

Testimony By

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The Future of Digital Assets: Identifying the Regulatory Gaps in Spot Market Regulation

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Chairman Johnson, Ranking Member Caraveo and Members of the Subcommittee:

Thank you for the opportunity to appear before you today and share my views about digital asset regulation, including the Commodity Futures Trading Commission's (CFTC) role in digital asset regulation. I had the honor of serving as the CFTC's General Counsel from 2017-2021 and currently advise clients about CFTC and digital asset regulation in my role as partner with Katten Muchin Rosenman LLP. However, my appearance before you today is in my own personal capacity; I am not representing or speaking on behalf of any other person, private sector agency or governmental agency.

I would like to address a few issues in my testimony today, including the current jurisdiction that the CFTC has over the digital asset market, including the spot market, the CFTC's substantial experience regarding digital assets, and the protections that the Commodity Exchange Act (CEA) and rules currently offer for investors, particularly to retail customers.

CFTC Jurisdiction Regarding Digital Assets

As this Subcommittee is well aware, the CFTC is the primary regulator of the futures, options on futures, and swaps markets. The CFTC also regulates leveraged retail commodity transactions. The CFTC's full "regulatory" authority includes the ability to require registration and examine registered entities that offer these products.

The CFTC also has enforcement jurisdiction (or anti-fraud and anti-manipulation jurisdiction) in the commodities markets at large. Thus, if the CFTC thinks that there is manipulation or fraud in a spot market for a commodity—such as gold or bitcoin—it can institute an enforcement action to enjoin that activity and seek recompense of ill-gotten gains from that activity.

Why is it important for the CFTC to have anti-fraud and anti-manipulation authority over the spot markets? Quite simply, because the spot markets highly influence the derivatives markets. Spot markets and derivatives markets are highly correlated. Furthermore, derivatives market

prices are largely determined by prices in the spot market. If somebody can manipulate the price of the spot market, they generally also can influence the price of derivatives products based upon the underlying asset.¹

Former CFTC Commissioner Dawn Stump provided an excellent explanation about the rationale and nature of the CFTC's anti-fraud and anti-manipulation authority for the spot market:

The public should be aware that where cash commodity markets are concerned, this limited authority (anti-fraud/manipulation/false reporting, as opposed to day-to-day regulatory oversight) is bestowed upon the CFTC as a tool to assist in its primary function of regulating derivatives products, such as futures. Futures contracts serve a price discovery function. Well-functioning futures (and other derivatives products) rely upon a sound underlying cash market and may reference cash market indexes in their pricing. Therefore, cash market transactions can potentially be part of a scheme to manipulate prices of derivatives products that are regulated by the CFTC. Congress has recognized these relationships between prices of cash transactions and derivatives products, and thus the CEA provides the CFTC with limited enforcement authorities with respect to cash transactions.²

Thus, CFTC enforcement actions in the spot market are not primarily focused on policing the spot market for its own sake. The CFTC emphasizes, instead, its role in regulating the derivatives markets. Chairman Behnam made these points in a Senate Agriculture Committee hearing last month:

As I discussed in December [2022], the CFTC does not have direct statutory authority to comprehensively regulate cash digital commodity markets. Its jurisdiction is limited to its fraud and manipulation enforcement authority. In the absence of direct regulatory and surveillance authority for digital commodities in an underlying cash market, our enforcement authority is by definition reactionary; we can only act after fraud or manipulation has occurred or been uncovered.³

The CFTC nevertheless has actively used its enforcement authority in the digital assets space. It has brought at least 70 enforcement actions involving digital asset commodities. In the last fiscal year, more than 20 percent of the Commission's enforcement actions related to digital asset commodities.⁴

The CFTC has a long history of involvement with digital assets. As early as 2014, the first Bitcoin denominated cash-settled swaps, options and non-deliverable forwards began trading on

¹ See, e.g., *In re Coinbase, Inc.*, CFTC No. 21-03 at 3-4 (Mar. 19, 2021).

² Concurring Statement of Commissioner Dawn D. Stump Regarding Enforcement Action against Coinbase, Inc., (Mar. 19, 2021), <https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement031921>.

³ Testimony of Chairman Rostin Behnam Before the U.S. Senate Committee on Agriculture, Nutrition, & Forestry, *Oversight of the Commodity Futures Trading Commission*, (Mar. 8, 2023), <https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam32>.

⁴ *Id.*

CFTC-registered swap execution facilities.⁵ The next year the CFTC found that Bitcoin and other virtual currencies were commodities.⁶ The first cash-settled Bitcoin futures contracts began trading on CFTC-registered Cboe Futures and CME in 2017.⁷ During the same year, the CFTC for the first time designated a swap execution facility and derivatives clearing organization to transact in physically deliverable Bitcoin swaps contracts. Also in 2017, the CFTC’s LabCFTC released a primer on virtual currencies.⁸

Since 2017, the CFTC has released additional backgrounders on virtual currencies and related derivatives products.⁹ And CFTC Staff in 2018 released an advisory regarding their priorities and expectations when reviewing new virtual derivatives products to be listed on CFTC regulated markets.¹⁰

Today, there are over a dozen actively trading futures and options contracts on digital assets on CFTC-registered markets.¹¹ These contracts are based on the two most-traded digital assets, Bitcoin and Ether. This long-standing and active oversight of digital asset derivatives has given the CFTC unique insights, expertise, and understanding of the operation of spot digital asset markets. As Dr. Chris Brummer noted to a similar subcommittee last year, “the CFTC gained expertise in overseeing the institutionalization of significant infrastructures intersecting directly with the digital asset commodity spot market, something that the SEC, which has yet to approve a spot Bitcoin or digital asset commodity ETF, has arguably only accomplished in attenuated fashion through multiple Bitcoin Futures ETFs.”¹²

⁵ Stan Higgins, *TeraExchange Receives US Approval to Launch First Bitcoin Derivative*, COINDESK (Sept. 12, 2014), <https://www.coindesk.com/tech/2014/09/12/teraexchange-receives-us-approval-to-launch-first-bitcoin-derivative/>; *In re TeraExchange LLC*, CFTC Docket No. 15-33 at 3 (Sept. 24, 2015) (“On September 11, 2014, Tera filed with [the CFTC Division of Market Oversight] a submission self-certifying the Bitcoin swap for trading on its [swap execution facility]. Tera began offering the Bitcoin swap for trading on September 12, 2014.”).

⁶ See *In re Coinflip, Inc.*, CFTC No. 15-29 (Sept. 17, 2015).

⁷ CFTC, Release No. 7654-17 (Dec. 1, 2017), <https://www.cftc.gov/PressRoom/PressReleases/7654-17>.

⁸ LabCFTC, *A Primer on Virtual Currencies* (Oct. 17, 2017),

https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf.

⁹ See CFTC Backgrounder on Self-Certified Contracts for Bitcoin Products,

https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/bitcoin_factsheet120117.pdf; CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets (Jan. 4, 2018), https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/backgrounder_virtualcurrency01.pdf.

¹⁰ See CFTC Staff Advisory No. 18-14 (May 21, 2018), <https://www.cftc.gov/node/214951>.

¹¹ Products are “self-certified” by a CFTC-registered entity. An entity self-certifying a product must provide to the CFTC “[a] concise explanation and analysis of the product and its compliance with applicable provisions of the [Commodity Exchange] Act, including core principles, and the Commission’s regulations thereunder.” 17 C.F.R. § 40.2(a)(3)(v). Furthermore, a registered entity must “provide [to CFTC staff] any additional evidence, information or data that demonstrates that the contract meets, initially or on a continuing basis, the requirements of the [Commodity Exchange] Act or the Commission’s regulations or policies thereunder.” *Id.* § 40.2(b). In certain circumstances, the Commission can stay the trading of the contract. *Id.* § 40.2(c).

¹² Testimony of Chris Brummer before the Subcommittee on Commodity Exchanges, Energy and Credit at 5 (June 23, 2022),

https://agriculture.house.gov/uploadedfiles/brummer_congressional_testimonythe_future_of_digital_asset_regulation.pdf. Indeed, last year the CFTC voluntarily opened up to public comment consideration of a registered entity’s proposed changes to the market structure for certain digital asset derivatives products. *CFTC Seeks Public Comment on FTX Request for Amended DCO Registration Order*, CFTC Release No. 8499-22 (Mar. 10, 2022),

Furthermore, the CFTC has clarified the scope of its authority to regulate retail commodity transactions that involve leverage, financing, or margin. A key statutory requirement for CFTC jurisdiction is whether “actual delivery” of retail commodity transactions have occurred within 28 days. The CFTC engaged in extensive rulemaking with the digital asset community and provided thorough guidance about the meaning of “actual delivery” as that phrase applied to digital assets, with multiple examples of acceptable and non-acceptable practices.¹³ With Commission-backed guidance on this issue in place after receiving and incorporating extensive public feedback, the Commission has used its enforcement authority to have market participants follow the guidance.¹⁴

Current Regulatory Gap in the Spot Market at the Federal Level

Neither the CFTC nor any other federal regulator has plenary regulatory authority over the trading of digital assets that qualify as commodities. If certain transactions involving a digital asset are considered securities, then the SEC would have jurisdiction. To evaluate the amount of the federal regulatory gap for digital asset transactions, the question then becomes the scope of the SEC’s jurisdiction in the digital asset space.

As you are all aware, there is currently a fair amount of discussion about the regulatory oversight of the digital asset market by the CFTC and the SEC, respectively. There have been discussions about which digital assets are under the jurisdiction of the CFTC (as a commodity) and of the SEC (as a security), and recently an apparent dispute regarding the classification of at least one digital asset—Ether—with the CFTC consistently stating that Ether is a commodity and the SEC Chairman last week before the House Financial Services Committee refusing to acknowledge that Ether is or is not a security. This is an important debate, and one that I will not resolve during my testimony today.¹⁵

<https://www.cftc.gov/PressRoom/PressReleases/8499-22>. The CFTC received 1,500 comments in response. See https://comments.cftc.gov/PublicComments/CommentList.aspx?id=7254&ctl00_ctl00_cphContentMain_MainContent_gvCommentListChangePage=1_50. Although the request was ultimately withdrawn, the public comment process provided the CFTC with valuable insight into a host of questions regarding the market structure and operation of digital asset exchanges.

¹³ CFTC Final Interpretive Guidance, *Retail Commodity Transactions Involving Certain Digital Assets*, 85 Fed. Reg. 37,734 (June 24, 2020).

¹⁴ See, e.g., *In re Payward Ventures, Inc.*, CFTC No. 21-20 (Sept. 28, 2021).

¹⁵ I do note that both the CFTC and SEC have previously worked together to provide extensive guidance on the lines between their respective jurisdictions. For example, Section 712(d)(1) of the Dodd-Frank Act required the CFTC and SEC jointly to further define the difference between a “swap” (subject to the CFTC’s jurisdiction) and a “security-based swap” (subject to the SEC’s jurisdiction). Within the space of about two years, the CFTC and SEC: (1) issued an advance notice of proposed rulemaking regarding the definitions; (2) published a proposed rulemaking; (3) received and reviewed almost 100 comments to the proposed rules; and (4) issued a final rule filling more than 150 pages in the Federal Register giving significant guidance, examples, and applications of the difference between “swaps” and “securities-based swaps.” *Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”*; *Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48,208, 48,209-211 (Aug. 13, 2012). This joint effort has greatly reduced the uncertainty regarding the differences between “swaps” and “securities-based swaps.” In addition, both agencies worked together to establish quantitative measures, later modified and adopted by Congress, to clarify the jurisdictional lines between futures and security futures. See 7 U.S.C. § 1a(35), 1a(44).

What I do want to point out is that, in terms of *market capitalization* and looking at the activities of the Commissions themselves (not the statements of a Chairman or a Commissioner), “commodities” have a much larger share of the spot digital asset market than “securities.”¹⁶

Let’s take the top fifteen digital assets by market capitalization. As of April 21, 2023, a popular crypto tracking website estimates that digital assets have a global market capitalization of about \$1.17 trillion.¹⁷ The top fifteen digital assets account for approximately \$1.01 trillion of market capitalization, or approximately **86 percent** of the market.¹⁸

As described above, CFTC-registered derivatives products have been trading on the top two digital assets in market capitalization—Bitcoin and Ether—for several years now. Bitcoin (45.3 percent of market cap) and Ether (19.0 percent of market cap) collectively account for approximately 64.3 percent of the total digital asset market capitalization. If Bitcoin and Ether were securities, they should not be trading on CFTC-registered exchanges, and the SEC has never challenged the trading of these products. So, right off the bat, almost two-thirds of the spot digital asset market appear to be outside the SEC’s jurisdiction.

One can also evaluate enforcement filings to determine which specific digital assets the CFTC and SEC have formally regarded as a security or a commodity. The numbers point to an even larger share of the spot digital asset market being outside the SEC’s jurisdiction.

The CFTC in enforcement filings has alleged that seven of the top fifteen digital assets are commodities (with estimated market capitalization as of April 21, 2023):

- Bitcoin (BTC)¹⁹ (45.3 percent)
- Ether (ETH)²⁰ (19.0 percent)
- Tether (USDt)²¹ (7.0 percent)
- USD Coin (USDC)²² (2.6 percent)
- Dogecoin (DOGE)²³ (1.0 percent)
- Binance USD (BUSD)²⁴ (0.6 percent)
- Litecoin (LTC)²⁵ (0.5 percent)

Collectively, these seven digital assets account for approximately **76 percent** of the total market capitalization of spot digital assets.

¹⁶ In a recent proposed rule regarding custody requirements for investment advisors, the SEC asserted that “most crypto assets are likely to be funds or crypto asset securities covered by the current [custody] rule.” *Safeguarding Advisory Client Assets*, 88 Fed. Reg. 14,672, 14,676 (Mar. 9, 2023). The SEC, however, did not specifically identify any particular digital asset as a security.

¹⁷ See CoinMarketCap, <https://coinmarketcap.com/> (last visited April 21, 2023).

¹⁸ *Id.*

¹⁹ Complaint at ¶ 2, *CFTC v. Binance*, No. 1:23-cv-01887 (N.D. Ill. Mar. 27, 2023).

²⁰ *Id.*

²¹ *Id.* at ¶ 24.

²² Complaint at ¶ 2, *CFTC v. Eisenberg*, No. 1:23-cv-00173 (S.D.N.Y. Jan. 9, 2023).

²³ Complaint at ¶ 1, *CFTC v. McAfee*, No. 1:21-cv-01919 (S.D.N.Y. Mar. 5, 2021).

²⁴ *Supra* note 19 at ¶ 24.

²⁵ *Id.*

The SEC has never asserted in either an enforcement action or a rulemaking that any of the above seven digital assets was or is a security. Of the top fifteen digital assets in terms of market capitalization, the SEC appears to have asserted that only XRP, with a market capitalization of approximately **2 percent** of the market, is a security.²⁶ For the other seven digital assets in the top fifteen—accounting for approximately 8.5 percent of market capitalization²⁷—neither agency has specifically asserted that the digital asset is a security or commodity.²⁸

Indeed, the SEC recently brought an enforcement action against digital asset trading platform Bittrex, Inc. (Bittrex) and related parties for, among other things, failure to register as a national securities exchange.²⁹ The SEC alleges that from 2014 to the present, Bittrex “made available more than 300 crypto assets for trading,”³⁰ including what appears to be most of the top fifteen digital assets by market capitalization. The SEC, however, did not assert in that complaint that any of the top fifteen digital assets were a security. Instead, the SEC relied primarily upon six digital assets with a total of less than **0.18 percent** of the total spot digital market capitalization to buttress its claim that Bittrex should have registered with the SEC.³¹

Customer Protections Provided in the CFTC Regime

Entities subject to CFTC jurisdiction must provide extensive protections to customers purchasing CFTC-regulated products. And the CFTC and the National Futures Association (NFA)³² have not hesitated to enforce these customer protections. In addition to the anti-fraud and anti-manipulation authority described above, there are significant rules regarding the segregation and protection of customer funds. CFTC-registered futures commission merchants (FCMs) must provide general written disclosures regarding the risks of futures trading and specific disclosure regarding their own circumstances.³³ FCMs and introducing brokers must have privacy policies and have procedures in place to protect customer information.³⁴

²⁶ Complaint at ¶ 1, *SEC v. Ripple Labs Inc.*, No. 1:20-cv-10832 (S.D.N.Y. Dec. 22, 2020).

²⁷ Those seven are BNB (BNB) (4.3 percent); Cardano (ADA) (1.1 percent); Polygon (MATIC) (0.8 percent); Solana (SOL) (0.7 percent); Polkadot (DOT) (0.6 percent); Shiba Inu (SHIB) (0.5 percent); and Tron (TRX) (0.5 percent).

²⁸ Over time it would be likely that the digital asset market would trend away from securities and toward commodities. That is because, as a digital asset either becomes more decentralized or becomes used for a consumptive purpose, it is less likely to be considered a security. In addition, if Congress or a court agree that secondary transactions in digital markets do not constitute an “investment contract” under the securities laws, then an even smaller portion of activity in the digital markets would fall within the jurisdiction of the SEC. *See, e.g.*, Motion to Dismiss in *SEC v. Wahi et al.*, Case No. 2:22-cv-01009, Doc. 33 at 13-27 (W.D. Wash. Feb. 6, 2023) (advancing the argument that secondary transactions in digital assets do not fall within the definition of an “investment contract”).

²⁹ Complaint at ¶ 3, *SEC v. Bittrex, Inc.*, No. 2:23-cv-00580 (W.D. Wash. Apr. 17, 2023).

³⁰ *Id.* at ¶ 67.

³¹ The six digital assets (and their percentage of market capitalization as of April 21, 2023) are: Algorand (ALGO) (0.1142 percent); Dash (DASH) (0.0472 percent); OMG Network (OMG) (0.0144 percent); Naga (NGC) (0.0007 percent); Monolith (TKN) (0.0002 percent); and I-House Token (IHT) (0.0000001 percent).

³² The NFA has been designated by the CFTC as a registered futures association.

³³ 17 C.F.R. § 1.55; NFA Rule 2-30.

³⁴ *See* 17 C.F.R. Parts 160 and 162.

The CFTC also has extensive rules to protect retail customers engaging in certain foreign exchange transactions.³⁵ Entities engaged in retail foreign transactions must register,³⁶ meet minimum financial requirements,³⁷ and comply with various recordkeeping and reporting requirements.³⁸ These entities must also provide appropriate disclosures to retail customers about the risks of engaging in these types of transactions, noting, among other things, that the customer can “rapidly lose all of the funds [they] deposit for such trading and [they] may lose more than [they] deposit.”³⁹

The NFA has additional rules that protect customers. For example, NFA members and associates must observe high standards of commercial honor and just and equitable principles of trade. This includes dealing fairly with customers and others at all times.⁴⁰ NFA members must also comply with express standards in all communications with the public generally and promotional literature specifically.⁴¹

The NFA additionally requires members to provide specific disclosures regarding their digital asset activities and comply with certain conduct standards regarding their activities involving the digital assets Bitcoin and Ether.⁴²

Conclusion

There appears to be a significant gap at the federal level in the regulation of spot digital assets. Assertions of jurisdiction by both the CFTC and SEC in enforcement actions suggest that most of the market capitalization of spot digital assets falls outside SEC jurisdiction.

The CFTC has extensive experience in the digital asset space through both its (1) overseeing of trading of digital asset-based derivatives on CFTC-regulated exchanges and (2) asserting its anti-fraud and anti-manipulation enforcement authorities over the spot markets. The CFTC and NFA also have significant experience in providing protections to customers participating in these markets.

Thank you for the opportunity to appear before the Subcommittee. I look forward to answering any questions you may have.

³⁵ See generally 17 C.F.R. Part 5.

³⁶ *Id.* § 5.3.

³⁷ *Id.* §§ 5.6-5.7.

³⁸ *Id.* §§ 5.10-5.11.

³⁹ *Id.* § 5.5(a)(2)(b).

⁴⁰ NFA Rule 2-4.

⁴¹ NFA Rule 2-28.

⁴² NFA Rule 2-51; see also NFA Interpretive Notice 9073.