Written Statement of Timothy G. Massad[*]

before the

Subcommittee on Digital Assets, Financial Technology and Inclusion

U.S. House of Representatives Financial Services Committee

and the

Subcommittee on Commodity Markets, Digital Assets and Rural Development

U.S. House of Representatives Committee on Agriculture

"The Future of Digital Assets: Measuring the Regulatory Gaps in the Digital Asset Market"

May 10, 2023

Chairman McHenry and Ranking Member Waters, Chairman Thompson and Ranking Member Scott, Subcommittee Chairman Hill and Ranking Member Lynch, Subcommittee Chairman Johnson and Ranking Member Caraveo, members of the committees and staff, I am honored to be testifying before you today.

Since 2014, when I became chairman of the Commodity Futures Trading Commission, I have spoken publicly and repeatedly about the need to strengthen digital asset regulation. Four years ago, I wrote a paper published by the Brookings Institute that began with the following sentence: "There is a gap in the regulation of crypto assets that Congress needs to fix."[1]

The gap I talked about then was the absence of a federal regulator for the spot market in crypto tokens that are not securities, such as bitcoin. It still exists, and it is made more complicated by the ongoing debate we have had about how to classify digital assets: are they securities or commodities, or something else?

If there is one thing I ask you to remember from my testimony today, it is that there are essentially two paths we might follow to fix that gap, and I believe one is

---

[*] Research Fellow and Director, Digital Assets Policy Project, Harvard Kennedy School Mossavar-Rahmani Center for Business and Government; Chairman of the Commodity Futures Trading Commission (2014-2017); Assistant Secretary for Financial Stability of the U.S. Treasury (2010-2014).

[1]Timothy Massad, *It's Time to Strengthen the Regulation of Crypto-Assets*, The Brookings Institute, p. 2 (Mar. 2019), https://www.brookings.edu/research/its-time-to-strengthen-the-regulation-of-crypto-assets/ (hereinafter "Massad 2019").

vastly preferable. I will explain those in a moment, after I provide a bit more background.

It was during my tenure as chairman of the CFTC that the agency declared bitcoin and other virtual currencies to be commodities. This gave the agency authority to regulate derivatives based on such commodities, but its authority over the spot market for any commodity is quite limited.[2] By contrast, the Securities and Exchange Commission has jurisdiction over the spot market for any digital asset that is a security.

Chair Gary Gensler of the SEC says most tokens are securities and the problem is a lack of compliance with existing legal requirements.[3] Industry participants complain about a lack of clarity in the rules for resolving this issue and have called for regulators to create a new set of rules specifically for crypto.

Meanwhile trading and lending platforms claim they are only dealing in tokens that are not securities—thereby avoiding direct federal oversight. As a result, investor protection on crypto trading and lending platforms is woefully inadequate. These platforms do not observe standards common in our financial markets that ensure protection of customer assets, prohibition of conflicts of interest, prevention of fraud and manipulation, and adequate transparency, among other things. That was made painfully obvious last year by the failures of trading platform FTX, crypto lender Celsius, the Terra/Luna stablecoin and others, resulting in hundreds of thousands of investors suffering losses.

There are other gaps in crypto-asset regulation. One is the lack of a federal regulatory framework for stablecoins. The report of the Financial Stability Oversight Council issued last fall identified additional gaps consisting of the opportunities for regulatory arbitrage and "whether vertically integrated market

---

[2] The CFTC has authority to bring enforcement actions for fraud and manipulation in the spot market and to regulate certain retail leveraged transactions, but it does not have the authority to prescribe standards under which trading platforms or other intermediaries must operate. For a discussion of the CFTC's authority, see ibid, pp. 32-33 as well as Timothy Massad and Howell Jackson, *How to improve regulation of crypto today—without Congressional action—and make the industry pay for it,* The Brookings Institute, pp. 8-9 (October, 2022), https://www.brookings.edu/research/how-to-improve-regulation-of-crypto-today-without-congressional-action-and-make-the-industry-pay-for-it/ (hereinafter "Massad-Jackson 2022").

[3] See, for example, Chair Gensler's testimony before the U.S. House of Representatives Financial Services Committee on April 18, 2023, at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408690

structures can or should be accommodated under existing laws and regulations.[4] While I agree with these findings and share the concerns in the FSOC report, and will make some brief comments about the absence of a federal regulatory framework for stablecoins at the end of my testimony, I will focus on the gap in regulation of the spot market.

How do we fix this gap?

Many suggest that we rewrite securities law so as to define a category of digital assets that do not constitute securities, and give the CFTC jurisdiction over spot market activity involving those assets.[5] While there are different formulations of this approach, the risk in all these proposals is that creating new regulatory categories of assets at this time might generate more confusion than clarity, and lead to disputes over their own meaning that could take years to resolve. Some of these definitions could undermine decades of securities law and jurisprudence. Moreover, unless there is some basic disclosure about a digital asset, it is difficult to know how to classify it.

Today, I want to suggest that there is another path forward. It would increase investor protection quickly without rewriting decades of law in one bill. It would not diminish the existing authority of either the SEC or the CFTC, and it would allow responsible digital innovation to go forward.

The idea is to create a baseline of investor protection by recognizing that many of the standards we need are the same regardless of whether a token falls in the securities or commodities bucket. Congress would pass a law mandating that any trading or lending platform that trades or uses bitcoin or ethereum must comply with a set of core principles for all tokens traded or used on that platform, unless the platform has already registered with the SEC or CFTC as a securities or derivatives intermediary. The principles would include protection of customer assets, prevention of fraud and manipulation, prohibition of conflicts of interest, adequate disclosure to investors, regular reporting, pre and post trade transparency, risk management and governance standards, among others.

---

[4] Financial Stability Oversight Council, *Report on Digital Asset Financial Stability Risks and Regulation*, p. 5 (October 2022), https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf (hereinafter the "FSOC Report").

[5] In my 2019 paper, I proposed that either the Securities and Exchange Commission or the Commodity Futures Trading Commission be given authority to regulate the spot market for crypto assets that are not securities. Either agency is capable of doing so ***provided*** it is given sufficient resources. I know first hand the challenges faced by the CFTC because of its limited budget, and the task of regulating the crypto asset (non-security) spot market would require significant resources.

Congress would direct the SEC and the CFTC to develop joint rules implementing these principles. Rules could also be developed by creating a new self-regulatory organization (SRO) jointly supervised by the SEC and the CFTC. SROs have been critical to the regulation of our securities and derivatives markets for decades, and there is precedent for SROs registered with both the SEC and the CFTC.[6] The SRO could also be charged with enforcing the rules.

I believe this approach has several advantages. It is simple. It focuses on the core of the problem. It is practical and feasible. It can be implemented quickly and efficiently. It does not rewrite existing law in ways that may create more confusion than clarity. And it is incremental. Let me explain each of these aspects and then provide some greater detail and background.

First, simplicity: the approach uses a definition of jurisdiction that does not require rewriting securities laws to create a new digital asset or digital commodity category. While we may wish to do that down the road, I believe it is premature. We do not need to do that because the requirements would apply to *all tokens* on any trading or lending platform that trades bitcoin or Ethereum, the two largest tokens in the market. That would capture all significant platforms. The investor protection principles are already well-known in financial market regulation, and therefore should command wide support.

Second, it focuses on the core of the problem. Over 90% of spot market trading is estimated to occur through centralized intermediaries.[7] This approach would dramatically improve investor protection on those platforms. Simply eliminating wash trading—where someone trades with themselves or an affiliate to inflate the price or trading volume of an asset, and which has been estimated to represent 50% or more of the trading on crypto platforms[8]--would be a huge improvement. I

---

[6] See Massad-Jackson 2022, *supra* note 2.

[7] See Coingecko, 2022 Annual Crypto Industry Report which estimated that as of the end of 2022, centralized exchanges had 93% of market share.

[8] *See* Lin William Cong et al., *Crypto Wash Trading* (July 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3530220 (estimating that wash trades account for 70 percent of volume on unregulated cryptocurrency exchanges); *see also* Jialan Chen et al., *Do Cryptocurrency Exchanges Fake Trading Volume?* 586 Physica A 126405 (Jan. 15, 2022); Matthew Hougan, et al., *Economic and Non-Economic Trading In Bitcoin: Exploring the Real Spot Market For The World's First Digital Commodity*, Bitwise Asset Management (May 24, 2019), https://www.sec.gov/comments/sr-nysearca-2019-01/srnysearca201901-5574233-185408.pdf (study demonstrating that "95% of reported trading volume in bitcoin is fake or non-economic in nature"); Javier Paz, *More Than Half of All Bitcoin Trades are Fake*, Forbes (Aug. 26, 2022), https://www.forbes.com/sites/javierpaz/2022/08/26/more-than-half-of-all-bitcoin-trades-are-fake/?sh=11ea350b6681; *see also* Steve Inskeep et al., *How "wash trading" is perpetuating crypto fraud*, NPR (Sept. 23, 2022), https://www.npr.org/2022/09/23/1124662811/how-wash-trading-is-perpetuating-crypto-fraud.

believe this approach would also take some of the speculative air out of the sector's sails generally. The proposal can also cover decentralized platforms, as the agencies or SRO can be directed to develop appropriate adjustments to rules for those as well.

Third, it is practical and feasible. It is based on the market as it exists today. It would not require a bifurcation of all trading into one platform for security tokens and one for commodity tokens. This is particularly useful because crypto trading involves pairs of tokens that might be classified into different buckets. It is feasible because the SEC and the CFTC have the experience to implement the principles and there are precedents for them working together. By forming an SRO, they could draw on the expertise of existing SROs such as the Financial Industry Regulatory Association (FINRA) and the National Futures Association (NFA). Finally, the cost of the SRO's activities could be imposed on the industry through membership fees, consistent with existing practice.

The approach would not involve rewriting existing securities or commodities law. There would be no changes to the definition of security, which might not only fail to bring clarity to crypto; that might unintentionally undermine decades of regulation and jurisprudence as it applies to traditional securities and derivatives markets.

In particular, the law should make clear that the SEC and CFTC would retain their existing authority. For example, the SEC could still contend that any particular token is a security. If it prevailed in any particular case, an intermediary would have to comply by ceasing to deal in that token, or only doing so on a registered platform. But the intermediary would not be shut down as long as it was complying with these basic standards. This would assure the platforms, and their customers, that operations will continue—on a far more responsible basis—while classification and other issues are resolved.

The approach would also create the disclosure we need to sort out classification issues. Platforms would be required to make sure there is some basic information available about a token before listing it. We cannot know whether a token represents an investment in a common enterprise, the value of which may increase because of the managerial efforts of others, unless such disclosure exists. And some basic disclosure would enhance investor protection as well.

Finally, the approach is incremental in several ways. It does not seek to regulate all crypto transactions or all players in the crypto world from the get-go or resolve the classification questions. While comprehensiveness is desirable, it can take a long time to build consensus, and it is much harder to get it right. This is way to do something incremental quickly that can protect millions of investors and serve as a foundation which can be added to and improved over time.

How Did We Get Here?

Former SEC Chairman Jay Clayton and I have advocated essentially this approach in a Wall Street Journal op-ed late last year. We wrote about how "the unique genesis of crypto assets. . . complicated the regulatory challenge.

> Unlike other financial innovations, bitcoin was launched globally and directly to retail consumers, with a claim that it would make traditional intermediaries obsolete. Because financial regulation is implemented on a national basis and largely through intermediaries, this "global retail" path of emergence has challenged regulators as traditional tools are less effective." [9]

It is ironic that an innovation that claimed it would make traditional intermediaries obsolete actually created a whole new category of intermediaries—crypto trading and lending platforms. These new intermediaries are also less accountable than the traditional ones that the creator of bitcoin and many crypto proponents complain about.

Former Chair Clayton and I went on to say that other complicating factors have been the fact that "the use case of many crypto assets is often cloudy"—it is not always clear whether a particular token offers an investment opportunity, access to goods or services, or a banklike product. In addition, the U.S. has a fragmented financial regulatory system with multiple regulators responsible for different product areas.[10] These factors have all contributed to the lack of a strong investor protection framework.

Achieving Investor Protection Now

A key virtue of this approach is that it will allow us to improve investor protection without having first to resolve questions of which tokens are securities and which

---

[9] Jay Clayton and Timothy Massad, How to Start Regulating the Crypto Markets—Immediately," The Wall Street Journal, (Dec. 4, 2022), https://www.wsj.com/articles/how-regulate-cryptocurrency-markets-11670110885
[10] *Ibid*.

are commodities. Crypto trading platforms are all quick to say they do not trade or list any tokens that are securities, but there is significant variation in what they do actually list, which should make us ask why that is the case.

For example, as of a recent date, the four largest U.S. platforms—Binance U.S., Coinbase, Gemini and Kraken, listed approximately 60 tokens in common, such as bitcoin and ethereum.[11] Each platform, however, lists a lot more tokens. The number ranges from over 250 (Coinbase) to about half that amount (Gemini). Collectively, the four platforms list a total of around 400 different tokens, and each one lists many tokens that none of the others list.

If each platform is confident that all the tokens it lists are not securities, why don't they list more tokens in common? Would they say all 400 tokens are not securities and claim their selection is based on other factors?

There are surely other factors that are considered, but it seems unlikely these would account for the degree of difference. For example, Coinbase says it considers other factors such as "customer demand (i.e., trading volume, market cap), traction of token/application (i.e. token holders) and anticipated liquidity."[12] Changpeng (C.Z.) Zhao, the co-founder and chief executive officer of Binance.com, once put it more bluntly: "If a coin has a large number of users, then we will list it. That's the overwhelming significant attribute." [13]

While it would seem reasonable for platforms to consider consumer demand, one would expect that criteria to lead to platforms listing the same tokens, not different tokens. And if instead selections reflect the platforms' different judgements about technical or security issues, that would suggest a need for better disclosure about tokens that are listed.

The SEC has some pending enforcement actions that may bring greater clarity to the question of which digital assets are securities. But that is uncertain and could take time, during which investors will continue to be at risk. Moreover, even if the SEC prevails in particular cases, it may face a game of whack-a-mole, where proponents of other tokens and the trading and lending platforms themselves argue that other tokens are different from the particular facts of an SEC victory,

---

[11] These numbers are based on a manual comparison of listings noted on their respective websites.
[12] Coinbase Exchange, "Listing Prioritization Process & Standards," (Oct. 2022), https://assets.ctfassets.net/c5bd0wqjc7v0/1DqPApt37t3uBHAMFUxPyI/4fa9169f9a8d90191d322635e597bfda/Coinbase_Exchange_Listing_Prioritization_Process_and_Standards.pdf
[13] Helen Partz, "Binance CEO reveals one key factor for token listings," Cointelegraph, (Nov. 30, 2021), https://cointelegraph.com/news/binance-ceo-reveals-one-key-factor-for-token-listings

triggering further litigation. My approach provides a way to improve investor protection without interfering with the exercise of the SEC or CFTC's authority or the proper role of the courts in resolving those questions. Indeed, if the SEC succeeds in establishing that a token is a security, then trading in that token would need to be on an SEC registered exchange. But we do not need to wait for any such case to be resolved.

Congress can also defer trying to define a new category of asset that is not a security. This may be something appropriate for the future, but the absence of a consensus on how to write that definition—there have been several proposals made-- shows how challenging it is. That was also illustrated by the separate hearings held last week by the two subcommittees. Of the nine other witnesses who testified, only two made specific proposals—one said all digital assets should be securities, and another said all digital assets should be treated as commodities. The others called on Congress to rewrite the law but without offering specifics:

"It is critical to provide clarity . . ."

"This [referring to which digital assets fall under SEC or CFTC jurisdiction] is an important debate and one that I will not resolve today."

"This lack of definitional clarity is highly problematic . . .This is an area where more work needs to be done."

"Making this call [as to whether a digital asset is a security or a commodity] is not so clear cut. . . Congress should step in with a new regulatory approach tailored to this asset class."

"Congress should provide a clear definition of and delineation between Digital Commodity and Digital Security, or when a digital asset is neither."

"Tailored, fit-for-purpose rules for this nascent industry are critical."

"Once Congress establishes a clear, workable test to determine which assets should be appropriately regulated as securities (itself a difficult task, to be sure), Congress should find that facilitating a transparent and well-regulated market for these assets is in the public interest . . ."[14]

---

[14] For testimony of witnesses see https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408718 and https://agriculture.house.gov/calendar/eventsingle.aspx?EventID=7604

The path I am proposing creates a requirement for the basic disclosure that will help us figure out how to classify digital assets or how to define a new category. We cannot even judge whether a digital asset meets the elements of the Howey test without some basic information about the development, governance and operation of the asset. That is, one cannot determine if ownership of an asset represents an investment of money in a common enterprise with the expectation of profit from the managerial efforts of others without some basic facts. Moreover, basic information, including about the technology of a particular asset, would enhance investor protection. Platforms would be required to make sure such information exists before listing a token as noted below.

The Principles

The principles that Congress would articulate would be familiar ones used in our securities and derivatives markets. The list could include the following:

- governance standards (including fitness standards for directors and officers);
- protection of customer assets, including segregation and protection in bankruptcy;
- conflicts of interest (including prohibitions or limitations on the ability of trading platforms to engage in proprietary trading or having financial interests in listed assets);
- having adequate financial resources, including capital and margin;
- recordkeeping and periodic public disclosures;
- execution and settlement of transactions in a competitive, open, efficient and timely manner
- pre- and post-trade transparency requirements;
- prevention of fraud, manipulation and abusive practices (including prevention of wash trading);
- disclosures to customers, including regarding fees, recourse, and dispute resolution;[15]

---

[15] Howell Jackson and I noted in our SRO paper (*see* note 2) that some have been critical of FINRA's arbitration proceedings for investor disputes involving securities transactions. *See, e.g.*, Mark Egan et al., *Arbitration with Uninformed Consumers*, Harvard Business School Finance Working Paper No. 19-046 (May 11, 2021),

- risk management practices;
- operational resilience, cybersecurity standards and business continuity and disaster recovery policies; and
- know your customer (KYC), anti-money laundering (AML) and combating financial terrorism (CFT) standards. [16]

As noted above, there would also be a requirement that a platform must make sure there is disclosure regarding a token, whether provided by a person seeking admission of a token to trading or otherwise. This is the approach taken in the new Regulation of the European Parliament and of the Council on Markets in Crypto-assets (MiCA), which provides that a crypto token cannot be listed unless there is a white paper on file that provides basic information.[17] The disclosure requirements need not mirror existing securities law requirements. Georgetown Law Professor Chris Brummer has argued that Regulation S-K, the SEC's primary disclosure regulation, is both "over-inclusive and under-inclusive" with respect to crypto: "it fails in some instances to account for critical aspects of the digital assets ecosystem, and in others imposes obligations with little to no relevance, creating both a lack of clarity and inefficiency in compliance."[18] The approach suggested here allows for development of disclosure requirements without undercutting

---

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3260442. Whatever concerns one might have about FINRA arbitration proceedings as currently implemented, the point to recognize is that consumers investing in crypto-asset markets now have no mechanism for supervised dispute resolution. Moreover, the most stringent system of oversight currently under debate for crypto-assets—full compliance with SEC requirements—implicitly contemplates the application of FINRA arbitration requirements. Conceivably a crypto-asset SRO might adopt better arbitration rules, but whatever rules they adopt would most likely be an improvement upon the status quo.

[16] See *also* Massad and Jackson (2022), *supra,* note 2.

[17] The white paper must contain "(a) information about the offeror or the person seeking admission to trading; (b) information about the issuer, if different from the offeror or person seeking admission to trading; (c) information about the operator of the trading platform in cases where it draws up the crypto-asset white paper; (d) information about the crypto-asset project; (e) information about the offer to the public of the crypto-asset or its admission to trading; (f) information about the crypto-asset; (g) information on the rights and obligations attached to the crypto-asset; (h) information on the underlying technology; (i) information on the risks; (j) information on the principal adverse impacts on the climate and other environment-related adverse impacts of the consensus mechanism used to issue the crypto-asset.

These requirements are spelled out in further detail in an appendix. There is also a requirement that the paper not contain any material omission. *See* European Parliament, "Position of the European Parliament adopted at first reading on 20 April 2023 with a view to the adoption of Regulation (EU) 2023/… of the European Parliament and of the Council on markets in crypto-assets, and amending Regulations (EU) No 1093/2010 and (EU) No 1095/2010 and Directives 2013/36/EU and (EU) 2019/1937" (April 24, 2023), Procedure: 2020/0265(COD), *available at* https://www.europarl.europa.eu/doceo/document/TA-9-2023-0117_EN.html#title2

[18] Georgetown Law Professor Chris Brummer has argued that Regulation S-K, the SEC's primary disclosure regulation, is both "over-inclusive and under-inclusive" with respect to crypto: "it fails in some instances to account for critical aspects of the digital assets ecosystem, and in others imposes obligations with little to no relevance, creating both a lack of clarity and inefficiency in compliance. Chris Brummer, Georgetown Law School*, Testimony before the Agriculture Committee of the U.S. House of Representatives, Subcommittee on Commodity Exchanges, Energy, and Credit* (June 23, 2002), https://docs.house.gov/meetings/AG/AG22/20220623/114931/HHRG-117-AG22-Wstate-BrummerC-20220623-U1.pdf.

existing securities law which would continue to apply to any token ultimately deemed a security.

The Broader Social Goals Served by this Approach

In addition to improving investor protection, requiring intermediaries to observe these principles will serve some broader policy goals. It will strengthen our ability to prevent crypto markets from being used for illicit activity. It will give regulators greater information that can help prevent any potential risks to financial stability. Requiring crypto intermediaries to have stronger resiliency standards and cybersecurity protections—which is critical given how common hacks and outages have been—can also help reduce the risk that such hacks and attacks result in collateral damage to other parts of the financial system.

Implementing the Approach Through a Self-Regulatory Organization

While Congress could direct the SEC and the CFTC to jointly develop and enforce rules implementing the principles, a more efficient approach may be to have the two agencies create and supervise a self-regulatory organization that would do so. Professor Howell Jackson of Harvard Law School and I have written about how such an approach could work in a recent paper.

The "self-regulatory" aspect of an SRO does not mean lax standards, as long as the SRO is properly supervised by the SEC and CFTC. On the contrary, our country's SROs have been important components of the regulation of our securities and derivatives markets for decades. They have been central to the development and implementation of strong standards, as well as enforcement of those standards against industry participants.

Although the SEC and CFTC have authority to create an SRO without legislation, and there are precedents for joint SROs,[19] having Congress direct the agencies to do so would make clear the importance of and authority for such an approach. A jointly supervised SRO is also appropriate given the fact that both the SEC and CFTC have some jurisdiction over crypto. To the extent there are some differences in existing law with respect to an agency's authority over or relationship to an SRO (such as in the process for approving rules), those could be harmonized or resolved in favor of one approach over another.[20] An SRO could

[19] *See* Massad-Jackson 2022, at note 2.
[20] For example, under current law, the SEC must approve an SRO's proposed rules; if the CFTC does not object to a proposed rule, it is deemed approved.

make it easier to conduct supervision and enforcement, because those activities could be conducted by SRO staff rather than joint teams of the two agencies. The Congress could also make clear that the SRO would be financed from industry member dues, as is the practice with existing SROs.

State Law Cannot Fill the Gaps

We cannot rely on state law to address the gaps in crypto regulation. The state law requirements that are imposed today on crypto trading firms by most states are minimal, arising primarily from state money transmitter laws. Those laws have their origins in the telegraph era, and generally impose only minimal requirements pertaining to net worth, security and permissible investments. They do not provide a regulatory framework comparable to that created by the federal laws and regulations governing the securities and derivatives markets. (They do trigger a requirement to register as a money service business with the Treasury Department and the application of the Bank Secrecy Act, which imposes anti-money laundering and other requirements.) Relying on state law would be analogous to relying on state blue sky laws to regulate the securities market after the crash of 1929, rather than what we actually did—which was to pass the Securities Act, the Securities Exchange Act and the other laws that are the foundation of the strongest capital markets in the world.

I should note that there are efforts in a few states to strengthen state law to address the obvious lack of investor protection in the crypto sector. One of the most notable is the proposal made by the New York Attorney General (NYAG) last week, which proposes sweeping new regulations, including prohibitions on conflicts of interest in the industry and standards to prevent fraud and manipulation on trading platforms.[21] I applaud the NYAG for seeking to address these issues. However, I do not agree with some of the particulars of the approach, and I believe these are issues that Congress must address. Otherwise we will face inconsistency between different states' requirements, which will create opportunities for regulatory arbitrage that the FSOC report highlighted.[22]

The Path Forward Should Not Depend on Views on the Value of Crypto

---

[21] "Attorney General James Proposes Nation-leading Regulations on Cryptocurrency Industry," May 5, 2023, https://ag.ny.gov/press-release/2023/attorney-general-james-proposes-nation-leading-regulations-cryptocurrency
[22] *See supra* note 4.

A recent Economic Report to the President issued by the White House takes a very negative view on the value of crypto to date:

> "In addition to the decentralized custody and control of money, it has been argued that crypto assets may provide other benefits, such as improving payment systems, increasing financial inclusion, and creating mechanisms for the distribution of intellectual property and financial value that bypass intermediaries that extract value from both the provider and recipient. . . So far, crypto assets have brought none of these benefits. . . Indeed, crypto assets to date do not appear to offer investments with any fundamental value . . . instead, their innovation has been mostly about creating artificial scarcity in order to support crypto assets' prices—and many of them have no fundamental value."[23]

Those who question the fundamental value of the crypto sector may believe that regulating crypto trading and lending firms will tend to legitimize or encourage more investment in a sector we should prefer to see decline, move offshore or at least not grow. By contrast, there are those who will argue that the United States is failing to create a regulatory framework that encourages the development of technology they believe is transformative and is deserving of a dedicated regulatory regime. They worry that important innovation will move overseas.

I continue to hold the views expressed in my 2019 paper:

> ". . .whether [crypto assets] are the next big thing or modern-day Dutch tulips should not determine whether or how we regulate them. There is nothing so exceptional about crypto assets that justifies giving them a regulatory pass. Nor should they be taxed or regulated out of existence. A traditional principle of financial market regulation in the United States has been to refrain from normative judgements about investments, require transparency and integrity in markets and let investors make their own decisions. We should follow that same principle here."[24]

This is important also as other jurisdictions work to clarify their crypto regulatory regimes. The possibility that activity moves abroad may not reduce risk to our markets or our citizens; it could simply make it harder for regulators to monitor and regulate that risk.

---

[23] The White House, Economic Report of the President, p. 238 (March 2023), https://www.whitehouse.gov/wp-content/uploads/2023/03/ERP-2023.pdf

[24] Massad 2019 *supra* at note 1, p. 6

The approach I am suggesting can find support on both sides of the political aisle. Former SEC Chair Jay Clayton and I advocated essentially this same approach in our Wall Street Journal op-ed late last year. We began by noting that "only someone who has been living under a rock could think cryptocurrency markets don't need stronger regulation."[25] We proposed that the SEC and CFTC develop a set of common, basic investor protection requirements and require platforms to adopt them if they haven't already registered with the SEC as a securities intermediary or with the CFTC as a derivatives intermediary. This would strengthen investor protection without either agency relinquishing any authority while classification and other issues are resolved.

In short, this is a proposal that people on both sides of the aisle, and people with different views on the merits of crypto, can support.

Another Critical Gap: The Lack of a Federal Regulatory Framework for Stablecoins

I wish to discuss briefly another critical gap, which is the lack of a federal regulatory framework for stablecoins, which are used extensively in the crypto spot market. Stablecoin market capitalization has grown quickly in the last few years, and has not declined dramatically despite the fact that the crypto market has generally lost two-thirds of its value since late 2021. The risks posed by stablecoins have been described in detail in two recent government reports--the report of the President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency,[26] and the report of the FSOC previously noted.[27] I will therefore not summarize those risks, nor the inadequacies of present regulation which are also described in those reports. Both those reports call on Congress to pass new legislation to provide specific authority to regulate stablecoins.

I believe we need to bring stablecoin activity within the federal regulatory perimeter rather than attempt to keep it outside. I believe that is a better way to oversee and manage the risks that stablecoins pose, both to consumers and to the

---

[25] *See supra*, at note 9.
[26] President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, *Report on Stablecoins* (Nov. 1 2021), https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf (hereinafter the "PWG Report").
[27]FSOC report, *supra* at note 4.

traditional financial system and financial stability generally. Limiting interconnections between crypto and the traditional banking sector generally, which appears to be the current policy of our bank regulators, may slow the growth of certain crypto activities, but it risks pushing the activity overseas, or to less-regulated or non-regulated areas of financial activity. That could ultimately make it harder to oversee and manage the risk. Bringing the activity within the regulatory perimeter is also the best way to realize any positive potential that stablecoins might offer. Although stablecoins are used mostly within the crypto sector today, they might have potential to improve payments in other areas.[28]

Professors Jackson of Harvard Law School and Dan Awrey of Cornell Law School and I wrote a paper recently outlining how such a regulatory framework could be created today by our financial regulators (primarily our banking regulators) under existing law without new legislation. However, our bank regulators appear reluctant or unwilling to do so unless given specific authority by Congress.

Therefore, I support legislation that would create a framework for stablecoin regulation based on principles followed primarily in our regulation of banks. As long as stablecoins are used as a payment mechanism, and do not pay interest or a return to their holders, I believe it is best to regulate them as payment instruments. There need to be prudential requirements on the issuer, including that stablecoins be fully backed by reserves in the form of cash or high quality liquid assets as well as capital and liquidity requirements. Operational requirements on the stablecoin issuer are necessary as well, such as KYC and AML requirements, risk management standards, cybersecurity, and restrictions on use of customer data. There should be standards on the issuer's selection and oversight of decentralized blockchains on which stablecoins are transferred. There also need to be standards requiring interoperability of stablecoins and prevention of concentration of power, as well as limitations on certain commercial affiliations.

The Digital Assets Policy Project at the Harvard Kennedy School, which I direct, held a roundtable on stablecoin regulation last November attended by senior leaders from government, the stablecoin industry, traditional financial institutions, academia and others. Although the event was conducted under Chatham House rules, a summary of the discussion and other materials, including comparisons of different legislative proposals on stablecoins, can be found at the Digital Assets Policy Project website.

---

[28] In the interests of full disclosure, I note that I am a member of PayPal's Advisory Council on Blockchain, Crypto and Digital Currencies. I am testifying in my personal capacity and the views I express are entirely my own.

I would be happy to answer any questions. Thank you.