

Testimony by

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U.S. House Financial Services Committee Subcommittee on Digital Assets, Financial
Technology, and Inclusion and the

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Rural Development

“The Future of Digital Assets: Identifying the Regulatory Gaps in Digital Asset Market Structure”

Wednesday, May 10, 2023, 9:30am

Chairman Hill, Chairman Johnson, Ranking Member Lynch, Ranking Member Caraveo, and
members of the subcommittees:

Thank you for the opportunity to testify before you today.

My name is Marco Santori. I am the Chief Legal Officer at Payward, Inc. d/b/a Kraken (Kraken). I oversee all legal, regulatory, and policy matters impacting Kraken’s global business operations. In this role, I manage over 50 lawyers and professionals around the world with deep and diverse public and private sector backgrounds.

I was one of the first lawyers practicing in the area of digital asset regulation. I have advised clients in this ecosystem for over a decade - nearly since blockchains were invented. I am honored to appear before this joint subcommittee hearing today. This cooperation across committees and across party lines demonstrates both the willingness and the ability for Congress to pass effective laws for the digital asset industry. Congressional action is critical for the United States to keep pace as other leading economies around the world advance frameworks for digital asset markets that protect consumers and support innovation.

We are at an important juncture in the development of U.S. digital asset policy. Domestically, in the absence of clear federal law, a patchwork of state legislations are advancing to close consumer protection gaps. Abroad, new fit-for-purpose regulatory frameworks are developing, drawing innovation and American consumer interest away from the United States. Now is the time for Congress to act.

My testimony focuses on three main topics:

- I. Kraken’s approach to risk management, security, and customer protection
- II. Current gaps in U.S. rules that can be addressed by Congress
- III. Legislative and regulatory advancements in other developed economies

I. OUR GLOBAL BUSINESS IS DESIGNED TO SUPPORT SAFE AND EFFICIENT DIGITAL ASSET MARKETS

Kraken was founded in San Francisco in 2011. Since then, we have steadily grown into a diversified, global digital asset business serving over 10 million customers around the world. Our mission is to accelerate the adoption of cryptocurrency so that the world can achieve financial freedom and inclusion. We continually strive to offer the most secure and transparent execution platform, deepest liquidity, and the best user experience in our markets.

The societal value of digital assets extends far beyond remittance and is changing the way we conduct business globally. New and exciting use cases include identity verification, storing medical records, crowdfunding and peer-to-peer lending. Digital assets empower people with new ways to transact in a borderless, real-time, and fair manner. Decentralized applications do not and cannot discriminate on the basis of race, gender, citizenship, or socioeconomic status. Everyone participates under the same rules and associated benefits.

Kraken has a team of over 2,000 professionals that operate on a remote-first basis. Today, our team spans the globe across more than 60 countries. We collaborate and advance our mission through a virtual environment with ideas and contributions from a wide range of geographies, professional backgrounds, cultures, ethnicities, and viewpoints. Our diversity is a competitive strength. It aligns us with the 24/7/365 global nature of our markets and the dynamic community of customers and innovators we serve.

Governance, including managing conflicts of interest, is central to our operating model. We benefit from experienced boards at our holding company and subsidiaries that bring together deep public and private sector experience.

Kraken offers a diverse range of products and services.

We provide products and services to retail and institutional customers that support key components across the digital asset market value chain. These include:

- **Trading** - We offer spot market trading, a custodial NFT marketplace, and futures in eligible jurisdictions.
- **Index services** - We operate the world's leading digital asset index business via our regulated index provider, CF Benchmarks, one of our UK-based businesses. CF Benchmarks is registered with and supervised by the UK Financial Conduct Authority (FCA). Our index customers include some of the largest global exchanges, asset managers, and other institutional market participants.
- **Staking** - Kraken provides clients in eligible jurisdictions with the ability to use their assets to secure proof-of-stake blockchain networks, contributing to the strength and security of digital asset ecosystems. By providing these services at scale, we enable individuals with smaller quantities of tokens to participate in these important governance functions where they wouldn't otherwise be able.
- **Kraken Bank** - Kraken Bank, one of our U.S. businesses, is chartered as a Special Purpose Depository Institution (SPDI) and supervised by the Wyoming Division of Banking. The SPDI charter has two innovative hallmarks: first, it prohibits the bank from lending; second, all deposits must be backed 1:1 by highly liquid assets.

Security is core to our culture.

Kraken is consistently named one of the most secure places to buy and sell digital assets due to our robust security for client assets. We take a comprehensive approach to protecting our systems and our clients from malicious actors:

- Kraken uses layers of identity verification and fraud prevention safeguards to combat identity theft, sanctions evasion, and money laundering. Platform users are identified in compliance with Know Your Customer (KYC) and Anti-Money Laundering (AML) standards that are equivalent to those used by banks and other financial institutions.
- Our robust AML controls include transaction monitoring, blockchain analytics, investigation, and suspicious activity reports (SARs).
- We proactively report suspicious activity to law enforcement. We also work closely with law enforcement to improve our reporting and undertake proactive two-way intelligence sharing.
- We undertake comprehensive investigations in response to law enforcement requests and other referrals.
- We invest significant resources in building and updating educational tools and resources to help our team members and customers spot common fraud warning signs and empower our customers as the first line of defense.
- We operate a best-in-industry client engagement team, who offer phone support 24/7, as well as open chat, social media and ticket support to help our clients trade digital assets safely.

We invest heavily in regulatory engagement and compliance.

As jurisdictions develop new rules for digital assets operations, we engage with regulators globally to serve customers in a compliant manner. We currently hold a number of registrations, licenses, authorizations and approvals across the globe. In the United States, Kraken maintains a registration as a Money Services Business with FinCEN and holds money transmitter licenses. Kraken Bank is supervised by the Wyoming Division of Banking under an SPDI charter. We also hold licenses and registrations across the UK, European Union, Canada, and Australia, among other developed and emerging markets.

Kraken is committed to supporting policy makers here in the U.S. and around the world to implement effective domestic rules and a coherent international regulatory framework for digital asset markets.

II. GAPS IN U.S. REGULATION REQUIRE CONGRESSIONAL ACTION TO EFFECTIVELY REGULATE DIGITAL ASSET MARKETS

There is precedent for effective cooperation between these committees and between the SEC and CFTC to develop and implement tailored rules for market regulation. For example, the statutory and regulatory creation of Swap Execution Facilities (SEFs) considered the different market and liquidity dynamics, product structure, and trading protocols of the swaps markets and their trading venues relative to other securities and derivatives markets. This was possible because Congress provided a clear roadmap for inter-agency cooperation on swaps regulation through the Dodd-Frank Act.

As described below, there are gaps in U.S. regulation that can be resolved with a clear mandate from Congress that will:

1. Establish a functional standard and process for drawing clear jurisdictional lines;
2. Create a viable path to regulate centralized digital asset exchanges where SEC jurisdiction has been defined by Congress;
3. Expand CFTC authority to regulate spot digital asset markets and exchanges;
4. Mandate interagency cooperation to facilitate coordinated oversight over digital assets and centralized exchanges; and
5. Define transitional arrangements to minimize market disruption and protect retail investors.

Congressional action is needed to resolve regulatory gaps.

1. Establish a functional standard and process for drawing clear jurisdictional lines

Kraken has a robust process for reviewing assets prior to supporting them on our platform. This process includes comprehensive risk, economic, and legal assessments. Kraken does not make assets available that fall within any definition of security in the U.S. Some digital assets are clearly commodities and some are not. Our industry needs a bright line and clear process to provide the market with legal certainty for the considerable number of assets in between.

A fundamental goal of the U.S. securities laws is to provide the public with truthful disclosure about material risks that may impact their investment, thereby empowering citizens to make their own decisions. The disclosure requirements and standards for traditional securities under the Securities Act of 1933 do not work well for digital assets. For example, what is “material” information related to a publicly traded company is likely to be very different than what is material for a decentralized, blockchain-based asset. The value of a digital asset - unlike the value of stocks and bonds - is often not dependent on the issuer’s operations or financial condition. Forcing digital assets into the existing corporate disclosure regime deprives consumers of the most valuable information while overwhelming them with the least valuable.

2. Create a viable path to regulate centralized digital asset exchanges where SEC jurisdiction has been defined by Congress

Digital asset trading platforms cannot be regulated like National Securities Exchanges (NSEs).

Extensive evidence in the public record illustrates the practical barriers to NSE registration for digital asset platforms, including:

- Digital asset trading platforms interact directly with retail clients. National securities exchanges, by contrast, permit only broker-dealers to participate.
- Securities exchanges are not set up for global, 24/7 trading. Stocks on NSEs trade only during regular market hours. Digital assets trade 24/7, with no pressures on price or volume created by opening and closing times. Digital asset prices and volumes are subject to market forces at all times.
- U.S. securities exchanges form part of a National Market System (NMS) and they trade exclusively NMS securities. Digital asset platforms trade a variety of assets that will fall under CFTC jurisdiction, such as Bitcoin (BTC), Ethereum (ETH), and other digital asset commodities.

Digital asset trading platforms cannot currently be regulated as Alternative Trading Systems (ATs) without modifications.

SEC-Registered ATs function like exchanges, but are regulated by FINRA and the SEC as broker-dealers. Currently, there are very few broker-dealers, and even fewer ATs, that are registered with FINRA to trade digital assets. These ATs are currently only permitted to trade digital assets that are securities. In the SEC's current view, ATs cannot trade non-securities such as BTC, ETH, or stablecoins.

Today, any digital asset trading platform that is registered as an AT would have to immediately stop trading all digital assets they currently trade, either on the SEC's theory that such assets are unregistered securities, or because such assets are non-securities. This would create significant market disruption. For example, BTC and ETH, which are commodities, account for 60% of digital asset market capitalization.

Digital assets are held, traded, custodied, and settled in a different manner than equity securities. No AT or other broker-dealer is currently permitted to custody customer digital assets, which is vital to smoothly and securely trade digital assets on an AT.

To resolve these gaps, Congress can create a new registration category for centralized digital asset markets that:

- Remains open to direct retail participation, as ATs are, and not be limited to requirements that customers are registered broker-dealers (as with NSEs).
- Reduce friction by being open to the trading of non-security digital assets (such as BTC, ETH, or stablecoins) side-by-side with digital assets that are determined to be securities.
- Have in place a rulebook that has been reviewed and approved by the SEC or CFTC.

3. Expand CFTC jurisdiction to regulate spot digital asset markets and exchanges

Measured by market value, most digital assets are commodities in the U.S. The CFTC currently lacks statutory authority to develop a comprehensive regulatory framework for spot digital commodity markets. The CFTC has a successful track record of regulating the digital asset futures markets, which play an integral role in a healthy and functioning spot market. The Commodity Exchange Act (CEA) should be amended to empower the CFTC to regulate spot digital asset markets, beyond policing fraud and manipulation, and should also provide a workable registration framework for centralized digital asset markets.

4. Mandate interagency cooperation to facilitate coordinated oversight over digital assets and centralized exchanges

With clear jurisdictional lines drawn, regulated digital asset platforms should have a clear path to registration at the CFTC and SEC. Each agency, where appropriate, should have inspection and examination authority over platforms that make digital assets available to trade. This is consistent with the approach adopted for swaps regulation. For example, a trading facility for swaps may be simultaneously registered as a Swap Execution Facility (SEF) with the CFTC, and as a Security-Based Swap Execution Facility with the SEC. As with SEFs, entities that are registered with one regulator should be allowed an abbreviated registration process with the other regulator. The Commissions should also be permitted to refer potentially violative conduct to each other for enforcement and share data. Rules on market integrity should be developed jointly by the CFTC and the SEC for consistent application.

5. Define transitional arrangements to minimize market disruption and protect retail investors

The creation of new, regulated trading platforms, the allocation of jurisdiction, and the establishment of inter-agency mechanisms for cooperation will take time. Until these new mechanisms can be firmly established, transitional arrangements should be put in place to allow digital asset markets to continue to operate with minimal disruption, and as little harm as possible to retail investors.

The SEC has the power to grant temporary conditional relief from Exchange Act requirements to platforms. For example, the SEC provided broad exemptions from traditional securities market rules that it determined were not compatible with security-based swaps. Such exemptive relief can be made conditional on digital asset platforms meeting certain requirements, such as maintaining and enforcing rules around market integrity, custody, and conflicts of interest. Such conditional relief would enable the orderly transition to regulated digital asset markets, without compromising investor protection.

III. DEVELOPED MARKETS AROUND THE WORLD ARE ADVANCING EFFECTIVE REGULATION

Traditional rules are being tailored to create effective regulation.

Digital asset markets are naturally global. Many jurisdictions, including the majority of G20 nations, have finalized, are progressing, or have signaled their intention to create a new regulatory framework for digital asset markets.

In the EU, the Markets in Crypto Assets Regulation (MiCA) has combined the most effective components of traditional market regulation and applied them in a bespoke manner to create a comprehensive and effective framework for digital assets. MiCA includes a licensing framework to conduct specific activities (e.g., issuance, brokerage, custody, exchange), prescribes governance arrangements, mandates uniform transparency and disclosure requirements, and addresses conflicts of interest, among many other fundamental elements of market regulation. EU lawmakers broadly defined tokens as “crypto assets” rather than attempting to apply traditional definitions to the entire market. MiCA sets clear transitional measures to avoid market disruption.

The UK is also amending existing financial service frameworks to reflect the unique characteristics and opportunities of digital assets. HM Treasury’s recent consultation builds on the UK government’s ambition to create a global hub for these markets within an effective regulatory perimeter.

Other developed markets like Singapore and Switzerland have also finalized foundational components of their digital asset frameworks and continue to advance other rules to develop a more comprehensive framework. Canada, Australia, Hong Kong, and South Korea are in various stages of their legislative and regulatory processes.

Similar to other financial services sectors, we believe responsible and successful digital asset businesses and activity will be drawn towards jurisdictions with effective and clear regulatory frameworks that allow innovators, markets and investors to plan, build, and compete on a level regulatory playing field.

Global markets need a coherent international framework for regulation.

International standard setters and other multilateral organizations are working to achieve global consistency of regulatory frameworks, which is critical to ensuring customer protection in highly mobile digital asset markets.

Examples include:

- **Tax** - The Organisation for Economic Co-operation and Development (OECD) developed the Crypto Asset Reporting Framework (CARF) in 2022, which is intended to bring increased harmonization of tax regulations to digital asset transactions globally.
- **Anti-money laundering** - The Financial Action Task Force (FATF) updated its “Travel Rule” in 2022, which extends key AML/KYC requirements to virtual assets and virtual asset providers.
- **Prudential requirements** - The Basel Committee on Banking Supervision (BCBS) issued its guidance on the prudential standards for banks’ exposure to crypto assets. As market regulation of digital asset markets strengthens, we expect capital rules to evolve accordingly.
- **Financial stability** - The Financial Stability Board (FSB) has been coordinating the work of national financial authorities and other international standard setters. The FSB published a consultation in October 2022 on regulation, supervision, and oversight of crypto activities and markets with recommendations to follow this year.
- **Market regulation** - We are encouraged by the work of the International Organization of Securities Commissions (IOSCO) to develop global standards specific to market regulation of digital assets and digital asset exchanges. The CFTC and SEC should continue to work with peers from developed and emerging markets to establish a coherent system of regulating digital asset markets. These markets transcend borders in new ways relative to legacy markets. Different jurisdictions with different underlying political, legal and regulatory systems will take different paths towards regulating digital assets, but can still align on common outcomes.

Conclusion

We at Kraken, in partnership with our community of innovators, customers, peers and industry bodies, will continue to support our U.S. lawmakers in passing effective rules that will allow digital assets to thrive in the U.S.

Forcing this technology and a growing global asset class into existing U.S. securities rules without modifications simply does not work. We share concerns regarding the domestic and international consequences of this approach as we see other developed economies advancing effective legislation and regulation for digital assets. We can learn from our past successes in bringing markets under cooperative supervision by the CFTC and SEC.

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Prior to Kraken, Marco was the Chief Legal Officer of Blockchain.com, as well as a Partner at each of Cooley LLP and Pillsbury Winthrop, where he counseled banks, broker-dealers and fintech companies making new and exciting uses of distributed ledger technology. Marco is an author of the SAFT Project Whitepaper, a self-regulatory effort to address initial coin offerings. He has served as an advisor to the International Monetary Fund, the Blockchain Ambassador to the State of Delaware, and was first the Chairman of the Regulatory Affairs Committee of the Bitcoin Foundation.