

## MEMORANDUM

To: Members of the Committee on Financial Services

From: Financial Services Committee Majority Staff

Date: April 24, 2023

Re: Subcommittee on Digital Assets, Financial Technology, and Inclusion entitled, “The Future of Digital Assets: Identifying the Regulatory Gaps in Digital Asset Market Structure”

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On Thursday, April 27, at 10:00 a.m. (ET), the Subcommittee on Digital Assets, Financial Technology, and Inclusion will hold a hearing, entitled: “Identifying the Regulatory Gaps in the Digital Asset Market Structure.” Testifying at the hearing will be:

- **Marta Belcher**, President & Chair, Filecoin Foundation
- **Daniel Gorfine**, Founder & CEO, Gattaca Horizons, LLC; Adjunct Professor of Law at the Georgetown University Law; and former Commodity Futures Trading Commission Chief Innovation Officer and Director of LabCFTC
- **Joshua Rivera**, General Counsel, Blockchain Capital
- **Zachary Zweihorn**, Partner, DavisPolk
- **Hilary Allen**, Professor of Law, American University Washington College of Law

### ***Jurisdiction of the U.S. Securities and Exchange Commission***

The central question of whether the SEC has jurisdiction over a digital asset is whether it falls within the definition of a security. The Securities Act of 1933 (the “Securities Act”) requires every offer or sale of securities to be registered with the SEC or meet a condition for exemption from registration.<sup>1</sup> The Securities Act defines a security to include an “investment contract,” which was in turn defined by the Supreme Court in *SEC v. W.J. Howey Co.*<sup>2</sup> Under *Howey* and the cases that followed, an arrangement qualifies as an investment contract if it is: 1) an investment of money; 2) in a common enterprise; 3) with the expectation of profits; 4) derived from the efforts of others. The test is not a “balancing test,” rather, all four factors must be present for the arrangement to constitute an investment contract.<sup>3</sup> Several characteristics central to digital assets may cause it not to meet the *Howey* test. These characteristics include functional

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<sup>1</sup> Paul Vigna, *SEC Clears Blockstack to Hold First Regulated Token Offering*, Wall Street Journal (Jul. 10, 2019), available at <https://www.wsj.com/articles/sec-clears-blockstack-to-hold-first-regulated-token-offering-11562794848>; Guillermo Jimenez, *SEC Greenlights a Second Crypto Offering: YouNow’s Props Tokens*, Yahoo Finance (Jul. 19, 2019), available at <https://finance.yahoo.com/news/sec-greenlights-second-crypto-offering-223301606.html>.

<sup>2</sup> See *SEC v. Howey Co.*, 328 U.S. 293 (1946).

<sup>3</sup> *Id.*

use that negates the expectation of profit and sufficient decentralization such that it is no longer reliant on the efforts of others.

While the Securities Act focuses on the registration of securities, the Exchange Act regulates secondary trading of securities. The Exchange Act imposes registration requirements on intermediaries that engage in or facilitate the trading of securities, including digital assets offered as part of an investment contract. These intermediaries include broker-dealers, exchanges, and clearing agencies, among others. Under current law, market participants that act in these capacities in connection with a digital asset deemed to be a security may be subject to registration and regulation, as with any other security.<sup>4</sup> However, certain Exchange Act requirements do not apply neatly to digital assets. The regulations governing these entities must be evaluated and enhanced to better protect consumers and investors.

### ***Jurisdiction of the Commodities Future and Trading Commission (CFTC)***

The CFTC is the primary market regulator for derivatives in the United States. Derivatives markets, unlike equity or debt markets, are not intended as capital raising venues. Rather, they are best understood as risk transfer markets, permitting an individual or entity with a commodity price risk (an end-user) to transfer that risk to a speculator. In doing so, the end user can achieve some certainty over future operating costs. This risk transfer mechanism is invaluable for entities as diverse as farmers selling wheat to their local grain elevator, pensions planning for their beneficiary's retirement, and multinational corporations conducting business in foreign countries.

Recent case law confirms the CFTC's view that the term commodity includes "virtual currencies" or digital commodities. As such, digital commodities are subject to the same jurisdiction of the Commission as any other commodity. However, in the instances in which a digital commodity is determined to be a security, CFTC jurisdiction does not apply.

The CFTC's regulatory authority is limited to transactions, participants, and intermediaries in the commodity derivatives markets. Regulated intermediaries include but are not limited to trading venues, clearinghouses, brokers, dealers, investment advisers, among others. The Commission currently does not have regulatory authority over spot market transactions, unless the transaction is a margin, leveraged, or financed retail commodity transaction or retail foreign exchange transaction. As such, the CFTC currently does not have regulatory authority over spot market transactions or intermediaries in the digital commodity spot markets.

### ***Risks of Inaction by Congress and Continued Regulation by Enforcement***

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<sup>4</sup> American Bar Association Derivatives and Futures Law Committee Innovative Digital Products and Processes Subcommittee Jurisdiction Working Group, Digital and Digitized Assets: Federal and State Jurisdictional Issues (Dec. 2020), available at [https://www.davispolk.com/sites/default/files/2021-08/aba\\_digital\\_assets\\_white\\_paper\\_section\\_3\\_december\\_2020.pdf](https://www.davispolk.com/sites/default/files/2021-08/aba_digital_assets_white_paper_section_3_december_2020.pdf).

Chairman Gensler has opined on numerous occasions that the “test to determine whether a crypto asset is a security is clear.”<sup>5</sup> However, Republican SEC Commissioner Hester Peirce and former SEC Commissioner Elad Roisman disagree, citing requests “[the SEC] receives for clarity and the consistent outreach to the Commission staff for no-action and other relief.”<sup>6</sup> Recently, Commissioner Hester Peirce emphasized her concerns with the SEC’s enforcement-centric approach and highlighted guiding principles for regulating the digital asset ecosystem.<sup>7</sup>

In the absence of United States leadership, other countries are rushing to build frameworks and become developmental hubs for the digital asset ecosystem. Currently, the largest trading platform and stablecoin issuer are based outside of the United States.<sup>8</sup> Many entrepreneurs are warning against doing business in the United States and advocating for digital asset companies to move offshore.<sup>9</sup> The European Union recently approved its Markets in Crypto-Assets (MiCA) regulation, and the United Kingdom will soon finalize its own digital asset regulatory proposal.<sup>10</sup> The ability of other countries to successfully build digital asset frameworks further demonstrates the necessity of congressional action.

Committee Republicans seek to establish a digital asset market structure framework appropriate for the unique characteristics of digital assets. This framework would provide digital asset firms with regulatory certainty and prevent the regulatory turbulence created by jurisdictional infighting and punitive enforcement actions. Congress must enact digital asset market structure legislation to ensure the next generation of financial innovation develops in the United States.

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<sup>5</sup> SEC Chairman Gensler Remarks Before the Aspen Security Forum (Aug. 3, 2021), available at <https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03>.

<sup>6</sup> Commissioner Peirce and former Commissioner Roisman Public Statement: In the Matter of Coinschedule (Jul. 14, 2021), available at <https://www.sec.gov/news/public-statement/peirce-roisman-coinschedule>.

<sup>7</sup> Commissioner Hester M. Peirce Remarks before the Digital Assets at Duke Conference (Jan. 20, 2023), available at <https://www.sec.gov/news/speech/peirce-remarks-duke-conference-012023>.

<sup>8</sup> Jeff Wilser, *US Crypto Firms Eye Overseas Move Amid Regulatory Uncertainty*, CoinDesk (Mar. 27, 2023), available at <https://www.coindesk.com/consensus-magazine/2023/03/27/crypto-leaving-us/>.

<sup>9</sup> Brady Dale, *The few crypto firms that have registered with the SEC*, Axios (Mar. 6, 2023), available at <https://www.axios.com/2023/03/06/crypto-register-sec-securities-exchange-commission>.

<sup>10</sup> Camomile Shumba, *With MiCA Past the Finish Line, UK's Crypto Industry Calls for Rules of Its Own*, CoinDesk, (Apr. 21, 2023), available at <https://www.coindesk.com/policy/2023/04/21/with-mica-past-the-finish-line-uks-crypto-industry-calls-for-rules-of-its-own/>.