The Honorable Debbie Stabenow
Chairwoman
U.S. Senate Committee on Agriculture,
Nutrition, and Forestry
328A Russell Senate Office Building
Washington, D.C. 20510

The Honorable John Boozman
Ranking Member
U.S. Senate Committee on Agriculture,
Nutrition, and Forestry
328A Russell Senate Office Building
Washington, D.C. 20510

The Honorable David Scott
Chair
U.S. House Committee on Agriculture
1301 Longworth House Office Building
Washington, D.C. 20515

The Honorable Glenn Thompson
Ranking Member
U.S. House Committee on Agriculture
1010 Longworth House Office Building
Washington, D.C. 20515

Re: S. 4760/ H.R. 8730, the Digital Commodities Consumer Protection Act of 2022

September 12, 2022

Dear Chairwoman Stabenow, Chair Scott, and Ranking Members Boozman and Thompson,

We write to you regarding the Digital Commodities Consumer Protection Act of 2022. We recognize that this bill has been crafted with thoughtfulness regarding consumer protection, and that the bill's authors are proposing a targeted, not sweeping, regulatory approach to fill a significant gap in cryptocurrency regulation – the lack of crypto spot market oversight.

Nonetheless, we remain deeply concerned that the proposal, by using an overly broad definition of "digital commodity" and relying on a regulatory framework principally developed for a market - commodity derivatives - dominated by large and sophisticated institutional markets, will create gaps and vulnerabilities that will be exploited by market actors in ways that will legitimize existing practices in the digital asset sector and lead to widespread consumer harm. We are also concerned that, if enacted in its present form, the bill may erode the ability of the Securities and Exchange Commission (SEC) and state securities regulators to assert necessary and appropriate jurisdiction over assets and actors that should rightly fall under their jurisdiction.

Our main concern lies in giving the Commodity Futures Trading Commission (CFTC) oversight over "digital commodities". The CFTC does not have an investor protection mandate and the commodity derivatives markets it oversees look very different from cryptocurrency - what the bill refers to as 'digital commodity' - markets.[1] Accordingly, the CFTC has little experience in crafting and enforcing rules designed to protect retail investors. Furthermore, the CFTC has used its existing anti-fraud, false reporting, and anti-manipulation enforcement authority over

[1] CFTC Chairman Rostin Behnam emphasized this point earlier this year in a written response to Committee questions: "The most notable difference between the digital asset market and other commodity markets is the level of retail participation. Most commodity derivative markets, such as the agriculture and energy markets, are dominated by wholesalers, end-users and institutional investors engaging in hedging and other risk management transactions. However, the digital asset market is characterized by a high level of retail participants engaged in price speculation, often with high levels of leverage." See, [Office of International Affairs (senate.gov)]

cryptocurrency spot markets sparingly. Since 2014, the CFTC has brought just over 50 enforcement actions pertaining to cryptocurrency, a surprisingly low number considering the rampant fraud and abuse in cryptocurrency markets.[2] The CFTC has aggressively gone after the most egregious violations, but the number of actions has not kept pace with the scale of the problem. Overall, the CFTC has thus far adopted a permissive approach to cryptocurrency oversight that has undermined market integrity and exposed consumers to potential harm. Dating back to 2017, the CFTC has failed to halt the self-certification of a single commodity derivative with cryptocurrency as the underlying asset, despite ample evidence of manipulation in the underlying asset that can lead to manipulation of the derivatives contract. In sum, there are reasons why the cryptocurrency industry prefers that the CFTC be the primary regulator of digital assets, and we urge the Committee to assess whether these reasons are compatible with promoting market integrity, protecting consumers, and maintaining financial stability.

While our preference is to give the SEC exclusive oversight over cryptocurrency spot markets, we do believe that it may be possible for the CFTC to perform this critical role, provided the bill is amended to address the following concerns:

1. Insufficient retail investor protections. The bill, even with provisions to expand CFTC authority and powers to oversee spot markets, will likely not provide sufficient protections for retail investors and/or protections comparable to those offered within the securities regime. In particular, the bill leaves key regulatory measures such as advertising and sales largely up to a forthcoming rule-making by the CFTC. The CFTC has very little experience developing rules to directly protect retail investors, very little legal standing/jurisprudence for doing so, and will likely be pressured by industry to keep these requirements minimal. **At a minimum, this bill should be amended to spell out in more detail the restrictions the Commission would place on how products regulated by the CFTC would be marketed and sold in a fair and responsible manner**.

2. Self-certification equals minimal review, fast-lane for a glut of risky products. The self-certification regime for new digital commodity trading facilities creates a fast lane through which cryptocurrency exchanges can list any new "digital commodity" with minimal regulatory review. Cryptocurrency exchanges, like all exchanges, have an economic incentive to list as many products as possible. Considering that anyone with a computer can create a new "digital commodity" by slightly modifying the codebase of an existing digital commodity, self-certification will likely lead to the listing of thousands of cryptocurrencies that have no economic utility and that are destined to be extremely volatile. And because "digital commodities" are entirely void of fundamentals, it will be a challenge for digital commodity trading facilities to adhere to the bill's

[2] Testimony by Vince McGonagle Director of the Division of Market Oversight before the Subcommittee on Commodity Exchanges, Energy, and Credit House Agriculture Committee, Washington, DC | CFTC. By way of comparison, since its creation in 2017, the SEC's Crypto Assets and Cyber Unit unit has brought more than 80 enforcement actions related to fraudulent and unregistered crypto asset offerings and platforms. See SEC.gov | SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit. Meanwhile, more than 46,000 people since 2021 alone have reported losing over $1 billion in crypto to scams to the FTC (which is self-reported losses; full losses may be much higher - https://www.ftc.gov/news-events/data-visualizations/data-spotlight/2022/06/reports-show-scammers-cashing-crypto-craze. Arguably, 50 enforcement actions is a very low response rate relative to the scale of harm reported here.

requirement that they “permit trading only in transactions in digital commodities that are not readily susceptible to manipulation.” This will require exchanges to conduct a comprehensive review of each ‘digital commodity’s’ code and “tokenomics" to ensure there can be no hacks or rug-pulls. Given that some of the most well-funded and well-resourced crypto projects have been hacked, investors should take little comfort in a cryptocurrency exchange’s self-certification of any “digital commodity”.

The self-certification regime would create a very high burden of proof for the CFTC to demonstrate that cryptocurrency exchanges are acting in a way that is inconsistent with the Commodity Exchange Act (CEA). While securities registration and disclosure requirements require brokers, dealers, and others to meet a higher threshold of soundness before entrance into the market, the CFTC regime allows minimal disclosure and standards to be met, then relies on after the fact analysis of products and traders for enforcement. We saw this most clearly in the CFTC’s civil complaint against the cryptocurrency exchange Gemini this past June.[3] The complaint alleges that in the months leading up to the self-certification of the CBOE Futures Exchange (CFE) cash-settled Bitcoin futures contract in December 2017, Gemini engaged in a systematic effort to deceive the CFTC about the trading volume on the Gemini exchange and in the Gemini Bitcoin Auction. 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. Therefore, the CFE contract came to market under false pretenses and in violation of CFTC Core Principle 3: “[t]he board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.” The CFTC’s failure to halt the self-certification of CBOE’s contract is even more concerning when you consider the fact that Gemini’s low trading volume was a known issue at the time within the cryptocurrency industry.[4] If the CFTC is unable to flag problems in the traditional markets -commodity derivatives - it oversees, there is little chance they will actively intervene to halt the self-certification of problematic new “digital commodities”.

Instead of permitting self-certification, we recommend the bill be amended to require cryptocurrency exchanges to submit all new product listings directly to the CFTC for prior review and approval. This is how the New York BitLicense operated until the New York Department of Financial Services (DFS) issued new guidance in 2020 that allows DFS to approve a virtual currency entity’s coin-listing policy, which then permits the virtual currency entity to self-certify to DFS that its listing of a new coin complies with its DFS-approved coin-listing policy.[5] DFS also maintains a “Greenlist” of cryptocurrencies that any licensed by DFS to conduct virtual currency business activity in New York is free to list. Both policies provide for more rigorous review of new cryptocurrencies and exchanges’ procedures for listing new cryptocurrencies than the self-certification process within the CEA. The Bill should be amended to ensure that licensed assets meet minimum operational standards, which is critical given the susceptibility of crypto assets to hacks and other operational problems.

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[3] https://www.cftc.gov/PressRoom/PressReleases/8540-22

[4] CFTC Complaint Against Gemini Reveals Weaknesses in the Agency’s Approach to Virtual Currency – The FinReg Blog (duke.edu)

[5] Industry Letter - June 24, 2020: Virtual Currency Guidance Regarding Adoption or Listing of Virtual Currencies | Department of Financial Services (ny.gov)

3. **Self-certification will shield assets from proper securities regime oversight.** The SRO reliant self-certification regime proposed in this bill would likely be exploited by crypto commodity issuers and platforms in a way that would erode the ability of securities regulators to deem digital assets as “securities” once they’ve gone the CFTC route.

For example, suppose a platform or token issuer receives certification from the CFTC, and a securities regulator later determines that the asset or actor would more appropriately fall under the securities regime, the regulator must now challenge both the issuer/actor’s certification and the CFTC’s own jurisdiction and/or determination on the certification. Given the legal and political barriers such a challenge poses, it’s not hard to conceive of a scenario where many tokens or platforms quickly seek registration under the CFTC system - whether or not they are appropriately designated as commodities - then rely on inertia, legal arbitrage and time to avoid proper regulatory oversight by securities regulators. In effect, the bill may result in a ‘castle wall’ erected by this regime that asset issuers and platforms could hide behind and avoid appropriate oversight

The bill’s treatment of Ether as a digital commodity provides a compelling and concerning illustration of this dynamic. The bill specifically states that Ether is not a security, notwithstanding that Ether is about to undergo a significant change in how it is managed (vis a vis the so-called “Merge” scheduled to launch later this week) and that it is widely acknowledged by many observers of securities markets and the digital asset industry that Ether was arguably created via an unregistered securities offering, and that a potential outcome of the merge is that the behavior and characteristics associated with products and actors within the Ethereum platform may bear an even stronger resemblance to securities after the merge.

Lastly, it is also possible to conceive of a likely scenario where issuers of non-crypto securities argue that their assets should be subject to this regime and not the securities regime, because the assets in question are fungible and represented digitally, and even if an intermediary is involved in hosting or transferring those assets, that intermediary may be merely useful rather than strictly necessary (and thus the asset may satisfy the definition of “digital commodity”).

Our recommendation from listed item #2 above regarding prior review and approval of products or actors seeking listing could potentially address this problem. Additionally, we recommend that the bill authors consult further with securities regulators and experts to identify potential amendments to the bill, such as a narrower definition of digital commodity, that could mitigate these regulatory arbitrage concerns and avoid the erosion of securities regulators’ oversight of other assets currently deemed non-digital. In a similar vein, we recommend that the bill authors consult with regulators and experts about the exception to the CFTC’s jurisdiction proposed for Section 7 U.S.C. 2(F), as the use of digital commodities “solely for the purchase or a sale of a good or a service” could unintentionally capture the conversion of the digital commodity into goods including other digital commodities. Lastly, we would recommend that given the size and scope of Ether’s market share, that the definition of digital commodity in this bill be amended in such a way as to not prejudge the determination of whether or not Ether is in fact best understood as a security.

4. Pre-emption of enhanced state regulatory oversight. We are concerned that the state pre-emption clauses in this bill would likely cap the ability of state regulators to provide enhanced oversight of crypto commodities and actors. Doing so would undermine or directly contradict not only state money transmitter laws, but also more robust digital asset regulator regimes such as those offered under the New York State BitLicensing program, or California's digital asset regulatory program overseen by its Department of Financial Protection and Innovation (DFPI).

Arguably, federal regulations should set a floor not a ceiling for baseline regulatory obligations, ensuring that all states and markets meet sufficient common standards, while not impeding the ability of state regulators to take additional action or measures where appropriate. This was largely the approach that the Dodd-Frank Consumer Protection Act of 2010 took towards enactment of consumer protection laws at the federal level, with good reason: as just one example, leading up the 2008 global financial crisis, the OCC preempted several state predatory lending laws, which had disastrous effects as the mortgage lending crisis took hold.

More generally, allowing states to lead on regulatory oversight ensures there are checks and balances between federal and state regulatory powers. If all regulatory oversight is left to one federal regulator, it is easier to imagine how conditions of regulatory capture could take hold.

We recommend that the bill be amended to address these concerns regarding pre-emption in ways that reflect the feedback received or solicited from state regulators.

Overarching Concerns

More broadly, we feel it's important to note a couple of critical distinctions between the practices commonly observed on crypto exchanges and those observed on commodity and securities exchanges, which highlight the limits that exist when pursuing regulation of digital assets within a commodities exchange framework.

First, by and large, the roles within securities markets are differentiated and regulated differently, for good reasons. Brokers have a set of obligations and interests that are distinct from those of a clearing house, which are again distinct from an exchange. Their regulatory obligations are tailored to those interests, to ensure investors are being treated fairly and honestly, and to ensure conflicts of interests are disclosed, mitigated or eliminated.

On crypto exchanges as they stand now, many of these lines are blurred. Platforms serve as brokers, advisers, and a host of other roles. The literature on abuses within the crypto industry is replete with examples of self-dealing and conflicts of interest that arise from these muddied roles.

This comes into focus when one considers that, by and large, when a contract is created in a commodities trading environment, it is usually for one product, on one exchange or platform. The application of the CFTC regulatory structure this bill pursues, even with some enhanced protections included, arguably fails to acknowledge or reconcile the fact that crypto platforms and actors aren't differentiated as they are in other markets, and these actors often seek sales and trades of digital assets across many, many platforms. Some have argued that exchanges like Coinbase or FTX make a majority of their profits from acting as brokers for clients and taking advantage of the price differences on these various exchanges, pocketing the difference in prices of assets that exist between the platform they buy the asset from and the platform they use to meet the buy order of their clients.

This arrangement as a result of these commingled roles is just one, but a significant example of the types of potential conflicts of interest that need to be addressed by effective regulation to protect investors and consumers. SEC Chair Gensler noted as such in his remarks this past week, and indicated he has asked his staff to explore what it would mean to disaggregate these functions, ultimately perhaps through the establishment of separate legal entities, in order to mitigate conflicts of interest within digital asset markets.[6] Yet we fear this bill, despite elements within it that seek to distinguish between digital commodity brokers, exchanges, and other actors, will not sufficiently disaggregate these functions, and may instead institutionalize the business model we describe above.

There are additional concerns with this proposal not discussed in this letter, but these remain our primary concerns. It is unclear whether or not the recommendations we have made here to address these concerns would be sufficient for this proposal to fully ensure that this regime would provide adequate protections for retail investors exposed to digital assets considered commodities, but such change would represent significant improvement to the proposal worth pursuing.

In addition to the recommendations named above, we encourage the Committee to use its convening power to facilitate further in-depth consultation with state and federal securities regulators to secure a deeper, shared understanding of how best to coordinate and harmonize regulatory oversight across these jurisdictions without undermining retail investor protections.

We also encourage the Committee to support the CFTC's efforts in coordinating with partner agencies, such as the SEC and the CFPB, to determine how their existing regulatory authorities and jurisdictions regarding digital assets complement one another and can be deployed today to protect consumers and investors. As one example, the Committee could seek clarity regarding progress on an MOU between the CFTC and the SEC that would clarify and affirm how the two agencies' jurisdiction over digital assets will be delineated and jointly managed going forward.

Thank you for your time and consideration. Should you have any questions, please do not hesitate to contact us to discuss further these concerns and recommendations.

Sincerely,

[6] https://www.sec.gov/news/speech/gensler-sec-speaks-090822

Hilary J. Allen, Professor and Associate Dean for Scholarship, American University Washington College of Law

Mark Hays, Senior Policy Analyst, Americans for Financial Reform/Demand Progress

Lee Reiners, Policy Director at the Duke Financial Economics Center

CC: The Honorable Sherrod Brown

The Honorable Patrick Toomey

The Honorable Maxine Waters

The Honorable Patrick McHenry