, 2017), available at <https://www.sec.gov/newsroom/press-releases/2017-185>; *SEC Emergency Action Halts ICO Scam*, SEC Press Rel. No. 2017-219 (Dec. 4, 2017), available at <https://www.sec.gov/newsroom/press-releases/2017-219>; *Company Halts ICO After SEC Raises Registration Concerns*, SEC Press Rel. No. 2017-227 (Dec. 11, 2017), available at <https://www.sec.gov/newsroom/press-releases/2017-227>.

the SEC’s assertions that tokens (or digital asset transactions) are themselves “investment contracts” is, in essence, a ban on blockchain technology in the U.S.⁶

Other projects decided to try to comply with the SEC’s rules for private securities offerings. Without conceding that token offerings are securities transactions, companies issued tokens in compliance with Regulation D and Regulation S. Technical compliance with those exemptions proved challenging for cryptocurrencies, however. Before projects learned to hard code lock-ups into tokens, for example, it was difficult to prevent secondary market transactions before holding periods were met. Likewise, it was difficult to prevent tokens issued to offshore persons from “flowing back” to the U.S. through secondary market exchanges. Rather than work with projects to craft workable pathways for blockchain projects to use the long-established Reg D and Reg S exemptions, however, the SEC brought enforcement actions for technical violations.⁷

In 2018 and 2019, the SEC shifted focus to the importance of “decentralization,” the transfer of control and decision-making from a centralized entity (individual, organization, or group) to a distributed network.⁸ The blockchain industry was initially optimistic, as it seemed like a viable path forward was emerging. Projects devoted considerable time to charting a course to “decentralize” before and shortly after launch. Commissioner Hester Peirce proposed a decentralization safe harbor⁹ that would have provided cryptocurrency projects—and the entire industry—with concrete, written rules they could follow.

Heartened by the SEC’s public statements, blockchain projects that emerged after the 2018-2019 staff guidance on decentralization generally were thoughtfully constructed to avoid issuing tokens in ways the SEC indicated — through enforcement cases — was problematic, and with a focus on decentralization. This included, for example, developing projects completely before launching any tokens to the public and building decentralized autonomous organizations (DAOs) to enable dispersed voting on the ongoing governance of projects, rather than vesting control of projects with founders and developers.

But the industry’s optimism was short-lived. The SEC did not pursue Commissioner Peirce’s proposal and quickly retreated from its public comments on decentralization. Instead, the SEC doubled-down on Enforcement’s chasing-fireflies approach to regulating digital assets. As a

⁶ As recently as last week, the SEC staff acknowledge that it had used confusing terminology in calling the tokens themselves “securities.” See Plaintiff SEC’s Mem. of Law in Supp. of Mot. for Leave to Amend at 24 n.6, *Sec. & Exch. Comm’n v. Binance Holdings Ltd.*, No. 23-1599-ABJ-ZMF (D.D.C. Sep. 12, 2024) (ECF No. 273-1). The federal securities laws contain no statute defining digital assets (or tokens, or cryptocurrencies) as a security.

⁷ See, e.g., *In the Matter of CoinAlpha Advisors LLC*, Securities Act Rel. No. 10582 (Dec. 7, 2018), available at <https://www.sec.gov/files/litigation/admin/2018/33-10582.pdf>; *In the Matter of The Registration Statement of American CryptoFed DAO LLC*, Securities Act Rel. No. 11134 (Nov. 18, 2022), available at <https://www.sec.gov/files/litigation/admin/2022/33-11134.pdf>.

⁸ William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto, (June 14, 2018), available at <https://www.sec.gov/news/speech/speech-hinman-061418>; Framework for “Investment Contract” Analysis of Digital Assets (April 3, 2019), available at https://www.sec.gov/about/divisions-offices/division-corporation-finance/framework-investment-contract-analysis-digital-assets#_ednref1.

⁹ Commissioner Hester M. Peirce, *Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization* (Feb. 6, 2020), available at <https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-blockress-2020-02-06>.

result, although projects, venture capital firms, and corporate securities lawyers devoted incredible amounts of time working on decentralization, the parade of Enforcement cases against blockchain projects continued unabated.¹⁰

It became increasingly clear that decentralization was not significant to new SEC leadership. Accordingly, although the industry still believed that demonstrating decentralization would avoid or reduce SEC scrutiny, it also became apparent that this line of reasoning was not persuasive to the SEC or its staff.¹¹

Around the same time, the SEC's Division of Enforcement began shifting its focus to centralized crypto asset trading and custody platforms. From the outside, the Division and its growing cryptocurrency specialized unit and dozens of new hires appeared to shift their efforts from the pursuit of one-off unregistered offering cases, to systemically shutting down crypto in the United States by taking out the platforms that make tokens available to the U.S. public, one by one.¹² In the years that followed, the SEC has targeted and brought enforcement actions against every significant digital asset exchange with a strong U.S. presence — Binance US, Coinbase, Kraken, Bittrex among them.¹³

It is also now clear that the SEC views virtually all digital assets as securities. Until the SEC publicly announced the closing of its investigation into Ethereum 2.0, even the SEC's position on

¹⁰ See, e.g., *SEC Charges Issuer With Conducting \$100 Million Unregistered ICO*, SEC Press Rel. No. 2019-87 (Jun. 4, 2019), available at <https://www.sec.gov/newsroom/press-releases/2019-87>; *SEC Charges Blockchain Company for \$6.3 Million Unregistered ICO*, Administrative Proceeding File No. 3-19332 (Aug. 12, 2019), available at <https://www.sec.gov/enforcement-litigation/administrative-proceedings/33-10671-s>; *SEC Charges ICO Incubator and Founder for Unregistered Offering and Unregistered Broker Activity*, SEC Press Rel. No. 2019-181 (Sep. 18, 2019), available at <https://www.sec.gov/newsroom/press-releases/2019-181>; *ICO Issuer Settles SEC Registration Charges, Agrees to Return Funds and Register Tokens As Securities*, SEC Press Rel. No. 2020-27 (Feb. 19, 2020), available at <https://www.sec.gov/newsroom/press-releases/2020-37>; *SEC Charges Founders and Issuer for Conducting Fraudulent and Unregistered ICO*, Litigation Rel. No. 24804 (Apr. 24, 2020), available at <https://www.sec.gov/enforcement-litigation/litigation-releases/lr-24804>; *SEC Charges Ripple and Two Executives with Conducting \$1.3 Billion Unregistered Securities Offering*, SEC Press Rel. No. 2020-338 (Dec. 22, 2020), available at <https://www.sec.gov/newsroom/press-releases/2020-338>.

¹¹ See, e.g., *SEC Charges Digital Asset Trading Platform and Its CEO with Registration Violations*, Litigation Rel. No. 25032 (Feb. 17, 2021), available at <https://www.sec.gov/enforcement-litigation/litigation-releases/lr-25032>; *SEC Charges New Hampshire Issuer of Digital Asset Securities with Registration Violations*, Litigation Rel. No. 25060 (Mar. 29, 2021), available at <https://www.sec.gov/enforcement-litigation/litigation-releases/lr-25060>.

¹² Indeed, well-funded projects were fighting back, draining significant resources from Enforcement staff. See, e.g., *SEC v. Telegram Group Inc. et al*, 19-cv-09439-PKC, S.D.N.Y. (filed Oct. 11, 2019), (S.D.N.Y. Oct 11, 2019), *SEC v. Kik Interactive, Inc.*, 19-cv-05244-AKH, S.D.N.Y. (filed Jun. 4, 2019); *SEC v. Ripple Labs, Inc., et al*, No. 20-cv-10832, S.D.N.Y. (filed Dec. 22, 2020).

¹³ *SEC Files 13 Charges Against Binance Entities and Founder Changpeng Zhao*, SEC Press Rel. No. 2023-101 (Jun. 5, 2023), available at <https://www.sec.gov/newsroom/press-releases/2023-101>; *SEC Charges Coinbase for Operating as an Unregistered Securities Exchange, Broker, and Clearing Agency*, SEC Press Rel. No. 2023-102 (Jun. 6, 2023), available at <https://www.sec.gov/newsroom/press-releases/2023-102>; *SEC Charges Kraken for Operating as an Unregistered Securities Exchange, Broker, Dealer, and Clearing Agency*, SEC Press Rel. No. 2023-237 (Nov. 20, 2023), available at <https://www.sec.gov/newsroom/press-releases/2023-237>; *SEC Charges Crypto Asset Trading Platform Bittrex and its Former CEO for Operating an Unregistered Exchange, Broker, and Clearing Agency*, SEC Press Rel. No. 2023-78 (Apr. 17, 2023), available at <https://www.sec.gov/newsroom/press-releases/2023-78>.

whether ETH is a security was murky.¹⁴ The SEC’s cases against trading platforms therefore pose an existential threat to the ability of U.S. consumers to access this asset class. If the SEC prevails in its pending actions against trading platforms, it will have succeeded in shutting down virtually the entire U.S. market to purchase or sell most digital assets.

Despite these headwinds, the industry continues to innovate and accept the risks of the uncertain and unforgiving SEC enforcement and regulatory environment, to try to provide the U.S. public with access to digital assets and technology. For example, right now the industry is working on exciting advancements in “DeFi protocols,” including a proliferation of restaking protocols, which do not require the use of centralized exchanges. However, unless there is a sea change in approach, it appears the SEC’s Division of Enforcement is looking at those projects as well.¹⁵

Observations and Lessons Learned

This history underscores the limitations of trying to glean meaning on how to act lawfully from the SEC’s hodgepodge of enforcement cases and unofficial guidance. At various inflection points, the SEC has missed the opportunity to provide clarity, and indeed, has actively avoided doing so. Instead of engaging in notice and comment rule making, or thoughtfully deploying its exemptive authority under the Securities Exchange Act of 1934,¹⁶ the SEC has brought case after case in the crypto space with the agency’s position revealed piecemeal. Only now, more than ten years after the agency first started studying crypto, has the agency’s position crystalized — and still not through official statements of the Commission but through a mosaic of enforcement cases — finally revealing that the SEC believes virtually all cryptocurrencies except BTC and ETH are securities, and appears that it will not stop until there is no digital asset industry left in the United States and available to U.S. market participants.¹⁷

It is worth noting that there is considerable ambiguity over whether the SEC has jurisdiction over digital assets in the first place. The only reason the SEC arguably has authority over digital assets is when they are transacted in “investment contracts.” There is no other statutory authority the SEC can point to over digital assets. Yet *Howey* is a dated decision about a “catch all” term (investment contract) that is heavily facts-and-circumstances dependent. Thus, *Howey* provides no predictability or certainty — it is an uneven, moving target. Both consumers and market participants have no way to know how the SEC might view any particular transaction. This is no way for a vibrant, technologically cutting-edge industry to develop. And that is why this uncertainty is pushing more and more blockchain companies overseas.

¹⁴ See, e.g., <https://www.youtube.com/watch?v=VhA1dZXeao0> (Chairman McHenry questioning SEC Chair Gensler on Ether at Hearing to Conduct Oversight of the SEC); see also Reuters, Crypto firm Consensus says US regulator has closed inquiry into Ethereum 2.0 (Jun. 19, 2024), available at <https://www.reuters.com/legal/crypto-firm-consensus-says-us-regulator-has-closed-inquiry-into-ethereum-20-2024-06-19/>.

¹⁵ See, e.g., SEC Charges Consensus Software for Unregistered Offers and Sales of Securities Through Its MetaMask Staking Service, SEC Press Rel. No. 2024-79 (Jun. 28, 2024), available at <https://www.sec.gov/newsroom/press-releases/2024-79>.

¹⁶ Section 36 of the Securities Exchange Act of 1934 grants the SEC broad authority to “exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions” from the statutes and rules of the federal securities laws. 15 U.S.C. § 78mm.

¹⁷ See *eToro Reaches Settlement with SEC and Will Cease Trading Activity in Nearly All Crypto Assets*, SEC Press Rel. No. 2024-125 (Sep. 12, 2024), available at <https://www.sec.gov/newsroom/press-releases/2024-125>.

The SEC's approach to cryptocurrency, however, shows an agency that has aggressively asserted jurisdiction over the industry, a foundational topic on which Congress has not spoken. Yet, the agency has no stated plan to address and engage with this industry, the asset class, or the technology other than through Enforcement. Although the Enforcement Division has obviously been very active, the other divisions have rarely engaged in proactive rulemaking — they have instead issued staff guidance or used rulemakings designed to address other areas of the market to have an indirect impact on the cryptocurrency industry. The SEC also has not endowed its FinHub Office with a true regulatory “sandbox” to allow for experimentation before rolling out potential solutions to the market.

To be clear, on the enforcement side, the Division of Enforcement has and should always aggressively pursue fraud falling within its authority. Thus, crypto investment schemes where funds are pooled and raised supposedly to be used for one purpose and are in fact used for another should be held to account. The SEC has always stood as the bulwark against securities fraud, but as history demonstrates, fraud happens in the traditional thoroughways of our capital markets, not just the backroads — Madoff, WorldCom, Theranos, being very high-profile examples. Last fiscal year, the SEC brought 167 actions it primarily categorized as tied to securities offerings, which includes offering frauds.¹⁸ Thus, justifying the SEC's approach to crypto as an industry rife with fraud is no justification at all. Enforcement Division staff will always pursue fraud, no matter the flavor.

But just as the SEC pursues various rulemakings to facilitate capital formation or foster fair and efficient markets, even while fraudsters may continue to pursue their schemes in traditional finance, so too should the SEC pursue rulemaking and other formal mechanisms to provide guidance and guardrails to an industry over which the SEC appears to believe it has complete dominion.

The SEC's current approach has several downsides. First, it allows the law to develop in a haphazard way. We have seen federal District Judges thoughtfully address challenging and novel questions over the application of the federal securities laws in cases pursued by the SEC and private class action plaintiffs over the last few years. Not surprisingly, different judges from different federal districts reach different conclusions. Thus, with each decision, a new signal is sent — from *Telegram* to *Kik* to *Ripple* to *Terraform* to *Coinbase* to *Binance* to *Kraken*, the law continues to change. Thus, for example, on the critical issue of whether secondary market sales are securities transaction under *Howey*, the industry pivots from court decision to decision, while the SEC continues to provide no realistic, workable path forward on this issue.¹⁹ Decisions by

¹⁸ SEC Announces Enforcement Results for Fiscal Year 2023, SEC Press Rel. No. 2023-234 (Nov. 14, 2023), available at <https://www.sec.gov/newsroom/press-releases/2023-234>; *Addendum to Division of Enforcement Press Release Fiscal Year 2023*, available at <https://www.sec.gov/files/fy23-enforcement-statistics.pdf>.

¹⁹ *Sec. & Exch. Comm'n v. Ripple Labs, Inc.*, 682 F. Supp. 3d 308, 331 (S.D.N.Y.), motion to certify appeal denied, 697 F. Supp. 3d 126 (S.D.N.Y. 2023) (“[T]he SEC does not develop the argument that these secondary market sales were offers or sales of investment contracts”); *Sec. & Exch. Comm'n v. Binance Holdings Ltd.*, No. CV 23-1599 (ABJ), 2024 WL 3225974, at *22 (D.D.C. June 28, 2024) (finding that “the complaint does not include sufficient facts to support a plausible inference that any particular secondary sales satisfy the *Howey* test for an investment contract”); *Order Denying Motion to Dismiss and Setting Case Management Conference*, Dkt. No. 90 at 18-19, *Sec.*

federal appellate courts are nascent and U.S. Supreme Court review of these fundamental questions is likely years away.

Second, in its eagerness to bring cases against an industry that the SEC's Chair has accused of "widespread fraud, bankruptcies, failures, and misconduct,"²⁰ the SEC may have fostered a culture that led to the DebtBox debacle.²¹ Much ink has been spilled on that case and the Enforcement Division has appropriately owned up to the mistakes made, but the core question to be asked is not why those mistakes occurred in that particular case, but how the agency got to the point where those mistakes could happen in the first place? In my experience, such an outcome and scolding for the SEC in district court is unprecedented. So, it is reasonable to wonder whether the agency's constant messaging around the ills of crypto created an environment where this could occur.

Third, the SEC has refused to engage in rulemaking in the crypto space.²² What this means is that areas that cry out for appropriate regulation to clarify a workable path for digital assets go unaddressed. It is simply untenable for the SEC to continue to claim that this new asset class and technology require no regulatory innovation to match. This is contrary to precedent. As new assets emerge or as financial innovation changes market processes, the SEC routinely engages in rulemaking to address it. For example, with the rise in popularity of crowdsourced fundraising mechanisms such as Kickstarter, the SEC adopted Reg CF to allow for crowdsourced securities fundraising.²³ As technology for clearance and settlement has advanced, the SEC has closed the time to settle equity securities transactions from 3 days to 2 and more recently from 2 days to 1.²⁴

Proposing a comprehensive rulemaking agenda for the appropriate regulation of digital assets and blockchain-based technologies is beyond my expertise as an enforcement defense attorney. But even apart from the core question how it should be determined which digital assets are securities, if any, it is not difficult to see areas where appropriate and modest modifications of existing rules could readily bring more of the cryptocurrency industry "under the tent." For example, custody rules for both broker-dealers and investment advisers should be modified to address the challenges of custodial digital assets that may be created on bespoke blockchains. Although custody solutions are emerging for "main stream" digital assets that are tied to the established blockchains, as new blockchain protocols are created, digital assets tied to those new protocols take time to be adopted by third-party custody solution providers. The rules should be modified to recognize that although some custody mechanisms are preferred, that does not mean there are not other safe and secure custody methods that could be deployed, with full disclosure

& Exch. Comm'n v. Payward Ventures (d/b/a "Kraken"), et al., No. 23-cv-06003-WHO (N.D. Cal. Aug. 23, 2024) ("[T]he fact that the transactions in question occurred on a secondary market does not by itself prevent those transactions from involving investment contracts, it simply means that the *Howey* test must be applied to the transactions as they occurred on the secondary market.")

²⁰ Chair Gary Gensler, *Statement on the Financial Innovation and Technology for the 21st Century Act* (May 22, 2024) available at <https://www.sec.gov/newsroom/speeches-statements/gensler-21st-century-act-05222024>.

²¹ Turner Wright, *Judge dismisses DEBT Box case, orders SEC to pay \$1.8M in fees*, Cointelegraph (May 28, 2024), <https://cointelegraph.com/news/judge-order-debt-box-sec-fees>.

²² <https://www.sec.gov/files/rules/petitions/2023/4-789-letter-secretary-grewal-121523.pdf>.

²³ 17 CFR § 227.

²⁴ 17 C.F.R. § 240.15c6-1 (shortening the standard settlement cycle for most broker-dealer transactions from T+2 to T+1); see also <https://www.finra.org/investors/insights/understanding-settlement-cycles> ("This isn't the first time such a change has occurred. In 2017, the SEC shortened the settlement cycle from T+3 to T+2.")

of the attendant risks, when the preferred option is not available or is being adapted to a new blockchain. Otherwise, the SEC is effectively picking winners and losers for all U.S. consumers by limiting the digital assets that can be held by brokers or investment advisers.

Likewise, the regulations for registering as an exchange should be adapted to fit the technological realities of digital asset exchanges. This may mean that not every statute or rule in place for national securities exchanges such as NYSE and NASDAQ would be applied to a registered digital asset exchange. It is disingenuous for the SEC to call for market participants to “come in and register” when the SEC will consider no compromise, no modification, no exemption to the rules that are simply structurally impossible in the context of digital assets recorded on distributed ledgers; or, at the very least, cannot work in the current state of the market. For example, the members of a national securities exchange must be registered broker-dealers.²⁵ But there are only two registered broker-dealer approved for digital assets.²⁶

And, in an ironic twist, national securities exchanges may only effect trades in registered securities.²⁷ So, this creates two immediate problems: First, to the extent the SEC has determined that Bitcoin and Ether are *not* securities, the SEC would not permit a national securities exchange to trade Bitcoin and Ether along with registered securities. (But, of course, BTC and ETH make up a significant volume of all daily traded digital assets²⁸ and without BTC and ETH available to serve as the “other” half of a token pair, most exchange business would be hampered.) Second, there is the ultimate “chicken or the egg” problem, which is that there are only a handful of digital assets that are registered securities (mostly as a result of early SEC enforcement actions),²⁹ and those digital assets have functionally ceased to trade. This means that even if an entity manages to register as a national securities exchange and is approved by the Commission to conduct trading in digital asset securities, when that entity opens for business, on day one . . . it will have precisely no business it can conduct.

Fourth, the SEC inexplicably has put its thumb on the scale of which particular digital asset products are being made available to retail consumers. For years, the SEC resisted approving the registration of a “spot” exchange traded products (ETP) for Bitcoin. The attempts of the industry to create this product and the SEC’s repeated denials of approval are well documented.³⁰ Finally, on January 10, 2024, after losing before DC Circuit Court of Appeals on the issue, the SEC approved the Greyscale Bitcoin Trust, which tracks the movements of the spot market for

²⁵ Exchange Act Section 3(a)(3)(A)

²⁶ <https://brokercheck.finra.org/firm/summary/312784>. Just last week, it was reported that a second special purpose broker-dealer has been approved for FINRA membership. <https://brokercheck.finra.org/firm/summary/316189>.

²⁷ In this context, registration is required under Section 12 of the Exchange Act, which registers the actual securities themselves, not the transaction-based approach under the Securities Act.

²⁸ <https://finance.yahoo.com/u/yahoo-finance/watchlists/crypto-top-volume-24hr/>, reflecting that as of September 16, 2024, Bitcoin and Ethereum have the second and third highest daily trading volume among digital currencies.

²⁹ See, e.g., In the Matter of CarriereQ, Inc., D/B/A Airfox, Securities Act. Rel. No. 10575 (Nov. 16, 2018); In the Matter of Paragon Coin, Inc., Securities Act Rel. No. 10574 (Nov. 16, 2018); In the Matter of Blockchain of Things, Inc., Securities Act Rel. No. 10736 (Dec. 18, 2019).

³⁰ See, e.g., Chair Gary Gensler, *Statement on the Approval of Spot Bitcoin Exchange-Traded Products* (Jan. 10, 2024), (acknowledging that “[b]eginning under Chair Jay Clayton in 2018 and through March 2023, the Commission disapproved more than 20 exchange rule filings for spot bitcoin ETPs”), available at <https://www.sec.gov/newsroom/speeches-statements/gensler-statement-spot-bitcoin-011023>.

Bitcoin.³¹ As detailed in the briefing on the appeal of the SEC's initial denial of approval, a spot Bitcoin ETP is an easy, safe, liquid way to provide U.S. retail investors exposure to Bitcoin, without the complexity of purchasing Bitcoin directly.³² Although the SEC had previously approved several Bitcoin futures ETPs, it had determined that retail investors should not have access to Bitcoin spot ETPs. The effect of this decision was to drive demand outside the U.S. where spot Bitcoin ETPs were available.³³ It should not have taken a court order to remedy this situation. Since the approval of the Grayscale spot Bitcoin ETP, many other market participants including Blackrock, Invesco, Fidelity, and others have successfully launched their own products.³⁴ And more recently the SEC approved spot ETH ETPs.³⁵ This is an encouraging sign that the SEC is allowing crypto-based financial products to diversify.

Path Forward

So where does the SEC go from here? I believe the answer lies in the very heart of the industry the SEC is trying to regulate. Innovation. Through innovation, the SEC can approach digital asset regulation not with a blank slate, but through the time-tested regulatory regime that has been put in place since the agency's creation, modified to fit this new industry. Through regulatory innovation for example, the SEC can try out different approaches to potential rulemaking frameworks through a sandbox approach led by its FinHub office. The SEC has broad exemptive authority under Exchange Act Section 36(a). It can deploy that authority to empower FinHub to selectively and carefully craft pathways to registration for securities transactions under the Securities Act, for securities under the Exchange Act, for broker-dealers and exchanges and clearing agencies. It can adopt the broker-dealer and investment adviser regime to better fit the realities of digital assets.

With regards to Enforcement, I believe that our markets are stronger with vigorous and vigilant law enforcement. The SEC's Division of Enforcement must continue to root out fraud and pursue other violations of the federal securities law that threaten the U.S. investing public. But at the same time, the Division must ask itself, how does the current program and priorities help investors? Perpetual investigations and litigation into potential registration violations consume vast amounts of SEC resources and can harm, rather than help, the very people the SEC is charged with protecting. In many cases, participants in digital asset projects targeted by the SEC wind up losing money, as projects are forced to shut down, their property becomes worthless and

³¹ See *Grayscale Invs., LLC v. Sec. & Exch. Comm'n*, 82 F.4th 1239 (D.C. Cir. 2023); Order Granting Accelerated Approval of Proposed Rule Changes, as Modified by Amendments Thereto, to List and Trade Bitcoin-Based Commodity-Based Trust Shares and Trust Units, Rel. No. 34-99306 (Jan. 10, 2024), available at <https://www.sec.gov/files/rules/sro/nysearca/2024/34-99306.pdf>.

³² See Brief for Amici Curiae, by Consent, of the Blockchain Association, the Chamber of digital Commerce, Chamber of Progress and Coin Center in Support of Petitioner and Reversal, *Grayscale Investments, LLC v. Sec. & Exch. Comm'n*, No. 22-1142 (D.C. Cir. Oct. 18, 2022) ("Blockchain Association Brief").

³³ Blockchain Association Brief at 11.

³⁴ <https://crsreports.congress.gov/product/pdf/TF/TF12573>

³⁵ Harrison Miller, Ethereum ETFs Win SEC Approval. Trading Starts Today, Investors.com (Jul. 23, 2024), [https://www.investors.com/news/ethereum-etf-sec-approval/#:~:text=The%20Securities%20and%20Exchange%20Commission,at%20market%20open%20on%20Tues day; Order Granting Accelerated Approval of Proposed Rule Changes, as Modified by Amendments Thereto, to List and Trade Shares of Ether-Based Exchange-Traded Products, Rel. No. 34-100224 \(May 23, 2024\), available at https://www.sec.gov/files/rules/sro/nysearca/2024/34-100224.pdf](https://www.investors.com/news/ethereum-etf-sec-approval/#:~:text=The%20Securities%20and%20Exchange%20Commission,at%20market%20open%20on%20Tues day; Order Granting Accelerated Approval of Proposed Rule Changes, as Modified by Amendments Thereto, to List and Trade Shares of Ether-Based Exchange-Traded Products, Rel. No. 34-100224 (May 23, 2024), available at https://www.sec.gov/files/rules/sro/nysearca/2024/34-100224.pdf).

undivestable, and they are precluded from trading. In contrast, in the traditional areas of the SEC's jurisdiction, such an outcome is rare, and typically limited to fraudulent conduct. In a departure from usual practice, SEC enforcement matters in the crypto space often result in the business closing down, even absent fraud or any showing of harm to the platform's purchasers or customers.³⁶

Moreover, in crypto matters, the Division should clearly and transparently communicate what it is investigating, what the basis for its concerns are, and the factors that it is considering. Too often defense attorneys in these investigations are left guessing at what the SEC thinks is wrong with the products, companies, or the industry, setting off a costly and time-consuming process of shadowboxing.

Ultimately, however, the best way to reduce the cycle of regulation by enforcement is for the SEC to regulate. And if it will not, then it is for Congress to legislate. The passage of FIT21³⁷ in a bipartisan manner shows the promise of how difficult policy issues related to digital assets can be addressed for the benefit of the American public.

I want to conclude by thanking the Subcommittee for its continued focus on this important area.

³⁶ In these cases, the SEC often then embarks, ironically, on a cumbersome and lengthy process of trying to give money back to the same consumers whom the SEC's enforcement actions have impacted. See, e.g., *In the Matter of Flyfish Club, LLC*, Order Instituting Cease and Desist Proceedings at ¶ 23, available at <https://www.sec.gov/files/litigation/admin/2024/33-11305.pdf>.

³⁷ <https://www.congress.gov/bills/118/congress/house-bills/4763/text?is=1&r=1&q=%7B%22search%22%3A%5B%22Financial+Innovation+and+Technology+for+the+21st+Century+Act.%22%5D%7D>

Chairman HILL. Thank you very much. Mr. Gallagher, you are recognized for 5 minutes.

STATEMENT OF HON. DAN GALLAGHER, CHIEF LEGAL, COMPLIANCE, AND CORPORATE AFFAIRS OFFICER, ROBINHOOD MARKETS, INC.

Mr. GALLAGHER: Thank you, Chairman Hill. Chairman Hill, Ranking Member Lynch, and members of the subcommittee, thank you for inviting me to testify today on the SEC's current methods of overseeing the U.S. digital asset markets. My name is Dan Gallagher, and I am chief legal compliance and corporate affairs officer at Robinhood Markets, Inc. I have practiced law in the financial services industry for more than 25 years, and I served as a SEC commissioner and deputy and co-acting director of the SEC's Division of Trading and Markets.

Cryptocurrency is a multitrillion dollar global market in which tens of millions of Americans participate. The technology underlying this market has the potential to fundamentally transform finance. For too long, the U.S. digital asset markets and millions of Americans who wish to participate in them have had to contend with innovation-killing Federal regulatory uncertainty, especially concerning which digital assets the SEC deems to be investment contracts requiring SEC registration in how tokens and platforms can become registered with the Commission.

For years, industry participants have asked that the SEC implement a clear and workable regulatory regime for digital assets, and support policy solutions that encourage Americans to engage in digital asset markets through responsible, appropriately regulated U.S. firms. Regrettably, the SEC has not done so. Instead, the SEC has engaged in regulation by enforcement, which is bad for American consumers who want greater access to digital assets. It is bad for the innovation in the blockchain and digital asset industries, and it is bad for the already eroding competitive position of the U.S. with regard to digital asset markets. This is not the way Americans expect our government to work. As Judge Amy Berman Jackson recently stated, "The SEC's decision to oversee this billion-dollar industry through litigation, case by case, coin by coin, court after court, is probably not an efficient way to proceed, and it risks inconsistent results that may leave the relevant parties and their potential customers without clear guidance." I could not agree more.

While Congress continues to pursue needed legislation in the digital asset space, the Commission has, and has had since 1996, the authority now to establish at least a basic provisional regulatory regime for digital assets. This rulemaking could include registration requirements, books and records requirements, anti-fraud protection for consumers, custody requirements and transaction reporting, all important protections that would have been handy prior to FTX's collapse in 2022. Unfortunately, the current Commission instead wistfully calls on the cryptocurrency platforms and token issuers to come in and register. Robinhood did, spending significant time, money, and effort to pursue registration. For all our efforts in return, Robinhood received a Wells notice stating that the Commission staff has made a preliminary determination to rec-

commend that the Commission file an enforcement action against us.

Ultimately, it will be up to Congress to rectify the Commission's failure to act, to register both tokens and platforms, and to provide clarity for those which do not require registration. Only Congress will be able to truly provide the necessary long-term regulatory clarity for digital assets but nothing is stopping the Commission from moving now to provide tailored relief that allows firms to register, even if provisionally, and continue to innovate in the meantime. It has simply chosen, and consistently done, not to do so.

I want to thank the subcommittee for holding this important hearing, and I look forward to your questions.

[Prepared statement of Mr. Gallagher follows:]



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Testimony of Daniel M. Gallagher
Chief Legal, Compliance and Corporate Affairs Officer, Robinhood Markets, Inc.
Before the U.S. House of Representatives House Financial Services
Subcommittee on Digital Assets, Financial Technology and Inclusion
“Dazed and Confused: Breaking Down the SEC’s Politicized Approach to Digital Assets”
September 18, 2024

I. Introduction

Thank you, Chairman Hill, Ranking Member Lynch, and members of the Subcommittee for inviting me to testify today on the U.S. Securities and Exchange Commission’s (“SEC” or “Commission”) current methods of overseeing the U.S. digital asset markets.

My name is Dan Gallagher. I am Chief Legal, Compliance and Corporate Affairs Officer of Robinhood Markets, Inc. (“Robinhood”). I served as an SEC Commissioner from 2011 to 2015 and Deputy and Co-Acting Director of the SEC’s Division of Trading and Markets from 2008 to 2010. I have practiced law in the financial services industry for more than twenty-five years.

Robinhood has a single mission—to democratize finance for all. Millions of Americans—including millions of Robinhood customers—want to participate and are participating responsibly in the digital asset economy. Robinhood provides them broad access to digital asset markets through a low-cost, intuitive platform. Robinhood Crypto, one of Robinhood’s wholly owned subsidiaries, allows customers in all 50 states and the District of Columbia, U.S. Virgin Islands, and Puerto Rico to buy, sell, store, and transfer (depending on the jurisdiction) up to 15 cryptocurrencies at low cost without trading commissions, account minimums, or other fees charged by our competitors.¹

Robinhood Crypto does so with a “Safety-First” mindset, taking a thoughtful, incremental approach to building its cryptocurrency business.² For example, despite consistent market demand, Robinhood Crypto has thoughtfully restricted the coins it makes available. It has made difficult choices not to list certain tokens or offer yield-generating products, such as lending and staking, that the Commission has alleged involve investment contracts. And Robinhood has never facilitated ICOs or issued its own native tokens, nor does it engage in proprietary trading.

¹ Aave (AAVE), Avalanche (AVAX), Bitcoin (BTC), Bitcoin Cash (BCH), Chainlink (LINK), Compound (COMP), Dogecoin (DOGE), Ethereum (ETH), Ethereum Classic (ETC), Litecoin (LTC), Shiba Inu (SHIB), Stellar Lumens (XLM), Tezos (XTZ), Uniswap (UNI), and USD Coin (USDC).

² In contrast to many cryptocurrency platforms, Robinhood has extensive experience operating in highly-regulated industries. Robinhood is also federally-registered as a money services business with FinCEN and has subjected itself to extensive state regulation by registering under applicable state laws. Specifically, Robinhood Crypto is licensed in 29 states, the District of Columbia, and Puerto Rico and holds a “BitLicense” from the New York State Department of Financial Services.

For too long, the U.S. digital asset markets and millions of Americans who wish to participate in them have had to contend with innovation-killing federal regulatory uncertainty. This uncertainty is particularly acute in the context of determining which digital assets the SEC deems to be investment contracts requiring SEC registration and how tokens and platforms can become registered with the Commission. Instead of providing regulatory certainty through appropriate rulemaking, the SEC has engaged in regulation by enforcement.

The current Commission's "scorched earth" approach to regulating cryptocurrency has real-world consequences.³ Regulation by enforcement is bad for American consumers who want greater access to digital assets, bad for innovation in the blockchain and digital asset industries, and bad for the already-eroding competitive position of the U.S. with regard to digital asset markets.

Because the Commission has taken a rigid, hostile approach to cryptocurrency and refused to provide regulatory clarity, U.S. customers have suffered as innovation has moved overseas.⁴ This should not be surprising. Many international jurisdictions are doing exactly what the American cryptocurrency industry has been requesting for years: providing regulatory clarity by enacting cryptocurrency-specific regulatory regimes. For example, the Markets in Crypto-Assets Regulation institutes uniform market rules for crypto-assets across the European Union; other jurisdictions have been taking similar steps towards establishing regulatory regimes of their own. The Commission should take steps to implement a clear and workable regulatory regime for digital assets and support policy solutions that encourage Americans to engage in digital asset markets through responsible, appropriately-regulated U.S. firms and not incentivize them to participate through often unregulated or lightly regulated foreign platforms. But it has not done so.

Cryptocurrency is a multi trillion-dollar global market in which tens of millions of Americans participate. And, importantly, the technology underlying this market has the potential to fundamentally transform finance. I strongly believe that Congress is the appropriate body to establish a clear and comprehensive regulatory framework for this important market.

But I would be remiss if I did not point out that, while Congress continues diligently to pursue much needed legislation, the Commission has—and has had since 1996—the authority *now* to establish at least a basic, provisional regulatory regime for digital assets. Specifically, as described in more detail below, the Commission could utilize its existing authority under Section 36 of the Securities Exchange Act of 1934 ("Exchange Act") to create a regulatory framework that could address many (though perhaps not all) of the core issues needed for the SEC to start registering and regularly overseeing platforms that would like to facilitate trading in digital

³ See Commissioner Hester M. Pierce, "Overdue: Statement of Dissent on LBRY" (Oct. 27, 2023), available at <https://www.sec.gov/newsroom/speeches-statements/pierce-statement-lbry-102723>.

⁴ Yaffe-Bellany, David, "Crypto Firms Start Looking Abroad as U.S. Cracks Down," N.Y. Times (June 7, 2023), available at [https://www.nytimes.com/2023/06/07/technology/crypto-firms-start-looking-abroad-as-us-cracks-down.html#:~:text=Coinbase%2C%20the%20largest%20crypto%20exchange,shut%20down%20its%20U.S.%20operations;see%20also%20Chipolina,Scott,%20US%20crypto%20clampdown%20pushes%20exchanges%20to%20go%20offshore,%20Fin.%20Times%20\(May%2016,%202023\),available%20at%20https://www.ft.com/content/10979399-ba25-45b9-b85d-776c1b75bfea](https://www.nytimes.com/2023/06/07/technology/crypto-firms-start-looking-abroad-as-us-cracks-down.html#:~:text=Coinbase%2C%20the%20largest%20crypto%20exchange,shut%20down%20its%20U.S.%20operations;see%20also%20Chipolina,Scott,%20US%20crypto%20clampdown%20pushes%20exchanges%20to%20go%20offshore,%20Fin.%20Times%20(May%2016,%202023),available%20at%20https://www.ft.com/content/10979399-ba25-45b9-b85d-776c1b75bfea).

assets the SEC deems to be investment contracts. This rulemaking could include registration requirements, books-and-records requirements, antifraud protections for consumers, custody requirements, and transaction reporting—all important protections that would have been handy prior to FTX’s collapse in 2022. Unfortunately, the current Commission has done nothing to use its existing authority to provide this much needed clarity and instead wistfully calls on cryptocurrency platforms and token issuers to “come in and register.”⁵

Robinhood heeded the Chair’s call to register—a workstream I call “crypto the hard way”—notwithstanding its current business model and its robust policies to ensure that it does not support digital assets on its platform that the SEC deems to be investment contracts. Robinhood spent significant time, money, and effort to pursue registration as a digital asset special purpose broker-dealer subject to SEC oversight. Robinhood had over a dozen meetings and calls with the SEC over a year and a half to discuss its cryptocurrency business, including its listing process. Robinhood also presented the Staff with a targeted, written request for relief for a registered special purpose broker-dealer that would be able to support transactions in both digital asset commodities and digital assets the SEC deems to be investment contracts in compliance with federal law. While the discussions with the SEC staff were always cordial and often deeply substantive, the staff was generally non-responsive to Robinhood’s requests for guidance or feedback on how to move its registration proposal forward.

Rather than issue rules to provide regulatory certainty to an industry craving it, the SEC has instead targeted individual firms, including Robinhood, through regulation by enforcement. This is not the way Americans expect our government to work. As Judge Amy Berman Jackson of the U.S. District Court for the District of Columbia recently stated, “The agency’s decision to oversee this billion dollar industry through litigation – case by case, coin by coin, court after court – is probably not an efficient way to proceed, and it risks inconsistent results that may leave the relevant parties and their potential customers without clear guidance.”⁶ Commissioners Hester Peirce and Mark Uyeda recently echoed this concern in their dissenting statement on the SEC’s enforcement action against a dining club that sold non-fungible tokens: “Leaving crypto to be addressed in an endless series of misguided and overreaching cases has been and continues to be a consequential mistake.”⁷ I couldn’t agree more.

II. SEC Registration—A Road to Nowhere

The Commission has long recognized that, as former SEC Chairman Jay Clayton noted in 2018, “the currently applicable regulatory framework for cryptocurrency trading was not designed with

⁵ Wieczner, Jen, “Gary Gensler on Crypto, SPACs, and Robinhood Wall Street’s top cop wants to police new finance with old rules,” *New York Magazine* (Sept. 13, 2021), available at <https://nymag.com/intelligencer/2021/09/gary-gensler-sec-chair-crypto-spacs-robinhood.html>; see also Testimony of Gary Gensler Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Sept. 14, 2021), at 6, available at <https://www.sec.gov/newsroom/speeches-statements/gensler-2021-09-14> (“I’ve suggested that platforms and projects come in and talk to us.”).

⁶ *SEC v. Binance Holdings Ltd., et al.*, Civil Action 23-1599 (ABJ), ECF No. 248 (D.D.C. June 28, 2024), at 21 hereinafter the “Binance Opinion”.

⁷ SEC Commissioners Peirce and Uyeda Dissent to Commission Action re Flyfish Cub, LLC, <https://www.sec.gov/newsroom/speeches-statements/peirce-uyeda-statement-flyfish-091624>.

trading of the type we are witnessing in mind.”⁸ Chair Gary Gensler initially appears to have agreed. For example, he testified before Congress in May 2021 that “the exchanges trading in these crypto assets do not have a regulatory framework either at the SEC, or our sister agency, the Commodity Futures Trading Commission.”⁹ The following year, he appears to have changed his tune.¹⁰ Now Chair Gensler and other members of the SEC Staff simply say that existing rules and regulations do apply, and that legislation is not necessary.¹¹

I disagree, as I think most securities lawyers would. The federal securities laws have been remarkably flexible in response to many forms of technological innovation in the financial services space. But they were enacted in the 1930s at a time when the idea of blockchain technology and cryptocurrencies was unimaginable. The rules that exist today, like so many things at the SEC, do not work properly for cryptocurrency. Serious gaps in existing statutes and regulations exist when it comes to digital assets. These gaps will require the need for platforms to obtain exemptive and/or no-action relief, such as the relief granted to Paxos Trust Company, LLC discussed below—relief the Commission under the current leadership is not willing to provide.¹²

The most fundamental problem in digital asset markets is that there is no clear guidance on which transactions in digital assets the SEC deems to be investment contracts.¹³ The SEC bases its analysis of whether a digital asset is an investment contract on decades-old Supreme Court cases. The primary case, *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), which was decided in 1946, establishes a four-part test to define an “investment contract.” There are legitimate questions around whether certain digital asset transactions should be governed by the *Howey* test and, if so, how the test applies to transactions in multiple individual tokens with their own unique characteristics. As my dear friend and mentor, the late Harvey Pitt, SEC Chairman from 2001 to

⁸ Testimony of Jay Clayton Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Feb. 6, 2018), available at <https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission>.

⁹ *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide*, Part III, 117th Cong. 1, 12 (May 6, 2021).

¹⁰ By at least December 2022, Chair Gensler “fe[lt] that [the SEC] ha[s] enough authority” to require digital asset firms “to come into compliance” with its rules and regulations governing registration. Singh, Kanishka, “SEC chair says crypto intermediaries should comply with law,” Reuters (Dec. 7, 2022), available at <https://www.reuters.com/markets/currencies/sec-chair-says-crypto-intermediaries-should-come-into-compliance-with-law-2022-12-07/>.

¹¹ See Chair Gary Gensler, “Statement on the Financial Innovation and Technology for the 21st Century Act” (May 22, 2024), available at <https://www.sec.gov/newsroom/speeches-statements/gensler-21st-century-act-05222024>.

¹² See Paxos Trust Company, LLC No-Action Letter, available at <https://www.sec.gov/divisions/marketreg/mr-noaction/2019/paxos-trust-company-102819-17a.pdf>.

¹³ See “Regulating cryptocurrencies is a national concern, not a political issue, says former SEC Chair Harvey Pitt,” CNBC (Dec. 13, 2022), available at <https://www.cnbc.com/video/2022/12/13/regulating-cryptocurrencies-is-a-national-concern-not-a-political-issue-says-former-sec-chair.html> (“It’s reminiscent of the old recipe for rabbit stew – first you have to start with a rabbit and it’s not clear to me that these are securities.”).

2003, said in a 2022 interview, “there is a need here for a concise and considered national policy that lays out the rules of the road.”¹⁴

Further, the SEC has not issued clear guidance on the registration requirements for cryptocurrency platforms and token issuers. In fact, exchanges, market intermediaries, and other market participants are not able to register with the SEC without obtaining additional regulatory relief addressing a number of issues. For example, regulatory relief is needed regarding exchange listing requirements; SEC custody requirements, including capital and accounting requirements for custodians; the trading of non-security digital assets and digital assets the SEC deems to be investment contracts on the same platform; the application of SEC trading rules, such as those under Regulation NMS and Regulation SHO; the application of SEC disclosure rules; and SEC clearing agency and transfer agent requirements.

III. The Current Commission’s Approach is Failing the American Public.

Following the SEC’s crackdown on fraudulent ICOs in 2018, the prior Commission engaged in a commendable (though ultimately limited) effort to provide tailored relief to the digital asset industry *without* sacrificing important investor protections. Notably, in October 2019, the SEC’s Division of Trading and Markets provided “no-action” relief for Paxos’ blockchain settlement platform to process transactions for a limited number of broker-dealers in certain listed U.S. equity securities.¹⁵ As a former SEC Commissioner and practitioner, I cannot emphasize enough the importance of the Paxos no-action letter. At a policy level, it demonstrates the proper role of government—allowing for innovation in a controlled manner without sacrificing investor protections. From a practitioner level, it plainly lays out the broad need for regulatory relief if we are to allow SEC-regulated tokens to trade in the U.S.

This short-lived period of innovation at the Commission abruptly ended in 2021. Rather than work with Congress to pass comprehensive legislation governing digital assets or issue a generally applicable rule, the current Commission’s approach to addressing digital asset regulatory issues is now largely two-fold: (1) bringing enforcement actions against industry participants; and (2) attempting to shoehorn cryptocurrency into proposed rules primarily addressing other discrete areas of traditional finance. Neither approach brings the regulatory clarity so desperately needed by the industry. And both fail the American public.

Of those two misguided approaches, my main concern for purposes of today’s hearing is the fact that the Commission has been asserting sweeping new authority over the entire cryptocurrency industry by bringing enforcement action after enforcement action against industry participants. Over the past year, for example, the Commission has been embroiled in contentious litigation with some of the nation’s major digital asset exchanges.¹⁶ The Commission is alleging that,

¹⁴ *Id.*

¹⁵ See Paxos Trust Company, LLC No-Action Letter, available at <https://www.sec.gov/divisions/marketreg/mr-noaction/2019/paxos-trust-company-102819-17a.pdf>

¹⁶ E.g., Press Release, “SEC Charges Kraken for Operating as an Unregistered Securities Exchange, Broker, Dealer, and Clearing Agency” (Nov. 20, 2023), available at <https://www.sec.gov/newsroom/press-releases/2023-237>; Press Release, “SEC Charges Coinbase for Operating as an Unregistered Securities Exchange, Broker, and Clearing Agency” (June 6, 2023), available at

among other things, they are operating as unregistered national securities exchanges, brokers, dealers, and/or clearing agencies. They are fighting the SEC and defending themselves against the SEC's allegations in court.

Some targets of the SEC's Enforcement Division, Robinhood included, have structured their businesses to operate in full compliance with applicable rules and regulations and have attempted to register with the SEC. Despite the good faith in which Robinhood has conducted its cryptocurrency business, Robinhood faces the potential of an SEC lawsuit for acting as an unregistered broker and clearing firm. In May 2024, Robinhood received a "Wells Notice" from the staff of the SEC's Enforcement Division stating that they have made a "preliminary determination" to recommend that the Commission file an enforcement action against us. This was so even after nearly two years of serious attempts to work with the SEC for regulatory clarity, including our well-known attempt to "come in and register." While I have tremendous respect for the SEC Enforcement staff, who have handled this matter professionally throughout, Robinhood firmly believes that the assets listed on our platform do not fall under the SEC's jurisdiction, and we have made it clear just how weak any case against Robinhood Crypto would be on both the facts and the law.

Such "regulation by enforcement" is, as Commissioner Hester Peirce has called it, "the opposite of a rational regulatory framework."¹⁷ I agree. Put simply, it is a horrible way to govern, goes against fundamental principles of fairness and justice, produces inconsistent outcomes, fosters confusion within the industry, and suffers from significant limitations as a means of setting policy. As House Financial Services Committee Chairman Patrick McHenry has appropriately recognized, "Regulation by enforcement is not sufficient nor sustainable. You're punishing digital asset firms for allegedly not adhering to the law when they don't know it will apply to them."¹⁸ I couldn't agree more.

Courts have started to take notice, too. This past June, federal district court judge Amy Berman Jackson expressed skepticism towards a number of the Commission's legal theories in its case against Binance, and rejected a number of the Commission's claims. In doing so, she did not mince words. "[T]he SEC seemed to speak[] out of both sides of its mouth" at the hearing on the motion to dismiss, Judge Jackson concluded.¹⁹ She also concluded that the SEC's approach represented "a departure from the *Howey* framework that leaves the Court, the industry, and future buyers and sellers with no clear differentiating principle between tokens in the marketplace that are securities and tokens that aren't."²⁰ Notably, she criticized the SEC's overall approach to regulating the cryptocurrency industry by enforcement:

<https://www.sec.gov/newsroom/press-releases/2023-102>; Press Release, "SEC Files 13 Charges Against Binance Entities and Founder Changpeng Zhao" (June 5, 2023), available at <https://www.sec.gov/newsroom/press-releases/2023-101>.

¹⁷ Commissioner Hester M. Peirce, "Outdated: Remarks before the Digital Assets at Duke Conference" (Jan. 20, 2023), available at <https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-duke-conference-012023>.

¹⁸ Sutton, Sam, and Declan Harty, "McHenry clashes with SEC's Gensler over crypto crackdown," *Politico* (Apr. 18, 2023), available at <https://www.politico.com/news/2023/04/18/mchenry-gensler-crypto-hearing-00092531>.

¹⁹ *Binance Opinion*, *supra* note 6, at 42.

²⁰ *Id.* at 43.

[T]he agency's decision to oversee this billion dollar industry through litigation—case by case, coin by coin, court after court—is probably not an efficient way to proceed, and it risks inconsistent results that may leave the relevant parties and their potential customers without clear guidance.²¹

Judge Jackson's concerns are not simply theoretical. Judicial opinions in the SEC's litigation against digital asset exchanges have themselves reached inconsistent results that leave the industry without clear guidance. Citing Judge Analisa Torres's decision in *SEC v. Ripple Labs, Inc.*, Judge Jackson's opinion in the Binance litigation dismissed the Commission's claims as to secondary market sales of digital assets; however, an earlier opinion in separate litigation by a different judge in a different district allowed similar Commission claims as to secondary market sales of digital assets to proceed.²² Such inconsistency is a direct product of the Commission's approach to bringing enforcement actions against the major players in the industry at the expense of providing the clear guidance long requested by the entire industry.

IV. The Path Forward

Given the lack of federal regulatory clarity for digital assets, it is no wonder that former SEC Chairman Jay Clayton and former CFTC Chairman Chris Giancarlo called for coordination with Congress in regulating digital assets, and why current CFTC Chairman Rostin Benham has called for Congress to provide additional authority to regulate digital asset markets.²³

I believe Congress can—and should—do so on a bipartisan basis. As you know, the Financial Innovation and Technology for the 21st Century Act passed the House with overwhelming bipartisan support. I applaud such Congressional efforts to foster the development of blockchain technology and digital asset markets in the U.S. and establish a clear and comprehensive regulatory framework for this important market through tailored, responsible regulation.

The Commission does have a role to play in the meantime, however. Rather than engage in regulation by enforcement, the Commission should heed the industry's call and undertake formal, notice-and-comment rulemaking to establish rules applicable to the entire cryptocurrency industry, at least on a provisional basis. In fact, it should have done so years ago. The Commission should establish a provisional regulatory regime for digital assets using its authority provided by Section 36 of the Exchange Act, which authorizes the Commission to exempt, even conditionally, any person, security, or transaction, or any class or classes of persons, securities, or

²¹ *Id.* at 21.

²² *SEC v. Coinbase, Inc. and Coinbase Global, Inc.*, No. 1:23-cv-04738-KPF, ECF No. 105 (S.D.N.Y. Mar. 27, 2024).

²³ Testimony of Jay Clayton Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Feb. 6, 2018), *available at* <https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission>; Testimony of J. Christopher Giancarlo Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Feb. 6, 2018), *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo37#P21_6885; Testimony of Rostin Benham Before the U.S. Senate Committee on Agriculture, Nutrition, and Forestry (Dec. 1, 2022), *available at* <https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam29>.

transactions, from any provision or provisions of the Exchange Act or any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors. This is not a theoretical proposition. The Commission used its general exemptive authority in 1998 when it adopted Regulation ATS, for example.²⁴ The Commission could similarly utilize this Section 36 authority to craft a tailored rule for the cryptocurrency industry, even if only on a provisional basis, that could include registration requirements, books-and-records requirements, antifraud protections for consumers, custody requirements, and transaction reporting. I seriously question, however, whether the current Commission, given its unfortunate track record with respect to rulemakings, is able to do so.

V. Conclusion

Ultimately, it will be up to Congress to rectify the Commission's failure to act to register both tokens and platforms. Only Congress will be able to truly provide the necessary, long-term, comprehensive regulatory clarity for digital assets that would allow token issuers, exchanges, intermediaries, and other market participants to provide products and services their customers want without the constant threat of crippling enforcement action, and would help ensure that the U.S. remains the global leader in responsible blockchain and digital asset innovation, as well as vibrant, appropriately regulated digital asset markets. Nothing is stopping the Commission from moving *now* to provide tailored relief that allows firms to register (even if provisionally) and continue to innovate in the meantime. It has simply chosen—consistently—not to do so.

I want to thank the Subcommittee for holding this important hearing, and I look forward to your questions.

²⁴ Regulation of Exchanges and Alternative Trading Systems, Securities Exchange Act Rel. No. 40760, 63 Fed. Reg. 70844, at 70846 (Dec. 22, 1998). The Commission went on to state that the regulation of the markets “should provide sufficient flexibility to ensure that new markets promote fairness, efficiency, and transparency.... The Commission believes that this regulatory approach effectively addresses commenters’ concerns while carefully tailoring a regulatory framework that is flexible enough to accommodate the evolving technology of, and benefits provided by, alternative trading systems.” *Id.*

Chairman HILL. Thank you, sir. He yields back. Mr. Fusaro, you are recognized for 5 minutes.

STATEMENT OF TEDDY FUSARO, PRESIDENT, BITWISE ASSET MANAGEMENT

Mr. FUSARO. Good morning, Chairman Hill, Ranking Member Lynch, Chair McHenry, and members of the subcommittee. Thank you for the opportunity to testify this morning. My name is Teddy Fusaro, and I am the president of Bitwise Asset Management. We are a digital asset and cryptocurrency asset management firm with over \$4.5 billion in assets under management globally. We are the issuer of one of the largest Bitcoin exchange-traded products in America, products that were first approved by the Securities and Exchange Commission earlier this year, and a project that we at Bitwise worked on in conjunction with the SEC staff for about 5 years. We first came in and attempted to register this exchange-traded product in 2019.

We believe that investors benefit from the freedom to choose to invest in cryptocurrencies and digital assets through the familiar and widely accessible format of the exchange-traded fund. Many types of security and non-security investable assets, from stocks and bonds to currencies, commodities, precious metals, and now in the United States in 2024, digital assets and cryptocurrencies, are packaged into ETFs and exchange-traded products (ETPs). Through this type of vehicle, investors benefit from the transparency disclosure regime and reporting requirements of a regulated offering, while also experiencing the ability to invest through the same channels that they use to manage the rest of their financial lives, either through a financial advisor or through a traditional brokerage account.

Exchange-traded funds, at large, have been one of the most successful financial innovations of the past 30 years, and they present a unique and mutually beneficial framework through which digital assets, such as Bitcoin and Ethereum and many other digital assets, can be brought inside the regulatory perimeter. We believe that investors will benefit if many more digital assets are approved for trading and listing in such a manner. We also believe that the approval of Bitcoin ETFs came too late. We believe that investors would have benefited from these approvals many years ago, prior to seeing many Americans spend their hard-earned money to unregulated and offshore-based cryptocurrency trading platforms, some of which ended up causing Americans meaningful financial harm.

While we are grateful that the SEC approved both Bitcoin and Ethereum exchange-traded products this year, we urge the SEC staff, SEC leadership, and the members of this subcommittee to consider the ways in which we can continue to make these regulated investment vehicles available to Americans with more underlying digital assets packaged in this product. They bring meaningful consumer protection benefits and provide much needed disclosure regarding the risks associated with investing in a new and volatile type of investment. We believe that all parties, and particularly mainstream Americans, will benefit from the approval of more digital asset ETFs.

Bitwise has been on a nearly 6-year journey in applying for and advocating for the approval of spot Bitcoin and digital asset exchange-traded products. We applied several times to bring such products to the U.S. market, filing our first registration statement for a Digital Asset ETP in 2018, followed by our first application for a Bitcoin ETP in 2019. We have submitted hundreds of pages of research and studies to support this effort, and we have met with the SEC numerous times during that period of years, a period that extended over two White House Administrations and two different SEC leadership regimes. Our company also recently expanded abroad with the acquisition of a London-based asset management company that issues ETPs in Europe. We did this in part because of the challenge of bringing new products to market at home, while the regulatory regime in Europe offers businesses clarity and the ability to list and launch multiple types of digital asset ETPs. We want that clarity at home.

We are optimistic that the commercial and consumer protection success of Bitcoin ETFs that were launched in 2024, followed by the launch of Ethereum ETFs this summer, represent the beginning of a positive trend and a new chapter for the regulation of digital assets in this country, and I look forward to answering more of your questions today.

[Prepared statement of Mr. Fusaro follows:]

September 18, 2024
WRITTEN TESTIMONY OF
Paul (“Teddy”) Fusaro
President, Bitwise Asset Management, Inc.

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

IN A HEARING ENTITLED
Dazed and Confused: Breaking Down the SEC’s Politicized Approach to Digital Assets

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

Thank you for the opportunity to testify at today’s hearing. My name is Teddy Fusaro and I am the President of Bitwise Asset Management, Inc., an asset management company that invests exclusively in the emerging digital asset industry.

Bitwise was founded in 2017 with the vision of providing Americans the opportunity to invest in bitcoin and other digital assets through traditional, regulated financial vehicles in order to provide them the benefits, protections and transparency afforded by our federal securities laws.

Today, Bitwise manages over \$4.5 billion in assets globally. We are the sponsor of one of the largest bitcoin ETFs in America, a product that was first approved by the Securities and Exchange Commission (“SEC”) in January of this year, and a project that we at Bitwise worked on for over six years to help make happen.

Bitwise is a company that began with a good idea. The same way many great American companies also began. The idea was that investors needed a better and safer way to access this emerging and volatile asset class through a traditional, regulated wrapper. Our collective experience at Bitwise in ETFs and traditional asset management strengthened our conviction that investors would benefit from having access to digital asset products offered with the investor protections that Americans have benefited from for nearly a century.

We also understood that financial investment professionals needed a partner to help them first understand, and then access for their clients, the opportunities available in this emerging asset class, and groundbreaking technological innovation.

We believed this could best be achieved by packaging bitcoin – and later other digital assets in this new asset class – in the well-understood and widely accessible format of an exchange traded fund (ETF). In this familiar format, bitcoin would be able to be offered within the regulatory perimeter, and investors would be able to participate in this emerging asset class using channels and platforms they currently access to manage their existing investments.

At the time of our founding, the primary way American investors were able to access exposure to an investment in bitcoin and other digital assets was through signing up for an account online using a website provided by a business familiarly known as an “cryptocurrency exchange.” Investors would then send money directly to this type of digital asset trading platform, where they could then buy, sell, store, or transfer these new types of digital asset. Many of these platforms were operated and managed from offshore jurisdictions, and oftentimes, investors did not have the information about where these platforms were managed, or in fact who was managing them.

Some of these platforms have become large and successful, and have built a track record of safety despite having to operate in an ambiguous environment without clear oversight, or clear rules of the road with which to comply. They too have for many years pursued regulatory clarity for their own operations. But, in part because of this ambiguity, there are other unfortunate examples of investors being taken advantage of not having information needed to properly assess the investment.

Historically, the barriers to entry for creating one of these websites was low. There was no comprehensive or unified regulatory regime, limited specific registration requirements to gatekeep participation, and no coherent disclosure process organized around a clear understanding of the differences between digital assets and traditional investable assets. The investment and other risks inherent in the asset class have been compounded by the structural organization of these access points. Unfortunately, a unified and coherent regulatory framework for digital assets still does not exist today at a national level -- placing the United States behind many other nations and now in a position of playing catch up.

Without the benefit of a unified disclosure regime, Americans often did not know where these platforms were domiciled, who was managing them, and whether or not material conflicts of interest existed in their operations. Businesses that attempted to build at home were often stuck in attempting to build a business in our new industry while attempting to comply with rules that were difficult to interpret and hard to make sense of. Entrepreneurs often chose to start these types of businesses outside of the United States, whether or not they intended to offer services to our citizens here. Many investors signed up for these types of platforms, and did so without the types of consumer protections that investors enjoy and are protected by through our federal securities laws: transparency, full and fair disclosures, regular financial reporting, audited financial statements, mandated separation of key organizational functions and disclosures of significant contracts and material conflicts of interest, to name a few. Americans deserve the freedom to make investment decisions for themselves, and should have the right to choose which services they use to buy all different types of products and services. But the growth of digital assets and the proliferation of online platforms advertising the ability to buy, sell, and store them, calls for sensible regulation and guidance and clear oversight of those businesses, and should also be paired with approvals that are fit for purpose within existing regulatory frameworks in order to best serve investors who wish to seek these types of exposures. ETFs are one of those existing frameworks.

ETFs have been one of the most successful – and democratizing – financial products of the last 30 years.

Since the first ETF was launched in 1993, the industry at large has grown dramatically. It is estimated that 15.2 million Americans, or about 12 percent of all US households, own ETFs. There are over 3,000 ETFs in the US market today, and as of year-end 2023, there were over \$8 trillion dollars of total net assets in those investment products¹.

There are many reasons that ETFs have become such popular investment vehicles. ETFs trade like stocks, offering investors intraday liquidity and the ability to purchase and sell investment exposure through a traditional brokerage account, while also dramatically increasing transparency by disclosing portfolio holdings daily, and significantly reducing costs due to this level of transparency and the increased competition brought to market by the proliferation of ETFs and ETF issuers. ETFs have allowed innovative asset management companies to package many types of exposures into an accessible, transparent, low cost, tax efficient vehicle that helps investors achieve their financial goals. ETFs have been one of the great equalizers in financial markets, leveling the playing field so that investors of all types have the ability to build wealth previously accessible to a smaller subset of the largest investors. The myriad types of financial exposures and investment strategies now available in this low cost, transparent packaging allows busy main street investors to access the same types of strategies available to large institutions, and has reduced costs to investors along the way. Thanks to this innovation, all types of investors now have access to strategies that include commodities, derivatives, fixed income, global equities, and more – including, as of 2024, spot bitcoin and spot Ethereum.

ETFs are a shining example of financial innovation and American ingenuity that reflect the best of what our dynamic capital markets can achieve.

Bitcoin and digital assets share certain similarities with ETFs, including the transparent nature of public blockchains and the daily liquidity and fungibility of the digital tokens that ride along blockchain rails. Bitcoin and digital assets are also historically very volatile and risky assets, that have experienced both significant increases in price and significant drawdowns since bitcoin was first introduced in 2009², highlighting the urgent need for investors to be made appropriately aware of the risks associated with such an investment position in order to fully assess whether this is an appropriate investment for them.

Believing that consumers would benefit from ability to access bitcoin through this popular financial structure, Bitwise filed its first registration statement for the Bitwise Bitcoin ETF in January of 2019³.

In conjunction with our first filing, Bitwise also notably provided in depth research to the SEC highlighting certain problematic market behaviors within our nascent industry. Specifically, we found that, the self-reporting of volume and trading statistics was vastly exaggerated, a

¹ Investment Company Institute (ICI) December 31, 2023
https://www.ici.org/faqs/faqs_etfs_market#:~:text=As%20of%20December%202023%2C%20the,companies%20at%20year%2Dend%202023.

² Bitcoin was first proposed by the pseudonymous publication of the Bitcoin Whitepaper in October 2008, and began operating as a network in 2009 <https://bitcoin.org/bitcoin.pdf>

³ <https://www.sec.gov/Archives/edgar/data/1763415/000149315219000408/forms-1.htm>

phenomenon primarily driven by offshore trading platforms, highlighting significant flaws in the reporting infrastructure of the bitcoin market, which called into question the reliability of the reporting data then widely in use, and the general understanding of the size of the bitcoin market, and its operating efficiency. In short, certain digital asset trading platforms were inflating the reported volume of bitcoin trading on their exchanges⁴ in order to attract more users to sign up for their services. Worse yet, we identified the fact that busy mainstream investors, without the ability to benefit from the consumer protections afforded by the ETF wrapper, were prime targets for these platforms, and could easily sign up for an account to trade and hold assets on these platforms. Yet there was no way to access bitcoin through the regulated and transparent ETF vehicle.

In contrast to the issues our research showed with these primarily offshore exchanges, our research also showed that the bitcoin market trading on primarily domestic and well-run platforms was efficient, liquid, operating effectively, and would be able to meet the standards previously applied to ETF approvals for other assets. When we compared what we identified as the accurately reported trading volume for bitcoin occurring on these platforms, we found that the regulated futures market (trading on the Chicago Mercantile Exchange (“CME”) and the Chicago Board Options Exchange (“Cboe”)) was a significant market for trading in bitcoin. While the existence of this mis-reported and inaccurate data was not a positive fact pattern generally, when deeply analyzed, it demonstrated that the remaining, accurately reported activity in the market was highly correlated with the regulated futures market, and was operating in an orderly and efficient manner. We believed that investors would benefit substantially from the protections of the ETF vehicle, and from the benefit of being able to access it in a regulated and transparent manner, and committed our business to pursuing the goal of bringing a bitcoin ETF to the marketplace.

The research we presented was also a warning to our domestic regulators that investors were signing up for and sending their hard-earned money to non-US-based businesses masquerading as exchanges that presented significant risks to these investors who were unable to understand and evaluate these risks because they lacked the information needed to do so.

Our initial proposal in the form of a request for Rule Change under Rule 19b-4 of the Securities Exchange Act of 1934 (“Exchange Act”) filed by NYSE Arca, Inc., in January 2019⁵, was rejected by the SEC in October of 2019⁶, and our subsequent proposal for a bitcoin ETF, proposed in October 2021⁷, was again rejected in June of 2022⁸.

During that period, we filed multiple amendments, proposals, and research studies and met with the Staff and Commissioners of the SEC more than 15 times, providing hundreds of pages of data and analysis to the division of Trading and Markets and Division of Economic and Risk Analysis demonstrating why we believed an approval would be appropriate.

⁴ <https://www.sec.gov/comments/sr-nysearca-2019-01/srnysearca201901-5164833-183434.pdf>

⁵ <https://www.sec.gov/files/rules/sro/nysearca/2019/34-85093.pdf>

⁶ <https://www.govinfo.gov/content/pkg/FR-2020-11-19/pdf/2020-25504.pdf>

⁷ <https://www.sec.gov/files/rules/sro/nysearca/2021/34-93445.pdf>

⁸ <https://www.govinfo.gov/content/pkg/FR-2022-07-06/pdf/2022-14316.pdf>

We worked jointly with the Staff to identify and evaluate data providers, run correlation studies, and produced academic whitepapers that demonstrated why we believed the SEC Staff's approval standards could be met. Our research more specifically conducted a detailed review of both academic and practitioner papers that focus on lead-lag relationships in financial markets, and concluded that CME bitcoin futures market led price discovery in a statistically significant manner when compared to spot bitcoin trading platforms.

As our journey continued, and our efforts continued to be denied, we became increasingly concerned that the lack of an approval order for bitcoin ETFs, combined with the massive and growing interest in digital assets by busy mainstream Americans, was creating an unsafe environment for American investors. This dynamic, in part, pushed investors to offshore trading platforms, to businesses that are not held to the same strict standard as ETFs are, and ultimately resulted in much pain and financial loss, culminating in the implosion of the unregulated, non-US-based digital asset trading platform FTX in November of 2022.

In mid 2023, 11 issuers, including Bitwise, submitted applications and registration statements once again seeking approval for bitcoin ETFs. We subsequently produced more research and rigorous academic analysis⁹ supporting the case for approval and again concluding that the CME bitcoin futures market generally led price discovery when compared to the spot bitcoin market on digital asset exchanges. Later that year, in August of 2023, the Circuit Court upheld a position that the SEC violated the Administrative Procedures Act when it denied Grayscale Investments, LLC's application to convert a publicly traded bitcoin Trust into an ETF¹⁰.

In January of 2024, about five months after that decision was upheld, the SEC approved Bitcoin ETFs¹¹.

Bitcoin ETFs were, when taken in the aggregate, the most successful ETF launch in the history of the ETF industry. The group of bitcoin ETFs that listed on January 11, 2024 gathered inflows of over \$17.5 billion by mid August, the fastest such asset gathering feat in the history of a fast growing market (the prior fastest growing ETF, the Invesco QQQ Trust Series 1, gathered approximately \$5 billion in its first year on the market)¹². Of the approximately 400 ETFs that have been launched in the past year, the top four from an asset gathering perspective are all bitcoin ETFs. Furthermore, there have been no reports of either operational issues or challenges among this group of ETFs, underscoring both the latent consumer demand and consumer protection benefits of these products. American investors wanted these types of products, and invested in them at an historically significant pace. They are products the market needs and wants, and as the financial center of the world, we believe more of them belong here.

We believed then – and still believe today – that bitcoin ETFs, and digital asset ETFs more broadly, bring busy mainstream investors the opportunity to benefit from the traditions and

⁹ <https://www.sec.gov/files/rules/sro/nysearca/2023/34-97884.pdf>

¹⁰ Grayscale Investments, LLC v. Sec. and Exch. Comm., No. 22-1142 (Aug. 29, 2023), at 2, available at [https://www.cadc.uscourts.gov/internet/opinions.nsf/32C91E3A96E9442285258A1A004FD576/\\$file/22-1142-2014527.pdf](https://www.cadc.uscourts.gov/internet/opinions.nsf/32C91E3A96E9442285258A1A004FD576/$file/22-1142-2014527.pdf)

¹¹ <https://www.sec.gov/files/rules/sro/nysearca/2024/34-99306.pdf>

¹² Source: Bloomberg

protections of the federal securities laws, benefits and protections that are not offered to investors through different avenues of accessing digital asset markets in other ways. Our views are strengthened by the magnitude of the success of the bitcoin ETFs in 2024.

A few months after the launch of bitcoin ETFs, in July of 2024, the SEC approved the listing and trading of spot Ethereum-based ETFs¹³. While these products did not launch with the same fanfare and public attention that was garnered by the launch of bitcoin ETFs, they were, nonetheless, met with significant demand, reflecting consumer desire for more digital assets packaged in the ETF vehicle. Three of the Ethereum ETFs that launched in July have already become among the top 25 asset gathering ETFs of all ETFs launched in the past year¹⁴.

According to research reports and surveys, including those conducted by the United States Federal Reserve¹⁵ somewhere between 7 and 12% of Americans have owned or traded bitcoin or digital assets over the past several years.

We believe these investors deserve the freedom of choice to invest in an ETF that offers the consumer protection benefits described herein for many different digital assets, not just bitcoin and Ethereum.

We encourage members of congress, the members of this subcommittee, the SEC Staff, and leadership of the SEC to consider ways in which we can continue to create an environment where buys mainstream investors can benefit from the unique protections, transparency, and disclosure protections of the ETF vehicle if they choose to make digital asset investments. Digital assets represent a new asset class, that pose unique risks and increased volatility when compared with other assets and other asset classes. We believe that this increases the need for investors to obtain the full protections and transparency that can be delivered through the offering of ETFs.

In foreign jurisdictions, there are much more well-developed regulatory environments that allow for the listing and trading of digital ETPs that hold many different assets and allow those funds to participate in more innovative and dynamic activities, such as the staking of assets in proof-of-reserve blockchain systems and the combination of multiple different digital assets into a single ETF. This regulatory clarity that exists in other countries is in part why Bitwise has chosen to expand its business to Europe through the acquisition of ETC Group, a UK-based company, where regulatory regimes allow for the production and issuance of exchange traded products investing in many different digital assets. Globally, there are over 200 digital asset ETPs listed on more than 20 exchanges in 16 countries¹⁶.

Instead of falling behind, we believe that the United States should be the leader of global financial markets and financial innovation, and that investors should benefit from these products here the way that they do in other global financial centers in foreign jurisdictions.

¹³ <https://www.sec.gov/files/rules/sro/nysearca/2024/34-100224.pdf>

¹⁴ Source: Bloomberg data

¹⁵ <https://www.federalreserve.gov/publications/files/2023-report-economic-well-being-us-households-202405.pdf>

¹⁶ <https://etfgi.com/news/press-releases/2024/06/etfgi-reports-crypto-etfs-and-etps-listed-globally-gathered-net-inflows>

ETFs do not present a comprehensive solution to the regulatory clarity that the bitcoin and digital asset industry needs to move forward and realize its full potential in the United States.

It is but one part of a broader set of needs that requires comprehensive and coherent set of rules for all market participants. The current manner in which the regulatory environment has evolved has been challenging for all participants – investors that seek to invest, companies that seek to build businesses in this emerging field, and developers that seek to pioneer the ways in which this technology can create our future. While we understand that new and novel types of assets that are now available in the digital age create complexities from a regulatory perspective, and we appreciate the need for businesses to comply with existing regulation, we also see much room for improvement and progress through thoughtful creation of new legislation and rulemaking with the participation of industry that will allow the industry to develop in a way that increases safety for all Americans.

We believe that the approval of more ETFs in the United States will bring important regulatory protections to many investors, and my colleagues and I look forward to continued engagement with the subcommittee and Subcommittee staff to advance this developing field and encourage the prioritization of legislation that facilitates the approval of more digital asset ETFs.

Chairman HILL. Thank you, sir. Mr. Schulp, you are recognized for 5 minutes for your oral presentation.

STATEMENT OF JENNIFER SCHULP, DIRECTOR OF FINANCIAL REGULATION STUDIES, CENTER FOR MONETARY AND FINANCIAL ALTERNATIVES, CATO INSTITUTE

Ms. SCHULP. Chairman Hill, Ranking Member Lynch, and distinguished members of the Subcommittee on Digital Assets, Financial, Technology, and Inclusion, my name is Jennifer Schulp, and I am the director of financial regulation studies at the Cato Institute's Center for Monetary and Financial Alternatives. Thank you for the opportunity to take part in today's hearing.

The Securities and Exchange Commission's approach to digital assets under Chairman Gensler's leadership can be characterized as an enforce-first, make-rules-never strategy. Because the application of existing rules to digital assets is uncertain or inappropriate, the Commission's current strategy effectively amounts to a ban on crypto activity in the United States. The SEC's approach has subjected those who choose to engage in digital-asset-related activities to extreme regulatory and compliance risk, and there is reason to believe that developers and projects that may have otherwise chosen to locate in the United States or serve U.S. customers are choosing to operate elsewhere.

The basic problem with the SEC's approach to digital assets is simple. Existing rules do not provide clear guidance to market participants as to whether the SEC's rules are even applicable, and if they are, how they can be complied with. Rather than providing clear guidance to market participants, and confronting difficult legal questions raised by the novel characteristics of digital assets, the SEC has claimed essentially limitless jurisdiction over digital assets and insists upon compliance with inapt rules. For example, the SEC's registration rules require disclosures about an issuer's balance sheet and cash-flow, but such disclosures often do not make sense or are not possible for software projects that are fundamentally distributed recordkeeping systems lacking traditional assets or business lines and when the development or operation of those software projects is decentralized or decentralizing, there may be no one to make such disclosures. These problems also plague secondary trading because the securities treatment required if a digital asset is registered as a security may preclude other uses of the token, such as facilitating the purchase and sale of goods or facilitating blockchain functionality.

Existing regulation is no better for digital asset marketplaces. Crypto platforms allow users to transact directly without the intermediation of a broker and vertically integrate functions that Securities Exchange rules require to be separated. Even if the functions were disaggregated, the SEC's rules create compliance challenges, for example, the SEC's rules mandate clearing Agency rules and procedures that are inept for instantaneous blockchain settlement. Again, these problems are more acute for decentralized platforms. Decentralized platforms do not custody assets, and they settle transactions on open and audible public blockchains. Traditional custody and market transparency rules are a poor fit for these circumstances.

Unfortunately, the SEC has shown little interest in working through any of these issues. Not only has the Commission failed to undertake any process toward rulemaking, but it has refused to engage with market participants seeking guidance. Instead, the Agency has led with enforcement. Rulemaking by enforcement is sub-optimal for many reasons, including that it creates worse rules. Enforcement actions may provide examples, often a bit light on the relevant details, about what a market participant should not do, but rarely provide a means to understanding what to do. This enforcement-first strategy creates a particularly hostile regulatory environment when actions are brought for failing to comply with rules for which the SEC provides no path to compliance, and that hostility is heightened by the SEC's own enforcement misconduct, including material misrepresentations to a Federal district court that raises the questions of whether the Agency is acting in good faith.

While the SEC's enforced-first, make-rules-never approach to digital assets is the wrong one, the SEC has the tools at its disposal, including executive authority, to undertake a better strategy toward digital assets. It is long past time to put those tools to use. Thank you, and I welcome any questions that you may have.

[Prepared statement of Ms. Schulp follows:]



Testimony

Before the U.S. House Committee on Financial Services
 Subcommittee on Digital Assets, Financial Technology and Inclusion
 Hearing on “Dazed and Confused: Breaking Down the SEC’s Politicized
 Approach to Digital Assets”

Jennifer J. Schulp
 Director of Financial Regulation Studies
 Center for Monetary and Financial Alternatives, Cato Institute

September 18, 2024

Chairman Hill, Ranking Member Lynch, and distinguished members of Subcommittee on Digital Assets, Financial Technology and Inclusion, my name is Jennifer Schulp, and I am the Director of Financial Regulation Studies at the Cato Institute’s Center for Monetary and Financial Alternatives. The views I express in this testimony are my own and should not be construed as representing any official position of the Cato Institute.

Thank you for the opportunity to take part in today’s hearing entitled, “Dazed and Confused: Breaking Down the SEC’s Politicized Approach to Digital Assets.”

The Securities and Exchange Commission’s approach to digital assets under the leadership of Chairman Gary Gensler can be characterized as an “enforce first, make rules never” strategy. While an enforcement-forward strategy may be effective—and perhaps even appropriate—where existing rules provide clear guidance to market participants, the Commission’s current strategy, where the application of existing rules to digital assets is uncertain or inappropriate, effectively amounts to a ban on crypto activity within the United States. This strategy simultaneously exceeds the agency’s authority and abdicates the agency’s role in overseeing the securities markets.¹

The SEC’s approach has subjected U.S. market participants who choose to engage in digital asset-related activities to extreme regulatory and compliance risk. Not only have the SEC’s actions directly put a stop to a host of digital asset activities in the United States,² there

¹ See Jack Solowey and Jennifer J. Schulp, “Crypto, Courts, and Congress,” Cato At Liberty Blog, April 5, 2024, <https://www.cato.org/blog/crypto-courts-congress>; Jack Solowey and Jennifer J. Schulp, “Lawmakers Should Check the SEC’s Wartime Consigliere with Legislation,” *Cointelegraph*, March 6, 2023, <https://www.cato.org/commentary/lawmakers-should-check-secs-wartime-consigliere-legislation>.

² See, e.g., Securities and Exchange Commission, “eToro Reaches Settlement with SEC and Will Cease Trading Activity in Nearly All Crypto Assets,” Press Release, September 12, 2024, <https://www.sec.gov/newsroom/press-releases/2024-125>; Securities and Exchange Commission, “Kraken to Discontinue Unregistered Offer and Sale of

are indications that developers and projects that may have otherwise chosen to operate in the United States, or serve U.S. customers, are choosing to operate elsewhere.³

The SEC's approach is anathema to sound public policy and the rule of law. My testimony today is intended to give an overview of the errors in the SEC's approach to digital assets, but it by no means provides a full catalogue of the ways in which the SEC's approach could be improved. I will first address the ways in which the SEC's existing rules, and the Commission's interpretation thereof, do not provide regulatory clarity to those wishing to engage with digital assets. Next, I will discuss how the SEC's enforcement-first strategy when coupled with an uncertain regulatory environment is particularly hostile to digital assets. Finally, I will identify a better approach to digital assets available to the Commission and how any steps that the SEC would claim it has taken in this direction are illusory.

Existing Rules Often Are a Poor Fit for Digital Assets

The starting point for examining the SEC's failed approach to digital assets is the most basic one: existing rules do not provide clear guidance to market participants as to whether the SEC's rules are even applicable, and if they are, how they can be complied with. While SEC Chairman Gary Gensler is fond of saying that "[n]ot liking the message is not the same thing as not receiving it," it is plain that there is a lack of clarity around the application of securities laws to digital assets.⁴ So plain in fact, that it has been noted not just by industry, but by other federal regulators and by legislators.⁵ Yet, Gensler continues to promote the fiction that the answer is simply to "come in and register."⁶

Crypto Asset Staking-As-A-Service Program and Pay \$30 Million to Settle SEC Charges," Press Release, February 9, 2023, <https://www.sec.gov/newsroom/press-releases/2023-25>; Sebastian Sinclair, "LBRY ends operations, cites feud with SEC and mounting debt," *Blockworks*, October 20, 2023, <https://blockworks.co/news/lbry-shutter-sec-debt>.

³ See Jennifer Schulp, "Join Us in Person or Online, Sept. 7 Cato Conference: 'Staying Ahead of the Curve: Crypto Regulation and Competitiveness,'" Cato At Liberty Blog, September 5, 2023, <https://www.cato.org/blog/weeks-conference-crypto-regulation-competitiveness>.

⁴ Gary Gensler, "Kennedy and Crypto," Speech, Securities and Exchange Commission, Sept. 8, 2022, <https://www.sec.gov/newsroom/speeches-statements/gensler-sec-speaks-090822>.

⁵ See, e.g., Rostin Behnam, Testimony before U.S. Senate Committee on Agriculture, Nutrition and Forestry's Hearing on the Oversight of Digital Commodities, July 10, 2024, <https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam48>; Reuters, "Yellen says Congress should provide authority to regulate stablecoins," *Reuters*, February 6, 2024, <https://www.reuters.com/markets/currencies/yellen-says-congress-should-provide-authority-regulate-stablecoins-2024-02-06/>; Jesse Hamilton and Nikhilesh De, "U.S. House Approves Crypto FIT21 Bill With Wave of Democratic Support," *CoinDesk*, May 22, 2024, <https://www.coindesk.com/policy/2024/05/22/us-house-approves-crypto-fit21-bill-with-wave-of-democratic-support/>.

⁶ See, e.g., Jen Wieczner, "Gary Gensler on Crypto, SPACs, and Robinhood," *New York Intelligencer*, Sept. 13, 2021, <https://nymag.com/intelligencer/2021/09/gary-gensler-sec-chair-crypto-spacs-robinhood.html>; Marco Quiroz-Gutierrez, "Amid FTX fallout, SEC's Gensler once again asks for a bigger budget but doesn't say how he'd use it," *FortuneCrypto*, December 7, 2022, <https://fortune.com/crypto/2022/12/07/gary-gensler-sec-enforcement-crypto-ftx-sam-bankman-fried/> (Gensler "once again called on crypto companies operating in the country to 'come into compliance' with U.S. securities laws or face the consequences).

The SEC's approach ignores the differences between digital assets and traditional securities, and unfairly views the entire digital assets industry as a monolith, which it decidedly is not.⁷ Those differences lead to problems applying existing rules to the digital assets ecosystem, which the Commission has failed to acknowledge (or remedy), resulting in a hostile regulatory environment for innovation.

The SEC's Jurisdiction Is Unclear

The starting point for any analysis of existing rules' appropriateness is whether a digital asset or digital asset-related service is under the SEC's jurisdiction. While determining whether an instrument is a security subject to SEC jurisdiction is not always a straightforward process, due to the breadth of the definition of a security and the flexibility with which it has been applied, answering this question is more difficult for digital assets due to their novel characteristics. Rather than wrestling with these legal questions, or providing clear guidance to market participants, the SEC has instead disclaimed any responsibility to provide workable guidance and claimed essentially limitless jurisdiction over digital assets.

Whether a digital asset is a security is often analyzed under the test for an "investment contract."⁸ The four-part *Howey* test requires (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profit, (4) to be derived from the efforts of others.⁹ In the era of the Securities Act and the *Howey* decision, and for decades thereafter, the archetypical covered entity under securities laws was a centralized enterprise with a corporate form, headquarters, and managerial hierarchy. Crypto projects aspire to upend this model, eschewing not only the physical plant of 20th-century enterprises but also, more importantly, managerial bodies exercising ongoing control over projects. And that creates significant challenges to the traditional concept of an investment contract.¹⁰

⁷ See, e.g., Jennifer J. Schulp, Testimony before U.S. Senate Committee on Banking, Housing, and Urban Affairs on "Crypto Crash: Why the FTX Bubble Burst and the Harm to Customers," December 14, 2022, <https://www.cato.org/testimony/crypto-crash-why-ftx-bubble-burst-harm-consumers>; Amanda Tuminelli, Testimony before H.S. House Committee on Financial Services, Subcommittee on Digital Assets, Financial Technology and Inclusion on "Decoding DeFi: Breaking Down the Future of Decentralized Finance," September 10, 2024, <https://docs.house.gov/meetings/BA/BA21/20240910/117620/HHRG-118-BA21-Wstate-TuminelliA-20240910.pdf>.

⁸ 15 U.S.C. §77b(a)(1).

⁹ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

¹⁰ See Jack Soloway and Jennifer Schulp, "Practical Legislation to Support Cryptocurrency Innovation," Briefing Paper No. 140, Cato Institute, August 2, 2022, <https://www.cato.org/briefing-paper/practical-legislation-support-cryptocurrency-innovation>; see also Hester Peirce, "Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization," Speech, Securities and Exchange Commission, February 20, 2020, <https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-blockress-2020-02-06>.

Rather than confront those challenges, though, Gensler has laid jurisdictional claim to essentially all digital assets except for Bitcoin.¹¹ He has repeatedly refused to provide guidance as to whether Ether can be considered a security—a position made all the more confusing by the fact that the Commodity Futures Trading Commission has deemed Ether a commodity—leaving the second largest blockchain in regulatory limbo with ongoing questions about whether the SEC will or will not assert jurisdiction.¹²

This issue is compounded by the fact that the jurisdictional theories that the SEC does assert stray beyond the *Howey* jurisprudence to instead establish SEC jurisdiction with almost no limit. As Commissioner Mary Uyeda has described, the SEC’s approach has been “that any item sold whose value is based on the efforts of others is a security,” but “[t]his broad reading of *Howey* would appear to scope in many common transactions in the non-digital world, including pre-purchase commitments, collectibles, art, and land.”¹³ The SEC has settled actions consistent with this limitless reading of its authority, specifically in the context of non-fungible tokens.¹⁴

Any market participant that questions the SEC’s expansive reading of its own jurisdiction—or any market participant that is legitimately unsure of whether the SEC has regulatory authority over its project—faces significant regulatory and compliance risks that can result in expensive investigation or litigation brought by the SEC. This alone stands as a major deterrent to operating in the digital assets space in the United States.

¹¹ See Jesse Coghlan, “Crypto lawyers flame Gensler over claims that all crypto are securities,” *Cointelegraph*, February 27, 2023, <https://cointelegraph.com/news/crypto-lawyers-flame-gensler-over-claims-that-all-crypto-are-securities>.

¹² Katherine Ross, “SEC Chair Gensler skirts questions on ETH as a commodity,” *Blockworks*, June 13, 2024, <https://blockworks.co/news/sec-gary-gensler-on-eth-status-commodity>; Dylan Butts, “CFTC chair calls Ethereum a commodity, in contrast to SEC chair Gensler’s position,” *Yahoo Finance*, March 3, 2023, <https://finance.yahoo.com/news/cftc-chair-calls-ethereum-commodity-111551034.html>; Jesse Hamilton, “House’s McHenry Accuses SEC Chief Gensler of Misleading Congress on Ethereum,” *CoinDesk*, April 30, 2024, <https://www.coindesk.com/policy/2024/04/30/houses-mchenry-accuses-sec-chief-gensler-of-misleading-congress-on-ethereum/>; Leo Schwartz, “SEC Signals Ethereum is no a security in settlement with eToro,” *FortuneCrypto*, September 12, 2024, <https://fortune.com/crypto/2024/09/12/etoro-sec-gensler-ethereum-bitcoin-crypto-lawsuit/>.

¹³ Mark Uyeda, “Remarks to the Council of Institutional Investors – Dangers of the Unbounded Administrative State,” Speech, Securities and Exchange Commission, March 5, 2024, <https://www.sec.gov/newsroom/speeches-statements/uyeda-remarks-cii-030524>.

¹⁴ In re Impact Theory, LLC, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, And Imposing a Cease-and-Desist Order, Securities Act Release No. 11226, File No. 3-21585, August 28, 2023, <https://www.sec.gov/files/litigation/admin/2023/33-11226.pdf>; Hester Peirce and Mark Uyeda, “NFTs & the SEC: Statement on Impact Theory, LLC,” Statement, Securities and Exchange Commission, August 28, 2023, https://www.sec.gov/newsroom/speeches-statements/peirce-uyeda-statement-nft-082823#_ftn1 (“The handful of company and purchaser statements cited by the order are not the kinds of promises that form an investment contract. We do not routinely bring enforcement actions against people that sell watches, paintings, or collectibles along with vague promises to build the brand and thus increase the resale value of those tangible items.”).

Securities Registration Rules Do Not Fit Digital Assets

Even if there were no jurisdictional questions and it were clear that an issuer of a digital asset was subject to the SEC's jurisdiction by virtue of issuing a security, the SEC's registration rules would still be a poor fit for digital assets.

Registered securities must provide initial and ongoing public disclosures about their issuer's officers and board of directors, the issuer's business activities, and the issuer's audited financial statements. But disclosure obligations related to balance sheets and cash flow statements for corporate entities often do not make sense for software projects that are, fundamentally, distributed recordkeeping systems lacking traditional assets or business lines.¹⁵ Registration is simply not a viable option where the SEC's rules require reporting that is inapplicable to digital asset issuers.¹⁶

These problems are all the more difficult when the development and/or operation of those software projects is decentralized (or in the process of decentralizing)—meaning that no single party or unified group maintains discretionary control over the project or its code. In such circumstances, there may be no centralized entity capable of making such ongoing disclosures.

Moreover, disclosures that would be relevant to crypto users—including the determinants of token supply and governance mechanisms for software updates—are not covered by legacy securities rules.¹⁷ Indeed, other jurisdictions, including the European Union, have recognized this and have established tailored disclosure regimes for digital assets.¹⁸ The SEC's failure to provide guidance on relevant disclosures for digital assets may create market confusion, where existing rules ask issuers for information not material to the user.¹⁹

¹⁵ See, e.g., 17 C.F.R. §§ 210.1, et seq.

¹⁶ Issuers may still make securities-law compliant offerings pursuant to the regulations that govern the SEC's exemptions from registration. Such exempt offerings, however, are subject to limitations as to the amount of money that can be raised and on the resale of securities and may be limited only to accredited investors. See Securities and Exchange Commission, "Overview of Capital-Raising Exemptions," <https://www.sec.gov/files/chart-amended-capital-raising-exemptions-oasb.pdf>.

¹⁷ See, e.g., Jack Soloway and Jennifer Schulp, "Practical Legislation to Support Cryptocurrency Innovation," Briefing Paper No. 140, Cato Institute, August 2, 2022, <https://www.cato.org/briefing-paper/practical-legislation-support-cryptocurrency-innovation>; Rodrigo Seira, Justin Slaughter, and Katie Biber, "The Current SEC Disclosure Framework Is Unfit for Crypto," Paradigm, April 20, 2023, <https://policy.paradigm.xyz/writing/secs-path-to-registration-part-iii>.

¹⁸ See, e.g., Philip Lee, "MiCA white papers – What obligations will crypto firms have under the new European legislation?," Lexology, May 30, 2022, <https://www.lexology.com/library/detail.aspx?g=beb201eb-21e9-48dd-ad90-071d368c3837>.

¹⁹ See Hester Peirce, "Overdue: Statement on Dissent of LBRY," Statement, Securities and Exchange Commission, October 27, 2023, https://www.sec.gov/newsroom/speeches-statements/peirce-statement-lbry-102723#_ftn9 ("Here, LBRY made significant disclosures outside of the registration process—disclosures that the Commission does not allege were fraudulent or misleading—and there is little to indicate that LBRY's disclosures did not provide token purchasers with information adequate to assess whether the tokens were a good fit for them.").

These problems do not end with the registration of a primary offering. Once a digital asset is registered as a security, it must be treated as a security in secondary trading. But such treatment may mean that the token is thus reduced—so to speak—to only being a security, and not able to provide any other use to its owner. Digital assets that are intended to be used to facilitate the purchase and sale of goods, to facilitate blockchain functionality, or to be used in other ways, are likely unable to be used consistent with those functions because of restrictions on the sale of those assets by the securities laws.²⁰

Exchange Regulations Do Not Fit Digital Asset Platforms

The fit of existing regulations is no better for the marketplaces over which digital assets are exchanged.²¹ The first major hurdle to registration of digital asset platforms follows from the discussion above. Because registered securities exchanges can only trade securities,²² any difficulties with respect to regulations' fit for digital assets themselves will be replicated in terms of their platforms' eligibility for SEC registration. But the poor fit of existing exchange regulations does not end there.

Even if securities registration were clear for digital assets, existing SEC rules and guidance make it impossible for digital asset platforms to register and comply with the requirements applicable to securities exchanges. Gensler has bemoaned the structure of current crypto platforms, which allow market participants to transact directly without the intermediation of a broker and vertically integrate some functions (such as custody and settlement) that securities exchange rules require to be separated.²³

But even if a crypto platform's consolidated functions were broken apart, the SEC's rules would not be compatible with allowing such a platform to function. For example, trading on a securities exchange is limited to broker-dealers,²⁴ but SEC guidance restricts the ability of

²⁰ See Hester Peirce, "Outdated: Remarks before the Digital Assets at Duke Conference," Speech, Securities and Exchange Commission, January 20, 2023, <https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-duke-conference-012023> ("When we insist on applying the securities laws in this manner, secondary purchasers of the token often are left holding a bag of tokens that they cannot trade or use because the SEC requires special handling consistent with the securities laws.").

²¹ See, e.g., Jack Soloway and Jennifer Schulp, "Regulatory Clarity for Crypto Marketplaces Part II: Centralized Exchanges," Briefing Paper No. 155, Cato Institute, May 10, 2023, <https://www.cato.org/briefing-paper/regulatory-clarity-crypto-marketplaces-part-ii-centralized-exchanges>; Committee on Capital Markets Regulation, "Cryptoasset Trading Platforms Cannot Register As Securities Exchanges," Statement, June 6, 2023, <https://capmktreg.org/wp-content/uploads/2023/06/CCMR-Crypto-Exchanges-Cannot-Register-With-the-SEC-06-06-23.pdf>.

²² Exchange Act §§ 3(a)(1), 6(b)(1); see also Jack Soloway and Jennifer Schulp, "Regulatory Clarity for Crypto Marketplaces Part II: Centralized Exchanges," Briefing Paper No. 155, Cato Institute, May 10, 2023, <https://www.cato.org/briefing-paper/regulatory-clarity-crypto-marketplaces-part-ii-centralized-exchanges> (explaining that SEC Rule 51c2-11 bars broker-dealers from transaction without certain information being available).

²³ Gary Gensler, "Kennedy and Crypto," Speech, Securities and Exchange Commission, Sept. 8, 2022, <https://www.sec.gov/newsroom/speeches-statements/gensler-sec-speaks-090822> ("The commingling of the various functions within crypto intermediaries creates inherent conflicts of interest and risks for investors.").

²⁴ 15 U.S.C. § 78f.

broker-dealers to handle digital assets for their clients, limiting it to “special-purpose” broker-dealers who solely handle crypto securities.²⁵ But the guidance covering these “special purpose broker-dealers,” issued in late 2020, appears to be unworkable, with only two entities (one just last week) having been approved for such a license.²⁶

This problem is repeated specifically with respect to custody. Even if a crypto platform were to cease custodialing a customer’s assets, the number of providers of qualified custodial services has been severely limited due to SEC guidance, including Staff Accounting Bulletin (SAB) 121 and the guidance on special-purpose broker-dealers.²⁷

Exchange rules regarding securities settlement and clearing are also incompatible with the settlement and clearing process for digital assets. Because settlement can occur instantaneously on a blockchain, there is no practical need for a clearing agency to assume the responsibility for the settlement process when trading digital assets. Yet, existing rules may require a digital asset platform that utilizes such technology for immediate settlement to register as a clearing agency and be subject to the inapt rules that apply to such an entity.²⁸ This makes little sense.²⁹

For decentralized platforms, the problems are even more acute.³⁰ Squaring securities laws designed for centralized financial intermediaries with a crypto ecosystem that includes tokens traded via disintermediated protocols is a significant challenge. Centralized platforms typically custody customer assets, settle transactions off-chain, and have opaque transaction records. But decentralized platforms do not custody the assets of users trading tokens and

²⁵ Securities and Exchange Commission, “Custody of Digital Asset Securities by Special Purpose Broker-Dealers,” Policy Statement, December 23, 2020, <https://www.sec.gov/files/rules/policy/2020/34-90788.pdf>.

²⁶ Leo Schwartz, “SEC and FINRA make tZero second recipient of special crypto license following controversial Prometheus approval,” *FortuneCrypto*, September 10, 2024, <https://fortune.com/crypto/2024/09/10/tzero-special-purpose-broker-dealer-license-finra-sec-gensler-prometheus-crypto/>. Importantly, the guidance that makes this license possible is set to expire in 2025—a short period of time from now for an operating business—and the SEC has made no public moves to extend or otherwise codify the ability of broker-dealers to engage in the business permitted by the guidance.

²⁷ See also Jack Soloway and Jennifer Schulp, “Regulatory Clarity for Crypto Marketplaces Part II: Centralized Exchanges,” Briefing Paper No. 155, Cato Institute, May 10, 2023, <https://www.cato.org/briefing-paper/regulatory-clarity-crypto-marketplaces-part-ii-centralized-exchanges> (explaining that the SEC’s proposed rule on safeguarding investment adviser assets may, if finalized, further erode access to, and safety of, qualified custodians).

²⁸ 15 U.S.C. §78c(a)(23); 17 C.F.R. § 240.17Ad-22.

²⁹ And while one can argue that the better analogue to crypto trading platforms are alternative trading systems, see Jack Soloway and Jennifer Schulp, “Regulatory Clarity for Crypto Marketplaces Part II: Centralized Exchanges,” Briefing Paper No. 155, Cato Institute, May 10, 2023, <https://www.cato.org/briefing-paper/regulatory-clarity-crypto-marketplaces-part-ii-centralized-exchanges>, with the one exception of Prometheus, and now tZero, the SEC has not steered the registration conversation in that direction. Indeed, the enforcement actions that it has brought against Coinbase, Binance, and others have been for failures to register as exchanges, not for failure to comply with the provisions of Reg ATS.

³⁰ See Jack Soloway and Jennifer Schulp, “Regulatory Clarity for Crypto Marketplaces Part I: Decentralized Exchanges,” Briefing Paper No. 154, Cato Institute, May 10, 2023, <https://www.cato.org/briefing-paper/regulatory-clarity-crypto-marketplaces-part-i-decentralized-exchanges>.

settle transactions on open and auditable public blockchains. Therefore, applying traditional custody and market transparency rules to decentralized platforms is, at best, unhelpful, and may be counterproductive.³¹ Regulations to address intermediary risks do not make sense for software designed to achieve disintermediation.

Unfortunately, the SEC has shown little interest in working through any of these issues—whether jurisdictional or related specifically to the poor fit of existing regulations for digital asset or exchange registration. Not only has the Commission failed to undertake any process towards rule-making in this space, but multiple market participants have publicly stated that they did attempt to engage with the SEC about registration, only to be rebuffed.³² And Commissioner Hester Peirce recently characterized the SEC’s posture as one where market participants asking the SEC about the “application of an old [rule] to new circumstances, too often now ... are met with ... well, crickets.”³³ These are not the actions of a regulator engaged in its mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Rather these are the actions of a regulator that, at a minimum, is showing callous indifference to the impact of rules that are not a good fit for evolving technology.

Enforcement-First Is a Harmful Regulatory Strategy for Digital Assets

Enforcement is a key part of the regulatory process; holding regulated parties to account for the rules that are put into place is important. But, as a matter of both fairness and efficiency, enforcement should happen only when the regulatory obligations being enforced are reasonably clear.

Where the application of existing rules to digital assets is uncertain or impossible, as discussed above, an enforcement-first strategy is inappropriate and effectively amounts to a deterrent to the entire digital assets ecosystem within the United States.

Regulation by Enforcement is Not an Efficient or Fair Way of Regulating

The SEC routinely touts its success in charging “first-of their kind” cases and bringing significant actions “to protect investors in new and emerging areas, including cases charging

³¹ Jennifer Schulp and Jack Solowey, “DeFi Must Be Defended,” *CoinDesk*, October 26, 2022, <https://www.cato.org/commentary/defi-must-be-defended>;

³² See Securities and Exchange Commission, Agency Rule List – Spring 2024 (Reg Flex Agenda), https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode&showStage=active&agencyCd=3235; Paul Grewal, “We asked the SEC for reasonable crypto rules for Americans. We got legal threats instead,” *Coinbase*, March 22, 2023, <https://www.coinbase.com/blog/we-asked-the-sec-for-reasonable-crypto-rules-for-americans-we-got-legal>; Daniel M. Gallagher, Testimony before U.S. House of Representatives Committee on Agriculture on “The Future of Digital Assets: Providing Clarity for Digital Asset Spot Markets,” June 6, 2023, <https://docs.house.gov/meetings/AG/AG00/20230606/116051/HHRG-118-AG00-Wstate-GallagherD-20230606.pdf>.

³³ Hester Peirce, “At the SEC: Nothing but Crickets Remarks at SEC Speaks,” *Speech*, Securities and Exchange Commission, April 2, 2024, <https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-sec-speaks-040224>.

misconduct involving cyber issues and crypto securities.”³⁴ While not all first-of-their-kind cases are inappropriate, the Commission should not champion leading with enforcement when addressing novel applications of existing rules.

Rulemaking achieved through enforcement is suboptimal for many reasons, including simply that it creates worse rules. As Commissioner Uyeda has explained, rulemaking through enforcement “fails to provide a mechanism for the Commission to consider the views of market participants,” which is an important input to creating “better crafted rules.”³⁵ Creating policy through enforcement also produces less certain and less clear rules for market participants and can result in unfair treatment of such market participants, undermining public trust in the agency. At their most fundamental level, enforcement actions may provide long lists of examples—often a bit light on relevant details—about what a market participant should not do, but they rarely provide a pathway for understanding what to do.³⁶

This has particularly been the case when the Commission has leaned heavily on enforcement to tell market participants about its view of the law on digital assets.³⁷

The failure of this strategy is particularly egregious when the SEC has brought enforcement actions against market participants for failing to comply with rules for which there was no path to compliance. One example of this is the SEC’s settled cases regarding staking.³⁸

³⁴ Securities and Exchange Commission, “Fiscal Year 2024 Congressional Budget Justification,” at 22, https://www.sec.gov/files/fy-2024-congressional-budget-justification_final-3-10.pdf.

³⁵ Mark Uyeda, “Remarks at the ‘SEC Speaks’ Conference 2022,” Speech, Securities and Exchange Commission, Sept. 9, 2022, <https://www.sec.gov/newsroom/speeches-statements/uyeda-speech-sec-speaks-090922>.

³⁶ See Hester Peirce, “Pourquoi Pas? Securities Regulation and the American Dream: Remarks before the Association of Private Enterprise Education,” Speech, Securities and Exchange Commission, April 8, 2024, <https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-association-private-enterprise-education-040824>. Establishing policy through enforcement is also very resource intensive, requiring the Commission’s limited enforcement resources to investigate and pursue (often iterative) enforcement actions to establish a rule that could have otherwise been made through formal notice-and-comment rulemaking or some other policy-making tool. The SEC’s Enforcement resources have been strained in recent years. For example, last year, 67 percent of enforcement staff “disagreed or strongly disagreed that the Enforcement Division’s human capital resources were sufficient to handle the investigative load.” The Office of Inspector General, “The Inspector General’s Statement on the SEC’s Management and Performance Challenges,” *Securities and Exchange Commission*, October 2023, at 15, <https://www.sec.gov/files/statement-secs-management-and-performance-challenges-october-2023.pdf>. Timeliness of enforcement investigations also remains an issue with the agency. Office of the Inspector General, “Enforcement Investigations: Measures of Timeliness Showed Some Improvement But Enforcement Can Better Communicate Capabilities for Expediting Investigations and Improve Internal Processes,” *Securities and Exchange Commission*, February 15, 2023, <https://www.sec.gov/files/enforcement-investigation-measures-timeliness-show-some-improvement-enforcement-can-better-comm.pdf>.

³⁷ Hester Peirce, “Kraken Down: Statement on SEC v. Payward Ventures, Inc., et al.,” Statement, Securities and Exchange Commission, February 9, 2023, <https://www.sec.gov/newsroom/speeches-statements/peirce-statement-kraken-020923> (“[u]sing enforcement actions to tell people what the law is in an emerging industry is not an efficient or fair way of regulating”).

³⁸ See, e.g., Securities and Exchange Commission, “Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay \$30 Million to Settle SEC Charges,” Press Release, February 9, 2023, <https://www.sec.gov/newsroom/press-releases/2023-25>.

While reasonable securities lawyers may disagree as to whether the specific facts and circumstances of a particular staking service fit the definition of an investment contract, the SEC's insistence that crypto platforms register those services without the agency first providing those platforms with a clear means of registering their staking services is problematic.³⁹ Instead of "initiat[ing] a public process to develop a workable registration process that provides valuable information to investors," the SEC instead chose to "just shut it down," in the words of Commissioner Peirce.⁴⁰ Similarly, the SEC's litigation against LBRY—which ultimately resulted in the company abandoning its appeal and winding down operations after exhausting its resources—charged LBRY with failing to register its tokens, despite the agency providing no path for LBRY to do so.⁴¹

These two examples, among others, make clear how an enforcement-first approach functions as an effective ban by the SEC on digital asset activity in the United States.

The SEC's Digital Assets Enforcement Is Worse Than Garden-Variety Regulation by Enforcement

The scale of the SEC's regulation by enforcement efforts on digital assets sets it apart from other times the agency has led with enforcement. The SEC touts its record in bringing "well over 100 crypto-related actions,"⁴² as if the sheer volume of enforcement actions itself does not suggest that there is some mismatch between what the agency thinks regulation requires and the practical application of regulation to functioning businesses. These enforcement actions have covered a diverse set of topics—from token registration to exchange registration to staking to non-fungible tokens to fraud—but have all taken place with little effort by the agency to engage with market participants or provide any guidance (besides enforcement actions) to assist in compliance.

But even beyond the scale of the enforcement efforts, the SEC's conduct in bringing these actions has further increased regulatory uncertainty—and leads one to question whether the agency is acting in good faith. To name a few examples:

³⁹ See Jack Soloway and Jennifer Schulp, "SEC Releases the Kraken...Settlement," Cato At Liberty Blog, February 10, 2023, <https://www.cato.org/blog/sec-releases-kraken-settlement>.

⁴⁰ Hester Peirce, "Kraken Down: Statement on SEC v. Payward Ventures, Inc., et al.," Statement, Securities and Exchange Commission, February 9, 2023, <https://www.sec.gov/newsroom/speeches-statements/peirce-statement-kraken-020923>.

⁴¹ Hester Peirce, "Overdue: Statement on Dissent of LBRY," Statement, Securities and Exchange Commission, October 27, 2023, https://www.sec.gov/newsroom/speeches-statements/peirce-statement-lbry-102723#_ftn9 ("[t]here is no path for a company liked LBRY to come in and register its functional token offering").

⁴² Gurbir Grewal, "What's Past is Prologue: Enforcing the Federal Securities Laws in the Age of Crypto," Speech, Securities and Exchange Commission, July 2, 2024, <https://www.sec.gov/newsroom/speeches-statements/grewal-remarks-age-crypto-070224>.

- Rather than engaging with entities under investigation, the SEC has often tried to hide the ball, limiting the opportunities of potential respondents to constructively engage with the agency prior to an enforcement action being filed.⁴³
- The SEC's legal theories are inconsistent and shifting, increasing regulatory risk and uncertainty for any market participant attempting to understand the agency's position as to its jurisdiction.⁴⁴
- Settled actions often provide little detail as to the basis for the charges, particularly where the charges rest on a finding that involves unregistered securities, making it more difficult for market participants to understand the basis for the enforcement action.⁴⁵
- The SEC has engaged in sanctioned misconduct, including material misrepresentations to a federal district court, in a digital assets-related case.⁴⁶

Even if the agency were enforcing clear rules, this type of conduct would reflect poorly on a regulator. These issues, among others, are indicative of the ways in which the SEC's crypto crusade has veered beyond simply enforcing existing rules.

In addition, the aggressive SEC enforcement activity—and lack of agency engagement with market participants—has resulted in an unusually high number of lawsuits against the agency seeking proactive relief.⁴⁷ This not only places additional demands on the SEC's resources—and potentially erodes the agency's authority—it should serve as a clear signal to the Commission that if market participants are willing to go to such (expensive) lengths to

⁴³ See, e.g., Paul Grewal, "We asked the SEC for reasonable crypto rules for Americans. We got legal threats instead," Coinbase, March 22, 2023, <https://www.coinbase.com/blog/we-asked-the-sec-for-reasonable-crypto-rules-for-americans-we-got-legal>.

⁴⁴ See, e.g., James Hunt, Sarah Wynn, Tim Copeland, "The SEC claims that when it said 'crypto asset securities' it never meant tokens were actually securities," *The Block*, September 13, 2024, <https://www.theblock.co/post/316406/sec-crypto-asset-securities?modal=newsletter>.

⁴⁵ For example, the SEC's settlement in ShapeShift for failure to register as a dealer failed to identify which crypto assets traded on the platform were investment contracts and failed to provide any explanation for its conclusion. In re ShapeShift, AG, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order," Exchange Act Release No. 99676, File No. 3-21891, March 5, 2024, https://www.sec.gov/files/litigation/admin/2024/34-99676.pdf?utm_medium=email&utm_source=govdelivery.

⁴⁶ James V. Masella III and Brad Gersehl, "Overreach and Misrepresentation: The SEC's Pursuit of Emergency Relief in 'DEBT Box,'" *New York Law Journal*, June 11, 2024, <https://www.ballardspahr.com/insights/alerts-and-articles/2024/06/overreach-and-misrepresentation-the-sec-pursuit-of-emergency-relief-in-debt-box>.

⁴⁷ See, e.g., Jake Chervinsky and Amanda Tuminelli, "In Lejilex vs. SEC, Crypto Goes on Offense in the Courts," CoinDesk, February 23, 2024, <https://www.coindesk.com/opinion/2024/02/23/in-lejilex-vs-sec-crypto-goes-on-offense-in-the-courts/>; Sander Lutz, "A Song Man and a Law Professor Walk Into the SEC—And Try to Take Down Its NFT Agenda," *Decrypt*, July 31, 2024, <https://decrypt.co/242653/song-man-law-professor-sec-nft-agenda>; Nathan Hennigh, "I'm a 24-year-old small business owner. Here's why I'm suing the SEC," *FortuneCrypto*, April 16, 2024, <https://fortune.com/crypto/2024/04/16/24-year-old-suing-sec-token-airdrop-beba/>.

achieve clarity, the agency has a long way to go in terms of providing sound regulation on digital assets.⁴⁸

A Better Approach Would Yield Clear and Predictable Rules

As demonstrated above, the SEC's "enforce first, make rules never," approach is the wrong one.

While there likely are regulatory gaps that can be filled only by legislation, the Commission has tools at its disposal to create clear and predictable rules to govern digital assets that fall within its jurisdiction. Congress has given the SEC broad exemptive authority that it has exercised to craft regulatory regimes tailored to products, asset classes, and entities for which the statutory scheme yielded unclear or anomalous results. The Commission has exercised those exemptive authorities for unregistered offerings, alternative trading systems, asset-backed securities, and exchange-traded funds, just to name a few.⁴⁹

But exemptive relief through formal rulemaking is not the only avenue available to the SEC; it can also provide no-action relief, release interpretative guidance, or perhaps at the most basic level, begin to engage with the relevant market participants through concept releases, roundtables, or otherwise. To date, the Commission has not engaged in any of this activity.⁵⁰

The SEC has the tools at its disposal; it just needs to use them.

Limited SEC Guidance and Rulemakings Related to Digital Assets Provide No Clarity

If the Commission were to defend its approach to keeping digital assets off its rulemaking agenda, it would likely point to a few scattered references to digital assets in its rulemaking and guidance over the past several years as satisfying identified needs. But in each instance, the SEC actions have not provided clarity or have exacerbated existing regulatory uncertainties.

One example of this is the SEC's issuance of SAB 121, which provided guidance to crypto custodians requiring them to list custodied assets on their own balance sheets. This guidance,

⁴⁸ Cf. Hester Peirce, "Out, Damned Spot! Out, I Say!: Statement on Omnibus Approval Order for List and Trade Bitcoin-Based Commodity-Based Trust Shares and Trust Units," Statement, Securities and Exchange Commission, January 10, 2024, <https://www.sec.gov/newsroom/speeches-statements/peirce-statement-spot-bitcoin-011023> (explaining that the disparate treatment of Bitcoin products will "harm our reputation far beyond crypto. Diminished trust from the public will inhibit our ability to regulate markets effectively" and that "our disproportionate attention on these filings has diverted limited staff resources away from other mission critical work").

⁴⁹ See, e.g., Hester Peirce, "Pourquoi Pas? Securities Regulation and the American Dream: Remarks before the Association of Private Enterprise Education," Speech, Securities and Exchange Commission, April 8, 2024, <https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-association-private-enterprise-education-040824>.

⁵⁰ See *id.* (describing the SEC's approach to the rise of the internet); see also Hester Peirce and Mark Uyeda, "Statement Regarding Denial of Petition for Rulemaking," Statement, Securities and Exchange Commission, December 15, 2023, <https://www.sec.gov/newsroom/speeches-statements/peirce-uyeda-petition-121523>.

however, is both substantively and procedurally flawed. On substance, SAB 121 upended generally accepted practices by calling on asset custodians to treat clients' digital assets as liabilities on custodians' own balance sheets.⁵¹ Reversing the standard practice of treating custody assets as off-balance sheet increases costs for any entity seeking to provide custody for digital assets. The result is that it has severely limited the number of qualified custodians for digital assets, an outcome that seems inconsistent with the SEC's investor protection mission.

But this guidance was also procedurally flawed; the Government Accountability Office found that SAB 121 was tantamount to a rule that required notice to Congress under the Congressional Review Act, which the SEC had failed to provide.⁵²

Although bipartisan majorities of both houses of Congress passed resolutions disapproving of SAB 121, the SEC has not reconsidered the guidance, but rather has doubled down—in a way that simply proves how poor of a method such staff guidance is for making policy. After rumors swirled about some prospective crypto custodians reaching deals with the SEC that did not subject them to the terms of SAB 121,⁵³ the SEC's Chief Accountant gave a speech that stood behind SAB 121 and outlined some fact patterns that were outside of the scope of SAB 121.⁵⁴ But market participants are left with little certainty about how to apply the purported non-binding staff guidance—that is now subject to a non-binding gloss in a staff speech that was informed by one-off discussions with market participants. This is not a healthy regulatory process.

Another example is the SEC's updates to the dealer rule,⁵⁵ which explicitly contemplate that the new category of dealers outlined in that rule might include certain crypto market participants. Among the many issues with the SEC's approach on this rule, is the most basic

⁵¹ Securities and Exchange Commission, Staff Accounting Bulletin No. 121, April 11, 2022, <https://www.sec.gov/regulation/staff-interpretations/accounting-bulletins/old/staff-accounting-bulletin-121>; see Jack Solowey and Jennifer Schulp, "Decentralized Networks and Separated Powers: An Historic Moment for Crypto Legislation," Cato At Liberty Blog, May 23, 2024, <https://www.cato.org/blog/decentralized-networks-separated-powers-historic-moment-crypto-legislation>.

⁵² U.S. Government Accountability Office, "Securities and Exchange Commission—Applicability of the Congressional Review Act to Staff Accounting Bulletin No. 121," B-334540, October 31, 2023, <https://www.gao.gov/products/b-334540>; see also Hester Peirce, "Response to Staff Accounting Bulletin No. 121," Statement, Securities and Exchange Commission, March 31, 2022, <https://www.sec.gov/newsroom/speeches-statements/peirce-response-sab-121-033122>.

⁵³ Amanda Iacone, "SEC Allows Some Exceptions to Crypto Accounting Compliance," *Bloomberg Law*, July 11, 2024, <https://news.bloomberglaw.com/banking-law/sec-allows-some-exceptions-to-crypto-accounting-rule-compliance>.

⁵⁴ Paul Munter, "Remarks before the 2024 AICPA & CIMA Conference on Banks & Savings Institution: Accounting for Crypto-Asset Safeguarding Obligations—A Facts-Based Analysis," Statement, Securities and Exchange Commission, Sept. 9, 2024, <https://www.sec.gov/newsroom/speeches-statements/munter-speech-safeguarding-crypto-assets-09-09-24>.

⁵⁵ Securities and Exchange Commission, "Further Definition of 'As a Part of Regular Business' in the Definition of Dealer and Government Securities Dealer in Connection with Certain Liquidity Providers," Rel. No. 34-99477, 89 Fed. Reg. 14938, February 29, 2024, <https://www.govinfo.gov/content/pkg/FR-2024-02-29/pdf/2024-02837.pdf>.

one: as Commissioners Peirce and Uyeda explained, “[p]eople right now are trying to figure out whether they have to register as dealers and, if so, which assets they can handle in the registered entity. To do so, they need to understand whether the assets for which they provide liquidity are securities.”⁵⁶ As described above, the answer to that question remains unclear, and the agency’s dealer rule provides no additional guidance.⁵⁷

Thoughtful Engagement by The SEC Is Long-Past Due

Rather than welcoming legislative intervention, Gensler pushed back explicitly against attempts by Congress to legislate, asserting that legislation was wholly unnecessary.⁵⁸ As laid out above, that cannot be further from the truth. Gensler’s SEC generally stands alone in believing that there is no room for improvement in the United States’s approach to digital assets. The Biden Administration has signaled that legislation is welcome.⁵⁹ Other executive agencies, including the CFTC and Treasury Department, have indicated that legislation is needed.⁶⁰ And the United States would hardly be alone in needing to update its laws to address technological change, as it would follow a host of other countries in doing so.⁶¹

Indeed, Gensler himself has even suggested at times that legislation may be needed or regulations may need to be updated, claiming to have “asked staff to consider” a number of questions about how to apply existing SEC rules to crypto exchanges—acknowledging that the

⁵⁶ Hester Peirce and Mark Uyeda, “On Today’s Episode of As the Crypto World Turns: Statement on ShapeShift AG,” Statement, Securities and Exchange Commission, March 5, 2024, https://www.sec.gov/newsroom/speeches-statements/peirce-uyeda-statement-crypto-world-turns-03-06-24#_ftnref4; see also Securities and Exchange Commission, “Further Definition of ‘As a Part of Regular Business’ in the Definition of Dealer and Government Securities Dealer in Connection with Certain Liquidity Providers,” Rel. No. 34-99477, 89 Fed. Reg. 14938, February 29, 2024, at n.134 <https://www.govinfo.gov/content/pkg/FR-2024-02-29/pdf/2024-02837.pdf> (“The application of the final rules turns on whether a particular crypto asset is a security...”); see also, e.g., Hester Peirce, “Dealer, No Dealer Statement on Further Definition of ‘As a Part of a Regular Business’ in the Definition of Dealer and Government Securities Dealer in Connection with Certain Liquidity Providers,” Statement, Securities and Exchange Commission, February 6, 2024, https://www.sec.gov/newsroom/speeches-statements/peirce-statement-dealer-trader-020624#_ftn21.

⁵⁷ The SEC’s rule proposal on the definition of an exchange is no more thoughtful, suggesting that the proposed regulations may impact DeFi by “reducing the extent to which a system is ‘decentralized.’” See Jack Solowey and Jennifer Schulp, Public Comment to “Amendments to Exchange Act Rule 3b-16 Regarding the Definition of ‘Exchange,’” File No. S7-02-22, June 13, 2023, <https://www.cato.org/sites/cato.org/files/2023-06/solowey-schulp-public-comments-6-13-2023.pdf>.

⁵⁸ Gary Gensler, “Statement on the Financial Innovation and Technology for the 21st Century Act,” Statement, Securities and Exchange Commission, May 22, 2024, <https://www.sec.gov/newsroom/speeches-statements/gensler-21st-century-act-05222024>.

⁵⁹ Executive Office of the President, “Statement of Administration Policy,” May 22, 2024, <https://www.whitehouse.gov/wp-content/uploads/2024/05/SAP-HR4763.pdf>.

⁶⁰ See *supra* n.5.

⁶¹ See Susannah Hammond and Todd Ehret, “Cryptocurrency regulations by country,” *Thomson Reuters*, April 4, 2022, <https://www.thomsonreuters.com/en-us/posts/wp-content/uploads/sites/20/2022/04/Cryptos-Report-Compendium-2022.pdf>.

application of existing rules is not crystal clear.⁶² But years after these acknowledgments, enforcement actions continue to be filed based on existing rules, and there is no visible progress towards solutions—no proposed rules or guidance, no formal process for gathering market participant input, and no docketing of an intention to address these issues on the agency’s agenda.⁶³

The SEC’s expansive interpretation of its authority is at odds with the nearly century-old securities laws from which the SEC is claiming to draw its power. It is difficult to find a mandate in those laws to bar the door to future innovations in capital market tools and, more generally, to technical infrastructure for decentralized and cryptographically secure computing. For instance, the Securities Exchange Act of 1934 begins with the statement that it’s in the “national public interest” to “provide for regulation and control of” securities transactions.⁶⁴ The lesser power to regulate whichever digital asset transactions are, in fact, securities transactions, does not include the greater power to prohibit them writ large. At the very least, such an expansive interpretation of the SEC’s powers should not come without a public rulemaking process, which requires consideration of whether the rulemaking “will promote efficiency, competition, and capital formation.”⁶⁵ The SEC’s current digital assets strategy is inconsistent with any of these goals.

* * *

Thank you for the opportunity to provide this information about the myriad deficiencies in the SEC’s approach to digital assets. I welcome any questions that you may have.

⁶² See, e.g., Lydia Beyoud and Yueqi Yang, “SEC Weighs Waiving Some Rules to Regulate Crypto, Gensler Says,” *Bloomberg*, July 14, 2022, <https://www.bloomberg.com/news/articles/2022-07-14/sec-weighs-waiving-some-rules-to-regulate-crypto-gensler-says>; Gary Gensler, “Kennedy and Crypto,” Speech, Securities and Exchange Commission, September 8, 2022, https://www.sec.gov/newsroom/speeches-statements/gensler-sec-speaks-090822#_ftnref11; Gary Gensler, “Prepared Remarks of Gary Gensler On Crypto Markets Penn Law Capital Markets Association Annual Conference,” Speech, Securities and Exchange Commission, April 4, 2022, <https://www.sec.gov/newsroom/speeches-statements/gensler-remarks-crypto-markets-040422>.

⁶³ Gensler has pointed to the Commission’s process for crafting rules for asset-backed securities disclosures as precedent for a process that would not see formal rules proposed for more than a decade after the industry’s rise. See Jessica Corso, “SEC’s Gensler Suggests Crypto Rules Could Be Years Away,” *Law360*, September 15, 2022, <https://www.law360.com/securities/articles/1530470/sec-s-gensler-suggests-crypto-rules-could-be-years-away>. Even if Gensler were belatedly starting the clock when he was appointed, the SEC has taken none of the steps—including industry engagement and exemptive relief or no-action relief to individual issuers—that it was taking with respect to asset-backed securities issuers in order to ultimately craft a formal rule.

⁶⁴ Securities Exchange Act of 1934, P.L. 73-291, 48 STAT 881, Sec. 2 (June 6, 1934).

⁶⁵ 15 U.S.C. §78c(f).

Chairman HILL. Thank you for your testimony. Mr. Reiners, you are recognized for 5 minutes for your oral presentation.

STATEMENT OF LEE REINERS, LECTURING FELLOW, DUKE UNIVERSITY

Mr. REINERS. Chairman Hill, Ranking Member Lynch, and members of the committee, thank you for inviting me to testify at today's hearing. My name is Lee Reiners, and I am a lecturing fellow at Duke University, where I teach courses related to financial regulation. Previously, I spent 5 years at the Federal Reserve Bank of New York examining systemically important financial institutions. The views expressed in my testimony today are mine and mine alone, and do not represent the views of Duke University or any affiliate thereof.

Narrative politics refers to the use of stories and narratives in the political sphere to shape perceptions, influence public opinion, and drive political action through the use of stories. Special interests and political actors seek to influence how the public perceives issues and events, which, in turn, affects policy preferences and can lead to specific policies being legitimized or delegitimized. Importantly, it does not matter if the narrative is true. What matters is if enough people believe it is true. Over the past year, the cryptocurrency industry has engaged in a classic case of narrative politics. The story they tell is simple, powerful, and false. It goes something like this.

There are millions of one-issue, pro-crypto voters who stand ready to support the candidates that embrace crypto and ensure the U.S. is host to the next great wave of technological innovation. To make sure policymakers get the message, the crypto industry has amassed an unprecedented campaign finance war chest. As Congressman Lynch noted, crypto corporations have poured over \$119 million directly into influencing Federal elections, which accounts for nearly half of all corporate spending in the 2024 election cycle thus far. Now, this kind of money buys powerful friends. After previously calling Bitcoin a scam whose value is highly volatile and based on thin air, Donald Trump recently told the crowd at Bitcoin 2024 that he would make the U.S. the crypto capital of the planet and fire SEC chair, Gary Gensler, on day one of his presidency.

More important than supportive statements from Presidential candidates is industry-friendly legislation that would hand crypto market oversight to the Commodity Futures Trading Commission (CFTC) and gut our Federal securities laws in the process. When the House passed the Financial Innovation and Technology for the 21st Century Act in May, the industry took one large step toward accomplishing their goal. The crypto industry has funded astroturf campaigns and commissioned dubious polls to provide policymakers with the cover they need to enact industry-friendly laws and regulations but the reality is that very few Americans own or use crypto, and among those that do, there is no evidence to suggest that their vote is principally influenced by candidates' stance on cryptocurrency.

The crypto industry has resorted to narratives and aggressive lobbying because it has yet to produce a product or service that provides genuine economic utility to most Americans. In the par-

lance of startups, crypto has still not found product market fit. To better understand this point, it is helpful to compare crypto's plight to that of another product that came shortly before: ridesharing. When Uber first launched, its business was illegal in almost every new city it entered. The company overcame this hurdle with one enormously powerful weapon: a product that consumers enjoyed. By solving the problem of unreliable taxi service, Uber quickly developed a large and vocal constituency of riders and drivers. This ultimately forced policymakers to accommodate a business model that forever changed the way we get around. In sum, a great product compelled regulatory change. The crypto industry seems to think the opposite, that regulatory change will compel a great product. This notion has led the industry to become mired in endless policy debates and fitful legislative efforts that only benefit their lawyers and lobbyists.

Fortunately, the Securities and Exchange Commission has resisted industry lobbying and upheld the securities laws established by Congress 90 years ago. In my written testimony, I offer context for ongoing debates about the SEC's role in cryptocurrency markets by examining the agency's long standing, consistent, and legally sound methods of cryptocurrency enforcement and regulation.

Many within the crypto sector assert that current securities laws, formulated long before blockchain technology emerged, are ill-suited to the nuances of digital assets, but using advanced technology as a justification for ignoring regulations is a convenient distraction from the truth. The business models of cryptocurrency platforms are fundamentally at odds with Federal securities laws.

My testimony reveals that the SEC is simply doing the job Congress tasked it with: enforcing the Federal securities laws. While crypto market participants may not like these laws, they have no basis to be mad at the SEC for enforcing them. To paraphrase Matthew McConaughey's character in "Dazed and Confused, that is what I love about these Federal securities laws, man. I get older. They stay the same age."

Thank you, and I look forward to taking your questions.

[Prepared statement of Mr. Reiners follows:]

**Hearing on
Dazed and Confused: Breaking Down the SEC's Politicized Approach to Digital Assets
Before the U.S. House Financial Services Committee Subcommittee on Digital Assets,
Financial Technology and Inclusion**

Wednesday, September 18, 2024

Prepared Statement

**Lee Reiners
Lecturing Fellow
Duke University**

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

Thank you for inviting me to testify at today's hearing. My name is Lee Reiners, and I am a lecturing fellow at Duke University. The views expressed in my testimony are mine alone and do not represent the views of Duke University or any affiliate thereof, and I have prepared this testimony on my own behalf. I teach courses in cryptocurrency law and policy, cybersecurity policy, climate change and financial markets, and financial regulation, and my research focuses on how new financial technologies and climate change fit within existing financial regulatory frameworks. Prior to entering academia, I spent five years examining systemically important financial institutions at the Federal Reserve Bank of New York. I also serve on the CFA Institute's Capital Markets Policy Council.

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I. Introduction

Narrative politics refers to the use of stories and narratives in the political sphere to shape perceptions, influence public opinion, and drive political action. Through the use of stories, special interest groups and political actors seek to influence how the public perceives issues and events, which in turn affects policy preferences and can lead to specific policies being legitimized or delegitimized. Importantly, it does not matter if the narrative is true. What matters is if enough people – the right people – believe it is true.

Over the past year, the cryptocurrency industry has engaged in a classic case of narrative politics. The story they tell is simple, powerful, and false. It goes something like this: there are millions of one issue pro-crypto voters who stand ready to support the candidates that embrace crypto and ensure the United States is host to the next great wave of technological and financial innovation. And what does “embracing” crypto look like? To most crypto executives, it means freeing the industry from the shackles of the Securities and Exchange Commission and the securities laws that have protected investors and facilitated unprecedented capital formation for the past 90 years.

To make sure policymakers get the message, the crypto industry has amassed an unprecedented campaign finance war chest. According to a recent report from Public Citizen, “crypto corporations have poured over \$119 million directly into influencing federal elections,” which accounts for nearly half of ALL corporate spending in the 2024 election cycle thus far.¹ This kind of money buys powerful friends. After previously calling Bitcoin a “scam” whose “value is highly volatile and based on thin air,”² Donald Trump recently told the crowd at Bitcoin 2024 that he would make the U.S. the “crypto capital of the planet” and fire SEC Chair Gary Gensler on day one of his presidency.

More important than supportive statements from presidential candidates is industry-friendly legislation that would hand crypto market oversight to the Commodities Futures Trading Commission and gut our federal securities laws in the process. When the U.S. House of Representatives passed the “Financial Innovation and Technology for the 21st Century Act” (FIT21) in May, the industry took one large step toward accomplishing their goal.³

The crypto industry has funded astroturf campaigns⁴ and commissioned dubious polls to provide policymakers with the cover they need to enact industry-friendly laws and regulations. One statistic that gets thrown around frequently is that 50 million Americans – roughly 20% of U.S. adults – own cryptocurrency. This figure comes from a 2023 Morning Consult poll – commissioned by a cryptocurrency exchange – that surveyed 2,202 U.S. adults.⁵ However, in the

¹ <https://www.citizen.org/article/big-crypto-big-spending-2024/>

² https://www.wsj.com/articles/donald-trump-crypto-currency-plan-bitcoin-conference-gary-gensler-sec-bd21f5aa?utm_source=securitiesdocket.beehiiv.com&utm_medium=newsletter&utm_campaign=can-the-u-s-president-fire-the-sec-chairman

³ [H.R. 4763 - 118th Congress \(2023-2024\): Financial Innovation and Technology for the 21st Century Act | Congress.gov | Library of Congress](https://www.congress.gov/118/congress/2023-2024/bills/4763/1/1)

⁴ See [New Astroturf Crypto Campaign Appears on Social Media - The American Prospect](#) and [Issue 62 - Grassroots \(citationneeded.news\)](#)

⁵ [Morning Consult Cryptocurrency Perception Study Feb2023 Memo_1_.pdf \(ctfassets.net\)](#)

first paragraph of their poll results, Morning Consult states that they intentionally oversampled 500 cryptocurrency investors.⁶ Another outlandish poll suggested that 1-2% of Democrats “may be leaning towards Trump due the [sic] Biden Administration’s hostility to crypto.”⁷ But this number was contrived by multiplying the number of Democratic respondents who said they were not voting for Kamala Harris by the percent of respondents who said the Biden Administration’s approach to crypto has been “too hostile,” despite there being no evidence that the reason these Democrats were not voting for Harris was because of anything related to crypto.⁸

The reality is that very few Americans own or use crypto, and among those that do, there is no evidence to suggest that their vote is principally influenced by a candidate’s stance on cryptocurrency. A more credible source on crypto ownership is the Federal Reserve’s 2023 Survey of Household Economics and Decisionmaking (SHED), which showed that only 7 percent of adults (about 18.3 million people) admitted to holding or using crypto—down from 10 percent in 2022 and 12 percent in 2021.⁹ Nor is cryptocurrency showing up in any surveys on the most important issues for US voters,¹⁰ a fact that was reflected in the omission of cryptocurrency from both candidates’ acceptance speeches at their respective party conventions,¹¹ and the topic’s absence from the first presidential debate.¹² Even the crypto industry implicitly acknowledges that voters are indifferent to crypto, as evidenced by the fact that industry-funded political ads never mention crypto.¹³

The crypto industry has resorted to narrative politics and aggressive lobbying because it has yet to produce a product or service that provides genuine economic utility to most Americans—in the parlance of startups, crypto has still not found product-market-fit.¹⁴ To better understand this point, it is helpful to compare crypto’s plight to that of another innovative product that came shortly before—ridesharing. When Uber first launched, its business was illegal in almost every new city it entered. The company overcame this hurdle with one enormously powerful weapon—a product that consumers enjoyed. By solving the frequent problem of unreliable taxi service, Uber quickly developed a large and vocal constituency of riders and drivers. This ultimately forced policymakers to accommodate a business model that forever changed the way we get around. In sum, a great product compelled regulatory change.

The crypto industry seems to think the opposite—that regulatory change will compel a great product. This notion has led the industry to become mired in endless policy debates and fitful legislative efforts that only benefit their lawyers and lobbyists. The truth is that crypto is not a kitchen table issue because, at present, it fails to solve real problems that ordinary people face. In

⁶ https://bettermarkets.org/wp-content/uploads/2023/07/BetterMarkets_Deceptive_Polling_Paid-For_ByCrypto_July2023-1.pdf

⁷ <https://policy.paradigm.xyz/writing/Dem-polling>

⁸ Interestingly, the same poll of registered Democrats found that amongst non-Harris voters, more (27%) thought the Biden Administration’s approach to crypto was either “too friendly” or “just about right” than thought it was “too hostile” (21%). See, <https://www.mollywhite.net/annotations/paradigm-democrat-poll/>

⁹ [Federal Reserve Board Publication](https://www.federalreserve.gov/publications/2023/survey-of-household-economics-and-decisionmaking-shed.aspx)

¹⁰ [Issues and the 2024 election | Pew Research Center](https://www.pewresearch.org/2023/07/12/issues-and-the-2024-election/) and [Most Important Problem | Gallup Historical Trends](https://www.gallup.com/historical/2023/07/12/most-important-problem.aspx)

¹¹ [Polymarket’s largest bet misses as Trump fails to mention Bitcoin at RNC speech \(crypto.news\)](https://www.cryptonews.com/polymarket-largest-bet-misses-as-trump-fails-to-mention-bitcoin-at-rnc-speech/)

¹² [The Harris-Trump Debate Showed How Little Crypto Matters to Voters and Politicians \(coindesk.com\)](https://www.coindesk.com/news/the-harris-trump-debate-showed-how-little-crypto-matters-to-voters-and-politicians/)

¹³ See [Fairshake - YouTube](https://www.youtube.com/watch?v=host2adimpact.com/admo/viewer/c708eecd-17dc-41b5-be8a-ca4b51f9b9bc) and host2.adimpact.com/admo/viewer/c708eecd-17dc-41b5-be8a-ca4b51f9b9bc

¹⁴ [What is Product-Market Fit? | Definition and Examples \(productplan.com\)](https://www.productplan.com/what-is-product-market-fit/)

fact, politicians are far more likely to hear from constituents who have suffered losses in any one of the numerous crypto-related failures and scams over the last several years.

Fortunately, the current leadership of the Securities and Exchange Commission has resisted industry lobbying and upheld the securities laws established by Congress ninety years ago. It is crucial to remember that Congress designed these laws to be principles-based. In the seminal case *SEC v. Howey*, the Supreme Court found that the term “investment contract:”

“[E]mbodies a flexible, rather than a static, principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”¹⁵

Cryptocurrency and blockchain technology are simply the latest scheme deployed by those seeking to profit from other people’s money.¹⁶ And despite the industry’s claims, the SEC has been clear and consistent about crypto dating to the chairmanship of Jay Clayton. Both Clayton and his successor, Gary Gensler, have said most cryptocurrencies are securities that need to be registered with the Commission. The SEC has also brought hundreds of cryptocurrency-related enforcement actions and amassed an impressive win-loss record that is the envy of any regulatory agency or law firm.¹⁷¹⁸ For any neutral observer, the law is very clear.

The crypto industry argues that even if the securities laws did apply to their activities, the decentralized nature of blockchain technology makes regulatory compliance impossible, thus the need for a completely new regulatory framework that only Congress can provide. This is a smokescreen. As I detail below, only a small fraction of cryptocurrency transactions are recorded on the blockchain,¹⁹ and centralized cryptocurrency exchanges in the U.S. do not use the blockchain to execute customer transactions. It is their conflict-laden business model, in which they perform multiple functions that are typically kept distinct in traditional securities markets, that makes regulatory compliance impossible.

While I applaud the SEC for clearly and consistently applying *Howey* and its progeny to protect investors in the crypto space, there remains a gap in crypto spot market regulation that only Congress can close. While I agree with chairman Gensler that most cryptocurrencies are securities that are subject to registration and disclosure requirements, some cryptocurrencies are

¹⁵ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

¹⁶ Note that there are other statutory standards and legal tests beyond “Howey” that can be applied to determine whether or not a given cryptocurrency is a security.

¹⁷ In fact, on issues pertaining to securities law, the SEC has just one notable loss, and a partial one at that. In *SEC v. Ripple*, Judge Analisa Torres ruled that Ripple’s secondary sales of XRP did not qualify as investment contracts. Judge Torres reasoning on this issue has since been rebuked by several federal judges in the same court, as I detail below. See [SEC Continues Crypto Crackdown Despite Recent Losses \(coinpaprika.com\)](#), and [Gensler’s SEC racks up legal wins against crypto - POLITICO](#)

¹⁸ Cornerstone Research, “SEC Tightens Cryptocurrency Enforcement,” January 18, 2023, <https://www.cornerstone.com/insights/press-releases/sec-tightens-cryptocurrency-enforcement/>. Note that additional enforcement actions and settlements since this article was published push the total number well over 130.

¹⁹ A National Bureau of Economic Research paper found that the off-chain transaction volume involving Bitcoin appears to have been at least 10 times the volume recorded on the Bitcoin blockchain. See, [w29337.pdf \(nber.org\)](#)

most likely commodities.²⁰ While the Commodity Futures Trading Commission (CFTC), regulates commodity derivatives, they do not regulate commodity spot markets. The practical effect of this structure is that cryptocurrency exchanges in the U.S. are presently not regulated at the federal level.²¹ That is a gap that Congress must close as soon as possible.

My testimony reveals that the SEC is simply doing the job Congress tasked it with – enforcing the federal securities laws. While crypto market participants may not like these laws, they have no basis to be mad at the SEC for enforcing them. To paraphrase Matthew McConaughey’s character in “Dazed and Confused”, that’s what I love about these federal securities laws, man; I get older, they stay the same.

A brief note on terminology. Throughout my testimony, I use the terms “cryptocurrency,” “crypto,” “digital asset,” “crypto asset,” and “token” interchangeably. In general, these terms refer to any fungible digital representation of value that can be exclusively possessed and transferred, person to person, without necessary reliance on an intermediary, and is recorded on a blockchain.

II. The Past, Present, and Future of SEC Cryptocurrency Enforcement

a. Overview

Despite the crypto industry’s self-serving cries for “regulatory clarity,” the SEC’s stance on cryptocurrency has been clear and consistent.²² As John Reed Stark, the former head of the SEC’s Office of Internet Enforcement, noted, critics of the SEC’s stance toward cryptocurrency overlook an important aspect of U.S. securities law — “[b]y design, it is a principles-based regulatory framework, much like other U.S. laws.”²³ This is why the definitions of “security” in Section 2(a)(1) of the Securities Act of 1933 (Securities Act), 15 U.S.C. 77b(a)(1) and Section 3(a)(10) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78c(a)(10) include not only conventional securities, such as “stock[s]” and “bond[s],” but also the more general term “investment contract.” In the seminal case *SEC v. Howey*, the Supreme Court found that the term “investment contract.”

²⁰ Bitcoin has long been considered by most observers and senior regulators to be a commodity. However, reporting by Paul Kiernan at the Wall Street Journal indicates that just five “maintainers” are responsible for updating and maintaining Bitcoin’s core software. Thus, the Howey Test’s efforts of other prong may be implicated and Bitcoin could possibly be considered an investment contract, and therefore a security. See Paul Kiernan, “Bitcoin’s Future Depends on a Handful of Mysterious Coders,” WSJ, Feb 16, 2023, <https://www.wsj.com/articles/bitcoin-core-maintainers-crypto-7b93804>

²¹ They are registered with the Financial Crimes Enforcement Network (FinCEN) for the purpose of complying with laws around money laundering and terrorist financing. In addition, many will hold state money transmitter licenses.

²² Gary Gensler, “Kennedy and Crypto,” (speech, Washington, D.C., September 8, 2022),

<https://www.sec.gov/news/speech/gensler-sec-speaks-090822>.

²³ [HHRG-118-BA16-Wstate-StarkJ-20240507.pdf](https://www.house.gov/imo/media/doc/HHRG-118-BA16-Wstate-StarkJ-20240507.pdf) (house.gov)

*"[E]mbodies a flexible, rather than a static, principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."*²⁴

Along these lines, in *Reves v. Ernst & Young*, in which the Supreme Court was asked to decide whether demand notes offered by a business are securities, the Court stated that:

*"The fundamental purpose undergirding the Securities Acts is 'to eliminate serious abuses in a largely unregulated securities market.' United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 421 U.S. 849 (1975). In defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of 'countless and variable schemes devised by those who seek the use of the money of others on the promise of profits,' SEC v. W.J. Howey Co., 328 U.S. 293, 328 U.S. 299 (1946), and determined that the best way to achieve its goal of protecting investors was 'to define the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.' . . . Congress therefore did not attempt precisely to cabin the scope of the Securities Acts . . . Rather, it enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment" (emphasis added).*²⁵

Federal courts have repeatedly confirmed the SEC's jurisdiction in numerous crypto-related enforcement actions. In fact, the SEC has brought close to 200 crypto-related enforcement actions and has won, or settled, the vast majority of them.²⁶ In most of these cases, the SEC has applied the *Howey* Test to argue that the cryptocurrency in question is an investment contract, and therefore a security subject to SEC registration and disclosure requirements.

The U.S. Supreme Court's *Howey* case and subsequent case law have found that an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. Although the "*Howey* test" "has been refined in the more than seventy years since it was first announced, it remains the guiding principle" for distinguishing between securities and non-securities.²⁷ As noted by the SEC's Enforcement Director, Gurbir Grewal, "*Howey* has proven to be a remarkably flexible and resilient test that courts have since applied to find a wide variety of offerings to be investment contracts and, thus, securities."²⁸ Grewal goes on to note that the list "includes offerings related

²⁴ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

²⁵ *Reves et al. v. Ernst & Young*, 494 U.S. 56 (1990).

²⁶ Cornerstone Research, "SEC Tightens Cryptocurrency Enforcement," January 18, 2023, <https://www.cornerstone.com/insights/press-releases/sec-tightens-cryptocurrency-enforcement/>; John Reed Stark, "Why 'SEC Regulation by Enforcement' is a Bogus Big Crypto Catchphrase," LinkedIn, January 23, 2023, <https://www.linkedin.com/pulse/why-sec-regulation-enforcement-bogus-big-crypto-john-reed-stark/?published=t>, see also [SEC.gov | Crypto Assets](https://www.sec.gov/cyber/cyberassets)

²⁷ Thomas Lee Hazen, *Tulips, Oranges, Worms, and Coins—Virtual, Digital, or Crypto Currency and the Securities Laws*, 20 N.C. J. L. & Tech. 493, 503 (2019).

²⁸ [SEC.gov | What's Past is Prologue: Enforcing the Federal Securities Laws in the Age of Crypto](https://www.sec.gov/what-is-prologue-enforcing-the-federal-securities-laws-in-the-age-of-crypto)

to whiskey, cosmetics, self-improvement courses, and pay phones, as well as a surprising number of creatures: earthworms, beavers, chinchillas, and even cattle embryos.”²⁹

In his testimony before the United States House of Representatives Financial Services Committee Subcommittee on Capital Markets this past May, John Reed Stark detailed several important SEC cases that should have served as early warnings to the crypto industry that federal judges would apply the federal securities laws, including *Howey*, to digital asset offerings.³⁰ These include *SEC v. Kik*,³¹ *SEC v. LBRY*,³² and *SEC v. Terraform Labs*.³³ In all three of these cases, judges also rejected the Due Process and Fair Notice defenses that crypto defendants frequently assert.

The SEC has used “multiple distribution channels to share its message and concerns regarding crypto, digital trading platforms, initial coin offerings, and other digital asset products and services over the past decade.”³⁴ The SEC first made investors aware of the dangers of investing in cryptocurrency in 2013 when the Office of Investor Education and Advocacy issued an Investor Alert on “Ponzi Schemes Using Virtual Currencies.”³⁵ A year later, the same office issued an Investor Alert on “Bitcoin and Other Virtual Currency-Related Investments.”³⁶ In 2017, the Commission released a Section 21(a) Report of Investigation that looked at the facts and circumstances of The DAO, which offered and sold approximately 1.15 billion DAO tokens in exchange for a total of approximately 12 million Ether (“ETH”) over a one-month period in 2016.³⁷ The SEC applied the *Howey* Test to the DAO tokens and concluded they were securities under the Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act”). While The DAO and DAO tokens were no longer operational at the time due to a high-profile hack that had resulted in the theft of most of the tokens, the Commission chose to release the report so as “to advise those who would use a Decentralized Autonomous Organization (“DAO Entity”), or other distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws.”³⁸ In 2019, the SEC released a “Framework for ‘Investment Contract’ Analysis of Digital Assets,” which provided additional details on when a digital asset has the characteristics of an investment contract and “whether offers and sales of a digital asset are securities transactions.”³⁹

²⁹ Id.

³⁰ [HHRG-118-BA16-Wstate-StarkJ-20240507.pdf](https://www.house.gov/imo/media/doc/HHRG-118-BA16-Wstate-StarkJ-20240507.pdf) (house.gov)

³¹ <https://www.sec.gov/news/press-release/2019-87>

³² <https://www.sec.gov/litigation/litreleases/lr-25060>

³³ <https://www.sec.gov/news/press-release/2023-32>

³⁴ Stark, “Big Crypto’s Bogus Demands,” [BIG CRYPTO’S BOGUS DEMANDS FOR “REGULATORY CLARITY” – The FinReg Blog](https://www.finregblog.com/2023/01/09/big-cryptos-bogus-demands/) (duke.edu)

³⁵ U.S. Securities and Exchange Commission, “Ponzi Schemes Using Virtual Currencies,” accessed January 9, 2023, https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf.

³⁶ U.S. Securities and Exchange Commission, “Investor Alert: Bitcoin and Other Virtual Currency-Related Investments,” May 17, 2013, <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investor-39>.

³⁷ U.S. Securities and Exchange Commission, “Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO,” July 25, 2017, <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

³⁸ Ibid.

³⁹ U.S. Securities and Exchange Commission, “Framework for ‘Investment Contract’ Analysis of Digital Assets,” April 3, 2019, <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>.

The SEC has also publicized its position on cryptocurrency in countless enforcement actions,⁴⁰ multiple speeches,⁴¹ congressional testimony,⁴² and several official SEC statements⁴³ and proclamations.⁴⁴ Chair Gensler has spoken frequently about the perils and illegality of crypto lending platforms and decentralized finance,⁴⁵ warning that their failure to register with the SEC may violate U.S. securities laws.⁴⁶ In one interview, Gensler said:

“The law is clear, it’s not about waving a wand. Congress spoke about this in 1934 . . . When a [digital] platform has securities on it, it is an exchange, and it’s a question of whether they’re registered or they’re operating outside of the law, and I’ll leave it at that.”⁴⁷

On September 8, 2022, Chair Gensler gave a speech reflecting on the flexibility of the securities laws and the SEC’s consistency in applying those laws to cryptocurrency.⁴⁸ Gensler noted that of the 10,000 different cryptocurrencies in the market, “the vast majority are securities.”⁴⁹ Gensler went on to note that the SEC has spoken with a “pretty clear voice” when it comes to cryptocurrency, “through the DAO Report, the Munchee Order, and dozens of enforcement actions, all voted on by the Commission” and that “[n]ot liking the message isn’t the same thing as not receiving it.”⁵⁰

In January 2023, the nonprofit Better Markets released a report detailing the SEC’s strong record on crypto regulation and enforcement.⁵¹ The report identifies the SEC’s three-pronged strategy to bring the crypto industry into compliance with federal securities laws: (1) publicly urging the industry to come in and speak with the agency in order to come into compliance, (2)

⁴⁰ U.S. Securities and Exchange Commission, “Crypto Assets and Cyber Enforcement Actions,” November 4, 2022, <https://www.sec.gov/spotlight/cybersecurity-enforcement-actions>.

⁴¹ Gary Gensler, “Remarks Before the Aspen Security Forum,” (speech, Washington D.C., August 3, 2021), <https://www.sec.gov/news/speech/gensler-aspen-security-forum-2021-08-03>.

⁴² Gary Gensler, “Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee,” (speech, Washington, D.C., May 26, 2021), <https://www.sec.gov/news/testimony/gensler-2021-05-26>.

⁴³ Jay Clayton, “Statement on Cryptocurrencies and Initial Coin Offerings,” U.S. Securities and Exchange Commission, December 11, 2017, <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.

⁴⁴ U.S. Securities and Exchange Commission, “Statement on Potentially Unlawful Online Platforms for Trading Digital Assets,” March 7, 2018, <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading>.

⁴⁵ Michael McSweeney, “Gensler Sets SEC Sights on DeFi, Crypto Lending and More in Expansive Speech on Regulation,” *The Block*, February 10, 2023, <https://www.theblock.co/post/113416/gensler-speech-crypto-defi-lending-sec>.

⁴⁶ Ben Werschul, “Crypto Platforms that Don’t Register with the SEC do Business ‘Outside the Law’: Gensler,” *Yahoo News*, March 4, 2022, <https://finance.yahoo.com/news/crypto-platforms-dont-register-with-sec-outside-the-law-gensler-164215740.html>.

⁴⁷ McSweeney, “Gensler Sets SEC Sights.”

⁴⁸ Gensler, “Kennedy and Crypto.”

⁴⁹ Id.

⁵⁰ Id.

⁵¹ Better Markets, “The SEC’s Excellent Record on Crypto: Regulation & Enforcement,” *Better Markets*, January 25, 2023, https://bettermarkets.org/wp-content/uploads/2023/01/BetterMarkets_SEC_Record_On_Crypto_01-25-2023.pdf.

selectively bringing enforcement actions, and (3) using its authority to “deny crypto firms’ requests to unlawfully engage in certain types of activities.”⁵²

In February 2023, Chair Gensler warned the crypto industry that it was time to register their offerings with the SEC, and that the “runway is getting awfully short.”⁵³

b. Recent Enforcement Actions

The runway finally ran out in the summer of 2023, when the SEC brought enforcement actions against the largest cryptocurrency platforms in the U.S. This marked a clear shift in strategy for the SEC, who rather than play a game of whack-a-mole with the tens of thousands of crypto issuers, decided that a better use of their limited enforcement resources was in targeting the platforms where most crypto investors bought and sold their tokens. In complaints against Binance⁵⁴ and Coinbase,⁵⁵ the SEC alleged that these companies combined the functions of an exchange, broker, dealer, and clearing agency without complying with the registration provisions of the federal securities laws applicable to any of those functions.⁵⁶ The SEC made similar allegations against Kraken in November 2023.⁵⁷ Central to all three cases is the assertion that they were listing at least one unregistered security.

These cases are still being litigated, but most of the SEC’s charges survived motions to dismiss, with the respective judges once again affirming the applicability of *Howey* to digital asset offers and sales.

On August 24, 2024, a U.S. District Court Judge in the Northern District of California denied cryptocurrency exchange Kraken’s motion to dismiss in the SEC’s case against them for acting as an unregistered broker, dealer, exchange, and clearing agency with respect to what the SEC refers to as “crypto asset securities.”⁵⁸ The SEC’s complaint alleged that 11 tokens listed on Kraken are unregistered securities. The judge’s decision focused on two of these tokens, ALGO and SOL, the native tokens of the Algorand and Solana blockchains, respectively. The court found that the SEC plausibly alleged ALGO and SOL were offered or sold on Kraken as investment contracts. In so doing, the judge rejected, as other courts have, Kraken’s argument that an investment contract requires “post-sale obligations” from the issuer to the purchaser who bought the token on a secondary marketplace, like Kraken. The court was clear that investment contracts are not limited to actual contracts and that the *Howey* test applies regardless of whether the transaction is on a primary or secondary market.

⁵² *Ibid.*, 3.

⁵³ SEC Chair Gary Gensler Blames Kraken for ‘Choosing’ Not to Follow the Law - Decrypt

⁵⁴ SEC.gov | SEC Files 13 Charges Against Binance Entities and Founder Changpeng Zhao

⁵⁵ <https://www.sec.gov/newsroom/speeches-statements/www.sec.gov/news/press-release/2023-102>

⁵⁶ The SEC’s complaint against Binance also alleged that the company commingled certain customer assets and attempted to evade U.S. securities laws by announcing sham controls that they disregarded so that they could keep high-value U.S. customers on their platforms.

⁵⁷ SEC.gov | SEC Charges Kraken for Operating as an Unregistered Securities Exchange, Broker, Dealer, and Clearing Agency

⁵⁸ SEC’s Case Against Kraken Will Proceed to Trial, California Judge Rules (coindesk.com)

On March 27, 2024 Judge Katherine Polk Failla, of the U.S. District Court for the Southern District of New York, denied Coinbase's motion to dismiss the SEC lawsuit against them, finding that the agency had a "plausible" case against the exchange (Judge Failla did dismiss the claim that Coinbase acted as an unregistered broker through its crypto wallet).⁵⁹ In her ruling, Judge Failla noted that "the 'crypto' nomenclature may be of recent vintage, but the challenged transactions fall comfortably within the framework that courts have used to identify securities for nearly eighty years."⁶⁰ Judge Failla's analysis focused on the "full set of contracts, expectations, and understandings" surrounding its [the crypto asset's] sale and distribution – frequently referred to using the shorthand "ecosystem." The Judge also rejected Coinbase's arguments that there needs to be a "formal contract between transacting parties for an investment contract to exist under *Howey*," and that an investment contract cannot be present if the investor purchases the token in a secondary market transaction where the issuer is not the seller. In rejecting the latter argument, Judge Failla also rejected the approach adopted by Judge Analise Torres in *SEC v. Ripple Labs*.

c. SEC v. Ripple

The Ripple case is an important plot line in the crypto industry's crusade against the SEC, because it is one of the few cases where the SEC had even a partial loss. However, the case's relevance is quickly diminishing due to several other courts rejecting the legal arguments marshalled by Judge Torres to find that certain sales of the cryptocurrency XRP were not investment contracts. Nonetheless, it is worth briefly summarizing Judge Torres' ruling and subsequent case law that disregards key aspects of her ruling.

On July 13, 2023 Judge Analisa Torres of the United States District Court for the Southern District of New York ruled on cross-motions for summary judgement filed by the SEC and Ripple in relation to ongoing litigation that dates back to December 2020.⁶¹ Judge Torres' ruling argues that a determination of an unlawful offer and sale of securities in violation of Section 5 of the Securities Act of 1933 should hinge on the facts and circumstances by which the *sale* was made. Judge Torres notes that in the original *Howey* case and its progeny, which have come to define the term "investment contract", "the subject of the investment contract was a standalone commodity, which was not itself inherently an investment contract." Thus, Judge Torres points to "the plain words of *Howey*", which make clear that an investment contract for purposes of the Securities Act means a *contract, transaction[,] or scheme.*" (emphasis added by Judge Torres). Judge Torres states that "XRP, as a digital token, is not in and of itself a 'contract, transaction[,] or scheme' that embodies the *Howey* requirements of an investment contract."

With this analysis established, Judge Torres then assesses the three categories of alleged unregistered XRP offer and sales conducted by Ripple:

- Institutional Sales under written contracts for which it received \$728 million;

⁵⁹ [Securities and Exchange Commission v. Coinbase, Inc. et al, No. 1:2023cv04738 - Document 105 \(S.D.N.Y. 2024\) :: Justia](#)

⁶⁰ *Id.*

⁶¹ [SEC vs Ripple 7-13-23.pdf\(uscourts.gov\)](#)

- Programmatic Sales on digital asset exchanges for which it received \$757 million; and
- Other Distributions under written contracts for which it recorded \$609 million in “consideration other than cash.”

Judge Torres found that only the “Institutional Sales” constituted the unregistered offer and sale of an investment contract, as all three prongs of the *Howey* Test were satisfied. For the Programmatic Sales, whereby Ripple sold XRP via cryptocurrency exchanges, Judge Torres ruled these did not constitute investment contracts because the third prong of the *Howey* Test (expect profits solely from the efforts of the promoter or a third party) was not satisfied because buyers were not aware they were buying XRP from Ripple and because Ripple “did not make any promises or offers because Ripple did not know who was buying the XRP.”

Judge Torres’ ruling was largely viewed as a victory for cryptocurrency exchanges because the tokens they list are similar to XRP in that they are not in and of themselves a “contract, transaction, or scheme.” Thus, if they are not listing investment contracts, they cannot be accused of operating an unregistered securities exchange. However, it is important to note acknowledge footnote 16 in Judge Torres’ ruling, which says:

“The Court does not address whether secondary market sales of XRP constitute offers and sales of investment contracts because that question is not properly before the Court. Whether a secondary market sale constitutes an offer or sale of an investment contract would depend on the totality of circumstances and the economic reality of that specific contract, transaction, or scheme.”

Judge Torres’ ruling flips securities law on its head. The securities laws were established to protect retail investors in the wake of companies raising money from the public during the 1920s based upon poor, absent, and misleading disclosures, which contributed to the stock market crash of 1929 and the resulting Great Depression. The result of Judge Torres’ ruling is that wealthy and sophisticated institutional token investors get the protections provided by the securities laws while retail investors do not. This outcome is counter to the purpose and intent of securities laws.

Thankfully, Judge Torres’ emphasis that a cryptocurrency buyer in the secondary market must know the identity of the seller in order for there to be an expectation of profit has since been ignored and rejected by multiple federal judges, including two of her fellow judges in the Southern District of New York. As noted above, Judge Failla declined to draw a distinction between token purchases directly from an issuer and tokens purchased in a secondary market transaction, noting, “Howey does not recognize such a distinction as a necessary element in its test of whether a transaction constitutes an investment contract, nor have courts, in the nearly eighty years of applying *Howey*, read such an element into the test. Rather, under *Howey*, the Court must consider the “economic reality” of the transaction to determine whether that transaction is an investment contract.”⁶²

⁶² [Securities and Exchange Commission v. Coinbase, Inc. et al, No. 1:2023cv04738 - Document 105 \(S.D.N.Y. 2024\) :: Justia](#)

Judge Torres' logic was also rejected by Judge Jed Rakoff of the United States District Court for the Southern District of New York in *SEC v. Terraform Labs Pte.* On July 31, 2023, Judge Rakoff denied Terraform Labs Pte and founder Do Kwon's motion to dismiss charges by the SEC that the company and its founder orchestrated a multi-billion-dollar fraud involving the development, marketing, and sale of various cryptocurrencies.⁶³ With respect to the Luna token, Judge Rakoff found that a common enterprise and expectation of profit existed because Terraform Labs used proceeds from LUNA coin sales to develop the Terraform blockchain and represented that these improvements would increase the value of the LUNA tokens. With respect to the Ripple decision, Judge Rakoff said the following:

*"It may also be mentioned that the Court declines to draw a distinction between these coins based on their manner of sale, such that coins sold directly to institutional investors are considered securities and those sold through secondary market transactions to retail investors are not. In doing so, the Court rejects the approach recently adopted by another judge of this District in a similar case, SEC v. Ripple Labs Inc., 2023 WL 4507900 (S.D.N.Y. July 13, 2023)."*⁶⁴

d. eToro Settlement

On September 12, 2024, crypto trading platform eToro USA LLC agreed to the entry of a SEC cease-and-desist order and agreed to pay \$1.5 million to settle charges that it operated as an unregistered broker and unregistered clearing agency in connection with its trading platform that facilitated buying and selling certain crypto assets as securities.⁶⁵ While the order did not identify specific tokens the SEC believed to be unregistered securities, the order did note that eToro would henceforth only support trading in Bitcoin, Bitcoin Cash, and Ether. Presumably, the SEC agreed to this action because they believe these three tokens are commodities, not securities, although the Commission has not explicitly acknowledged this interpretation. In the SEC's press release, Enforcement Director Grewal stated that the settlement "offers a pathway for other crypto intermediaries."⁶⁶ Of course, an additional pathway to resolve SEC charges for crypto exchanges would be to register with the SEC.

e. NFTs

Last month, it was reported that non-fungible token (NFT) marketplace OpenSea received a Wells Notice from the SEC.⁶⁷ OpenSea's CEO went on X to say that the SEC believes OpenSea is listing a security, which would make them an unregistered securities exchange.⁶⁸ NFTs are digital tokens recorded on a blockchain that can be sold and traded. There is also a specialized form of NFT, "soulbound" tokens, which are non-transferrable and

⁶³ <https://assets.bwbx.io/documents/users/iqjWHBFdfxIU/rwwEEo0YbENc/v0>

⁶⁴ Id.

⁶⁵ [SEC.gov | eToro Reaches Settlement with SEC and Will Cease Trading Activity in Nearly All Crypto Assets](https://www.sec.gov/press/2024/20240912etoro.htm)

⁶⁶ Id.

⁶⁷ [OpenSea Expecting SEC Lawsuit Over NFTs Being Securities, Says CEO - Decrypt](https://decrypt.co/100000/opensea-expecting-sec-lawsuit-over-nfts-being-securities-says-ceo)

⁶⁸ Devin Finzer (@dfinzer.eth) on X: "OpenSea has received a Wells notice from the SEC threatening to sue us because they believe NFTs on our platform are securities. We're shocked the SEC would make such a sweeping move against creators and artists. But we're ready to stand up and fight. Cryptocurrencies have long" / X

represent a person's reputation and accomplishments similar to an enhanced resume. Most blockchain tokens are designed to be "fungible" (i.e., interchangeable). The best-known example of such a token is Bitcoin; one Bitcoin is interchangeable with another. By contrast, NFTs represent ownership of "non-fungible" (i.e., unique) items. NFTs can represent assets ranging from digital artwork and music files to real property titles.

As with the broader cryptocurrency market, the NFT market has experienced a major decline over the past two years.⁶⁹ The fall in NFT prices was inevitable and predictable, as nearly anyone can create an NFT from scratch at little to no cost. Unlike tangible art or collectibles, the supply of potential NFTs is infinite.

NFTs and the ownership they are supposed to represent in the digital world present legal challenges and cause confusion. Data stored on a blockchain is simply computer code. For the Bitcoin blockchain, the data stored represents the history of every Bitcoin transaction. NFTs are also computer code, i.e., they are not digital art. Each NFT is assigned a unique identifier directly linked to one blockchain address, and the owner of each NFT is simply the blockchain address where each NFT resides.

Because an NFT is only a token on a blockchain that links to an underlying asset, the owner or possessor of the NFT does not automatically have intellectual property rights in the underlying asset.⁷⁰ Without the necessary rights to sell the underlying asset, anyone minting or more accurately, creating, NFTs may face infringement complaints from the copyright owner. Many companies in the NFT business are aware of the legal perils and are taking steps to address issues related to intellectual property rights.⁷¹

As has been publicized by technologists and in the popular press: "With NFTs, the thing you've bought does not tend to give you ownership of the underlying item (image, game asset, etc.) in any way you would normally transfer physical or digital art."⁷² Rather, NFTs contain links to an asset hosted elsewhere and they do not convey ownership of the copyright, storage, or usage rights to the asset itself. As explained by software programmer Molly White, when someone buys an NFT, "[t]hey've paid to have their wallet address etched into a database alongside a pointer to something."⁷³

Because it is technically possible for anyone to make an NFT of any image even if he or she doesn't own the copyright for the image, there have been numerous instances of "counterfeit" NFTs trading on secondary platforms like OpenSea. In December 2022, researchers from the online art community, DevianArt, found approximately 25,000 digital

⁶⁹ [The Rise and Fall of NFTs – Forbes Advisor Australia](#)

⁷⁰ Archer, Christopher C. and Anastasia Dergacheva. "NFTs: Key Considerations for Rights Clearance." *Morgan Lewis*, 10 Feb. 2022, <https://www.morganlewis.com/blogs/sourcingatmorganlewis/2022/02/nfts-key-considerations-for-rights-clearance>. And

⁷¹ "Yuga Labs acquires CryptoPunks and Meebits and gives commercial rights to the community." *Yuga Labs*, 11 Mar. 2022,

https://mirror.xyz/0xEc9f53fA69682833FBd760C104B5D61aE29221E0/Km81y6Mc3O5LzS0wnrghVIV0HnZgLOd4wsnfcGw3_21.

⁷² [NFTs Don't Work the Way You Might Think They Do | WIRED](#)

⁷³ [Id.](#)

images that had been turned into NFTs and sold without the permission of the original artists.⁷⁴

In June 2022, the U.S. Attorney's Office for the Southern District of New York brought charges in the first ever case of alleged insider trading in NFTs.⁷⁵ A former employee at OpenSea traded NFTs that he allegedly knew would soon be featured on OpenSea's homepage, and thus appreciate in value.

Some NFTs could be considered "securities" subject to SEC regulations. Specifically, an NFT could be classified as a security if it meets *Howey's* definition of investment contract. In May 2021, NBA Top Shot creator Dapper Labs was sued for allegedly selling its NFTs as unregistered securities.⁷⁶ NBA Top Shot is a basketball collectibles platform that allows users to buy, sell, and trade video highlights, called Moments, as NFTs. At issue in the lawsuit is whether the Top Shot NFT collectibles are investment contracts, and therefore securities. In February 2023, United States District Judge Victor Marrero denied Dapper Labs' motion to dismiss the amended complaint.⁷⁷ As noted by Judge Marrero: "When a person purchases a Moment, the owner does not acquire any rights to the basketball highlight depicted by the NFT or the underlying artwork or other intellectual property, and thus does not acquire any rights to exploit the highlight with the express permission of the NBA, NBAPA, and Dapper Labs."⁷⁸

Judge Marrero found "that Plaintiffs' allegations render each consideration under *Howey* facially plausible." As to the first prong of *Howey*, both parties agreed that there was an investment of money. For the second prong, common enterprise, the Court found that Plaintiffs adequately allege horizontal commonality. For the final *Howey* prong, "a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others," the Court found that "Defendants' public statement and marketing materials objectively led purchasers to expect profits." In June 2024, Dapper Labs settled the lawsuit for \$4 million; as part of the settlement, plaintiffs can no longer claim that Top Shot NFTs are securities.

On August 28, 2023, the Securities and Exchange Commission charged, and subsequently settled with, Impact Theory, for conducting an unregistered offering of securities in the form of NFTs.⁷⁹ The SEC alleged that the three tiers of NFTs offered and sold by the company, known as KeyNFTs, were unregistered investment contracts, per *Howey*. Impact Theory used the NFT offering proceeds for "development," "bringing on more team," and "creating more projects."⁸⁰ The company communicated extensively via Discord to promote their NFTs: "In advance of the Offering, Impact Theory hosted several live speaking events on Discord (a voice, video, and

⁷⁴ [OpenSea's NFT Free-for-All - WSJ](#)

⁷⁵ "Former Employee Of NFT Marketplace Charged In First Ever Digital Asset Insider Trading Scheme." *Department of Justice, U.S. Attorney's Office, Southern District of New York*, 1 June 2022, <https://www.justice.gov/usao-sdny/pr/former-employee-nft-marketplace-charged-first-ever-digital-asset-insider-trading-scheme>.

⁷⁶ Crawley, Jamie. "Dapper Labs Sued on Allegations NBA Top Shot Moments Are Unregistered Securities." *CoinDesk*, 14 Sep. 2021, <https://www.coindesk.com/markets/2021/05/14/dapper-labs-sued-on-allegations-nba-top-shot-moments-are-unregistered-securities/>.

⁷⁷ [2023.02.22 Dapper MTD Order.pdf \(dropbox.com\)](#)

⁷⁸ [friel-v-dapper-labs-inc.pdf \(skadden.com\)](#)

⁷⁹ [Impact Theory, LLC \(sec.gov\)](#)

⁸⁰ *Id.*

text communication service), [and] posted recordings of those events on the company's Discord channels for the public to view."⁸¹

The SEC also relied on statements made by KeyNFT investors on the company's discord channel to demonstrate that purchasers expected a return on their investment: "Given these statements, numerous prospective and actual purchasers of KeyNFTs stated on Impact Theory's Discord channels that they viewed KeyNFTs as investments into the company and understood Impact Theory's statements to mean that the company's development of its projects could translate to appreciation of the KeyNFTs' value over time."⁸²

In September 2023, the SEC charged, and settled with, Stoner Cats 2 LLC (SC2) for conducting an unregistered offering of securities in the form of NFTs called Stoner Cats.⁸³ The proceeds from the sale of Stoner Cat NFTs were used to build an animated web series. In their order, the SEC highlighted several aspects of the Stoner Cats offering that revealed "[I]nvestors in Stoner Cats NFTs had a reasonable expectation of obtaining a profit based on SC2's [the issuer] managerial and entrepreneurial efforts."

1. There was a secondary market for Stoner Cats holders to trade and profit off their NFTs.
2. The SEC also points to the fact that Stoner Cats NFT "owners" did not actually control the intellectual property associated with Stoner Cats.
3. Secondary market re-sales of Stoner Cats generated royalties for the original issuer (SC2).
4. SC2 used social media to promote the profit potential of Stoner Cats NFTs.

Last month, Miami federal court judge Federico Moreno denied, in part, Shaquille O'Neal's motion to dismiss in a class action lawsuit that alleges O'Neal and Astrals LLC engaged in the offer and sale of unregistered securities in the form of Astrals NFTs and the related Galaxy token.⁸⁴ Judge Moreno applied the elements of *Howey* to the Astrals NFTs and concluded that "plaintiffs have plausibly alleged that they were led to reasonably expect profits from the Astrals purchases."⁸⁵

In the press release announcing the charges against Stoner Cats 2 LLC (SC2), Gurbir S. Grewal, Director of the SEC's Division of Enforcement, stated:

*"Regardless of whether your offering involves beavers, chinchillas or animal-based NFTs, under the federal securities laws, it's the economic reality of the offering – not the labels you put on it or the underlying objects – that guides the determination of what's an investment contract and therefore a security."*⁸⁶

⁸¹ Id

⁸² Id

⁸³ <https://www.sec.gov/litigation/admin/2023/33-11233.pdf>

⁸⁴ [Order on Motion to Dismiss for Failure to State a Claim – #91 in Harper v. O'neal \(S.D. Fla., 1:23-cv-21912\) – CourtListener.com](#)

⁸⁵ Id.

⁸⁶ [SEC.gov | SEC Charges Creator of Stoner Cats Web Series for Unregistered Offering of NFTs](#)

While most NFTs are likely digital collectibles that do not meet all elements of *Howey*, the above examples reveal that there are clearly *some* NFTs that are investment contracts. Like the recent approach taken by the SEC with respect to fungible tokens (cryptocurrencies), the OpenSea Wells Notice suggests that the Commission may now be focusing its efforts on the large platforms where NFTs are bought and sold.

III. Exchange Traded Products

Another case that the crypto industry likes to tout as evidence of the SEC's crypto overreach is *Grayscale v. SEC*, whereby the D.C. Circuit ruled that the Commission's decision to deny the listing of Grayscale's proposed Bitcoin exchange traded product (ETP) was arbitrary and capricious.⁸⁷ The ruling paved the way for the listing of 11 spot Bitcoin ETPs in January 2024.⁸⁸ However, the D.C. Circuit's ruling was based on principles of administrative law, not securities law. The Court agreed with Grayscale's claim that the SEC failed to treat "like cases alike by denying the listing of Grayscale's proposed bitcoin ETP and approving two bitcoin futures ETPs."⁸⁹ An important element of this ruling that has received little attention is that it is the CFTC who put the SEC in the position of having to treat "like cases alike."

On Friday, December 1, 2017, the Chicago Mercantile Exchange Inc. ("CME") and the CBOE Futures Exchange ("CFE") self-certified new contracts for cash-settled Bitcoin futures products.⁹⁰ The self-certification process allows designated contract markets ("DCMs") to list new derivative products one day after submitting in writing to the Commodity Futures Trading Commission ("CFTC") that the product complies with the Commodity Exchange Act ("CEA") and CFTC regulations.⁹¹ Self-certification requires the listing exchange to verify the new contract is not readily susceptible to manipulation and there was ample evidence at the time, ignored by the CFTC, that Bitcoin, and therefore, Bitcoin futures, could be manipulated.⁹² The CFTC subsequently acknowledged the problem when it filed a civil complaint in 2022 against the cryptocurrency exchange Gemini "for making false or misleading statements of material facts or omitting to state material facts to the CFTC in connection with the self-certification of a bitcoin futures product."⁹³ The complaint alleges that in the months leading up to the self-certification of the CFE cash-settled Bitcoin futures contract in December 2017, Gemini engaged in a systematic effort to deceive the CFTC about the trading volume on the Gemini exchange and in the Gemini Bitcoin Auction. The trading volume on Gemini had direct bearing on whether CFE's Bitcoin futures contract could be manipulated because the contract settled based upon the price of Bitcoin from the Gemini Bitcoin Auction.

⁸⁷ [22-1142-2023-08-29.pdf \(justia.com\)](https://www.justia.com/courts/dccircuit/opinions/2023-08-29/22-1142-2023-08-29.pdf)

⁸⁸ [SEC Approves Bitcoin Exchange-Traded Products \(ETPs\) \(congress.gov\)](https://www.congress.gov/newsroom/press-releases/2024/01/11/sec-approves-bitcoin-exchange-traded-products-etps)

⁸⁹ [22-1142-2023-08-29.pdf \(justia.com\)](https://www.justia.com/courts/dccircuit/opinions/2023-08-29/22-1142-2023-08-29.pdf)

⁹⁰ Also, on December 1, 2017, the Cantor Exchange self-certified a new contract for bitcoin binary options. See U.S. COMMODITY FUTURES TRADING COMM'N, CFTC BACKGROUNDER ON SELF-CERTIFIED CONTRACTS FOR BITCOIN PRODUCTS (2017), https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/bitcoin_factsheet120117.pdf.

⁹¹ 17 C.F.R. § 40.2 (2018).

⁹² I detailed my concerns in a law review article, <https://scholarship.law.unc.edu/ncbi/vol23/iss1/8/>

⁹³ <https://www.cftc.gov/PressRoom/PressReleases/8540-22>

Shortly before the listing of Bitcoin futures contracts in 2017, the SEC rejected an initial application to list a spot Bitcoin ETP.⁹⁴ The Commission's disapproval was premised on its finding that the proposal did not comply with the Securities Exchange Act's Section 6(b)(5), which, among other requirements, stipulates that the rules of a national securities exchange be designed "to prevent fraudulent and manipulative acts and practices" and "to protect investors and the public interest."⁹⁵ The SEC's main concern was that because the asset underlying the proposed ETPs was unregulated and traded on unregulated platforms, a spot Bitcoin ETP could be easily manipulated.

After Bitcoin futures came to market in December 2017, the SEC received a flood of new ETP applications that all proposed to track the price of Bitcoin futures. The issuers and exchanges behind these new applications argued that because Bitcoin futures were regulated by the CFTC and traded on regulated futures exchanges, the SEC can feel comfortable that an ETP tracking the price of Bitcoin futures cannot be manipulated. The SEC eventually agreed, and in 2022, "two bitcoin *futures* ETPs were approved by the SEC and, for both products, the applicable listing exchange had a surveillance sharing agreement with the Chicago Mercantile Exchange ("CME") that allayed the SEC's antifraud concerns."⁹⁶ However, the Commission continued to deny the approval of spot-Bitcoin ETPs until the DC Circuit ruled that it was arbitrary and capricious to approve an ETP tracking Bitcoin futures but deny an ETP tracking spot Bitcoin.

When the Commission eventually approved the listing and trading of spot Bitcoin ETPs in January, Chair Gensler issued a begrudging statement implying that the only reason the Commission was doing so was because of the DC Circuit's ruling. He further attempted to warn investors that further crypto-related ETPs would not be forthcoming by stating that, "today's Commission action is cabined to ETPs holding one non-security commodity, bitcoin," and that it "should in no way signal the Commission's willingness to approve listing standards for crypto asset securities."⁹⁷ However, several months later, the Commission approved eight Ethereum ETPs for listing and trading on SEC-regulated exchanges.⁹⁸ Chair Gensler did not provide a detailed explanation for the Commission's decision, but the threat of litigation likely played a role, as the Commission had already approved Ether futures ETPs. Furthermore, the SEC approved the applications under the rules for commodity-based trust shares, which implies the Commission considers Ether a commodity and not a security.

The SEC's approval of Bitcoin and Ether ETPs is the biggest development in the crypto industry since FTX's collapse. Bitcoin ETPs have total assets under management of \$61.01 billion – BlackRock's IBIT being the biggest beneficiary of this demand – making them the fastest-growing ETPs or ETFs in the history of such products.⁹⁹ In many ways, the demand for crypto ETPs is an indictment of spot cryptocurrency and the platforms that facilitate spot crypto

⁹⁴ <https://sites.law.duke.edu/thefinregblog/2018/01/12/sec-stands-firm-against-new-bitcoin-etf-proposals/>

⁹⁵ 15 U.S.C. § 78f(b)(5) (2009).

⁹⁶ [SEC approves Spot Bitcoin ETP, opening new pathway to Bitcoin investment - A&O Shearman](#) (aoshearman.com)

⁹⁷ [SEC.gov | Statement on the Approval of Spot Bitcoin Exchange-Traded Products](#)

⁹⁸ [SEC Approves Spot Ether ETFs | Troutman Pepper](#)

⁹⁹ <https://www.etf.com/topics/spot-bitcoin>, and [Bitcoin ETF blowout wows even BlackRock's Larry Fink | Fox Business](#) and [Bitcoin ETF blowout wows even BlackRock's Larry Fink | Fox Business](#)

trading. This is because unlike other Commodity ETPs, where it is unfeasible or undesirable for an investor to acquire the underlying – most investors don’t want to hold on to corn, gold, wheat, oil and so on – it is easy for investors to acquire and store Bitcoin or Ether because they are digital assets. There are dozens of online exchanges where investors can acquire these tokens in exchange for fiat currency and many of these exchanges will also custody investors’ crypto as well. Investors can also store their crypto in a digital wallet or choose to keep their private key offline. Given this critical difference between crypto and other commodities that underlie ETPs, it is fair to wonder why a Bitcoin or Ether ETP is even needed. The truth is that they serve no economic purpose other than to provide a means to speculate on the price of Bitcoin or Ether without having to acquire actual Bitcoin or Ether.

Approving the listing of Bitcoin and Ether ETPs was a mistake, and I believe the SEC had sufficient legal grounds to deny the listing applications. Rather than detail the technical reasons why, I will simply point to Commissioner Caroline Crenshaw’s dissent on proposed rule changes to list and trade Bitcoin ETPs and note that I agree with all of her arguments.¹⁰⁰ The nonprofit Better Markets was rightly critical of the SEC after they approved the listing of spot Ether ETPs.¹⁰¹ They highlighted that the SEC’s decision came one week after “the Department of Justice charged two brothers with exploiting the integrity of the Ethereum blockchain to fraudulently obtain \$25 million worth of cryptocurrency in 12 seconds,” which suggests the Ethereum blockchain has “features that make it make it vulnerable to fraud and manipulation.”¹⁰²

While the collapse of FTX and the subsequent crypto winter did not spill into the broader financial statement, that outcome was not preordained. In October 2022, the Financial Stability Oversight Council warned:

“Crypto-asset activities could pose risks to the stability of the U.S. financial system if their interconnections with the traditional financial system or their overall scale were to grow without adherence to or being paired with appropriate regulation, including enforcement of the existing regulatory structure.”¹⁰³

The current global crypto market cap of ~\$2 trillion is larger than the value of subprime mortgages in the U.S. in March 2007 (\$1.3 trillion), and we have never had “appropriate regulation.”¹⁰⁴ And with the launch of Bitcoin and Ether ETPs, the SEC has built a superhighway connecting the traditional financial system with the crypto economy – regulatory filings revealed that Goldman Sachs and Morgan Stanley purchased a total of more than \$600 million in spot Bitcoin ETPs during the second quarter of 2024 – such that a problem in one can easily spill into the other.¹⁰⁵

¹⁰⁰ <https://www.sec.gov/newsroom/speeches-statements/crenshaw-statement-spot-bitcoin-011023>

¹⁰¹ [The SEC Endangers Investors by Approving Spot Ether ETPs | Better Markets](#)

¹⁰² Id

¹⁰³ Financial Stability Oversight Council, *Report on Digital Asset Financial Stability Risks and Regulation 2022* (Washington, D.C.: Financial Stability Oversight Council, 2022) <https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf>.

¹⁰⁴ Associated Press, “Will Subprime Mess Ripple through Economy?” *NBC News*, March 13, 2007, <https://www.nbcnews.com/id/wbna17584725>.

¹⁰⁵ [Goldman Sachs, Morgan Stanley took stakes in US spot bitcoin ETFs in Q2, filings show \(yahoo.com\)](#)

Policymakers and market participants have already identified potential points of failure. On September 03, 2024, the FBI issued a public service announcement warning:

“North Korean malicious cyber actors conducted research on a variety of targets connected to cryptocurrency exchange-traded funds (ETFs) over the last several months. This research included pre-operational preparations suggesting North Korean actors may attempt malicious cyber activities against companies associated with cryptocurrency ETFs or other cryptocurrency-related financial products.”¹⁰⁶

This announcement has renewed concerns¹⁰⁷ about the role of Coinbase, who is the custodian of choice for eight of the eleven spot Bitcoin ETPs¹⁰⁸ and eight of the nine newly approved Ether ETPs.¹⁰⁹ If a bad actor “were to gain access to Coinbase’s systems, they could potentially target over 70% of the Bitcoin held in ETFs, posing a significant threat to the market.”¹¹⁰

Now that the SEC has permitted the listing of two crypto ETPs, it will be harder for them to deny applications to list additional crypto-related ETPs unless a court has found that the cryptocurrency in question is an unregistered security. The intermediaries – issuers, listing exchanges, custodians, and authorized participants – who stand to financially benefit from additional products coming to market have an incentive to demand that the SEC approve an ever-greater variety of crypto ETPs. Just last week, Grayscale announced the creation and launch of Grayscale XRP Trust¹¹¹, which has led to speculation that they will eventually seek to convert the Trust to a XRP ETP.¹¹²

If the industry gets its way, we could soon see hundreds of single token ETPs, inverse token ETPs, leveraged token ETPs, and token index ETPs. All these products would have as an underlying a purely speculative asset that is “wholly unconnected to the productive purpose that defines finance: helping businesses, individuals, and governments raise, save, transmit, and use money for socially and economically useful ends.”¹¹³ Just as complex and speculative derivatives played a central role in the 2008 financial crisis by amplifying risk, obscuring true asset values, and spreading financial instability throughout the global economy, so too could crypto ETPs and crypto derivatives in the next crisis.

IV. The Risks of Cryptocurrency Custody and SEC Efforts to Address These Risks

¹⁰⁶ [North Korea Aggressively Targeting Crypto Industry with Well-Disguised Social Engineering Attacks \(ic3.gov\)](https://www.ic3.gov/Newsroom/2024/09/03/240903a)

¹⁰⁷ <https://x.com/EleanorTerrett/status/1831352537670131890>

¹⁰⁸ [How we keep digital assets safe \(coinbase.com\)](https://www.coinbase.com/learn/asset-protection/how-we-keep-digital-assets-safe)

¹⁰⁹ [Coinbase Named As Trusted Partner and Custodian of Eight Ethereum ETFs, Says CEO Brian Armstrong - The Daily Hodl](https://www.dailyhodl.com/news/coinbase-named-as-trusted-partner-and-custodian-of-eight-ethereum-etfs-says-ceo-brian-armstrong/)

¹¹⁰ <https://medium.com/@BlockchainLycan/coinbase-the-leading-custodian-for-bitcoin-amid-security-concerns-730a0dc69018>

¹¹¹ [Grayscale Investments® Launches Grayscale® XRP Trust \(globenewswire.com\)](https://www.globenewswire.com/press-release/2024/09/03/1088884/0/en/Grayscale-Investments-Launches-Grayscale-XRP-Trust)

¹¹² [Ripple’s XRP Rises 8% on Grayscale Trust News \(coindesk.com\)](https://www.coindesk.com/news/ripple-xrp-rises-8-on-grayscale-trust-news/)

¹¹³ Todd H. Baker, “Let’s Stop Treating Crypto Trading as If It Were Finance,” *The CLS Blue Sky Blog*, November 29, 2022, <https://clsbluesky.law.columbia.edu/2022/11/29/lets-stop-treating-crypto-as-if-it-were-finance/>.

a. Overview

Blockchain technology's unique attributes compelled the SEC and other regulatory agencies to issue new guidance and, in some case, new rules and regulations designed to address the novel risks present in the use of blockchain by regulated entities and in regulated markets. Some examples are SEC Staff Accounting Bulletin 121,¹¹⁴ the SEC's Special Purpose Broker-Dealer (SPBD) release, and the SEC's proposed safeguarding rule. Before diving into more detail on these examples, it is important to understand how custody works on a public blockchain. In what follows, I borrow heavily from Professor Adam Levitin's excellent paper: "Not Your Keys, Not Your Coins: Unpriced Credit Risk in Cryptocurrency."¹¹⁵ Professor Levitin's paper draws a direct line between how custody operates on a blockchain and the business models of cryptocurrency exchanges, which will help inform my analysis of SAB 121, the SPBD release, and the proposed safeguarding rule.¹¹⁶

b. How Custody Works on the Blockchain

Cryptocurrencies such as Bitcoin and Ethereum are purely digital assets. The cryptocurrency exists only as an entry on an append-only distributed ledger called a blockchain that associates a cryptocurrency balance with a network address on the blockchain. The blockchain tracks the association of cryptocurrency with cryptographic keys—an alphanumeric string of characters—rather than who "owns" the keys.

Undertaking a transaction in the cryptocurrency—that is, to change the network address associated with some amount of cryptocurrency on the blockchain—requires a paired public key and a private key (password). These keys are each associated with an address on the blockchain. The public key is a large numerical value used for encrypting the transaction while the private key is a password that is used to verify the authorization of the transaction.

To transfer cryptocurrency into a blockchain address, a transferor must digitally sign the transaction with the private key of the address from which the cryptocurrency is being sent and the public key of the recipient address and broadcast the transaction to the blockchain network. The transaction is verified through a cryptographic hashing process called mining.

Cryptocurrencies vary in how they incentivize network participants to engage in mining. The key detail here is that without the private key, it is impossible to access cryptocurrency associated with a blockchain address. Thus, if a key is lost, so too is access to the cryptocurrency.

Critically, the private key can be used by anyone who has access to it, not just by its "owner." While the key is the authorization device for transactions on the blockchain, the mining system only checks the validity of the key, not the authorization for the key's use in the transaction. Each cryptocurrency runs on its own blockchain, and each cryptocurrency blockchain address has its own public and private key. Thus, if an individual owns both Bitcoin and Ethereum, the individual

¹¹⁴ <https://www.sec.gov/rules/policy/2020/34-90788.pdf>

¹¹⁵ [Not Your Keys, Not Your Coins: Unpriced Credit Risk in Cryptocurrency | Texas Law Review](#)

¹¹⁶ Professor Levitin graciously granted me permission to quote from his paper without having to footnote it every time.

will have two separate sets of keys because there are two separate blockchains involved, one for each cryptocurrency.

Investors need to keep their private keys somewhere when they are not using them. Investors store their private keys in crypto wallets. While a private key can be written down on paper and stored physically until it needs to be used, cryptocurrency investors generally store their keys in crypto wallets. Crypto wallets are encrypted software programs. Typically, the investor would enter a password in order to unencrypt the private key, which would then be used to authorize a transaction on the blockchain.

There are two types of crypto wallets: unhosted and hosted. An unhosted wallet – also referred to as a “self-hosted” wallet – involves storage of the customer’s private keys in some format in the customer’s possession. This might be in the form of a non-custodial software wallet such as a wallet app on the investor’s phone or computer, a thumb drive, or even a scrap of paper. While an unhosted wallet lets the investor retain possession of the private key, it also poses a risk of loss. If the investor loses the scrap of paper, the thumb drive, or the digital device, the key and thus the access to the cryptocurrency is lost forever. Unhosted wallets are also attractive to “illicit actors due to anonymity, the lack of limits on portability, mobility, transaction speed, and usability.”¹¹⁷ Another risk is that transactions between two unhosted wallets operate fully outside the regulatory perimeter.

In contrast, a hosted or custodial wallet puts the customer’s private keys in the custody of a third party, generally a cryptocurrency exchange. With a hosted wallet, the exchange has possession of the private keys, and the customer accesses them using a password or other security protocol provided by the exchange. These security protocols might let a customer who forgot a password still access his private keys. Additionally, if the hosted wallet provider were to lose the keys, it would be liable to the customer.

Unhosted and hosted wallets can either be “hot” or “cold.” A cryptocurrency hot wallet is a digital wallet connected to the internet, allowing users to quickly and easily access and transact their cryptocurrency. This type of wallet is convenient for frequent trading and spending but is more vulnerable to cyberattacks and hacking due to its online presence. In contrast, a cold wallet is not connected to the internet, storing cryptocurrency offline, typically on a hardware device or a piece of paper. Cold wallets are considered more secure against online threats, making them ideal for long-term storage of large amounts of cryptocurrency, although they are less convenient for regular transactions. Cryptocurrency exchanges will use a mix of hot and cold wallets, but the exact details are confidential due to security concerns.

Cryptocurrency investors use hosted wallets for several reasons: concerns about losing their own unhosted wallets; avoiding fees for transferring funds between wallets; the transactional ease offered through hosted wallets that are integrated with an exchange; access to additional income-generating services such as lending and staking ventures that exchanges offer customers with hosted wallets; and greater ease at converting cryptocurrency to fiat currency or vice versa, which

¹¹⁷ [Updated Guidance for a Risk-Based Approach for Virtual Assets and Virtual Asset Service Providers \(fatf-gafi.org\)](https://www.fatf-gafi.org/publications/fatfpublications/documents/FATF-Guidance-for-Virtual-Assets-and-Virtual-Asset-Service-Providers.pdf)

requires a service that can route fiat payments from a bank account or settle them into a bank account, something that is not possible on an unhosted wallet alone.

Cryptocurrency exchanges will generally offer custodial services for hosted wallets for their customers. This means that the customer is giving the private keys—and hence access to the associated cryptocurrency—to the exchange for safekeeping. While the exchange might be contractually limited in what, if anything, it can do with the private keys, the private keys are in the control of the exchange and can only be accessed by the customer using the exchange’s security protocols.

Rather than leave each customer’s account segregated, exchanges will often transfer the customers’ cryptocurrency to one or more omnibus accounts for which it alone holds the private key(s). Using omnibus accounts has several operational benefits for the exchange. Among other things, it lets the exchange keep down mining fees for transactions through bundling and netting. The customer’s interest is then tracked solely on the exchange’s books and records rather than on the blockchain. The SEC’s complaint against Coinbase provides a succinct explanation for how customer traders are handled:

“Coinbase requires that customers seeking to buy, sell, or trade through the Coinbase Platform and Prime create an account on coinbase.com and transfer their crypto assets or fiat currency to Coinbase. Once assets are transferred to Coinbase, Coinbase credits the customer account with the corresponding amounts in Coinbase’s internal ledger. The Coinbase internal ledger individually tracks each deposit and withdrawal of crypto assets and fiat currency for each customer, but Coinbase otherwise commingles customer funds and crypto assets that are similar in nature.”¹¹⁸

Thus, the customers’ interests in the cryptocurrency are merely tracked on the exchange’s own ledger, not the blockchain. If the customer were to look at his account statement on the exchange, however, the account statement would indicate what is in the exchange’s own ledger, not the blockchain, such that without doing an audit of the blockchain, the transfer of the cryptocurrency from the customer’s own private key to an omnibus account controlled by the exchange’s own private key would not be visible to the customer. This is why some crypto platforms hire independent auditors to conduct what’s known as a “proof of reserves,” which is simply a review to ensure customer account balances are backed by real cryptocurrency on the blockchain. However, there are severe limitations¹¹⁹ to using proof of reserves to assess the health of a crypto platform – it ignores a platform’s liabilities amongst other problems – and several firms that provided proof of reserves stopped doing so after they came under public and regulatory scrutiny.¹²⁰

The current approach to crypto custody by exchanges poses risks for cryptocurrency investors, as many discovered in the wake of multiple failures in the cryptocurrency industry throughout 2022, FTX being the most notable. Operating this way also puts cryptocurrency exchanges in the role of performing multiple functions that are required to be kept separate in

¹¹⁸ <https://www.sec.gov/files/litigation/complaints/2023/comp-pr2023-102.pdf> at 23

¹¹⁹ [Proof of reserves is proof of nothing \(coppolacomment.com\)](https://coppolacomment.com)

¹²⁰ [Accounting firms aim to replace ‘dangerous’ Proof of Reserves approach used by crypto giants – DL News](#)

traditional securities markets. Cryptocurrency exchanges frequently serve as the broker, the dealer, the exchange, the clearing agency, and the custodian; and as discussed previously, the SEC has begun to crack down on this behavior.¹²¹ In addition, large crypto exchanges may also have a venture arm that invests in projects whose tokens end up being listed on the exchange.¹²² Combining all these functions within one entity creates enormous conflicts of interest that could lead to customer and investor harm, as we saw most clearly in the FTX collapse.

Cryptocurrency exchanges operating in the US, including the former FTX.US, claim that they only list digital assets that are commodities, not securities. The Commodity Futures Trading Commission (CFTC) regulates commodity derivatives markets, but they do not have the legal authority to regulate commodity spot (cash) markets (this is why FTX.us did not offer derivatives products but the main FTX.com exchange out of the Bahamas did). Thus, there is no federal regulation of cryptocurrency exchanges other than for anti-money laundering purposes.

Nor is there any sort of Federal Deposit Insurance Corporation or Securities Investor Protection Corporation insurance to protect cryptocurrency exchange customers. Likewise, there is no specialized regime for resolving failed cryptocurrency exchanges. Accordingly, there is no statutory prioritization of the claims of exchanges' customers, unlike those of depositors in bank insolvencies. This has resulted in millions of customers of failed cryptocurrency exchanges becoming unsecured creditors in the bankruptcy process. Customers who held one Bitcoin on FTX when it collapsed thought they would get one Bitcoin back from the estate. Instead, customers are being treated as unsecured creditors, meaning they will receive \$16,871 for each Bitcoin they held on FTX, which was the price as of Nov. 11, 2022 (the day FTX filed for bankruptcy). Considering that Bitcoin is currently trading at ~ \$60,000, customers will miss out on gains of roughly \$43,000.¹²³

c. SEC Staff Accounting Bulletin 121

The unique risks involved in crypto custody prompted SEC staff in the Division of Corporation Finance and the Office of the Chief Accountant to release SAB 121 in 2022.¹²⁴ The bulletin acknowledges that these risks are “not present in arrangements to safeguard assets that are not crypto-assets, including technological, legal, and regulatory risks and uncertainties.” The staff elaborates on each of these:

- **“Technological risks** – there are risks with respect to both safeguarding of assets and rapidly-changing crypto-assets in the market that are not present with other arrangements to safeguard assets for third parties;”
- **“Legal risks** – due to the unique characteristics of the assets and the lack of legal precedent, there are significant legal questions surrounding how such arrangements would

¹²¹ See SEC v Coinbase, SEC v Binance, SEC v Kraken.

¹²² See [Coinbase CEO downplays VC arm's role in token listing, clarifies 'not a lawyer' - CoinGeek](#) and [Coinbase caught listing 8 crypto tokens without disclosing its investment \(protos.com\)](#)

¹²³ [FTX Customers Fight for What's Left of Their Crypto - WSJ](#)

¹²⁴ [SEC.gov | Staff Accounting Bulletin No. 121](#)

be treated in a court proceeding arising from an adverse event (e.g., fraud, loss, theft, or bankruptcy); and”

- **“Regulatory risks** – as compared to many common arrangements to safeguard assets for third parties, there are significantly fewer regulatory requirements for holding crypto-assets for platform users or entities may not be complying with regulatory requirements that do apply, which results in increased risks to investors in these entities.”¹²⁵

The staff believe these risks are significant enough that it warrants requiring SEC registrants that maintain “the cryptographic key information necessary to access the crypto-assets” of its customers to present a liability on its balance sheet to reflect its obligation to safeguard the crypto-assets held for its platform users” and that “it would be appropriate for [the firm] to recognize an asset at the same time that it recognizes the safeguarding liability, measured at initial recognition and each reporting date at the fair value of the crypto-assets held for its platform users.”

SAB 121 makes it clear that the staff’s intention is to provide investors and other users of financial statements with the information necessary to make an informed “capital allocation” decision, and in the staff’s opinion, the risks posed by providing custodial services for crypto assets are so severe that disclosure is a necessary remedy. I agree. However, by forcing firms to reflect crypto assets held in custody on their balance sheet, SAB 121 disincentivizes insured depository institutions from providing crypto asset custody because they would have to hold capital against such activity. Typically, assets under custody are not included on a custodian’s balance sheet since they belong to the customers.

SAB 121 is one of the few issues that unites the crypto and banking industries. After the Government Accountability Office (GAO) issued an opinion that found SAB 121 met the Congressional Review Act’s (CRA) definition of a rule and should have been submitted to Congress,¹²⁶ members of the House and Senate submitted a joint resolution of disapproval to nullify the rule. The resolution passed in both chambers but was vetoed by President Biden on May 31, 2024.¹²⁷ In his signing statement, the President noted that reversing “the considered judgment of SEC staff” “risks undercutting the SEC’s broader authorities regarding accounting practices.”¹²⁸

I agree with President Biden’s veto, but this issue should never have come to his desk. As long as cryptocurrency is legal in the U.S., these assets need to be custodied somewhere (most investors do not want to self-custody their crypto). From an investor protection standpoint, federally regulated banks are arguably the safest place for investors to keep their crypto. The danger in letting banks provide crypto custody is that it may open the door for banks to engage in additional crypto-asset activities that may threaten their safety and soundness and, potentially, financial stability. This is not a hypothetical risk. Last year, “three banks that engaged in crypto activities—

¹²⁵ Id.

¹²⁶ [Securities and Exchange Commission—Applicability of the Congressional Review Act to Staff Accounting Bulletin No. 121 | U.S. GAO](#)

¹²⁷ [A Message to the House of Representatives on the President's Veto of H.J.Res. 109 | The White House](#)

¹²⁸ Id.

Silvergate Bank, SVB, and Signature—all experienced runs and had to be placed into voluntary liquidation or receivership.”¹²⁹

The federal banking agencies have broad discretion to limit bank activities that cannot be conducted in a safe and sound manner, and under the Biden administration, the agencies issued several interpretive letters that require banks to first inform their regulator before engaging in crypto asset activities and a joint statement that suggests banks are not permitted to hold crypto-assets on their balance sheet.¹³⁰ There is still room for the banking agencies to limit the scope of bank-permissible activities, but crypto asset custody should be kept in scope. Accordingly, I encourage the SEC to revisit SAB 121 and assess if there are other ways to accomplish their goal of informing investors about the risks associated with a firm’s crypto asset custodial activities without having this activity reflected on the balance sheet. One possibility is to require disclosure in a footnote to the financial statements. I am heartened by recent reports that SEC accounting staff are working with firms to address the risks associated with crypto custody and granting exemptions to SAB 121 in limited circumstances, but this process should be more transparent and conducted subject to formal guidance put forward by the Commission.¹³¹

d. Special Purpose Broker Dealer Release

As the crypto market grew in size, SEC registered broker-dealers began to raise “questions concerning the application of the federal securities laws and the rules of the Financial Industry Regulatory Authority (“FINRA”) to the potential intermediation—including custody—of digital asset securities and transactions.”¹³² The SEC and FINRA first attempted to provide clarity to these market participants in 2019 with the “Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities,” also known as the “Four Step Process.”¹³³ The statement reiterates that an “entity that buys, sells, or otherwise transacts or is involved in effecting transactions in digital asset securities for customers or its own account is subject to the federal securities laws, and may be required to register with the Commission as a broker-dealer” and become a member of FINRA. And if the entity is a broker-dealer, “it must comply with broker-dealer financial responsibility rules, including, as applicable, custodial requirements under Rule 15c3-3 under the Securities Exchange Act of 1934 (the “Exchange Act”), which is known as the Customer Protection Rule.” Importantly, the Joint Staff Statement did not preclude registered broker-dealers from providing custody for “digital asset securities” provided they can comply with all elements of the Customer Protection Rule, and it also noted that registered broker-dealers operating alternative trading systems (ATSs) that do not at any time exercise any level of control over the digital asset securities being sold or the cash being used to make the purchase are exempt from the Customer Protection Rule.

¹²⁹ [RI Banking-Unfinished-Business-Financial-Reform_Brief_082024.pdf \(rooseveltinstitute.org\)](#)

¹³⁰ Joint Statement on Crypto-Asset Risks to Banking Organizations, Bd. Of Govs. Of the Fed. Rsr. Sys., Fed. Deposit Ins. Corp, Off. Of the Comptroller of the Currency, (January 3, 2023), <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf>. Last Accessed January 16, 2023, see also Reiners, Lee and Gazi, Sangita, Wanted: A Prudential Framework for Crypto-Assets (January 17, 2023). Arkansas Law Review, Available at SSRN: <https://scholarworks.uark.edu/alr/vol76/iss2/6/>

¹³¹ [SEC Surprisingly Details Exemptions From SAB 121, Further Muddying the Waters - Unchained \(unchainedcrypto.com\)](#)

¹³² [SEC.gov | Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities](#)

¹³³ Id.

The Customer Protection Rule requires broker-dealers to safeguard customer assets and to keep customer assets separate from the firm's assets, thus increasing the likelihood that customers' securities and cash can be returned to them in the event of the broker-dealer's failure. The Joint Staff Statement acknowledges that crypto's unique risks may make complying with the Customer Protection Rule difficult: "the manner in which digital asset securities are issued, held, and transferred may create greater risk that a broker-dealer maintaining custody of them could be victimized by fraud or theft, could lose a "private key" necessary to transfer a client's digital asset securities, or could transfer a client's digital asset securities to an unknown or unintended address without meaningful recourse to invalidate fraudulent transactions, recover or replace lost property, or correct errors"¹³⁴ The Statement also acknowledges that just because a broker-dealer (or its third party custodian) maintains the private key does not mean that "no other party has a copy of the private key and could transfer the digital asset security without the broker-dealer's consent."

On December 23, 2020 the SEC released "Custody of Digital Asset Securities by Special Purpose Broker-Dealers" to "encourage innovation around the application of the Customer Protection Rule to digital asset securities."¹³⁵ The SPBD release makes clear that its intention is to ensure that broker-dealers performing the full set of broker-dealer functions with respect to digital asset securities – including maintaining custody of these assets – do so "in a manner that addresses the unique attributes of digital asset securities and minimizes risk to investors and other market participants."¹³⁶ According to the release, these "unique attributes" necessitate requiring a broker-dealer engaged in digital asset securities activity to limit "its business to digital asset securities to isolate risk" and to have "policies and procedures to, among other things, assess a given digital asset security's distributed ledger technology and protect the private keys necessary to transfer the digital asset security."¹³⁷

The SPBD release acknowledges that it "may not be possible for a broker-dealer to establish control over a digital asset security with the same control mechanisms used in connection with traditional securities" and that the "manner in which digital assets, including digital asset securities, are issued, held, or transferred may create greater risk that a broker-dealer maintaining custody of this type of asset, as well as the broker-dealer's customers, counterparties, and other creditors, could suffer financial harm." These risks include the possibility that the "broker-dealer could be victimized by fraud or theft, could lose a "private key" necessary to transfer a client's digital assets, or could transfer a client's digital assets to an unintended address without the ability to reverse a fraudulent or mistaken transaction."

The SPBD release states that "a broker-dealer that maintains custody of a fully paid or excess margin digital asset security for a customer must hold it in a manner that complies with Rule 15c3-3, including that the digital asset security must be in the exclusive physical possession or control of the broker dealer." The release also clarifies that a SPBD must limit its business to "dealing in, effecting transactions in, maintaining custody of, and/or operating an alternative trading system

¹³⁴ Id.

¹³⁵ [Commission Statement and Request for Comment: Custody of Digital Asset Securities by Special Purpose Broker-Dealers](#)

¹³⁶ Id.

¹³⁷ Id.

for digital asset securities” in order “to shield traditional securities customers, counterparties, and market participants from the risks and consequences of digital asset security fraud, theft, or loss.”

In May 2023, Prometheus Capital was approved as the first special purpose broker-dealer (“SPBD”), making it the first SEC registered custodian for digital asset securities under the federal securities laws.¹³⁸ In December 2023, FINRA approved the company to offer clearing and settlement services in addition to custody services.¹³⁹ Prometheus’s parent company, Prometheus Inc., also owns Prometheus ATS, a broker-dealer and SEC registered ATS. Combined, these entities will allow Prometheus to provide a regulated framework for the trading, clearance, settlement, and custody of digital asset securities.

On September 10, 2024, tZERO announced that they were the second entity to obtain a special purpose broker dealer license.¹⁴⁰ The company’s press release noted that now, compliant digital security issuers “can fully utilize the power of transformational blockchain infrastructure and engage with tZERO as a one-stop shop for digital asset security issuance and a range of compliant secondary trading modalities, including continuous automated trading, auctions and block trades for a range of private assets.”¹⁴¹ The company goes on to state that receiving the SPBD license advances their “long-standing position that many digital assets in the market constitute securities under existing legal frameworks and require fully-developed infrastructure, including broker-dealer led custody, to effectively exist and migrate into a regulated securities environment.”¹⁴²

On September 11, 2024, Prometheus Capital officially launched its custody platform for institutional investors, and they now provide custodial services for Optimism (OP), The Graph (GRT), Ethereum (ETH), Uniswap (UNI), and Arbitrum (ARB).¹⁴³ There has been wild speculation that the SEC granted a SPBD license to Prometheus Capital in order to “obstruct congressional efforts towards legislation.”¹⁴⁴ These rumors are unfounded and appear politically motivated.¹⁴⁵ Prometheus and tZERO’s ability to meet the rigorous application requirements to obtain a SPBD license proves that it is possible for crypto intermediaries to follow the federal securities laws and points the way for a compliant path forward for crypto in the United States.¹⁴⁶

e. Safeguarding Advisory Client Assets Proposal

¹³⁸ [Crypto Firm Prometheus Capital Gets Special Purpose Broker Dealer With SEC - Bloomberg](#)

¹³⁹ [Prometheus Receives FINRA Approval for Expanded Crypto Services - Unchained \(unchainedcrypto.com\)](#)

¹⁴⁰ [tZERO Receives Landmark Approval To Custody Digital Securities and Support End-to-End Digital Securities Lifecycle in the United States \(prnewswire.com\)](#)

¹⁴¹ Id

¹⁴² Id

¹⁴³ [Prometheus Capital Launches its Custody Platform for Digital Asset Securities | Business Wire](#)

¹⁴⁴ [Blockchain Association Calls for Investigation into SEC Approval of Prometheus Ember Capital as Special Purpose Broker-Dealer - Blockchain Association \(theblockchainassociation.org\)](#)

¹⁴⁵ I asked Prometheus’s co-CEO, Aaron Kaplan, about this rumor and additional rumors of ties to the Chinese Communist Party on my podcast, The FinReg Pod: <https://open.spotify.com/episode/3sAJ0tpkmJTFeAEciKF1IJ>

¹⁴⁶ Prometheus co-CEO, Aaron Kaplan, described the application process in testimony before the House Financial Services Committee last June: [Prometheus Hearing Document - 6-11-23 \(house.gov\)](#)

In February 2023, the SEC proposed new rules and amendments to rule 206(4)-2, the Commission's custody rule, under the Investment Advisers Act of 1940.¹⁴⁷ The Dodd-Frank Act gave the SEC authority to expand the advisers' custody rule to apply to all assets, not just funds or securities, but they had yet to exercise this authority. While the proposal applies to all assets that registered investment advisers custody on behalf of their investors, the text makes it clear that the SEC's primary motivation in updating the safeguarding rule is the emergence of cryptocurrency as an investable asset class.

The proposal expands and enhances the role of qualified custodians when registered investment advisers custody assets on behalf of their investors. The Commission's goal is to ensure that advisers don't inappropriately use, lose, or abuse investors' assets.

The proposed rule retains the definition of a "qualified custodian" but imposes additional conditions on banks and savings associations as well as foreign financial institutions to qualify as "qualified custodians." The proposal reiterates that a qualified custodian must maintain "possession or control" of client assets and requires advisers with custody of a client's crypto assets "to ensure those assets are maintained with a qualified custodian that has possession or control of the assets at all times."

Once again, the SEC acknowledges the unique challenges associated with the custody of crypto assets and provides details on how a qualified custodian of crypto assets can meet the "possession or control" requirements. The proposal states: "while we understand that it is possible for a custodian to implement processes that seek to create exclusive possession or control of crypto assets (e.g., private key creation, maintenance, etc.), it may be difficult actually to demonstrate exclusive possession or control of crypto assets due to their specific characteristics (e.g., being transferable by anyone in possession of a private key)." Thus, the proposal focuses on whether the "the qualified custodian is required to participate in a change in beneficial ownership" of a crypto asset.

The Commission acknowledges that it may be challenging for firms that are currently providing crypto custody services – most of whom are registered as state-chartered trust companies – to comply with the safeguarding rule. This is because "most crypto assets, including crypto asset securities, trade on platforms that are not qualified custodians," and these platforms "require investors to pre-fund trades, a process in which investors transfer their crypto assets, including crypto asset securities, or fiat currency to such an exchange prior to the execution of any trade" so that the platform can directly settle all trades they receive. Given how these crypto platforms operate, the SEC concedes that "an adviser with custody of a crypto asset security" would be "in violation of the current custody rule because custody of the crypto asset security would not be maintained by a qualified custodian from the time the crypto asset security was moved to the trading platform through the settlement of the trade." In a statement accompanying the proposal's release, SEC Chair Gary Gensler said: "Make no mistake: Based upon how crypto platforms generally operate, investment advisers cannot rely on them as qualified custodians."¹⁴⁸

¹⁴⁷ [SEC.gov | SEC Proposes Enhanced Safeguarding Rule for Registered Investment Advisers](https://www.sec.gov/SEC-Proposes-Enhanced-Safeguarding-Rule-for-Registered-Investment-Advisers)

¹⁴⁸ [SEC.gov | Statement on Proposed Rules Regarding Investment Adviser Custody](https://www.sec.gov/Statement-on-Proposed-Rules-Regarding-Investment-Adviser-Custody)

Critics of the proposed safeguarding rule have decried it as an effort to “shadow ban” registered investment advisers from offering their clients crypto assets.¹⁴⁹ And the proposal leaves some doubt as to whether state-chartered trust companies meet the definition of qualified custodian.¹⁵⁰ However, if crypto platforms were to simply register with the SEC as a broker-dealer, which should have already happened given that they are listing investment contracts, then they would meet the definition of qualified custodian.

The SEC reopened the comment period for the safeguarding rule in August 2023 and the rule has yet to be finalized.¹⁵¹ I encourage the SEC to clarify that state-chartered trust companies do not qualify as qualified custodians. Trust company charters have a natural appeal to crypto exchanges because the “traditional activities of a trust company — holding financial assets on behalf of customers — are analogous to certain of the core activities conducted by cryptocurrency exchanges and providers of digital wallet services.”¹⁵² They are also regulated less stringently than other kinds of qualified custodians, such as banks and broker-dealers, because they typically are regulated by just the state regulator who chartered them. State trust companies are also subject to less onerous capital requirements than banks.

Unfortunately, several state-chartered trust companies engaged in crypto custody have experienced significant problems. In June 2023, Nevada’s Financial Institutions Division placed Prime Trust, an uninsured state-chartered crypto trust company, in receivership.¹⁵³ In a bankruptcy court filing, the company revealed that it lost access to \$45 million worth of crypto locked in its wallet.¹⁵⁴

The cryptocurrency exchange Gemini is also registered as a trust company in New York, and in October 2023, they were sued by the New York Attorney General for defrauding customers of \$1.1 billion as part of its Gemini Earn program.¹⁵⁵ The lawsuit noted that, “Gemini has long sought to differentiate itself from other cryptocurrency companies by claiming to embrace legal regulation and encouraging its customers to place a heightened degree of trust and confidence in Gemini and its products.”¹⁵⁶

Multiple states are now courting the crypto industry by passing favorable legislation that creates entirely new types of charters or makes it easier for crypto firms to obtain a state trust charter.¹⁵⁷ State financial regulators do not have the resources to ensure these novel entities are following all the rules and regulations and not placing customer assets at risk, as Prime Trust and Gemini demonstrate. Therefore, state-chartered trust companies should not meet the definition of qualified custodian in the SEC’s final safeguarding rule.

¹⁴⁹ [How the SEC Could Cripple Crypto Venture Capitalists — The Information](#)

¹⁵⁰ [SEC Proposal Could Bar Investment Advisers From Keeping Assets at Crypto Firms \(coindesk.com\)](#)

¹⁵¹ [SEC.gov | SEC Reopens Comment Period for Enhanced Safeguarding Rule for Registered Investment Advisers Proposal](#)

¹⁵² [The trust company — an old tool for a new age | Reuters](#)

¹⁵³ <https://www.coindesk.com/policy/2023/06/27/nevada-places-crypto-custodian-prime-trust-into-receivership/>

¹⁵⁴ <https://unchainedcrypto.com/prime-trust-lost-8-million-investing-in-terrausd/>

¹⁵⁵ [Attorney General James Sues Cryptocurrency Companies Gemini, Genesis, and DCG for Defrauding Investors \(ny.gov\)](#)

¹⁵⁶ [nysoag-complaint-against-gemini-et-al.pdf](#)

¹⁵⁷ See [States take lead on crypto bank charters and digital asset rules | American Banker](#)

f. Reflecting on the SEC's Efforts

Many within the cryptocurrency sector assert that current securities laws, formulated long before blockchain technology emerged, are ill-suited to the nuances of digital assets. Nevertheless, as previously mentioned, most cryptocurrency transactions in the U.S. do not utilize blockchain. Using advanced technology as a justification for ignoring regulations is a convenient distraction from the truth: the business models of cryptocurrency platforms are fundamentally at odds with federal securities laws. As Professor Hilary Allen testified before this Subcommittee, “it is entirely possible for a blockchain-based technology business to comply with existing investor protection and financial stability regulation.”¹⁵⁸ The choice not to comply is primarily an economic one.¹⁵⁹

Contrary to the assertion that SEC crypto-related enforcement actions and rulemaking amount to a “shadow ban” on the asset class, the Commission has adopted a flexible approach that seeks to bring the cryptocurrency sector within a regulatory framework that safeguards investors from fraud and market manipulation. The Commission has also demonstrated a willingness to allow traditional securities markets intermediaries to engage in digital asset securities activity provided appropriate guardrails are in place that account for the unique risks associated with blockchain and distributed ledger technology. But there is little the SEC can do if cryptocurrency issuers refuse to register their offering with the SEC when it meets the definition of “investment contract.” Congress tasked the SEC with enforcing the securities laws, an investment contract is a security under the federal securities laws, and the Supreme Court has defined what an investment contract is. The SEC has little discretion in the matter.

V. FIT21's Fatal Weaknesses

In my written testimony before this Subcommittee last March, I noted that the best way to close the gap in cryptocurrency spot market regulation is to have Congress carve out cryptocurrency from the definition of a commodity in the Commodity Exchange Act and recognize cryptocurrencies as securities under a special definition to the securities laws.¹⁶⁰ This does not mean that the requirements currently applicable to securities issuers and intermediaries must apply to crypto firms on a one-for-one basis. One area for potential compromise is a tailored disclosure regime for cryptocurrencies that qualify as securities. The information a cryptocurrency investor would want in order to make an informed investing decision is different than what an investor in a corporate equity would want. Therefore, I encourage the Commission to use its existing authority to develop tailored disclosures for crypto asset securities.¹⁶¹

¹⁵⁸ [HIAHFESTestimony \(house.gov\)](#)

¹⁵⁹ Owen Lau, an analyst at Oppenheimer & Co. estimates that if Coinbase loses its case vs. the SEC, it “could potentially shave as much as 30% off of its revenue.” See, <https://www.bloomberg.com/news/articles/2024-09-03/how-coinbase-went-from-dc-kids-table-to-political-power-seat>

¹⁶⁰ [Hearing Entitled: Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem | Financial Services Committee \(house.gov\)](#)

¹⁶¹ Even Chairman Gensler has acknowledged the merit of this idea: “Given the nature of crypto investments, I recognize that it may be appropriate to be flexible in applying existing disclosure requirements. Tailored disclosures exist elsewhere — for example, asset-backed securities disclosure differs from that for equities”. See, [SEC.gov |](#)

I will not elaborate here on my proposal to have Congress grant the SEC exclusive oversight over crypto markets other than to note that even SEC Commissioner Hester Peirce agrees with me that the CFTC is ill-suited to regulate crypto spot markets. In a 2023 speech at the Digital Assets at Duke conference,¹⁶² Commissioner Peirce stated:

“Some people within crypto would prefer to see regulatory authority over token disclosures and spot markets given to the Commodity Futures Trading Commission (“CFTC”). The CFTC’s retail experience is more limited than the SEC’s. Moreover, if the CFTC were given regulatory authority over crypto spot markets, would there soon be calls for the CFTC to regulate other spot markets, such as wheat, oil, and corn markets? Adding crypto to the CFTC’s remit also would stretch the small agency’s resources.”¹⁶³

The U.S. House of Representatives ignored Commissioner Peirce’s advice when it passed the Financial Innovation and Technology for the 21st Century Act (FIT21) on May 22, 2024.¹⁶⁴ The bill gives primary regulatory authority over crypto markets, via a rubber stamp self-certification process, to the CFTC, and guts the *Howey* Test and federal securities laws in the process.

At its core, the bill reflects the belief that many cryptocurrencies evolve over the course of their lifetime, from centralized to decentralized, and that a different regulatory regime should apply once this mystical threshold is passed. When a digital asset is certified as “decentralized,” it becomes a digital commodity subject to CFTC jurisdiction.

The bill attempts to define decentralization from a technical and economic perspective. However, decentralization exists along a spectrum, as many in the crypto industry have already acknowledged. In January 2024, the CFTC’s Technology Advisory Committee’s (TAC) subcommittee on Digital Assets and Blockchain Technology – many subcommittee members work in the crypto industry – released a report on Decentralized Finance that identified five major dimension of decentralization: access, development, governance, finances, and operations.¹⁶⁵ The report found: “Most DeFi systems are not completely decentralized or centralized, but instead fit on a multi-level spectrum of (de)centralization (varying along each of the functional and technical dimensions), creating a challenge in trying to meet certain industry calls for either regulators or industry to coalesce around a particular defined level of decentralization for all business and technology models that would make it “sufficiently decentralized.”

Kennedy and Crypto. See also, https://www.theblock.co/post/314246/sec-should-customize-forms-mark-uveda?utm_source=m6-labs.beehiiv.com&utm_medium=newsletter&utm_campaign=ripple-s-lawyer-slams-sec-wazirx-hacker-moves-6-5m-in-eth

¹⁶²The 2025 conference will be held Feb 5-7, 2025 on Duke’s campus: [Home - Duke Digital Assets Conference \(digitalassetsatduke.org\)](https://digitalassetsatduke.org)

¹⁶³<https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-duke-conference-012023>

¹⁶⁴<https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=409277>

¹⁶⁵[Statement of Commissioner Christy Goldsmith Romero on CFTC’s Digital Assets and Blockchain Technology Subcommittee Release of Decentralized Finance Report | CFTC](#)

From a technical perspective, the Bill says a blockchain system is decentralized as long as “no person” during the previous 12-month period had the unilateral authority to “control or materially alter the functionality of the blockchain system,” or the unilateral authority to restrict any other person’s ability to use the blockchain system.”¹⁶⁶ The problem with this technical definition of decentralization is that it is nearly impossible to know ex-ante if these conditions are met. There have been several instances in which blockchains have been altered after vulnerabilities were exposed. For example, the Ethereum blockchain was exploited via a smart contract called The DAO in June 2016, which led to a hard fork in the Ethereum blockchain that was publicly supported by the Ethereum Foundation and Ethereum’s creator Vitalik Buterin.¹⁶⁷ You could argue that in this example, no one person “unilaterally” forked the Ethereum blockchain, but this points to a flaw in bill’s language as being too narrowly construed. In addition, there have been other instances when attackers have gained more than 51% of a blockchain network’s computing power and used it to rewrite the transaction history.¹⁶⁸

Furthermore, the bill is wrong to focus on decentralization from the blockchain’s perspective instead of the asset or protocol perspective. Blockchain is just the settlement layer, and while each blockchain will have its native token, the majority of cryptocurrencies are smart contracts that leverage a specific blockchain network (ERC-20 is a common token standard for Ethereum smart contracts). For example, the stablecoins USDT (Tether) and USDC (Circle) exist on multiple blockchains, and both entities have the ability to freeze addresses. Other non-stablecoin tokens can similarly be influenced by the issuer or a related party.

The bill defines economic decentralization as: “no digital asset issuer or affiliated person beneficially owned, in the aggregate, 20 percent or more of the total amount of units of such digital asset.”¹⁶⁹ The 20% threshold is intentionally high. There have been several examples of venture capital firms controlling less than 20% of governance tokens and still exerting considerable influence over a digital asset.¹⁷⁰ In addition, the bill’s definition of “Decentralized System” includes language permitting alterations to the codebase by the issuer and affiliated person for purposes of addressing “vulnerabilities, errors, regular maintenance, cybersecurity risks, or other technical changes to the blockchain system.”¹⁷¹ However, if the issuer maintains the ability to make changes to the codebase, for whatever reason, then clearly the digital asset is not decentralized.

To help digital asset developers reach “decentralization”, the bill allows issuers to raise initial funds to build their project through a newly created SEC registration exemption that is significantly more generous than existing registration exemptions and opens the door for significant investor harm. Under Section 301, a new Section 4(a)(8) exemption would be created

¹⁶⁶ [Text - H.R.4763 - 118th Congress \(2023-2024\): Financial Innovation and Technology for the 21st Century Act | Congress.gov | Library of Congress](#)

¹⁶⁷ [The DAO Hack: How a \\$60M Ethereum Attack Shaped Crypto History \(coindesk.com\)](#)

¹⁶⁸ [Once hailed as unhackable, blockchains are now getting hacked | MIT Technology Review](#)

¹⁶⁹ [Text - H.R.4763 - 118th Congress \(2023-2024\): Financial Innovation and Technology for the 21st Century Act | Congress.gov | Library of Congress](#)

¹⁷⁰ See [Crypto VC Firm A16z’s Role in Uniswap Vote Sparks Debate Over Concentration of Voting Power \(coindesk.com\)](#)

¹⁷¹ [Text - H.R.4763 - 118th Congress \(2023-2024\): Financial Innovation and Technology for the 21st Century Act | Congress.gov | Library of Congress](#)

that allows an issuer of digital assets to raise \$75 million per offering – 15 times as much as the equity crowdfunding exemption, and far in excess of the approximately \$18.3 million raised in the 2014 Ethereum initial coin offering.¹⁷² Non-accredited investors can purchase digital assets under the exemption provided that their purchases over a 12-month period do not exceed 10% of their income or net worth. Furthermore, “an intermediary or digital asset issuer may rely on a purchaser’s representation concerning” their annual income and net worth.

If true decentralization is even possible, it does not take \$75 million to achieve. While I do not believe a new exemption should be created, if there is to be one, it should be limited to \$5 million, which is the same as the current crowdfunding exemption. In addition, general solicitation should be prohibited, and digital asset issuers should have to demonstrate their plans to achieve decentralization when applying for the exemption.

Once a cryptocurrency is believed to be sufficiently decentralized, the bill would allow “any person” to “certify to the SEC that the blockchain system to which a digital asset relates is a decentralized system.” Allowing anyone to make the certification guarantees that the SEC will be inundated with certification requests. And given that the SEC only has 60 days to rebut a certification, it is likely that many digital assets will be certified as decentralized that likely don’t meet the definition. Stacking the deck against the “appropriate securities regulation of crypto assets that should fall under the SEC’s jurisdiction” all but “guarantees many asset issuers and traders will flood the system seeking registration under the CFTC.”¹⁷³

FIT21's self-certification process for classifying a digital asset as decentralized and thus exempt from federal securities laws undermines the very purpose of the *Howey* test, which is to "prevent parties from structuring transactions to evade the securities laws."¹⁷⁴ Not only could this decentralization framework "allow crypto firms to largely continue with dangerous business practices as usual; it could also enable traditional financial firms to evade more robust regulatory oversight by claiming their products and platforms meet this decentralization rubric (e.g. "slap a blockchain on it")."¹⁷⁵

To make matters worse, Title II of FIT21 - Clarity for Assets Offered as Part of an Investment Contract - creates new opportunities for issuers (not just of digital assets) to escape SEC registration requirements by clarifying that “the term ‘security’ does not include an investment contract asset.”¹⁷⁶ The crypto industry has consistently argued that the object of an investment contract is distinct from the investment contract itself (e.g., orange groves are not a security but when packaged with a management contract it constitutes an investment contract). Courts and the SEC have not disputed this assertion; therefore, it is unnecessary to include this language in the bill and doing so invites “non-crypto actors to use this new terminology to evade coverage of the Howey Test for their investment products and activities as well.”¹⁷⁷

¹⁷² [History of Crypto: The ICO Boom and Ethereum's Evolution \(cointelegraph.com\)](https://cointelegraph.com/history-of-crypto-the-ico-boom-and-ethereum-s-evolution)

¹⁷³ [2HR 4763 \(Crypto Markets Bill\) Opposition Sign-On Letter. UPDATED.docx \(ourfinancialsecurity.org\)](#)

¹⁷⁴ Wendy Gerwick Couture, *The Risk of Regulator Arbitrage: A Response to Securities Regulation in Virtual Space*, 74 Wash. & Lee L. Rev. Online 234, 236 (2018).

175 <https://ourfinancialsecurity.org/2023/06/statement-statement-for-the-record-to-the-house-financial-services-committee-in-response-to-the-hfsc-recent-hearing-on-digital-assets/>

176 [BILLS-118hr4763rfs.pdf \(congress.gov\)](#)

¹⁷⁷ [2HR 4763 \(Crypto Markets Bill\) Opposition Sign-On Letter.UPDATED.docx \(ourfinancialsecurity.org\)](#)

While the professed purpose of FIT21 may be to “provide regulatory clarity and robust consumer protections...for the digital asset ecosystem,” the bill does neither.¹⁷⁸ I have additional concerns about FIT21, but in the main, the bill was clearly drafted to make current conflict-laden and predatory business models legal. In fact, the bill contains an expansive safe harbor for crypto firms currently being sued by the SEC via a “notice of intent to register” provision. The bill allows for entities that have filed a notice of intent to register as a digital asset trading system, a digital asset broker, a digital asset dealer, a digital commodity exchange, digital commodity broker, or digital commodity dealer to “be exempt from Commission rules and regulations pertaining to registering as a national securities exchange, broker, dealer, or clearing agency, for activities related to a digital asset.”¹⁷⁹ In short, should FIT21 become law, the SEC’s allegations that Coinbase, Kraken, and Binance are all operating an unregistered securities exchange, broker, dealer, and clearing agency will no longer be ripe. Finally, the bill explicitly excludes decentralized financial activities from its provisions,¹⁸⁰ ensuring that a parallel financial system will be allowed to grow outside the regulatory perimeter and without any investor protection.

VI. Conclusion

I realize that giving the SEC additional authority under its present leadership is unpalatable to some members of this committee. However, SEC chairs come and go. The American people are looking to Congress to exercise foresight in determining how to regulate the crypto industry for the long-term. This requires lawmakers to look at the core competencies at the relevant agencies. The SEC was endowed with a mandate to protect investors, and investor protections are sorely lacking in crypto markets.

I applaud the committee’s focus on this crucial task, but it is worth noting that this is not a race. The crypto industry is eagerly pointing to favorable regulatory regimes abroad as an example for U.S. lawmakers to follow, and warning that if the U.S. does not act quickly, new and existing crypto firms will set up shop overseas. However, getting it right is more important than being first. Passing financial regulatory legislation is hard, and once in place, it tends not to change absent some future crisis. Passing FIT21 into law will be a Pyrrhic victory when it fuels a 2008-style financial crisis down the road. I urge you and your colleagues to consider a different path.

¹⁷⁸ [House Passes Financial Innovation and Technology for the 21st Century Act with Overwhelming Bipartisan Support | Financial Services Committee](#)

¹⁷⁹ [BILLS-118hr4763rfs.pdf \(congress.gov\)](#)

¹⁸⁰ Sec. 409 and Sec. 509 of FIT21 exempt decentralized finance activities from the Securities Exchange Act of 1934 and the Commodity Exchange Act.

Chairman HILL. The gentleman yields back. We will recognize the ranking member of the full committee, Ms. Waters, for a 1-minute opening statement.

STATEMENT OF HON. MAXINE WATERS, RANKING MEMBER OF THE FINANCIAL SERVICES COMMITTEE, A U.S. REPRESENTATIVE FROM CALIFORNIA

Ms. WATERS. Thank you very much. I am very pleased to see the SEC holding bad actors accountable, whether they are using crypto or some other means to scam investors. Unfortunately, in less than 2 weeks' time, the government may shut down because, once again, extreme Make America Great Again (MAGA) Republicans are playing games with the salaries of Federal employees, including Federal law enforcement agencies like the staff of the SEC. So I do not care if you deal in paper stock certificates or if you are dealing crypto coins, the law is the law, and the SEC is right to protect investors when you break it. Thank you, and I yield back.

Chairman HILL. The gentlewoman yields back. I now turn to member questions. We thank the panel for their discussion. I want to also thank Mr. Lynch, my ranking member during this Congress, our members on both sides of the aisle for their diligent work on digital assets legislation during this Congress, and particularly thank our committee staff and our personal staffs for their engagement on this new complex area in which we have had a lot of debate and some successful legislation crossed the House floor.

Chairman Gensler has often said that the existing securities rules apply to digital asset companies in a straightforward manner, that they simply just need to come in and register with the SEC. He has made that argument here many times, and he leaves the impression, I think, with viewers at home and Members of Congress, that just is so easy. It is just like a form out on the SEC's website. Meanwhile, the SEC staff under his leadership continues its very aggressive approach of regulation by enforcement, suing companies that are actually working in good faith to try to "come in and register." We have now heard that consistently, certainly in this Congress and the Congress previous.

Mr. Gallagher, you are the chief legal and compliance officer for one of those companies, Robinhood, which received a Wells notice from the SEC, and I want to quote from that: "After years of good faith, attempts to work with the SEC for regulatory clarity, including our well-known attempt to come in and register, we are disappointed that the Agency has decided to issue a Wells notice related to our U.S. crypto business." That is in Robinhood's filing. So you attempted to come in and register, I think, as a special purpose broker dealer, and the Commission has approved one of those before. What was it like working with the Commission, and what does it say when you want to come in and register? Is it as straightforward as the chairman makes you think?

Mr. GALLAGHER. Well, thanks for the question, Chairman Hill. Look, we heard Chair Gensler's call to come in and register loud and clear. Admittedly, I scratched my head a bit because there was no established regime, at least published regime, but being seasoned securities lawyers, we thought we will just roll up our sleeves. It is a competitive advantage we have as being a regulated

entity at Robinhood, and we committed to coming in and register. We spent about a year and a half, a dozen or so meetings with the SEC staff. We crafted what we believe to be a workable model for registration, utilizing the special purpose broker regime that Chairman Clayton had established in his time but with modifications that actually made it workable.

One thing that became very obvious to us is that the special purpose broker regime does not work for digital assets, so we recommended modifications that would make it work. We were submitting to full regulation by the Commission, and it was a fruitful process. It was very cordial with the SEC staff until about early 2023, when we got a very perfunctory note from the chairman's office telling us that there is no reason to talk anymore.

Chairman HILL. It is pretty frustrating to the private sector, and really, I mentioned it in my opening comments about the millions of dollars of legal fees and delays but in this special purpose broker-dealer, is that a good example? In your testimony, you talk about Section 36 authorities dating back to 1996 on using exemptive relief using the existing authorities of the Commission. Could the Commission have modified just the approach to that, the special purpose broker-dealer licensing requirements?

Mr. GALLAGHER. Yes, Chair, the SEC could have come out with a more workable proposal than the special purpose broker. If you remember, the special purpose broker was actually a no-action letter. It was not technically exemptive relief. As I state in my written testimony, if the Commission were to propose a registration and regulation regime utilizing Section 36, and it is appropriate to be talking about it here, Congress in its wisdom in 1996 in Isthmian gave the Commission the authority to exempt certain activities, certain participants, from requirements of the securities laws when they deem fit, when it is in the best interest of investors in the country. In this instance, I would argue that it would be in those best interests to, at least for a provisional regime, use Section 36 to craft a registration regime and oversight regime, books and records, the very basics—

Chairman HILL. Thank you.

Mr. GALLAGHER [continuing]. While Congress debates more—

Chairman HILL. I appreciate your views on that, and that is why we took the approach of fit for purpose in our FIT21 bill was to lay out a framework that the Commission itself could have used, and we provide statutory authority both for the CFTC and the SEC. Mr. Reiners talked about that the Commission just needs to defend the laws and asserts that maybe we are the ones misunderstanding it here on Capitol Hill. In my opening statement, I referenced the legal faceplants the Commission has repeatedly had before Federal courts.

I want to insert in the record a op-ed editorial in the Wall Street Journal, September 12, "All the President's Legal Defeats," including an outline of the digital assets legal defeats by the SEC before the Federal courts.

Without objection, that will be included in the record.

[The information referred to can be found in the appendix.]

Chairman HILL. I yield back the balance of my time. I turn to my friend, the ranking member, Mr. Lynch, for 5 minutes of questions.

Mr. LYNCH. Thank you, Mr. Chairman. Mr. Reiners, the SEC efforts to enforce investor protection laws are to ensure market participants are playing by the rules. The SEC investor protection regime is both preventive—making sure our financial markets are not exposed to undue risk, fraudulent offerings, or reckless speculation—and on the other hand, it is also prosecutorial—finding and catching bad actors in the act to prevent more consumers or investors from being harmed.

Now, the SEC's enforcement record spans a wide range of actions against a wide range of bad actors. As you know, earlier this year, the SEC charged two individuals with fraudulent crypto scheme known as HyperFund. HyperFund raised about \$1.7 billion from investors worldwide, mostly from developing countries. The defendants drew investors in with the promise of high returns from a crypto mining scheme, but in reality, the project was a simple pyramid scheme. Then again, last month, the SEC filed charges against Novatech, alleging that its founders fraudulently raised \$650 million from more than 200,000 investors worldwide, again including many Haitian Americans. The firm's co-founders used social media posts to appeal to their victims' religious faith and promised investors their funds would be safe. Instead, regulators allege the company was a pyramid scheme, which also ultimately collapsed in 2023.

So, Professor Reiners, what can you tell us about how the industry's culture of disregard for securities law has helped create an environment for scams like these two to occur and what do you think would happen if the SEC surrendered to the industry pressure and established a permissive regulatory framework for the crypto industry to allow that activity to happen more widely here in the U.S.?

Mr. REINERS. Certainly. Thank you, Congressman. I think for every sort of high-profile enforcement action the SEC takes against these larger crypto platforms, there are countless enforcement actions that they are taking against these type of frauds that you just mentioned. You can go to the SEC's website, and it is literally almost every single day. So it is important to note that the SEC is, in my opinion, doing their job as a cop on the beat but with crypto, it is very hard because there are 20,000 different tokens out there. It does not take a lot of work or effort to create a new token and promote it on social media, so it is just a challenging position to be in. I think the risk is that if you pass a light-touch regulatory regime, it is going to give the veneer of legitimacy to this industry and draw in more consumers who are not as sophisticated and who will ultimately be taking advantage of these scams of the variety that you just mentioned.

Mr. LYNCH. In your testimony, you talked about the lack of a crypto product market fit. It appears to me that crypto operates as a collectible out there, so there is no killer app for it yet. They are still working on that. It sort of operates on the greater fool theory: as long as there is someone else out there willing to pay more for a Bitcoin, it will succeed but if people you know are lacking con-

fidence in it, like after the FTX collapse, it plummeted. What is the safest way to regulate something like that is purely speculative and operates more like a collectible than as an actual currency with value?

Mr. REINERS. Well, I think, I mean, as you mentioned, that the primary sort of motivation for most people when they purchase crypto is speculation, is to profit, and they are speculating on assets that have no intrinsic value, right? There are no cash-flows that are discounting, right, so there is no sort of valuation model. In fact, most studies have shown J.P. Morgan, for instance, looked at their customers who bought crypto via their J.P. Morgan checking account and found that most of them had lost money. So I think the solution is to bring it within the securities regulatory perimeter so we can have some just sort of basic investor protections that have existed for over 90 years in this country and that folks are generally comfortable with.

Chairman HILL. Are you good?

Mr. LYNCH. I do also want to point out that Bitcoin has been around since 2009, so it has been 15 years, and you look at most other technological innovations, usually they have a huge adoption, and that has not happened in crypto.

Mr. Chairman, I yield back.

Chairman HILL. The gentleman yields back. The gentleman from Oklahoma, Mr. Lucas, recognized for 5 minutes of questions.

Mr. LUCAS. Thank you, Mr. Chairman. Mr. Gallagher, it has been reported that there is a high rate of staff turnover at the SEC, particularly in the Enforcement Division. Could you discuss the effect that has on the Commission and how it impacts the market participants?

Mr. GALLAGHER. Well, thanks for the question, Congressman. Yes, the Enforcement Division of the SEC is one of the pillars of the Agency. It is critically important. It is how it is measured by the public, in many ways. The idea that there is high attrition and that, more importantly, the good people are leaving is very problematic. It really goes to the reputation of the Agency. I do not have statistics myself, but I have heard anecdotes. I have heard gossip coming out of the building that morale is pretty low, and so it is definitely a concern.

Mr. LUCAS. Ms. Schulp, could you also share your perspective on the issue of staff turnover in the Enforcement Division, how that impacts things?

Ms. SCHULP. The Enforcement Division, as Mr. Gallagher said, is one of the cornerstones of the SEC's functions, and high turnover is very difficult. First, the SEC itself, as in an inspector general report in 2023, more than two-thirds of enforcement staff that had been surveyed said that they did not believe that they had the resources to complete their job. Turnover only exacerbates that problem and leaves other parts of the SEC's function in enforcing other rules as well left to difficulty.

Mr. LUCAS. Mr. Fusaro, during the last several years, there has been much attention to the Bitcoin exchange-traded products, and the SEC approved 11 Bitcoin ETPs in January of this year, but we have had other regulated futures products for the same amount of

time. Could you explain the difference between each product and why investors would want Bitcoin ETPs or futures-based products?

Mr. FUSARO. Thank you for your question, Mr. Lucas. I certainly can. Just to clarify the record, the SEC allowed a Bitcoin futures-based ETF into the marketplace in 2021 and then did not allow the Bitcoin spot-based products into the market until this year, as you said. Generally, futures-based products are more expensive for end users. They have disadvantageous tax consequences. Generally, they are more complex to run, more difficult to manage, and ultimately lead to higher costs and a higher level of difference between the performance of the fund and the underlying asset than you would see in a spot product.

Just to give an example, the largest Bitcoin futures-based exchange-traded product has a management fee that is about 5 times as high as the average of the spot Bitcoin ETFs. Since the launch of the spot or physical Bitcoin exchange-traded product at the beginning of this year, the largest futures-based ETP has lagged behind from a performance perspective by about 6-and-a-half percent.

Mr. LUCAS. Could you expand on that about what the consumer demand has been for these products since their approval, because that reflects how the implementation is done.

Mr. FUSARO. Yes, absolutely. Consumer demand for spot Bitcoin ETPs has been nothing short of remarkable. When you measure the asset growth over the period of time that the group of Bitcoin exchange-traded products has had, the 11 that you mentioned were approved, Mr. Lucas, in 2024, they have taken in net inflows of over \$16 billion this year. That is the most successful exchange-traded product launch of all time. As I mentioned, the ETF industry is one of the most successful financial innovations of the last thirty years. If you look to compare that to what the most successful ETF launch had been prior to this, the popular Nasdaq Invesco QQ product raised about \$5 billion in its first year, and we have not even had these products in the market for three quarters of a year and four of those Bitcoin ETFs, have been the top 25 fastest-growing ETPs of all time.

Mr. LUCAS. My time is about to expire. I yield back, Mr. Chairman.

Chairman HILL. Thank you, gentleman. The chair now recognizes the ranking member of the full committee, the gentlewoman from California, Ms. Waters, for 5 minutes.

Ms. WATERS. Thank you very much. Since Chair Gensler was sworn in as chair on April 17, 2021, the SEC has filed more than 100 crypto-related enforcement actions, more than a third of which were fully settled at the time of filing. Through these enforcement actions, the SEC has obtained orders for more than \$5.5 billion in monetary relief, including more than \$800 million in civil penalties and more than \$4.8 billion in disgorgement. In most cases, disgorged figures are returned to investors. Additionally, at least 103 enforcement actions were taken during the time that Clayton, who was a Trump appointee, was chair, and then, of course, when Chair White, who was an Obama appointment, was in charge.

So having seen that these actions were taken by chairs who are the appointees of both Clayton and Obama, which of any of these actions can any of you point to that you have discovered were abso-

lutely wrong, that the facts were not correct? Which one would you point out that the SEC was involved with settling was wrong?

Mr. GALLAGHER. I guess I will go first, Congresswoman, and I am assuming my fellow panelists would disagree with me on this. Of course, sort of the one notable partial loss in the SEC's track record, of course, is the Ripple case, which I think is important to note that complaint was filed while Jay Clayton was chair of the SEC, right? So Chair Gensler has just continued on with the approach and the policy of his predecessor. Even in that partial loss, that logic, that ruling has since been in essence, repudiated by several other Federal judges in that same Federal district court. So I think their track record here is very strong.

Ms. WATERS. Thank you. Well, let me just go to Michael, I think, Liftik. Are you a crypto attorney?

Mr. LIFTIK. Thank you, Ranking Member Waters. I am a securities lawyer. I have been a securities lawyer for about 20 years, and a decent part of my practice involves clients involved in the blockchain industry.

Ms. WATERS. Mr. Gallagher, how are you related to crypto? Are you advocating for Robinhood? Is that what you are doing?

Mr. GALLAGHER. Yes, Ranking Member Waters. I am here on behalf of Robinhood.

Ms. WATERS. So I understand that Robinhood is attempting to get,—what, licensed for crypto?

Mr. GALLAGHER. We were, Ranking Member, for a good part of 2022 and into 2023 trying to heed Chair Gensler's call to come in and register. Ultimately, his office told us that there was no path forward.

Ms. WATERS. So, has Robinhood been turned down, turned back?

Mr. GALLAGHER. Correct.

Ms. WATERS. Why?

Mr. GALLAGHER. I do not have the rationale. We did not get an explanation. We just got a stop sign.

Ms. WATERS. That is odd you do not know why your client was not licensed. Teddy Fusaro, how are you involved with crypto?

Mr. FUSARO. Thank you, Ranking Member Waters. I am the president of a digital asset and cryptocurrency asset management firm. What we attempt to do is take digital assets and cryptocurrencies and package them inside regulated vehicles, like ETFs, to offer those to the public.

Ms. WATERS. Do you believe there needs to be serious guardrails with crypto to protect the investors?

Mr. FUSARO. We do, and we think that the exchange-traded product or exchange-traded fund provides a lot of those benefits, and ETF gives transparency, a disclosure regime.

Ms. WATERS. So do you agree with any of the actions that have been taken? Are you disagreeing specifically with any of the actions?

Mr. FUSARO. I do not agree or disagree with any of the specific actions you mentioned, and I am not a lawyer or a specialist on enforcement actions.

Ms. WATERS. Thank you very much. I yield back the balance of my time.

Chairman HILL. I thank the ranking member. I now recognize myself for 5 minutes for questions.

Mr. Reiners, I hope no one is listening to you about this market, especially as a student trying to understand the space. It is over a trillion dollars just for Bitcoin. The market is over \$2 trillion. Clearly, lots of consumers find value in this space, and, frankly, the idea that you could point out that there is only one time that the SEC was even partially wrong has to be willful ignorance.

I mean, I do not know how it could be anything other than deceit. It is hard for me to understand because on August 29, 2023, the circuit court upheld the position that the SEC violated the Administrative Procedures Act when it denied Grayscale's application to convert Grayscale Bitcoin Trust into a Bitcoin ETP. Following that decision, the SEC waited until January 2024 to actually approve the conversion, and, basically, this was a pure rebuke of the actions. If you look at DEBT Box, another pure rebuke. Lawyers would normally get disbarred for the conduct of SEC in the DEBT Box case.

So there are lots of cases where they have been caught and told that they were wrong by the courts, and the market continues to reinforce that there really is value just looking at Bitcoin alone. People right now believe that it is a secure way to store value with a level of confidence of around \$60,000. I mean, that is a new security product on the market that you could digitally secure a unit of value, and people believe in it enough to put almost \$60,000 into one unit of measure in a Bitcoin, and they do not just want to store it there. They want to be able to transfer it in a permissionless, peer-to-peer way. So if you read the Bitcoin white paper available at Bitcoin.org, you could see the concept, even if you just read the abstract. It is not just meant to be parked there or speculated on. It is meant to be able to be moved in a permissionless way.

Now, we do not know how much of that trillion dollars of market cap in Bitcoin is self-custody versus third-party custody, but the SEC, under Gary Gensler's leadership, has willfully undermined the ability for anyone to custody digital assets, not just Bitcoin, but the rest of the space as well. So they have decided that if they cannot completely end the entire space, they want to push custody of it to some third party that they can control or manipulate. They certainly do not want individual American citizens to custody their own wealth and be able to move it, amongst others.

So, Mr. Fusaro, when you look at this space and the special purpose broker-dealer path that we saw, people saying we would love to try to custody digital assets for others, what kind of problems did you find with the current framework offered by Mr. Gensler?

Mr. FUSARO. A few of the challenges that relate specifically to Bitcoin and crypto exchange-traded products that I can mention: One is that as an issuer, someone who wants to offer these products, the larger and well-established custody banks that typically participate in custody of assets in collective investment vehicles are effectively barred from participating in the space. They do not have a way to bring custody services to the market. That is one challenge. A second one that I would like to mention is that in the ETF structure itself or the ETP structure itself, typically, the funds have a creation and redemption mechanism that works through

what is known as an in-kind process, where the fund exchanges shares in exchange for the underlying asset itself. Because broker dealers are not able to handle Bitcoin and crypto, we cannot have that type of mechanism in the exchange traded product——

Mr. DAVIDSON. Is that a consistent way that it is applied for the ETF products? Are they treating this differently?

Mr. FUSARO. In overseas jurisdictions, we have the in-kind transactions that occur in ETFs and ETPs, but it is consistently applied here in that we are not able to bring that type of structure to market, which is the thing that we think slightly increases costs for end users.

Chairman HILL. Yes, as the court found a very different set of rules for this space than the rest of the market. Ms. Schulp, in December 2020, the SEC issued this framework. Have any broker-dealers successfully utilized this framework to custody the space?

Ms. SCHULP. I do not believe any have successfully done so. There have been two approved, one just last week. The one that had been approved a while ago, actually earlier last year, Prometheus, has not operated with most of its services and has only begun offering partial services.

Chairman HILL. Yes. Thank you. I wish I had more time. My time has, in fact, expired, and I now recognize the gentleman from New York, Mr. Torres, for 5 minutes.

Mr. TORRES. Thank you. The SEC has a pattern of using the term, “digital asset security.” Mr. Gallagher, does the term, “digital asset security,” appear anywhere in any statute enacted by Congress?

Mr. GALLAGHER. Thanks for the question, Congressman. Not that I know of.

Mr. TORRES. Okay.

Mr. GALLAGHER. Not until you enact legislation.

Mr. TORRES. Does the term, “digital asset security,” appear anywhere in any rule promulgated by the SEC?

Mr. GALLAGHER. No, sir.

Mr. TORRES. Does the term, “digital asset security,” appear in any precedent by the Supreme Court?

Mr. GALLAGHER. Not that I know of.

Mr. TORRES. Okay. Does the term, “digital asset security,” appear anywhere in the 2 million pages of the Federal Register?

Mr. GALLAGHER. Not that I know of——

Mr. TORRES. Okay.

Mr. GALLAGHER [continuing]. unless the special purpose broker dealer no-action letter was in the Federal Register, but I do not think it was.

Mr. TORRES. So if it appears nowhere, neither in rule nor statute, did the SEC invent the term out of thin air?

Mr. TORRES. They certainly created it. I do not know if came out of thin air.

Mr. TORRES. In fact, in a recent court filing, the SEC apologized for using the term——

Mr. GALLAGHER. Correct.

Mr. TORRES [continuing]. “digital asset security,” because it is misleading. It gives the impression that a digital asset in and of itself is a security. Is that correct?

Mr. GALLAGHER. I saw that. Yes, it is correct.

Mr. TORRES. Mr. Gensler has asserted that all digital assets, except Bitcoin, are securities, and so I want to examine in detail Mr. Gensler's notion of Ether as a security. The textbook example of a security is a stock. If I invest in Apple stock, it means I am expecting a profit from the managerial efforts of Apple, the company. If I buy Ether, from whose managerial efforts am I expecting a profit? In other words, what is the Ethereum equivalent of Apple, the company?

Mr. GALLAGHER. There is not one that I know of, Congressman.

Mr. TORRES. In the *Howey* case, the Supreme Court emphasizes that the SEC must zero in on the "economic reality of a transaction." Since there is no entity that centrally controls Ether in the same manner that Apple controls an Apple stock, would it be fair to say that the economic reality of purchasing a decentralized digital asset, like Ether, is qualitatively different from the economic reality of purchasing a security like an Apple stock?

Mr. GALLAGHER. That would be fair, Congressman.

Mr. TORRES. Okay. So I have a question about SEC Accounting Bulletin 121. It requires a custodian bank, like the Bank of New York, to put custodial digital assets on its balance sheet, which has the practical effect of effectively banning blockchain and banning the tokenization of real world assets, and this question could be for Ms. Schulp, if she wants to weigh in. Is it considered good accounting practice for a custodian to put custodial assets on its own balance sheet? Is that customary?

Ms. SCHULP. That is not customary. That is typically not how that is handled under generally accepted accounting principles.

Mr. TORRES. It is a violation of generally accepted. Okay. So the SEC is asking banks to violate generally accepted accounting practices and to treat digital assets differently from any other financial asset. Correct me if I am wrong. Did FTX put custodial assets on its own balance sheet?

Ms. SCHULP. I believe so.

Mr. TORRES. Yes.

Ms. SCHULP. At least there were a lot of problems—

Mr. TORRES. Is not that ironic that Staff Accounting Bulletin No. 121 (SAB 121) contains a cruel irony that it is asking banks to do what FTX did, which is put custodial assets on its own balance sheet? I just find that ironic. When Mr. Gensler was testifying before the Financial Services Committee, I asked him whether the sale of a Pokemon card constitutes a security transaction, and he said no. I then asked him whether the sale of a Pokemon card via the blockchain, whether that constitutes a security transaction, and he equivocated. He seems to hold that the mere use of a blockchain, the mere process of tokenization, magically transfers a commodity into a security. It magically transforms a collectible like a Pokemon card into a security.

Again, the Supreme Court has said what matters is not the form of the transaction. What matters is the substance, the economic reality of the transaction. If you apply the logic of the Supreme Court to the Pokemon hypothetical, what matters is not whether a Pokemon card takes a tokenized form. What matters is the underlying economic reality of the Pokemon sale, regardless of its

tokenized form. So would it be fair to say that the economic reality of purchasing a collectible, like a Pokemon card, is qualitatively different from the economic reality of purchasing a security, like an Apple stock? Mr. Gallagher, do you wish to weigh in?

Mr. GALLAGHER. Congressman, I think that would be fair to say. I think there is a minor distinction. If you are buying a piece of a Pokemon card versus the whole card, I think that might be a little bit of a different analysis, but I think your statement is fair.

Mr. TORRES. But the value of a Pokemon card does not depend on a Pokemon corporation, right?

Mr. GALLAGHER. That is correct.

Mr. TORRES. It is a collectible.

Mr. GALLAGHER. That is right.

Mr. TORRES. I am done. Thank you.

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

Mr. ROSE. Thank you, Chairman. I appreciate you and Ranking Member Lynch for holding the hearing, and thank you to our witnesses for being with us today.

Mr. Gallagher, it is a pleasure to see you again. I hope the opportunity to hear you testify in front of the House Agriculture Committee in June regarding the FIT21 discussion draft. As you may recall, during that hearing, we discussed how securities that are not registered are impossible to be listed by a U.S.-registered broker-dealer intending to market them to the public.

Recently, Prometheus, a U.S.-registered broker-dealer with significant ownership from investors with ties to the Chinese Communist Party and the first special purpose broker-dealer license in the U.S., has stated that it will treat Ether, Uniswap, and Arbitrum as crypto asset securities on its platform, despite the fact that the SEC has effectively acknowledged that Ether is not a security and the remaining assets have not been deemed securities by a court. Mr. Gallagher, can Robinhood list securities and digital asset nonsecurities on the same platform if there is uncertainty about whether a given token is a security?

Mr. GALLAGHER. Thank you for the question, Congressman. The answer is no, and that actually was one of the nuances that we requested relief from the Commission for with respect to our application to come in and register a special purpose broker. The special purpose broker letter right now is limited to so-called digital asset securities and will not allow that broker to handle nonsecurities. I do not know the details of the Prometheus model. It vexes me a bit, given the limitation within the four corners of the letter itself.

Mr. ROSE. Mr. Gallagher, I want to make it clear. I do not believe that these assets are securities. However, suppose we were to accept Prometheus's argument, how can Prometheus legitimately argue that it can make tokens that they assert are securities available to the general public if they have not been registered?

Mr. GALLAGHER. Congressman, to the best of my knowledge, you cannot make a non-security a security just by fiat, so I do not know how they can make that statement.

Mr. ROSE. As I see this situation playing out, and I think about one of our witnesses today, and Chair Gensler's actions, and the SEC, I am reminded of the "Andy Griffith Show" back in the day.

Many in this room probably remember seeing that show, and there was the character Barney Fife, the deputy sheriff. While earnest, he was always enforcing the law and wanting to put people in jail, anxious to get his bullet out and use it, but he did not have the knack that, say, Sheriff Andy Taylor had for understanding what was good for the people of Mayberry. It seems to me that we need a Sheriff Taylor who can look at the situation, size it up, and, using tools like Section 36 of the Securities and Exchange Act, make the decision that is best for the people of Mayberry.

Mr. GALLAGHER, at this stage in the SEC's regulation-by-enforcement approach, is it possible for Robinhood or any U.S. broker-dealer to list unregistered securities for the general public without exemptive relief from the SEC?

Mr. GALLAGHER. It is impossible right now for a regulated broker to deal in both, quite frankly, what the SEC deems to be digital asset securities as well as just non-security digital assets, the custody rules, the net capital rules, the customer protection rules. None of them accommodate the blockchain infrastructure, so a rulemaking is simply required. The idea of coming in and register, it is just a falsehood.

Mr. ROSE. I think you have technically answered the next question, but what relief exactly would be needed to make listing these assets possible?

Mr. GALLAGHER. Well, Congressman, in lieu of legislation, which I do hope comes, I think, as a provisional measure, as I lay out in my written testimony, the Commission could use Section 36 to tailor a registration regime that would just give you the fundamentals of oversight, registration, books and records, things like that. Currently, those provisions, those requirements in the Exchange Act, at least, do not accommodate digital assets.

Mr. ROSE. I think the time is not sufficient to get into my next question, so, Mr. Chairman, I yield back.

Chairman HILL. The gentleman yields back. The gentleman from Illinois, Mr. Casten, is recognized for 5 minutes.

Mr. CASTEN. Thank you, Mr. Chairman. Thanks to our witnesses. I want to remind everybody that since 2013, the SEC has pursued 173 crypto-related enforcement cases. One hundred of those were for fraud, and the crypto industry's response to that has too often not been to shut down the causes of fraud, but to claim that because they are decentralized, they are not liable to SEC rules and disclosure, and, therefore, you are not required to show the fraud.

I am specifically concerned about World Liberty Project. This is a new decentralized finance (DeFi) project that has been promoted by the former President. The details of this were announced earlier this week, and I want to highlight a couple points. That DeFi platform, based on the announcements, says it is going to create a governance token, and 20 percent of the tokens will be reserved for team compensation, which will include members of the Trump family. That 20 percent sounds suspiciously similar to the language in the FIT21 bill that says that if you have less than 20-percent ownership, you are decentralized and, therefore, not subject to regulation.

Mr. Reiners, I think you mentioned a little bit of this in your opening testimony, but can you just talk about how a venture cap-

ital firm or other who owns 20 percent or less of a protocol's governance tokens could still exert considerable influence over that security?

Mr. REINERS. Sure. Thank you, Congressman. So, you know most of these DeFi protocols, they operate according to a decentralized autonomous organization structure, which, in essence, requires there to be a governance token so that folks can participate in the execution of that protocol. Those governance tokens are normally distributed to, as you alluded to, project developers as well as backers of the project in many cases, which is a legal entity or some type of foundation, and those backers are venture capital firms. So even if they have below the 20-percent threshold, they are still able to exert influence on the project, the protocol, and the people building on it. You know, maybe they have a traditional equity investment in the corporation or whatever that is developing it, so we have seen several examples of this play out in various sort of DeFi actions where large venture capitals (VCs) have attempted to sort of shape the outcome one way or the other.

Mr. CASTEN. That protocol could be designed in a way that made it more susceptible to fraud, right? I want to stay on that point because this World Liberty Group has also intentionally said that they will only sell those tokens to accredited investors under the Reg D exemption, which lets them raise money without registering with the SEC. So I guess, Mr. Liftik, I will start with you. Under the Reg D exemption, would the founders be required to disclose to investors that their most recent investment has lost 70 percent of its value since March?

Mr. LIFTIK. Well, Reg D applies to private offering of securities and the premise—

Mr. CASTEN. Yes, but so they would not have to disclose that information, right?

Mr. LIFTIK. They need to disclose all material information relating to the investment.

Mr. CASTEN. Is that a "yes" or "no?" They have lost 70 percent. They are currently sitting there trying to figure out if they can liquidate that holding in Trump Media. Would they be required to disclose their pretty poor performance?

Mr. LIFTIK. I am not familiar with the details of that particular project.

Mr. CASTEN. Okay. Well, would they be required to disclose to investors that they have ties to a failed DeFi protocol that suffered a \$2-million hack?

Mr. LIFTIK. I think the point, Congressman, is that if a digital asset project chooses to proceed through a private offering of securities, the Reg D pathways are well understood in terms of the disclosure obligations.

Mr. CASTEN. Okay. Let us be more specific then. Chase Herro, this guy who is associated with them—I have to clean this up for this promo—but this is one of the guys who is involved in this. He has said about crypto, "You can literally sell"—I am going to fix the words—"feces in a can wrapped in urine, covered in human skin for \$1 billion if the story is right, and people will buy it." I am not going to question the right and wrong of all that. Would you have to disclose under Reg D that is the person who is running this ven-

ture that you are trying to now sell crypto tokens with, or would they have to dig that up on the internet, as I just did?

Mr. LIFTIK. Well, typically, a private offering memorandum does disclose all the relevant people that are involved in a project, but I think the point for—

Mr. CASTEN. Let me move on because I want to get to one more point. They have also said that these tokens will be nontransferable and will not earn yield in order to avoid securities law and disclosures. I would note that when Fred Trump bought \$3 million of casino tokens because his son was missing a debt payment, he did not expect that to be transferred, nor did he expect to earn interest. It was still fraudulent. I understand why people who have a history of fraud, who have a history of laundering money would find this very attractive. I find it troubling that it is partisan for us to try to shut down ventures that make fraud easier, that make it easier to launder money, and that make it harder to protect investors. I yield back.

Chairman HILL. The gentleman yields back. The gentleman from South Carolina, Mr. Timmons, is recognized for 5 minutes.

Mr. TIMMONS. Thank you, Mr. Chairman, and I want to thank the witnesses for being here today.

Federal securities laws governing the registration of securities and the broker-dealers that offer them were designed in the 1930s to regulate centralized entities issuing securities primarily to raise capital. This framework is built so that when a company registers to offer security, they are required to submit a number of disclosures that are relevant for investors. However, these disclosures fail to capture many of the unique qualities of digital assets, showing a clear disconnect between traditional regulatory structures and this emerging technology.

Let us take nonfungible tokens, for instance. Non-fungible tokens (NFTs) create trusted, immutable records of digital ownership. The potential applications of NFTs are endless, be it artwork, loyalty points, concert tickets, property titles or video game items. These unique digital records have transformational potential in almost every industry in the United States. From my perspective, it is clear that blockchains and NFTs they empower are data transfer protocols that support both financial and nonfinancial use cases. That is why I have been concerned by the SEC treating all NFTs as speculative financial instruments.

On August 28, OpenSea, one of the leading NFT marketplaces, received a Wells notice from the SEC threatening to sue the firm for hosting unregistered securities on their platform and on Monday, Flyfish Club settled with the SEC for over \$750,000 for an NFT offering that simply allowed for exclusive restaurant access. These actions not only represent severe overreach from the SEC, but also suggest that the SEC is engaging in predatory regulation by enforcement. Mr. Liftik, in these cases, did the SEC articulate a standard that they employ to determine whether the sale of an NFT is considered a securities transaction?

Mr. LIFTIK. Well, thank you for the question, Congressman. I think that gets to the heart of the matter, which is that the Howey Test does not work well for digital assets, and, in particular, in the context of NFTs, as I think Commissioners Peirce and Uyeda said

in their dissent that they issued on the Flyfish Club, just because the intent of a buyer cannot transform something from a non-security to a security. Particularly in the NFT space as we have grappled with it on the defense side, the challenge is that we consistently analogize to Pokemon cards, collectibles, whether it is art or watches or baseball cards, and we have not heard a compelling response to that out of the SEC. These are collectible items. Each one is unique. They are bought for whatever purpose they are bought for, and trying to apply the Howey Test to it simply shows the breakdown in the approach the SEC has taken.

Mr. TIMMONS. Thank you for that. What has been the impact of the SEC pursuing enforcement actions without first providing clear and consistent rulemaking or guidance for NFT companies to follow?

Mr. LIFTIK. Well, the challenge then becomes that it becomes a roulette wheel as you are trying to advise projects whether they can be in compliance or not in compliance, applying the Howey Test. It is a facts-and-circumstances test that applies to each transaction. So going into a project on the front end, a consumer or a company has no way to know whether they will draw scrutiny from the SEC.

Mr. TIMMONS. Thank you. Ms. Schulp, do you believe that the vast majority of NFTs are consumer products outside the purview of the SEC?

Ms. SCHULP. I believe that there are a lot of NFTs that would not fall within the SEC's purview.

Mr. TIMMONS. Thank you for that. In your view, should the regulation of NFTs focus on the nature and function of these assets or treat them all as financial instruments?

Ms. SCHULP. They certainly should not be treated all as financial instruments. The nature and function is important here, and it also goes to the heart of what the securities laws are themselves trying to impact. Those are focused on financial instruments and also focused on the asymmetrical information that the manager or issuer of that asset has over an investor. That is simply not relevant in the case of most NFTs.

Mr. TIMMONS. Thank you. Chair Gensler continues to mislead and stifle a diverse and innovative tech industry, driven by what appears to be a misguided power grab. Unfortunately, the American public stands to lose out as a result. My proposed legislation, the New Frontiers in Technology Act, seeks to address Chair Gensler's unjustified assault on nonfinancial NFTs by exempting them from securities regulations.

Under this bill, NFTs would be classified according to their nature and function, providing clarity as to whether they qualify as financial instruments. By offering a precise legal definition of "NFTs", Congress would not only give industry stakeholders the certainty they need to innovate, but also provide regulators with the necessary guidance to apply appropriate oversight. This legislation represents a crucial step toward ensuring that NFTs are properly categorized, enabling their regulation as both financial and nonfinancial products where applicable. Failure to pass this legislation will perpetuate a flawed system where American innovators face two stark choices, risk unpredictable SEC enforcement, or take

their ambitions overseas. I know which option I would choose. We need to act on this. With that, Mr. Chairman, I yield back. Thank you.

Chairman HILL. The gentleman yields back. The gentleman from North Carolina, Mr. Nickel is recognized for 5 minutes.

Mr. NICKEL. Thanks so much, Chair Hill and Ranking Member Lynch, for holding today's important hearing on the SEC's politicized approach to digital assets. Not only is Gary Gensler's approach to digital assets politicized, it is just downright wrong. He is hurting consumers, innovation, American competitiveness, and the Democratic Administration. In May, 71 Democrats sent a strong message by supporting FIT21. Our bill regulates digital asset intermediaries, safeguards consumers, and cements the U.S. as a global leader in finance and technology. Also in May, Democrats in both chambers supported my congressional Review Act resolution with Congressman Flood to rescind the SEC's SAB 121, which puts consumers and the financial system at risk. While these are major milestones, the job is not done. Unfortunately, the SEC did not get the message. The will of Congress, and, most importantly, the will of millions and millions of our constituents is falling on deaf ears at the SEC.

Under Chairman Gensler's leadership, the Commission has taken the most hostile, aggressive, and irrational approach to technology, although they state that they are technology neutral. This approach is not only against our ideals as Democrats, but it is a real detriment to investors and innovators. The Commission has refused to provide regulatory clarity and has instead over and over relied on regulation by enforcement, taking our country in the wrong direction. I am very hopeful that we will continue to protect digital innovation in the U.S., protect consumers. Those are the things that we can do in this Congress.

Mr. Gallagher, first question to you. Robinhood has been in the crypto space for 6 years, yet it is only now receiving a Wells notice. What would you say is an effective way to regulate a fast-evolving industry like crypto, and how would a more proactive approach from the SEC, such as issuing clear guidelines up front, have changed your company's trajectory?

Mr. GALLAGHER. Thank you, Congressman Nickel. As I state in my written testimony, I think transparency and clarity, regulatory certainty is the only way to proceed, and we do not have that right now. Regulation by enforcement does not give that to us. For companies like Robinhood, which embraces regulation, which embraces compliance with the securities laws—that is our main business, by the way—as being a fully regulated broker and overseen by the SEC and Financial Industry Regulatory Authority (FINRA). We want that clarity. We want to be regulated. Some corners of the crypto markets do not want to. We do. We think it is a competitive advantage. Even with that, and even with running what we believe to be a fully compliant platform, we have to look over our shoulder left and right because of this regulatory uncertainty.

As I lay out in my testimony, I believe the Commission should provisionally use their exemptive authority that Congress very wisely gave the Commission in 1996 to craft a regime that will

bridge us until the day that Congress can act and give us more prescriptive and comprehensive legislation.

Mr. NICKEL. You mentioned your efforts to engage with the SEC, yet you still received a Wells notice. Can you talk about the level of communication and engagement you have had with the SEC, and do you feel that they have been responsive and transparent in their communications, or has the process been opaque and frustrating?

Mr. GALLAGHER. Well, in the end, it is been opaque and frustrating. Throughout the process, though, I give the staff of the SEC across all the divisions much credit. It was a very intellectual and lively exchange of ideas. I think they appreciated that we came in as real securities lawyers, and we offered them a solution that would actually give life to the chair's call to come in and register. Otherwise, it is a false promise. We gave it to them, and ultimately the Chair's Office shot it down. So very frustrating in the end, spending hundreds of thousands of dollars, over 12 meetings with the staff, draft no-action letters, taking this very seriously, and then being told there is no process left for us, and then we get a Wells notice on our very compliant Robinhood crypto offering.

Mr. NICKEL. Very frustrating. Next question, Ms. Schulp. Rescinding SAB 121 is well within the SEC's authority, and there is ample precedent for revisiting a staff accounting bulletin. However, instead of recognizing its misstep and rescinding the guidance, the SEC's Office of Chief Accountant has worked with certain institutions to bypass the balance sheet reporting requirements under certain circumstances. Can you provide us with some insight as to why the SEC would approach SAB 121 in this manner, and what is the impact of this confusing approach?

Ms. SCHULP. Unfortunately, I cannot provide much insight as to why the SEC is proceeding this way because it is confusing, and it is not a good way to regulate. Instead of either revising the guidance or providing clear, different guidance, rescinding it entirely, what we are left with is "nonbinding staff guidance" in the form of SAB 121, that has been updated by a nonbinding staff speech that suggests that there may be exceptions to SAB 121, as well as one-off conversations with the SEC staff. This is not clear at all and provides no level of certainty for market participants.

Chairman HILL. The gentleman's time has expired.

Mr. NICKEL. My time is up. I yield back.

Chairman HILL. I recognize the gentleman from Wisconsin, Mr. Steil, for 5 minutes.

Mr. STEIL. Thank you very much, Mr. Chairman. If I could start with you, Mr. Gallagher, the SEC recently amended its complaint against Binance, introducing some procedural updates and legal modifications. In the amendment, the SEC declared that when it used the term, "crypto asset securities," the Commission was not referring to the crypto asset itself as a security. Put more plainly, the crypto asset is the subject of the investment contract. According to the filing, the SEC was using "crypto asset securities," that term, as a shorthand term, but no longer using it because it is confusing. Can you speak to the amended filing and what the implications are for market participants who may be currently in the SEC's sights?

Mr. GALLAGHER. Thanks for the question, Congressman. I took note of that. I saw the brief itself and found it a very odd admission by the Commission that they have been using this term basically out of thin air. I think the net result of it, to your question, is that a real high emphasis is now going to be placed on the secondary market transactions in these assets. If you recall, the judicial decision in the Ripple case said that secondary market transactions do not give rise to investment contracts——

Mr. STEIL. Is this simply an argument for us to pass FIT21?

Mr. GALLAGHER. Well, I think you need to pass FIT21. I think, yes, it would bolster that case.

Mr. STEIL. Thank you. Let me jump to you, if I can, Ms. Jennifer Schulp. Chairman Gensler keeps saying that digital asset project sponsors should just come in and register. If only it were that simple, right? We have discussed many times at this committee our current disclosure requirements for stock and other common investment vehicles really are not a good fit for digital asset projects, and I think it is important we get this right, both for investors and for issuers. Can you just provide a quick example for the record of how these disclosure requirements are not a good fit for digital assets?

Ms. SCHULP. Sure, and I will note that the SEC, when confronted with other poor fits for registration requirements for assets, has engaged in other rulemaking to make the fits better. Asset-backed securities are a good example of that. When we are looking at digital assets, the disclosure regime is focused on the issuer itself, where the issuer is, what exactly their business lines are. That is not necessarily relevant when we are talking about our digital tokens, and the disclosure regime does not cover information that might be important to the purchasers of those tokens, such as tokenomics, such as the token supply, where the tokens are being held back for project insiders.

So investors are getting the short end of the stick here on both sides. They are not getting information that they need, and if they were to follow the SEC's registration requirement here, it is likely that they would not be able to get the information that the disclosure requirements ask for because that information may not exist.

Mr. STEIL. So not only are they not getting the information that you think you would deem relevant for an individual to be able to have, but also the disclosures that they are able to obtain are not terribly relevant. Is that——

Ms. SCHULP. Correct.

Mr. STEIL. Mr. Michael Liftik, do you agree with that assessment?

Mr. LIFTIK. I do, and I think I would take it even one step further, which is that there is a risk that in applying the traditional disclosure regime, it actually could be misleading to investors because it assumes a connection between the so-called issuer and the security, the equity, if you are talking about ownership shares in a company. If you are talking about a digital asset and a project that originally minted it, given all that information about that token minter may have no connection or little connection to the digital asset.

Mr. STEIL. I agree with you. I want to come back to you, Ms. Jennifer Schulp, if I can. The SEC has taken enforcement actions

against practically all U.S.-based digital assets trading platforms, including many that have tried to engage with the SEC preemptively to work toward registration. What message does that send to startups, to developers who want to bring their products into the United States?

Ms. SCHULP. I think the message is clear. The message is go away, find somewhere else to do this, the United States is not welcoming.

Mr. STEIL. You are nodding your head, Mr. Gallagher. You agree?

Mr. GALLAGHER. I absolutely agree, and, in fact, it is real life for me. We launched our crypto product in Europe last year because there is regulatory certainty, and we could not continue to grow and innovate here because there is no regulatory certainty.

Mr. STEIL. Thank you. I think what is so important is that we are working to allow innovation and development inside the United States, not pushing this overseas. I think there is a competitive nature to this, and what we are going to see is other countries working and developing in this space rather than in the United States. I think it is imperative that we move forward with the regulatory framework. Mr. Chairman, I yield back.

Chairman HILL. The gentleman yields back. The gentleman from Illinois, Mr. Foster, is recognized for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman, and to our witnesses. Mr. Gallagher, thank you for your time today. You mentioned in your testimony that Robinhood has made difficult choices not to list certain tokens and crypto products. Can you describe the review process that Robinhood follows for determining whether or not to list certain digital assets?

Mr. GALLAGHER. Thanks for the question, Congressman. Robinhood crypto has a listing process and a listing committee that evaluates tokens for listing on the platform. Right now we have 15 coins listed, including Bitcoin, Ether (ETH), and other coins.

Mr. FOSTER. I believe we have delisted some, too, or stopped supporting. I guess, the Cardano, Polygon, and Solana, you have recently stopped supporting. Could you just explain why the criteria that you applied to say that said these are okay and others are not?

Mr. GALLAGHER. Yes. Thanks for the question, Congressman. Those three coins that were delisted a year ago, actually, I think close to the same day we had a hearing, the Ag Committee with Congressman Rose, were listed in the complaint that the SEC filed against both Binance and Coinbase, as, in the SEC's estimation, being securities. One of the factors that our listing committee looks at is whether the SEC has weighed in publicly on the security status of a token. The committee took that into consideration, even though, quite frankly, we disagree with the SEC. We do not believe they are securities, and I have memos from a national law firm saying that they are not.

Mr. FOSTER. Do you also consider, for example, their use in illicit finance? Is that a factor?

Mr. GALLAGHER. Well, we have a very vibrant anti-money laundering (AML) and know your customer (KYC) function at Robinhood, and so, clearly, we take these things into account.

Mr. FOSTER. Yes. Yes, obviously. Our committee spent a lot of time worried about cryptocurrency's role in illicit finance, ransomware, the whole spectrum, you know, much of which is enabled by the anonymous, permissionless, self-hosted nature of these assets as well as methods to jump chains, to privacy-enhanced coins, and back-end mixers, the whole ball of wax. I presume that Robinhood, one of your goals is to not become a convenient on-and-off ramp for illicit finance, and so does Robinhood currently allow users to transfer their crypto from permissionless, self-hosted wallets onto the Robinhood platform?

Mr. GALLAGHER. Congressman, I actually do not know the answer to that question. I do know that we—

Mr. FOSTER. It is fundamental. If you are trying to not be an onramp and an offramp to illicit finance, and apparently, unless there are technological changes I am not aware of, it is not possible to prevent anonymous, self-hosted crypto from being used for those purposes. How do you ensure that when you onboard money, if you could get return for the record, say, exactly how it is that you attempt to stop the crypto assets that have been used or could have been used for illicit finance, how you attempt to stop those from being onboarded on your platform and some estimate of how effective that is?

Mr. GALLAGHER. Sure. We are happy to submit that to you.

Mr. GALLAGHER. I will tell you that we have, as I have said before, what we call the Fin Crimes Group, which conducts very intense AML and KYC reviews generally across the platform.

Mr. FOSTER. Okay. Well, many of the frauds that the SEC is charged with preventing—wash trades, front running, investment government frauds—interestingly, I have been told that these are actually documented in the Babylonian Cuneiform Tablets. So these are not new inventions, things like front running and wash trades. I guess this is probably a question for the whole panel. One of the fundamental things if you are going to have a healthy market, is to have a market participant understand what the market price is. There have been estimates that over half of all transactions in Bitcoin, for example, are wash trades. Is that still the current number? Does anyone know? Has that been superseded? So it is of that magnitude. So how do you understand what a market price is in an object where a majority of the transactions are sort of demonstrably illegitimate things like wash trades? Is there any technological solution to that, or is that just a fundamental feature of what we are talking about? Yes, sure.

Mr. FUSARO. If I may, Congressman. The ETP industry has what I think is a very effective solution for determining what the price of a Bitcoin is. What we use is something called a volume-weighted median price that uses inputs from multiple different cryptocurrency or Bitcoin trading platforms. You take those inputs in from multiple different platforms, throw out the outliers, and then you average them in time partitions. What we have seen—

Mr. FOSTER. Now, are these platforms all SEC regulated or are these platforms offshore with no clear governance?

Mr. FUSARO. They come from multiple different jurisdictions—

Mr. FOSTER. Some of which we have no control over, and that is one of the fundamental problems in understanding what the quote,

unquote, market price is. If there are unregulated platforms on which a lot of the trading or offshore platforms, is there a solution to that problem?

Mr. FUSARO. So there is a market-based solution, which is that we use this price that is calculated by a third party and includes inputs from many different platforms. Then what we see on the U.S.-regulated market with the Bitcoin exchange-traded product is that it trades very tightly to that price that we see, that we use as an input for valuation.

Mr. FOSTER. All right. My time is up. I yield back.

Chairman HILL. Mr. Sherman is recognized for 5 minutes.

Mr. SHERMAN. I want to thank the gentleman from Illinois for illustrating what I think we all know: crypto does not work without self-hosted wallets. That is the whole point. That is why they call it hidden money, and with these self-hosted wallets, you have a giant hole in our anti-money laundering system. There is another whole currency. That is why we only printed up to \$100 bill, the same maximum bill that we had half a century ago.

The Republican Party has invested Mr. Trump with substantial governmental power. Even today, he is the nominee of one of our two major parties. He has announced that he is now the chief crypto advocate. So on the one hand, he has all that power given to him by the Republican Party. On the other hand, he is trying to make billions of dollars for advocating crypto. That is a conflict of interest that makes Clarence Thomas look like Mother Teresa. We also see that Mr. Trump has advocated that U.S. Government money be "invested," wagered on crypto. That means he takes our taxpayer money, gives it to the Crypto Bros. They get cash. We get whatever the crypto is worth. Maybe it is Hamster Coin. Who knows what it is? Who knows whether it will be worth anything in the years to come? We have another Republican hearing aiming at the SEC in order to enrich the Crypto Bros.

Thank God for the SEC doing all it can to protect investors. Sam Bankman-Fried was not one snake in a crypto Garden of Eden. He is emblematic of this industry that has a scandal every couple of weeks. Now we are told that the SEC is "going rogue." No, they are doing what we appropriated the money to them to do. They have the support of the administration. They have the support, I think, of a majority, or at least a large number of Members of Congress.

Every one of the SEC's enforcement actions is brought in a U.S. Federal court established under Article III of our Constitution. Mr. Reiners, are the Article III Federal courts a proper venue, and do they afford due process? Does the American court system work?

Mr. REINERS. Yes.

Mr. SHERMAN. That is an easy answer. Now, we are told by the crypto industry that they just want clarity. They do not like the fact that they do not know whether they are a security or not a security. Then we are told that somehow if they are security, the form does not meet their specifications. We have, over the last century, developed a system for every other security, every other not intangible investment. It works for soups. It works for nuts. It works for bonds. It works for stocks. Yet, the crypto industry does not want to apply it to crypto and is spending many hundreds of millions of dollars to prevent that.

So I will ask, we have some crypto advocates here, would any of you support legislation that would just eliminate this whole controversy and just declare that crypto is a security, subject to the same very well-developed standards that we apply to all these other investments? If you are in favor of such legislation, please raise your hand.

[Hand raised.]

Mr. SHERMAN. I will point out that one witness raised his hand, but none of the advocates for the crypto industry did so. Okay. Let us see. So then we have the DeFi platforms. Very analogous to the test we faced for what is a security under the Howey Test. Mr. Reiners, under the Howey Test, if you have the promoter handle your oranges and you get the profits from the oranges, that is a security. Would that also apply to having the promoter loan out your crypto or engage in the lending business and then give you the profits? Does the Howey Test make it clear that DeFi lending platforms are secured?

Mr. REINERS. Well, the Howey Test is a facts-and-circumstances-based test, Congressman, so I cannot sort of speak to a general hypothetical like that. In many of these lending protocols the SEC and courts have found that they are, in fact, securities.

Mr. SHERMAN. Thank you.

Chairman HILL. I invite the gentleman to expand on his answer in writing.

Chairman HILL. Now I will turn to my friend from Houston. Mr. Green has 5 minutes for questions.

Mr. GREEN. Thank you, Mr. Chairman. Mr. Reiners, in your information that you have shared with us, you indicate that the crypto industry is eagerly pointing to favorable regulatory regimes abroad as an example for U.S. lawmakers to follow and warning that if U.S. does not act quickly, new and existing crypto firms will set up shop overseas. Do you still stand by that?

Mr. REINERS. Yes.

Mr. GREEN. Okay. Let me continue. You go on to say getting it right is more important than being first. You indicate that passing financial regulatory legislation is hard, and once in place, it tends not to change absent some future crisis. You stand by that?

Mr. REINERS. Yes.

Mr. GREEN. You indicate that we might be looking at some sort of 2008 financial crisis down the road if we do not get it right?

Mr. REINERS. That is correct.

Mr. GREEN. Okay. What is your prognostication? What are you saying? This is pretty strong language. That is why I am asking. What are you thinking will happen if we do not get it right? What will happen?

Mr. REINERS. Well, it is impossible to predict, and I think this industry and this asset class has sort of defied predictions from the very beginning, but, again, it comes back to what is the inherent value in these tokens. Again, they are entirely speculative, and now we have these exchange-traded products that are, you know, I call it a superhighway connecting the traditional financial system with the crypto economy, so that a problem in one could easily spill into the other. So you could have a situation like FTX in the future, and I believe there will be another and probably bigger

version of FTX at some point in the future that could cause real damage in the financial system, right, and you could have interconnections, just like we saw in the 2008 crisis.

I will just note, and you know, I cannot help but, of course, be a bit intimidated by the portrait behind you of Barney Frank, of course, one of the coauthors of the Dodd-Frank legislation, I think you know, which was obviously passed in response to 2008 crisis, right? So, we enact financial legislation after major crises, right? We do not sort of make adjustments sort of along the way. My fear is that if we pass a sort of light-touch regulatory bill for crypto, it is just going to, again, provide a veneer of legitimacy to this asset class, bring in more people and then ultimately, there will be some event where folks get hurt—perhaps it is a systemic risk event—and then we are back to the drawing board.

Mr. GREEN. Well, you mentioned a crisis, and that crisis that you mentioned had, at its root, criminality. Is that something that you see as something that we should be extremely concerned about, given the current regime that is proposed?

Mr. REINERS. Well, there is certainly a lot of criminality going on in the crypto industry but I think the 2008 crisis was more of a kind of classic speculative mania in housing-related assets, and we have certainly seen speculative mania—

Mr. GREEN. No, but you mentioned Fried. You mentioned Sam Fried.

Mr. REINERS. Sam Bankman-Fried?

Mr. GREEN. Yes. You mentioned him. That is criminality. You brought him into it.

Mr. REINERS. Yes. I mean, certainly he engaged in a crime. He was convicted of a crime.

Mr. GREEN. Right.

Mr. REINERS. But it was a crime that was enabled by crypto. He was able to execute the crime by allowing an affiliated hedge fund to borrow FTX customer assets that were secured by tokens that he minted out of thin air, right?

Mr. GREEN. Uh-huh.

Mr. REINERS. So it was a crypto-fueled crime.

Mr. GREEN. Yes. So it is your opinion that we could have more of this, much more of this?

Mr. REINERS. If what, Congressman?

Mr. GREEN. If we do not take the time to regulate appropriately?

Mr. REINERS. Yes.

Mr. GREEN. Okay. My colleague asked a question earlier, and there was only one person to raise a hand. I am just curious, do you think that taking our time is something that would cause us greater harm than we might suffer if we do not immediately regulate, Mr. Gallagher?

Mr. GALLAGHER. Thanks for the question, Congressman. I think the SEC certainly has been taking its time. There is no regulation in place, so regulation by enforcement, as I say in my written testimony, is just not a way to properly regulate these markets. So I encourage, as I do in my testimony, actual regulation, and I encourage legislation also from Congress.

Mr. GREEN. Well, my time has expired. I am concerned about criminality, and I think that Mr. Reiners makes a good point. I yield back.

Chairman HILL. The gentleman yields back. I want to thank our excellent panel today. Thank our members for their engagement and their questions.

Without objection, all members will have 5 legislative days within which to submit additional written questions for the witnesses to the chair, which will be forwarded to the witnesses for their response. I ask our witnesses to please respond as promptly as you are able.

This hearing is adjourned.

[Whereupon, at 11:53 a.m., the subcommittee was adjourned.]

A P P E N D I X

September 18, 2024

9/18/24, 9:58 AM

All the President's Legal Defeats - WSJ

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All the President's Legal Defeats

Biden's agencies keep violating the law and losing in court: the list.

By The Editorial Board [Follow](#)

Sept. 12, 2024 5:49 pm ET



The Supreme Court Building in Washington PHOTO: ANNA MONEYMAKER/GETTY IMAGES

President Biden considers himself a law-abiding fellow. But when it comes to living within the law as established by Congress, his Administration is the most lawless in long memory. His regulators keep rewriting laws as they see fit, and the result is that they keep losing in court in humiliating fashion.

As a public service, and to illustrate the breadth of the law-breaking, we're providing a summary of the legal defeats across five of the most lawless agencies. Clip and save in case Donald Trump or Kamala Harris retain anyone running these agencies.

Federal Communications Commission

<https://www.wsj.com/opinion/biden-administration-legal-defeats-courts-sec-epa-ftc-fcc-gary-gensler-lina-khan-regulation-fc496d28>

1/6

- *Net neutrality rule*. The FCC tried to classify broadband providers as common carriers under Title II of the Communications Act of 1934. The Sixth Circuit Court of Appeals blocked it in August, citing the Supreme Court's major questions doctrine, which holds that regulators need express direction from Congress on consequential rules.

- *National Association of Broadcasters v. FCC*. In 2022 the D.C. Circuit vacated part of a 2021 FCC rule requiring broadcasters to verify the sponsors of programs by checking two federal sources.

Department of Education

- *Student loans*. The Supreme Court ruled 6-3 in 2023 (*Biden v. Nebraska*) that Mr. Biden's plan to forgive \$400 billion in student loans usurped Congress's power of the purse. Mr. Biden then boasted that the Court couldn't stop him and came up with the SAVE plan, which caps payments at 5% of discretionary income and forgives balances after 10-20 years. The Eighth Circuit recently put that plan on hold with a nationwide injunction.

- *Title IX*. Six federal judges this year have blocked a new Title IX nondiscrimination rule from going into effect in 26 states. "The new rule contravenes the plain text of Title IX by redefining 'sex' to include gender identity, violates government employees' First Amendment rights, and is the result of arbitrary and capricious rulemaking," wrote Judge Danny Reeves.

Environmental Protection Agency

- *Clean Power Plan*. In 2022 the Supreme Court vacated an Obama-era rule regulating greenhouse gas emissions. "EPA 'claim[ed] to discover in a long-extant statute an unheralded power' representing a 'transformative expansion in [its] regulatory authority'" in violation of the major questions doctrine, wrote Chief Justice John Roberts for a 6-3 majority in *West Virginia v. EPA*. The Biden Administration has issued a new rule that also uses indirect means to shut down coal plants and is being challenged in court.

- *Waters of the U.S.* In 2023 the Supreme Court ruled 5-4 in *Sackett v. EPA* that dry land on the Sacketts' property doesn't constitute "waters of the United States" under the Clean Water Act merely because it has a tangential connection to a navigable body of water.
- *Good Neighbor Plan.* In June the Supreme Court issued a stay on the EPA's "good neighbor" rule that would have restricted ozone emissions in certain states because of their alleged downwind effect on other states. The EPA's plan "likely runs afoul" of "long-settled standards," Justice Neil Gorsuch wrote for a 5-4 majority.

9:58

Federal Trade Commission

- *Noncompete ban.* In August a federal judge struck down FTC Chair Lina Khan's 2024 rule banning employee noncompete agreements. Judge Ada Brown concluded the FTC lacked legal authority under the FTC Act and that the rule was "unreasonably overbroad without a reasonable explanation."
- *Welsh Carson antitrust case.* In May federal Judge Kenneth Hoyt dismissed an FTC lawsuit against Welsh Carson. The private equity firm had a minority stake in an anesthesiology company, and the judge ruled that even if the anesthesiology firm violated antitrust law, holding a minority stake couldn't make Welsh Carson liable.
- *Administrative law judges.* In 2023 the Supreme Court ruled 9-0 in *Axon Enterprise v. FTC* and *SEC v. Cochran* that companies can take constitutional challenges to federal court rather than having to first go through administrative agency tribunals that invariably rule for the agencies.
- *Meta acquisition.* In January 2023, federal Judge Edward Davila ruled that the FTC did not meet standards of proof in its antitrust case against Meta's acquisition of virtual reality app Within Unlimited.
- *Microsoft purchase of Activision Blizzard.* In 2023 federal Judge Jacqueline Scott Corley dismissed the FTC's attempt to block a Microsoft-Activision merger. "The FTC has not shown it is likely to succeed on its assertion the combined firm will probably pull *Call of Duty* from Sony PlayStation, or that its ownership of

Activision content will substantially lessen competition in the video game library subscription and cloud gaming markets," the judge wrote.

Securities and Exchange Commission

- *Proxy advisory rule.* In June the Fifth Circuit ruled that the SEC's rescission of a 2020 proxy advisory rule was arbitrary and capricious. SEC Chairman Gary Gensler had sought to preserve the duopoly of Glass Lewis and Institutional Shareholder Services.
- *Private fund disclosure rule.* In June the Fifth Circuit blocked the SEC's rule that would have micromanaged contracts between private funds and their investors, saying the agency lacked statutory authority.
- *Debt Box.* In March a federal judge in Utah imposed sanctions on the SEC "for bad faith conduct" in its crypto case against Debt Box. In May the SEC was ordered to pay \$1.8 million in fees and the case was dismissed.
- *Stock buyback rule.* In December 2023, the Fifth Circuit vacated the SEC's rule that required extensive public disclosures when a company decides to buy back its own shares: "The SEC acted arbitrarily and capriciously, in violation of the APA, when it failed to respond to petitioners' comments and failed to conduct a proper cost-benefit analysis."
- *Grayscale.* In 2023 the D.C. Circuit ruled against the SEC's denial of Grayscale's bitcoin fund. "The denial of Grayscale's proposal was arbitrary and capricious because the Commission failed to explain its different treatment of similar products," Judge Neomi Rao wrote for the court.
- *Ripple.* In 2023 federal judge Analisa Torres rejected a significant part of the SEC's case against Ripple's sale of a digital token. Judge Torres ruled that about half of Ripple's token sales did not constitute an illegal securities sale.

This is an extraordinary record of lawlessness, and note the variety of judges who have ruled in these cases. They illustrate the degree to which the

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All the President's Legal Defeats - WSJ

progressive administrative state simply disregards the law as its avatars seek to impose their will on Americans without the consent of the governed.

It's also worth noting that both FTC Chair Khan and SEC Chair Gensler were Sen. Elizabeth Warren's hand-picked choices whom President Biden accepted when he subcontracted his Presidency to the left. They bull-rush their policies via regulation and dare the judiciary to stop them. Americans are fortunate the Founders created an independent judiciary to block this will to undemocratic power.

Appeared in the September 13, 2024, print edition as 'All the President's Legal Defeats'.

Videos



Policy

Due to SEC Inaction, Registration is Not a Viable Path for Crypto Projects

03.23.2023 | By Justin Slaughter, Katie Biber, Rodrigo Seira

See Part II [here](#).

See Part III [here](#).

Getting a startup off the ground involves preparing and filing a lot of documents and forms, most of which are relatively easy and straightforward. For example, a founder will have to file a certificate of incorporation with the Secretary of State's office in order to form a new corporation. They will also need to file Form SS-4 with the IRS in order to get an employee identification number (EIN).

While many founders work with lawyers on this process, it's simple enough that they could do it themselves. As a result, thousands of U.S. small businesses are formed each day.

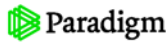
SEC Chair Gary Gensler would like the American public to believe that it is just as simple and easy for crypto founders to register tokens or crypto products with the SEC.

It's not.

Yet in a recent nationally televised [interview](#), Gensler admonished crypto exchange Kraken over the company's failure to register its staking product, which resulted in a [settlement](#) with the SEC pursuant to which Kraken had to pay damages and shut down the program. "These firms, Kraken knew how to register. Others know how to register, it's just a form on our website," he said, without providing further detail. "They know how to do it. They are just choosing not to do it," he added later on.

Gensler elaborated on his message in an [opinion piece](#) a few days following, lamenting that "Frankly, though, crypto intermediaries aren't exactly lining up to register with the SEC and comply with the laws enacted by Congress. Maybe it's simply that their business models rely on being noncompliant."

And yesterday, after years of failing to provide guidance or regulatory certainty to Coinbase, the SEC [sent](#) the Company a Wells notice. According to Coinbase, the SEC threatened the company for listing



Chair Gensler's public comments and actions are self-serving in two ways: they attempt to justify an unconstitutional expansion of the SEC's jurisdiction over crypto by wrongly implying that most crypto products and tokens are securities and should therefore register with the SEC, while also painting the crypto industry as composed of willful lawbreakers who actively chose not to follow simple rules and, like boundary pushing toddlers, are deserving of punishment by the SEC.

Yet, even putting aside the question of whether securities laws apply in the first place, the "forms" representing the "clear" path for crypto projects to "comply" cannot be completed on Legal Zoom or DIY'ed with free online resources. For example, Form S-1, which is used by the most mature private companies when they want to go public or conduct an "IPO," typically takes an army of lawyers and millions of dollars to [complete](#). [Here](#) it is: try making sense of it yourself.

In fairness to the Chair, he never explicitly said that filing a registration form would be easy or cheap. But his suggestion that crypto companies can register by "filling out a form online" fails for a much more straightforward reason: until the SEC adapts the registration framework to the unique aspects of digital assets, it is impossible to "come in and register." The current registration forms rely on a set of disclosures that are inadequate for crypto's unique aspects and leave investors vulnerable. Registration also entails a host of additional regulations for the token, the reporting company, and other participants in the ecosystem that makes the functioning of most crypto protocols impossible.

Indeed, the reason there are virtually no registered token offerings in the US is because the SEC has failed to provide any actionable guidance, issue a single rule or constructively engage with anyone in the crypto industry to provide a workable regulatory framework for security tokens.

The example of Coinbase is illustrative. An SEC registered company itself, Coinbase submitted a [rulemaking petition](#) to the SEC in summer of 2022 that asked for clarity regarding many unresolved issues needed for a functioning market in digital assets, including registration as an exchange and staking. That petition went unanswered. Instead, yesterday the SEC continued its pattern of regulation by enforcement by sending Coinbase a Wells notice covering activities the company was actively seeking clarity on through their public rulemaking.

The claim that crypto projects can "just come in and register" with the SEC today is a fabrication - much more is needed from them if the SEC genuinely wants to provide appropriate investor protection in the crypto asset space.

Our hope is that building consensus on the viability of crypto projects registering with the SEC under the current regime can spur a true, honest discussion about how this industry should be regulated, with



[Part II](#) starts with a general background on the SEC registration process and then reviews the history of the crypto projects that have attempted to register, either as part of an SEC settlement or on their own accord. Understanding the struggles and resulting failures of the majority of these projects illustrates how the “path to registration” is not currently a viable one.

Part III will analyze the current SEC disclosure regime by focusing on Form S-1. We will argue that the current disclosure framework is fundamentally misaligned with most tokens, as it presumes an issuer-security relationship that does not exist in decentralized systems. We will discuss various gaps in the disclosures required by the form and places where clarity is needed to make registration a viable path and adequately inform investors.

Finally, Part IV will underscore how the SEC’s current position, which claims most crypto projects need to be registered, while at the same time making the registration impossible, amounts to a regulatory ban of crypto which exceeds the SEC’s authority.

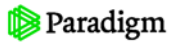
Special thanks to Mike Selig for his review.

Written by

Justin Slaughter, Katie Biber, Rodrigo Seira

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Policy

Lessons from Crypto Projects' Failed Attempts to Register with the SEC

03.23.2023 | By Justin Slaughter, Katie Biber, Rodrigo Seira

See Part I [here](#).See Part III [here](#).

1. What is SEC registration?

The grand bargain of the US securities laws is that any issuer selling securities to the general public must provide the public with a set of disclosures approved by the SEC. These laws are intended to address information asymmetry and ensure that the investing public has the material information necessary to make informed investment decisions. The securities laws are not intended to turn the SEC into a gatekeeper or “merit regulator” that itself decides which projects are investable and which are not. Congress meant for discretion to remain solidly in the hands of individual investors.¹

According to this framework, whenever a crypto project is distributing tokens in a “securities offering,”² it must be either registered with the SEC or comply with an exemption from registration. Most frequently, crypto projects rely on exemptions for private offerings made only to “accredited investors” or only to non-U.S. persons.

However, there are four main paths to registering or qualifying a token offering that includes non-accredited investors under the Securities Act of 1933 (the “1933 Act”):

1. a “mini-IPO” under Regulation A pursuant to [Form 1-A](#)³;
2. offering under Regulation Crowdfunding pursuant to [Form C](#)⁴;
3. a typical IPO by a domestic issuer on [Form S-1](#); and
4. an IPO by a foreign issuer on [Form F-1](#).

In order to register or qualify an offering, the issuer needs to fill out the appropriate form and submit it to the SEC with other documents, including typically 2 years of financial statements. The SEC will review



Even if the token distribution is exempt from the registration requirements of the 1933 Act, if the tokens are considered “equity” securities and the project meets certain minimum asset and holder requirements,⁶ they may also be required to register under the Securities Exchange Act of 1934 (the “1934 Act” and together with the 1933 Act, the “Securities Acts”) by filing [Form 10](#). Form 10 is automatically effective 60 days after it is filed. However, the SEC can provide comments that need to be addressed to prevent the registration from being revoked.

Many crypto projects are understandably concerned that, in exercising discretion when commenting on and approving registration statements (or not), the SEC could overstep its mandate and act effectively as a merit regulator, depriving the public from their ability to choose their own investments. But the SEC’s job is to ensure adequate disclosure of securities opportunities for investors, not to decide what investors can invest in. That power remains entirely with the American people.

In addition, most SEC registration forms reference yet other SEC regulations, most notably Regulation S-K and S-X, which provide for a wide variety of specialized disclosures. There are also “schedules” for registrants in certain industries, such as oil & gas and banking, to address the unique elements of those industries. There are even special rules for issuers of asset-backed securities, excepting these issuers from some requirements applicable to “traditional companies” and adding other disclosures. But has the SEC done the same for companies working on crypto projects? No.

2. What obligations do SEC registered projects have?

Registration is not a “one and done” process. When a project registers a token it will also become a publicly-reporting company that must file annual, quarterly, and current reports, and become subject to the proxy, tender offer, Sarbanes-Oxley, and a host of other rules.⁷

Once a project has registered a token, either under the 1933 or 1934 Act, that token will only be able to trade on a National Securities Exchange, Alternative Trading System (“ATS”), or by brokers OTC.⁸ In addition, many intermediaries dealing with the token will be subject to onerous regulation. However, as stated by Coinbase in its [petition for rulemaking](#), “The U.S. does not currently have a functioning market in digital asset securities due to the lack of a clear and workable regulatory regime.”

This is because tokens that register as securities would not be tradeable on existing crypto exchanges, none of which are registered as a national securities exchange. But there are also no registered national



On the rare occasion the SEC lets a token project legitimize through registration, that token lands in a world lacking the infrastructure necessary to trade it. Specifically, the SEC has refused to license intermediaries such as broker-dealers and exchanges. As a result, the restrictions on the secondary market trading of tokens registered as securities will severely hinder if not totally impede the operation of most crypto projects. The SEC has created a world where project founders are required to register as ice cream, while making freezers illegal. Good luck!

Crypto projects seeking to register tokens or other products will also face a daunting process. Despite the substantial time and extraordinary costs incurred by the few projects that have attempted registration, these projects have [arguably](#) been unable to operate their businesses while complying with the securities laws, or have operated their businesses at a significant disadvantage to others in the market who operate without registration and with no adverse regulatory consequences. In the sections that follow, we will provide an overview of the tokens that have attempted to register with the SEC.⁹

3. ICO era enforcement actions

The earliest attempts at registering tokens under the Securities Acts came as a result of settlements relating to SEC enforcement actions. Six projects that conducted ICOs starting in 2017 — CarrierEQ Inc. (dba "Airfox"), [Paragon Coin, Inc.](#), [Gladius Network](#), [Blockchain of Things, Inc.](#), [Enigma MPC](#) and [Salt Blockchain Inc.](#) — were each charged by the SEC with undertaking an unregistered offering and sale of securities.¹⁰ In order to settle the charges, each of the projects agreed to repay investors, to register their respective tokens as a "class of securities" under the 1934 Act by filing Form 10 and to comply with ongoing reporting obligations.

a. How have those projects fared?

At the time, the SEC [hailed](#) the settlements as "a model for companies that have issued tokens in ICOs and seek to comply with the federal securities laws" and [argued](#) the settlements represented "a path to compliance with the federal securities laws going forward, even where issuers have conducted an illegal unregistered offering of digital asset securities." The SEC even declined to impose additional penalties on each of the projects to account for their respective "remedial" actions, including their commitment to register the tokens as securities.

Yet one can argue the SEC's requirement that these companies register their tokens was not meant to provide an avenue for the projects to continue operating as reporting companies — it was intended only to



longer operating in the US or reporting to the SEC and none of the six tokens has any meaningful utility or market.

These examples reveal that the SEC's suggested "path to compliance" was really an ascent to the afterlife. And while some might dismiss this as worthy punishment for projects that conducted unregistered offerings, it reveals the impossibility of complying with the current SEC regime. A former SEC enforcement lawyer was even [quoted](#) at the time saying the SEC's settlement model was "impractical." Perhaps recognizing this fact, the SEC has largely since stopped requiring projects to register as part of settlements for unregistered offerings of securities.¹¹

AIRFOX

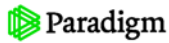
Airfox was a Massachusetts-based start up that, between August and October 2017, raised \$15 million through its ICO of "AirTokens." The company entered into a [settlement](#) with the SEC on Nov. 16, 2018, that included the obligation to register the AirTokens by filing a Form 10 within 90 days. Nearly 4 months later, on March 15, 2019, Airfox [filed](#) its Form 10, which became automatically effective on May 14, 2019, making AirTokens the first token to be registered with the SEC on Form 10. However, Airfox's Form 10 had to be subsequently amended four times in order to respond to SEC comments.

While Airfox initially complied with its obligation to register the AirTokens and make ongoing disclosures, the company was forced to pivot away from their token and in May 2020 was [acquired](#) by a Brazilian retailer. In a [current report](#) filed on Form 8-K, the company noted it would discontinue the development of AirTokens because "[c]urrent laws and regulatory regimes do not provide for the Company to utilize the AirTokens as envisioned by the Company..." Since then, the company has stopped operating in the US and the AirTokens have had no [liquidity](#). The token is effectively dead.

PARAGON

Paragon Coin Inc. ("Paragon") was a Delaware company that raised \$12 million from their 2017 ICO of "PRG Tokens" as part of a scheme to integrate blockchain technology to the cannabis industry. Paragon also entered into a [settlement](#) with the SEC on the same date and on substantially the same terms as Airfox, including the requirement to register the PRG Tokens on Form 10 within 90 days.

On March 29, 2019, more than 4 months after the settlement, Paragon Coin [filed](#) its first and only Form 10 registration, which became automatically effective 60 days after. However, the company failed to answer



According to [reports](#), in April 2020 Paragon announced that it was filing for bankruptcy and ceasing operations, noting that its “plans were impossible to achieve due to several legal mistakes”.

On March 9 of this year, the SEC officially [revoked](#) the registration of the PRG tokens. There is also no [market](#) in the PRG Tokens. This project is dead.

GLADIUS

Gladius Network LLC (“Gladius”) was a Nevada company that was developing a network that allowed participants to rent out spare bandwidth and storage space. The company raised ~\$12.7 million pursuant to its 2017 ICO of “GLA Tokens.”

On February 20, 2019, Gladius also entered into a settlement with the SEC that required it to register the GLA Tokens on Form 10 within 90 days. The Gladius settlement order included an additional provision stating that the company may later choose to file a [Form 15](#) to de-register the GLA Tokens.¹²

The reference to Form 15 supports the view that a crypto asset may initially be offered and sold as part of an investment contract but later (e.g., as a result of sufficient decentralization) no longer be part of any investment contract.

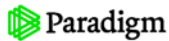
However in Gladius’ case, the company didn’t even file any Form 10 registration statement as agreed to in the SEC settlement, nor did it [reportedly](#) pay back any of the tokenholders, opting to dissolve instead. This project is dead.

BLOCKCHAIN OF THINGS, INC.

Blockchain of Things, Inc. (“BCOT”) was a NY-based corporation that, from December 2017 through July 2018, raised more than \$12 million from its sales of “BCOT Tokens.”

On December 18, 2019, the company entered into a [settlement](#) with the SEC pursuant to which it agreed to register the BCOT Tokens under Form 10 within 120 days. In June 2020, BCOT [filed](#) its initial Form 10 registration, which it had to subsequently amend.

While BCOT temporarily complied with its ongoing reporting obligations, in March of 2023, it announced that it was ceasing operations and liquidating. In connection with the wind down, the company filed a [Form 15](#) to de-register the BCTO Tokens, which is the first and only time tokens have been de-registered, albeit in the contest of a dissolution not a project decentralizing. This project is dead.



the summer and fall of 2017. On February 19, 2020, the company entered into a [settlement](#) with the SEC that required the company to register the ENG Tokens using Form 10.

Like others before it, the company initially complied with the settlement obligations and [filed](#) a Form 10 registration statement, which it subsequently amended three times in response to SEC comments. However, the company stopped making any disclosures after May 31, 2021, and is currently in an administrative [proceeding](#) for being delinquent on its reporting. The ENG Token has virtually no [liquidity](#). This project appears to be comatose at best.

SALT BLOCKCHAIN INC.

Salt Blockchain Inc. (“Salt”) is a Colorado based corporation that operates a lending business that allows borrowers to obtain US-denominated loans collateralized by digital assets. During a period beginning in August 2017 and ending in August 2019, Salt raised ~\$47 million from its sale of “Salt Tokens.”

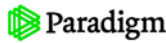
On Sept. 30, 2020, Salt entered into a [settlement](#) with the SEC that included an obligation to file a registration statement on Form 10 within 120 days. In May 2021, Salt filed its initial Form 10, which was subsequently amended four times in response to SEC comments.

While Salt is an exception amongst the group given that it is still operating in the US, the Salt Token itself seems to have been largely deprecated and has almost non-existent [liquidity](#). Despite this, the company has not filed a Form 15 to deregister the token, meaning they are subject to the burden of ongoing disclosure despite the token having no real utility.

Reg A offerings

The next wave of attempts at “compliant” token offerings were done as “mini-IPOs” under Regulation A promulgated under the 1933 Act (“Reg A”). Reg A offerings are technically exempted offerings as opposed to registered offerings, yet relevant to the discussion as they provide a potential alternative for regulated token distributions. As we will see, however, Reg A did not turn out to be a viable path either.

Reg A was updated by the JOBS Act in 2012 to provide an alternative for small companies to raise from unaccredited investors using “slimmed down” disclosures as compared to a traditional IPO on Form S-1. Those wishing to conduct a Reg A offering must draft an Offering Statement including the information required on [Form 1-A](#), file it with the SEC and address any comments before getting “qualified.”¹³



will review and approve the amendment. As described below, this obligation to update the Offering Statement on an ongoing basis can cause significant friction for crypto projects which typically iterate on product quickly and therefore will need to constantly amend their disclosures.

Reg A issuers also have ongoing reporting requirements. Although these disclosure obligations are less burdensome than those required after a fully registered offering, they nonetheless result in material ongoing costs to the token issuers. In addition, a significant challenge for Reg A token offerings is the lack of secondary markets, as the tokens must trade on SEC registered trading venues, none of which are workable options today.

When the Reg A offerings of Hiro Systems PBC (f/k/a Blockstack PBC, “Hiro”) and YouNow (each described below) were qualified in 2019, some argued that Reg A was a “[potential solution](#)” to regulated token distributions.¹⁴ However, as described in more detail below, Reg A offerings did not turn out to be a viable option, partly due to the prohibitively high costs, the restrictions with trading the tokens, and the burden of disclosure obligations. This pathway has also led to a dead-end.

With four years of hindsight, the assessment from those same commentators was stark. The lead lawyer for both Hiro and YouNow recently [noted](#) that “To date, the SEC still has not adopted a single rule with which to govern crypto, has not amended a single disclosure or registration form to reflect the unique aspects of crypto, and has not created a workable process by which digital asset issuers can register their tokens for public sale or trade those tokens in a liquid secondary market.”

HIRO

On July 10, 2019, the SEC qualified the first Reg A token issuance. Hiro’s \$40 million offering of “Stacks Tokens” structured as a “Tier 2” Reg A offering reportedly cost the company \$2.8 million in fees and took over 10 months to prepare.

In addition to being the first, the most remarkable aspect of Hiro’s [Offering Circular](#) was that it laid out the company’s long-term plans for decentralization, noting that its “ultimate goal is that the evolution and development of the Blockstack network become independent of [Hiro].” Therefore, Hiro noted that while it was treating the Stack Tokens as securities “for the foreseeable future,” its Board would be “responsible for regularly considering and ultimately determining whether the Stacks Tokens no longer constitute securities.”

In other words, Hiro had registered the Stacks Tokens as securities out of an “abundance of caution,” but from day one aspired for the tokens to “morph” into non-securities, at which point Hiro would no longer



as investment contracts that are securities under the federal securities laws.”¹⁵

As a result, Hiro would no longer be required to file reports pursuant to Reg A. In making this critical determination, Hiro’s management and Board relied on a legal opinion from Wilson Sonsini, a summary of which was made publicly available.

Despite Hiro’s self-declaration that the Stacks Tokens were no longer securities, the SEC never formally weighed in. And it’s not clear the SEC agrees with Hiro’s position. In its latest [annual report](#), Hiro disclosed that it “is responding to an inquiry from the Division of Enforcement” related to its decision to no longer treat the Stacks Tokens as securities.

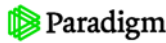
While the SEC staff guidance has stated that the analysis of whether a digital asset represents an investment contract (and thus, a security) may change over time, it has failed to provide any bright line rule or further clarification as to the mechanics of tokens “morphing” from securities to non-securities. Therefore, until the SEC clarifies the point of “transformation,” other token issuers considering a Reg A token distribution will face similar uncertainty as to the status of their tokens as securities.

Hiro’s Offering Circular also acknowledged the limitations on the secondary market for registered tokens, noting that “there may not be a trading market available for the Stacks Tokens, or any digital token exchange on which holders of Stacks Tokens may transfer or resell their Stacks Tokens... As a result, the tokens may initially only be traded on very limited range of venues, including US registered exchanges or regulated alternative trading systems for which a Form ATS has been properly submitted to the SEC.” The disclosure continues by noting that “As far as we are aware, there are currently no national securities exchanges or exchanges that have been approved by the [FINRA] or registered under Form ATS with the SEC... to support the trading of Stacks Tokens on the secondary market.”

YOUNOW - PROPS

Also in July 2019, just a few days after the qualification of Hiro’s Reg A offering, the SEC qualified the Reg A [Offering Circular](#) of YouNow, Inc. (“YouNow”), which allowed the company to distribute up to \$50 million worth of Props Tokens (“Props”) as part of its loyalty rewards program.

Despite [reportedly](#) spending over 2 years working with the SEC to get the Props offering qualified, in August 2021, YouNow [announced](#) that “given the regulatory constraints” they no longer had a “viable future.” In particular, YouNow pointed to its obligation to update disclosures on an ongoing basis and the lack of a secondary market for its tokens as the reasons it was shutting down, explaining that:



a result, we are unable to follow anything remotely like proper product development of “launch, measure, iterate” and struggle to launch new key functionalities we develop (like staking or per-app tokens). In addition, although we submitted to the regulation of Props Tokens as qualified securities, no U.S. exchange has been able to list crypto assets such as the Props Token, which has hindered holders wishing to trade them.”

According to YouNow, these regulatory restrictions meant that the company had “not been able to develop Props Tokens in ways that could lead to commercial success, and there is no reasonable prospect of that happening in the future, given the regulatory framework.” As [described](#) by CoinDesk at the time, “The news certainly puts a damper on the viability of Reg A for token founders looking to build the next-generation web powered by crypto.

CERES

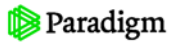
Since the SEC’s qualification of Hiro and YouNow in the summer of 2019, there has only been one other Reg A token offering qualified by the SEC. After responding to eleven rounds of SEC comment letters and amending their [Offering Circular](#) five times over a period of over two years, Ceres Coin LLC (“CERES”) had its Reg A offering qualified on March, 2021.¹⁶

As described in its Offering Circular, CERES intends to develop a private blockchain to enable participants in the cannabis industry to transact more efficiently. However, the company has yet to finalize the development of the private blockchain or issue any tokens and has to date recorded no revenue.

5. The History of Attempted Registrations Show it is Not Currently a Viable Path

Recounting the history of crypto projects that have tried to register their tokens with the SEC is like taking a walk through a cemetery. As we have shown in the case studies above, the projects that attempted to come into compliance with the SEC’s registration requirements expended great effort and resources yet ultimately most of them failed, and those that persist do so in a state of uncertainty and comparative disadvantage.

The failure of projects that have attempted to register is due in large part to the SEC’s reluctance to provide a workable framework through rulemaking, exemptive relief, guidance and industry engagement. Instead, the agency’s preferred approach has been to engage in a highly publicized campaign



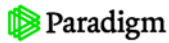
register, including by filing a public [rulemaking petition](#) and meeting with the staff over 30 times in the preceding nine months.

In the forthcoming Part III of this series, we will further analyze why the applicable disclosure regime is not fit for purpose when applied to crypto, focusing on Form S-1. Part IV will then underscore how the SEC's current position represents in practice a ban of the industry that exceeds the agency's authority.

Special thanks to Mike Selig for his review.

Footnotes

- 1 Chair Gensler has acknowledged that "We're not a merit-based regulator primarily, we're primarily a disclosure-based regulator and that's the basic bargain. The public gets to decide what risk they want to take." See [A Fireside Chat with SEC Chair Gary Gensler](#). ↵
- 2 We believe most token offerings would not qualify as securities offerings and in the event that they do, the "investment contract" transaction should not be confused with the token, which is the underlying object of that transaction. See Lewis Cohen et al, [The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets Are not Securities](#), as well as our amicus briefs in the [Ripple](#) and [Wahi](#) cases. ↵
- 3 Reg. A offerings are technically not a registered, but an exempted, offerings. However, we include them in our analysis as they are an alternative path to offering tokens to the public. ↵
- 4 In a Regulation Crowdfunding offering, issuers will only be able to issue up to \$5m worth of tokens in a twelve month period. ↵
- 5 The issuer will have limited ability to make "offers" before the registration statement is effective. ↵
- 6 \$10 million of assets and has at least 500 non-accredited or 2,000 total holders of record of those equity securities. ↵
- 7 Projects that qualify an offering under Reg. A will be exempt from 1934 Act reporting requirements so long as they comply with Reg. A's own reporting requirements, which are a similar but streamlined version. ↵
- 8 Securities issued as Reg CF offerings must trade on Crowdfunding Platform. ↵



- 10 Importantly, none of the charges included allegations of fraud. [↗](#)
- 11 See, e.g., the SEC's [settlement](#) with Block.one, which raised \$4.1 billion, which is orders of magnitude more than the ICO issuers that were required to register. [↗](#)
- 12 Specifically, the Gladius order noted: "If Respondent plans to file a Form 15 to terminate its registration pursuant to Rule 12g-4 under the Securities Exchange Act of 1934 on the grounds that the GLA Token no longer constitutes a "class of securities" under Rule 12g-4 because the GLA Token is no longer a "security" under Section 3(a)(10) of the 1934 Act, Respondent will notify the Commission staff at least thirty (30) days prior to such filing. Upon such notification, the Commission staff may make reasonable requests for further information, and Respondent agrees to provide such information, as applicable". [↗](#)
- 13 There are two "tiers" of Reg A offerings: Tier 1, which is capped at \$20 million in a 12-month period; and Tier 2, which is capped at \$75 million in a 12-month period. Amongst other differences, issuers in Tier 2 offerings are not required to register or qualify their offerings with state securities regulators, which can provide meaningful relief for projects looking to offer their tokens to all Americans. [↗](#)
- 14 A WSJ [article](#) at the time framed it in these terms: "The Securities and Exchange Commission on Wednesday cleared blockchain startup [Hiro] to sell bitcoin-like digital tokens, a first-of-its-kind offering that could give young cryptocurrency businesses a new fundraising template". [↗](#)
- 15 Hiro is no longer in the position of providing, and will no longer be able to provide, essential managerial services to the Stacks Blockchain. Management concluded further that if Hiro is no longer in the position of providing, and will no longer be able to provide, essential managerial services to the Stacks Blockchain, then it is no longer necessary for Hiro to treat the Stacks Tokens as investment contracts that are securities under the federal securities laws. [↗](#)
- 16 Chair Gensler's nomination was pending before the full Senate in March 2021, and he was confirmed by the Senate in April 2021. While there is only one SEC Chair at a time, Acting Chairs traditionally keep nominees for SEC Chair abreast of key decisions leading up to their confirmation and avoid taking major actions without the tacit approval of the incoming Chair. [↗](#)

Written by



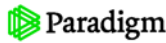
Policy

The Current SEC Disclosure Framework Is Unfit for Crypto

04.20.2023 | By Justin Slaughter, Katie Biber, Rodrigo Seira

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assets that may not even constitute “securities” into an ill-fitting disclosure framework is bad policy: it fails to provide crypto asset users and investors with the information they need, while also denying crypto entrepreneurs a viable path to compliance.¹

As we note in Section 2 below, the current SEC disclosure framework was established in the 1930s and designed to regulate the securities issued by centralized companies for fundraising. However, as discussed in Section 3, crypto asset markets differ from securities markets in fundamental ways. Unsurprisingly, without major changes to the SEC’s current disclosure regime, the SEC is unable to effectively regulate crypto asset markets.

Section 4 discusses two key issues that need to be clarified to determine whether transactions involving the sale of crypto assets are required to be registered in the first place. Section 5 then highlights how the current disclosures required by [Form S-1](#), one of the most widely used registration forms, do not provide the right mix of information to crypto asset users or investors.²

This is not to say that developers of crypto projects should be exempt from having to make any disclosures when they fundraise through the sales of crypto assets. Rather, our point is to highlight why regulators need to be more thoughtful about developing a viable framework that gives tokenholders the information they need and deserve.³

2. Current SEC disclosure regime was developed for securities issued by centralized companies

Securities such as stocks and bonds represent a legal claim against, or interest in, the assets and profits of a specific legal entity. Those legal entities are controlled by company management and a group of “insiders” who have access to non-public information that can affect the value of the company’s securities and can be exploited to the detriment of the public and the market.

As discussed in Part II, federal securities laws address information asymmetries by requiring issuers of securities to register and publicly disclose material information to enable investors to make informed investment decisions. While the Securities Act of 1933 (the “1933 Act”) is the principal federal statute governing public offerings of securities, it is supplemented by various rules and regulations promulgated by the SEC that include additional requirements for public offerings of securities, including Regulation C,⁴ Regulation S-K⁵ and Regulation S-X.⁶ In addition, most issuers of registered securities are required to keep these disclosures current by filing quarterly and annual reports, as well as disclosing material events as they arise.



relationship (e.g., stocks or bonds). It is this legal entity, this issuer, that of necessity is the driver of the value to investors in securities. Accordingly, when a company registers an offering of securities on the SEC's [Form S-1](#), it is required to provide a number of disclosures about the company's history, operations, financial statements, leadership, risks it may face, and other information about its business. While these disclosures are clearly relevant for investors trading securities issued by centralized legal entities, they fail to adequately inform crypto asset users and investors because, as shown in the next section, the disclosures do not reflect crypto assets' unique qualities.

3. Markets for crypto assets differ fundamentally from securities markets

Crypto asset markets differ in meaningful ways from securities markets. As a result crypto requires a different regulatory framework with disclosures tailored to the unique nature of crypto assets and market regulation that reflects the "stack" on which crypto assets trade. As explained below, an adequate disclosure framework for crypto assets that are sold in investment contract transactions must, at a minimum (a) distinguish between the legal rights against issuers that define securities and the technological abilities in protocols that define many crypto assets; (b) reflect that, unlike securities, crypto assets exist independent of the entity that initially sold these assets in fundraising transactions; (c) reflect that crypto assets can accrue value differently than securities; and finally (d) reflect that crypto assets operate, trade and settle on a very different technology "stack" than that used for the trading of securities.

a. Most crypto assets do not provide legal rights against an identifiable "issuer," but rather provide technological abilities enforced by a blockchain-based protocol

As compared to stocks or bonds, crypto assets typically do not represent ownership of an interest in a legal entity, nor any type of legal claim against one.² Even when crypto assets are originally "minted" by a development company, they generally do not make the token holders part owners of that company, nor do they provide any legal rights to dividends or other income generated by that company. Crypto assets also do not typically provide any governance rights applicable to a company, such as the right to elect the board of directors or to vote on other matters directly affecting the company.

Instead, owners of crypto assets are endowed with certain technological abilities within a protocol that are enabled by smart contract code. While these technological abilities are sometimes referred to using terminology borrowed from corporate law (e.g., "governance rights"), they are completely different from



technological abilities can also be outside of the control of the individual or entity that originally deployed the code that created the crypto assets and related protocol.⁹

In stark contrast, securities rely on legal rights against a centralized entity, like a shareholder's right to receive a dividend from a company or vote to elect its board. These legal rights need to be enforced through an ex-post adjudication by a judicial or similar proceeding. As discussed further in Section 5(a), an appropriate disclosure regime needs to recognize and address this critical difference between legal rights and technological abilities if it is to provide adequate information to tokenholders. Current securities regulations simply do not accomplish this.

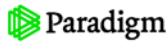
b. Crypto assets can exist independent of the existence of an "issuer"

Crypto assets are also fundamentally different from securities because they can exist and function as intended independent of the ongoing existence of the legal entity that created them. In some instances, crypto assets may even be created programmatically through a process that does not involve any legal entity that could be classified as the "issuer" of the assets.

Securities of necessity depend on their issuer—the legal entity that created them—for their continued existence. For example, if a company dissolves, its shares cease to exist in any meaningful way, becoming at best a useless paper memento of strictly historical interest.

However, crypto assets lack this dependence on an "issuer" and can continue to exist notwithstanding the dissolution of the company that created or "minted" them.⁹ Crypto assets created using an immutable protocol deployed on a public blockchain will retain their full on-chain functionality despite the dissolution of the entity that created them. This is because, as we discussed above, crypto assets do not depend on legal claims against a corporate entity, but rather on technological abilities provided by smart contract code deployed on a distributed protocol. This results in an arrangement that can be much more resilient in the face of extraneous or endogenous factors that may affect the going concern value of the issuer of securities or its ability to meet contractual promises contained in instruments it issued.

In addition, some crypto assets are created programmatically in a process that does not require the actions of a legal entity (or individual) at all. For example, the Ethereum blockchain programmatically distributes new ether tokens to validator node operators that stake existing ether tokens to be able to validate transactions on the network. Those new ether tokens are not "issued" by a corporate entity for capital formation purposes, but rather automatically distributed to validators pursuant to the network's consensus mechanism as a reward for confirming transactions and contributing to the security of the



Therefore, the current disclosure regime's myopic focus on the concept of an issuer, wholly appropriate when looking at securities, is at odds with the nature of crypto assets which exist independent of any issuers.

c. Crypto assets accrue value differently than securities

Another key difference between crypto assets and securities is how each of them accrues value. It is basic financial dogma that the price of a company's shares reflects the markets' expectations of that company's future financial performance ("discounted cash flow"). However, the value of many crypto assets is not tied to the financial performance of any centralized entity. This is most evident when looking at the markets for the most widely adopted and decentralized crypto assets like BTC or ETH which, like other commodities markets, are largely driven by general market forces and expectations of the future demand for use of the related protocol.¹¹

But even in the context of nascent crypto projects that were launched by a development company, the value of crypto assets is often largely driven by factors other than the financial performance of the development company.¹²

People obtain crypto assets to use them within blockchain networks and applications or to hold them in anticipation of increased future demand for such use, as opposed to securities which are only ever passively held. A crypto asset's utility as well as the underlying protocol's mechanism design can therefore influence the value of the crypto asset more than the financial performance of the entity that created them.

Moreover, given the open-source nature of most crypto asset-based projects, many crypto assets also accrue value from the contributions of a diverse group of developers outside of the development company or "founding team," some of whom may remain pseudonymous. It is not uncommon for a development company to write the initial codebase for a new network or application, mint a native crypto asset, and subsequently seek to decentralize control of the project. For example, the development company may opt to transfer the permission to upgrade the smart contracts related to a specific network or application to crypto asset holders or a DAO so that future upgrades are decided by consensus. The developers can also transfer the permissions to a "burn" address, ensuring that no one is able to make any future changes.¹³

Further, such networks and applications may even be subject to "forks" and upgrades that are not supported or anticipated by the original developer. For example, the current Ethereum network is actually a fork of the original Ethereum network created in 2016 and now known as "Ethereum Classic".



have better information about the value proposition of the network or application relative to the broader decentralized community.

d. Crypto assets operate on a fundamentally different “stack” than securities

Crypto assets are also unique because they are traded on a fundamentally different technology “stack” than that used in the markets for securities. The shares of public companies, in particular, are traded, settled and custodied using a relatively archaic system that provides opportunities for numerous rent-seeking intermediaries. Therefore, while Chair Gensler may like to refer to his brokerage account as containing “digital assets,” these assets operate fundamentally differently than crypto assets.¹⁴

Publicly offered securities are typically issued using a paper certificate or are “dematerialized” (i.e., “certificateless”). The certificate or electronic record for a dematerialized security typically includes information about the security, such as the name of the issuer, the name of the holder and details regarding transfer restrictions. It is common for a security to be registered in “street name,” or in the name of the purchaser’s broker-dealer, rather than in the name of the purchaser. Many broker-dealers are members of The Depository Trust Company (or “DTC”), which is a not-for-profit SEC-registered clearing agency that custodies stock certificates and manages records of dematerialized securities. National securities exchanges require retail investors to purchase and sell securities on the exchange via intermediation by a broker-dealer that is a member of the exchange and such transactions are settled by a clearing agency, such as the DTC.

In contrast to stock and bond certificates, crypto assets can trade and settle peer-to-peer on a 24/7 basis and be custodied directly by their owner, all without the need for any intermediaries. In addition, public permissionless blockchains rely on independent and unaffiliated entities to operate the nodes that process transactions, secure the network, and approve software implementations, which means, among other things, that major changes to the network require adoption by independent parties.

The current regulatory framework for securities reflects the legacy market structure of the securities market. Forcing the trading of crypto assets into this framework would significantly hobble the development of the technology in the US by requiring it to run on the very rails it seeks to replace.

4. Clarity is needed to determine whether registration is required



projects to conclusively determine the fundamental question of when registration would be required and how such registration should be effected.

a. When are crypto assets securities

At this point, there is a general consensus that at least some crypto assets, in particular, BTC and its various forks or variations, are not securities. In addition, while Chair Gensler has been [unable to convey](#) a concrete view on this subject, most thoughtful commentators have concluded that ETH is also not a security—certainly, the CFTC has reached this conclusion.¹⁵ However, there is no clear agreement as to how the judicially mandated Howey and Reves tests would apply to most other crypto assets.¹⁶ As a result of the inherent complexities of these legal tests and the SEC’s unwillingness to meaningfully clarify their views as to how these tests should be applied to crypto assets,¹⁷ projects are incapable of making a definitive determination as to the status of most crypto assets.

Both the Howey and Reves tests call for an assessment of the specific facts and circumstances associated with a given transaction to determine whether the federal securities laws apply. The tests are typically applied remedially, after a transaction has already occurred and a dispute has arisen which the parties are seeking to resolve in court. The “20/20 hindsight” and heavily fact-dependent nature of the analyses called for by these precedents can make it challenging for projects distributing crypto assets to apply these tests prospectively. The entity selling tokens must consider the totality of the facts and circumstances surrounding the transaction in advance and then speculate about how a court would view the arrangement in hindsight. Further, even where an initial fundraising sale of crypto assets can be safely categorized as a securities transaction, the treatment of the assets themselves is often much less clear. For example, it appears that the SEC’s view is that events that occur after the crypto assets have been initially sold (e.g., reliance on future efforts to upgrade a network or application, responses to an exploit, etc.) could impact whether the asset itself should be treated as a security, at least temporarily.

The securities analysis of tokens has been further complicated by the SEC staff’s suggestion that a token’s status can “morph” from being a security to a non-security (and potentially even back again!).¹⁸ Projects like Hiro, discussed in Part II, and more recently Web3 Foundation (in respect of the Polkadot network’s native token, DOT), have publicly taken the position that their tokens were once investment contracts and therefore a security but are no longer.¹⁹ However, as previously discussed, there is currently no clarity as to when, if ever, it is appropriate to consider that a token has either become, or ceased to be, a security.



In addition to clarifying whether (or when) crypto assets are securities, the SEC must clarify what type of securities they are.

The current SEC disclosure regime is designed for traditional corporate entities that generally issue equity and debt securities for purposes of raising capital. For example, Form S-1 requires issuers to determine whether the securities to be offered are equity or debt securities for purposes of evaluating the need to make certain disclosures.²⁰

The SEC most commonly characterizes crypto assets as “investment contracts,”²¹ a term the Supreme Court defined broadly enough to encompass both equity or debt securities for registration statement purposes.

Although the SEC staff has not provided formal guidance on the topic, it has indicated that some crypto assets that are investment contracts should be considered equity securities under Regulation C.²² However, some practitioners have pushed back on the SEC’s reasoning, arguing that the agency misreads the statutes.²³

The distinction between equity or debt (or something else) is critical because it has many downstream effects for the entity deemed to be the issuer. For example, if the crypto assets that are investment contracts are deemed to be equity securities then the Section 12(g) registration requirements of the Securities Exchange Act of 1934 will apply. In addition, outside of the area of securities law, in the context of crypto assets that can earn a reward from staking or other activities, the distinction between equity and debt can affect the characterization of any income stream and their tax status.

5. Current disclosure requirements do not provide the right information about crypto assets

Assuming that some crypto assets are considered securities and therefore subject to registration, the current SEC disclosure framework will need to be significantly adjusted and clarified in order to provide the market with the right mix of information about those crypto assets.

a. What information about crypto assets is “material”?

Issuers of registered securities are required to publicly disclose all “material” information related to an investment opportunity so that investors may make an informed decision. The Supreme Court has



However, since the disclosure requirements of Form S-1 and Regulation S-K are tailored for offerings of securities by centralized corporate entities seeking to raise capital to run a business enterprise and, as we explained in Section 3, crypto assets differ fundamentally from this, the current disclosure requirements do not capture material information for crypto assets. In fact, the typical information required by securities laws could be misleading to crypto asset investors, who may believe that information is material simply because the SEC mandated its disclosure, when it is not. Moreover, some of the material information that crypto asset users and investors would want to know is publicly available to technologically sophisticated participants.

Despite adding controversial disclosure requirements related to topics like climate change,²⁵ the SEC has not provided any guidance with respect to the types of disclosures it views as material in the context of crypto assets that are securities. As a result, the question of what information would be relevant (or “material”) to purchasers has been left to ad hoc determinations by the sellers of these crypto assets. Nor has the Commission tailored a distinct registration statement form for crypto asset security offerings, as it has done for other types of securities.²⁶ The need for this guidance was even acknowledged by Chair Gensler who noted that “it may be appropriate to be flexible in applying existing disclosure requirements,” and that “[t]ailored disclosures exist elsewhere — for example, asset-backed securities disclosure differs from that for equities.”

In the subsections below, we analyze the current disclosure requirements that are inadequate with respect to crypto asset securities, as well as various missing disclosures.

b. Current disclosure requirements are focused on information that is not material for owners of crypto assets

I. BUSINESS AND FINANCIAL INFORMATION

Form S-1 and SEC Regulation S-K require the issuer to provide a detailed description of the issuer’s business and “revenue-generating activities, products and/or services,” along with audited financial statements.²⁷ In addition, besides having to provide a full suite of audited (and, if applicable, unaudited interim) financial statements, registrants must include a highly detailed discussion of those financial statements known as “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (or “MD&A”). While it may be possible for some sellers of crypto asset securities to provide such information, in many instances this information may not be particularly material and could wind up actually being misleading to purchasers.



blockchain network or application, the selling entity may not have any future business or revenue-generating plans that would be relevant to an initial or subsequent purchaser. Simply put, the original creators of crypto assets often have little relevance to the value of the asset being sold and only become less relevant over time.

Information about the issuer's ongoing business activities and financial statements may therefore not be material to investors on an ongoing basis. By contrast, investors will likely deem to be more material certain information about the network or application that is unrelated to the business of the selling entity and that is not contemplated by Form S-1 and associated disclosure regulations.

The technical requirements of Form S-1 and Regulation S-X (as to financial statement information) may also present challenges for issuers that can result in purchasers being misled. For example, Regulation G requires issuers that present non-Generally Accepted Accounting Principles ("GAAP") information to present the closest GAAP measure and a reconciliation. Since accounting standards like GAAP have not yet been updated to reflect the unique qualities of crypto assets, in practice this makes it very difficult to clearly present financial information that can be most relevant for disclosure.

II. ISSUER AND TEAM INFORMATION

Form S-1 and Regulation S-K are tailored for securities offerings made by a single legal entity issuer with a traditional management structure. For example, the issuer is required to disclose biographical information for the executives,²⁸ board of directors and certain other significant employees,²⁹ along with their compensation and benefits, holdings in the company, and other information.

However, as we have noted above, information related to the management of the legal entity deemed to be the "issuer" will often be less important in the context of crypto asset securities than it is for most other types of securities. Crypto assets are often launched by a distributed community that does not have a clear hierarchy or clearly defined bounds. In some extreme situations, the asset seller itself may dissolve and the team move on to do other things. In others, the original team will remain and continue working on the project, but over time purchasers may come to care more about third-party contributors who may not work on the project full time or have any formal relationship to the legal entity. It is not clear what level of disclosure would apply to these contributors. If covered by the disclosure obligations, they would not have the option of remaining anonymous, as is common today.

III. USE OF PROCEEDS



ether, but there is no centralized entity that receives proceeds in connection with these distributions. Additionally, it is common for crypto assets to be “air dropped” for free to users of an application or holders of a particular type of crypto asset.

Moreover, the use of proceeds may not be determined by the issuer of the crypto assets and such proceeds may accrue to another person rather than the original seller, making it impossible for the seller to adequately disclose the relevant information in a registration statement. For example, it is common for a group of founders, who sometimes form development companies, to distribute a token and direct the proceeds to a community “treasury” (i.e., a blockchain address typically controlled by a “multi-sig” wallet typically by the vote of the tokenholders themselves.

c. Missing disclosures

In addition to focusing on information that is not relevant, current disclosure requirements also do not cover a number of features unique to crypto assets that would be considered material when making an investment decision. Since others have written extensively on the subject of disclosures for crypto assets, we only highlight some themes below.³⁰

I. GOVERNANCE

While the current SEC disclosure framework focuses extensively on the corporate governance rights that the holders of securities have relative to an issuer, the disclosure framework completely misses the “governance abilities” that crypto assets have relative to their native protocols. As described above in Section 3(a), crypto assets largely derive their value and functionality on the basis of technological power they can exercise in a network. Understanding “governance” in the context of crypto assets therefore calls for different disclosures than in the context of securities.³¹

For example, it is critical for holders to understand the extent to which their token votes or other actions are self-executing or “on-chain,” as opposed to “off-chain”, relying on a legal or social enforcement mechanism. A tailored disclosure framework would also delve into how code upgrades can be implemented, including highlighting whether specific smart contracts are upgradeable and if so, which network addresses have the upgrade permissions and who controls those addresses.

II. SECURITY



Given the severity of the cybersecurity threat in crypto, a tailored disclosure framework that focuses on the unique security issues raised by crypto assets and networks is required to protect investors and users.

For example, the developers could be required to disclose any code audits provided the related software documentation and accompanying commentary. In addition, any incentives for white hat hackers to submit bug bounties or perform rescues would be material.

III. NETWORK OR APPLICATION DESIGN

Unlike companies that offer stock or bonds, sellers of crypto assets are typically offering an asset associated with a blockchain network or application. Although most projects publish the open-source code associated with the network or application, most purchasers of crypto assets lack the technological sophistication to read and understand the code. Accordingly, purchasers of crypto assets are likely to be particularly interested to learn more about the technical design of the network or application in making a decision to purchase the crypto asset. Indeed, the blockchain network or application may continue on well after the issuer is no longer operational.

IV. TOKENOMICS

The “tokenomics” of crypto assets is highly material to investors but not currently covered by the disclosure requirements. For example, information including the initial allocation of the tokens, total supply of tokens and future issuance schedule can have material impact on a crypto asset’s value.

V. CONSUMPTIVE USE / UTILITY

Securities are by and large passive investment instruments that cannot be used or consumed in the same way as a commodity or collectible. But crypto assets are generally designed to be used within a blockchain network or application. Accordingly, purchasers of crypto assets are likely to desire information related to how the crypto assets can be used - or the crypto assets’ “utility.”

6. Conclusion



disclosure considerations. Unfortunately, the current SEC Chair and staff have failed to recognize the uniqueness of crypto assets and are instead engaged in a campaign to attempt to brute force crypto into an ill-fitting disclosure regime. This campaign will ultimately harm the same public the SEC is tasked with protecting.

As Nobel prize winning economist George Akerlof argued in his seminal [paper](#) “The Market For ‘Lemons’”, the quality of goods in markets that lack disclosure standards and exhibit information asymmetries between participants degrade over time. Applied to the market for crypto assets, Akerlof’s theory shows how the SEC’s insistence on applying an ill-fitting disclosure framework to crypto assets will result in the quality of crypto assets degrading, with direct harm to users, investors and the market generally.

While the SEC Chair’s repeated catchphrase that crypto projects must “come in and register” might make for a good soundbite, it is no substitute for thoughtful policy. In order to fulfill its mission, the SEC must radically change course and work with the crypto industry to develop tailored disclosure requirements that provide crypto users and investors with the information that they need.

Footnotes

- 1 See Chris Brummer, Disclosure, Dapps and DeFi, Jun 29, 2022, Stanford Journal of Blockchain Law & Policy, available [here](#), for the first published analysis of the ambiguities in the securities disclosure framework as applied to DeFi and Chris Brummer, Trevor Kiviat, Jai R. Massari, What Should be Disclosed in an Initial Coin Offering?, Dec. 17, 2018, available [here](#), for the first published analysis of securities disclosures as applied to ICOs. These seminal pieces should be consulted by anyone interested in these topics. [↗](#)
- 2 There are of course many other registration forms, including S-2 and S-3, F-1, F-2, F-3 and others. While our analysis below focuses solely on Form S-1, we believe the same arguments would apply to the rest of the registration forms, which share Form S-1’s general structure. [↗](#)
- 3 SEC Commissioner Hester Peirce recently expressed her frustration with the SEC’s approach, noting that “[t]oday’s Commission tells entrepreneurs trying to do new things in our markets to come in and register. When entrepreneurs find they cannot, the Commission dismisses the possibility of making practical adjustments to our registration framework to help entrepreneurs register, and instead rewards their good faith with an enforcement action.” (Hester M. Peirce, Commissioner, SEC, “Rendering Innovation Kaput: Statement

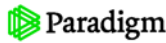


- registration statement, including requirements related to proper form, incorporation by reference, confidential treatment, and submission to the SEC. 17 C.F.R. Part 230. [↗](#)
- 5 Regulation S-K details the requirements for disclosing certain non-financial qualitative descriptors that issuers must include in the registration statement. 17 C.F.R. Part 229. [↗](#)
- 6 Regulation S-X describes the requirements for the disclosure of financial statements in the registration statement. 17 C.F.R. Part 210. [↗](#)
- 7 Lewis Rinaudo Cohen, Gregory Strong, Freeman Lewin, Sarah Chen, The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets Are Not Securities (Nov. 10, 2022), available [here](#). [↗](#)
- 8 Smart contracts are immutable by default, meaning they cannot be removed or updated by anyone once deployed. It is possible for the smart contract's developers to, prior to the smart contract's deployment, include the ability to update its functionality. This ability to update functionality can be revoked by transferring the permissions for this ability to a "burn" Ethereum address for which there is no corresponding private key. This placeholder is known as "the zero address." Once the ability to update a contract has been revoked, it cannot be reclaimed and the contract can no longer be changed. [↗](#)
- 9 For example, MakerDAO, the community behind the stablecoin DAI, dissolved the foundation they relied on during the early stages of the project. [↗](#)
- 10 See Proof of Stake Alliance, U.S. Federal Securities and Commodity Law Analysis of Liquid Staking Receipt Tokens (Feb. 21, 2023), available [here](#). [↗](#)
- 11 Nareg Essaghoolian, Initial Coin Offerings: Emerging Technology's Fundraising Innovation, 66 UCLA L. Rev. 294, 304 (2019) ("Since Bitcoin is not backed by the trust of a central authority, its value is derived solely by market forces."). [↗](#)
- 12 Michael Selig, What If Regulators Wrote Rules for Crypto?, CoinDesk (Jan. 23, 2023), available [here](#) ("Crypto assets are network assets. Unlike firms, networks are generative. The value of a network derives from the applications, organizations and projects built on the network by its users."). [↗](#)
- 13 See FN 7 for more detail. [↗](#)
- 14 House Financial Services Committee, Hearing Entitled: Oversight of the Securities and Exchange Commission, April 18, 2023, available [here](#). [↗](#)



exchange to list an ETH futures product if ETH was a security. “I’ve made the argument that Ether is a commodity. It’s been listed on CFTC exchanges for quite some time and for that reason it creates a very direct jurisdictional hook for us to police obviously the derivatives market but also the underlying market as well ... we would not have allowed the product, in this case the ether futures product, to be listed on a CFTC exchange if we did not feel strongly that it was a commodity asset.”. [↗](#)

- 16 See S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946) and Reves v. Ernst & Young, 494 U.S. 56 (1990). Outside of Howey and Reves, the SEC has argued that certain crypto assets meet the definition of “security” for other reasons. For example, in SEC v. Terraform Labs PTE Ltd., Case No. 1:23-cv-01346 (S.D. NY Feb. 15, 23) (complaint), the SEC argues that UST is a security because it is a right to purchase a security and wLUNA is a security because it is a receipt for a security. [↗](#)
- 17 Strategic Hub for Innovation and Financial Technology, Framework for “Investment Contract” Analysis of Digital Assets (Apr. 3, 2019), available [here](#) (the “FinHub Framework”). The FinHub Framework expands the four prong Howey analysis into approximately fifty non-exhaustive factors, none of which is necessarily intended to be weighted more heavily than any other or to be dispositive as to security status. [↗](#)
- 18 As former SEC Director of Corporation Finance William Hinman noted in [public remarks](#), it is possible for a crypto asset to initially be offered and sold as a security because it is part of an investment contract, but later no longer be part of any investment contract (e.g., as a result of decentralization of the associated network or application). [↗](#)
- 19 Web3 Foundation Announces Polkadot Blockchain’s Native Token (DOT) Has Morphed and Is Software, Not a Security, November 10, 2022, available [here](#). [↗](#)
- 20 The form requires issuers of equity securities to specify the dividend rights associated with each security and whether the issuer intends to pay cash dividends to holders (and, if the issuer has sufficient earnings to do so, the reason that the issuer does not plan to do so). Additionally, issuers of equity securities must outline the voting rights, liquidation rights, preemption rights, and sinking fund provisions associated with the securities, among other things. Importantly, the form assumes that the dividend, voting, and preemption rights are associated with the issuer legal entity rather than a blockchain network or DAO. Issuers of debt securities must provide disclosures with respect to, among other things, maturity, interest, conversion, redemption, amortization, sinking fund, and retirement. [↗](#)
- 21 The SEC has also recently argued that certain crypto assets are securities under theories that such assets constitute a right to purchase a security, a receipt for a security and a security-based swap. (See, e.g., SEC v.



2019), available [here](#) (although issuer noted that it does not believe that the tokens are equity or debt, issuer included disclosures typical of an equity security offering); INX Limited, Form F-1 (Aug. 19, 2019), available [here](#) (issuer expressly characterized tokens as equity securities). [↗](#)

- 23 See Robert Rosenblum, Reading the Not-So-Subtle Tea Leaves: What the SEC is Likely to Do Next in Crypto, and How Crypto Participants Should Prepare (July 28, 2022), available [here](#). (First, tokens that are securities because they are investment contracts under the Howey test usually lack traditional indicia of equity securities of the issuer of the tokens; the tokens generally provide the token holder with no right to dividends or other income from the issuer of the tokens, and they give the token holder no rights to vote for directors of the issuer or to vote on any other matters directly affecting the issuer. Second, most Howey tokens do not seem to come within the relevant definitions of “equity security.” Section 3(a)(11) of the Exchange Act defines the term “equity security” to mean, in relevant part, “any stock or similar security.” Rule 3a11-1 under the Exchange Act contains a somewhat broader definition of “equity security,” including in pertinent part “any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust ...” The list of instruments in Rule 3a11-1 is based on instruments described in the definition of security in Section 3(a)(10) of the Exchange Act. Notably, Rule 3a11-1 does not include in its definition of an equity security an “investment contract.” The term investment contract is, of course, listed in the definition of “security” in Section 3(a)(10), and its absence from the list of instruments in Rule 3a11-1 strongly suggests that investment contracts generally are not equity securities. Therefore, tokens that are securities solely because they are investment contracts do not appear to be equity securities under Rule 3a11-1, and the issuers of those tokens should not be subject to a Section 12(g) registration requirement with respect to those tokens.). [↗](#)
- 24 Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988). [↗](#)
- 25 See The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (Apr. 11, 2022). [↗](#)
- 26 The SEC has created special disclosure “schedules” for issuances of asset-backed securities and securities by companies in the oil and gas and the banking sectors as well as special rules for sales of securities by foreign governments, among others. [↗](#)
- 27 This includes audited balance sheets as of the end of each of the two most recent fiscal years, or, if the issuer has been in existence for less than one fiscal year, an audited balance sheet as of a date within 135 days of the date of filing the registration statement. [↗](#)



other person who performs similar policy making functions for the issuer. ↵

- 29 Such significant employees include production managers, sales managers, or research scientists who are not executive officers but who make or are expected to make significant contributions to the business. ↵
- 30 [Disclosure, Dapps and DeFi](#) (3.24.2022) by Chris Brummer, [LeXpunks Regulation X Proposal](#) (4.25.2022) by Sarah Brennan, Andrew Glidden, Darren Sandler and Gabriel Shapiro and accompanying [Safe Harbor X](#) (1.8.2022) by Gabriel Shapiro, [Token Safe Harbor Proposal 2.0](#) (4.31.2021) by SEC Commissioner Hester Pierce, [What Should Be Disclosed in an Initial Coin Offering](#) (11.29.2018) by Chris Brummer, Trevor Kiviat, Jai R. Massari. ↵
- 31 Some projects have relied on offshore legal entities with governance mechanisms that are informed by tokenholders. For example, many projects have formed ownerless foundation companies in the Cayman Islands that have adopted charters requiring the foundation's directors to take the recommendations of tokenholders, expressed via governance voting, into account and generally act in accordance with the recommendations of tokenholders. However, the "governance rights" that these tokenholders have vis-a-vis offshore entities are significantly more limited than the rights a shareholder enjoys vis-a-vis a related corporation and tokenholder votes generally are not legally binding on a foundation's directors in the same way that shareholder votes are binding with regard to a corporation. ↵

Written by

Justin Slaughter, Katie Biber, Rodrigo Seira

Disclaimer: This post is for general information purposes only. It does not constitute investment advice or a recommendation or solicitation to buy or sell any investment and should not be used in the evaluation of the merits of making any investment decision. It should not be relied upon for accounting, legal or tax advice or investment recommendations. This post reflects the current opinions of the authors and is not made on behalf of Paradigm or its affiliates and does not necessarily reflect the opinions of Paradigm, its affiliates or individuals associated with Paradigm. The opinions reflected herein are subject to change without being updated.



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September 17, 2024

Chair Patrick McHenry
Ranking Member Maxine Waters
Honorable Members of the Committee
U.S. House Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

Re: Dazed and Confused: Breaking Down the SEC's Politicized Approach to Digital Assets

Dear Chair McHenry, Ranking Member Waters and Members of the Committee,

On Wednesday, September 18, 2024, the House Financial Services Subcommittee on Digital Assets, Financial Technology and Inclusion will hold a hearing with the blinkered title, "Dazed and Confused: Breaking Down the SEC's Politicized Approach to Digital Assets."

We believe the Securities and Exchange Commission (SEC) performs well when it protects investors from the blizzard of scams and inherent regulatory evasions of cryptocurrencies and related exchanges. The genesis of this hearing, intended to blunt that mission, comes from the recycling of the ill-gotten gains of crypto into political spending. We attach a recent opinion piece that explores this dangerous development.

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

Sincerely,

Public Citizen

Crypto's Protection Racket

By Bartlett Naylor

In Hollywood crime movies, criminals regularly pay off the cops to protect their illicit trade, plots often rooted in reality. (See [Serpico](#).) The cryptocurrency sector, or “crypto bros,” may be film buffs, because they’re using the very same script. They have deployed a record amount of money into the 2024 election cycle in an attempt to convince lawmakers to ignore crypto’s harms, with obvious results. They’ve wilted the will of politicians, especially Democrats, who must otherwise understand that crypto is a Ponzi-like scheme. (The only way to make a profit is to sell the crypto to someone willing to pay more; there are no dividends from a token that is, after all, simply a string of computer numbers.) The crypto industry’s ultimate target: dismantling the efforts by the Securities and Exchange Commission (SEC), led by [brave chair Gary Gensler](#), to insist that crypto purveyors honor the same rules that apply to all those who invite the public to invest in their projects.

Unfortunately, the current state of affairs is that a lawmaker who votes “no” on pro-crypto legislation that would disenfranchise the SEC will lead a handful of crypto zillionaires to deploy millions of dollars to defeat this scrupulous lawmaker in the coming election. Public Citizen’s Rick Claypool [documented this phenomenon in two reports](#). As of August 2024, the crypto sector amassed \$169 million to spend in support or opposition to candidates based on their crypto statements and votes. That amount is more than any other sector is spending in elections—more than Wall Street, Big Oil, and Pharma. It’s nearly half of all corporate money contributed in the 2024 election cycle. It’s 15 percent of all known corporate money contributions since the U.S. Supreme Court’s disastrous 2010 decision in [Citizens United](#) that made such unlimited corporate political spending legal (expanding the previous 1976 [Buckley](#) decision). Alone, this deluge of corporate spending constitutes an unprecedented, frightening corruption of lawmaking, the starkest example to date, as Public Citizen President Robert Weissman [has opined](#).

To be clear, not all corporate political spending is legal. Public Citizen co-filed [a complaint](#) with Molly White alleging that contributor Coinbase violated campaign finance rules that prohibit contributions when the firm seeks or obtains a government contract.

A dangerous U.S. House bill that not only harms investor protection for crypto but any investment that uses the same digital platform called blockchain to record transactions [drew 71 Democrats](#) in support. These Democrats defied the warnings of Rep. Maxine Waters (D-Calif.) ranking member of the House Financial Services Committee and Minority Leader Hakeem Jeffries (D-N.Y.). Fear of crypto political spending arguably prevailed.

Other illicit enterprises will surely learn from the example. A sector that bilks billions from Americans will find it a cheap escape from accountability to redirect a small fraction of these ill-gotten gains to buy off

enough politicians to block sensible reform. Ripple, a crypto sponsor and payment systems firm, paid [a \\$125 million](#) fine following an SEC case. Its otherwise sizeable \$45 million in political spending so far in 2024 pales next to that penalty.

Importantly, this spending doesn't pay for political advertisements that discuss crypto. The political ads don't mention crypto at all. Crypto policy holds little interest for most Americans. Ninety-three percent of Americans neither own nor use crypto at all, according to [Federal Reserve data](#). And that figure rose over the last few years as more people learn about crypto. The number of people who own crypto has declined over the last several years as information about the sector has increased. Maybe these political ads avoid referencing crypto because a growing number of Americans understand this sector as all hype and little hope. A 2022 [Pew poll](#) found that about half of all crypto investors report their experience fell below expectations, and only 15 percent said they did better than anticipated. In 2023, [Pew found that 88](#) percent of Americans familiar with crypto reported they were not confident that crypto is safe. In the sober confines of the courtroom, where lies and exaggeration aren't tolerated, even crypto lawyers liken crypto to a [Beanie Baby](#) in order to escape SEC oversight, as opposed to an investment in Beanie Baby Inc. (Technically, Ty Inc.) Maybe the ads don't mention crypto because sector leaders such as Sam Bankman-Fried and Changpeng Zhao now serve [prison sentences](#) for theft or other lawbreaking connected to their crypto companies. Maybe the political ads funded by crypto avoid mentioning their product because scams abound, as detailed weekly by crypto skeptic [Molly White](#), or recorded on an [SEC website](#).

Instead, crypto political spending goes to advertisements with no mention of the candidate's crypto position. Crypto political funder Fairshake-- underwritten largely by venture capital firm Andreessen Horowitz, crypto firm Coinbase, Ripple and others-- spent some \$10 million to defeat Senate candidate Katie Porter who challenged the massive energy use by crypto. Instead of this issue, the [ads deviously claimed](#) she'd broken a promise to eschew support from disfavored industries such as Big Oil and Big Banks, an unfounded assertion. Hiding their breathless claims of crypto potential tellingly reveals they must understand this neither resonates with voters, nor finds purchase in reality.

Perniciously, this crypto spending goes to super PACS legally divorced from candidate campaigns. This insulates the candidate from criticism that they may be shills for the crypto Ponzi scheme. By contrast, candidates that accept money from certain rapacious industries such as Wall Street or Big Pharma face public opprobrium for accepting this lucre, as Fairshake unfairly exploited in the Porter race.

The crypto bros [openly discuss](#) this protection racket. Said one, "Having money, unfortunately, is a big part of the way government works in the US." Said another, "It's now become quite risky, I would say even maybe political suicide, to be anti-crypto in DC."

Politicians may believe they face a cruel dilemma. They can avoid taking a position on crypto or even vote to support the sector, betraying their scruples. Or they can oppose crypto, and invite the wrath of crypto-funded ads, jeopardizing their election and ability to serve average Americans on a myriad of other issues. Washington doesn't always follow the Hollywood script where the honest cop eventually prevails over the corrupt ones.

There's no easy, obvious escape from this dilemma.

Ultimately, *Citizens United* must be overturned and campaign finance reform fully realized. Until then, this Hollywood crime show becomes a horror movie series.

October 1, 2024

Daniel Martin Gallagher Jr.
Chief Legal, Compliance & Corporate Affairs Officer
Robinhood Markets, Inc.
85 Willow Road, Menlo Park
California, 94025

Dear Mr. Gallagher:

Thank you for testifying before the Subcommittee on Digital Assets, Financial Technology and Inclusion of the House Committee on Financial Services on September 18, 2024, at the hearing titled “Dazed and Confused: Breaking Down the SEC’s Politicized Approach to Digital Assets.” Per the instructions announced at the conclusion of the hearing, Members submitted additional questions for your response. Please respond to the questions below and submit your responses by October 22, 2024.

Should you or your staff have any questions or need additional information, please contact Trish Halloran at (202) 225-7502.

Sincerely,

Patrick McHenry
Chairman

Questions for the Record

Representative Maxine Waters:Honorable Dan Gallagher (Answers Bolded)

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)

PATRICK McHENRY, NC
CHAIRMAN



MAXINE WATERS, CA
RANKING MEMBER

United States House of Representatives
One Hundred Eighteenth Congress
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

October 1, 2024

Teddy Fusaro
President
Bitwise Asset Management, Inc.
250 Montgomery Street
San Francisco, CA

Dear Mr. Fusaro:

Thank you for testifying before the Subcommittee on Digital Assets, Financial Technology and Inclusion of the House Committee on Financial Services on September 18, 2024, at the hearing titled "Dazed and Confused: Breaking Down the SEC's Politicized Approach to Digital Assets." Per the instructions announced at the conclusion of the hearing, Members submitted additional questions for your response. Please respond to the questions below and submit your responses by October 21, 2024.

Should you or your staff have any questions or need additional information, please contact Trish Halloran at (202) 225-7502.

Sincerely,

A handwritten signature in blue ink that reads "Patrick McHenry".

Patrick McHenry
Chairman

Questions for the Record

Representative Maxine Waters:Mr. Teddy Fusaro

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)



Dazed and Confused: Breaking Down the SEC's Politicized
Approach to Digital Assets

Questions for the Record to Jennifer J. Schulp

Submitted October 9, 2024

Questions from Representative Maxine Waters

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)

Answer: a. White or Caucasian

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)

Answer: a. Woman



I

118TH CONGRESS
1ST SESSION

H. R. 5741

To prohibit certain Federal agencies from requiring certain institutions to include assets held in custody as a liability, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

SEPTEMBER 27, 2023

Mr. FLOOD (for himself, Mr. TORRES of New York, Mr. HILL, and Mr. NICKEL) introduced the following bill; which was referred to the Committee on Financial Services

A BILL

To prohibit certain Federal agencies from requiring certain institutions to include assets held in custody as a liability, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Uniform Treatment
5 of Custodial Assets Act”.

6 **SEC. 2. ACCOUNTING TREATMENT OF CUSTODY ACTI-** 7 **TIES.**

8 (a) IN GENERAL.—The appropriate Federal banking
9 agency, the National Credit Union Administration (in the

1 case of a credit union), and the Securities and Exchange
2 Commission may not require or take supervisory action
3 that would cause a depository institution, national bank,
4 Federal credit union, State credit union, trust company,
5 or any affiliate thereof—

6 (1) except as provided in subsection (b), to in-
7 clude assets held in custody or safekeeping, or the
8 assets associated with a cryptographic key held in
9 custody or safekeeping, as a liability on such institu-
10 tion's financial statement or balance sheet;

11 (2) to hold additional regulatory capital against
12 assets in custody, or safekeeping, or the assets asso-
13 ciated with a cryptographic key held in custody or
14 safekeeping, except as necessary to mitigate against
15 operational risks under regulations with general ap-
16 plication, as determined by—

17 (A) the appropriate Federal banking agen-
18 cy or State bank supervisor;

19 (B) the National Credit Union Administra-
20 tion (in the case of a credit union); or

21 (C) a State credit union supervisor; or

22 (3) to recognize a liability for any obligations
23 related to activities or services performed for digital
24 assets that such institution does not have beneficial
25 ownership of if that liability would exceed the ex-

1 pense recognized in the income statement as a result
2 of the corresponding obligation.

3 (b) EXCEPTION FOR COMMINGLING.—Cash held for
4 a third party by an institution described in subsection (a)
5 may be treated as a liability on such institution’s financial
6 statement or balance sheet if such cash is commingled
7 with the general assets of such institution.

8 (c) DEFINITIONS.—In this section:

9 (1) AFFILIATE.—The term “affiliate” has the
10 meaning given the term in section 2 of the Bank
11 Holding Company Act of 1956 (12 U.S.C. 1841).

12 (2) CREDIT UNION TERMS.—The terms “Fed-
13 eral credit union” and “State credit union” have the
14 meaning given those terms, respectively, in section
15 101 of the Federal Credit Union Act (12 U.S.C.
16 1752).

17 (3) FDIA TERMS.—The terms “appropriate
18 Federal banking agency”, “depository institution”,
19 and “State bank supervisor” have the meanings
20 given the terms, respectively, in section 3 of the
21 Federal Deposit Insurance Act (12 U.S.C. 1813).

22 (4) STATE CREDIT UNION SUPERVISOR.—The
23 term “State credit union supervisor” means a State

1 official described in section 107A(e) of the Federal
2 Credit Union Act (12 U.S.C. 1757a(e)).

○

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(Original Signature of Member)

118TH CONGRESS
2D SESSION

H. R. _____

To specify the treatment of covered non-fungible tokens under the securities laws, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

Mr. TIMMONS introduced the following bill; which was referred to the Committee on _____

A BILL

To specify the treatment of covered non-fungible tokens under the securities laws, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the “New Frontiers in Technology Act”.

SEC. 2. TREATMENT OF COVERED NON-FUNGIBLE TOKENS UNDER THE SECURITIES LAWS.

(a) IN GENERAL.—For purposes of the securities laws—

1 (1) a covered non-fungible token is not an in-
 2 vestment contract; and

3 (2) a transaction in a covered non-fungible
 4 token is not a transaction in a security.

5 (b) DEFINITIONS.—In this section and section 3:

6 (1) COVERED NON-FUNGIBLE TOKEN.—

7 (A) IN GENERAL.—The term “covered
 8 non-fungible token” means any non-fungible
 9 token, the primary purpose of which is as—

10 (i) a work of art, musical composition,
 11 literary work, or other intellectual prop-
 12 erty;

13 (ii) a collectible, merchandise, virtual
 14 land, or video game asset;

15 (iii) an affinity, reward, or loyalty
 16 point; or

17 (iv) a right, license, or ticket.

18 (B) EXCLUSION.— The term “covered
 19 non-fungible token” does not include a non-fun-
 20 gible token that is marketed by an issuer or
 21 promoter—

22 (i) primarily as an investment oppor-
 23 tunity; or

24 (ii) making actual or implied promised
 25 actions or a series of actions designed to

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1 increase the value of the non-fungible
2 token.

3 (2) NON-FUNGIBLE TOKEN.—

4 (A) IN GENERAL.—The term “non-fungible
5 token” means any asset—

6 (i) which is of such quality or limited
7 production that it can be independently
8 valued;

9 (ii) the record of ownership of which
10 is recorded on a cryptographically secured
11 public distributed ledger;

12 (iii)(I) which is a digital equivalent of
13 a tangible or intangible good; or

14 (II) which has some other inherent
15 value beyond the fact that the record of
16 ownership of the asset is recorded on a
17 cryptographically public distributed ledger;
18 and

19 (iv) the record of which can be exclu-
20 sively possessed and transferred, person to
21 person, without necessary reliance on an
22 intermediary.

23 (B) EXCLUSIONS.—The term “non-fun-
24 gible token” does not include—

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1 (i) any note, stock, treasury stock, se-
2 curity future, security-based swap, bond,
3 debenture, evidence of indebtedness, cer-
4 tificate of interest or participation in any
5 profit-sharing agreement, collateral-trust
6 certificate, preorganization certificate or
7 subscription, transferable share, put, call,
8 straddle, option, privilege on any security,
9 certificate of deposit, or group or index of
10 securities (including any interest therein or
11 based on the value thereof); or

12 (ii) any asset which, based on its
13 terms and other characteristics, is, rep-
14 resents, or is functionally equivalent to an
15 agreement, contract, or transaction that
16 is—

17 (I) a contract of sale of a com-
18 modity (as defined under section 1a of
19 the Commodity Exchange Act) for fu-
20 ture delivery or an option thereon;

21 (II) a security futures product;

22 (III) a swap;

23 (IV) an agreement, contract, or
24 transaction described in section

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1 2(c)(2)(C)(i) or 2(c)(2)(D)(i) of the
2 Commodity Exchange Act;

3 (V) a commodity option author-
4 ized under section 4c of the Com-
5 modity Exchange Act; or

6 (VI) a leverage transaction au-
7 thorized under section 19 of the Com-
8 modity Exchange Act.

9 (C) RULE OF CONSTRUCTION.—Nothing in
10 this paragraph may be construed to create a
11 presumption that a non-fungible token is a rep-
12 resentation of any type of security not excluded
13 from the definition under subparagraph (B).

14 (3) SECURITIES LAWS.—The term “securities
15 laws” has the meaning given that term is section
16 3(a) of the Securities Exchange Act of 1934.

17 **SEC. 3. STUDY ON NON-FUNGIBLE TOKENS.**

18 (a) IN GENERAL.—The Comptroller General of the
19 United States shall carry out a study of non-fungible to-
20 kens that analyzes—

21 (1) the nature, size, role, purpose, and use of
22 non-fungible tokens;

23 (2) the similarities and differences between non-
24 fungible tokens and other digital assets, including

- 1 payment stablecoins, and how the markets for those
- 2 digital assets intersect with each other;
- 3 (3) how non-fungible tokens are minted by
- 4 issuers and subsequently administered to purchasers;
- 5 (4) how non-fungible tokens are stored after
- 6 being purchased by a consumer;
- 7 (5) the interoperability of non-fungible tokens
- 8 between different blockchain systems;
- 9 (6) the scalability of different non-fungible
- 10 token marketplaces;
- 11 (7) the benefits of non-fungible tokens, includ-
- 12 ing verifiable digital ownership;
- 13 (8) the risks of non-fungible tokens, including—
- 14 (A) intellectual property rights;
- 15 (B) cybersecurity risks; and
- 16 (C) market risks;
- 17 (9) whether and how non-fungible tokens have
- 18 integrated with traditional marketplaces, including
- 19 those for music, real estate, gaming, events, and
- 20 travel;
- 21 (10) whether non-fungible tokens can be used
- 22 to facilitate commerce or other activities through the
- 23 representation of documents, identification, con-
- 24 tracts, licenses, and other commercial, government,
- 25 or personal records;

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1 (11) any potential risks to traditional markets
2 from such integration; and

3 (12) the levels and types of illicit activity in
4 non-fungible token markets.

5 (b) REPORT.—Not later than 1 year after the date
6 of the enactment of this Act, the Comptroller General shall
7 make publicly available a report that includes the results
8 of the study required by subsection (a).

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.....
 (Original Signature of Member)

118TH CONGRESS
 2D SESSION

H. R. _____

To codify the Strategic Hub for Innovation and Financial Technology of the Securities and Exchange Commission and LabCFTC of the Commodity Futures Trading Commission, and for other purposes.

 IN THE HOUSE OF REPRESENTATIVES

Mr. LUCAS introduced the following bill; which was referred to the Committee
 on _____

A BILL

To codify the Strategic Hub for Innovation and Financial Technology of the Securities and Exchange Commission and LabCFTC of the Commodity Futures Trading Commission, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
 2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Securing Innovation
 5 in Financial Regulation Act”.

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1 **SEC. 2. CODIFICATION OF THE SEC STRATEGIC HUB FOR**
2 **INNOVATION AND FINANCIAL TECHNOLOGY.**

3 Section 4 of the Securities Exchange Act of 1934 (15
4 U.S.C. 78d) is amended by adding at the end the fol-
5 lowing:

6 “(1) STRATEGIC HUB FOR INNOVATION AND FINAN-
7 CIAL TECHNOLOGY.—

8 “(1) OFFICE ESTABLISHED.—There is estab-
9 lished within the Commission the Strategic Hub for
10 Innovation and Financial Technology (referred to in
11 this section as the ‘FinHub’).

12 “(2) PURPOSES.—The purposes of FinHub are
13 as follows:

14 “(A) To assist in shaping the approach of
15 the Commission to technological advancements.

16 “(B) To examine financial technology inno-
17 vations among market participants.

18 “(C) To coordinate the response of the
19 Commission to emerging technologies in finan-
20 cial, regulatory, and supervisory systems.

21 “(3) DIRECTOR OF FINHUB.—FinHub shall
22 have a Director who shall be appointed by the Com-
23 mission, from among individuals having experience
24 in both emerging technologies and Federal securities
25 laws and serve at the pleasure of the Commission.
26 The Director shall report directly to the Commission

1 and perform such functions and duties as the Com-
2 mission may prescribe.

3 “(4) RESPONSIBILITIES.—FinHub shall—

4 “(A) foster responsible technological inno-
5 vation and fair competition within the Commis-
6 sion, including around financial technology, reg-
7 ulatory technology, and supervisory technology;

8 “(B) provide internal education and train-
9 ing to the Commission regarding financial tech-
10 nology;

11 “(C) advise the Commission regarding fi-
12 nancial technology that would serve the Com-
13 mission’s functions;

14 “(D) analyze technological advancements
15 and the impact of regulatory requirements on
16 financial technology companies;

17 “(E) advise the Commission with respect
18 to rulemakings or other agency or staff action
19 regarding financial technology;

20 “(F) provide businesses working in emerg-
21 ing financial technology fields with information
22 on the Commission, its rules and regulations;
23 and

24 “(G) encourage firms working in emerging
25 technology fields to engage with the Commis-

1 sion and obtain feedback from the Commission
2 on potential regulatory issues.

3 “(5) ACCESS TO DOCUMENTS.—The Commis-
4 sion shall ensure that FinHub has full access to the
5 documents and information of the Commission and
6 any self-regulatory organization, as necessary to
7 carry out the functions of FinHub.

8 “(6) REPORT TO CONGRESS.—

9 “(A) IN GENERAL.—Not later than Octo-
10 ber 31 of each year after 2024, FinHub shall
11 submit to the Committee on Banking, Housing,
12 and Urban Affairs of the Senate and the Com-
13 mittee on Financial Services of the House of
14 Representatives a report on the activities of
15 FinHub during the immediately preceding fiscal
16 year.

17 “(B) CONTENTS.—Each report required
18 under subparagraph (A) shall include—

19 “(i) the total number of persons that
20 met with FinHub;

21 “(ii) the total number of market par-
22 ticipants FinHub met with, including the
23 classification of those participants;

24 “(iii) a summary of general issues dis-
25 cussed during meetings with persons;

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1 “(iv) information on steps FinHub
2 has taken to improve Commission services,
3 including responsiveness to the concerns of
4 persons;

5 “(v) recommendations—

6 “(I) with respect to the regula-
7 tions of the Commission and the guid-
8 ance and orders of the Commission;
9 and

10 “(II) for such legislative actions
11 as FinHub determines appropriate;
12 and

13 “(vi) any other information, as deter-
14 mined appropriate by the Director of
15 FinHub.

16 “(C) CONFIDENTIALITY.—A report under
17 subparagraph (A) may not contain confidential
18 information.

19 “(7) SYSTEMS OF RECORDS.—

20 “(A) IN GENERAL.—The Commission shall
21 establish a detailed system of records (as de-
22 fined under section 552a of title 5, United
23 States Code) to assist FinHub in commu-
24 nicating with interested parties.

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1 “(B) ENTITIES COVERED BY THE SYS-
 2 TEM.—Entities covered by the system required
 3 under subparagraph (A) include entities or per-
 4 sons submitting requests or inquiries and other
 5 information to Commission through FinHub.

6 “(C) SECURITY AND STORAGE OF
 7 RECORDS.—FinHub shall store—

8 “(i) electronic records—

9 “(I) in the system required under
 10 subparagraph (A); or

11 “(II) on the secure network or
 12 other electronic medium, such as
 13 encrypted hard drives or back-up
 14 media, of the Commission; and

15 “(ii) paper records in secure facilities.

16 “(8) EFFECTIVE DATE.—This subsection shall
 17 take effect on the date that is 180 days after the
 18 date of the enactment of this subsection.”.

19 **SEC. 3. CODIFICATION OF LABCFTC.**

20 (a) IN GENERAL.—Section 18 of the Commodity Ex-
 21 change Act (7 U.S.C. 22) is amended by adding at the
 22 end the following:

23 “(c) LABCFTC.—

24 “(1) ESTABLISHMENT.—There is established in
 25 the Commission LabCFTC.

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1 “(2) PURPOSE.—The purposes of LabCFTC
2 are to—

3 “(A) promote responsible financial tech-
4 nology innovation and fair competition for the
5 benefit of the American public;

6 “(B) serve as an information platform to
7 inform the Commission about new financial
8 technology innovation; and

9 “(C) provide outreach to financial tech-
10 nology innovators to discuss their innovations
11 and the regulatory framework established by
12 this Act and the regulations promulgated there-
13 under.

14 “(3) DIRECTOR.—LabCFTC shall have a Direc-
15 tor, who shall be appointed by the Commission and
16 serve at the pleasure of the Commission. Notwith-
17 standing section 2(a)(6)(A), the Director shall re-
18 port directly to the Commission and perform such
19 functions and duties as the Commission may pre-
20 scribe.

21 “(4) DUTIES.—LabCFTC shall—

22 “(A) advise the Commission with respect
23 to rulemakings or other agency or staff action
24 regarding financial technology;

1 “(B) provide internal education and train-
2 ing to the Commission regarding financial tech-
3 nology;

4 “(C) advise the Commission regarding fi-
5 nancial technology that would bolster the Com-
6 mission’s oversight functions;

7 “(D) engage with academia, students, and
8 professionals on financial technology issues,
9 ideas, and technology relevant to activities
10 under this Act;

11 “(E) provide persons working in emerging
12 technology fields with information on the Com-
13 mission, its rules and regulations, and the role
14 of a registered futures association; and

15 “(F) encourage persons working in emerg-
16 ing technology fields to engage with the Com-
17 mission and obtain feedback from the Commis-
18 sion on potential regulatory issues.

19 “(5) ACCESS TO DOCUMENTS.—The Commis-
20 sion shall ensure that LabCFTC has full access to
21 the documents and information of the Commission
22 and any self-regulatory organization or registered fu-
23 tures association, as necessary to carry out the func-
24 tions of LabCFTC.

25 “(6) REPORT TO CONGRESS.—

1 “(A) IN GENERAL.—Not later than Octo-
 2 ber 31 of each year after 2024, LabCFTC shall
 3 submit to the Committee on Agriculture of the
 4 House of Representatives and the Committee
 5 on Agriculture, Nutrition, and Forestry of the
 6 Senate a report on its activities.

7 “(B) CONTENTS.—Each report required
 8 under paragraph (1) shall include—

9 “(i) the total number of persons that
 10 met with LabCFTC;

11 “(ii) a summary of general issues dis-
 12 cussed during meetings with the person;

13 “(iii) information on steps LabCFTC
 14 has taken to improve Commission services,
 15 including responsiveness to the concerns of
 16 persons;

17 “(iv) recommendations made to the
 18 Commission with respect to the regula-
 19 tions, guidance, and orders of the Commis-
 20 sion and such legislative actions as may be
 21 appropriate; and

22 “(v) any other information determined
 23 appropriate by the Director of LabCFTC.

1 “(C) CONFIDENTIALITY.—A report under
2 paragraph (A) shall abide by the confidentiality
3 requirements in section 8.

4 “(7) SYSTEMS OF RECORDS.—

5 “(A) IN GENERAL.—The Commission shall
6 establish a detailed system of records (as de-
7 fined in section 552a of title 5, United States
8 Code) to assist LabCFTC in communicating
9 with interested parties.

10 “(B) PERSONS COVERED BY THE SYS-
11 TEM.—The persons covered by the system of
12 records shall include persons submitting re-
13 quests or inquiries and other information to the
14 Commission through LabCFTC.

15 “(C) SECURITY AND STORAGE OF
16 RECORDS.—The system of records shall store
17 records electronically or on paper in secure fa-
18 cilities, and shall store electronic records on the
19 secure network of the Commission and on other
20 electronic media, such as encrypted hard drives
21 and back-up media, as needed.”.

22 (b) CONFORMING AMENDMENTS.—Section
23 2(a)(6)(A) of the Commodity Exchange Act (7 U.S.C.
24 2(a)(6)(A)) is amended—

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1 (1) by striking “paragraph and in” and insert-
2 ing “paragraph,”; and

3 (2) by inserting “and section 18(c)(3),” before
4 “the executive”.

5 (c) EFFECTIVE DATE.—The Commodity Futures
6 Trading Commission shall implement the amendments
7 made by this section (including complying with section
8 18(c)(7) of the Commodity Exchange Act) within 180
9 days after the date of the enactment of this Act.

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.....
(Original Signature of Member)

118TH CONGRESS
2D SESSION

H. R. _____

To establish the Joint Advisory Committee on Digital Assets, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

Mr. ROSE introduced the following bill; which was referred to the Committee on _____

A BILL

To establish the Joint Advisory Committee on Digital Assets, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Bridging Regulation
5 and Innovation for Digital Global and Electronic Digital
6 Assets Act” or the “BRIDGE Digital Assets Act”.

1 **SEC. 2. CFTC-SEC JOINT ADVISORY COMMITTEE ON DIG-**
2 **ITAL ASSETS.**

3 (a) ESTABLISHMENT.—The Commodity Futures
4 Trading Commission and the Securities and Exchange
5 Commission (in this section referred to as the “Commis-
6 sions”) shall jointly establish the Joint Advisory Com-
7 mittee on Digital Assets (in this section referred to as the
8 “Committee”).

9 (b) PURPOSE.—

10 (1) IN GENERAL.—The Committee shall—

11 (A) provide the Commissions with advice
12 on the rules, regulations, and policies of the
13 Commissions related to digital assets;

14 (B) further the regulatory harmonization
15 of digital asset policy between the Commissions;

16 (C) examine and disseminate methods for
17 describing, measuring, and quantifying digital
18 asset—

19 (i) decentralization;

20 (ii) functionality;

21 (iii) information asymmetries; and

22 (iv) transaction and network security;

23 and

24 (D) examine the potential for digital as-
25 sets, blockchain systems, and distributed ledger
26 technology to improve efficiency in the oper-

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1 ation of financial market infrastructure and
2 better protect financial market participants, in-
3 cluding services and systems which provide—

- 4 (i) improved customer protections;
5 (ii) public availability of information;
6 (iii) greater transparency regarding
7 customer funds;
8 (iv) reduced transaction cost; and
9 (v) increased access to financial mar-
10 ket services.

11 (2) REVIEW BY AGENCIES.—Each Commission
12 shall—

13 (A) review the findings and recommenda-
14 tions of the Committee;

15 (B) promptly issue a public statement each
16 time the Committee submits a finding or rec-
17 ommendation to a Commission—

18 (i) assessing the finding or rec-
19 ommendation of the Committee;

20 (ii) disclosing the action or decision
21 not to take action made by the Commis-
22 sion in response to a finding or rec-
23 ommendation; and

24 (iii) explaining the reasons for the ac-
25 tion or decision not to take action; and

1 (C) each time the Committee submits a
 2 finding or recommendation to a Commission,
 3 provide the Committee with a formal response
 4 to the finding or recommendation not later than
 5 3 months after the date of the submission of
 6 the finding or recommendation.

7 (c) MEMBERSHIP AND LEADERSHIP.—

8 (1) NON-FEDERAL MEMBERS.—

9 (A) IN GENERAL.—The Commissions shall
 10 appoint at least 20 nongovernmental stake-
 11 holders who represent a broad spectrum of in-
 12 terests, equally divided between the Commis-
 13 sions, to serve as members of the Committee.
 14 The appointees shall include—

15 (i) digital asset issuers;

16 (ii) persons registered with the Com-
 17 missions and engaged in digital asset re-
 18 lated activities;

19 (iii) individuals engaged in academic
 20 research relating to digital assets; and

21 (iv) digital asset users.

22 (B) MEMBERS NOT COMMISSION EMPLOY-
 23 EES.—Members appointed under subparagraph
 24 (A) shall not be deemed to be employees or

1 agents of a Commission solely by reason of
2 membership on the Committee.

3 (2) CO-DESIGNATED FEDERAL OFFICERS.—

4 Notwithstanding section 1009 of title 5, United
5 States Code, the Committee shall have two des-
6 ignated Federal officers or employees, as described
7 under such section, with each Commission desig-
8 nating one officer or employee of the Commission to
9 serve as a designated Federal officer or employee,
10 from among individuals who possess an under-
11 standing of digital assets, blockchain systems, and
12 financial technology.

13 (3) COMMITTEE LEADERSHIP.—

14 (A) COMPOSITION; ELECTION.—The Com-
15 mittee members shall elect, from among the
16 Committee members—

- 17 (i) a chair;
18 (ii) a vice chair;
19 (iii) a secretary; and
20 (iv) an assistant secretary.

21 (B) TERM OF OFFICE.—Each member
22 elected under subparagraph (A) in a 2-year pe-
23 riod referred to in section 1013(b)(2) of title 5,
24 United States Code, shall serve in the capacity

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1 for which the member was so elected, until the
2 end of the 2-year period.

3 (d) NO COMPENSATION FOR COMMITTEE MEM-
4 BERS.—All Committee members shall—

5 (1) serve without compensation; and

6 (2) while away from the home or regular place
7 of business of the member in the performance of
8 services for the Committee, be allowed travel ex-
9 penses, including per diem in lieu of subsistence, in
10 the same manner as persons employed intermittently
11 in the Government service are allowed expenses
12 under section 5703(b) of title 5, United States Code.

13 (e) FREQUENCY OF MEETINGS.—The Committee
14 shall meet—

15 (1) not less frequently than twice annually; and

16 (2) at such other times as either Commission
17 may request.

18 (f) DURATION.—Section 1013(a)(2) of title 5, United
19 States Code, shall not apply to the Committee.

20 (g) TIME LIMITS.—The Commissions shall—

21 (1) adopt a joint charter for the Committee
22 within 90 days after the date of the enactment of
23 this section;

24 (2) appoint members to the Committee within
25 120 days after such date of enactment; and

1 (3) hold the initial meeting of the Committee
2 within 180 days after such date of enactment.

3 (h) FUNDING.—The Commissions shall jointly fund
4 the Committee.

5 (i) DEFINITIONS.—In this section:

6 (1) BLOCKCHAIN.—The term “blockchain”
7 means any technology—

8 (A) where data is—

9 (i) shared across a network to create
10 a public ledger of verified transactions or
11 information among network participants;

12 (ii) linked using cryptography to
13 maintain the integrity of the public ledger
14 and to execute other functions; and

15 (iii) distributed among network par-
16 ticipants in an automated fashion to con-
17 currently update network participants on
18 the state of the public ledger and any other
19 functions; and

20 (B) composed of source code that is pub-
21 licly available.

22 (2) DIGITAL ASSET.—The term “digital asset”
23 means any fungible digital representation of value
24 that can be exclusively possessed and transferred,
25 person to person, without necessary reliance on an

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1 intermediary, and is recorded on a cryptographically
2 secured public distributed ledger.

3 (3) DIGITAL ASSET ISSUER.—With respect to a
4 digital asset, the term “digital asset issuer” means
5 any person that, in exchange for any consideration—

6 (A) issues or causes to be issued a unit of
7 such digital asset to a person; or

8 (B) offers or sells a right to a future
9 issuance of a unit of such digital asset to a per-
10 son.

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[DISCUSSION DRAFT]118TH CONGRESS
2D SESSION**H. R.** _____

To codify the special purpose broker dealer, and for other purposes.

IN THE HOUSE OF REPRESENTATIVESM. _____ introduced the following bill; which was referred to the
Committee on __________
A BILLTo codify the special purpose broker dealer, and for other
purposes.1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*3 **SECTION 1. SHORT TITLE.**4 This Act may be cited as the “[To be added Act of
5 2024]”.6 **SEC. 2. REGISTRATION AND REGULATION OF SPECIAL PUR-**
7 **POSE BROKERS AND DEALERS.**8 (a) IN GENERAL.—The Securities Exchange Act of
9 1934 (15 U.S.C. 78a et seq.) is amended by inserting after
10 section 15G the following:

1 **“SEC. 15H. REGISTRATION AND REGULATION OF SPECIAL**
2 **PURPOSE BROKERS AND DEALERS.**

3 “(a) IN GENERAL.—A broker or dealer may file an
4 application with the Commission to register as a special
5 purpose broker or dealer.

6 “(b) REQUIREMENTS.—A broker or dealer may only
7 register as a special purpose broker or dealer if the broker
8 or dealer complies with the following:

9 “(1) The broker or dealer has access to quali-
10 fied tokenized securities or permitted payment
11 stablecoins and the capability to transfer them using
12 distributed ledger technology;

13 “(2) The broker or dealer limits the business of
14 the broker or dealer to—

15 “(A) dealing in, effecting transactions in,
16 maintaining custody of, or operating an alter-
17 native trading system for, and settlement of,
18 qualified tokenized securities and permitted
19 payment stablecoins;

20 “(B) holding proprietary positions in secu-
21 rities other than qualified tokenized securities,
22 but solely for the purposes of—

23 “(i) meeting the minimum net capital
24 requirements of the broker or dealer re-
25 quired under section 15c3–1 of title 17,

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1 Code of Federal Regulations, or any suc-
2 cessor rule; or

3 “(ii) hedging the risks of the propri-
4 etary positions of the broker or dealer in
5 such securities, qualified tokenized securi-
6 ties, and permitted payment stablecoins.

7 “(3) The broker or dealer establishes, main-
8 tains, and enforces reasonably designed written poli-
9 cies and procedures to conduct and document an
10 analysis that confirms that a qualified tokenized se-
11 curity is offered and sold pursuant to an effective
12 registration statement or an available exemption
13 from registration.

14 “(4) The broker or dealer establishes, main-
15 tains, and enforces reasonably designed written poli-
16 cies and procedures to assess the characteristics of
17 a qualified tokenized security’s distributed ledger
18 technology and associated network prior to under-
19 taking to maintain custody of the qualified tokenized
20 security and at reasonable intervals thereafter.

21 “(5) The broker or dealer does not undertake
22 to maintain custody of a qualified tokenized security
23 if the broker or dealer—

24 “(A) is aware of any material security or
25 operational problems or weaknesses with the

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1 distributed ledger technology and associated
2 network used to access and transfer the quali-
3 fied tokenized security; or

4 “(B) is aware of other material risks posed
5 to the business of the broker or dealer by the
6 qualified tokenized security.

7 “(6) The broker or dealer establishes, main-
8 tains, and enforces reasonably designed written poli-
9 cies, procedures, and controls that are consistent
10 with industry best practices to—

11 “(A) demonstrate the broker or dealer has
12 exclusive control over any qualified tokenized
13 securities and permitted payment stablecoins
14 the broker or dealer holds in custody; and

15 “(B) protect against the theft, loss, and
16 unauthorized and accidental use of the private
17 keys necessary to access and transfer the quali-
18 fied tokenized securities or the permitted pay-
19 ment stablecoins the broker or dealer holds in
20 custody.

21 “(7) The broker or dealer establishes, main-
22 tains, and enforces reasonably designed written poli-
23 cies, procedures, and arrangements to—

24 “(A) identify, in advance, the steps the
25 broker or dealer will take in response to events

1 that could affect the broker or dealer’s custody
2 of qualified tokenized securities, including—
3 “(i) blockchain malfunctions;
4 “(ii) 51 percent attacks;
5 “(iii) hard forks; or
6 “(iv) airdrops;
7 “(B) allow for the broker or dealer to com-
8 ply with a court-ordered freeze or seizure of a
9 qualified tokenized security or permitted pay-
10 ment stablecoin; and
11 “(C) allow for the transfer of the qualified
12 tokenized securities or permitted payment
13 stablecoins held by the broker or dealer to an-
14 other special purpose broker or dealer, a trust-
15 ee, receiver, liquidator, or person performing a
16 similar function, or to another appropriate per-
17 son, in the event the broker or dealer can no
18 longer continue as a going concern and self-
19 liquidates or is subject to a formal bankruptcy,
20 receivership, liquidation, or similar proceeding.
21 “(8) The broker or dealer provides written dis-
22 closures to prospective customers, clarifying the fol-
23 lowing:
24 “(A) Based on the broker or dealer’s reg-
25 istration under this section, the broker or dealer

1 considers itself to be in possession or control of
2 qualified tokenized securities or permitted pay-
3 ment stablecoins in the same manner as a
4 broker or dealer is in possession or control of
5 fully-paid securities or excess margin securities
6 for the purposes of section 15c3-3(b)(1) of title
7 17, Code of Federal Regulations.

8 “(B) The risks of investing in or holding
9 qualified tokenized securities, including by—

10 “(i) describing the risks of fraud, ma-
11 nipulation, theft, and loss associated with
12 qualified tokenized securities;

13 “(ii) describing the risks relating to
14 valuation, price volatility, and liquidity as-
15 sociated with qualified tokenized securities;
16 and

17 “(iii) describing the processes, soft-
18 ware and hardware systems, and any other
19 formats or systems utilized by the broker
20 or dealer to—

21 “(I) create, store, or use the
22 broker or dealer’s private keys; and

23 “(II) protect customer assets
24 from loss, theft, or unauthorized or
25 accidental use

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1 “(9) The broker or dealer enters into a written
2 agreement with each customer that sets forth the
3 terms and conditions with respect to receiving, pur-
4 chasing, holding, safekeeping, selling, transferring,
5 exchanging, custodying, liquidating, and otherwise
6 transacting in qualified tokenized securities on be-
7 half of the customer.

8 “(c) CONSIDERATION OF APPLICATIONS.—With re-
9 spect to an application to register as a special purpose
10 broker or dealer, the Commission shall—

11 “(1) make a final decisions on the application
12 not more than 60 days after receiving the applica-
13 tion;

14 “(2) with respect to an application that is de-
15 nied by the Commission—

16 “(A) include with the denial a clear articu-
17 lation of the specific reasons for the denial and
18 the specific modifications needed to receive ap-
19 proval; and

20 “(B) permit the broker or dealer to re-
21 apply.

22 “(d) RULE EXEMPTION.—Section 240.15c3–3 of title
23 17, Code of Federal Regulations, (and any successor rule)
24 does not apply to a special purpose broker or dealer reg-
25 istered under this section.

- 1 “(e) RULEMAKING.—The Commission shall—
- 2 “(1) not later than six months after the date of
- 3 enactment of this section, propose rules to carry out
- 4 this section; and
- 5 “(2) not later than 12 months after the date of
- 6 enactment of this section, issue final rules to carry
- 7 out this section.
- 8 “(f) DEFINITIONS.—In this section:
- 9 “(1) PERMITTED PAYMENT STABLECOIN.—
- 10 “(A) IN GENERAL.—The term ‘permitted
- 11 payment stablecoin’ means a digital asset issued
- 12 using distributed ledger technology—
- 13 “(i) that is or is designed to be used
- 14 as a means of payment or settlement;
- 15 “(ii) the issuer of which—
- 16 “(I) is obligated to convert, re-
- 17 deem, or repurchase for a fixed
- 18 amount of monetary value;
- 19 “(II) represents will maintain or
- 20 creates the reasonable expectation
- 21 that it will maintain a stable value rel-
- 22 ative to the value of a fixed amount of
- 23 monetary value; or
- 24 “(III) is subject to regulation by
- 25 a Federal or State regulator with au-

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1 thority over entities that issue pay-
2 ment stablecoins; and

3 “(iii) that is not—

4 “(I) a national currency; or

5 “(II) a security issued by an in-
6 vestment company registered under
7 section 8(a) of the Investment Com-
8 pany Act of 1940 (15 U.S.C. 80a-
9 8(a)).

10 “(B) MONETARY VALUE DEFINED.—For
11 purposes of subparagraph (A), the term ‘mone-
12 tary value’ means a national currency, deposit
13 (as defined under section 3 of the Federal De-
14 posit Insurance Act), or an equivalent instru-
15 ment that is denominated in a national cur-
16 rency.

17 “(2) QUALIFIED TOKENIZED SECURITY.—The
18 term ‘qualified tokenized security’ means a security
19 that—

20 “(A) is issued using distributed ledger
21 technology as the definitive record of ownership;

22 “(B) is not a bearer asset; and

23 “(C) uses embedded smart contracts to en-
24 sure compliance with securities laws regarding
25 transfers.”.

1 (b) SUNSET.—Effective after the end of the 5-year
2 period beginning on the date that the final rules required
3 under section 15H(e)(2) of the Securities Exchange Act
4 of 1934 are issued, such section 15H is repealed.

5 **SEC. 3. STUDY ON FINANCIAL MARKET INFRASTRUCTURE**
6 **IMPROVEMENTS.**

7 (a) IN GENERAL.—The Securities and Exchange
8 Commission shall conduct a study to assess whether addi-
9 tional guidance or rules are necessary to facilitate the de-
10 velopment of tokenized securities, to the extent such guid-
11 ance or rules would foster the development of fair and or-
12 derly financial markets, be necessary or appropriate in the
13 public interest, and be consistent with the protection of
14 investors and customers.

15 (b) REPORT.—

16 (1) TIME LIMIT.—Not later than 1 year after
17 the date of enactment of this Act, the Securities and
18 Exchange Commission shall submit to the relevant
19 congressional committees a report that includes the
20 results of the study required by subsection (a).

21 (2) RELEVANT CONGRESSIONAL COMMITTEES
22 DEFINED.—In this section, the term “relevant con-
23 gressional committees” means—

24 (A) the Committees on Financial Services
25 of the House of Representatives; and

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- 1 (B) the Committees on Banking, Housing,
- 2 and Urban Affairs of the Senate.

