

**Hearing on
Coincidence or Coordinated? The Administration’s Attack on the Digital Asset Ecosystem
Before the U.S. House Financial Services Committee Subcommittee on Digital Assets,
Financial Technology and Inclusion**

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Prepared Statement

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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 the Policy Director at the Duke Financial Economics Center and a lecturing fellow at Duke University School of Law.¹ 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 regulatory frameworks. Prior to entering academia, I spent five years examining systemically important financial institutions at the Federal Reserve Bank of New York. On February 14, 2023, I testified in front of the Senate Banking Committee for a hearing titled, “Crypto Crash: Why Financial System Safeguards are Needed for Digital Assets.”² For today’s hearing, I am resubmitting my Senate testimony with a few updates.

Table of Contents

I. Executive Summary	2
II. Cryptocurrency’s Long and Tortuous History	5
III. The Crypto Crash Could Have Been Much Worse	10
IV. Regulatory Options That Do Not Involve New Financial System Safeguards	20
V. Applying Traditional Financial Regulatory Principals and Frameworks to Crypto	24
VI. Stablecoins	333

¹ The views expressed in my testimony are mine alone and do not represent the views of the Duke Financial Economics Center, the Duke University School of Law, or Duke University.

² See a recording of the hearing and witness testimony at <https://www.banking.senate.gov/hearings/crypto-crash-why-financial-system-safeguards-are-needed-for-digital-assets>

I. Executive Summary

The title of today’s hearing implies that the main impediment to the growth and success of the digital asset (or crypto) industry is regulation; specifically, overzealous enforcement by existing financial regulatory agencies. But I would argue that the crypto industry’s main problem is the product it is selling. Cryptocurrency “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.”³ This leaves you with an asset class with no fundamentals that trades entirely on sentiment. In fact, I have repeatedly asked crypto proponents to explain their valuation methodology to me and I have yet to receive a straight answer.

Despite this inherent flaw with their product and the fragilities revealed by the implosion of FTX and multiple other crypto entities over the past year, the crypto industry wants us to believe that their salvation lies in Congress or the Securities and Exchange Commission (SEC) granting them “regulatory clarity.” But regulation is not some magical pixie dust you can sprinkle on an asset class and transform its fundamental essence. The truth is that the crypto industry wants the same thing as every industry that came before – light touch regulation and favorable taxation.

Most of the crypto industry’s ire is directed towards the SEC for simply doing its job. It is important to remember that Congress intentionally crafted our securities 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.”*⁴

Cryptocurrency and blockchain technology are simply the latest scheme deployed by those seeking to profit from other people’s money.⁵ 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 over 130 cryptocurrency-related enforcement actions and they have yet to lose a single case.⁶ For any neutral observer, the law is very clear.

The SEC is not a merit-based regulator. Anyone can raise money from the public regardless of how bad the business idea may be, provided they register with the Commission and disclose

³ 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/>.

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

⁵ 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. I elaborate on some of these below.

⁶ 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 over 130.

the relevant risk factors to prospective investors. However, the entity must have something to disclose if they are to register. Imagine a corporation approached the SEC because it wanted to do an IPO of common stock, but the company had no cash flows or a credible plan to generate cash flows, no audited financial statements, and the stock it was selling conferred no legal rights on the purchaser. If the SEC told that corporation that it wasn't ready to sell to the public markets, would you say that the SEC acted inappropriately? Incredibly, many token issuers and crypto firms who fit this example claim that the SEC is treating them unfairly.

I applaud the SEC and other financial regulatory agencies for enforcing the law. However, more must be done. While I agree with chairman Gensler that most cryptocurrencies are securities that are subject to registration and disclosure requirements, some cryptocurrencies are most likely commodities.⁷ 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.⁸ That is a gap that Congress must close as soon as possible.

In what follows, I detail several options for regulating the crypto sector in a way that protects investors and maintains financial stability. But first, in Section II, I make the case for why a comprehensive regulatory regime is needed by describing crypto's negative impacts on financial inclusion, national security, economic security, and our environment. In Section III, I note that despite the crypto industry's persistent efforts to integrate into mainstream finance, the fallout of FTX's failure was isolated within the crypto sector due in part to the actions of the SEC and federal banking agencies. Section IV provides an overview of several options for regulating cryptocurrency that do not involve Congress imposing traditional financial regulatory safeguards on the crypto sector. These options include (1) banning cryptocurrency, (2) regulating cryptocurrency as gambling, and (3) using existing regulatory authorities to regulate crypto without additional legislation. While each of these options has merit, I believe the best, and most feasible, path forward is for Congress to 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.

Section V provides a detailed roadmap for how Congress can give the SEC exclusive authority to regulate all aspects of the crypto industry and provide greater certainty to market participants. The SEC simply has more expertise, more resources, and more appetite for enforcement in the crypto realm than the CFTC does. Most importantly, unlike the CFTC, the SEC has a statutory mandate to protect investors. As I note below, bringing cryptocurrency within the definition of a security in federal law does not necessarily mean that the requirements currently applicable to securities issuers and intermediaries will apply to crypto firms on a one-for-one basis. For example, current requirements for issuer disclosure may not be well-suited to

⁷ Bitcoin has long been considered by most observers and senior regulators to be a commodity. However, recent 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>

⁸ 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.

elicit the most useful information for crypto purchasers. Therefore, Congress can grant the SEC authority to develop tailored requirements for crypto issuers and intermediaries should the SEC feel such requirements are warranted.

If Congress does not wish to give the SEC exclusive authority over crypto, then lawmakers should consider passing legislation that requires crypto intermediaries to implement basic customer safeguards, such as segregating customer assets from firm assets. Section V also provides additional information on how Congress can impose such discrete requirements on crypto intermediaries before concluding with an examination of why treating crypto exchanges as self-regulatory organizations is a mistake.

I conclude my testimony in Section VI by offering my perspective on the best path forward on stablecoin regulation, where I do see the potential for a bipartisan solution. I recommend Congress grants the SEC the authority to regulate stablecoins like money market mutual funds, with strict requirements that stablecoin reserves be held in cash and Treasury securities and that these reserves be subject to periodic audits and disclosure.

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. Quickly passing crypto legislation will not matter if we end up experiencing a crypto-fueled 2008-style financial crisis down the road.

Even if you disagree with me on the underlying merits of cryptocurrency, we should still be able to agree on the need for a robust regulatory regime for crypto that protects investors and minimizes the risks to financial stability. For the crypto industry to grow and generate sustainable profits for the long-term, consumers need to trust it. The crypto industry currently suffers from a trust deficit, but this can be remedied if consumers know they have the same basic safeguards in crypto that they have come to know and expect from the traditional financial system.

Thorough disclosure and robust regulation played a critical role in making U.S. capital markets the envy of the world. The cryptocurrency industry will need similar guardrails if it is going to have any long-term success.

II. Cryptocurrency's Long and Tortuous History

Satoshi Nakamoto introduced the first cryptocurrency, Bitcoin, to the world in a nine-page white paper posted to an online cryptography mailing list on Halloween 2008, and the first Bitcoin transaction was posted in January 2009.⁹ Fourteen years, thousands of cryptocurrencies, and trillions of investor losses later, crypto scarcely resembles the “purely peer-to-peer version of electronic cash” first envisioned by Satoshi.

By technology standards, crypto is not new. For comparison, the iPhone was introduced in 2007. Anyone who held a smartphone in their hand for the first time immediately recognized its transformative potential; now, 85% of Americans own a smartphone.¹⁰ More recently, OpenAI made the artificial intelligence chatbot ChatGPT available to the public in November 2022; two months later, ChatGPT had 100 million monthly active users, “making it the fastest-growing consumer application in history,” according to one study.¹¹

After fourteen years and innumerable claims that crypto represents the future of money, finance, or something else, we have yet to see crypto's killer use case. In fact, only 16% of U.S. adults have invested in, traded, or used cryptocurrency.¹² For those that have, the two most commonly cited reasons are (1) it is a different way to invest (78%), and (2) it is a good way to make money (75%). In other words, most people invest in cryptocurrency for no other reason than they think they can sell it to someone else at a higher price in the future.

However, fourteen years have provided ample evidence of the dire harm cryptocurrency inflicts throughout our society, which I will now detail.

a. Investor Losses

After peaking at \$69,000 in November 2021, Bitcoin has proceeded to decline by roughly 70%. Over the same time, the market cap of all cryptocurrencies went from \$3 trillion to \$1 trillion, a staggering loss of wealth in a short period of time. According to a study released last November by the Bank for International Settlements, around three-quarters of people who invested in Bitcoin between 2015 and 2022 lost money.¹³ Similarly, Pew reports that 46% of those who invested in cryptocurrency admit their investments have done worse than expected, while only 15% say they have done better than expected.¹⁴ Both surveys were conducted before

⁹ Satoshi Nakamoto, “Bitcoin: A Peer-to-Peer Electronic Cash System,” accessed January 30, 2023, <https://bitcoin.org/bitcoin.pdf>.

¹⁰ Pew Research Center, “Mobile Fact Sheet,” November 16, 2022, <https://www.pewresearch.org/internet/factsheet/mobile/>.

¹¹ Krystal Hu, “ChatGPT Sets Record for Fastest-Growing User Base - Analyst Note,” *Reuters*, February 2, 2023, <https://www.reuters.com/technology/chatgpt-sets-record-fastest-growing-user-base-analyst-note-2023-02-01/>.

¹² Michelle Faverio and Navid Massarat, “46% of Americans Who Have Invested in Cryptocurrency Say It's Done Worse than Expected,” Pew Research Center, November 21, 2022, <https://www.pewresearch.org/fact-tank/2022/08/23/46-of-americans-who-have-invested-in-cryptocurrency-say-its-done-worse-than-expected/>.

¹³ Raphael Auer, Giulio Cornelli, Sebastian Doerr, Jon Frost and Leonardo Gambacorta, *Crypto Trading and Bitcoin Prices: Evidence from a New Database of Retail Adoption* (Basel, BIS: 2022), accessed January 30, 2023, <https://www.bis.org/publ/work1049.pdf>.

¹⁴ Faverio and Massarat, “46% of Americans.”

the collapse of FTX, so the number of crypto investors who have suffered losses is surely higher now.

The same Pew study cited above found that “Asian, Black and Hispanic adults are more likely than White adults to say they have ever invested in, traded or used a cryptocurrency.”¹⁵ A 2022 survey from Charles Schwab found that one-quarter of Black Americans own cryptocurrency, compared to 15% for White Americans.¹⁶ Particularly troubling was Schwab’s finding that “Black investors are more than twice as likely to say cryptocurrency was their first investment” (11% of Black investors compared to 4% of White investors.) In December 2022, JPMorgan Chase released a report that analyzed data from 600,000 checking account customers who had bought crypto and found “[m]ost individuals who transferred money to crypto accounts did so when crypto-asset prices were significantly higher than recent levels, and those with lower incomes likely made purchases at elevated prices relative to higher earners.”¹⁷ Unfortunately, crypto losses have centered disproportionately on groups that have historically been excluded from the traditional financial system and the wealth-building opportunities it provides.

Such data flies in the face of the repeated claims by the crypto industry that crypto promotes financial inclusion by providing easy access to financial services and an opportunity to build wealth. The Treasury Department looked into those claims and concluded in a report released last September that “the potential financial inclusion benefits of crypto-assets largely have yet to materialize.”¹⁸ Similarly, in a thoroughly researched article for the Brookings Institution, Tonantzin Carmona assessed the industry’s claims that crypto promotes financial inclusion and found that “crypto’s current capabilities do not match the needs of the groups it purports to serve” and that crypto “carries a host of risks and drawbacks that undermine its benefits.”¹⁹

Beyond the investing losses associated with cryptocurrency’s extreme volatility, millions of ordinary investors have fallen victim to countless frauds, scams, and hacks in the crypto sector. Blockchain analytics company Chainalysis recently reported that “2022 was the biggest year ever for crypto hacking, with \$3.8 billion stolen from cryptocurrency businesses.”²⁰ Crypto hacks and scams have led to a surge in consumer complaints. According to a September 2022 report from the Department of Justice, the Consumer Financial Protection Bureau (CFPB) published 2,404 cryptocurrency-related consumer complaints in its Consumer Complaint Database in 2021, and more than 1,000 cryptocurrency-related complaints during 2022 year-to-

¹⁵ Ibid.

¹⁶ Schwab Moneywise, “Ariel-Schwab Black Investor Survey (2022),” accessed February 8, 2023, <https://www.schwabmoneywise.com/tools-resources/ariel-schwab-survey-2022>.

¹⁷ Chris Wheat and George Eckerd, *The Dynamics and Demographics of U.S. Household Crypto-Asset Use* (New York: JPMorgan Chase Institute, 2022), <https://www.jpmorganchase.com/institute/research/financial-markets/dynamics-demographics-us-household-crypto-asset-cryptocurrency-use>.

¹⁸ U.S. Department of the Treasury, *Crypto-Assets: Implications for Consumers, Investors, and Businesses*, (Washington, DC: GPO, 2022), https://home.treasury.gov/system/files/136/CryptoAsset_EO5.pdf.

¹⁹ Tonantzin Carmona, *Debunking the Narratives about Cryptocurrency and Financial Inclusion*, (Washington, D.C.: Brookings, 2022) <https://www.brookings.edu/research/debunking-the-narratives-about-cryptocurrency-and-financial-inclusion/>.

²⁰ Chainalysis, “2022 Biggest Year Ever For Crypto Hacking with \$3.8 Billion Stolen, Primarily from DeFi Protocols and by North Korea-Linked Attackers,” *Chainalysis*, February 1, 2023, <https://blog.chainalysis.com/reports/2022-biggest-year-ever-for-crypto-hacking/>.

date.²¹ The report also noted that “[t]he CFPB has also received hundreds of servicemember complaints involving cryptocurrency assets or exchanges in the last 12 months, approximately one-third of which concerned frauds or scams.”²² In June 2022, the Federal Trade Commission issued a report finding that “since the start of 2021 more than 46,000 people have reported losing over \$1 billion in crypto to scams – that’s about one out of every four dollars reported lost, more than *any* other payment method.”²³ The median individual loss was a staggering \$2,600.

In their September report, the Treasury Department bluntly summarized cryptocurrency’s risks to consumers:

*“Consumers and investors are exposed to improper conduct in the crypto-asset ecosystem for a variety of reasons, including a lack of transparency as well as the fact that crypto-assets have relatively novel and rapidly developing applications. This leads to frequent instances of operational failures, market manipulation, frauds, thefts, and scams.”*²⁴

b. National Security Risks

Cryptocurrency is increasingly being used by organized crime syndicates and nation-states to undermine U.S. national security. We know that Iran, Russia, and North Korea are using cryptocurrency to bypass U.S. economic and financial sanctions.²⁵ The United Nations and U.S. intelligence officials have noted that North Korea’s cyber operations are used to fund the country’s illicit ballistic missile and nuclear programs.²⁶ North Korea’s brazenness was revealed to the public last year when the venture capital-backed “Web 3” video game, Axie Infinity, was hacked by the Lazarus Group and \$620 million in the cryptocurrency Ether was stolen.²⁷ In January, the FBI announced that the Lazarus Group was also behind the \$100 million hack of

²¹ The United States Department of Justice, “Justice Department Announces Report on Digital Assets and Launches Nationwide Network,” September 16, 2022, <https://www.justice.gov/opa/pr/justice-department-announces-report-digital-assets-and-launches-nationwide-network>.

²² Ibid.

²³ Emma Fletcher, “Reports Show Scammers Cashing in on Crypto Craze,” Federal Trade Commission, August 11, 2022, <https://www.ftc.gov/news-events/data-visualizations/data-spotlight/2022/06/reports-show-scammers-cashing-crypto-craze>.

²⁴ U.S. Treasury, *Crypto-Assets*.

²⁵; Emily Flitter and David Yaffe-Bellany, “Russia Could Use Cryptocurrency to Mitigate U.S. Sanctions,” *The New York Times*, February 24, 2022, <https://www.nytimes.com/2022/02/23/business/russia-sanctions-cryptocurrency.html>; Kyle Barr, “Iran Plans to Use Crypto to Pay for Imports to Help Get Around Sanctions,” *Gizmodo*, August 9, 2022, <https://gizmodo.com/iran-crypto-imports-sanctions-1849389297>; Mike Orcutt, “This Is How North Korea Uses Cutting-Edge Crypto Money Laundering to Steal Millions,” *MIT Technology Review*, April 2, 2020, <https://www.technologyreview.com/2020/03/05/916688/north-korean-hackers-cryptocurrency-money-laundering/>.

²⁶ Christian Davies and Scott Chipolina, “How North Korea Became a Mastermind of Crypto Cybercrime,” *Ars Technica*, November 14, 2022, <https://arstechnica.com/information-technology/2022/11/how-north-korea-became-a-mastermind-of-crypto-cyber-crime/>.

²⁷ Aaron Schaffer, “North Korean Hackers Linked to \$620 Million Axie Infinity Crypto Heist,” *The Washington Post*, April 14, 2022, <https://www.washingtonpost.com/technology/2022/04/14/us-links-axie-crypto-heist-north-korea/>.

Harmony Protocol.²⁸ Chainalysis estimates that North Korea-linked hackers stole roughly \$1.7 billion worth of cryptocurrency in 2022 (by way of comparison, North Korea’s total exports totaled \$142 million in 2020).²⁹ Just last week, Reuters reported on a confidential United Nations report that found North Korea stole more cryptocurrency assets in 2022 than any other year.³⁰ Anne Neuberger, US deputy national security adviser for cyber security, said in July 2022 that North Korea “uses cyber to gain, we estimate, up to a third of their funds for their missile program.”³¹

Terrorist organizations have also been soliciting cryptocurrency donations for several years.³² In December 2022, blockchain analytics firm TRM Labs reported that an ISIS affiliate in Afghanistan recently began “accepting cryptocurrency donations amid ramped-up propaganda and recruitment efforts.” That is in keeping with a trend, noted by the Treasury Department last November, of ISIS increasingly using virtual assets service providers to finance their subordinates in central and south Asia.³³ In January, TRM Labs also reported that KillNet, a pro-Russian cybercriminal group, uses crypto to raise funds for Russia’s illegal invasion of Ukraine and targets critical infrastructure in countries opposed to the invasion.³⁴ The U.S. Cybersecurity and Infrastructure Security Agency (CISA) noted last April that KillNet is just one of many Russia-aligned cyber groups conducting malicious activities against the U.S. and our allies.³⁵ Finally, in January 2022, the Government Accountability Office (GAO) issued a report finding that “[v]irtual currency is increasingly used illicitly to facilitate human and drug trafficking.”³⁶

c. Economic Security

Cryptocurrency has fueled a surge in ransomware that has victimized American businesses, healthcare systems, and state and local governments. In May 2022, the majority staff on the Homeland Security & Governmental Affairs Committee released a startling report on

²⁸ Sander Lutz, “FBI Confirms North Korea Behind \$100 Million Harmony Hack,” *Decrypt*, January 24, 2023, <https://decrypt.co/119861/fbi-north-korea-lazarus-horizon-harmony-bridge-hack>.

²⁹ Chainalysis, “Biggest Year Ever.”

³⁰ Michelle Nichols, “Exclusive: Record-Breaking 2022 for North Korea Crypto Theft, UN Report Says,” *Reuters*, February 7, 2023, <https://www.reuters.com/technology/record-breaking-2022-north-korea-crypto-theft-un-report-2023-02-06/>.

³¹ Davies and Chipolina, “North Korea.”

³² For example, see The United States Department of Justice, “Global Disruption of Three Terror Finance Cyber-Enabled Campaigns,” August 13, 2020, <https://www.justice.gov/opa/pr/global-disruption-three-terror-finance-cyber-enabled-campaigns>.

³³ See TRM, “New Evidence Confirms ISIS Affiliate in Afghanistan Accepting Cryptocurrency Donations,” *TRM Insights*, accessed February 10, 2023, <https://www.trmlabs.com/post/new-evidence-confirms-isis-affiliate-in-afghanistan-accepting-cryptocurrency-donations> and U.S. Department of the Treasury, *Fact Sheet: Countering ISIS Financing*, November 18, 2022, <https://home.treasury.gov/system/files/136/Fact-Sheet-on-Countering-ISIS-Financing.pdf>.

³⁴ TRM, “Spotlight on KillNet: The Cybercriminal Group Raising Funds for Russia’s War in Ukraine,” *TRM Insights*, accessed February 10, 2023, <https://www.trmlabs.com/post/spotlight-on-killnet-the-cybercriminal-group-raising-funds-for-russias-war-in-ukraine>.

³⁵ Cybersecurity and Infrastructure Security Agency, “Russian State-Sponsored and Criminal Cyber Threats to Critical Infrastructure,” accessed February 10, 2023, <https://www.cisa.gov/uscert/ncas/alerts/aa22-110a>.

³⁶ U.S. Government Accountability Office, “Virtual Currencies: Additional Information Could Improve Federal Agency Efforts to Counter Human and Drug Trafficking [Reissued with Revisions Feb. 7, 2022],” January 10, 2022, <https://www.gao.gov/products/gao-22-105462>.

ransomware.³⁷ The report notes that, in 2021, “ransomware attacks impacted at least 2,323 local governments, schools, and healthcare providers in the United States” and that the FBI “received 3,729 ransomware complaints with adjusted losses of more than \$49.2 million.” The report acknowledges that these numbers underestimate the true scale of the problem because many ransomware victims do not report to authorities. As evidence, they cite data from Chainalysis that found “malign actors received at least \$692 million in cryptocurrency extorted as part of ransomware attacks” in 2020. The report notes that “cryptocurrency, typically Bitcoin, has become a near-universal form of ransom payment in ransomware attacks, in part, because cryptocurrency enables criminals to extort huge sums of money from victims across diverse sectors with incredible speed.”

The Treasury Department’s Financial Crimes Enforcement Network (FinCEN) releases periodic “Financial Trend Analysis” of ransomware-related Bank Secrecy Act (BSA) filings. The most recent analysis, from November 2022, covers ransomware trends in BSA filings from July–December 2021 and notes that “FinCEN received 1,489 ransomware-related filings worth nearly \$1.2 billion in 2021.”³⁸ The total number of ransomware filings, and the dollar value of these filings, in 2021 exceeded the previous ten years combined. In their previous Financial Trend Analysis, covering data from the first six months of 2021, FinCEN identified Bitcoin as the most common ransomware-related payment method, with the use of Monero — a cryptocurrency that provides even more privacy than Bitcoin — on track to increase in the years to come.³⁹

d. Environmental Damage

The proof-of-work consensus mechanism used to maintain the Bitcoin blockchain is extremely energy intensive — by design — and contributes to carbon emissions, electronic waste, noise pollution, and supply chain disruptions.⁴⁰ A report released last September by the White House Office of Science and Technology Policy (OSTP) estimated that, as of August 2022, electricity usage for crypto-assets ranged between 120 and 240 billion kilowatt-hours per year, which is comparable to all the electricity consumed by Argentina or Australia and the annual electricity usage of all conventional data centers in the world.⁴¹ The OSTP estimated that the U.S. is home to roughly one-third of global crypto use and that this consumes about 0.9% to 1.7% of total U.S.

³⁷ United States Senate Committee on Homeland Security & Governmental Affairs, “Use of Cryptocurrency in Ransomware Attacks, Available Data, and National Security Concerns,” accessed February 8, 2023, <https://www.hsgac.senate.gov/wp-content/uploads/imo/media/doc/HSGAC%20Majority%20Cryptocurrency%20Ransomware%20Report.pdf>.

³⁸ U.S. Treasury Financial Crimes Enforcement Network, “Financial Trend Analysis: Ransomware Trends in Bank Secrecy Act Data Between July 2021 and December 2021,” accessed February 8, 2023, https://www.fincen.gov/sites/default/files/2022-11/Financial%20Trend%20Analysis_Ransomware%20FTA%202021%20508%20FINAL.pdf.

³⁹ U.S. Treasury Financial Crimes Enforcement Network, “Financial Trend Analysis: Ransomware Trends in Bank Secrecy Act Data Between January 2021 and June 2021,” accessed February 8, 2023, https://www.fincen.gov/sites/default/files/2021-10/Financial%20Trend%20Analysis_Ransomware%20508%20FINAL.pdf.

⁴⁰ Proof-of-work’s goal is to make it prohibitively expensive to overwhelm the network with hashing power, thereby preventing bad actors from taking over the blockchain. The block reward provides an incentive for honest miners to incur the computational expense.

⁴¹ The White House, “Climate and Energy Implications of Crypto-Assets in the United States,” accessed February 6, 2023, <https://www.whitehouse.gov/wp-content/uploads/2022/09/09-2022-Crypto-Assets-and-Climate-Report.pdf>.

electricity usage, which contributed to 25 to 50 metric tons of carbon dioxide emitted per year or 0.4% to 0.8% of U.S. greenhouse gas emissions.

Because Bitcoin mining — the process that verifies and adds new transactions to the blockchain — relies on highly specialized computers that quickly become obsolete, mining produces 35,000 tons of electronic waste per year, “equivalent to the annual electronic waste generation of the Netherlands.”⁴² Cryptocurrency’s energy consumption has certainly come down in the wake of Ethereum’s switch to the far more energy-efficient proof-of-stake consensus mechanism last September, but it remains needlessly high.⁴³ The University of Cambridge’s Bitcoin Electricity Consumption Index indicates that Bitcoin consumes more electricity per year (106.4 TWh) than the Philippines and slightly less than the Netherlands.⁴⁴ Due to its libertarian roots and lack of any coordinating body, there is little chance that the Bitcoin blockchain would ever migrate to a less energy-intensive consensus mechanism absent a government mandate.

Crypto mining has also exacerbated the global shortage of semiconductor chips.⁴⁵ Crypto miners use application-specific integrated circuit (ASIC) hardware to improve speed and efficiency. Given the short lifespan of ASIC computers at constant use, miners can run through valuable chips quickly. A positive association has been found between the MSCI worldwide semiconductor index return and crash periods of the cryptocurrency market, meaning the two industries are closely tied.⁴⁶

Local businesses and residents can also be negatively impacted when a crypto mining facility opens nearby. For example, in Plattsburgh, NY, crypto mining resulted in residential electric bills that were reportedly up to \$300 higher than usual during the winter of 2018, causing the city to introduce the nation’s first 18-month moratorium on new mining operations.⁴⁷

III. The Crypto Crash Could Have Been Much Worse

a. Financial Stability Implications

While millions of Americans have suffered crypto-related financial losses over the past year, we should be thankful that problems in the crypto sector have not spilled into the traditional financial system and threatened financial stability. That outcome was not preordained, and it

⁴² *Ibid.*, 26.

⁴³ The Ethereum Foundation has claimed that the transition reduced Ethereum’s energy consumption by 99.95%. See Q.Ai, “Proof-Of-Stake: Will The Ethereum Merge Really Lead To A Rally?” *Forbes*, September 27, 2022, <https://www.forbes.com/sites/qai/2022/09/27/proof-of-stake-will-the-ethereum-merge-really-lead-to-a-rally/?sh=566f65d0223d>.

⁴⁴ University of Cambridge, “Cambridge Bitcoin Electricity Consumption Index (CBECEI),” accessed February 1, 2023, <https://ccaf.io/cbeci/index/comparisons>.

⁴⁵ Diana Li, “Crypto Mining Is Exacerbating Chip Shortage and Energy Consumption, Skeptics Say,” *Six Feet Forward*, January 4, 2022, <https://wp.nyu.edu/coveringcovid/2022/01/04/crypto-mining-is-exacerbating-chip-shortage-and-energy-consumption-skeptics-say/>.

⁴⁶ Tripti Rathi, “Effect of Cryptocurrency Mining on Semiconductor Industry,” *SSRN*, January 11, 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4005868.

⁴⁷ Congressional Research Service, “Bitcoin, Blockchain, and the Government Sector,” August 9, 2019, <https://crsreports.congress.gov/product/pdf/R/R45863>.

represents a little-celebrated policy success. Last October, 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.”⁴⁸

At its peak in November 2021, the crypto market (\$3 trillion) was significantly larger than the value of subprime mortgages in the U.S. in March 2007 (\$1.3 trillion), and we have never had “appropriate regulation.”⁴⁹ Therefore, the lack of systemic implications is due primarily to the limited interconnections between the crypto ecosystem and the traditional financial system. But what is true today may not be true tomorrow, and over the past six years, the crypto industry has waged an aggressive campaign to integrate crypto into mainstream finance in such a way that the two would be indistinguishable. These efforts, some successful, others not, include:

- The launch of cash-settled Bitcoin futures contracts in December 2017.⁵⁰ There are now multiple U.S.-listed cryptocurrency derivatives contracts that anyone can access.
- Repeated unsuccessful attempts to list a spot Bitcoin ETF. In June 2022, Grayscale Investments sued the SEC after its latest attempt to convert the Grayscale Bitcoin Trust (GBTC) into a spot Bitcoin ETF was denied.⁵¹
- The listing of an ETF that tracks the price of Bitcoin futures in 2021.⁵²
- The unsuccessful attempts of state-chartered “crypto banks” to obtain a Federal Reserve Master Account and access to the Federal Reserve’s payment system. In June 2022, Wyoming-chartered crypto bank Custodia sued the Federal Reserve Board of Governors and Federal Reserve Bank of Kansas City for delaying a decision on its master account application.⁵³

⁴⁸ 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>.

⁴⁹ Associated Press, “Will Subprime Mess Ripple through Economy?” *NBC News*, March 13, 2007, <https://www.nbcnews.com/id/wbna17584725>. The Financial Crisis Inquiry Commission also provided information about subprime mortgage originations in the years leading up to 2008, showing that “[i]n 2006, \$600 billion of subprime loans were originated,” with slightly more being originated in 2005 and somewhat fewer in 2004. Financial Crisis Enquiry Commission, “The Financial Crisis Enquiry Report,” (Washington, D.C.: GPO, 2011), <https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

⁵⁰ Reuters Staff, “Cboe, CME to Launch Bitcoin Futures Contracts,” *Reuters*, December 7, 2017, <https://www.reuters.com/article/us-bitcoin-futures-contracts/cboe-cme-to-launch-bitcoin-futures-contracts-idUSKBNIE10KC>.

⁵¹ Ryan Browne, “Grayscale Sues SEC after Rejection of Bid to Turn the Largest Bitcoin Fund into an ETF,” *CNBC*, June 30, 2022, <https://www.cnbc.com/2022/06/30/grayscale-sues-sec-after-rejected-bid-to-turn-bitcoin-fund-into-etf.html>.

⁵² Tanaya Macheel, “First Bitcoin Futures ETF Rises More than 4% in Trading Debut on the NYSE,” *CNBC*, October 19, 2021, <https://www.cnbc.com/2021/10/19/first-bitcoin-futures-etf-rises-2percent-in-trading-debut.html>.

⁵³ James Rubin, “Crypto Bank Custodia Sues Federal Reserve,” *CoinDesk*, June 8, 2022, <https://www.coindesk.com/policy/2022/06/07/crypto-bank-custodia-sues-federal-reserve/>. Note that last month the Federal Reserve Board rejected Custodia’s membership application, and the Kansas City Fed rejected Custodia’s master account application. See Anna Hrushka, “Custodia Bank Denied Fed membership, Master Account,”

- BNY Mellon, the world’s largest asset custodian, going live last October with its Digital Asset Custody platform in the U.S., allowing select institutional clients to hold and transfer Bitcoin and Ether.⁵⁴
- Fidelity Investments, the country’s largest provider of 401(k) plans by total assets, starting to allow companies (from fall 2022) to offer employees the option to invest up to 20% of their 401(k)s in Bitcoin.⁵⁵
- A 2022 application by FTX to the CFTC that would have permitted FTX to self-clear non-intermediated crypto derivatives traded on margin by retail investors.⁵⁶

The failure of crypto to fully integrate into mainstream finance is due to a combination of luck and prudent action by a handful of regulatory agencies. Below, I single out the actions of the SEC and the federal banking agencies. However, the Department of Labor also deserves recognition for releasing guidance last year expressing “serious concerns about the prudence of a fiduciary’s decision to expose a 401(k) plan’s participants to direct investments in cryptocurrencies, or other products whose value is tied to cryptocurrencies.”⁵⁷ The Department’s actions likely prevented more employers from including Bitcoin as an investment option in their employees’ 401(k) plans.

b. The SEC’s Consistent Approach to Crypto

Despite the crypto industry’s self-serving cries for “regulatory clarity,” the SEC’s stance on cryptocurrency has been clear and consistent dating from 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.⁵⁸ 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 — “securities regulation is not meant to be precise but is instead intentionally drafted to be broad and all-encompassing.”⁵⁹ 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:”

Banking Dive, January 30, 2023, <https://www.bankingdive.com/news/crypto-custodia-denied-fed-membership-master-account-caitlin-long-kansas-city/641529/>.

⁵⁴ BNY Mellon, “BNY Mellon Launches New Digital Asset Custody Platform,” October 11, 2022, <https://www.bnymellon.com/us/en/about-us/newsroom/press-release/bny-mellon-launches-new-digital-asset-custody-platform-130305.html>.

⁵⁵ Greg Iacurci, “Fidelity, ForUsAll Now Offering 401(k) Investors Access to Cryptocurrency,” *CNBC*, November 4, 2022, <https://www.cnbc.com/2022/11/04/fidelity-forusall-offering-401k-investors-access-to-cryptocurrency.html>.

⁵⁶ 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>.

⁵⁷ U.S. Department of Labor, “Compliance Assistance Release No. 2022-11: 401(k) Plan Investment in ‘Cryptocurrencies,’” <https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/compliance-assistance-releases/2022-01>.

⁵⁸ Gary Gensler, “Kennedy and Crypto,” (speech, Washington, D.C., September 8, 2022), <https://www.sec.gov/news/speech/gensler-sec-speaks-090822>.

⁵⁹ John Stark, “Big Crypto’s Bogus Demands for ‘Regulatory Clarity,’” *The FinReg Blog*, November 28, 2022, <https://sites.duke.edu/thefinregblog/2022/11/28/big-cryptos-bogus-demands-for-regulatory-clarity-2/>.

“[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.”⁶⁰

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).⁶¹

Federal courts have repeatedly confirmed the SEC’s jurisdiction in numerous crypto-related enforcement actions. In fact, as of January 18, 2023, the SEC has brought over 130 crypto-related enforcement actions without losing a single case.⁶² 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.

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.”⁶³ 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.”⁶⁴ A year later, the same office

⁶⁰ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

⁶¹ *Reves et al. v. Ernst & Young*, 494 U.S. 56 (1990).

⁶² 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>.

⁶³ Stark, “Big Crypto’s Bogus Demands.”

⁶⁴ U.S. Securities and Exchange Commission, “Ponzi Schemes Using Virtual Currencies,” accessed January 9, 2023, https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf.

issued an Investor Alert on “Bitcoin and Other Virtual Currency-Related Investments.”⁶⁵ 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 2016.⁶⁶ 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.”⁶⁷ 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.”⁶⁸

The SEC has also publicized its position on cryptocurrency in countless enforcement actions,⁶⁹ multiple speeches,⁷⁰ congressional testimony,⁷¹ and several official SEC statements⁷² and proclamations.⁷³ Chairman Gensler, has spoken frequently about the perils and illegality of crypto lending platforms and decentralized finance,⁷⁴ warning that their failure to register with the SEC may violate U.S. securities laws.⁷⁵ 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

⁶⁵ 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>.

⁶⁶ 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>.

⁶⁷ Ibid.

⁶⁸ 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>.

⁶⁹ U.S. Securities and Exchange Commission, “Crypto Assets and Cyber Enforcement Actions,” November 4, 2022, <https://www.sec.gov/spotlight/cybersecurity-enforcement-actions>.

⁷⁰ 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>.

⁷¹ 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>.

⁷² 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>.

⁷³ 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>.

⁷⁴ 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>.

⁷⁵ 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>.

whether they're registered or they're operating outside of the law, and I'll leave it at that."⁷⁶

On September 8, 2022, Chairman Gensler gave a speech reflecting on the flexibility of the securities laws and the SEC's consistency in applying those laws to cryptocurrency.⁷⁷ Gensler noted that of the 10,000 different cryptocurrencies in the market, "the vast majority are securities."⁷⁸ 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."⁷⁹

In January, the nonprofit Better Markets released a report detailing the SEC's strong record on crypto regulation and enforcement.⁸⁰ 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) selectively bringing enforcement actions, and (3) using its authority to "deny crypto firms' requests to unlawfully engage in certain types of activities."⁸¹

Under the latter prong, the SEC has repeatedly rejected attempts by exchanges seeking to list shares of a trust or exchange-traded funds (ETFs) that track the price of Bitcoin. The SEC's main concern has always been manipulation in the underlying Bitcoin spot market. When they first rejected an application to list and trade shares of a Bitcoin trust in 2017, they noted that the proposal was inconsistent "with Section 6(b)(5) of the Exchange Act, which requires, among other things, 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."⁸² Recent events reveal that crypto markets continue to be rife with fraud and manipulation, and the SEC's refusal to permit a Bitcoin ETF saved would-be investors a lot of money.⁸³

While the SEC has largely been an effective cop on the beat, their track record on crypto is not spotless. Unfortunately, they failed to stop Celsius and Gemini from offering their customers

⁷⁶ McSweeney, "Gensler Sets SEC Sights."

⁷⁷ Gensler, "Kennedy and Crypto."

⁷⁸ Ibid.

⁷⁹ Ibid.

⁸⁰ 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.

⁸¹ Ibid., 3.

⁸² U.S. Securities and Exchange Commission, "Self-Regulatory Organizations; Bats BZX Exchange, Inc.; Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, to List and Trade Shares Issued by the Winklevoss Bitcoin Trust," March 10, 2017, <https://www.sec.gov/rules/sro/batsbzx/2017/34-80206.pdf>.

⁸³ I defended the SEC's approach to crypto exchange-traded products in two blog posts from 2018 and 2019. See Lee Reiners, "SEC Stands Firm Against New Bitcoin ETF Proposals," *The FinReg Blog*, January 12, 2018, <https://sites.duke.edu/thefinregblog/2018/01/12/sec-stands-firm-against-new-bitcoin-etf-proposals/>; Lee Reiners, "The SEC Should Continue to Say No to Bitcoin Exchange-Traded Products," *The FinReg Blog*, June 18, 2019, <https://sites.duke.edu/thefinregblog/2019/06/18/the-sec-should-continue-to-say-no-to-bitcoin-exchange-traded-products/>.

a cryptocurrency lending product despite these products being available for several years and the Commission filing successful enforcement actions in similar cases, like BlockFi, and preventing Coinbase from offering its cryptocurrency lending product, Lend. Celsius filed for bankruptcy last July, leaving roughly 600,000 account holders unable to access their assets, collectively valued at \$4.2 billion at the time of bankruptcy.⁸⁴ After the collapse of FTX last November, the cryptocurrency exchange Gemini halted customer withdrawals from its Earn program after its lending partner, Genesis Global, decided to pause withdrawals.⁸⁵ In January, the SEC charged Genesis and Gemini with offering unregistered securities in connection with the Earn program, but this action came too late to help Gemini customers who have over \$900 million stuck in that program.⁸⁶

The SEC has also been slow to bring civil charges against cryptocurrency exchanges for being an unregistered securities exchange⁸⁷ or broker-dealer despite repeated claims by Chairman Gensler that most crypto platforms are offering unregistered securities and the Commission bringing enforcement actions in other cases that imply a crypto exchange was operating an unregistered securities exchange.⁸⁸ Last July, the SEC filed “insider trading charges against a former Coinbase product manager, his brother, and his friend for perpetrating a scheme to trade ahead of multiple announcements regarding certain crypto-assets that would be made available for trading on the Coinbase platform.”⁸⁹ In their complaint, the Commission provides a detailed analysis as to why nine of the cryptocurrencies defendants traded in are securities. These

⁸⁴ In January, the Celsius bankruptcy judge ruled that customers’ crypto deposits at Celsius are owned by Celsius, meaning these customers are now unsecured creditors in the bankruptcy estate. See Dietrich Knauth, “U.S. Judge Says Celsius Network Owns Most Customer Crypto Deposits,” *Reuters*, January 6, 2023, <https://www.reuters.com/business/finance/us-judge-says-celsius-network-owns-most-customer-crypto-deposits-2023-01-05/>.

⁸⁵ Q.Ai, “Gemini Crypto Pauses Withdrawals, Fallout Continues From FTX Collapse,” *Forbes*, November 30, 2022, <https://www.forbes.com/sites/qai/2022/11/30/gemini-crypto-pauses-withdrawals-fallout-continues-from-ftx-collapse/?sh=6d8de0264a84>.

⁸⁶ Shortly after the SEC filed charges, Genesis filed for Chapter 11 bankruptcy protection. See Rohan Goswami, “Crypto Firms Genesis and Gemini Charged by SEC with Selling Unregistered Securities,” *CNBC*, January 12, 2023, <https://www.cnb.com/2023/01/12/sec-charges-genesis-and-gemini-with-selling-unregistered-securities.html>; Rohan Goswami, “Crypto Lender Genesis Files for Bankruptcy in Latest Blow to Barry Silbert’s DCG Empire,” *CNBC*, January 20, 2023, <https://www.cnb.com/2023/01/20/crypto-lender-genesis-trading-files-for-bankruptcy-barry-silbert-digital-currency-group.html>.

⁸⁷ In 2018, the SEC filed an enforcement action against the EtherDelta founder for operating an unregistered securities exchange. This was the first such enforcement action in the digital asset space. See “SEC Charges EtherDelta Founder With Operating an Unregistered Exchange,” November 8, 2022, <https://www.sec.gov/news/press-release/2018-258#:~:text=The%20Securities%20and%20Exchange%20Commission,an%20unregistered%20national%20securities%20exchange>. In 2021 the SEC did charge digital asset trading platform Poloniex with operating an unregistered exchange. See “SEC Charges Poloniex for Operating Unregistered Digital Asset Exchange,” August 9, 2022, <https://www.sec.gov/news/press-release/2021-147>.

⁸⁸ See Gensler, “Aspen Security Forum,” where he noted, “A typical trading platform has more than 50 tokens on it. In fact, many have well in excess of 100 tokens. While each token’s legal status depends on its own facts and circumstances, the probability is quite remote that, with 50 or 100 tokens, any given platform has zero securities.” See also Gensler, “Kennedy and Crypto”, where he said, “Given that many crypto tokens are securities, it follows that many crypto intermediaries are transacting in securities and have to register with the SEC in some capacity,” “Furthermore, these platforms likely are trading securities,” and “I’ve asked staff to work on a number of projects related to the platforms. First is getting the platforms themselves registered and regulated much like exchanges.”

⁸⁹ U.S. Securities and Exchange Commission, “SEC Charges Former Coinbase Manager, Two Others in Crypto Asset Insider Trading Action,” July 21, 2022, <https://www.sec.gov/news/press-release/2022-127>.

charges imply that Coinbase was offering unregistered securities on its platform, but the SEC has yet to file an enforcement action against Coinbase.

Regulating complex financial markets is difficult, and it is unrealistic to expect the SEC or any other agency to catch every violation before investors are harmed. With cryptocurrency, the SEC's job is made that much harder by the fact that an unlimited supply of cryptocurrencies can be minted out of thin air, the industry's deliberate choice not to comply with securities laws, and the industry's aggressive lobbying for light-touch regulation on Capitol Hill and state capitols throughout the country.⁹⁰

c. Federal Banking Agencies

The federal banking agencies (Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency) also deserve commendation for limiting the systemic implications of the crypto market's collapse. Each agency had sound guidance in place at the time of FTX's failure expressing concerns over banks' abilities to engage in crypto-asset activities in a safe and sound manner and requiring banks to notify their appropriate regulator before engaging in such activity. This guidance likely limited banks' willingness to engage in crypto-asset activities and restricted a potentially large contagion channel through which volatility in the crypto markets could have spilled into the traditional financial system.

Budding bank-crypto connections and the crypto-asset sector's "significant volatility and vulnerabilities over the past year" prompted the federal banking agencies to issue a "Joint Statement on Crypto-Asset Risks to Banking Organizations" on January 3, 2023 (Joint Statement).⁹¹ The Joint Statement lists eight "key risks associated with crypto-assets and crypto-asset sector participants that banking organizations should be aware of" and reinforces previously issued guidance by each agency that requires supervised firms to inform their respective regulators of any crypto-related activities they wish to engage in or are currently engaged in. However, the Joint Statement uses more forceful language and "calls into question the safety and soundness practices of those engaging in crypto-assets, including banks with concentrated exposure to the crypto-assets sector."⁹² Furthermore, the Joint Statement includes language that suggests banks are not permitted to hold crypto-assets on their balance sheet (custody excluded):

"Based on the agencies' current understanding and experience to date, the agencies believe that issuing or holding as principal crypto-assets that are issued, stored, or

⁹⁰ For an example, see Alexander Sammon, "The Eight Congressmen Subverting the SEC's Crypto Investigation," *The American Prospect*, March 25, 2022, <https://prospect.org/power/eight-congressmen-subverting-secs-crypto-investigation/>.

⁹¹ Board of Governors of the Federal Reserve System, "Agencies Issue Joint Statement on Crypto-Asset Risks to Banking Organizations," January 3, 2023, <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf>.

⁹² Deloitte, *Banking Regulators Reinforce Wall for Bank Involvement in Crypto-Assets*, (New York: Deloitte, 2023) accessed January 16, 2023, https://www2.deloitte.com/content/dam/Deloitte/us/Documents/dcrs/Deloitte_Banking%20brick%20wall%20for%20crypto_January%202023.pdf.

*transferred on an open, public, and/or decentralized network, or similar system is **highly likely to be inconsistent with safe and sound banking practices***” (emphasis added).⁹³

On January 23, 2023, the Board of Governors issued a Policy Statement (208.112) that provides additional clarity on the types of crypto-asset activity state member banks can engage in.⁹⁴ The statement notes “the Board will presumptively exercise its authority to limit state member banks to engaging as principal in only those activities that are permissible for national banks,” and provides Supplementary Information that clarifies that state member banks are not permitted to hold crypto-assets as principal. One month later, in response to massive deposit outflows at several crypto-focused banks, the banking agencies issued a joint statement highlighting liquidity risks to banks that rely on funding from crypto-asset-related entities (the statement reiterates existing liquidity risk management principles.)⁹⁵

Despite clear guidance and repeated warnings around banks’ crypto-asset activities, FTX’s failure revealed that several banks were more exposed to crypto-asset activities than previously realized. Two notable examples are Silvergate Capital Corporation and Moonstone Bank. Silvergate positioned itself as the leading bank for cryptocurrency exchanges (including FTX) and investors. At the end of September 2022, deposits from crypto clients made up 90% of the bank’s overall deposit base, leaving the bank highly exposed to a volatile sector.⁹⁶ This risk became manifest post-FTX’s collapse when the bank experienced \$8.1 billion in deposit outflows during the fourth quarter of 2022, more than 60% of its total deposits.⁹⁷ To meet deposit outflows, Silvergate was forced to sell assets, resulting in a loss of \$718 million, which exceeded “the bank’s total profit since at least 2013.”⁹⁸ Silvergate was also forced to borrow \$4.3 billion from the Federal Home Loan Bank of San Francisco to stay afloat.⁹⁹ Last week, Silvergate announced they were delaying the release of their annual report because they were evaluating their “ability to continue as a going concern for the twelve months following the issuance of these financial statements.”¹⁰⁰

⁹³ Board of Governors, “Joint Statement.”

⁹⁴ Board of Governors of the Federal Reserve System, “Policy Statement on Section 9(13) of the Federal Reserve Act,” January 27, 2023, <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230127a2.pdf>.

⁹⁵ Board of Governors of the Federal Reserve System, “Agencies Issue Joint Statement on Liquidity Risks Resulting from Crypto-Asset Market Vulnerabilities,” February 23, 2023, <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230223a.htm>

⁹⁶ Marc Rubinstein, “These Banks Were Left Holding the Bag in Crypto Implosion,” *The Washington Post*, November 23, 2022, https://www.washingtonpost.com/business/these-banks-were-left-holding-the-bag-in-crypto-implosion/2022/11/22/b8de2096-6a2b-11ed-8619-0b92f0565592_story.html.

⁹⁷ David Benoit, “Silvergate’s Deposit Run Is Worse Than Great Depression-Era Runs,” *The Wall Street Journal*, January 5, 2023, <https://www.wsj.com/livecoverage/stock-market-news-today-01-05-2023/card/silvergate-s-deposit-run-is-worse-than-great-depression-era-runs-CqZpNYLAuW1R1Rwv4221?page=1>.

⁹⁸ David Benoit, “Silvergate Raced to Cover \$8.1 Billion in Withdrawals During Crypto Meltdown,” *The Wall Street Journal*, January 5, 2023, <https://www.wsj.com/articles/silvergate-raced-to-cover-8-1-billion-in-withdrawals-during-crypto-meltdown-11672895207?page=1>.

⁹⁹ Kate Berry, “Silvergate Bank Loaded up on \$4.3 Billion in Home Loan Bank Advances,” *American Banker*, January 10, 2023, <https://www.americanbanker.com/news/silvergate-bank-loaded-up-on-4-3-billion-in-fhlb-advances>.

¹⁰⁰ David Hollerith, “Silvergate stock crashes after company delays annual report, reveals new losses,” YahooFinance, March 2, 2023, <https://finance.yahoo.com/news/silvergate-stock-crashes-after-company-delays-annual-report-reveals-new-losses-121923800.html>

Another unpleasant surprise came in a FTX bankruptcy filing when it was revealed that Alameda Research, a crypto trading firm founded and owned by Sam Bankman-Fried, made an \$11.5 million investment in the parent company (FBH Corp.) of Washington state-based Farmington State Bank in March 2022, more than double the bank’s net worth at the time.¹⁰¹ Farmington then changed its name to Moonstone Bank, and shortly thereafter, Moonstone’s deposit base jumped from \$10 million — where it had been for decades — to \$84 million, of which \$71 million came from just four accounts.¹⁰² Alameda’s investment came on the heels of Farmington’s pivot to servicing crypto firms after the bank was purchased by FBH in 2020 and received a Federal Reserve Master Account in 2021.¹⁰³ According to Camden Fine, the former president and CEO of the Independent Community Bankers of America, “[t]he fact that an offshore hedge fund that was basically a crypto firm was buying a stake in a tiny bank for multiples of its stated book value should have raised massive red flags for the F.D.I.C., state regulators and the Federal Reserve.”¹⁰⁴

I encourage bank regulators to learn from these examples and ramp up their efforts to better understand all the ways in which banks under their supervision are exposed to crypto. Bank regulators should formalize a horizontal exercise that will gather this information and make the results public, so that bank customers and investors will not be surprised when the next large crypto firm fails and they find out their bank was over-exposed to crypto. I also encourage the FDIC to revisit its rules around brokered deposits, which may have played a role in Silvergate’s liquidity problems.¹⁰⁵

As noted in a forthcoming article I co-authored with Sangita Gazi, “the Joint Statement signals a new era of intense regulatory scrutiny of *any* bank involvement in crypto-asset activity, but there remains the question: where should regulators draw the line?” Some scholars have called for a “Glass-Steagall 2.0” that would completely separate banking and crypto, but this is beyond the agencies’ ability to implement and would require congressional action.¹⁰⁶ As the Joint Statement makes clear, “[b]anking organizations are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation.” Provided cryptocurrency and its progeny, like stablecoins, are legal in the U.S., banks are free to conduct business with crypto firms. However, bank regulators do have the authority to impose additional prudential requirements on such activity and they should develop a comprehensive framework that clarifies the type of crypto-asset activity banks can engage in

¹⁰¹ Protos, “The Curious Case of FTX and Farmington State Bank, aka Moonstone,” *Protos*, November 24, 2022, <https://protos.com/the-curious-case-of-ftx-and-farmington-state-bank-aka-moonstone/>.

¹⁰² Stephen Gandel, “Crypto Firm FTX’s Ownership of a U.S. Bank Raises Questions,” *The New York Times*, December 6, 2022, <https://www.nytimes.com/2022/11/23/business/ftx-cryptocurrency-bank.html>; Moonstone Bank, “FBH Corp. raises \$11.5M in private equity funding from Alameda Research Ventures,” Cision PR Newswire, March 7, 2022, <https://www.prnewswire.com/news-releases/fbh-corp-raises-11-5m-in-private-equity-funding-from-alameda-research-ventures-301497307.html>.

¹⁰³ Protos, “The Curious Case.”

¹⁰⁴ Gandel, “Crypto Firm.”

¹⁰⁵ Kyle Campbell, “Policy Advocates Question Brokered Deposit Role in Silvergate Run,” *American Banker*, February 3, 2023, <https://www.americanbanker.com/news/policy-advocates-question-brokered-deposit-role-in-silvergate-run>.

¹⁰⁶ Hilary J. Allen, “Crypto Crash: Why the FTX Bubble Burst and the Harm to Consumers,” Statement before the Senate Commission on Banking, Housing, and Urban Affairs, December 14, 2022, <https://www.banking.senate.gov/imo/media/doc/Allen%20Testimony%2012-14-22.pdf>.

and the prudential requirements (capital and liquidity) required to engage in such activity. That may require the bank agencies to implement more rigorous standards than the Basel Committee on Banking Supervision’s final prudential standard for crypto-asset exposures, issued in December 2022.¹⁰⁷

IV. Regulatory Options That Do Not Involve New Financial System Safeguards

This section will introduce and briefly discuss three options for regulating cryptocurrency that do not involve Congress imposing traditional financial regulatory safeguards on the crypto sector. These options are (1) banning cryptocurrency, (2) regulating cryptocurrency as gambling, and (3) using existing regulatory authorities to regulate crypto without additional legislation. Any proposal to regulate the crypto industry must be assessed by how well it protects investors and maintains financial stability. I refer to these two goals as the “dual mandate” of crypto regulation.

a. Banning Cryptocurrency

The most effective way to protect investors and preserve financial stability would be to ban cryptocurrency outright. I argued for this approach in the wake of the Colonial Pipeline hack in a 2021 op-ed, in which I called out crypto’s connection to ransomware and noted that the associated costs outweigh any benefits crypto provides.¹⁰⁸ Given crypto’s negative externalities detailed above, the case for a crypto ban has only grown stronger. More recently, Professor Hilary Allen argued for a crypto ban in front of this Committee in December.¹⁰⁹ Addressing the retort that crypto’s decentralized nature makes a ban impossible to enforce, Professor Allen correctly noted:

“[C]rypto is not actually decentralized,¹¹⁰ and so there are many people against whom such a ban could be enforced. Most obviously, centralized exchanges (like FTX) serve as important gateways to the crypto markets. If they were banned from listing cryptoassets, then the market for cryptoassets would most likely diminish significantly.”

Further buttressing Professor Allen’s point is the fact that China banned cryptocurrency in 2021.¹¹¹ While there are certainly some Chinese citizens who transact in crypto, the industry has completely pulled out of China, and the country was spared the fallout from the most recent “crypto winter.” Berkshire Hathaway vice-chairman Charlie Munger is an admirer of China’s crypto ban, writing in the Wall Street Journal in February 2023 that “the communist government of China recently banned cryptocurrencies because it wisely concluded that they would provide more harm

¹⁰⁷ Basel Committee on Banking Supervision, *Prudential Treatment of Cryptoasset Exposures* (Basel: BIS, 2022), accessed January 7, 2023, <https://www.bis.org/bcbs/publ/d545.pdf>.

¹⁰⁸ Lee Reiners, “Ban Cryptocurrency to Fight Ransomware,” *WSJ*, May 25, 2021, <https://www.wsj.com/articles/ban-cryptocurrency-to-fight-ransomware-11621962831>.

¹⁰⁹ Allen, “Crypto Crash.”

¹¹⁰ Sirio Aramonte, Wenqian Huang, and Andreas Schrimpf, “DeFi Risks and the Decentralization Illusion,” *BIS Quarterly Review*, (December 2021).

¹¹¹ BBC News, “China Declares All Crypto-Currency Transactions Illegal,” *BBC News*, September 24, 2021, <https://www.bbc.com/news/technology-58678907>.

than benefit.”¹¹² You can disagree with the means — as Mr. Munger and I do — by which China implemented a ban, but they have proven it can be done.¹¹³

b. Regulating Cryptocurrency as Gambling

Some commentators have noted that cryptocurrency’s lack of fundamental value and speculative nature make crypto “investing” akin to gambling. Columbia professor Todd Baker noted:

*“Crypto trading is wholly unconnected to the productive purpose that defines finance: helping businesses, individuals, and governments raise, save, transmit, and use money for socially and economically useful ends.”*¹¹⁴

Fabio Panetta, a member of the executive board for the European Central Bank, had similar things to say about unbacked crypto-assets:

*“They do not perform any socially or economically useful function: they are rarely used for payments and do not fund consumption or investment. As a form of investment, unbacked cryptos lack any intrinsic value, too. They are speculative assets. Investors buy them with the sole objective of selling them on at a higher price. In fact, they are a gamble disguised as an investment asset.”*¹¹⁵

Baker argues that it is a categorical error to equate crypto with finance and that subjecting crypto to traditional financial regulation would legitimize crypto-asset activities and jeopardize financial stability. The solution, therefore, is to regulate crypto like gambling.

While these commentators are correct in their diagnosis that crypto investing is no different from gambling, I disagree that the cure is to regulate crypto as gambling. For starters, unlike with crypto exchanges, gamblers do not leave their money at the casino at the end of the night. This fact alone calls for more robust investor protections. Second, gambling is regulated at the state or tribal and local levels in the U.S. Regulating crypto as gambling would therefore allow some states to implement lax regulations and could lead to a race to the bottom whereby states compete to woo the crypto industry by adopting ever more lenient regulation (this is already happening to a certain extent).¹¹⁶ Finally, while gambling's negative externalities have immediate effects on individual families and surrounding communities, those impacts don't have the same

¹¹² Charlie Munger, “Why America Should Ban Crypto,” *WSJ*, February 2, 2023, <https://www.wsj.com/articles/why-america-should-ban-crypto-regulation-economy-finance-china-england-trading-currency-securities-commodity-gamble-11675287477>.

¹¹³ Mr. Munger notes in his *WSJ* article: “What should the U.S. do after a ban of cryptocurrencies is in place? Well, one more action might make sense: Thank the Chinese communist leader for his splendid example of uncommon sense.”

¹¹⁴ 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/>.

¹¹⁵ Fabio Panetta, “Caveat Emptor Does Not Apply to Crypto,” *Financial Times*, January 4, 2023, <https://www.ft.com/content/95249051-f9f0-494d-9fa0-c7cca8edaa69?shareType=nongift>.

¹¹⁶ See Eric Lipton and David Yaffe-Bellany, “Crypto Industry Helps Write, and Pass, Its Own Agenda in State Capitols,” *The New York Times*, April 10, 2022, <https://www.nytimes.com/2022/04/10/us/politics/crypto-industry-states-legislation.html>.

potential as crypto to create broader ripple effects through the financial system and the economy. Therefore, a more comprehensive financial regulatory approach that does not validate crypto as legitimate financial activity is needed.

c. Using Existing Authorities to Regulate Crypto without Additional Legislation

Post-FTX, many policymakers have called on financial regulators to use their existing legal authority more aggressively to clean up the crypto industry and protect investors.¹¹⁷ I agree that regulators can, and should, do more, but I also believe that congressional action is needed to close gaps in the current regulatory framework. Most pleas for regulatory action are focused on the SEC, and as noted above, the SEC has aggressively used its enforcement authority when warranted. But bringing a successful enforcement action takes time and resources, two things that any regulator will tell you are always in short supply. Furthermore, despite repeated pleas from Chairman Gensler to the industry to come in and get registered, the crypto industry has willfully chosen to operate outside the regulatory perimeter. It simply is not possible for the SEC to litigate an entire industry into compliance, and even if they did, there would still be some cryptocurrencies, like Bitcoin, that would be considered commodities and not securities.¹¹⁸

The CFTC has classified Bitcoin and Ethereum — and by extension, other cryptocurrencies that are similarly structured — as commodities (courts have also upheld this classification). While the CFTC regulates commodity derivatives, they do not regulate commodity spot markets, although they do have enforcement authority for fraud and manipulation in commodity spot markets. The CFTC also needs to do more to protect crypto investors, but, apart from a few meaningful enforcement actions, the agency has unfortunately demonstrated little desire to do so at the scale needed.

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.¹¹⁹ That is why the agency became the preferred regulator of the crypto industry¹²⁰ and why Sam Bankman-Fried was an outspoken advocate¹²¹ for the Digital

¹¹⁷ Jennifer Schonberger, “Elizabeth Warren Calls on SEC to Use 'Full Force of its Regulatory Powers' in Crypto Crackdown,” *Yahoo News*, January 26, 2023, <https://news.yahoo.com/elizabeth-warren-calls-on-sec-to-use-full-force-of-its-regulatory-powers-in-crypto-crackdown-210442856.html>.

¹¹⁸ SEC Chairman Gary Gensler has said that Bitcoin is a commodity. See Kevin Helms, “SEC Chair Gensler Affirms Bitcoin Is a Commodity — 'That's the Only One I'm Going to Say,’” *Bitcoin.com*, June 27, 2022, <https://news.bitcoin.com/sec-chair-gensler-bitcoin-is-a-commodity/>.

¹¹⁹ 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.

¹²⁰ 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>.

¹²¹ 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*

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.¹²² 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.¹²³ 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.¹²⁴ 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 cases in the digital asset space since 2014” and that these enforcement actions began with a referral or whistleblower tip from an external source.”¹²⁵ 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,

Markets, December 26, 2022, <https://bettermarkets.org/newsroom/ftx-penetration-of-the-cftc-by-a-revolving-door-hiring-spree-of-former-cftc-officials/>.

¹²² 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>. I co-wrote a public letter with Hilary Allen and Mark Hays that identifies a number of shortfalls in the DCCPA, see <https://ourfinancialsecurity.org/wp-content/uploads/2022/09/AFR-Letter-Stabenow-Bill.pdf>.

¹²³ 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>.

¹²⁴ 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>.

¹²⁵ 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/opabeznam29>.

it would have ensured that the virtual currency spot markets continue to operate without federal regulatory surveillance for fraud and manipulation.”¹²⁶

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.

V. Applying Traditional Financial Regulatory Principles and Frameworks to Crypto

The lack of crypto spot market regulation is a glaring gap in oversight that Congress must address. As noted above, the CFTC has jurisdiction over commodity derivatives, but they do not oversee commodity “spot” or cash markets, except in instances of fraud or manipulation.¹²⁷ Because U.S.-based crypto exchanges argue that they only list commodities, no federal agency presently supervises crypto exchanges on an ongoing basis.¹²⁸ No one would suggest that it is a good idea for the New York Stock Exchange or the NASDAQ to be unregulated, yet that is exactly the situation we currently have with crypto exchanges. As a result, cryptocurrency exchanges do not have to:

- Provide audited financial statements;
- Provide books and records upon request to a federal regulatory agency;
- Have exchange listing standards;
- Enforce codes of conduct against exchange members;
- Segregate customer assets from firm assets;
- Have rules governing conflicts of interest;
- Maintain net capital at required levels to protect customers and creditors from monetary losses if the exchange fails; or
- Pay into a government-mandated insurance fund that would make customers whole if the exchange were to fail or lose customer assets.¹²⁹

It also means that cryptocurrency exchanges are allowed to fulfill multiple functions that are typically separated in traditional securities markets, this includes being a broker, market maker,

¹²⁶ 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.

¹²⁷ CFTC jurisdiction is also implicated when a commodity is offered for trading on a margined, leveraged, or financed basis. See LABCFTC, “A CFTC Primer on Virtual Currencies,” October 17, 2017, https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf.

¹²⁸ Of course, SEC Chairman Gary Gensler believes most U.S. crypto exchanges are listing securities and operating unregistered securities exchanges. But the SEC has yet to file an enforcement action asserting that; therefore, crypto exchanges remain unregulated for the time being. Also, the U.S. Department of the Treasury’s Financial Crimes Enforcement Network (“FinCEN”) does consider “administrators” and “exchangers” of convertible virtual currencies to be money services businesses subject to regulations implementing the Bank Secrecy Act. See Financial Crimes Enforcement Network, “Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies,” March 18, 2013, <https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering>.

¹²⁹ This list is by no means exhaustive.

exchange, clearing agency, and custodian. As we saw with FTX, comingling these “various functions within crypto intermediaries creates inherent conflicts of interest and risks for investors.”¹³⁰ And most importantly for crypto investors, the lack of federal cryptocurrency spot market regulation is one reason why investors become unsecured creditors when a crypto intermediary fails, as millions of Americans found out the hard way over the past year.¹³¹

What is needed is one dedicated regulatory agency with exclusive oversight over cryptocurrency issuance and trading. The threshold questions, however, are which agency should be given this task, and what should be the extent of its authority? I have previously argued that this authority should be given to the SEC.¹³² The following section will detail the benefits of Congress granting the SEC exclusive oversight over crypto markets.

a. Congress Should Grant the SEC Oversight over Cryptocurrency Spot Markets

The debate around whether a given digital asset is a commodity, security, or something else must be addressed if one agency is to have sole authority over digital asset markets. This bifurcation has contributed to strange outcomes in trading markets. For example, the CFTC permitted the listing of cryptocurrency futures contracts, and the SEC subsequently authorized an ETF tracking cryptocurrency futures, but the SEC has yet to authorize a spot cryptocurrency ETF. A spot cryptocurrency ETF and cash-settled cryptocurrency futures both provide exposure to cryptocurrency without requiring investors to ever take possession of cryptocurrency. The fact that we have one without the other makes little sense. Furthermore, it is not entirely clear how securities and commodities law apply to novel crypto projects, such as decentralized finance (DeFi) protocols. For example, can a token issued by a decentralized autonomous organization (DAO) be considered an investment contract if there truly is no central party, or parties, essential to the DAO’s performance?¹³³

The only way to address this uncertainty is by statutorily recognizing and defining cryptocurrency or a similar term (crypto-assets or digital assets) in federal law. Of course, most financial assets are digital, so the definition must be precise enough to exclude traditional assets

¹³⁰ Gensler, “Kennedy and Crypto.”

¹³¹ Bankruptcy law is private law, and if there are adequate private law arrangements in place to segregate funds, crypto investors should be protected even if there is no regulation in place. But per crypto exchanges’ terms of service, there are no such arrangements. See Adam J. Levetin, “Not Your Keys, Not Your Coins: Unpriced Credit Risk in Cryptocurrency,” *Texas Law Review*, August 28, 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4107019.

¹³² Lee Reiners, “Congress Should Grant the SEC Oversight of Digital Asset Spot Markets,” *The CLS Blue Sky Blog*, April 21, 2022, <https://clsbluesky.law.columbia.edu/2022/04/21/congress-should-grant-the-sec-oversight-of-digital-asset-spot-markets/>.

¹³³ The governance tokens for most DAOs tend to be concentrated in the hands of founders, venture capitalist funders, and crypto whales. Therefore, enforcement efforts could be targeted at these holders. See Chainalysis, “Dissecting the DAO: Web3 Ownership is Surprisingly Concentrated,” *Chainalysis Blog*, June 27, 2022, available at <https://blog.chainalysis.com/reports/web3-daos-2022/>. The FSOC Report on Digital Asset Financial Stability Risks and Regulation uses the UNI governance token to illustrate the point that “the top 1 percent of addresses of certain governance tokens hold over 90 percent of the total supply.” See Financial Stability Oversight Council, *Report on Digital Asset Financial Stability*.

that are already subject to robust regulation, yet broad enough to incorporate cryptocurrency as well as current and future cryptocurrency offshoots (DAOs, DeFi, non-fungible tokens (NFTs), etc.). Importantly, whatever crypto regulatory regime Congress devises cannot be less stringent than existing financial regulation, otherwise, it will be arbitrated by legacy firms.

I urge Congress to carve out cryptocurrency, or a similar term like crypto-asset, from the definition of a commodity in the Commodity Exchange Act and recognize cryptocurrencies as securities under a special definition to the securities laws. This would give the SEC exclusive authority to regulate all aspects of the crypto industry and provide greater certainty to market participants, as no Howey test analysis would be needed to determine whether the asset qualifies as a security. The SEC simply has more expertise, more resources (although, to be clear, additional funding would be required), and more appetite for enforcement in the digital assets area than the CFTC does. Most importantly, unlike the CFTC, the SEC has a statutory mandate to protect investors. It is worth noting that even former CFTC Chairman Timothy Massad agrees that the SEC should be given oversight over digital asset spot markets: “Despite my personal affection for the CFTC, the SEC may be better suited to the task because it is more focused on retail investors and cash markets.”¹³⁴

Bringing cryptocurrency within the definition of security in federal law does not necessarily mean that the requirements currently applicable to securities issuers and intermediaries will apply to crypto issuers and intermediaries on a one-for-one basis. Cryptocurrency is unique in multiple ways, and it may make sense for the SEC to craft more customized rules so that crypto issuers and intermediaries can better comply with the spirit of securities laws. Even Chairman Gensler has acknowledged this point, noting in a speech last September:

*“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.”*¹³⁵

SEC Commissioner Hester Peirce elaborated on this point in a speech at Duke University in January:

“Whether Congress gives the disclosure task to the SEC or another regulator, several models exist. A few projects have been able to navigate their way through existing registration regimes. Disclosure under current regulations, however, is not well-suited to elicit the most useful and appropriate information for token purchasers because it does ‘not cover a number of features unique to digital assets that would undoubtedly be considered important when making an investment decision,’ as a recent petition to the SEC argued. Instead, traditional disclosures are ‘designed for traditional corporate entities that typically issue and register equity and debt securities’ and ‘focus on disclosure about companies, their management, and their financial results — topics that poorly fit the decentralized and open-source nature of blockchain-based digital asset

¹³⁴ Timothy G. Massad, *It’s Time to Strengthen the Regulation of Crypto-Assets*, (Washington, D.C.: Brookings, 2017) <https://www.brookings.edu/wp-content/uploads/2019/03/Economis-Studies-Timothy-Massad-Cryptocurrency-Paper.pdf>.

¹³⁵ Gensler, “Kennedy and Crypto.”

securities.’ Thus, a more tailored crypto disclosure regime would be good for investors and crypto companies.’¹³⁶

In authorizing legislation granting the SEC oversight over crypto, Congress can order the SEC to engage in notice and comment rulemaking around a crypto disclosure regime. This would have the added benefit of giving the public a formal opportunity to weigh in on the information they think is most relevant to make an informed crypto investment decision.

Beyond *what* information should be disclosed regarding prospective crypto purchases, there is also the issue of *who* is responsible for disclosure. Some cryptocurrencies, like Bitcoin, “do not provide a claim on an identifiable issuer since coins can be created or “minted” according to a protocol which has been coded by computer developers often based in overseas or unknown locations.”¹³⁷ Therefore, who is responsible for Bitcoin’s disclosure? The European Union’s proposed Markets in Crypto-assets (MiCA) regulation punts on this issue by exempting crypto-assets that are created through mining from the obligation to publish a white paper (a form of prospectus).¹³⁸ The U.S. should not adopt that approach. Instead, for cryptocurrencies without an identifiable issuer, the crypto exchange should be required to take on the responsibilities of the issuer if they wish to list the cryptocurrency (this idea was recently proposed by His Majesty’s Treasury in the U.K.)¹³⁹

If cryptocurrency is classified as a security, then cryptocurrency exchanges would be required to register as national securities exchanges or else qualify for an exemption, such as operating an “alternative trading system.”¹⁴⁰ As noted previously, crypto exchanges operate very differently than traditional securities exchanges; if they are forced to register with the SEC as a securities exchange, their business model would have to change (this is one reason why crypto exchanges have been so resistant to SEC registration). The Securities Exchange Act of 1934 (1934 Act) and the regulations thereunder list the requirements that apply to national securities exchanges. Among them, exchanges must permit any SEC-registered broker-dealer in good standing to become a member¹⁴¹ and must deny membership to a non-registered broker-dealer.¹⁴² That means that absent any carve-out in new legislation, retail investors would no longer be able to directly access crypto exchanges. Instead, they would have to trade crypto through an SEC-registered broker-dealer (note that there are already broker-dealers, like Robinhood, providing crypto trading to retail investors).

¹³⁶ Hester M. Pierce, “Outdated: Remarks before the Digital Assets at Duke Conference,” (speech, Duke University, January 20, 2023), <https://www.sec.gov/news/speech/peirce-remarks-duke-conference-012023>.

¹³⁷ His Majesty’s Treasury in the United Kingdom floated this possibility in a crypto-asset consultation released earlier last month. See HM Treasury, *Future Financial Services Regulatory Regime for Cryptoassets: Consultation and Call for Evidence* (London: HM Treasury, 2023) https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1133404/TR_Privacy_edits_Future_financial_services_regulatory_regime_for_cryptoassets_vP.pdf.

¹³⁸ Council of the European Union, “Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937 (MiCA) - Letter to the Chair of the European Parliament Committee on Economic and Monetary Affairs,” October 5, 2022, <https://data.consilium.europa.eu/doc/document/ST-13198-2022-INIT/en/pdf>.

¹³⁹ HM Treasury, *Future Financial Services*.

¹⁴⁰ U.S. Code 15 § 78e.

¹⁴¹ *Ibid.* § 78f(b)(2).

¹⁴² *Ibid.* § 71f(c)(1).

Brokers serve valuable purposes in securities trading, mainly in terms of protecting investors and ensuring a smooth trading experience. Brokers are held to stringent requirements around asset custody, capital, rehypothecation, and order routing. Under the latter, brokers are subject to a “duty of best execution,” which requires them to obtain the best price possible on a customer’s order.¹⁴³ Given that crypto exchanges in the U.S. currently function as both the broker and the exchange, and that consumers seem to prefer this model as opposed to placing crypto trades through a broker, it may not make sense to split these functions apart provided sufficient investor safeguards are in place. Therefore, Congress should consider authorizing a new entity under federal securities law called a “national cryptocurrency exchange” and allow the SEC to craft rules to regulate such exchanges. That would give the SEC flexibility to force crypto exchanges to give up the multiple roles that they currently play (broker, exchange, custodian, etc.) or allow crypto exchanges to continue to perform some of these functions subject to appropriate safeguards. No matter what, national cryptocurrency exchanges should be required to segregate individual customers’ assets from firm assets and other customers’ assets. Nor should national cryptocurrency exchanges be permitted to list traditional securities (if they want to list both, they should be required to register as a traditional securities exchange with the SEC). If the SEC permits a national cryptocurrency exchange to custody customer assets — as opposed to requiring the use of a qualified custodian — that exchange should also be subject to special resolution administered by the Securities Investor Protection Corporation (“SIPC”) so that, in the event of exchange failure, customer assets fall outside the bankruptcy estate and customers are insured against losses up to \$500,000.¹⁴⁴

In authorizing legislation, Congress should also make clear that the SEC has the authority to draft rules governing DeFi applications. These rules may not look all that different from existing requirements. Accessing DeFi protocols directly requires a level of technological sophistication that most people do not have. Therefore, several firms have developed online user interfaces that allow users to access DeFi protocols.¹⁴⁵ These firms should be required to register as broker-dealers.¹⁴⁶ Protocols that truly are decentralized, meaning they run exclusively on blockchain-based smart contracts and are not reliant on the efforts of others, present more of a regulatory challenge. However, the potential risk associated with those protocols is limited by the fact that very few people have the technological wherewithal to access them directly as well as the fact that DeFi is an entirely self-referential system with little tie-in to real-world assets. Given that the main risks currently associated with DeFi are flaws in the underlying code that

¹⁴³ *Securities Exchange Act Release No. 51808* (June 9, 2005), 70 FR 37496, 37538 (June 29, 2005) (“Regulation NMS Adopting Release”). See also *Geman v. SEC*, 334 F.3d 1183, 1186 (10th Cir. 2003) (“[T]he duty of best execution requires that a broker-dealer seek to obtain for its customer orders the most favorable terms reasonably available under the circumstances.”) (quoting *Newton*, supra note 8, 135 F.3d at 270); *Kurz v. Fidelity Management & Research Co.*, 556 F.3d 639, 640 (7th Cir. 2009) (describing the “duty of best execution” as “getting the optimal combination of price, speed, and liquidity for a securities trade”).

¹⁴⁴ SIPC, *The Investor’s Guide to Brokerage Firm Liquidations* (Washington, D.C.: SIPC, 2015) <https://www.sipc.org/media/brochures/Liquidations-Web.pdf>

¹⁴⁵ See, e.g., Ariel Shapira, “DEXs and KYC: A Match Made in Hell or a Real Possibility?” *CoinTelegraph*, March 23, 2022, <https://cointelegraph.com/news/dexs-and-kyc-a-match-made-in-hell-or-a-real-possibility>.

¹⁴⁶ Sam Bankman-Fried made a similar argument last October: “If you host a website aimed at facilitating and encouraging US retail to connect to and trade on a DEX [decentralized exchange], this may end up falling under something like a broker-dealer/FCM/etc.” See Sam Bankman-Fried, “Possible Digital Asset Industry Standards,” October 19, 2022, <https://www.ftxpolicy.com/posts/possible-digital-asset-industry-standards>.

result in hacks,¹⁴⁷ the SEC could begin by requiring independent code audits and IT security tests of DeFi protocols.¹⁴⁸ The Commission should retain the flexibility to impose more stringent requirements on DeFi protocols if needed.

To be clear, if my recommendation is implemented, many, if not most, crypto issuers would be unable to comply. This is a good thing, as most cryptocurrencies provide no productive purpose — does anyone believe we need, or should want, over 20,000 different cryptocurrencies?¹⁴⁹ Crypto issuers who seek access to public markets will have to comply with Section 5 of the Securities Act of 1933, which prohibits the offer or sale of a security without first registering with the SEC unless an exemption from registration is available. As Professor Hilary Allen noted, most “cryptocurrencies require significant amounts of demand and liquidity to support their value.”¹⁵⁰ That means it will be unfeasible for most crypto issuers to seek an exemption from registration because those exemptions restrict who is eligible to purchase the securities in question and the resale of those securities. Thus, most crypto issuers will have to register with the SEC, and incurring the associated costs only makes sense if the token has “some long-term value creation potential.”¹⁵¹

Bringing digital assets within the securities laws will also allow investors to avail themselves of Rule 10b-5 of the 1934 Act, which provides an additional measure of investor protection by making it illegal for any person to defraud or deceive someone, including through the misrepresentation of material information, with respect to the sale or purchase of a security.¹⁵²

My proposal would also grant the SEC oversight of stablecoins. If enacted, the Commission should impose strict requirements that all stablecoin reserves be held in cash or U.S. Treasury securities and subject stablecoin issuers to routine audits and disclosure. I offer more detailed thoughts on stablecoins below, but it is worth noting that my proposal does not preclude Congress from regulating stablecoin issuers as banks or bank subsidiaries. The Supreme Court’s *Marine Bank v. Weaver* decision held that “deposits” are “securities” for purposes of the federal securities laws unless those deposits are accepted either by FDIC-insured U.S. banks or by foreign banks that are governed by regulatory regimes providing comparable protections to their depositors.¹⁵³ Thus, as professor Arthur Wilmarth has noted, it is possible for stablecoins to be regulated as both “deposits” and “securities” unless Congress decides to bring stablecoins into the banking system and protect them with FDIC insurance.¹⁵⁴

b. Congress Can Enact Discrete Requirements for Crypto Intermediaries

¹⁴⁷ According to Chainalysis, DeFi hacks accounted for 82%, or \$3.1 billion, of all crypto stolen by hackers in 2022. See Cheyenne DeVon, “Crypto Investors Lost Nearly \$4 Billion to Hackers in 2022,” *CNBC*, February 4, 2023. <https://www.cnb.com/2023/02/04/crypto-investors-lost-nearly-4-billion-dollars-to-hackers-in-2022.html>

¹⁴⁸ HM Treasury, *Future Financial Services*.

¹⁴⁹ Data on the number of cryptocurrencies comes from CoinMarketCap, accessed February 8, 2022, <https://coinmarketcap.com/>.

¹⁵⁰ Allen, “Crypto Crash.”

¹⁵¹ *Ibid.*

¹⁵² U.S. Code 17 § 240.10b-5.

¹⁵³ *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

¹⁵⁴ Arthur S. Wilmarth, “It’s Time to Regulate Stablecoins as Deposits and Require Their Issuers to Be FDI Insured Banks,” *Banking & Financial Services Policy Report*, 41, 2 (2022), https://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2834&context=faculty_publications.

If Congress does not want to assign crypto oversight to a single agency, lawmakers should consider passing legislation that requires crypto intermediaries to implement basic customer safeguards. The most urgently needed reform is a ban on the commingling of customer assets with company assets. Unfortunately, commingling seems to be the norm in the crypto industry, and restricting this practice will go a long way toward minimizing investor losses when crypto firms fail. Crypto intermediaries should also be required to inform customers about their rights and risks in a simple and easy-to-understand format. Too many crypto investors have found out the hard way that they have no legal rights vis-à-vis the crypto issuer, or that they will be an unsecured creditor if the crypto platform in possession of their assets fails.

In addition to those common-sense requirements, Congress should also consider requiring the following customer protections and market integrity guardrails recently put forth by CFTC Commissioner Christy Goldsmith-Romero:

- Resolution of conflicts of interest with respect to insiders and affiliated entities;
- Broad application of the Bank Secrecy Act (including its anti-money laundering provisions);
- Strong cybersecurity requirements; and
- Broker fiduciary duties to customers.¹⁵⁵

If those requirements become law, some agency will need to enforce them. Rather than settle the “is it a commodity or security” debate, Congress could simply instruct the CFTC and SEC to engage in a joint rulemaking and share enforcement authority. There is precedent for this, as the two agencies did engage in joint rulemaking to implement Title VII, which governed the regulation of derivatives, of the Dodd-Frank Act.

c. Self-Regulatory Organizations Are a Mistake

Others have argued that Congress should designate crypto exchanges as self-regulatory organizations (SROs) as a first step toward comprehensive crypto regulation.¹⁵⁶ This is like letting the fox guard the henhouse. It is true that traditional financial exchanges have long operated as SROs, but these firms have also been subject to robust regulatory scrutiny by the CFTC or SEC, with both agencies having the ability to disapprove of SRO rule changes. Traditional SROs also operate within established regulatory regimes; in the absence of a clear regulatory regime for crypto, we would be asking crypto exchange SROs not only to supervise and take enforcement actions against market actors but also to devise a regulatory regime from first principles. That is more responsibility than traditional SROs have, and it is a responsibility that the crypto industry certainly hasn’t earned.

¹⁵⁵ Commodity Futures Trading Commission, “Keynote Address by Commissioner Christy Goldsmith Romero at The Wharton School and the University of Pennsylvania Carey Law School,” (speech, Wharton, January 18, 2023), <https://www.cftc.gov/PressRoom/SpeechesTestimony/oparomero5>.

¹⁵⁶ Yesha Yadav, “Toward a Public-Private Oversight Model for Cryptocurrency Markets,” *Vanderbilt Law Research Paper No. 22-26*, accessed January 15, 2023, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4241062.

Furthermore, the members of traditional financial exchanges are sophisticated institutions — broker-dealers in the case of securities exchanges and futures commission merchants in the case of commodity derivatives exchanges — who themselves are typically subject to regulation and examination. In other words, I cannot place a trade directly on the NASDAQ, but I can place a trade on Charles Schwab who then routes the trade to NASDAQ, or some other venue or market maker, for execution. By contrast, crypto exchanges are principally used by less sophisticated retail investors who are more vulnerable to predacious behavior on the exchange.

Arguing for crypto exchanges to be designated as SROs rests on the false premise that exchanges have an economic incentive to police themselves and the behavior on their platforms. If you can trust the exchanges, then more users will trade on them — or so the logic goes. But if that were true, then crypto exchanges would have already come together and voluntarily formed an SRO. In fact, the industry attempted a voluntary SRO in 2018 that went nowhere. Gemini Exchange founders Cameron and Tyler Winklevoss advanced a proposal for the Virtual Commodity Association (VCA), which was intended to be non-profit, independent (not a trade organization), and “in compliance with global standards and best practices for SROs.”¹⁵⁷ In addition to “sound practices” compliance, the proposed VCA would also seek to promote “price discovery, efficiency, and transparency” while providing incentives for “the detection and deterrence of manipulative and fraudulent acts and practices.” As events over the past year have demonstrated, the VCA has had no impact in cleaning up the crypto spot market (the VCA’s website lists just two working group members: Gemini and bitFlyer).¹⁵⁸

Professor Ryan Clements noted that voluntary SROs face several challenges, including “classic economic problems like organizing ‘the commons’ and dealing with free-riders, as well as practical and legal considerations like ensuring [SRO] accountability, enforcing non-compliance penalties, facilitating government oversight, creating suitable member incentives to participate, and ensuring a high cost of expulsion.”¹⁵⁹ Some of these challenges may be addressed by SROs operating with a government mandate and the legal authority to enforce rules, but publicly mandated crypto SROs will only work if the industry has a serious interest in regulatory compliance. As noted previously, the crypto industry, including U.S.-based exchanges, has chosen to operate outside the regulatory perimeter and repeatedly thumb its nose at regulators. For example:

- After the SEC told Coinbase that their proposed Lend product needed to be registered with the Commission, Coinbase CEO Brian Armstrong tweeted: “Some really sketchy behavior coming out of the SEC recently.”¹⁶⁰

¹⁵⁷ Cameron Winklevoss, “A Proposal for a Self-Regulatory Organization for the U.S. Virtual Currency Industry,” *Medium*, January 30, 2020, <https://medium.com/@winklevoss/a-proposal-for-a-self-regulatory-organization-for-the-u-s-virtual-currency-industry-79e4d7891cfc>.

¹⁵⁸ “Members,” Virtual Commodity Association, accessed February 9, 2023, <https://virtualcommodities.org/#Members>.

¹⁵⁹ Ryan Clements, “Can a Cryptocurrency Self-Regulatory Organization Work? Assessing Its Promise and Likely Challenges,” *The FinReg Blog*, June 21, 2018, <https://sites.duke.edu/thefinregblog/2018/06/21/can-a-cryptocurrency-self-regulatory-organization-work-assessing-its-promise-and-likely-challenges/>.

¹⁶⁰ Brian Armstrong (@brian_armstrong), tweet, September 8, 2021, 10:06 a.m., accessed February 10, 2023, https://twitter.com/brian_armstrong/status/1435439291715358721.

- After the SEC filed a civil complaint against Gemini and Genesis alleging the Gemini Earn product was an unregistered security, Gemini co-founder Tyler Winklevoss tweeted that the SEC’s “behavior is totally counterproductive” and akin to a “manufactured parking ticket.”¹⁶¹
- Last July, the CFTC filed a civil complaint against 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.”¹⁶² 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.¹⁶³
- In 2015, after New York implemented the comprehensive BitLicense to regulate crypto firms operating in the state, the crypto exchange Kraken announced they were discontinuing service to New York residents and released a blog post calling the BitLicense “a creature so foul, so cruel that not even Kraken possesses the courage or strength to face its nasty, big, pointy teeth.”¹⁶⁴ Several years later, after the New York Attorney General’s office released a report on crypto trading platforms, Kraken’s CEO, Jesse Powell, tweeted: “NY is that abusive, controlling ex you broke up with 3 years ago but they keep stalking you, throwing shade on your new relationships, unable to accept that you have happily moved on and are better off without them.”¹⁶⁵
- Last week, after SEC Chairman Gary Gensler went on CNBC¹⁶⁶ to discuss the Commission’s charges against Kraken for failing to register the offer and sale of their crypto assets staking-as-a-service program,¹⁶⁷ Mr. Powell tweeted: “Oh man, all I had to do was fill out a form on a website and tell people that staking rewards come from staking? Wish I’d seen this video before paying a \$30m fine and agreeing to permanently shut down the service in the US. How dumb do I look. Gosh.”¹⁶⁸

¹⁶¹ Tyler Winklevoss (@Tyler), tweet, January 13, 2023, 6:10 a.m., accessed February 10, 2023, <https://twitter.com/tyler/status/1613674686646484992?s=20&t=gKb89UeYRa7k99h7w3ZBeA>.

¹⁶² Commodity Futures Trading Commission, “CFTC Charges Gemini Trust Company for Making Material False or Misleading Statements and Omissions to the Commission,” June 2, 2022, <https://www.cftc.gov/PressRoom/PressReleases/8540-22>.

¹⁶³ Last June, I wrote a blog post that highlighted how Gemini’s deceit is a perfect example of why the CFTC’s self-certification process is flawed. See Lee Reiners, “CFTC Complaint Against Gemini Reveals Weaknesses in the Agency’s Approach to Virtual Currency,” *The FinReg Blog*, July 20, 2022, <https://sites.duke.edu/thefinregblog/2022/07/20/cftc-complaint-against-gemini-reveals-weaknesses-in-the-agencys-approach-to-virtual-currency/>.

¹⁶⁴ Krakenfx, “Farewell, New York,” *Kraken Blog*, June 8, 2017, <https://blog.kraken.com/post/253/farewell-new-york/>.

¹⁶⁵ Castro, Amy, “‘Someone’s Got to Be the Voice of Reason’ — Kraken Responds to NY AG Report,” *Bitcoin Magazine*, September 20, 2018, <https://bitcoinmagazine.com/business/someones-got-be-voice-reason-kraken-responds-ny-ag-report>.

¹⁶⁶ “SEC’s Gary Gensler on Kraken Staking Settlement: Other Crypto Platforms Should Take Note of This,” *CNBC*, February 10, 2023, <https://www.cnbc.com/video/2023/02/10/short-sec-chair-gensler-heres-why-we-cracked-down-on-kraken.html>.

¹⁶⁷ U.S. 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,” February 9, 2023, <https://www.sec.gov/news/press-release/2023-25>.

¹⁶⁸ Jesse Powell (@jespow), tweet, February 11, 2023, 5:44 a.m., accessed February 10, 2023, https://twitter.com/jespow/status/1624177588074848256?s=20&t=HOdh3N_p01j2PI85fpaINA.

These do not sound like firms and executives that are eager to assume the role of regulator.

Rather than allow crypto exchanges to serve as their own SROs, it would be better for Congress to grant SRO authority to an independent entity, like FINRA. CFTC Commissioner Christy Goldsmith Romero noted that an “independent SRO would avoid certain conflicts of interest and bring consistency across exchanges” and provide an “important bulwark to ensure that exchanges have the corporate governance, personnel, systems and controls required of a regulated market holding assets for U.S. customers.”¹⁶⁹

VI. Stablecoins

I conclude by offering my thoughts on the best path forward on stablecoin regulation, where I do see the potential for a bipartisan solution. In November 2021, the President’s Working Group on Financial Markets (PWG), joined by the FDIC and OCC, released a report on stablecoins that called on Congress to pass legislation that would require fiat-backed stablecoin issuers to be insured depository institutions.¹⁷⁰ In an op-ed last November, I explained why this is the wrong approach, and I will borrow heavily from that piece here.¹⁷¹

The PWG and banking agencies are concerned about a potential run on fiat-backed stablecoins that could be triggered if stablecoin holders have reason to doubt the quantity and quality of reserves backing their stablecoin. To address this risk, regulators want fiat-backed stablecoin issuers to be insured depository institutions subject to federal supervision and regulation. That approach would make sense if stablecoins were a widely used payment mechanism, but they are not, and I doubt they ever will be. Instead, stablecoins are principally used to trade other cryptocurrencies and participate in DeFi protocols, which is why Gary Gensler likens stablecoins to poker chips at the casino — if you want to speculate in the crypto economy, you need stablecoins.¹⁷²

If stablecoin issuers are forced to become banks, it would give stablecoins instant credibility, propel the growth of DeFi — a new form of shadow banking — and deepen connections between the highly regulated banking system and the unregulated crypto economy, thereby increasing the chances that a problem in one would spill into the other.

Fears about a run on fiat-backed stablecoins are misplaced. As I noted in November:

¹⁶⁹ Commodity Futures Trading Commission, “Keynote Address.”

¹⁷⁰ U.S. Department of the Treasury, “President’s Working Group on Financial Markets Releases Report and Recommendations on Stablecoins,” November 1, 2021, <https://home.treasury.gov/news/press-releases/jy0454>.

¹⁷¹ Lee Reiners, “Regulators Are Thinking about Stablecoins in the Wrong Way,” *The Hill*, November 12, 2022, <https://thehill.com/opinion/finance/3731399-regulators-are-thinking-about-stablecoins-in-the-wrong-way/>.

¹⁷² Crypto News, “SEC Chair Gensler Compares Stablecoins to Poker Chips at Casinos,” *Crypto News*, September 22, 2021, <https://cryptonews.net/news/legal/1909625/#:~:text=The%20SEC%20chair%20has%20previously,crypto%20trading%20and%20lending%20programs>.

“Runs are problematic for two reasons. First, the entity being run on could fail and cease its intermediating function. Second, to meet liability outflows, the entity would be forced to sell assets at discounted prices, which could trigger a fire sale that impacts the price of the assets being sold and the solvency of other institutions that hold similar assets.”¹⁷³

Because stablecoins are used for speculation, a run would have no impact on credit or payments intermediation in the real economy. Nor would a run on stablecoins produce a damaging fire sale. The total stablecoin supply is under \$140 billion, with the majority of fiat-backed stablecoin reserves consisting of bank deposits and Treasury securities. The market would easily absorb any sale of these reserves should a run on stablecoins occur.

Rather than force stablecoins into the banking system, Congress can grant the SEC the authority to regulate them like money market mutual funds, with strict requirements that stablecoin reserves be held in cash and Treasury securities. The composition of reserves should be subject to periodic audits and disclosure, which would impose much-needed market discipline.

¹⁷³ Reiners, “Regulators.”