



Statement of

Eva Su

Analyst in Financial Economics

Before

Committee on Financial Services
Subcommittee on Oversight and Investigations
U.S. House of Representatives

Hearing on

**“American on ‘FIRE’: Will the Crypto Frenzy
Lead to Financial Independence and Early
Retirement or Financial Ruin? ”**

June 30, 2021

Congressional Research Service

7-5700

www.crs.gov

<Product Code>

Chairman Green, Ranking Member Emmer, Members of the Subcommittee, thank you for the opportunity to testify today. My name is Eva Su, and I am an Analyst in Financial Economics at the Congressional Research Service (CRS) focusing on capital markets and securities regulation. CRS's role is to provide objective, nonpartisan research and analysis to Congress. CRS takes no position on any specific policy. Any arguments presented in my written and oral testimony are for the purposes of informing Congress, not to advocate for a particular policy outcome.

My testimony will focus on digital asset investments, investor protection, and regulatory issues relating to securities regulation and the Securities and Exchange Commission (SEC).

Overview

In recent years, financial innovation in capital markets has fostered a new asset class—digital assets—and introduced new forms of fundraising and trading. *Digital assets*, which include *cryptocurrencies*, *crypto assets*, and *crypto tokens*, among others, are digital representations of value. Regardless of the terms used to describe these assets, depending on their characteristics, some digital assets are subject to securities laws and regulations. Securities regulation generally applies to all securities, whether they are digital or traditional. The SEC is the primary regulator overseeing securities offerings, sales, and investment activities.

The current regulatory landscape for digital assets is perceived by certain industry observers to be fragmented. Multiple agencies apply different regulatory approaches to digital assets at the federal and state levels. For example, the SEC treats some digital assets as “securities,” the Commodity Futures Trading Commission (CFTC) treats some digital assets as “commodities,”¹ and the Internal Revenue Service treats some digital assets as “property.” State regulators oversee digital asset exchanges through state money transfer laws, and the Treasury Department’s Financial Crimes Enforcement Network (FinCEN) monitors them for anti-money laundering purposes.

Digital assets have a growing presence in the financial services industry. Their increasing use in capital markets raises policy questions regarding whether changes to existing laws and regulations are warranted and, if so, when such changes should happen, what form they should take, and which agencies should take the lead. The current innovative environment is not the regulatory regime’s first encounter with changing technology since its inception in the 1930s. Some technological advancements led to regulatory changes, whereas others were dealt with through the existing regime.

The general consensus is that regulatory oversight should be balanced with the need to foster financial innovation, but the basic objectives of regulation should apply to ensure market integrity and investor protection. Some believe that certain digital asset activities that may appear similar to traditional activities nonetheless require adjusted regulatory approaches to account for particular operating models that may amplify risks differently. In general, policymakers contending with major financial innovations have historically focused on addressing risk concerns while tailoring a regulatory framework that was flexible enough to accommodate evolving technology. Current developments that raise policy issues include the following:

¹ Because a cryptocurrency meets the definition of a “commodity” under the Commodity Exchange Act (CEA; P.L. 93-463), the Commodity Futures Trading Commission (CFTC) has authority over them. For example, Bitcoin is not a security but a commodity, overseen by the CFTC’s general anti-fraud and manipulation oversight and enforcement authority. CFTC, *Customer Advisory: Understand the Risks of Virtual Currency Trading*, at https://www.cftc.gov/sites/default/files/idc/groups/public/@customerprotection/documents/file/customeradvisory_urvct121517.pdf. For more information, see CRS Legal Sidebar LSB10227, *CFTC and Virtual Currencies: New Court Rulings and Implications for Congress*, by Nicole Vanatko.

Digital asset “exchanges.” Some industry observers perceive digital asset trading platforms as functional equivalents to the SEC-regulated securities exchanges in buying and selling digital assets. These platforms are not subject to the same level of regulation, suggesting that they may be less transparent and more susceptible to manipulation and fraud.

Digital asset custody. Custodians provide safekeeping of financial assets and are important building blocks for the financial services industry. Digital assets present custody-related compliance challenges because custodians face difficulties in recording ownership, recovering lost assets, and providing audits, among other considerations.

Digital asset exchange-traded funds (ETFs). ETFs are pooled investment vehicles that gather and invest money from a variety of investors. ETF shares can trade on securities exchanges like a stock. Currently, digital assets themselves are generally not sold on SEC-regulated national exchanges. However, if portfolios of digital assets were made available as ETFs, they may be sold on national exchanges. The SEC has not yet approved any digital asset ETFs because of market manipulation and fraud concerns.

Stablecoins in securities markets. Stablecoin is a digital asset designed to maintain a stable value by linking its value to another asset or a basket of reserve assets. In policy discussions, some suggest applying ETF regulatory frameworks to certain stablecoins; others argue for more disclosure of reserve asset breakdowns to expose potential deceptive activities.

Initial coin offerings (ICOs). ICOs as a digital asset fundraising method can be offered in many forms using existing public and private securities offerings channels. Although ICOs may be useful fundraising tools, some of them raise regulatory oversight and investor protection concerns.

What Are Digital Assets and Digital Asset Securities?

Digital assets are assets issued and transferred using distributed ledger or blockchain technology.² Digital assets can, depending on their individual features, be considered securities, currencies, commodities, or property under various legal and regulatory definitions. Although market participants use different terms to describe them, financial regulators have stated that—regardless of what they are called—financial activities, services, and market participants must adhere to applicable laws and regulations. In the case of digital assets, depending on their characteristics, this can include securities laws and regulations.³

The SEC is the primary regulator overseeing securities offers, sales, and investment activities, including when digital assets qualify as securities. However, many digital assets are not securities. In general, a security is “the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.”⁴ When a digital asset meets the criteria defining a security, it would be subject to securities regulation, per existing SEC jurisdiction. For example, most of the ICOs are

² U.S. Securities and Exchange Commission (SEC), *Framework for “Investment Contract” Analysis of Digital Assets*, April 3, 2019, at <https://www.sec.gov/files/dlt-framework.pdf>. For more information on blockchain technology, see CRS Report R45116, *Blockchain: Background and Policy Issues*, by Chris Jaikaran.

³ SEC, “Leaders of CFTC, FinCEN, and SEC Issue Joint Statement on Activities Involving Digital Assets,” public statement, October 11, 2019, at https://www.sec.gov/news/public-statement/cftc-fincen-secjointstatementdigitalassets#_ftn4.

⁴ For more details, see SEC, *Framework for “Investment Contract” Analysis of Digital Assets*, April 3, 2019, at <https://www.sec.gov/files/dlt-framework.pdf>.

securities, but Bitcoin is not a security, mainly because it does not have a central third-party common enterprise.⁵

Digital Assets as a New Asset Class

Cryptocurrencies have emerged as a growing asset class for investors, with a total market value of more than \$2 trillion in May 2021, compared with around \$260 billion a year before and around \$20 billion in early 2017.⁶ The size of the cryptocurrencies market is significant, but still relatively small, given the size of traditional asset markets. For example, the U.S. fixed income market is worth about \$50 trillion and the Standard & Poor's 500 index—an index including 500 large U.S. publicly-traded companies—is worth about \$35 trillion as of May 2021.⁷ Some investors view crypto assets as “digital gold” due to some of their characteristics. The size of the cryptocurrencies market is comparable to the value of gold held by private investors, which is estimated to be around \$3 trillion.⁸

Digital assets have reportedly experienced rapid ramp up in institutional adoption. For example, institutional investors are increasingly directly investing in digital assets or providing inflow for digital asset managers such as Grayscale, a company that provides cryptocurrency trusts that allow investors to gain exposure to digital assets without directly owning them.⁹

Institutional investors enter into digital asset markets to seek investment returns and to allocate assets to achieve perceived diversification benefits. Some of their major concerns as they begin this investing include uncertainty of the future of the technology, security and safekeeping of assets, and regulatory uncertainty.¹⁰ As more institutional investors (including asset managers, pension funds, endowments, and insurance companies) have entered into digital asset markets, large financial institutions that offer related services (such as digital asset custody and safekeeping) have begun to expand their infrastructure to accommodate this investing.¹¹ The level of engagement with reputable institutional investors, and the industry's creation of new digital product and service infrastructure, may indicate that the acceptance of the digital asset market has achieved or is nearing achieving a critical mass at which digital asset investing becomes generally acceptable by a wide range of investors.

The SEC's Current Regulatory Approach

Although digital assets as a capital market innovation evolved quickly, the SEC to date has not been active in promulgating new digital-asset-specific rules. One rationale for this approach is that, because it

⁵ SEC Division of Corporate Finance Director William Hinman, “Digital Asset Transactions: When Howey Met Gary (Plastic),” speech delivered at Yahoo Finance All Markets Summit: Crypto, San Francisco, CA, June 14, 2018, at <https://www.sec.gov/news/speech/speech-hinman-061418>.

⁶ CoinMarketCap, “Global Cryptocurrency Charts,” at <https://coinmarketcap.com/charts>.

⁷ SIFMA, “Fixed Income Outstanding,” at <https://www.sifma.org/resources/research/fixed-income-chart>.

⁸ Bernstein, *An Early Spring for Cryptoassets*, April 14, 2021, at <https://www.alliancebernstein.com/library/An-Early-Spring-For-Cryptoassets.htm>.

⁹ Kate Rooney, “Crypto Investment Firm Grayscale Sees 900% Jump In Assets to \$20 billion Amid Bitcoin Frenzy,” *CNBC*, January 14, 2021, at <https://www.cnn.com/2021/01/13/grayscale-sees-900percent-jump-in-inflows-as-wall-street-flocks-to-bitcoin.html>.

¹⁰ Bernstein, *Cryptoassets: Discretion of the Better Part of Valor*, at <https://www.bernstein.com/bernstein/email/cryptoassetsvalor.pdf>.

¹¹ Gary Silverman, “State Street to Set up Digital Unit to Capitalize on Crypto Craze,” *Financial Times*, June 10, 2021, at <https://www.ft.com/content/52b1b8a9-2322-496c-ac16-a847c658d186>.

is uncertain how the characteristics and use of digital assets will evolve, highly prescriptive regulations could become obsolete, and potentially inefficient.¹²

The SEC's current regulatory framework that governs traditional and digital securities includes the Securities Act of 1933,¹³ the Securities Exchange Act of 1934,¹⁴ the Investment Company Act of 1940,¹⁵ and the Investment Advisers Act of 1940.¹⁶ It has also used existing tools and a number of initiatives besides rulemaking to address specific regulatory issues arising from certain unique digital asset features. The SEC's approach includes the following:

- **Innovation office.** The SEC created the Strategic Hub for Innovation and Financial Technology (FinHub) in 2018 to engage in financial technology, consolidate and clarify communications, and inform policy research. FinHub became a standalone office in December 2020.¹⁷
- **Enforcement.** The SEC has brought enforcement actions against securities token issuers and digital asset traders and asset managers, among others.
- **No-action letters.** The SEC uses no-action letters to provide relief for digital-asset-related businesses and to signal its regulatory intentions to capital markets.¹⁸
- **Solicitation for public input.** The SEC released a letter to the industry in March 2019 to solicit public input regarding digital asset custody.¹⁹ The comments helped the SEC understand the challenges the industry faces and assess investor-protection risks.
- **New product approval.** The SEC could approve or reject new digital asset products. For example, the SEC has reviewed Bitcoin ETF proposals in recent years and has consistently rejected such proposals as of May 2021.²⁰

Policy Issues and Related Proposals

This section discusses selected policy issues relating to: (1) cryptocurrency “exchanges;” (2) digital asset custody; (3) digital asset ETFs; (4) stablecoins; and (5) ICOs.

Digital Asset Trading Platforms: Cryptocurrency “Exchanges”

Typically, cryptocurrency transactions happen on a trading platform, often called an “exchange.” These cryptocurrency exchanges are normally state-licensed enterprises that allow people to buy and sell

¹² For example, statements by Jay Baris, Partner at Shearman & Sterling LLP. See page 46 of SEC FinHub Forum transcript at Bloomberg, *Securities and Exchange Commission Fintech Forum: Distributed Ledger Technology and Digital Assets*, June 3, 2019, at <https://www.bgov.com/core/news/#!/articles/PSJXC08JMDC0>.

¹³ P.L. 73-22.

¹⁴ P.L. 73-291.

¹⁵ P.L. 76-768.

¹⁶ P.L. 76-768. For more details on the SEC's existing regulatory framework, see SEC, *The Laws That Govern the Securities Industry*, at <https://www.sec.gov/answers/about-lawshtml.html>.

¹⁷ SEC, “SEC Announces Office Focused on Innovation and Financial Technology,” press release, December 3, 2020, at <https://www.sec.gov/news/press-release/2020-303>.

¹⁸ No-action letters are official communications stating a regulator does not expect to take enforcement actions against particular companies in certain situations.

¹⁹ SEC, “Engaging on Non-DVP Custodial Practices and Digital Assets,” March 12, 2019, at <https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206>.

²⁰ For more on ETFs, see CRS Report R45318, *Exchange-Traded Funds (ETFs): Issues for Congress*, by Eva Su.

cryptocurrencies. Often these companies are registered as money transmitters, a particular kind of money service business.²¹ There are two general types of exchanges. Intermediary platforms operate similar to a traditional stock exchange in certain ways (although they are not regulated by the SEC like a stock exchange), where a third party sets prices and clears transactions. Peer-to-peer platforms eliminate the third party and allow buyers and sellers to settle prices directly. In either case, the cryptographic nature of these exchanges provide some measure of anonymity to both the buyer and seller.

Trading Platforms as Money Transmitters

Cryptocurrency exchanges are often state-registered enterprises called money transmitters.²² Money transmitters are subject to registration and some reporting requirements from the Financial Crimes Enforcement Network (FinCEN), a bureau of the Treasury Department responsible for implementing the Bank Secrecy Act (BSA; P.L. 91-508). For example, money transmitters are required to obtain and verify customer identity and record beneficiary information for transfers of \$3,000 or more, and they are required to file “Suspicious Activity Reports” for certain transactions exceeding \$2,000. In 2013, FinCEN issued interpretative guidance for cryptocurrency exchanges, stating that an “administrator or exchanger that (1) accepts and transmits a convertible virtual currency or (2) buys or sells convertible virtual currency for any reason is a money transmitter under FinCEN’s regulation.”²³

Trading Platforms as SEC-Registered National Securities Exchanges

Because money transmitter regulations were not designed with large-scale interstate domestic and international trading activities in mind, some argue that they are insufficient for regulating the transfer of digital assets.²⁴ For some observers, regulating cryptocurrency exchanges as money transmitters raises investor-protection concerns because although sometimes they could be viewed as functional equivalents to stock exchanges or other forms of markets that receive federal regulation, they are not subject to the same level of investor protection regulation as those types of exchanges and markets.²⁵

This is not to say that cryptocurrency exchanges are not subject to any security or commodity exchange-related regulation. As noted previously, the CFTC has authority to bring enforcement actions for fraud and market manipulation involving commodities and derivatives. In addition, the SEC issued a statement clarifying that the online platforms for buying and selling crypto assets that qualify as securities could be unlawful.²⁶ The SEC took its first enforcement action against an unregistered crypto asset exchange in 2018. The agency stated that the platform “had both the user interface and underlying functionality of an

²¹ For more on money transmitters and virtual currency, see CRS Report R46486, *Telegraphs, Steamships, and Virtual Currency: An Analysis of Money Transmitter Regulation*, by Andrew P. Scott.

²² See CRS Report R46486 by Andrew Scott.

²³ Financial Crimes Enforcement Network (FinCEN), “Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies,” March 18, 2013, at <https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering>.

²⁴ Peter Van Valkenburgh, “The Need for a Federal Alternative to State Money Transmission Licensing,” *Coin Center Report*, January 2018, at <https://coincenter.org/files/2018-01/federalalternativev1-1.pdf>.

²⁵ A national securities exchange is a securities exchange that has registered with the SEC under §6 of the Securities Exchange Act of 1934. See SEC Fast Answers, *National Securities Exchanges*, at <https://www.sec.gov/fast-answers/divisionsmarketregmrexcangeshtml.html>.

²⁶ The SEC states that “if a platform offers trading of digital assets that are securities and operates as an ‘exchange,’ as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration.” For more details, see SEC, “Statement on Potentially Unlawful Online Platforms for Trading Digital Assets,” March 7, 2018, at <https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading>.

online national securities exchange and was required to register with the SEC or qualify for an exemption,” but appeared to have failed to do so.²⁷

Cryptocurrency “Exchanges” Versus National Securities Exchanges

The differences between cryptocurrency exchange investor protections under current regulation and what they would be if most or all were regulated as SEC-regulated national securities exchanges could include requirements to increase transparency, fairness, and efficiency.²⁸ These are principles guiding the national securities exchange regulation, yet they are perceived by some as lacking for cryptocurrency exchanges’ current practices. Downsides of providing heightened regulation may include compliance costs, hindrance of financial innovation, and competitive pressure for resources and talent internationally. This section illustrates the scale of the risk mitigation challenges and the types of risks that may occur at cryptocurrency exchanges.

Nontransparent and Fraudulent Activities

Many cryptocurrency exchanges (including those that generally allow trading of digital assets that are not securities, and thus not regulated by the SEC) are reportedly exaggerating their volumes to attract more participation.²⁹ Many investors are perceived to have no idea whether the trading volume and prices reflect real activities or market manipulation. To take the more frequently studied digital asset Bitcoin for example,³⁰ one study shows that 95% of Bitcoin’s trading volume displayed on digital asset price and volume aggregator CoinMarketCap.com is either fake or non-economic in nature.³¹ Another widely cited academic study illustrates the scale of potential damage that digital asset market manipulations could create, underlining the investor-protection concerns in the digital asset space. The study argues that a single market manipulator likely fueled half of Bitcoin’s 2017 price surge that pushed its price close to \$20,000.³² The activities were reportedly carried out through the largest cryptocurrency exchange at that time, Bitfinex, and used stablecoin Tether to boost the demand for Bitcoin.³³

²⁷ SEC, “SEC Charges EtherDelta Founder With Operating an Unregistered Exchange,” press release, November 8, 2018, at <https://www.sec.gov/news/press-release/2018-258>.

²⁸ For a more detailed list of principles relating to trading, see International Organization of Securities Commissions, *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation*, May 2017, at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD562.pdf>.

²⁹ Olga Kharif, “On Crypto Exchanges, The Trades Don’t Always Add Up,” *Bloomberg*, July 25, 2019, at <https://www.bloomberg.com/news/articles/2019-07-25/on-crypto-exchanges-the-trades-don-t-always-add-up>.

³⁰ Bitcoin is a commodity rather than a security and is under the CFTC’s general anti-fraud and manipulation oversight and enforcement authority. CFTC, *Customer Advisory: Understand the Risks of Virtual Currency Trading*, at https://www.cftc.gov/sites/default/files/idc/groups/public/@customerprotection/documents/file/customeradvisory_urvct121517.pdf. The SEC generally regulates securities transactions and their related intermediaries. The SEC does not have direct oversight of transactions in non-security currencies or commodities. SEC Chairman Jay Clayton, *Chairman’s Testimony on Virtual Currencies: The Roles of the SEC and CFTC*, February 6, 2018, at <https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission>.

³¹ Bitwise Asset Management, *Presentation to The U.S. Securities and Exchange Commission*, March 19, 2019, at <https://www.sec.gov/comments/sr-nysearca-2019-01/srnysearca201901-5164833-183434.pdf>.

³² John Griffin and Amin Shams, *Is Bitcoin Really Un-Tethered?* SSRN, October 28, 2019, at <https://ssrn.com/abstract=3195066>.

³³ Philip Rosenstein, “\$1.4T Bitcoin Manipulation Case Preposterous, Tether Says,” *Law360*, November 15, 2019, at <https://www.law360.com/articles/1220333/>; and New York Attorney General, “Attorney General James Announces Court Order Against ‘Crypto’ Currency Company Under Investigation For Fraud,” press release April 25, 2019, at <https://ag.ny.gov/press-release/2019/attorney-general-james-announces-court-order-against-crypto-currency-company>.

Network Congestions and Market Inefficiencies

Unlike national securities exchanges for stocks, cryptocurrency exchanges frequently face network congestions or trading halts, leading some to question the readiness of these exchanges to serve a growing marketplace. For example, during a rapid digital asset selloff and recovery in May 2021, multiple major cryptocurrency exchanges reported technical issues, further intensifying market stress during a volatile time of increased trading.³⁴ These market disruptions could generate investor protection concerns due to investors' inability to get in and out of their investment positions in a timely manner, or investors' inability to seek best execution for their trades—often common features of a fair and efficient trading system.

Policy Proposals Relating to Cryptocurrency “Exchanges”

Many observers have called for a more enhanced regulatory framework to govern the cryptocurrency exchanges. Given the alleged scale of fraud, scams, and market efficiency issues, some have questioned whether digital asset trading warrants more regulatory safeguards that protect investors and promote more efficient market operations.³⁵ It is difficult to predict the extent to which an SEC-regulated digital asset national exchange would have mitigated the market manipulations, or if the SEC's regulatory framework is the best fit for addressing all the digital-asset-trading-related policy concerns. For example, the CFTC has the authority to regulate for fraud and market manipulation in markets for digital assets that qualify as commodities under the Commodities Exchange Act (P.L. 74-675). Still, cryptocurrency exchanges under the current operating environment appear vulnerable to misconduct.³⁶ A finance professor with a background in forensics suggested that “years from now, people will be surprised to learn investors handed over billions to people they didn't know and who faced little oversight.”³⁷

SEC Chair Gary Gensler has asked Congress to provide more clarity regarding authority over cryptocurrency exchanges. At a congressional hearing in May 2021, Gensler voiced concerns regarding the lack of a regulatory framework for cryptocurrency exchanges.³⁸ He stated that the lack of oversight represents a “gap in our system” that denies traders basic investor protection.³⁹ Gensler emphasized the

³⁴ Daniel Palmer, “Top Crypto Exchanges See Technical Issues Amid Market Crash,” *Coindesk*, May 19, 2021, at <https://www.coindesk.com/top-crypto-exchanges-see-technical-issues-amid-market-crash>; and Robert Hart, “Leading Crypto Exchanges Down As Bitcoin and Ether Plummet,” *Forbes*, May 19, 2021, at <https://www.forbes.com/sites/roberthart/2021/05/19/leading-crypto-exchanges-down-as-bitcoin-and-ether-plummet>.

³⁵ For example, former SEC Chairman Jay Clayton reportedly commented that “if [investors] think there's the same rigor around that price discovery as there is on the Nasdaq or New York Stock Exchange ... they are sorely mistaken ... we have to get to a place where we can be confident that trading is better regulated.” Jeff Cox, “SEC Chairman Says He Doesn't See Bitcoin Trading on a Major Exchange Until It Is ‘Better Regulated,’” *CNBC*, September 20, 2019, at <https://www.cnn.com/2019/09/19/jay-clayton-delivering-alpha.html>. For more discussions on regulatory concerns, see Office of the New York State Attorney General, *A.G. Schneiderman Launches Inquiry Into Cryptocurrency “Exchanges,”* April 17, 2018, at <https://ag.ny.gov/press-release/2018/ag-schneiderman-launches-inquiry-cryptocurrency-exchanges>.

³⁶ Office of the New York State Attorney General, *A.G. Schneiderman Launches Inquiry Into Cryptocurrency “Exchanges,”* April 17, 2018, at <https://ag.ny.gov/pressrelease/ag-schneiderman-launches-inquiry-cryptocurrency-exchanges>.

³⁷ Matthew Leising and Matt Robinson, “Lone Bitcoin Whale Likely Fueled 2017 Price Surge, Study Says,” *Bloomberg*, November 4, 2019, at <https://www.bloomberg.com/news/articles/2019-11-04/lone-bitcoin-whale-likely-fueled-2017-price-surge-study-says>.

³⁸ SEC Chair Gary Gensler stated, “right now the exchanges trading these crypto assets do not have a regulatory framework ... right now there is not a market regulator around these crypto exchanges, and thus there's really not protection against fraud or manipulation.” Bloomberg transcript for House Financial Services Committee hearing *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part III*, May 6, 2021, at <https://www.bgov.com/core/news/#!/articles/QSQ5G8JMDC0>.

³⁹ Steven Dennis and Jesse Hamilton, “Crypto's Wild Ride Leaves Washington Grasping at What to Do,” *Bloomberg*, May 19, 2021, at <https://www.bloomberg.com/news/articles/2021-05-19/crypto-s-wild-ride-leaves-washington-grasping-at-how-to>.

importance of bringing the same protections found in traditional securities markets to cryptocurrency exchanges. He added that “none of the exchanges trading crypto tokens has registered yet as an exchange with the SEC. Altogether, this has led to substantially less investor protection than in our traditional securities markets, and to correspondingly greater opportunities for fraud and manipulation.”⁴⁰

Digital Asset Custody Services

Custodians provide safekeeping of financial assets. They are financial institutions that do not have legal ownership of assets but are tasked with holding and securing assets, among other administrative functions.⁴¹ Both securities regulators and banking regulators have developed custody rules to impose requirements designed to protect client assets from the possibility of being lost or misappropriated.

Digital Asset Securities Custody

Digital asset securities custody has attracted regulatory attention because the SEC custody rules could pose unique challenges for custodians of digital assets. The custody rules were developed for traditional assets, which are easier than crypto assets to secure and produce tangible tracks of physical existence or records. Digital assets generally lack physical existence or records produced by intermediaries, as seen in traditional assets such as gold or bank accounts. Common practice in the digital asset industry so far focuses on safeguarding private keys—unique numbers assigned mathematically to digital asset transactions to confirm asset ownership.⁴² This practice raises the question of how possession or control of a digital asset should be defined for regulatory purposes. Some believe that the digital asset custody definition should go beyond the verification of the keys to incorporate holistic custody views.⁴³

Potential Amendments to the Custody Rule

On July 8, 2019, the SEC and Financial Industry Regulatory Authority (FINRA), a self-regulatory organization, issued a joint statement to outline considerations for digital asset securities custody.⁴⁴ They acknowledged the challenges of applying custody requirements to digital assets and stated that there were initiatives underway to solicit input from market participants that could help develop new ways to

respond.

⁴⁰ SEC Chair Gary Gensler, *Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee*, May 26, 2021, at <https://www.sec.gov/news/testimony/gensler-2021-05-26>.

⁴¹ §17(f) of the Investment Company Act and 17 C.F.R. §§270.17f-1–270.17f-7; 17 C.F.R. §275.206(4)-2 and the SEC Customer Protection Rule, or Rule 15c3-3, under the Securities Exchange Act of 1934 (P.L. 73-291).

⁴² Some financial institutions offer digital asset custody services. These service providers also consider the control of the private keys as the control of the digital assets. European Financial Reporting Advisory Group, *EFRAG Research Project on Crypto-Assets Analysis of Scope – Initial Coin Offerings and Custodial Services*, May 22, 2019, at <https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F1904050854507613%2F06-01%20-%20TEG%20Issues%20paper%20on%20scope%20of%20crypto-assets.pdf>.

For more on the general background of private keys and custody requirements, see Debevoise & Plimpton LLP, *Custody of Digital Assets: Centralized Safekeeping of Decentralized Assets under the Investment Advisers Act*, December 17, 2018, at https://www.debevoise.com/~media/files/insights/publications/2018/12/20181217_custody_of_digital_assets.pdf; and Fidelity Digital Assets, *Custody in the Age of Digital Assets*, October 2018, at https://www.fidelitydigitalassets.com/bin-public/060_www_fidelity_com/documents/FDAS/custody-in-the-age-of-digital-assets.pdf.

⁴³ Swen Werner, Managing Director, Global Product Manager at State Street, “What Is Custody of Digital Assets?” *Global Custodian*, at <https://www.globalcustodian.com/blog/custody-digital-assets/>.

⁴⁴ SEC Division of Trading and Markets and FINRA Office of General Counsel, *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, July 8, 2019, at <https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities>.

establish “possession or control” for digital asset securities.⁴⁵ On December 23, 2020, the SEC issued a statement and request for comment regarding digital asset securities custody.⁴⁶ In the request, the SEC asked about digital asset custody best practices, processes, risk disclosure, and risk implications, among other things. Amendments to the custody rules have been included in the SEC’s 2021 rulemaking agenda.⁴⁷

Digital Asset ETFs

ETFs are pooled investment vehicles that gather and invest money from a variety of investors.⁴⁸ ETFs combine features of both mutual funds and stocks and can trade on national exchanges. Some industry practitioners hope that the ETF structure could incorporate digital assets.⁴⁹ As mentioned previously, some digital assets are securities subject to securities laws and regulations. But digital assets could also be part of ETF products which would be subject to applicable securities regulation, even if the underlying assets are not securities. The proposed Bitcoin ETFs are the most prominent example of such a structure.⁵⁰ Although Bitcoin is not a security,⁵¹ Bitcoin ETFs would be securities products with value linked to the underlying Bitcoins and are subject to securities regulation, including the Investment Company Act of 1940 and Investment Advisers Act of 1940.

The SEC’s Bitcoin ETF Approval Status

Reportedly, around 10 cryptocurrency ETF applications were awaiting SEC approval as of May 2021.⁵² The SEC has not yet approved any cryptocurrency ETFs because of market manipulation and fraud concerns. The SEC repeatedly stated in its rejections that Bitcoin ETF proposals did not meet standards governing national securities exchanges.⁵³ Specifically, the SEC stated that the proposals have not met the requirements in Section 6(b)(5) of the Exchange Act that order national exchanges, which could potentially list Bitcoin ETF shares, to be “designed to prevent fraudulent and manipulative acts and practices.”⁵⁴

⁴⁵ SEC Division of Trading and Markets and FINRA Office of General Counsel, *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, July 8, 2019.

⁴⁶ SEC, “SEC Issues Statement and Requests Comment Regarding the Custody of Digital Asset Securities by Special Purpose Broker-Dealers,” press release, December 23, 2020, at <https://www.sec.gov/news/press-release/2020-340>.

⁴⁷ Office of Management and Budget, *Agency Rule List - Spring 2021*, at <https://www.reginfo.gov/public/do/eAgendaMain>.

⁴⁸ For more on ETFs, see CRS Report R45318, *Exchange-Traded Funds (ETFs): Issues for Congress*, by Eva Su.

⁴⁹ David Weisberger, “The Case for a Bitcoin ETF,” *Coindesk*, November 23, 2019, at <https://www.coindesk.com/the-case-for-a-bitcoin-etf>.

⁵⁰ Bitcoin exchange-traded funds (ETFs) are funds that are backed by Bitcoins. They allow investors to gain Bitcoin exposure through the funds instead of trading Bitcoin itself. For more on ETFs, see CRS Report R45318, *Exchange-Traded Funds (ETFs): Issues for Congress*, by Eva Su.

⁵¹ SEC Division of Corporate Finance Director William Hinman, “Digital Asset Transactions: When Howey Met Gary (Plastic),” speech delivered at Yahoo Finance All Markets Summit: Crypto, San Francisco, CA, June 14, 2018, at <https://www.sec.gov/news/speech/speech-hinman-061418>.

⁵² Katherine Greifeld and Claire Ballentine, “Bitcoin ETF Approval Odds Grow Longer After Gensler Critique,” *Bloomberg*, May 10, 2021, at <https://www.bloomberg.com/news/articles/2021-05-10/bitcoin-etf-approval-odds-grow-longer-after-gensler-critique>.

⁵³ For example, see SEC, *Release No. 34-87267, Self-Regulatory Organizations; NYSE Arca, Inc.: Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, Relating to the Listing and Trading of Shares of the Bitwise Bitcoin ETF Trust Under NYSE Arca Rule 8.201-E*, October 9, 2019, at <https://www.sec.gov/rules/sro/nysearca/2019/34-87267.pdf>.

⁵⁴ 15 U.S.C. §78f(b)(5).

Bitcoin ETF Related Policy Debates

While U.S. regulators have been more cautious in approving digital asset ETFs, other countries have been more permissive. For example, in Canada, multiple Ethereum and Bitcoin ETFs have received regulatory approval and popular market reception.⁵⁵ The SEC articulated its rationale in a 2018 staff letter that listed challenges related to a Bitcoin ETF. In addition to market manipulation concerns, major Bitcoin ETF challenges included valuation and pricing, custody, and liquidity.⁵⁶ Bitcoin ETFs also have supporters who hope to see cryptocurrency ETFs in the United States. One institutional investor argues that ETFs provide a familiar and convenient way for investors to invest in digital assets, enabling them to participate in digital asset trading and partake in the potential financial gains brought by technological advancements, despite the potential trade-offs with respect to investor protection.⁵⁷

Stablecoins

A *stablecoin* is a digital asset designed to maintain a stable value by linking its value to another asset or a basket of reserve assets, typically collateralized by fiat currencies or facilitated by algorithms.⁵⁸ This section selected two examples to illustrate potential stablecoin regulation (1) using a perceived ETF regulatory structure; and (2) through an enhanced mandatory disclosure process for stablecoins, especially regarding their reserve asset portfolios.

Facebook-Backed Diem (Formally Libra) and Its Perceived ETF Structure

The Facebook-backed stablecoin Libra, which was later renamed Diem,⁵⁹ has attracted congressional attention since its announcement on June 18, 2019. The Diem Association, the nonprofit that oversees Diem's development, reportedly planned to launch a U.S. dollar stablecoin pilot in 2021.⁶⁰ At related congressional hearings in 2019, Facebook received multiple questions regarding whether Libra is an ETF and how it should be regulated.⁶¹ These questions arose because to create the stablecoin, Libra would be backed by reserve assets, including bank deposits and short-term government securities.⁶² New Libra

⁵⁵ Nate DiCamillo, "Canada Approves Three Ethereum ETFs in One Day," *Coindesk*, April 16, 2021, at <https://www.coindesk.com/purpose-investments-gets-approval-to-launch-first-ether-etf-in-canada>.

⁵⁶ SEC staff letter, *Engaging on Fund Innovation and Crypto-currency Related Holdings*, January 18, 2018, at <https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm>. Liquidity refers to the ease of buying and selling securities without affecting the price.

⁵⁷ Jordan Clifford, "The Road to a Bitcoin ETF," *Medium*, August 14, 2018, at <https://medium.com/scalar-capital/the-road-to-a-bitcoin-etf-4364b07a7e15>.

⁵⁸ Financial Stability Board, *Regulatory Issues of Stablecoins*, October 18, 2019, at <https://www.fsb.org/wp-content/uploads/P181019.pdf>.

⁵⁹ Andrew Ackerman, "Facebook-Backed Digital Currency Project Revamps to Address U.S. Regulators' Concerns," *Wall Street Journal*, May 12, 2021, at <https://www.wsj.com/articles/facebook-backed-digital-currency-project-revamps-to-address-u-s-regulators-concerns-11620854340>.

⁶⁰ Ryan Browne, "Facebook-backed Diem aims to launch digital currency pilot later this year," *CNBC*, April 20, 2021, at <https://www.cncb.com/2021/04/20/facebook-backed-diem-aims-to-launch-digital-currency-pilot-in-2021.html>.

⁶¹ U.S. Congress, House Committee on Financial Services, *Examining Facebook's Proposed Cryptocurrency and Its Impact on Consumers, Investors, and the American Financial System*, hearing, 116th Cong., 1st sess., July 17, 2019, at <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=404001>; and U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Examining Facebook's Proposed Digital Currency and Data Privacy Considerations*, 116th Cong., 1st sess., July 16, 2019, S.Hrg. 116-71 (Washington: GPO, 2019), at <https://www.banking.senate.gov/hearings/examining-facebooks-proposed-digital-currency-and-data-privacy-considerations>.

⁶² Libra Association, *Libra White Paper*, 2019, at <https://libra.org/en-US/white-paper>.

tokens could only be created or destroyed by authorized sellers. Some industry practitioners argue that Libra's proposed operational structure is similar to the creation and redemption process used by ETFs.⁶³

Facebook acknowledged at a House hearing that Libra uses operational mechanisms that are similar to ETFs, but stated its view that it is still a payment tool and not an investment vehicle.⁶⁴ Diem's design was based on Libra, but incorporated updates. Diem's core structure for creating a reserve asset portfolio and designating dealers continues to somewhat resemble the ETF structure.⁶⁵ If deemed an ETF, Diem must comply with the SEC's regulatory regime governing securities, investment advisors, and investment companies. SEC approval would be required to launch the project. The SEC was reportedly evaluating whether such structure makes it an ETF.⁶⁶

Tether's Reserve Asset Portfolio: Could Mandatory Disclosures Be Helpful?

The largest stablecoin, Tether, was created in 2014 with the intention to be fully backed by fiat currency.⁶⁷ Tether's prospectus states that "each tether issued into circulation will be backed in a one-to-one ratio with the equivalent amount of corresponding fiat currency held in reserves by Hong Kong based Tether Limited."⁶⁸ It raised investor protection concerns because investigations revealed that it was not *fully backed* at all times. The New York attorney general's office charged Tether and its affiliated trading platform Bitfinex \$18.5 million to settle a case in 2021, claiming that the stablecoin overstated its reserves and covered up losses.⁶⁹ Tether and Bitfinex denied any wrongdoing, but paid the fine and agreed to provide quarterly disclosures of reserve assets. At Tether's first disclosure of its reserves breakdown,⁷⁰ investors learned for the first time that a large portion of Tether's reserves was in unspecified commercial paper, a type of short-term debt instrument.⁷¹ With Tether's market valuation achieving around \$60 billion as of June 2, 2021, some observers worry that potential deceptive activities may create widespread harm to investors.⁷² The usefulness of Tether's disclosure of reserve asset breakdowns, which helped investors to identify potential deceptive activities, drew discussions about whether such disclosure should be more

⁶³ Dave Nagid, "Most Interesting ETF Filing Ever: Libra," ETF.com, June 25, 2019, at <https://www.etf.com/sections/blog/most-interesting-etf-filing-ever-libra>; and Izabella Kaminska, "Treating Stablecoins Like ETFs," *Financial Times*, December 9, 2019, at <https://www.ft.com/content/2dd03db3-67c4-4ccc-8a9c-1439a1b24fae>. For more details on ETF structure and operations, see CRS Report R45318, *Exchange-Traded Funds (ETFs): Issues for Congress*, by Eva Su.

⁶⁴ U.S. Congress, House Committee on Financial Services, *Examining Facebook's Proposed Cryptocurrency and Its Impact on Consumers, Investors, and the American Financial System*, hearing, 116th Cong., 1st sess., at <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=404001>.

⁶⁵ Diem, *White Paper v2.0*, at <https://www.diem.com/en-us/white-paper>.

⁶⁶ Dave Michaels and Lalita Clozel, "SEC Weighs Whether to Regulate Facebook's Libra," *Wall Street Journal*, July 13, 2019, at <https://www.wsj.com/articles/sec-weighs-whether-to-regulate-facebooks-libra-11563015601>.

⁶⁷ For size of Tether, see CoinMarketCap at <https://coinmarketcap.com>.

⁶⁸ Tether, *Tether: Fiat Currencies on the Bitcoin Blockchain*, at <https://tether.to/wp-content/uploads/2016/06/TetherWhitePaper.pdf>.

⁶⁹ New York Attorney General Letitia James, *Attorney General James Ends Virtual Currency Trading Platform Bitfinex's Illegal Activities in New York*, February 23, 2021, at <https://ag.ny.gov/press-release/2021/attorney-general-james-ends-virtual-currency-trading-platform-bitfinex-illegal>; and Olga Kharif, "Bitfinex Settles New York Probe Into Tether, Hiding Losses," *Bloomberg*, February 23, 2021, at <https://www.bloomberg.com/news/articles/2021-02-23/crypto-exchange-bitfinex-settles-with-new-york-to-end-probe>.

⁷⁰ Tether, *Reserve Breakdown at March 31, 2021*, at <https://tether.to/wp-content/uploads/2021/05/tether-march-31-2021-reserves-breakdown.pdf>.

⁷¹ Jemima Kelly, "Tether Says Its Reserves are Backed by Cash to The Tune of ... 2.9%," *Financial Times*, May 14, 2021, at <https://www.ft.com/content/529eb4e6-796a-4e81-8064-5967bbe3b4d9>.

⁷² Jacob Silverman, "Is Tether Just a Scam to Enrich Bitcoin Investors?" *New Republic*, January 13, 2021, at <https://newrepublic.com/article/160905/tether-cryptocurrency-scam-enrich-bitcoin-investors>.

broadly mandated for other stablecoins. Others worry that additional disclosures may increase compliance costs and hinder innovation.

Initial Coin Offerings

Businesses raise funding from capital markets through securities offerings, such as stocks, bonds, and digital assets. ICOs are a new fundraising mechanism in which projects sell their digital tokens in exchange for fiat currency (e.g., dollars) or cryptocurrency (e.g., Bitcoin).⁷³ An early study from Satis Group, a digital asset advisory firm, found that 81% of ICOs were scams and another 11% failed for operational reasons.⁷⁴ In addition, some digital asset companies offering securities do not comply with SEC registration and disclosure obligations, potentially affecting investors' ability to understand their risk exposures.⁷⁵

Industry practitioners have been increasingly aware of the existing securities regulations and compliance requirements. For example, the industry has transitioned to use the term *security token offerings* (STOs) to describe ICOs.⁷⁶ This change of terminology reflects the industry's acceptance that many ICOs are securities offerings and thus subject to securities laws and regulations.⁷⁷

Policy Proposals to Provide Regulatory Clarity on the Definition of "Security"

As previously mentioned, a security is "the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others."⁷⁸ When a digital asset meets the criteria defining a security, it would be subject to securities regulation. But sometimes, digital asset issuers do not immediately understand if their assets are securities or not. Multiple policy proposals exist to provide clarity regarding how the *securities* definition would apply to digital assets.⁷⁹

⁷³ SEC, "Investor Bulletin: Initial Coin Offerings," July 25, 2017, at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings.

⁷⁴ Satis Group, *Crypto-asset Market Coverage Initiation: Network Creation*, July 11, 2018, at https://research.bloomberg.com/pub/res/d28giW28tf6G7T_Wr77aU0gDgFQ.

⁷⁵ Financial Industry Regulatory Authority, *Initial Coin Offerings (ICOs)—What to Know Now and Time-Tested Tips for Investors*, Investor Alert, August 16, 2018, at <http://www.finra.org/investors/alerts/initial-coin-offerings-what-to-know>.

⁷⁶ Roger Aitken, "After 'Crypto's Winter', ICOs Growing Less But Maturing With Shift To STOs," *Forbes*, March 8, 2019, at <https://www.forbes.com/sites/rogeraitken/2019/03/08/after-cryptos-winter-icos-growing-less-but-maturing-with-shift-to-stos/#3e666a687bcf>.

⁷⁷ Terminologies change or evolve relatively rapidly in the digital assets industry. Other illustrative examples include Initial Exchange Offerings (IEOs), which are ICOs launched exclusively on digital trading platforms. SEC Division of Corporate Finance Director William Hinman, "Digital Asset Transactions: When Howey Met Gary (Plastic)," speech delivered at Yahoo Finance All Markets Summit: Crypto, San Francisco, CA, June 14, 2018, at <https://www.sec.gov/news/speech/speech-hinman-061418>.

⁷⁸ For more details, see SEC, *Framework for "Investment Contract" Analysis of Digital Assets*, April 3, 2019, at <https://www.sec.gov/files/dlt-framework.pdf>.

⁷⁹ For example, the Token Taxonomy Act of 2021 (H.R. 1628) proposes to reduce the purview of securities regulation by excluding certain digital tokens from the definition of a security, thus excluding them from securities regulation. The Managed Stablecoins are Securities Act of 2019 (H.R. 5197 in the 116th Congress), on the other hand, proposed to broaden the purview of securities regulation by amending the statutory definition of the term *security* to include a new category of securities called "managed stablecoins," thus subjecting such stablecoins to securities regulation.