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Hearing on "Dazed and Confused: Breaking Down the SEC's Politicized Approach to Digital Assets"

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Chairman Hill, Ranking Member Lynch, and distinguished members of Subcommittee on Digital Assets, Financial Technology and Inclusion, my name is Jennifer Schulp, and I am the Director of Financial Regulation Studies at the Cato Institute's Center for Monetary and Financial Alternatives. The views I express in this testimony are my own and should not be construed as representing any official position of the Cato Institute.

Thank you for the opportunity to take part in today's hearing entitled, "Dazed and Confused: Breaking Down the SEC's Politicized Approach to Digital Assets."

The Securities and Exchange Commission's approach to digital assets under the leadership of Chairman Gary Gensler can be characterized as an "enforce first, make rules never" strategy. While an enforcement-forward strategy may be effective—and perhaps even appropriate—where existing rules provide clear guidance to market participants, the Commission's current strategy, where the application of existing rules to digital assets is uncertain or inappropriate, effectively amounts to a ban on crypto activity within the United States. This strategy simultaneously exceeds the agency's authority and abdicates the agency's role in overseeing the securities markets.[1]

The SEC's approach has subjected U.S. market participants who choose to engage in digital asset-related activities to extreme regulatory and compliance risk. Not only have the SEC's actions directly put a stop to a host of digital asset activities in the United States,[2] there

[1] *See* Jack Solowey and Jennifer J. Schulp, "Crypto, Courts, and Congress," Cato At Liberty Blog, April 5, 2024, https://www.cato.org/blog/crypto-courts-congress; Jack Solowey and Jennifer J. Schulp, "Lawmakers Should Check the SEC's Wartime Consigliere with Legislation," *Cointelegraph*, March 6, 2023, https://www.cato.org/commentary/lawmakers-should-check-secs-wartime-consigliere-legislation.

[2] *See, e.g.,* Securities and Exchange Commission, "eToro Reaches Settlement with SEC and Will Cease Trading Activity in Nearly All Crypto Assets," Press Release, September 12, 2024, https://www.sec.gov/newsroom/press-releases/2024-125; Securities and Exchange Commission, "Kraken to Discontinue Unregistered Offer and Sale of

are indications that developers and projects that may have otherwise chosen to operate in the United States, or serve U.S. customers, are choosing to operate elsewhere.[3]

The SEC's approach is anathema to sound public policy and the rule of law. My testimony today is intended to give an overview of the errors in the SEC's approach to digital assets, but it by no means provides a full catalogue of the ways in which the SEC's approach could be improved. I will first address the ways in which the SEC's existing rules, and the Commission's interpretation thereof, do not provide regulatory clarity to those wishing to engage with digital assets. Next, I will discuss how the SEC's enforcement-first strategy when coupled with an uncertain regulatory environment is particularly hostile to digital assets. Finally, I will identify a better approach to digital assets available to the Commission and how any steps that the SEC would claim it has taken in this direction are illusory.

Existing Rules Often Are a Poor Fit for Digital Assets

The starting point for examining the SEC's failed approach to digital assets is the most basic one: existing rules do not provide clear guidance to market participants as to whether the SEC's rules are even applicable, and if they are, how they can be complied with. While SEC Chairman Gary Gensler is fond of saying that "[n]ot liking the message is not the same thing as not receiving it," it is plain that there is a lack of clarity around the application of securities laws to digital assets.[4] So plain in fact, that it has been noted not just by industry, but by other federal regulators and by legislators.[5] Yet, Gensler continues to promote the fiction that the answer is simply to "come in and register."[6]

Crypto Asset Staking-As-A-Service Program and Pay $30 Million to Settle SEC Charges," Press Release, February 9, 2023, https://www.sec.gov/newsroom/press-releases/2023-25; Sebastian Sinclair, "LBRY ends operations, cites feud with SEC and mounting debt," *Blockworks*, October 20, 2023, https://blockworks.co/news/lbry-shutter-sec-debt.

[3] *See* Jennifer Schulp, "Join Us in Person or Online, Sept. 7 Cato Conference: 'Staying Ahead of the Curve: Crypto Regulation and Competitiveness,'" Cato At Liberty Blog, September 5, 2023, https://www.cato.org/blog/weeks-conference-crypto-regulation-competitiveness.

[4] Gary Gensler, "Kennedy and Crypto," Speech, Securities and Exchange Commission, Sept. 8, 2022, https://www.sec.gov/newsroom/speeches-statements/gensler-sec-speaks-090822.

[5] *See, e.g.,* Rostin Behnam, Testimony before U.S. Senate Committee on Agriculture, Nutrition and Forestry's Hearing on the Oversight of Digital Commodities, July 10, 2024, https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam48; Reuters, "Yellen says Congress should provide authority to regulate stablecoins," *Reuters*, February 6, 2024, https://www.reuters.com/markets/currencies/yellen-says-congress-should-provide-authority-regulate-stablecoins-2024-02-06/; Jesse Hamilton and Nikhilesh De, "U.S. House Approves Crypto FIT21 Bill With Wave of Democratic Support," *CoinDesk*, May 22, 2024, https://www.coindesk.com/policy/2024/05/22/us-house-approves-crypto-fit21-bill-with-wave-of-democratic-support/.

[6] *See, e.g.,* Jen Wieczner, "Gary Gensler on Crypto, SPACs, and Robinhood," *New York Intelligencer*, Sept. 13, 2021, https://nymag.com/intelligencer/2021/09/gary-gensler-sec-chair-crypto-spacs-robinhood.html; Marco Quiroz-Gutierrez, "Amid FTX fallout, SEC's Gensler once again asks for a bigger budget but doesn't say how he'd use it," *FortuneCrypto*, December 7, 2022, https://fortune.com/crypto/2022/12/07/gary-gensler-sec-enforcement-crypto-ftx-sam-bankman-fried/ (Gensler "once again called on crypto companies operating in the country to 'come into compliance' with U.S. securities laws or face the consequences).

The SEC's approach ignores the differences between digital assets and traditional securities, and unfairly views the entire digital assets industry as a monolith, which it decidedly is not.[7] Those differences lead to problems applying existing rules to the digital assets ecosystem, which the Commission has failed to acknowledge (or remedy), resulting in a hostile regulatory environment for innovation.

The SEC's Jurisdiction Is Unclear

The starting point for any analysis of existing rules' appropriateness is whether a digital asset or digital asset-related service is under the SEC's jurisdiction. While determining whether an instrument is a security subject to SEC jurisdiction is not always a straightforward process, due to the breadth of the definition of a security and the flexibility with which it has been applied, answering this question is more difficult for digital assets due to their novel characteristics. Rather than wrestling with these legal questions, or providing clear guidance to market participants, the SEC has instead disclaimed any responsibility to provide workable guidance and claimed essentially limitless jurisdiction over digital assets.

Whether a digital asset is a security is often analyzed under the test for an "investment contract."[8] The four-part *Howey* test requires (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profit, (4) to be derived from the efforts of others.[9] In the era of the Securities Act and the *Howey* decision, and for decades thereafter, the archetypical covered entity under securities laws was a centralized enterprise with a corporate form, headquarters, and managerial hierarchy. Crypto projects aspire to upend this model, eschewing not only the physical plant of 20th-century enterprises but also, more importantly, managerial bodies exercising ongoing control over projects. And that creates significant challenges to the traditional concept of an investment contact.[10]

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[7] *See, e.g.,* Jennifer J. Schulp, Testimony before U.S. Senate Committee on Banking, Housing, and Urban Affairs on "Crypto Crash: Why the FTX Bubble Burst and the Harm to Customers," December 14, 2022, https://www.cato.org/testimony/crypto-crash-why-ftx-bubble-burst-harm-consumers; Amanda Tuminelli, Testimony before H.S. House Committee on Financial Services, Subcommittee on Digital Assets, Financial Technology and Inclusion on "Decoding DeFi: Breaking Down the Future of Decentralized Finance," September 10, 2024, https://docs.house.gov/meetings/BA/BA21/20240910/117620/HHRG-118-BA21-Wstate-TuminelliA-20240910.pdf.

[8] 15 U.S.C. §77b(a)(1).

[9] *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

[10] *See* Jack Solowey and Jennifer Schulp, "Practical Legislation to Support Cryptocurrency Innovation," Briefing Paper No. 140, Cato Institute, August 2, 2022, https://www.cato.org/briefing-paper/practical-legislation-support-cryptocurrency-innovation; *see also* Hester Peirce, "Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization," Speech, Securities and Exchange Commission, February 20, 2020, https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-blockress-2020-02-06.

Rather than confront those challenges, though, Gensler has laid jurisdictional claim to essentially all digital assets except for Bitcoin.[11] He has repeatedly refused to provide guidance as to whether Ether can be considered a security—a position made all the more confusing by the fact that the Commodity Futures Trading Commission has deemed Ether a commodity—leaving the second largest blockchain in regulatory limbo with ongoing questions about whether the SEC will or will not assert jurisdiction.[12]

This issue is compounded by the fact that the jurisdictional theories that the SEC does assert stray beyond the *Howey* jurisprudence to instead establish SEC jurisdiction with almost no limit. As Commissioner Mary Uyeda has described, the SEC's approach has been "that any item sold whose value is based on the efforts of others is a security," but "[t]his broad reading of Howey would appear to scope in many common transactions in the non-digital world, including pre-purchase commitments, collectibles, art, and land."[13] The SEC has settled actions consistent with this limitless reading of its authority, specifically in the context of non-fungible tokens.[14]

Any market participant that questions the SEC's expansive reading of its own jurisdiction—or any market participant that is legitimately unsure of whether the SEC has regulatory authority over its project—faces significant regulatory and compliance risks that can result in expensive investigation or litigation brought by the SEC. This alone stands as a major deterrent to operating in the digital assets space in the United States.

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[11] *See* Jesse Coghlan, "Crypto lawyers flame Gensler over claims that all crypto are securities," *Cointelegraph*, February 27, 2023, https://cointelegraph.com/news/crypto-lawyers-flame-gensler-over-claims-that-all-crypto-are-securities.

[12] Katherine Ross, "SEC Chair Gensler skirts questions on ETH as a commodity," *Blockworks*, June 13, 2024, https://blockworks.co/news/sec-gary-gensler-on-eth-status-commodity; Dylan Butts, "CFTC chair calls Ethereum a commodity, in contrast to SEC chair Gensler's position," *Yahoo Finance*, March 3, 2023, https://finance.yahoo.com/news/cftc-chair-calls-ethereum-commodity-111551034.html; Jesse Hamilton, "House's McHenry Accuses SEC Chief Gensler of Misleading Congress on Ethereum," *CoinDesk*, April 30, 2024, https://www.coindesk.com/policy/2024/04/30/houses-mchenry-accuses-sec-chief-gensler-of-misleading-congress-on-ethereum/; Leo Schwartz, "SEC Signals Ethereum is no a security in settlement with eToro," *FortuneCrypto*, September 12, 2024, https://fortune.com/crypto/2024/09/12/etoro-sec-gensler-ethereum-bitcoin-crypto-lawsuit/.

[13] Mark Uyeda, "Remarks to the Council of Institutional Investors – Dangers of the Unbounded Administrative State," Speech, Securities and Exchange Commission, March 5, 2024, https://www.sec.gov/newsroom/speeches-statements/uyeda-remarks-cii-030524.

[14] In re Impact Theory, LLC, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, And Imposing a Cease-and-Desist Order, Securities Act Release No. 11226, File No. 3-21585, August 28, 2023, https://www.sec.gov/files/litigation/admin/2023/33-11226.pdf; Hester Peirce and Mark Uyeda, "NFTs & the SEC: Statement on Impact Theory, LLC," Statement, Securities and Exchange Commission, August 28, 2023, https://www.sec.gov/newsroom/speeches-statements/peirce-uyeda-statement-nft-082823#_ftn1 ("The handful of company and purchaser statements cited by the order are not the kinds of promises that form an investment contract. We do not routinely bring enforcement actions against people that sell watches, paintings, or collectibles along with vague promises to build the brand and thus increase the resale value of those tangible items.").

Securities Registration Rules Do Not Fit Digital Assets

Even if there were no jurisdictional questions and it were clear that an issuer of a digital asset was subject to the SEC's jurisdiction by virtue of issuing a security, the SEC's registration rules would still be a poor fit for digital assets.

Registered securities must provide initial and ongoing public disclosures about their issuer's officers and board of directors, the issuer's business activities, and the issuer's audited financial statements. But disclosure obligations related to balance sheets and cash flow statements for corporate entities often do not make sense for software projects that are, fundamentally, distributed recordkeeping systems lacking traditional assets or business lines.[15] Registration is simply not a viable option where the SEC's rules require reporting that is inapplicable to digital asset issuers.[16]

These problems are all the more difficult when the development and/or operation of those software projects is decentralized (or in the process of decentralizing)—meaning that no single party or unified group maintains discretionary control over the project or its code. In such circumstances, there may be no centralized entity capable of making such ongoing disclosures.

Moreover, disclosures that would be relevant to crypto users—including the determinants of token supply and governance mechanisms for software updates—are not covered by legacy securities rules.[17] Indeed, other jurisdictions, including the European Union, have recognized this and have established tailored disclosure regimes for digital assets.[18] The SEC's failure to provide guidance on relevant disclosures for digital assets may create market confusion, where existing rules ask issuers for information not material to the user.[19]

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[15] *See, e.g.,* 17 C.F.R. §§ 210.1, et seq.

[16] Issuers may still make securities-law compliant offerings pursuant to the regulations that govern the SEC's exemptions from registration. Such exempt offerings, however, are subject to limitations as to the amount of money that can be raised and on the resale of securities and may be limited only to accredited investors. *See* Securities and Exchange Commission, "Overview of Capital-Raising Exemptions," https://www.sec.gov/files/chart-amended-capital-raising-exemptions-oasb.pdf.

[17] *See, e.g.,* Jack Solowey and Jennifer Schulp, "Practical Legislation to Support Cryptocurrency Innovation," Briefing Paper No. 140, Cato Institute, August 2, 2022, https://www.cato.org/briefing-paper/practical-legislation-support-cryptocurrency-innovation; Rodrigo Seira, Justin Slaughter, and Katie Biber, "The Current SEC Disclosure Framework Is Unfit for Crypto," Paradigm, April 20, 2023, https://policy.paradigm.xyz/writing/secs-path-to-registration-part-iii.

[18] *See, e.g.,* Philip Lee, "MiCA white papers – What obligations will crypto firms have under the new European legislation?," *Lexology*, May 30, 2022, https://www.lexology.com/library/detail.aspx?g=beb201eb-21e9-48dd-ad90-071d368c3837.

[19] *See* Hester Peirce, "Overdue: Statement on Dissent of LBRY," Statement, Securities and Exchange Commission, October 27, 2023, https://www.sec.gov/newsroom/speeches-statements/peirce-statement-lbry-102723#_ftn9 ("Here, LBRY made significant disclosures outside of the registration process—disclosures that the Commission does not allege were fraudulent or misleading—and there is little to indicate that LBRY's disclosures did not provide token purchasers with information adequate to assess whether the tokens were a good fit for them.").

These problems do not end with the registration of a primary offering. Once a digital asset is registered as a security, it must be treated as a security in secondary trading. But such treatment may mean that the token is thus reduced—so to speak—to only being a security, and not able to provide any other use to its owner. Digital assets that are intended to be used to facilitate the purchase and sale of goods, to facilitate blockchain functionality, or to be used in other ways, are likely unable to be used consistent with those functions because of restrictions on the sale of those assets by the securities laws.[20]

Exchange Regulations Do Not Fit Digital Asset Platforms

The fit of existing regulations is no better for the marketplaces over which digital assets are exchanged.[21] The first major hurdle to registration of digital asset platforms follows from the discussion above. Because registered securities exchanges can only trade securities,[22] any difficulties with respect to regulations' fit for digital assets themselves will be replicated in terms of their platforms' eligibility for SEC registration. But the poor fit of existing exchange regulations does not end there.

Even if securities registration were clear for digital assets, existing SEC rules and guidance make it impossible for digital asset platforms to register and comply with the requirements applicable to securities exchanges. Gensler has bemoaned the structure of current crypto platforms, which allow market participants to transact directly without the intermediation of a broker and vertically integrate some functions (such as custody and settlement) that securities exchange rules require to be separated.[23]

But even if a crypto platform's consolidated functions were broken apart, the SEC's rules would not be compatible with allowing such a platform to function. For example, trading on a securities exchange is limited to broker-dealers,[24] but SEC guidance restricts the ability of

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[20] *See* Hester Peirce, "Outdated: Remarks before the Digital Assets at Duke Conference," Speech, Securities and Exchange Commission, January 20, 2023, https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-duke-conference-012023 ("When we insist on applying the securities laws in this manner, secondary purchasers of the token often are left holding a bag of tokens that they cannot trade or use because the SEC requires special handling consistent with the securities laws.").

[21] *See, e.g.,* Jack Solowey and Jennifer Schulp, "Regulatory Clarity for Crypto Marketplaces Part II: Centralized Exchanges," Briefing Paper No. 155, Cato Institute, May 10, 2023, https://www.cato.org/briefing-paper/regulatory-clarity-crypto-marketplaces-part-ii-centralized-exchanges; Committee on Capital Markets Regulation, "Cryptoasset Trading Platforms Cannot Register As Securities Exchanges," Statement, June 6, 2023, https://capmktsreg.org/wp-content/uploads/2023/06/CCMR-Crypto-Exchanges-Cannot-Register-With-the-SEC-06-06-23.pdf.

[22] Exchange Act §§ 3(a)(1), 6(b)(1); *see also* Jack Solowey and Jennifer Schulp, "Regulatory Clarity for Crypto Marketplaces Part II: Centralized Exchanges," Briefing Paper No. 155, Cato Institute, May 10, 2023, https://www.cato.org/briefing-paper/regulatory-clarity-crypto-marketplaces-part-ii-centralized-exchanges (explaining that SEC Rule 51c2-11 bars broker-dealers from transaction without certain information being available).

[23] Gary Gensler, "Kennedy and Crypto," Speech, Securities and Exchange Commission, Sept. 8, 2022, https://www.sec.gov/newsroom/speeches-statements/gensler-sec-speaks-090822 ("The commingling of the various functions within crypto intermediaries creates inherent conflicts of interest and risks for investors.").

[24] 15 U.S.C. § 78f.

broker-dealers to handle digital assets for their clients, limiting it to "special-purpose" broker-dealers who solely handle crypto securities.[25] But the guidance covering these "special purpose broker-dealers," issued in late 2020, appears to be unworkable, with only two entities (one just last week) having been approved for such a license.[26]

This problem is repeated specifically with respect to custody. Even if a crypto platform were to cease custodying a customer's assets, the number of providers of qualified custodial services has been severely limited due to SEC guidance, including Staff Accounting Bulletin (SAB) 121 and the guidance on special-purpose broker-dealers.[27]

Exchange rules regarding securities settlement and clearing are also incompatible with the settlement and clearing process for digital assets. Because settlement can occur instantaneously on a blockchain, there is no practical need for a clearing agency to assume the responsibility for the settlement process when trading digital assets. Yet, existing rules may require a digital asset platform that utilizes such technology for immediate settlement to register as a clearing agency and be subject to the inapt rules that apply to such an entity.[28] This makes little sense.[29]

For decentralized platforms, the problems are even more acute.[30] Squaring securities laws designed for centralized financial intermediaries with a crypto ecosystem that includes tokens traded via disintermediated protocols is a significant challenge. Centralized platforms typically custody customer assets, settle transactions off-chain, and have opaque transaction records. But decentralized platforms do not custody the assets of users trading tokens and

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[25] Securities and Exchange Commission, "Custody of Digital Asset Securities by Special Purpose Broker-Dealers," Policy Statement, December 23, 2020, https://www.sec.gov/files/rules/policy/2020/34-90788.pdf.

[26] Leo Schwartz, "SEC and FINRA make tZero second recipient of special crypto license following controversial Prometheum approval," *FortuneCrypto*, September 10, 2024, https://fortune.com/crypto/2024/09/10/tzero-special-purpose-broker-dealer-license-finra-sec-gensler-prometheum-crypto/. Importantly, the guidance that makes this license possible is set to expire in 2025—a short period of time from now for an operating business—and the SEC has made no public moves to extend or otherwise codify the ability of broker-dealers to engage in the business permitted by the guidance.

[27] *See also* Jack Solowey and Jennifer Schulp, "Regulatory Clarity for Crypto Marketplaces Part II: Centralized Exchanges," Briefing Paper No. 155, Cato Institute, May 10, 2023, https://www.cato.org/briefing-paper/regulatory-clarity-crypto-marketplaces-part-ii-centralized-exchanges (explaining that the SEC's proposed rule on safeguarding investment adviser assets may, if finalized, further erode access to, and safety of, qualified custodians).

[28] 15 U.S.C. §78c(a)(23); 17 C.F.R. § 240.17Ad-22.

[29] And while one can argue that the better analogue to crypto trading platforms are alternative trading systems, *see* Jack Solowey and Jennifer Schulp, "Regulatory Clarity for Crypto Marketplaces Part II: Centralized Exchanges," Briefing Paper No. 155, Cato Institute, May 10, 2023, https://www.cato.org/briefing-paper/regulatory-clarity-crypto-marketplaces-part-ii-centralized-exchanges, with the one exception of Prometheum, and now tZero, the SEC has not steered the registration conversation in that direction. Indeed, the enforcement actions that it has brought against Coinbase, Binance, and others have been for failures to register as exchanges, not for failure to comply with the provisions of Reg ATS.

[30] *See* Jack Solowey and Jennifer Schulp, "Regulatory Clarity for Crypto Marketplaces Part I: Decentralized Exchanges," Briefing Paper No. 154, Cato Institute, May 10, 2023, https://www.cato.org/briefing-paper/regulatory-clarity-crypto-marketplaces-part-i-decentralized-exchanges.

settle transactions on open and auditable public blockchains. Therefore, applying traditional custody and market transparency rules to decentralized platforms is, at best, unhelpful, and may be counterproductive.[31] Regulations to address intermediary risks do not make sense for software designed to achieve disintermediation.

Unfortunately, the SEC has shown little interest in working through any of these issues—whether jurisdictional or related specifically to the poor fit of existing regulations for digital asset or exchange registration. Not only has the Commission failed to undertake any process towards rule-making in this space, but multiple market participants have publicly stated that they did attempt to engage with the SEC about registration, only to be rebuffed.[32] And Commissioner Hester Peirce recently characterized the SEC's posture as one where market participants asking the SEC about the "application of an old [rule] to new circumstances, too often now … are met with … well, crickets."[33] These are not the actions of a regulator engaged in its mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Rather these are the actions of a regulator that, at a minimum, is showing callous indifference to the impact of rules that are not a good fit for evolving technology.

Enforcement-First Is a Harmful Regulatory Strategy for Digital Assets

Enforcement is a key part of the regulatory process; holding regulated parties to account for the rules that are put into place is important. But, as a matter of both fairness and efficiency, enforcement should happen only when the regulatory obligations being enforced are reasonably clear.

Where the application of existing rules to digital assets is uncertain or impossible, as discussed above, an enforcement-first strategy is inappropriate and effectively amounts to a deterrent to the entire digital assets ecosystem within the United States.

Regulation by Enforcement is Not an Efficient or Fair Way of Regulating

The SEC routinely touts its success in charging "first-of their kind" cases and bringing significant actions "to protect investors in new and emerging areas, including cases charging

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[31] Jennifer Schulp and Jack Solowey, "DeFi Must Be Defended," *CoinDesk*, October 26, 2022, https://www.cato.org/commentary/defi-must-be-defended;

[32] *See* Securities and Exchange Commission, Agency Rule List – Spring 2024 (Reg Flex Agenda), https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode&showStage=active&agencyCd=3235; Paul Grewal, "We asked the SEC for reasonable crypto rules for Americans. We got legal threats instead," Coinbase, March 22, 2023, https://www.coinbase.com/blog/we-asked-the-sec-for-reasonable-crypto-rules-for-americans-we-got-legal; Daniel M. Gallagher, Testimony before U.S. House of Representatives Committee on Agriculture on "The Future of Digital Assets: Providing Clarity for Digital Asset Spot Markets," June 6, 2023, https://docs.house.gov/meetings/AG/AG00/20230606/116051/HHRG-118-AG00-Wstate-GallagherD-20230606.pdf.

[33] Hester Peirce, "At the SEC: Nothing but Crickets Remarks at SEC Speaks," Speech, Securities and Exchange Commission, April 2, 2024, https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-sec-speaks-040224.

misconduct involving cyber issues and crypto securities."[34] While not all first-of-their-kind cases are inappropriate, the Commission should not champion leading with enforcement when addressing novel applications of existing rules.

Rulemaking achieved through enforcement is suboptimal for many reasons, including simply that it creates worse rules. As Commissioner Uyeda has explained, rulemaking through enforcement "fails to provide a mechanism for the Commission to consider the views of market participants," which is an important input to creating "better crafted rules."[35] Creating policy through enforcement also produces less certain and less clear rules for market participants and can result in unfair treatment of such market participants, undermining public trust in the agency. At their most fundamental level, enforcement actions may provide long lists of examples—often a bit light on relevant details—about what a market participant should not do, but they rarely provide a pathway for understanding what to do.[36]

This has particularly been the case when the Commission has leaned heavily on enforcement to tell market participants about its view of the law on digital assets.[37]

The failure of this strategy is particularly egregious when the SEC has brought enforcement actions against market participants for failing to comply with rules for which there was no path to compliance. One example of this is the SEC's settled cases regarding staking.[38]

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[34] Securities and Exchange Commission, "Fiscal Year 2024 Congressional Budget Justification," at 22, https://www.sec.gov/files/fy-2024-congressional-budget-justification_final-3–10.pdf.

[35] Mark Uyeda, "Remarks at the 'SEC Speaks' Conference 2022," Speech, Securities and Exchange Commission, Sept. 9, 2022, https://www.sec.gov/newsroom/speeches-statements/uyeda-speech-sec-speaks-090922.

[36] *See* Hester Peirce, "Pourquoi Pas? Securities Regulation and the American Dream: Remarks before the Association of Private Enterprise Education," Speech, Securities and Exchange Commission, April 8, 2024, https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-association-private-enterprise-education-040824. Establishing policy through enforcement is also very resource intensive, requiring the Commission's limited enforcement resources to investigate and pursue (often iterative) enforcement actions to establish a rule that could have otherwise been made through formal notice-and-comment rulemaking or some other policy-making tool. The SEC's Enforcement resources have been strained in recent years. For example, last year, 67 percent of enforcement staff "disagreed or strongly disagreed that the Enforcement Division's human capital resources were sufficient to handle the investigative load." The Office of Inspector General, "The Inspector General's Statement on the SEC's Management and Performance Challenges," *Securities and Exchange Commission*, October 2023, at 15, https://www.sec.gov/files/statement-secs-management-and-performance-challenges-october-2023.pdf. Timeliness of enforcement investigations also remains an issue with the agency. Office of the Inspector General, "Enforcement Investigations: Measures of Timeliness Showed Some Improvement But Enforcement Can Better Communicate Capabilities for Expediting Investigations and Improve Internal Processes," *Securities and Exchange Commission*, February 15, 2023, https://www.sec.gov/files/enforcement-investigat-meas-timeliness-show-some-improvement-enforcement-can-better-comm.pdf.

[37] Hester Peirce, "Kraken Down: Statement on SEC v. Payward Ventures, Inc., et al.," Statement, Securities and Exchange Commission, February 9, 2023, https://www.sec.gov/newsroom/speeches-statements/peirce-statement-kraken-020923 ("[u]sing enforcement actions to tell people what the law is in an emerging industry is not an efficient or fair way of regulating").

[38] *See, e.g.,* Securities and Exchange Commission, "Kraken to Discontinue Unregistered Offer and Sale of Crypto Asset Staking-As-A-Service Program and Pay $30 Million to Settle SEC Charges," Press Release, February 9, 2023, https://www.sec.gov/newsroom/press-releases/2023-25.

While reasonable securities lawyers may disagree as to whether the specific facts and circumstances of a particular staking service fit the definition of an investment contract, the SEC's insistence that crypto platforms register those services without the agency first providing those platforms with a clear means of registering their staking services is problematic.[39] Instead of "initiat[ing] a public process to develop a workable registration process that provides valuable information to investors," the SEC instead chose to "just shut it down," in the words of Commissioner Peirce.[40] Similarly, the SEC's litigation against LBRY—which ultimately resulted in the company abandoning its appeal and winding down operations after exhausting its resources—charged LBRY with failing to register its tokens, despite the agency providing no path for LBRY to do so.[41]

These two examples, among others, make clear how an enforcement-first approach functions as an effective ban by the SEC on digital asset activity in the United States.

The SEC's Digital Assets Enforcement Is Worse Than Garden-Variety Regulation by Enforcement

The scale of the SEC's regulation by enforcement efforts on digital assets sets it apart from other times the agency has led with enforcement. The SEC touts its record in bringing "well over 100 crypto-related actions,"[42] as if the sheer volume of enforcement actions itself does not suggest that there is some mismatch between what the agency thinks regulation requires and the practical application of regulation to functioning businesses. These enforcement actions have covered a diverse set of topics—from token registration to exchange registration to staking to non-fungible tokens to fraud—but have all taken place with little effort by the agency to engage with market participants or provide any guidance (besides enforcement actions) to assist in compliance.

But even beyond the scale of the enforcement efforts, the SEC's conduct in bringing these actions has further increased regulatory uncertainty—and leads one to question whether the agency is acting in good faith. To name a few examples:

[39] *See* Jack Solowey and Jennifer Schulp, "SEC Releases the Kraken…Settlement," Cato At Liberty Blog, February 10, 2023, https://www.cato.org/blog/sec-releases-kraken-settlement.
[40] Hester Peirce, "Kraken Down: Statement on SEC v. Payward Ventures, Inc., et al.," Statement, Securities and Exchange Commission, February 9, 2023, https://www.sec.gov/newsroom/speeches-statements/peirce-statement-kraken-020923.
[41] Hester Peirce, "Overdue: Statement on Dissent of LBRY," Statement, Securities and Exchange Commission, October 27, 2023, https://www.sec.gov/newsroom/speeches-statements/peirce-statement-lbry-102723#_ftn9 ("[t]here is no path for a company liked LBRY to come in and register its functional token offering").
[42] Gurbir Grewal, "What's Past is Prologue: Enforcing the Federal Securities Laws in the Age of Crypto," Speech, Securities and Exchange Commission, July 2, 2024, https://www.sec.gov/newsroom/speeches-statements/grewal-remarks-age-crypto-070224.

- Rather than engaging with entities under investigation, the SEC has often tried to hide the ball, limiting the opportunities of potential respondents to constructively engage with the agency prior to an enforcement action being filed.[43]
- The SEC's legal theories are inconsistent and shifting, increasing regulatory risk and uncertainty for any market participant attempting to understand the agency's position as to its jurisdiction.[44]
- Settled actions often provide little detail as to the basis for the charges, particularly where the charges rest on a finding that involves unregistered securities, making it more difficult for market participants to understand the basis for the enforcement action.[45]
- The SEC has engaged in sanctioned misconduct, including material misrepresentations to a federal district court, in a digital assets-related case.[46]

Even if the agency were enforcing clear rules, this type of conduct would reflect poorly on a regulator. These issues, among others, are indicative of the ways in which the SEC's crypto crusade has veered beyond simply enforcing existing rules.

In addition, the aggressive SEC enforcement activity—and lack of agency engagement with market participants—has resulted in an unusually high number of lawsuits against the agency seeking proactive relief.[47] This not only places additional demands on the SEC's resources—and potentially erodes the agency's authority—it should serve as a clear signal to the Commission that if market participants are willing to go to such (expensive) lengths to

[43] *See, e.g.,* Paul Grewal, "We asked the SEC for reasonable crypto rules for Americans. We got legal threats instead," Coinbase, March 22, 2023, https://www.coinbase.com/blog/we-asked-the-sec-for-reasonable-crypto-rules-for-americans-we-got-legal.

[44] *See, e.g.,* James Hunt, Sarah Wynn, Tim Copeland, "The SEC claims that when it said 'crypto asset securities' it never meant tokens were actually securities," *The Block*, September 13, 2024, https://www.theblock.co/post/316406/sec-crypto-asset-securities?modal=newsletter.

[45] For example, the SEC's settlement in ShapeShift for failure to register as a dealer failed to identify which crypto assets traded on the platform were investment contracts and failed to provide any explanation for its conclusion. In re ShapeShift, AG, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order," Exchange Act Release No. 99676, File No. 3-21891, March 5, 2024, https://www.sec.gov/files/litigation/admin/2024/34-99676.pdf?utm_medium=email&utm_source=govdelivery.

[46] James V. Masella III ad Brad Gersehl, "Overreach and Misrepresentation: The SEC's Pursuit of Emergency Relief in 'DEBT Box,'" *New York Law Journal*, June 11, 2024, https://www.ballardspahr.com/insights/alerts-and-articles/2024/06/overreach-and-misrepresentation-the-sec-pursuit-of-emergency-relief-in-debt-box.

[47] *See, e.g.,* Jake Chervinsky and Amanda Tuminelli, "In Lejilex vs. SEC, Crypto Goes on Offense in the Courts," CoinDesk, February 23, 2024, https://www.coindesk.com/opinion/2024/02/23/in-lejilex-vs-sec-crypto-goes-on-offense-in-the-courts/; Sander Lutz, "A Song Man and a Law Professor Walk Into the SEC—And Try to Take Down Its NFT Agenda," *Decrypt*, July 31, 2024, https://decrypt.co/242653/song-man-law-professor-sec-nft-agenda; Nathan Hennigh, "I'm a 24-year-old small business owner. Here's why I'm suing the SEC," *FortuneCrypto*, April 16, 2024, https://fortune.com/crypto/2024/04/16/24-year-old-suing-sec-token-airdrop-beba/.

achieve clarity, the agency has a long way to go in terms of providing sound regulation on digital assets.[48]

A Better Approach Would Yield Clear and Predictable Rules

As demonstrated above, the SEC's "enforce first, make rules never," approach is the wrong one.

While there likely are regulatory gaps that can be filled only by legislation, the Commission has tools at its disposal to create clear and predictable rules to govern digital assets that fall within its jurisdiction. Congress has given the SEC broad exemptive authority that it has exercised to craft regulatory regimes tailored to products, asset classes, and entities for which the statutory scheme yielded unclear or anomalous results. The Commission has exercised those exemptive authorities for unregistered offerings, alternative trading systems, asset-backed securities, and exchange-traded funds, just to name a few.[49]

But exemptive relief through formal rulemaking is not the only avenue available to the SEC; it can also provide no-action relief, release interpretative guidance, or perhaps at the most basic level, begin to engage with the relevant market participants through concept releases, roundtables, or otherwise. To date, the Commission has not engaged in any of this activity.[50]

The SEC has the tools at its disposal; it just needs to use them.

Limited SEC Guidance and Rulemakings Related to Digital Assets Provide No Clarity

If the Commission were to defend its approach to keeping digital assets off its rulemaking agenda, it would likely point to a few scattered references to digital assets in its rulemaking and guidance over the past several years as satisfying identified needs. But in each instance, the SEC actions have not provided clarity or have exacerbated existing regulatory uncertainties.

One example of this is the SEC's issuance of SAB 121, which provided guidance to crypto custodians requiring them to list custodied assets on their own balance sheets. This guidance,

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[48] *Cf.* Hester Peirce, "Out, Damned Spot! Out, I Say!: Statement on Omnibus Approval Order for List and Trade Bitcoin-Based Commodity-Based Trust Shares and Trust Units," Statement, Securities and Exchange Commission, January 10, 2024, https://www.sec.gov/newsroom/speeches-statements/peirce-statement-spot-bitcoin-011023 (explaining that the disparate treatment of Bitcoin products will "harm our reputation far beyond crypto. Diminished trust from the public will inhibit our ability to regulate markets effectively" and that "our disproportionate attention on these filings has diverted limited staff resources away from other mission critical work").

[49] *See, e.g.,* Hester Peirce, "Pourquoi Pas? Securities Regulation and the American Dream: Remarks before the Association of Private Enterprise Education," Speech, Securities and Exchange Commission, April 8, 2024, https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-association-private-enterprise-education-040824.

[50] *See id.* (describing the SEC's approach to the rise of the internet); *see also* Hester Peirce and Mark Uyeda, "Statement Regarding Denial of Petition for Rulemaking," Statement, Securities and Exchange Commission, December 15, 2023, https://www.sec.gov/newsroom/speeches-statements/peirce-uyeda-petition-121523.

however, is both substantively and procedurally flawed. On substance, SAB 121 upended generally accepted practices by calling on asset custodians to treat clients' digital assets as liabilities on custodians' own balance sheets.[51] Reversing the standard practice of treating custody assets as off-balance sheet increases costs for any entity seeking to provide custody for digital assets. The result is that it has severely limited the number of qualified custodians for digital assets, an outcome that seems inconsistent with the SEC's investor protection mission.

But this guidance was also procedurally flawed; the Government Accountability Office found that SAB 121 was tantamount to a rule that required notice to Congress under the Congressional Review Act, which the SEC had failed to provide.[52]

Although bipartisan majorities of both houses of Congress passed resolutions disapproving of SAB 121, the SEC has not reconsidered the guidance, but rather has doubled down—in a way that simply proves how poor of a method such staff guidance is for making policy. After rumors swirled about some prospective crypto custodians reaching deals with the SEC that did not subject them to the terms of SAB 121,[53] the SEC's Chief Accountant gave a speech that stood behind SAB 121 and outlined some fact patterns that were outside of the scope of SAB 121.[54] But market participants are left with little certainty about how to apply the purported non-binding staff guidance—that is now subject to a non-binding gloss in a staff speech that was informed by one-off discussions with market participants. This is not a healthy regulatory process.

Another example is the SEC's updates to the dealer rule,[55] which explicitly contemplate that the new category of dealers outlined in that rule might include certain crypto market participants. Among the many issues with the SEC's approach on this rule, is the most basic

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[51] Securities and Exchange Commission, Staff Accounting Bulletin No. 121, April 11, 2022, https://www.sec.gov/regulation/staff-interpretations/accounting-bulletins/old/staff-accounting-bulletin-121; *see* Jack Solowey and Jennifer Schulp, "Decentralized Networks and Separated Powers: An Historic Moment for Crypto Legislation," Cato At Liberty Blog, May 23, 2024, https://www.cato.org/blog/decentralized-networks-separated-powers-historic-moment-crypto-legislation.

[52] U.S. Government Accountability Office, "Securities and Exchange Commission—Applicability of the Congressional Review Act to Staff Accounting Bulletin No. 121," B-334540, October 31, 2023, https://www.gao.gov/products/b-334540; *see also* Hester Peirce, "Response to Staff Accounting Bulletin No. 121," Statement, Securities and Exchange Commission, March 31, 2022, https://www.sec.gov/newsroom/speeches-statements/peirce-response-sab-121-033122.

[53] Amanda Iacone, "SEC Allows Some Exceptions to Crypto Accounting Compliance," *Bloomberg Law*, July 11, 2024, https://news.bloomberglaw.com/banking-law/sec-allows-some-exceptions-to-crypto-accounting-rule-compliance.

[54] Paul Munter, "Remarks before the 2024 AICPA & CIMA Conference on Banks & Savings Institution: Accounting for Crypto-Asset Safeguarding Obligations—A Facts-Based Analysis," Statement, Securities and Exchange Commission, Sept. 9, 2024, https://www.sec.gov/newsroom/speeches-statements/munter-speech-safeguarding-crypto-assets-09-09-24.

[55] Securities and Exchange Commission, "Further Definition of 'As a Part of Regular Business' in the Definition of Dealer and Government Securities Dealer in Connection with Certain Liquidity Providers," Rel. No. 34-99477, 89 Fed. Reg. 14938, February 29, 2024, https://www.govinfo.gov/content/pkg/FR-2024-02-29/pdf/2024-02837.pdf.

one: as Commissioners Peirce and Uyeda explained, "[p]eople right now are trying to figure out whether they have to register as dealers and, if so, which assets they can handle in the registered entity. To do so, they need to understand whether the assets for which they provide liquidity are securities."[56] As described above, the answer to that question remains unclear, and the agency's dealer rule provides no additional guidance.[57]

Thoughtful Engagement by The SEC Is Long-Past Due

Rather than welcoming legislative intervention, Gensler pushed back explicitly against attempts by Congress to legislate, asserting that legislation was wholly unnecessary.[58] As laid out above, that cannot be further from the truth. Gensler's SEC generally stands alone in believing that there is no room for improvement in the United States's approach to digital assets. The Biden Administration has signaled that legislation is welcome.[59] Other executive agencies, including the CFTC and Treasury Department, have indicated that legislation is needed.[60] And the United States would hardly be alone in needing to update its laws to address technological change, as it would follow a host of other countries in doing so.[61]

Indeed, Gensler himself has even suggested at times that legislation may be needed or regulations may need to be updated, claiming to have "asked staff to consider" a number of questions about how to apply existing SEC rules to crypto exchanges—acknowledging that the

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[56] Hester Peirce and Mark Uyeda, "On Today's Episode of As the Crypto World Turns: Statement on ShapeShift AG," Statement, Securities and Exchange Commission, March 5, 2024, https://www.sec.gov/newsroom/speeches-statements/peirce-uyeda-statement-crypto-world-turns-03-06-24#_ftnref4; *see also* Securities and Exchange Commission, "Further Definition of 'As a Part of Regular Business' in the Definition of Dealer and Government Securities Dealer in Connection with Certain Liquidity Providers," Rel. No. 34-99477, 89 Fed. Reg. 14938, February 29, 2024, at n.134 https://www.govinfo.gov/content/pkg/FR-2024-02-29/pdf/2024-02837.pdf ("The application of the final rules turns on whether a particular crypto asset is a security…"); *see also, e.g.,* Hester Peirce, "Dealer, No Dealer Statement on Further Definition of 'As a Part of a Regular Business' in the Definition of Dealer and Government Securities Dealer in Connection with Certain Liquidity Providers," Statement, Securities and Exchange Commission, February 6, 2024, https://www.sec.gov/newsroom/speeches-statements/peirce-statement-dealer-trader-020624#_ftn21.

[57] The SEC's rule proposal on the definition of an exchange is no more thoughtful, suggesting that the proposed regulations may impact DeFi by "reducing the extent to which a system is 'decentralized.'" *See* Jack Solowey and Jennifer Schulp, Public Comment to "Amendments to Exchange Act Rule 3b-16 Regarding the Definition of 'Exchange,'" File No. S7-02-22, June 13, 2023, https://www.cato.org/sites/cato.org/files/2023-06/solowey-schulp-public-comments-6-13-2023.pdf.

[58] Gary Gensler, "Statement on the Financial Innovation and Technology for the 21st Century Act," Statement, Securities and Exchange Commission, May 22, 2024, https://www.sec.gov/newsroom/speeches-statements/gensler-21st-century-act-05222024.

[59] Executive Office of the President, "Statement of Administration Policy," May 22, 2024, https://www.whitehouse.gov/wp-content/uploads/2024/05/SAP-HR4763.pdf.

[60] *See supra* n.5.

[61] *See* Susannah Hammond and Todd Ehret, "Cryptocurrency regulations by country," *Thomson Reuters*, April 4, 2022, https://www.thomsonreuters.com/en-us/posts/wp-content/uploads/sites/20/2022/04/Cryptos-Report-Compendium-2022.pdf.

application of existing rules is not crystal clear.[62] But years after these acknowledgments, enforcement actions continue to be filed based on existing rules, and there is no visible progress towards solutions—no proposed rules or guidance, no formal process for gathering market participant input, and no docketing of an intention to address these issues on the agency's agenda.[63]

The SEC's expansive interpretation of its authority is at odds with the nearly century-old securities laws from which the SEC is claiming to draw its power. It is difficult to find a mandate in those laws to bar the door to future innovations in capital market tools and, more generally, to technical infrastructure for decentralized and cryptographically secure computing. For instance, the Securities Exchange Act of 1934 begins with the statement that it's in the "national public interest" to "provide for regulation and control of" securities transactions.[64] The lesser power to regulate whichever digital asset transactions are, in fact, securities transactions, does not include the greater power to prohibit them writ large. At the very least, such an expansive interpretation of the SEC's powers should not come without a public rulemaking process, which requires consideration of whether the rulemaking "will promote efficiency, competition, and capital formation."[65] The SEC's current digital assets strategy is inconsistent with any of these goals.

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Thank you for the opportunity to provide this information about the myriad deficiencies in the SEC's approach to digital assets. I welcome any questions that you may have.

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[62] *See, e.g.,* Lydia Beyoud and Yueqi Yang, "SEC Weighs Waiving Some Rules to Regulate Crypto, Gensler Says," *Bloomberg*, July 14, 2022, https://www.bloomberg.com/news/articles/2022-07-14/sec-weighs-waiving-some-rules-to-regulate-crypto-gensler-says; Gary Gensler, "Kennedy and Crypto," Speech, Securities and Exchange Commission, September 8, 2022, https://www.sec.gov/newsroom/speeches-statements/gensler-sec-speaks-090822#_ftnref11; Gary Gensler, "Prepared Remarks of Gary Gensler On Crypto Markets Penn Law Capital Markets Association Annual Conference," Speech, Securities and Exchange Commission, April 4, 2022, https://www.sec.gov/newsroom/speeches-statements/gensler-remarks-crypto-markets-040422.

[63] Gensler has pointed to the Commission's process for crafting rules for asset-backed securities disclosures as precedent for a process that would not see formal rules proposed for more than a decade after the industry's rise. *See* Jessica Corso, "SEC's Gensler Suggests Crypto Rules Could Be Years Away," *Law360*, September 15, 2022, https://www.law360.com/securities/articles/1530470/sec-s-gensler-suggests-crypto-rules-could-be-years-away. Even if Gensler were belatedly starting the clock when he was appointed, the SEC has taken none of the steps—including industry engagement and exemptive relief or no-action relief to individual issuers—that it was taking with respect to asset-backed securities issuers in order to ultimately craft a formal rule.

[64] Securities Exchange Act of 1934, P.L. 73-291, 48 STAT 881, Sec. 2 (June 6, 1934).

[65] 15 U.S.C. §78c(f).