House Committee on Financial Services Hearing
The Future of Digital Assets: Providing Clarity for the Digital Asset Ecosystem

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Statement for the Record

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I. Introduction

We appreciate the opportunity to submit this formal statement for the record and agree with members of the House Financial Services Committee and the House Committee on Agriculture that events in the digital asset market over the past year demonstrate the need for comprehensive regulatory oversight and action to protect digital asset investors and the broader financial system at large.

Unfortunately, those on the Committee who have introduced draft legislation meant to provide a new framework for such oversight appear to have done so relying largely on consultations with the crypto industry itself and have opened up this draft for broader comment under a timeline likely to limit real discussion. The proposal as introduced fails to provide adequate protections for consumers and investors, legitimizes risky business models within the industry that could amplify harm for these consumers and investors, and creates numerous loopholes that can be exploited by crypto-native and legacy firms to the detriment of these consumers and investors as well as financial stability.[1] This proposal is inferior to the robust securities regulatory regime that already covers most crypto-assets.

The discussion draft fails to heed the lessons traditional financial markets continuously teach us – complex regulation does not guarantee resilient markets. Just look at risk-based capital ratios, which were shown, yet again, to underestimate the capital needed during this spring's regional banking crisis. While the technological underpinnings of cryptocurrency may sometimes seem complex, it does not follow that the optimal regulatory framework requires the level of complexity laid out in the discussion draft.

In 2012, Andrew Haldane, the former executive director for financial stability at the Bank of England, delivered a now-well-known – within financial regulatory circles at least – speech at the Kansas City Fed's annual Jackson Hole conclave. In that speech, he details all the ways regulatory complexity failed to address the causes of the 2008 financial crisis. Policymakers should keep Haldane's penultimate paragraph in mind when considering how to regulate cryptocurrency:

[1] Republicans court Democratic support of crypto bill

"Modern finance is complex, perhaps too complex. Regulation of modern finance is complex, almost certainly too complex. That configuration spells trouble. As you do not fight fire with fire, you do not fight complexity with complexity. Because complexity generates uncertainty, not risk, it requires a regulatory response grounded in simplicity, not complexity."[2]

There is an opportunity here to apply this lesson to crypto markets regulation. We believe existing securities laws currently apply, and are well suited, to most digital assets. As such, Congress could fully close the gap in digital asset spot market regulation by declaring that all digital assets are securities under a special definition to the securities laws.[3]This simpler approach to regulating digital assets is both desirable and possible.

In the text below we attempt to identify and explain our major concerns with the discussion draft. Given how recently the text was introduced and its length and complexity, there may be additional questions or concerns that arise based on further analysis by us or others. However, we have seen enough to easily say we urge Committee members to oppose this bill. Furthermore, we urge members to exercise caution before deciding to introduce strengthening language to address its flaws. While legislative processes often involve compromise, the potential risks and flaws in this bill are structural, nonincidental, and may not be easily resolved with tweaks to the text or grafting simple concepts into the overall edifice of the bill. This bill is too flawed to serve as a starting point for negotiations.

II. Title I's Definitions Create Opportunities for Regulatory Arbitrage

The discussion draft's complexity is largely the result of trying to craft a bespoke regulatory framework that can accommodate cryptocurrency's perceived unique features without also providing a pathway for traditional assets and intermediaries to opt-in to what is clearly a less stringent regulatory regime. This is why the bill begins by defining over 15 terms (functional network, digital commodity, digital asset, decentralized organization, decentralized network, blockchain protocol, blockchain network, etc.). These definitions (see Section 101) are extremely detailed, which is problematic because they are tied to the state of blockchain and related technologies at this particular moment in time, and to the way that crypto industry business models use these technologies at this particular moment in time. As a result, this legislation will become outdated very quickly, and industry participants will find it very easy to exploit loopholes in the proposed legislation by making technological adjustments or through clever lawyering. Broad, simple rules – like the ones that the securities laws already provide – are more effective at protecting investors from harm.

While we do not recommend that legislation be tied so closely to a particular technology (both because doing so will ensure that the legislation is soon outdated, and because such complex legislation will inevitably include multiple loopholes), if legislation does include detailed definitions of technologies, it is critical that technologists who are not affiliated with the crypto industry be consulted on the development of those definitions. For example, the definition of "source code" in this proposed legislation could be considered unusual because it

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[2] Andrew G Haldane: The dog and the frisbee (bis.org)

[3] Hilary Allen and Lee Reiners have advocated for this approach in Congressional testimony. See, Allen Testimony 12-14-22.pdf (senate.gov) and HHRG-118-BA21-Wstate-ReinersL-20230309.pdf (house.gov)

would exclude interpreted code and any other non-compiled code, potentially creating a loophole.

Additionally, what should be deeply concerning to members of Congress is that the definition of "digital asset" in this bill could also create opportunities for traditional financial assets to sidestep existing financial regulation simply by recording ownership on a public blockchain (which is discussed further below). This definition says that "any fungible digital representation of value" (which would include traditional financial instruments like deposits and stocks in publicly traded companies) will be a digital asset, so long as ownership is "recorded on a cryptographically secured public distributed ledger." Because this proposed legislation is less onerous than the existing securities laws, we can expect the issuers of traditional securities to begin using blockchain reporting and then argue that they fall within the ambit of this proposed legislation.

III. Problems with Proposed Registration Exemption

At its core, the discussion draft 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. Indeed, the press release for the discussion draft included a "visual representation of a digital asset project lifecycle" with a portion of this lifecycle labeled "The Road to Decentralization."[4]

The notion that cryptocurrencies can evolve into a more decentralized structure over time has led to no shortage of ideas and proposals that would provide regulatory relief, or certainty, to token developers while they work towards the decentralized promised land. This includes a simple agreement for future token (SAFT)[5] and SEC Commissioner Hester Peirce's token safe harbor proposal that would provide "a three-year grace period within which, under certain conditions, they [network developers] can facilitate participation in and the development of a functional or decentralized network, exempted from the registration provisions of the federal securities laws."[6]

Centralization, and decentralization, exist on a spectrum, and when you try to define it in legislative text, you provide an opportunity for the rules to be gamed. The discussion draft allows digital asset project developers (digital asset issuers) to raise initial funds to build their project through a newly created registration exemption. SEC Commissioner Caroline Crenshaw provided a helpful summary on the differences between public and private (i.e., exempt) offerings:

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[4] digital_asset_project_lifecycle.pdf (house.gov)

[5] A SAFT is modeled off the simple agreement for future equity (SAFE) which is a common instrument for early-stage fundraising. A SAFT allows an accredited investor, like a venture capital firm, to provide funds to the crypto project now in return for a contract promising delivery of the project's tokens at a later date. "The theory here is that the SAFT fundraising is a securities offering — the crypto project is selling investment contracts for cash — but the underlying *tokens* are not securities; the *tokens* are just a form of currency for use in the crypto project. They are, in crypto lingo, "utility tokens;" people buy them not as speculative investments in a business but to *use* them to do crypto-y stuff." See When Is a Token Not a Security? - Bloomberg and SAFT-Project-Whitepaper.pdf

[6] SEC.gov | Token Safe Harbor Proposal 2.0

"From the inception of the federal securities laws, companies could choose to offer to the broad investing public by taking on substantial disclosure obligations in exchange for exclusive access to the relatively unlimited pool of public capital; private companies, on the other hand, had to raise capital from insiders or certain large financial institutions, and were subject to restrictions on transfer and resale."[7]

Over time, the SEC has promulgated rules for multiple capital raising exemptions that typically involve restrictions around how much can be raised, from whom it can be raised, and resales.[8] Each exemption also comes with its own disclosure requirements, which in some cases means no disclosures are provided. Section 4(a)(6) (the equity crowdfunding exemption introduced by the JOBS Act of 2012) is the most recently introduced Securities Act exemption that focuses on retail investors.[9] That exemption limits the amount that can be raised to $5 million, which limits the amount of investor harm that can be inflicted by a particular offering. Under proposed Section 201 of the discussion draft, a new Section 4(a)(8) exemption would be created 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.[10]

The equity crowdfunding rules offer inadequate protections to investors, but at least they do not allow general solicitations (except through a funding portal or broker/dealer that must be interposed between the issuer and the investor to afford a measure of investor protection). The proposed new Section 4(a)(8) allows general solicitations, and it does not require that an intermediary be involved. In general, it is highly unusual for securities laws to allow general solicitations of retail investors without full SEC registration. Retail investors are at least as vulnerable to harm in digital assets markets as they are in equity crowdfunding markets, and so digital asset investors should have, at the very least, equivalent protections as equity crowdfunding investors – though to be clear, we believe these protections are insufficient as well.

The proposed digital asset exemption also fails to require digital asset issuers to disclose their plans for transitioning to a decentralized structure to qualify for the new exemption, even though issuers who have raised funds under the exemption are required to file a semiannual report that includes "an updated description of the current state and timeline for the development of the blockchain network to which the digital asset relates, showing how and when the blockchain network intends or intended to be considered a functional network and a decentralized network." Given that the whole point of the digital asset exemption is to allow issuers to raise funds so that they can build a decentralized network, this provides another opportunity for regulatory arbitrage and investor harm. Issuers who have no intention of relinquishing control over their "blockchain network" can still raise funds from the public under the new digital asset exemption. There have

[7] SEC.gov | Big "Issues" in the Small Business Safe Harbor: Remarks at the 50th Annual Securities Regulation Institute

[8] For a summary, see here: SEC.gov | Overview of Capital-Raising Exemptions*

[9] Final Rule: Crowdfunding (sec.gov)

[10] Ethereum (ETH) ICO - Rating, News & Details | CoinCodex

been many blockchain projects that failed to make the leap to decentralization, with Facebook's Libra/Novi being one notable example.[11]

IV. Moving from Centralized to Decentralized

Once a blockchain network is operational, "any person" may certify to the SEC that the network and its related digital asset has crossed the "decentralized" threshold. Assuming the SEC agrees, the digital asset transforms into a "digital commodity" subject to CFTC oversight.

As mentioned in Section II, the definition of "decentralization" is so complicated that it is likely to contain multiple loopholes to exploit. Section 204 also creates lots of procedural presumptions in favor of those asserting their networks are decentralized and therefore outside of SEC jurisdiction, making it more challenging for the SEC to protect investors from harm. Allowing literally anyone to petition the SEC at any time virtually guarantees that the Commission will be inundated with certification filings. In addition, under the proposed statute, the SEC is expected to review and respond within 30 days, and to do so after having invited comments from the public and the CFTC (stays are permitted, but only once, and only for 90 days). This is an unrealistic timeframe for the SEC to engage with other stakeholders and provide the detailed analysis required by the legislation (this analysis must be sufficiently detailed to survive the anticipated judicial review). It effectively creates a presumption of decentralization that is very difficult for the SEC to rebut. This presumption is especially troubling considering how economically centralized most of the digital asset industry currently is.

The discussion draft defines decentralization from a technical and economic perspective. On the technical side, decentralization means that no person has the unilateral authority "to control or materially alter the functionality or operation of the blockchain network;" or "to restrict or prohibit any person" from accessing and using the blockchain and associated digital asset. The problem with this technical definition is that it completely ignores that unilateral actors are often able to find and exploit code flaws in nominally decentralized digital asset projects. There have been many "blockchain networks" – this term includes smart contracts in the draft – that were presumed to be decentralized until a malicious actor unilaterally exploited a flaw in the underlying code to drain funds or otherwise control or alter the functionality of the network. Publicly disclosing the source code, as the discussion draft requires, will not address this problem. The source code for digital assets and blockchain networks is already public and closely vetted by sophisticated and wealthy firms and individuals, and yet solo actors are still able to compromise digital assets and blockchains, demonstrating that their technological decentralization was always overstated.

Furthermore, there are many other ways in which the *economic* decentralization of digital asset markets has been shown to be exaggerated or compromised. To take just a few examples, 66.7% of all crypto trading on centralized exchanges (which themselves constitute the bulk of all crypto trading) occurs on Binance.[12] As of July 2022 one analysis determined that .04% of BTC

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[11] Of course, Libra failed to launch for other reasons, and it was technically a stablecoin so it may not have fallen under the definition of digital asset, but its acknowledgement that it would not transition to a permissionless blockchain highlights the challenges in making the transition. See, [Facebook's Libra was always destined to fail - Decrypt]

[12] https://cryptonews.com/news/binance-has-grabbed-two-thirds-of-all-crypto-trading-volume-what-happened-to-the-decentralization of-finance.htm

addresses (or wallets) held 62.25% of all Bitcoins issued.[13] Many of the decentralized autonomous organizations (DAOs) that are meant to provide governance or oversight of decentralized blockchain platforms exhibit high levels of concentration, with a small number of wallets controlling a disproportionately high number of so-called governance tokens.[14] Even if technological decentralization were achieved, it would do nothing to guarantee economic decentralization, and so the question must be asked: should an entire new regulatory regime for these assets be built around the idea of decentralization, when it is so dynamic, difficult to articulate, and perhaps even more difficult to fully realize? That is a more profound question than even determining which regulator should regulate which assets and actors.

A more immediate concern with the draft's decentralization definitions and provisions is that it makes legal a business model that is currently illegal. In this way, the draft serves as a reverse bill of attainder. At the heart of the SEC's recent complaints against Binance and Coinbase is the allegation that both platforms are operating unregistered securities exchanges, brokers, and clearing agencies. For this to be true, the platforms have to be listing just one unregistered security, and in both complaints, the SEC details a number of tokens that it believes constitute investment contracts, and thus securities. Some of these tokens were clearly securities when they were first issued. For example, Solana "sold its tokens through a SAFT and filed forms with the SEC about the offering."[15] But Binance and Coinbase believe these tokens are no longer securities – because they are now decentralized – and thus argue that they are not listing unregistered securities (the SEC disagrees). Coinbase explained its reasoning in their Wells submission to the SEC:

> "Unlike for traditional securities like stocks which represent ongoing claims against an issuer, for the Commission to prevail, it will need to show that particular digital assets are sold as part of investment contracts when traded on Coinbase, even though none of the asset issuers, their affiliates, or underwriters are in ongoing contractual privity with the purchasers of those digital assets."[16]

The finance writer Matt Levine perfectly articulated the flaws in this argument:

> "To me, tokens are stock. The investment contract involved when a crypto project raises money by selling tokens is: "You give us money, we will use the money to build a project, and you will get tokens that entitle you to some form of economic ownership of the project." The form of economic ownership is not exactly the same as it is in the case of stock, but it is closely analogous. If you buy a token and the project becomes popular, the token will be worth more. The token might pay dividends (in the form of staking rewards), or its price might be propped up by buybacks (burning) paid for out of the revenues of the project, just as in the case of corporate stock. It might have some sort of voting or governance rights, or a right to validate transactions in the project. But in any

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[13] https://cointelegraph.com/news/hodlers-and-whales-who-owns-the-most-bitcoin-in-2022

[14] For more on flaws in claims of blockchain's decentralization, see AFR's March 2023 submission to the Office of Science and Technology Policy

[15] https://www.bloomberg.com/opinion/articles/2023-06-07/when-is-a-token-not-a-security#xj4y7vzkg

[16] https://assets.ctfassets.net/c5bd0wqjc7v0/2pW56ln6rPJ7koLHlu2L8G/5041e0166c408698b621fde543539d76/2023-04-19_Coinbase_Wells_Submission.pdf

case, it will go up and down with the popularity of the project, of the business; it will remain a speculative investment in the project."[17]

Given the functional reality of tokens, the discussion draft would codify a way to sell unregistered stock indefinitely (these sales of "digital commodities" would still be subject to de-minimis CFTC regulation under the draft). As Matt Levine noted: "You can include most of the economic features of stock in a crypto token, and if you sell it to venture capitalists and wait a year then you never have to worry about securities regulation."

This proposal would also create opportunities for the issuers of traditional financial assets to opt into the deregulated path it offers, allowing them to sidestep existing securities regulation simply by recording ownership on a public blockchain. To elaborate, the discussion draft would allow a non-crypto firm to use a blockchain to raise funds in an exempt offering, spin up a nominally decentralized project that meets the letter of the law, and then have their tokens freely trade on the secondary market without having to comply with SEC regulations. In short, this proposed legislation could eviscerate the securities laws and their ability to protect investors from harm – not just harm from the crypto industry, but from a wide variety of issuers from other industries as well. **If asset issuers, crypto or otherwise, can legally bypass SEC registration and reporting requirements, they will do it!**

V. The Fragilities of Blockchains Underlying Digital Assets Remain Unaddressed

Our concerns about decentralization are not limited to the digital assets themselves. As the authors of this comment have noted in both public statements and in previous testimony before Congress, there is good reason to be skeptical of claims from the digital asset industry regarding whether their underlying blockchains can truly be considered decentralized; whether technological decentralization, if achievable, is sufficient to address the economic incentives present in any part of our financial system that lead to centralization; and whether such decentralization, as conceived by the digital asset industry, is compatible with sound measures to protect digitally-based financial systems from a wide array of cybersecurity risks.[18]

Currently blockchains as they operate now demonstrate high degrees of 'centralization' by many measures. For example, as of January 2023, two mining pools controlled 51% of Bitcoin's hash rate (with similar levels of concentration found on other chains).[19] A recent *Wall Street Journal* article revealed how a group of roughly half a dozen coders "serve as stewards of Bitcoin Core, an open-source program that keeps the cryptocurrency's digital ledger up-to-date on thousands of computers that make up its network."[20]

With that context in mind, we believe this bill does not adequately address the fragilities of underlying blockchains, which is a glaring deficiency in any bill designed to regulate the structure of digital asset markets.

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[17] When Is a Token Not a Security? - Bloomberg
[18] See, Allen Testimony 12-14-22.pdf (senate.gov) and HHRG-118-BA21-Wstate-ReinersL-20230309.pdf (house.gov)
[19] https://cryptoslate.com/behind-the-two-mining-pools-controlling-51-percent-of-the-global-hash-rate/ For more on flaws in claims of blockchain's decentralization, see AFR's March 2023 submission to the Office of Science and Technology Policy.
[20] https://www.wsj.com/articles/bitcoin-core-maintainers-crypto-7b93804

As one example, proposed Section 404 of the bill would introduce a new Section 5i into the Commodity Exchange Act, which requires exchanges listing digital assets to consider cybersecurity and operational issues associated with the digital assets. However, there is no real element of the bill, as we understand it, that identifies and addresses the cybersecurity and operational issues associated with the underlying blockchains on which the digital assets depend. Blockchains are open-source software, and this kind of software is not "set and forget." These systems will require monitoring and maintenance, but who has the incentives to invest time and effort in ensuring the resilience of blockchain software? If, as referenced above, the Bitcoin blockchain currently depends on four or five people sponsored by industry to maintain its code, there will be a major security vulnerability if this arrangement fails or is compromised.[21]

The bill fails to address many important questions about blockchains, including: What power do the relevant core software developers have exactly? How are they chosen, are they compensated, and if so, by whom? Who determines when a software update is needed, who ensures that it is developed, and who ensures that miners/validators will accept it? Can developers/miners/validators be counted on to get the infrastructure up and running in a timely manner after an outage? What happens if developers/miners/validators lose interest in supporting a blockchain that settles "digital assets" and/or "digital commodities" transactions?

Compare these unanswered questions to the Principles for Financial Market Infrastructure, which require providers of regulated financial infrastructures to, among other things, identify operational risks and develop systems, policies, procedures, and controls to mitigate the impact of such risks; engage in business continuity management planning; design their systems to have "adequate, scalable capacity," and "ensure a high degree of security and operational reliability."[22]

If the fundamental premise of crypto is that the technological innovation which drives it can be a substitute for the role that other intermediaries – such as regulators, brokers, or SROs play in finance – then the security and integrity of this system is highly reliant on how well its "hardware" and "software" operate and deal with manifold cybersecurity risks. that.

VI. CFTC Should Not Oversee "Digital Commodities."

It is important to note that the CFTC has been the crypto industry's preferred regulator from the beginning, and for good reason. The CFTC currently employs roughly 680 full-time employees[23] and has an annual budget of $365 million[24], while the SEC employs over 4,500[25] and has a budget of over $2 billion.[26] The wide resource gap between the two agencies means that bad actors in the crypto space will find it easier to evade a CFTC regulatory regime. In

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[21] https://www.wsj.com/articles/bitcoin-core-maintainers-crypto-7b93804
[22] Principles for Financial Market Infrastructures (bis.org)
[23] CFTC Chair Warns Of 'Disaster,' Mass Layoffs If Budget Is Cut - Law360
[24] Harris Remarks at FY24 Budget Hearing for the Commodity Futures Trading Commission (As Prepared) | House Committee on Appropriations - Republicans
[25] SEC.gov | About the SEC
[26] FY 2024 Congressional Budget Justification (sec.gov)

addition, the CFTC has been a pliant regulator for the crypto industry dating back to 2017. Lee Reiners summarized the CFTC's permissive approach in his March 2023 testimony to the Digital Assets Subcommittee:

"Beginning with the CFTC's decision to permit the self-certification of cash-settled Bitcoin futures in 2017 — despite ample evidence of manipulation in Bitcoin that could lead to manipulation of the futures contract — the CFTC has given the crypto industry most of what they have asked for.[27] *That is why the agency became the preferred regulator of the crypto industry*[28] *and why Sam Bankman-Fried was an outspoken advocate*[29] *for the Digital Commodities Consumer Protection Act (DCCPA), which would create a new federally recognized asset class called digital commodities and give oversight of digital commodity markets to the CFTC.*[30] *The CFTC was also actively considering granting FTX's application to amend its order of registration as a Derivatives Clearing Organization ("DCO"), which would have revised FTX's existing non-intermediated model to allow for clearing of margined, as well as fully collateralized, trades.*[31] *I wrote a public comment letter with Professors Hilary Allen and Ryan Clements opposing FTX's application and attended a public roundtable held at the CFTC to discuss intermediation in derivatives trading and clearing, which was precipitated by FTX's application.*[32] *The CFTC pretended that the roundtable was not designed to discuss any specific application, but the presence of Sam Bankman-Fried and several of his employees made it clear that participants were there to weigh in on FTX's application. Had FTX been successful in its attempt to offer retail investors direct access to crypto derivatives on margin 24/7, more Americans would have suffered losses when the firm collapsed.*

As noted, the CFTC does have fraud and manipulation enforcement authority over commodity spot markets, but they have used this authority sparingly when it comes to crypto. In December, CFTC Chairman Rostin Behnam told the U.S. Senate Committee on Agriculture, Nutrition, and Forestry that the agency "has brought more than 60 enforcement

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[27] The self-certification process allows designated contract markets (DCMs) to list new derivative products one day after submitting in writing to the CFTC that the product complies with the Commodity Exchange Act (CEA) and CFTC regulations.
[28] Robert Schmidt and Allyson Versprille, "Crypto Platforms Ask for Rules But Have a Favorite Watchdog," *Bloomberg*, March 31, 2022, https://www.bloomberg.com/news/articles/2022-03-31/crypto-exchanges-want-say-in-rules-under-biden-administration?leadSource=uverify%20wall.
[29] Paul Kiernan, "FTX's Collapse Upends Sam Bankman-Fried's Washington Play," *WSJ*, November 28, 2022, https://www.wsj.com/articles/ftxs-collapse-upends-sam-bankman-frieds-washington-play-11669545002?mod=hp_lead_pos4. Note also that FTX hired several former CFTC employees, see Dennis M. Kelleher, "FTX'S Penetration of the CFTC by a Revolving Door Hiring Spree of Former CFTC Officials," *Better Markets*, December 26, 2022, https://bettermarkets.org/newsroom/ftxs-penetration-of-the-cftc-by-a-revolving-door-hiring-spree-of-former-cftc-officials/.
[30] U.S. Congress, Senate, *Digital Commodities Consumer Protection Act of 2022*, S.4760, 117th Congress, introduced in Senate August 3, 2022, https://www.congress.gov/bill/117th-congress/senate-bill/4760/text. The authors of this submission also co-wrote a public letter in 2022 that identifies a number of shortfalls in the DCCPA, see https://ourfinancialsecurity.org/wp-content/uploads/2022/09/AFR-Letter-Stabenow-Bill.pdf.
[31] Commodity Futures Trading Commission, "CFTC Seeks Public Comment on FTX Request for Amended DCO Registration Order," March 10, 2022, https://www.cftc.gov/PressRoom/PressReleases/8499-22.
[32] Hilary Allen, Ryan Clements, and Lee Reiners, "Non-Intermediate Clearing of Crypto Derivatives on Margin Is a Bad Idea," *The FinReg Blog*, May 12, 2022, https://sites.duke.edu/thefinregblog/2022/05/12/non-intermediate-clearing-of-crypto-derivatives-on-margin-is-a-bad-idea/; Commodity Futures Trading Commission, "CFTC Announces Roundtable Discussion on Non-intermediation," April 27, 2022, https://www.cftc.gov/PressRoom/PressReleases/8519-22#:~:text=CFTC%20Announces%20Staff%20Roundtable%20Discussion%20on%20Non%2Dintermediation,-April%2027%2C%202022&text=Washington%2C%20D.C.%20%E2%80%94%20Staff%20of%20the,in%20derivatives%20trading%20and%20clearing.

cases in the digital asset space since 2014" and that these enforcement actions began with a referral or whistleblower tip from an external source."[33] *Relying on the goodwill of strangers to let you know when something is amiss in crypto markets is absurd. Crypto-related frauds and scams are discussed daily on Twitter, Discord, Telegram, Reddit, and countless other online communication channels. There is nothing stopping the CFTC from creating dedicated surveillance teams to monitor these channels for signs of commodities fraud. Chairman Behnam's testimony also betrays one of the reasons the CFTC gave for permitting the self-certification of Bitcoin futures in 2017:*

> *"Had it even been possible, blocking self-certification would not have stemmed interest in Bitcoin or other virtual currencies nor their spectacular and volatile valuations. Instead, it would have ensured that the virtual currency spot markets continue to operate without federal regulatory surveillance for fraud and manipulation."*[34]

At the time, the CFTC believed requiring Bitcoin futures exchanges to enter into information-sharing agreements with Bitcoin spot market platforms would give the agency greater visibility into the workings of the Bitcoin spot market. They were mistaken, and the agency is still flying blind."[35]

This proposal says nothing about increasing the CFTC's funding, capacity, or expertise, or of reorienting its mandate to focus on retail investor protections. These are indeed glaring deficiencies, but merely adding these kinds of provisions to the draft legislation would not remedy the inadequacies of the proposal. Instead, such additions would be, at best, wishful thinking and, at worst, an effort to mislead stakeholders about what is possible.

Increased funding and funding structures for the CFTC have been a deeply contested issue for many years in Washington.[36] Some members of Congress are actively supporting passage of this bill as they simultaneously seek to reduce funding for regulatory agencies, including the CFTC, in others. Ultimately, this bill gives the CFTC an unfunded mandate, making it more likely that the CFTC would face increased resource challenges in fulfilling both the oversight responsibilities outlined in this bill and its traditional responsibilities. House Agriculture Committee members should be asking whether such an arrangement would ultimately serve the communities in their jurisdiction that depend on the CFTC's oversight to ensure agricultural economic activity has adequate risk management and mitigation options. House Agriculture Committee members should also consider how non-crypto stakeholders regulated by the CFTC might react to any amendment to the proposal that contemplates levying industry fees to fund the CFTC.

Furthermore, any attempt to include language in the bill that would import investor protection concepts into the CFTC's initial mission and authorization is likely to stumble.

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[33] Commodity Futures Trading Commission, "Testimony of Chairman Rostin Benham Before the U.S. Senate Committee on Agriculture, Nutrition, and Forestry," December 1, 2022, https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam29.
[34] Commodity Futures Trading Commission, "CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets," January 4, 2018, https://www.skadden.com/-/media/files/publications/2018/10/the-distributed-ledger-october-2018/fn18_2_backgrounder_virtualcurrency01.pdf.
[35] HHRG-118-BA21-Wstate-ReinersL-20230309.pdf (house.gov)
[36] See Opinion: Congress should renew the CFTC so it can regulate shadowy markets - MarketWatch

Transforming the CFTC into an agency that prioritizes the type of regulatory approach that understands and prioritizes retail investors would require changing the mission and mandate of the agency, and the underlying statutes that guide it. It is clear the digital asset industry views its products and services as akin to commodities, and thus strenuously believes that the types of regulatory principles that are used to oversee securities market activity do not, and should not, apply. If legislators adopt language that is inconsistent with the remit of the Commodities Exchange Act, the agency could be subject to litigation. If the authority to develop regulations that foster such comparable investor protections is given to the CFTC via rulemaking authority, there is little to suggest that those strong investor protection principles would survive a rulemaking process that creates a favorable playing field for regulated entities and their legal representation. And should the agency succeed in issuing such strong regulations, the prospect of litigation that argues such new rules are in conflict with the agency's foundational statutes is still present.

To reiterate, with this bill, as it is currently written, these points are largely moot. The bill lacks the phrase 'investor protection', and the language used to allude to various aspects of such protections – such as that found throughout Title IV, which outlines the registration process for digital asset commodities exchanges and brokers – is either vague, or incomplete, and largely appears to mirror the types of oversight the CFTC already exerts over existing non-crypto financial actors – oversight which is not, by and large, oriented towards protecting retail investors.

In summary, even outspoken crypto advocate SEC Commissioner Hester Peirce has said publicly that the SEC is better suited to regulating crypto spot markets than the CFTC:

> *"Congress can figure out whether and how to fill the regulatory gaps. Given our extensive experience regulating disclosure, if tokens need federal disclosure rules, the SEC could do the job well. Given our extensive experience regulating retail-oriented exchanges, if trading platforms need a federal regulator, the SEC could do the job well."*[37]

In the same speech, Peirce went on highlight the CFTC's shortcomings:

> *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.*

VII. The SEC Does Not Need a New Mission

This bill contains several provisions designed to update the SEC's mission to accommodate the digital asset industry's claims that blockchain technology's disruptive nature requires regulators to change how they approach all financial innovation.

[37] https://www.sec.gov/news/speech/peirce-remarks-duke-conference-012023

For example, Section 306 of the bill, entitled "Modernization of Securities Regulation via modifications to existing rules for digital assets" would require the SEC to complete a study and revise rules under Regulation National Market System, Regulation Systems Compliance and Integrity, and the Market Access Rule, among others, to modernize such rules for digital assets. With just a few words, this section exposes US securities laws, and self-regulatory systems, to massive change that would likely spread beyond the digital asset space.

The regulations and systems named in this section are the core regulatory structures that govern public markets, and that make them national markets. The self-regulatory organizations (SROs) that operate in securities markets are rooted in this system, which serves to create and incentivize a culture of compliance that, while not perfect, is often rigorous and self-reinforcing.

Yet, Section 306 would direct the SEC to "modernize" this system with respect to digital assets, with scant detail on what modernization means, or what objectives such modernization efforts are meant to serve. The only guidance given is the revised rules that the SEC would enact under this law "may not be unnecessarily or unduly burdensome."

It does not take a securities lawyer to understand how this could disrupt financial markets and financial regulation writ large and open up numerous possibilities to further weaken existing oversight for securities markets and actors. Again, the presence of this language raises the question of whether the bill's authors are truly focused on creating regulatory "clarity" for the digital asset industry or are more interested in simply rewriting securities and market regulation writ large.

Perhaps the most fundamental and dangerous change in this proposal is Section 504, which would require the SEC to consider "innovation" in *all* of its rulemakings, not just those relating to digital assets.

This would effectively require the SEC to consider whether any rule it makes could in any way hamper private sector financial innovation – and yet such innovation sometimes benefits innovators at the expense of investors harmed by it.[38] It would be an outlier, in terms of international practice, to give a financial regulatory agency such a mandate, and it assumes that the SEC should be making judgments about what financial technology is and is not innovative. Instead, the SEC was created to protect investors and has done so for nearly one hundred years.

An innovation mandate would undermine the SEC's existing mandate to protect investors from harm and is likely to prove profoundly deregulatory in practice. Superficially neutral requirements like cost-benefit analysis have been weaponized by litigants to undermine the SEC's rulemaking process, notwithstanding that such cost-benefit analysis requirements are a very poor fit for financial regulation.[39]If this provision were implemented, members of affected industries would similarly petition courts to strike down SEC rules for perceived impediments to innovation. If SEC rulemakings accommodate private sector innovation in order to avoid the prospect of such litigation, that will fundamentally undermine the investor protection mission of the regulator.

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[38] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4031044
[39] https://www.yalelawjournal.org/article/cost-benefit-analysis-of-financial-regulation

VIII. Conclusion

Consumers have lost trillions due to the crypto collapse[40], in addition to the billions lost directly to scams, fraud and theft.[41] Public opinion has soured on these speculative investments.[42] Venture capital funding, which pumped crypto hype for years, often for their own firms' benefit, has plummeted, and is now migrating to the next shiny thing - AI.[43]

Most of the industry's wounds are self-inflicted and are a result of either failures in the most basic financial management principles, rampant fraud, or both.[44, 45] After 14 years crypto still struggles to demonstrate viable use cases outside of speculative investment.[46] While other tech has proven its usefulness many times over, crypto's big moment is always just over the horizon. The crypto market today is valued at just over $1 trillion, which represents a small fraction of the value of other major financial markets in comparison.

Yet, a concentrated lobbying effort by the crypto industry – which in addition to all of the challenges listed earlier, is facing regulatory action at the state, federal and international level in response to the failures and misdeeds of some of its most prominent founders and firms – has moved this Committee to prioritize advancing potentially radical proposals that would, in the name of "crypto innovation", broadly reshape agency jurisdiction over financial products and services writ large – and move it through the committee before the end of the summer.

We believe this would be rash and would introduce a policy "cure" that would likely be worse than the disease when it comes to providing crypto consumers and investors with sound protection. Regulators already have extensive existing powers to regulate this industry, the same way other financial products and services are regulated. What regulatory gaps may exist would at the very last require a targeted, measured approach – yet this bill is sweeping in scope, and should it become law it would profoundly undermine the SEC's ability to support orderly markets and protect investors from harm.

Instead of pursuing this ill-advised proposal, the best immediate step Congress could take to protect consumers who choose to participate in crypto markets would be to support regulators' ongoing efforts to enforce existing rules – the very basic elements of securities and banking regulation which provide the foundation for consumer and investor protections in the financial regulatory realm.

Thank you for considering these comments in your deliberations. Please contact Mark Hays with Americans for Financial Reform (markhays@ourfinancialsecurity.org) to respond with any questions or comments you have about our submission.

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[40] https://www.cnbc.com/2022/11/11/crypto-peaked-in-nov-2021-investors-lost-more-than-2-trillion-since.html
[41] https://www.cnn.com/2023/03/13/politics/fbi-online-fraud-report/index.html
[42] https://www.pewresearch.org/short-reads/2023/04/10/majority-of-americans-arent-confident-in-the-safety-and-reliability-of-cryptocurrency/
[43] https://qz.com/venture-capital-funding-crypto-firms-plunge-in-2023-1850506521
[44] https://www.wsj.com/articles/accounting-red-flags-are-common-among-public-crypto-companies-11670395681
[45] https://web3isgoinggreat.com/
[46] https://blog.mollywhite.net/its-not-still-the-early-days/