Testimony of Coy Garrison
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Before the U.S. House of Representatives Committee on Financial Services
"The Future of Digital Assets: Providing Clarity for the Digital Asset Ecosystem"
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Thank you, Chairman McHenry, Ranking Member Waters, and members of the Committee for the invitation to testify on the urgent need for legislation to bring clarity to the digital asset ecosystem.

My name is Coy Garrison. I am a partner in the Washington, D.C. office of Steptoe & Johnson LLP. As a member of Steptoe's Blockchain & Cryptocurrency practice, I advise a range of participants in the digital asset ecosystem on securities law compliance and how to navigate the challenging legal and regulatory issues facing the industry. Prior to joining Steptoe one year ago, I was an attorney for the U.S. Securities and Exchange Commission ("SEC" or the "Commission"), first working in multiple roles within the Division of Corporation Finance until I had the honor of serving as counsel to Commissioner Hester M. Peirce for nearly three years. My testimony today is a product of my experiences in both government and in private practice, but I appear before you on my own behalf and not on behalf of my firm or any client of the firm.

I. Congress must act to bring appropriate regulation to the digital asset industry.

My message to you today is simple: Congress must act to bring sensible regulation to the digital asset industry. The Digital Asset Market Structure Discussion Draft is a thoughtful and measured approach, and would create a workable regulatory framework for the industry. Before addressing the details of the draft, I'd like to explain the circumstances that necessitate congressional action.

a. Currently, there is no meaningful federal regulation of the digital asset markets, which harms investors, responsible industry participants, and the U.S. economy.

The status quo fails to protect people who trade or hold digital assets on centralized exchanges. While there are a number of responsible trading platforms appropriately safeguarding customers' assets and monitoring against fraud and manipulation, some trading platforms have put their customers' assets at dramatic risk and caused significant loss.[1] Enforcement actions are tools to hold wrongdoers accountable, but they cannot replace sensible market regulation that can help deter, identify, and mitigate wrongdoing.

The status quo also creates a business environment where responsible actors in the digital asset industry are hindered in their potential to innovate, add jobs to the economy, and realize the benefits of their technology. They are also limited in their ability to compete against traditional

[1] United States Attorney's Office Southern District of New York, United States Attorney Announces Charges Against FTX Founder Samuel Bankman-Fried (Dec. 13, 2022), https://www.justice.gov/usao-sdny/pr/united-states-attorney-announces-charges-against-ftx-founder-samuel-bankman-fried.

institutions. Most digital asset industry participants simply want clear rules of the road and will pour tremendous resources into compliance if those rules are provided.

Further, the status quo puts the U.S. at a competitive disadvantage. The European Union, Canada, Dubai, and Hong Kong are examples of jurisdictions that in recent months have implemented new legislation or regulations for digital assets, which create attractive destinations for entities that are made to feel increasingly unwelcome by regulators here in the U.S. This is not empty rhetoric: I have travelled to two of these jurisdictions in the past six months to explore business opportunities under these new foreign regulatory regimes, and I have regular conversations with industry participants in the U.S. actively considering moving to new jurisdictions.

b. The application of existing securities laws to digital assets is not always clear.

Blockchain technology, like nearly any new innovation, does not fit nicely into existing regulatory regimes. The foundational question of whether any digital asset is a security or commodity is therefore not easily answered. As a preliminary matter, to the extent a digital asset fits within the broad definition of a commodity under the Commodity Exchange Act, the Commodity Futures Trading Commission ("CFTC") currently has enforcement authority in the spot market for digital assets, but does not have regulatory authority.[2]

The SEC has increasingly asserted its authority over digital asset trading platforms in recent weeks.[3] The legal analysis of whether any particular digital asset is sold pursuant to a security in any particular transaction requires a facts-and-circumstances consideration of the economic realities of the transaction, which involves nuance and judgment. Sweeping statements that nearly all digital assets are securities, or are not securities, ignore the complexity of the analysis and distract from finding a workable solution to the numerous legal and regulatory issues involved in this context.

To determine whether a digital asset is sold as a security, a proper analysis requires one to start with the statute: the Securities Act of 1933 ("Securities Act"). In Section 2(a)(1) of the Securities Act, Congress defines "security" by referencing more than thirty specific instruments, including stocks, bonds, and notes. Each instrument listed in the statutory definition is subject to its separate legal analysis as explained by the relevant case law. Unsurprisingly, digital assets are not included in the list of securities.

The concept of an "investment contract," however, is included in the statute as a type of security. In 1946, in the *Howey* case, the Supreme Court first defined an investment contract as a "contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[4] While the

[2] 7 U.S.C. § 6(c); 17 C.F.R. § 180.1.
[3] SEC Files 13 Charges Against Binance Entities and Founder Changpeng Zhao (June 5, 2023), https://www.sec.gov/news/press-release/2023-101; SEC Charges Coinbase for Operating as an Unregistered Securities Exchange, Broker, and Clearing Agency (June 6, 2023), https://www.sec.gov/news/press-release/2023-102.
[4] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

Howey case related to the sale of orange groves in conjunction with service contracts for the cultivation and sale of the oranges, seventy-seven years of case law on the subject has found securities transactions relating to schemes involving the sale of items ranging from chinchillas to whiskey receipts.[5] In the 2017 DAO Report, the SEC first asserted that digital assets may be sold pursuant to investment contracts under the *Howey* test.[6]

The application of the *Howey* test to digital assets is not always a straightforward exercise. As a preliminary matter, determining whether an investment contract exists in any digital asset transaction involves a complex analysis of the particular facts and circumstances. The SEC staff issued guidance on the subject in 2019 and identified more than sixty factors to be considered, which underscores the complexity of the analysis.[7]

Additionally, even if it is determined that an investment contract is present in a digital asset transaction, the digital asset itself is not the investment contract.[8] Rather, the digital asset plus the promises and efforts of the promoter or the third party constitute the contract, transaction, or scheme that is the investment contract. There is no case law addressing the application of the *Howey* test to a secondary market transaction in an investment contract.[9] This creates tremendous uncertainty in seeking to determine whether the securities laws apply to secondary trading of digital assets that were sold pursuant to investment contracts. The SEC has recently begun to shift its focus in enforcement actions to arguing that secondary transactions in certain digital assets constitute investment contracts,[10] but courts have not had an opportunity to assess the SEC's arguments regarding the applicability of securities laws to such transactions.

Further adding to the complexity, the SEC staff has taken the position that a digital asset at one point in time may represent the investment contract, but that the same digital asset may no longer represent the investment contract over time if the network is sufficiently decentralized.[11] There is no clear guidance from the SEC on how to determine whether a network is sufficiently decentralized and how a digital asset can transition from a security to a non-security.

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[5] *See* Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974); Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027, 1034–1035 (2d Cir. 1974).

[6] SEC, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (Jul. 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf/.

[7] SEC Staff, Framework for "Investment Contract" Analysis of Digital Assets (Apr. 3, 2019), https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

[8] *See* SEC v. Telegram Group Inc., No. 1:19-cv-09439-PKC (S.D.N.Y. Mar. 24, 2020) ("While helpful as a shorthand reference, the security in this case is not simply the Gram, which is little more than alphanumeric cryptographic sequence.")

[9] For an excellent discussion of the application of *Howey* to digital assets, see Cohen, Lewis and Strong, Greg and Lewin, Freeman and Chen, Sarah, The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets Are not Securities (November 10, 2022). Available at SSRN: https://ssrn.com/abstract=4282385.

[10] *See supra* note 3. *See also* SEC Charges Former Coinbase Manager, Two Others in Crypto Asset Insider Trading Action (Jul. 21, 2022), https://www.sec.gov/news/press-release/2022-127; SEC Charges Crypto Asset Trading Platform Bittrex and its Former CEO for Operating an Unregistered Exchange, Broker, and Clearing Agency (Apr. 17, 2023), https://www.sec.gov/news/press-release/2023-78.

[11] William Hinman, then-Director of Division of Corporation Finance, Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418. *See also* Framework *supra* note 7 (describing factors to consider when evaluating whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales).

Nevertheless, the desire to be sufficiently decentralized under the securities laws drives a significant number of decisions for persons working on digital asset networks.

These difficult, unresolved legal issues surrounding the proper application of the *Howey* test to primary and secondary transactions in digital assets underscore the uncertainty facing the digital asset industry and investors.

c. The SEC has refused to create a workable regulatory framework for digital assets.

The securities markets function well for capital raising activities through traditional instruments such as stocks and bonds. For example, when a company grows to the size that it needs additional capital and can afford the costs of being a public company, it will file a registration statement with the SEC to sell shares to the public and include disclosures of material business and financial information to allow investors to make informed investment decisions. On an ongoing basis, public companies are required to provide periodic and current disclosures so that investors have sufficient information to make informed investment and voting decisions. Secondary transactions of shares in public companies are executed through a host of intermediaries: broker-dealers, clearing agencies, national securities exchanges, alternative trading systems ("ATS"), transfer agents, and others. The SEC oversees an intricate set of rules and regulations designed to ensure that these intermediaries treat investors fairly and honestly.

However, to the extent digital assets are sold pursuant to securities transactions, they are not traditional securities like stocks or bonds. As previously discussed, digital assets may be sold pursuant to investment contracts. The SEC's rules and regulations, however, are not designed for investment contracts. Nor are the SEC's rules and regulations designed for digital assets that permit holders to participate in the functioning of a blockchain network. Generally, unlike common stock, investment contracts are not sold pursuant to registered offerings.[12] Many of the existing disclosures that would be required in a registration statement do not provide useful information in the digital asset context. Additionally, under the existing regulations, there is no such thing as an exchange for investment contracts where buyers and sellers can trade.

The problem, therefore, with demands from SEC officials that digital asset trading platforms register with the SEC under existing equity market structure rules is that those rules are not designed with the realities of how digital assets trade or operate. Existing equity market structure rules do not contemplate concepts made possible by digital asset trading, such as instantaneous settlement, the potential for the trading of securities and non-securities on the same platform, and the lack of a need for intermediaries for various functions. Reasonable regulation of digital assets would consider changes to the existing rules to address these new capabilities. However, the SEC has shown little interest in such rulemaking, or even in providing actionable guidance to the industry. For example, despite years of engagement with the industry, the SEC has yet to provide clarity on how broker-dealers and investment advisers are permitted to custody digital assets in a compliant manner.

[12] To my knowledge, there is only one context in which an issuer has registered the sale of investment contracts: in the marketplace lending industry where the investment contracts were non-separable from the notes also being registered and had no separate value from the notes being registered.

d. ***The SEC's special purpose broker-dealer concept is not a sufficient solution.***

The limited efforts by the SEC to date to permit broker-dealers to interact with digital asset securities have, regrettably, not been effective. In September 2020, the SEC staff issued a no-action letter to FINRA outlining two non-custodial models for ATSs to facilitate secondary transactions in digital asset securities.[13] Notably, the no-action position permits trading of digital asset securities for a tiny corner of the digital asset market. Only digital assets that are offered or sold pursuant to a registered offering or a valid exemption are eligible. As most digital assets are not sold pursuant to registered offerings or a valid exemption, the vast majority of digital assets are not eligible for this no-action position. While there are some ATSs that rely on this no-action letter to facilitate transactions in digital asset securities, the universe of digital assets permitted to trade on these ATSs is very small and the trading volumes are relatedly low. The attractiveness of these business models is hampered by the uncertainty of determining whether a digital asset is offered as a security.

The SEC also issued a statement in December 2020 outlining a new special purpose broker-dealer, whereby broker-dealers could seek approval to provide custody of digital asset securities if they comply with nine specific requirements.[14] For nearly three years, no broker-dealer was approved to operate as a special purpose broker-dealer despite numerous applicants. Last month, FINRA approved a member to operate as a special purpose broker-dealer. Under the SEC's statement, there are two significant limitations for any special purpose broker-dealer. First, just as with the September 2020 no-action letter, only a tiny corner of the digital asset market will be permitted to be custodied by the special purpose broker-dealer. The vast majority of digital assets will not be able to be custodied under this program. Second, the special purpose broker-dealer no-action position is only good for five years and thus will expire in February 2026 absent further Commission action. The limited scope and duration of the special purpose broker-dealer license renders the license not well-suited for most market participants.

e. The SEC needs direction from Congress to engage in meaningful rulemaking.

The SEC has the ability to use its rulemaking and exemptive authorities to bring clarity on these issues and to provide a workable regulatory framework for digital assets sold pursuant to investment contracts. Indeed, SEC Commissioner Peirce proposed token safe harbor proposals in 2020 and 2021, which would have relied on these agency authorities to create a temporary regulatory regime for digital assets.[15] Unfortunately, the Commission did not move forward with the ideas, and there have been no new proposals for a tailored regulatory framework since. Rather than using its rulemaking and exemptive authorities, the Commission

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[13]Division of Trading and Markets, SEC, ATS Role in the Settlement of Digital Asset Security Trades (Sept. 25, 2020), https://www.sec.gov/divisions/marketreg/mr-noaction/2020/finra-ats-role-in-settlement-of-digital-asset-security-trades-09252020.pdf.

[14] SEC, Custody of Digital Asset Securities by Special Purpose Broker-Dealers, Rel No. 34-90788 (Dec. 23, 2020), https://www.sec.gov/rules/policy/2020/34-90788.pdf.

[15] Hester Peirce, Commissioner, SEC, Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization (Feb. 6, 2020), https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06; *see also* Hester Peirce, Commissioner, SEC, Token Safe Harbor Proposal 2.0 (Apr. 13, 2021), https://www.sec.gov/news/public-statement/peirce-statement-token-safe-harbor-proposal-2.0.

is instead relying on enforcement actions to articulate its application of the securities laws to the digital asset ecosystem. Some of these cases will likely take years of litigation and appeals to result in any binding judicial precedent. Absent a congressional directive to the SEC to engage in rulemaking, the status quo will likely persist for the foreseeable future.

II. The Digital Asset Market Structure Discussion Draft creates a responsible regulatory framework for the digital asset industry.

The discussion draft provides the foundation for a responsible regulatory framework for the digital asset ecosystem and addresses a number of the regulatory uncertainties I have previously highlighted. The draft reflects a thoughtful, balanced approach that is rooted in existing securities and commodities laws concepts. First, the discussion draft creates a new exemption from registration for the sale of digital assets pursuant to an investment contract with important investor protection provisions: an aggregate offering limit, individual investment limits for non-accredited investors, bad actor disqualification, tailored initial and on-going disclosure requirements, and limitations on resales by insiders. These provisions are modeled after familiar securities laws and regulations, including Regulation A, Regulation Crowdfunding, and Rule 144. The tailored disclosure requirements for digital assets are an improvement from the existing disclosure requirements for registered offerings.

Second, the discussion draft provides for the secondary trading of these restricted digital assets on ATSs, and directs the SEC to modernize Regulation ATS in key ways. The current issue of digital asset securities not being permitted to trade against non-security digital assets would be resolved by requiring ATSs to be allowed to trade restricted digital assets, digital commodities, and payment stablecoins on the same platform. Additionally, Regulation ATS would be amended to accommodate the benefits of blockchain technology by permitting disintermediated trading and real-time settlement of digital assets, with appropriate safeguards. These measures would address the shortcomings of the special purpose broker-dealer regime and the current, limited ATS functionality permitted by the September 2020 SEC no-action letter.

Third, the discussion draft tackles the problem of when a digital asset that is sold pursuant to a securities transaction can become a digital asset that is no longer part of a securities transaction because the network is sufficiently decentralized. A certification process would be established at the SEC, providing the agency the ability to rebut a presumption of certification and providing the applicant due process both in the agency and through the courts. A potential area for improvement on this section would be to clarify the standards by which the SEC considers and reviews such certifications.

Fourth, the discussion draft provides the CFTC with authority to regulate the spot markets for digital commodities. Digital commodity exchanges, dealers, brokers, and qualified custodians would have to register with the CFTC, become members of the National Futures Association ("NFA"), and be subject to significant oversight. The CFTC would impose regulations concerning the monitoring of trading activity, the treatment of customer assets, recordkeeping and reporting, and conflicts of interest, which would provide much-needed protections in spot market trading of digital commodities.

Digital asset trading platforms would have the ability to register as both an ATS and a digital commodity exchange, and the SEC and CFTC would be instructed to work together to remove any duplicative requirements. This will help ensure that the trading of digital assets, whether restricted digital assets on an ATS, or digital commodities on a digital commodity exchange, are subject to similar, but not overlapping or duplicative requirements. Moreover, the draft legislation creates processes for determining which agency has jurisdiction over which assets, providing a clear roadmap for determining the legal status of any digital asset.

The discussion draft gives both the SEC and the CFTC the ability to put their stamps on the appropriate regulatory regime through rulemakings. The two agencies would be instructed to engage in joint rulemakings to implement the bill and to establish a joint advisory committee to address ongoing matters. While the CFTC gains significant new jurisdiction in overseeing the spot digital commodity markets, the SEC is granted a significant role in regulating digital assets, and is directed to modernize a variety of its rules in this context, including the Customer Protection Rule and Market Access Rule for broker-dealers, Regulation NMS, and Regulation SCI.

Finally, the discussion draft is limited to the problem at hand: the lack of federal regulation of spot market trading of digital assets. Importantly, the draft clarifies that certain ancillary activities involving digital assets, such as validating, that do not require the securities or commodities laws are not covered by the statutes. Additionally, the agencies are instructed to study DeFi and NFTs, which should lay the groundwork for more responsible, thoughtful regulation of those areas of the digital asset ecosystem.

III. Conclusion

Throughout my career, I have sought to bring regulatory clarity to the digital asset industry. Not surprisingly, I did not always see eye-to-eye with my colleagues at the SEC on issues relating to digital assets. My experience in private practice has reaffirmed my belief that most market participants want to comply and will do so when provided with clear rules. I also know from my time at the agency that the SEC staff is filled with capable and dedicated securities lawyers that could provide the industry a workable regulatory framework, if the SEC staff were empowered to do so. I hope you will allow them the opportunity through this legislation. Thank you for your unprecedented work on this important legislation with the Agriculture Committee.