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United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

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RANKING MEMBER

June 25, 2021

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: June 30, Subcommittee on Oversight & Investigations Hearing entitled, "America on "FIRE": Will the Crypto Frenzy Lead to Financial Independence and Early Retirement or Financial Ruin?"

The Subcommittee on Oversight & Investigations will hold a hearing entitled, "America on "FIRE": Will the Crypto Frenzy Lead to Financial Independence and Early Retirement or Financial Ruin?" on Wednesday, June 30 at 10 am in room 2128 of the Rayburn House Office Building. There will be one panel with the following witnesses:

- **Ms. Alexis Goldstein**, Director of Financial Policy, Open Markets Institute
- **Ms. Sarah Hammer**, Managing Director, Stevens Center for Innovation in Finance at the Wharton School of the University of Pennsylvania
- **Ms. Christine Parker**, Partner, Reed Smith LLP
- **Ms. Eva Su**, Analyst in Financial Economics, Congressional Research Service
- **Mr. Peter Van Valkenburgh**, Director of Research, Coin Center

Background

In recent years, innovation in financial technology and markets has fostered a new digital asset class, and introduced new forms of trading. *Digital assets*, including cryptocurrencies, stablecoins (a subset of cryptocurrencies pegged to a stable reserve asset(s)), and central bank digital currencies are all digital representations of value.[1] Since 2008, these new digital assets that use cryptography and distributed ledger technology (DLT) have gained prominence and value in the global economy.[2] Cryptocurrencies usually require no centralized intermediary to buy, sell, or exchange because the ledgers are public, cryptographically verified, and stored on a distributed network of computers.[3] Some digital assets are subject to regulation as securities depending on their characteristics or how they are offered and sold.[4] Other digital assets have been deemed commodities under the Commodity Exchange Act.[5] Exchanges that trade digital assets have generally not been regulated as securities exchanges, leading to concerns that the industry does not have adequate supervision or oversight.[6]

[1] Eva Szalay and Siddharth Venkataramakrishnan, *What are cryptocurrencies and stablecoins and how do they work?*, Financial Times (May 28, 2021).
[2] *See* Congressional Research Service (CRS), *Financial Innovation: "Cryptocurrencies"* (Feb. 7, 2018) (IF10824).
[3] CRS, *Cryptocurrency: The Economics of Money and Selected Policy Issues* (Apr. 9, 2020) (R45427).
[4] *See e.g.* SEC, *SEC Charges Ripple and Two Executives with Conducting $1.3 Billion Unregistered Securities Offering* (Dec. 22, 2020) (2020-338).
[5] Commodity Exchange Act, Pub. L. No. 93-463 title I, §101(a), title II, §§201, 202 (1974) (codified at 7 U.S.C. §2 (2020)).
[6] Avi Salzman, *Cryptocurrency Exchanges Need Direct Regulation, SEC Chair Says*, Barron's (May 6, 2021).

Cryptocurrencies have emerged as a growing asset class for investors, with a total market value of more than $2 trillion in May 2021, compared with around $260 billion in 2020 and around $20 billion in early 2017.[7] The size of the cryptocurrency market is significant but still relatively small compared to traditional asset markets. For example, the U.S. fixed income market is worth about $50 trillion as of May 2021.[8] The current size of the cryptocurrency market is comparable to the value of gold held by private investors, which is estimated to be around $3 trillion.[9]

As more institutional investors (including asset managers, pension funds, endowments, and insurance companies) enter digital asset markets, large financial institutions that offer related services (such as digital asset custody and safekeeping) have expanded their infrastructure to accommodate activities in such assets. For example, State Street and Bank of New York Mellon have set up digital divisions to handle demand, which reportedly tripled within months.[10] Alternative investment funds are also investing heavily in digital assets. A May 2021 survey conducted by Price Waterhouse Coopers found that hedge fund investment in digital assets doubled over the past year, with one in seven hedge funds holding at least 10-20% of their total assets under management in cryptocurrencies.[11] According to another survey of hedge fund executives in North America, Europe, and Asia, 98% of survey participants plan to invest in digital assets within the next five years.[12]

Individual and Systemic Risks Related to Cryptocurrency Usage

Some cryptocurrencies, such as Bitcoin, are widely accessible by all types of institutional and individual retail investors, including retail investors who may have a disadvantage in understanding all the risks involved. Like other speculative investments, cryptocurrencies can result in significant investor losses due to fraud, market volatility, and rapid swings in value.[13] Cryptocurrencies are highly volatile in their valuations compared to traditional assets such as stocks, bonds, and gold.[14] The potential for significant losses could heighten investor protection concerns, especially if individual investors of limited financial means rely on cryptocurrencies for potential retirement income. Cryptocurrency business operations could also pose risks to investors if businesses fail due to illicit activities or the inability to deliver the promised products or services. In addition to risks to investors, some experts have raised concerns that leveraged cryptocurrency positions and cryptocurrency derivatives could present systemic risks to the global economy.[15]

Federal agencies, including the Securities and Exchange Commission (SEC),[16] Federal Trade Commission (FTC),[17] Consumer Financial Protection Bureau (CFPB),[18] and Commodity Futures Trading Commission (CFTC),[19] have issued bulletins or alerts warning the public of possible risks of the

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[7] Coinmarketcap, Global Cryptocurrency Charts (accessed on Jun. 17, 2021).
[8] SIFMA, Fixed Income Outstanding (accessed on Jun. 17, 2021).
[9] Christopher Brigham et al., *An Early Spring for Cryptoassets*, Alliance Bernstein (Apr. 14, 2021).
[10] Gary Silverman, *State Street to Set up Digital Unit to Capitalize on Crypto Craze*, Financial Times (Jun. 10, 2021).
[11] PricewaterhouseCoopers, *3rd Annual Global Crypto Hedge Fund Report 2021* (May 2021), 40.
[12] Andrew Asmakov, *Hedge Funds Expected to Increase Crypto Holdings Over Next 5 Years*, Decrypt (Jun. 15, 2021).
[13] FTC, *FTC Data Shows Huge Spike in Cryptocurrency Investment Scams* (May 17, 2021).
[14] Seeking Alpha, *Bitcoin Vs. Gold: Which Is The Better Investment?* (Apr. 28, 2021).
[15] *See, e.g., Bitcoin Crash: Jim Cramer Sees 'New Systemic Risk', Wants Regulation* , The Street (May 20, 2021).
[16] *See* SEC, *Investor Alert: Watch Out for Fraudulent Digital Asset and "Crypto" Trading Websites* (Apr. 24, 2019).
[17] *See* FTC, What To Know About Cryptocurrency and Scams (accessed Apr. 2021).
[18] *See* CFPB, *CFPB Warns Consumers About Bitcoin* (Aug. 11, 2014).
[19] *See* CFTC, *Watch Out for Fraudulent Digital Asset and "Crypto" Trading Websites* (Apr. 24, 2019).

cryptocurrency industry. Nevertheless, in recent years, thousands of investors have lost, in aggregate, hundreds of millions of dollars to cryptocurrency investment scams.[20]

Recent data released by the FTC indicates the number of scams and the size of losses to investors is growing.[21] From October 2020 to March 2021, 7,000 cryptocurrency scams worth $80 million were reported to the FTC, representing more than 12 times as many scams from the same period a year earlier over 1,000% greater amount lost.[22] At this time, the SEC has not yet approved any cryptocurrency-based exchange-traded fund (ETF) because of market manipulation and fraud concerns, with the SEC repeatedly stating in its rejections that cryptocurrency ETF proposals did not meet standards governing national securities exchanges.[23] However, some publicly traded companies (e.g., MicroStrategy, Inc.) have increasingly incorporated cryptocurrencies, usually Bitcoin, in their capital allocation strategies, which some have argued creates a "Bitcoin proxy" which serves as an "ETF tracking Bitcoin."[24]

The emergence of peer-to-peer or decentralized cryptocurrency exchanges (DEXs), which are not contemplated by current government regulation, has led to another avenue for cryptocurrency scams.[25] As many DEXs generally allow any digital asset projects to be swapped on their platform, bad actors can create a new cryptocurrency, solicit investors to exchange more established and valuable cryptocurrency for their new project, and then abandon the new project and leave with investors' more established cryptocurrency.[26] This increasingly common scam is known as a rug pull and has made headlines recently as celebrity investors were potentially victimized.[27]

Investor Protection and Regulation of Cryptocurrency Exchanges

Typically, cryptocurrency is obtained on a trading platform, often called an exchange, and is held in a digital wallet.[28] There are two types of exchanges: (1) hosted, centralized platforms where a third-party sets prices and clears transactions and (2) peer-to-peer, decentralized platforms, (as mentioned previously) which eliminate the third party and allow buyers and sellers to settle prices directly. In either case, the cryptographic nature of these exchanges provides some measure of anonymity to both the buyer and seller. Some cryptocurrency exchanges are state-licensed enterprises that allow people to buy and sell cryptocurrencies.[29] Most often, these state-licensed enterprises opt to be registered as money transmitters, a kind of money service business with far fewer restrictions and regulations than a stock exchange.[30] Money transmitters are subject to registration and some reporting requirements from the Financial Crimes

[20] FTC, *Cryptocurrency buzz drives record investment scam losses* (May 17, 2021).
[21] FTC, *FTC Data Shows Huge Spike in Cryptocurrency Investment Scams* (May 17, 2021).
[22] FTC, *Cryptocurrency Buzz Drives Record Investment Scam Losses* (May 2021).
[23] *See, e.g.,* SEC, *Order Disapproving a Proposed Rule Change for NYSE Arca Rule 8.201-E*, at 3 (Oct. 9, 2019).
[24] Felice Maranz, *Microstrategy Slips with Bitcoin-Linked Rally Seen Going too far,* Bloomberg (Dec. 1, 2020).
[25] *See generally*, Gertrude Chavez-dreyfuss, *Crypto crime down in 2021 through April, but 'DeFi' fraud at record - CipherTrace*, Reuters (May 13, 2021).
[26] CoinMarketCap, *What Is a Rug Pull?* (Accessed Jun. 21, 2021).
[27] Taylor Locke, *'People have been participating without understanding the risks': Here's what to know about cryptocurrency-based DeFi*, CNBC (Jun. 18, 2021).
[28] *See, e.g.,* Ethos, What are Cryptocurrency Exchanges? (Accessed Jun. 22, 2021); *see also* NerdWallet, *What Is Cryptocurrency? Here's What You Should Know* (Jun. 22, 2021).
[29] For more on money transmitters and virtual currency, *see* CRS, *Telegraphs, Steamships, and Virtual Currency: An Analysis of Money Transmitter Regulation* (Aug. 20, 2020) (R46486).
[30] *Id*.

Enforcement Network (FinCEN), a bureau of the Treasury Department responsible for implementing the Bank Secrecy Act.[31]

In 2013, FinCEN issued interpretative guidance for cryptocurrency exchanges, stating that an "administrator or exchanger that (1) accepts and transmits a convertible virtual currency or (2) buys or sells convertible virtual currency for any reason is a money transmitter under FinCEN's regulation."[32] Yet, because money transmitter regulations were not designed with large-scale interstate domestic and international trading activities in mind, some argue that the regulations are insufficient for regulating the transfer of digital assets.[33] Notably, in 2018, the SEC issued a statement indicating that online platforms used to buy and sell digital assets that qualify as securities could be unlawful.[34] In the same year, the SEC took its first enforcement action against an unregistered crypto-asset exchange that "had both the user interface and underlying functionality of an online national securities exchange and was required to register with the SEC or qualify for an exemption," but failed to do so.[35]

Cryptocurrency exchanges generally allow trading of digital assets that are not considered securities, and therefore not regulated by the SEC. Some cryptocurrency exchanges have reportedly been exaggerating their volumes to attract more participation.[36] A 2019 study by Bitwise Asset Management suggested that 95% of Bitcoin's trading volume displayed on digital asset price and volume aggregator CoinMarketCap.com is either fake or non-economic in nature.[37] A 2020 study published in the Journal of Finance argued that a single market manipulator likely fueled half of Bitcoin's 2017 price surge that pushed its price close to $20,000.[38] For this alleged manipulation, Bitfinex and Tether faced a class action complaint seeking a total of $1.4 trillion in damages[39] and are under investigation by federal and state regulators.[40] Cryptocurrency exchanges also frequently face network congestions or trading halts, calling into question their readiness to serve a growing marketplace.[41] For example, during a rapid cryptocurrency selloff and recovery in May 2021, multiple major platforms reported technical issues, further intensifying market stress during a volatile time of increased trading.[42]

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[31] FinCEN, FinCEN's Mandate From Congress (accessed Jun. 21, 2021).

[32] FinCEN, *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies* (Mar. 18, 2013) (FIN-2013-G001).

[33] Coin Center, *The Need for a Federal Alternative to State Money Transmission Licensing*, at 14 (Jan. 2018).

[34] The SEC states that "if a platform offers trading of digital assets that are securities and operates as an 'exchange,' as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration." For more details, *see* SEC, *Statement on Potentially Unlawful Online Platforms for Trading Digital Assets* (Mar. 7, 2018).

[35] SEC, *SEC Charges EtherDelta Founder With Operating an Unregistered Exchange* (Nov. 8, 2018) (2018-258).

[36] Olga Kharif, *On Crypto Exchanges, The Trades Don't Always Add Up*, Bloomberg Businessweek (July 25, 2019).

[37] Memorandum from Lauren Yates, Office of Market Supervision, Division of Trading and Markets, Meeting with Bitwise Asset Management NYSE Arca, Inc., and Vedder Price P.C., SEC (Mar. 20, 2019).

[38] John Griffin and Amin Shams, *Is Bitcoin Really Un-Tethered?*, SSRN, at 5-6 (Nov. 28, 2019).

[39] Philip Rosenstein, *$1.4T Bitcoin Manipulation Case Preposterous, Tether Says* Law360 (Nov. 15, 2019); *see also* New York State Attorney General, *Attorney General James Announces Court Order Against 'Crypto' Currency Company Under Investigation For Fraud* (Apr. 25, 2019).

[40] The Department of Justice (DOJ), CFTC, and New York Attorney General's office are reportedly investigating whether Tether was used to prop up Bitcoin's price. Shiraz Jagati, *How Severe Is Roche Freedman's Lawsuit Against Tether and Bitfinex?*, Cointelegraph (Oct. 11, 2019); *see also* Matt Robinson and Tom Schoenberg, *Bitcoin-Rigging Criminal Probe Focused on Tie to Tether,* Bloomberg (Nov. 20, 2018).

[41] Daniel Palmer, *Top Crypto Exchanges See Technical Issues Amid Market Crash* (May 19, 2021).

[42] *Id.*; *and* Robert Hart, *Leading Crypto Exchanges Down As Bitcoin and Ether Plummet*, Forbes (May 19, 2021).

Enforcement Activity Against Cryptocurrency Market Participants

Federal regulators increased their enforcement activities in the cryptocurrency market. The CFTC has announced 22 enforcement actions related to cryptocurrency and digital asset schemes and frauds since June 2019.[43] The total amount of money recovered by the CFTC in the 17 cases for which the amount was disclosed was approximately $370 million.[44] During the same period, the SEC brought digital asset or initial coin offering-related enforcement actions in 44 cases.[45] The total amount of money taken in the 35 cases for which the amount disclosed was over $5.6 billion.[46]

SEC Chair Gary Gensler has asked Congress for clear authority over cryptocurrency exchanges, stating that he looks forward to "working with fellow regulators and with Congress to fill in the gaps of investor protection in these crypto markets."[47] At a congressional hearing before the House Financial Services Committee in May 2021, Gensler voiced concerns regarding the lack of a regulatory framework for cryptocurrency exchanges.[48] In December 2020, the SEC filed a complaint against Ripple Labs for engaging in an illegal, unregistered securities offering, arguing that for seven years, Ripple sold or offered over 14 billion units of their own cryptocurrency in return for $1.38 billion from its users without registering the offering with the SEC.[49] State regulators have also increased their enforcement activities. In 2021, Tether, the largest stablecoin provider with a top valuation of $60 billion, and its affiliated trading platform, Bitfinex paid $18.5 million to settle New York State charges that the stablecoin overstated reserves and covered up losses, and failed to provide quarterly disclosures of reserve assets.[50]

Regulatory Activity and Rulemaking on Digital Assets

Federal regulators have increased their scrutiny of the cryptocurrency market. In May 2021, the Federal Deposit Insurance Corporation (FDIC) issued a request for information (RFI) on digital assets.[51] The RFI posed a number of questions on the possible use cases for cryptocurrencies at U.S. banking institutions, particularly with respect to settlements, payments, custody, and investments in digital assets. Additionally, in May 2021, Acting Comptroller of the Currency Michael Hsu testified before the House Financial Services Committee that the OCC would review all of its activities on digital assets and cryptocurrencies, including all interpretative letters and guidance, and pending license decisions.[52]

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[43] CFTC, Press Releases (accessed June 21, 2021) (enforcement actions on file with House Financial Services Committee).
[44] *Id.*
[45] SEC, *Cyber Enforcement Actions* (accessed Jun. 17, 2021) (enforcement actions on file with House Financial Services Committee).
[46] *Id.*
[47] SEC, *Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee* (May 26, 2021).
[48] SEC Chair Gary Gensler stated, "right now the exchanges trading these crypto assets do not have a regulatory framework … right now there is not a market regulator around these crypto exchanges, and thus there's really not protection against fraud or manipulation." Bloomberg, *House Financial Services Committee Hearing Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part III* (May 6, 2021).
[49] Complaint, 1 (Dec. 22, 2020), *SEC v. Ripple Labs et al.* S.D.N.Y (No. 1:20-cv-10832).
[50] New York State Attorney General, *Attorney General James Ends Virtual Currency Trading Platform Bitfinex's Illegal Activities in New York* (Feb. 23, 2021); *see also* Olga Kharif, *Bitfinex Settles New York Probe Into Tether, Hiding Losses*, Bloomberg (Feb. 23, 2021).
[51] FDIC, *Request for Information and Comment on Digital Assets* (May 17, 2021).
[52] OCC, *Statement Of Michael J. Hsu Acting Comptroller Of The Currency Before The Committee On Financial Services United States House Of Representatives*, at 13 (May 19, 2021).

Appendix A: Timeline of 2021 Events

- **January 1, 2021:** 1 BTC = ~$30,000 USD
- **January 2021:** BlackRock adds Bitcoin futures as a potential investment for two of its funds.[53]
- **January 2021:** Elon Musk adds #bitcoin to his Twitter bio, preceding a 20% rise in price of Bitcoin
- **February 2021:** Tesla purchases $1.5 billion in Bitcoin for "more flexibility to further diversify and maximize returns on our cash."[54]
- **February 2021**: Bank of New York Mellon announces plans for digital currencies to pass through the same financial network it uses for traditional holdings like U.S. Treasury bonds and equities.[55]
- **March 2021:** Morgan Stanley launches three investment fund products with Bitcoin exposure for its high net worth clients.[56]
- **March 2021:** Morgan Stanley, New York Life, MassMutual, Soros Fund Management, and others announce participation in a $200 million investment round in NYDIG, a firm leading Bitcoin related strategic initiatives that span investment management, insurance, and banking.[57]
- **April 14, 2021**: Coinbase lists on NASDAQ, reaches $100 billion market cap first day of trading.[58]
- **April 2021:** Bitcoin hits peak of 1 BTC = ~$65,000 USD
- **April 26, 2021:** Tesla reverses course and sells its Bitcoin holdings, citing environmental concerns, making proceeds of $272 million.[59]
- **May 2021:** Bitcoin plummets to 1 BTC = ~$30,000 USD
- **May 6, 2021**: SEC Chairman Gary Gensler calls for greater investor protections in the cryptocurrency marketplace, including crypto exchanges. Chair Gensler warns FSC members that "Right now these [cryptocurrency] exchanges do not have a regulatory framework at the SEC or at our sister agency, the Commodity Futures Trading Commission. Right now, there's not a market regulator around these crypto exchanges and thus there's really no protection around fraud or manipulation."[60]
- **May 11, 2021**: SEC issues staff statement calling Bitcoin "a highly speculative investment," warning investors in mutual funds that trade Bitcoin futures about their potential exposure to hidden risks.[61]
- **June 10, 2021**: SEC and CFTC issues Investor Bulletin urging investors to carefully consider the "volatility of Bitcoin and the Bitcoin futures market, as well as the lack of regulation and potential for fraud or manipulation in the underlying Bitcoin market."[62]

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[53] SEC, *BlackRock Global Allocation Fund, Inc. Form NPORT-P Monthly Portfolio Investments Report* (accessed Jun. 21, 2021).
[54] SEC, *Tesla, Inc. Form 10-K for the fiscal year ending December 31, 2020* (Feb. 08, 2021).
[55] Thomas, Franck, *BNY Mellon to offer bitcoin services, a validation of crypto from a key bank in the financial system,* CNBC (Feb. 11, 2021).
[56] Hugh Son, *Morgan Stanley becomes the first big U.S. bank to offer its wealthy clients access to bitcoin funds*, CNBC (Mar. 17, 2021).
[57] PR Newswire, *NYDIG Raises $200 Million from Strategic Partners*, (Mar. 08, 2021).
[58] Ari Levy, *Coinbase closes at $328.28 per share in Nasdaq debut, valuing crypto exchange at $85.8 billion*, CNBC (Apr. 14, 2021).
[59] Nate DiCamillo, *Elon Musk's Tesla Sold Bitcoin in Q1 for Proceeds of $272M,* CoinDesk (Apr. 26, 2021).
[60] CQ, *House Financial Services Committee Holds Hearing on Gamestop Short Selling and Market Volatility, Part Three* (May 06, 2021).
[61] SEC, *Staff Statement on Funds Registered Under the Investment Company Act Investing in the Bitcoin Futures Market* (May 11, 2021).
[62] SEC, *Funds Trading in Bitcoin Futures – Investor Bulletin* (Jun. 10, 2021).