Hearing on
Dazed and Confused: Breaking Down the SEC's Politicized Approach to Digital Assets
Before the U.S. House Financial Services Committee Subcommittee on Digital Assets, Financial Technology and Inclusion

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Prepared Statement

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Chairman Hill, Ranking Member Lynch, and Members of the Committee:

Thank you for inviting me to testify at today's hearing. My name is Lee Reiners, and I am a lecturing fellow at Duke University. The views expressed in my testimony are mine alone and do not represent the views of Duke University or any affiliate thereof, and I have prepared this testimony on my own behalf. I teach courses in cryptocurrency law and policy, cybersecurity policy, climate change and financial markets, and financial regulation, and my research focuses on how new financial technologies and climate change fit within existing financial regulatory frameworks. Prior to entering academia, I spent five years examining systemically important financial institutions at the Federal Reserve Bank of New York. I also serve on the CFA Institute's Capital Markets Policy Council.

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I. Introduction

Narrative politics refers to the use of stories and narratives in the political sphere to shape perceptions, influence public opinion, and drive political action. Through the use of stories, special interest groups and political actors seek to influence how the public perceives issues and events, which in turn affects policy preferences and can lead to specific policies being legitimized or delegitimized. Importantly, it does not matter if the narrative is true. What matters is if enough people – the right people – believe it is true.

Over the past year, the cryptocurrency industry has engaged in a classic case of narrative politics. The story they tell is simple, powerful, and false. It goes something like this: there are millions of one issue pro-crypto voters who stand ready to support the candidates that embrace crypto and ensure the United States is host to the next great wave of technological and financial innovation. And what does "embracing" crypto look like? To most crypto executives, it means freeing the industry from the shackles of the Securities and Exchange Commission and the securities laws that have protected investors and facilitated unprecedented capital formation for the past 90 years.

To make sure policymakers get the message, the crypto industry has amassed an unprecedented campaign finance war chest. According to a recent report from Public Citizen, "crypto corporations have poured over $119 million directly into influencing federal elections," which accounts for nearly half of ALL corporate spending in the 2024 election cycle thus far.[1] This kind of money buys powerful friends. After previously calling Bitcoin a "scam" whose "value is highly volatile and based on thin air,"[2] Donald Trump recently told the crowd at Bitcoin 2024 that he would make the U.S. the "crypto capital of the planet" and fire SEC Chair Gary Gensler on day one of his presidency.

More important than supportive statements from presidential candidates is industry-friendly legislation that would hand crypto market oversight to the Commodities Futures Trading Commission and gut our federal securities laws in the process. When the U.S. House of Representatives passed the "Financial Innovation and Technology for the 21st Century Act" (FIT21) in May, the industry took one large step toward accomplishing their goal.[3]

The crypto industry has funded astroturf campaigns[4] and commissioned dubious polls to provide policymakers with the cover they need to enact industry-friendly laws and regulations. One statistic that gets thrown around frequently is that 50 million Americans – roughly 20% of U.S. adults – own cryptocurrency. This figure comes from a 2023 Morning Consult poll – commissioned by a cryptocurrency exchange – that surveyed 2,202 U.S. adults.[5] However, in the

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[1] https://www.citizen.org/article/big-crypto-big-spending-2024/
[2] https://www.wsj.com/articles/donald-trump-crypto-currency-plan-bitcoin-conference-gary-gensler-sec-bd21f5aa?utm_source=securitiesdocket.beehiiv.com&utm_medium=newsletter&utm_campaign=can-the-u-s-president-fire-the-sec-chairman
[3] H.R.4763 - 118th Congress (2023-2024): Financial Innovation and Technology for the 21st Century Act | Congress.gov | Library of Congress
[4] See New Astroturf Crypto Campaign Appears on Social Media - The American Prospect and Issue 62 – Grassroots (citationneeded.news)
[5] Morning_Consult_Cryptocurrency_Perception_Study_Feb2023_Memo__1_.pdf (ctfassets.net)

first paragraph of their poll results, Morning Consult states that they intentionally oversampled 500 cryptocurrency investors.[6] Another outlandish poll suggested that 1-2% of Democrats "may be leaning towards Trump due the [*sic*] Biden Administration's hostility to crypto."[7] But this number was contrived by multiplying the number of Democratic respondents who said they were not voting for Kamala Harris by the percent of respondents who said the Biden Administration's approach to crypto has been "too hostile," despite there being no evidence that the reason these Democrats were not voting for Harris was because of anything related to crypto.[8]

The reality is that very few Americans own or use crypto, and among those that do, there is no evidence to suggest that their vote is principally influenced by a candidate's stance on cryptocurrency. A more credible source on crypto ownership is the Federal Reserve's 2023 Survey of Household Economics and Decisionmaking (SHED), which showed that only 7 percent of adults (about 18.3 million people) admitted to holding or using crypto—down from 10 percent in 2022 and 12 percent in 2021.[9] Nor is cryptocurrency showing up in any surveys on the most important issues for US voters,[10] a fact that was reflected in the omission of cryptocurrency from both candidates' acceptance speeches at their respective party conventions,[11] and the topic's absence from the first presidential debate.[12] Even the crypto industry implicitly acknowledges that voters are indifferent to crypto, as evidenced by the fact that industry-funded political ads never mention crypto.[13]

The crypto industry has resorted to narrative politics and aggressive lobbying because it has yet to produce a product or service that provides genuine economic utility to most Americans – in the parlance of startups, crypto has still not found product-market-fit.[14] To better understand this point, it is helpful to compare crypto's plight to that of another innovative product that came shortly before — ridesharing. When Uber first launched, its business was illegal in almost every new city it entered. The company overcame this hurdle with one enormously powerful weapon — a product that consumers enjoyed. By solving the frequent problem of unreliable taxi service, Uber quickly developed a large and vocal constituency of riders and drivers. This ultimately forced policymakers to accommodate a business model that forever changed the way we get around. In sum, a great product compelled regulatory change.

The crypto industry seems to think the opposite — that regulatory change will compel a great product. This notion has led the industry to become mired in endless policy debates and fitful legislative efforts that only benefit their lawyers and lobbyists. The truth is that crypto is not a kitchen table issue because, at present, it fails to solve real problems that ordinary people face. In

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[6] https://bettermarkets.org/wp-content/uploads/2023/07/BetterMarkets_Deceptive_Polling_Paid-For_ByCrypto_July2023-1.pdf
[7] https://policy.paradigm.xyz/writing/Dem-polling
[8] Interestingly, the same poll of registered Democrats found that amongst non-Harris voters, more (27%) thought the Biden Administration's approach to crypto was either "too friendly" or "just about right" than thought it was "too hostile" (21%). See, https://www.mollywhite.net/annotations/paradigm-democrat-poll/
[9] Federal Reserve Board Publication
[10] Issues and the 2024 election | Pew Research Center and Most Important Problem | Gallup Historical Trends
[11] Polymarket's largest bet misses as Trump fails to mention Bitcoin at RNC speech (crypto.news)
[12] The Harris-Trump Debate Showed How Little Crypto Matters to Voters and Politicians (coindesk.com)
[13] See Fairshake - YouTube and host2.adimpact.com/admo/viewer/c708eecd-17dc-41b5-be8a-ca4b51f9b9bc
[14] What is Product-Market Fit? | Definition and Examples (productplan.com)

fact, politicians are far more likely to hear from constituents who have suffered losses in any one of the numerous crypto-related failures and scams over the last several years.

Fortunately, the current leadership of the Securities and Exchange Commission has resisted industry lobbying and upheld the securities laws established by Congress ninety years ago. It is crucial to remember that Congress designed these laws to be principles-based. In the seminal case *SEC v. Howey*, the Supreme Court found that the term "investment contract:"

> *"[E]mbodies a flexible, rather than a static, principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."*[15]

Cryptocurrency and blockchain technology are simply the latest scheme deployed by those seeking to profit from other people's money.[16] And despite the industry's claims, the SEC has been clear and consistent about crypto dating to the chairmanship of Jay Clayton. Both Clayton and his successor, Gary Gensler, have said most cryptocurrencies are securities that need to be registered with the Commission. The SEC has also brought hundreds of cryptocurrency-related enforcement actions and amassed an impressive win-loss record that is the envy of any regulatory agency or law firm.[17][18] For any neutral observer, the law is very clear.

The crypto industry argues that even if the securities laws did apply to their activities, the decentralized nature of blockchain technology makes regulatory compliance impossible, thus the need for a completely new regulatory framework that only Congress can provide. This is a smokescreen. As I detail below, only a small fraction of cryptocurrency transactions are recorded on the blockchain,[19] and centralized cryptocurrency exchanges in the U.S. do not use the blockchain to execute customer transactions. It is their conflict-laden business model, in which they perform multiple functions that are typically kept distinct in traditional securities markets, that makes regulatory compliance impossible.

While I applaud the SEC for clearly and consistently applying *Howey* and its progeny to protect investors in the crypto space, there remains a gap in crypto spot market regulation that only Congress can close. While I agree with chairman Gensler that most cryptocurrencies are securities that are subject to registration and disclosure requirements, some cryptocurrencies are

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[15] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

[16] Note that there are other statutory standards and legal tests beyond "Howey" that can be applied to determine whether or not a given cryptocurrency is a security.

[17] In fact, on issues pertaining to securities law, the SEC has just one notable loss, and a partial one at that. In SEC v. Ripple, Judge Analisa Torres ruled that Ripple's secondary sales of XRP did not qualify as investment contracts. Judge Torres reasoning on this issue has since been rebuked by several federal judges in the same court, as I detail below. See SEC Continues Crypto Crackdown Despite Recent Losses (coinpaprika.com), and Gensler's SEC racks up legal wins against crypto - POLITICO

[18] Cornerstone Research, "SEC Tightens Cryptocurrency Enforcement," January 18, 2023, https://www.cornerstone.com/insights/press-releases/sec-tightens-cryptocurrency-enforcement/. Note that additional enforcement actions and settlements since this article was published push the total number well over 130.

[19] A National Bureau of Economic Research paper found that the off-chain transaction volume involving Bitcoin appears to have been at least 10 times the volume recorded on the Bitcoin blockchain. See, w29337.pdf (nber.org)

most likely commodities.[20] While the Commodity Futures Trading Commission (CFTC), regulates commodity derivatives, they do not regulate commodity spot markets. The practical effect of this structure is that cryptocurrency exchanges in the U.S. are presently not regulated at the federal level.[21] That is a gap that Congress must close as soon as possible.

My testimony reveals that the SEC is simply doing the job Congress tasked it with – enforcing the federal securities laws. While crypto market participants may not like these laws, they have no basis to be mad at the SEC for enforcing them. To paraphrase Matthew McConaughey's character in "Dazed and Confused", that's what I love about these federal securities laws, man; I get older, they stay the same.

A brief note on terminology. Throughout my testimony, I use the terms "cryptocurrency," "crypto," "digital asset," "crypto asset," and "token" interchangeably. In general, these terms refer to any fungible digital representation of value that can be exclusively possessed and transferred, person to person, without necessary reliance on an intermediary, and is recorded on a blockchain.

II. The Past, Present, and Future of SEC Cryptocurrency Enforcement

a. Overview

Despite the crypto industry's self-serving cries for "regulatory clarity," the SEC's stance on cryptocurrency has been clear and consistent.[22] As John Reed Stark, the former head of the SEC's Office of Internet Enforcement, noted, critics of the SEC's stance toward cryptocurrency overlook an important aspect of U.S. securities law — "[b]y design, it is a principles-based regulatory framework, much like other U.S. laws."[23] This is why the definitions of "security" in Section 2(a)(1) of the Securities Act of 1933 (Securities Act), 15 U.S.C. 77b(a)(1) and Section 3(a)(10) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78c(a)(10) include not only conventional securities, such as "stock[s]" and "bond[s]," but also the more general term "investment contract." In the seminal case *SEC v. Howey*, the Supreme Court found that the term "investment contract:"

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[20] Bitcoin has long been considered by most observers and senior regulators to be a commodity. However, reporting by Paul Kiernan at the Wall Street Journal indicates that just five "maintainers" are responsible for updating and maintaining Bitcoin's core software. Thus, the Howey Test's efforts of other prong may be implicated and Bitcoin could possibly be considered an investment contract, and therefore a security. See Paul Kiernan, "Bitcoin's Future Depends on a Handful of Mysterious Coders," WSJ, Feb 16, 2023, https://www.wsj.com/articles/bitcoin-core-maintainers-crypto-7b93804

[21] They are registered with the Financial Crimes Enforcement Network (FinCEN) for the purpose of complying with laws around money laundering and terrorist financing. In addition, many will hold state money transmitter licenses.

[22] Gary Gensler, "Kennedy and Crypto," (speech, Washington, D.C., September 8, 2022), https://www.sec.gov/news/speech/gensler-sec-speaks-090822.

[23] HHRG-118-BA16-Wstate-StarkJ-20240507.pdf (house.gov)

> *"[E]mbodies a flexible, rather than a static, principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."*[24]

Along these lines, in *Reves v. Ernst & Young*, in which the Supreme Court was asked to decide whether demand notes offered by a business are securities, the Court stated that:

> *"The fundamental purpose undergirding the Securities Acts is 'to eliminate serious abuses in a largely unregulated securities market.' United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 421 U.S. 849 (1975).* ***In defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of 'countless and variable schemes devised by those who seek the use of the money of others on the promise of profits****, SEC v. W.J. Howey Co., 328 U.S. 293, 328 U.S. 299 (1946), and determined that the best way to achieve its goal of protecting investors was 'to define the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.' . . . Congress therefore did not attempt precisely to cabin the scope of the Securities Acts . . . Rather, it enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment" (emphasis added).*[25]

Federal courts have repeatedly confirmed the SEC's jurisdiction in numerous crypto-related enforcement actions. In fact, the SEC has brought close to 200 crypto-related enforcement actions and has won, or settled, the vast majority of them.[26] In most of these cases, the SEC has applied the *Howey* Test to argue that the cryptocurrency in question is an investment contract, and therefore a security subject to SEC registration and disclosure requirements.

The U.S. Supreme Court's *Howey* case and subsequent case law have found that an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. Although the "*Howey* test" "has been refined in the more than seventy years since it was first announced, it remains the guiding principle" for distinguishing between securities and non-securities.[27] As noted by the SEC's Enforcement Director, Gurbir Grewal, "*Howey* has proven to be a remarkably flexible and resilient test that courts have since applied to find a wide variety of offerings to be investment contracts and, thus, securities."[28] Grewal goes on to note that the list "includes offerings related

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[24] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

[25] *Reves et al. v. Ernst & Young*, 494 U.S. 56 (1990).

[26] Cornerstone Research, "SEC Tightens Cryptocurrency Enforcement," January 18, 2023, https://www.cornerstone.com/insights/press-releases/sec-tightens-cryptocurrency-enforcement/; John Reed Stark, "Why 'SEC Regulation by Enforcement' is a Bogus Big Crypto Catchphrase," LinkedIn, January 23, 2023. https://www.linkedin.com/pulse/why-sec-regulation-enforcement-bogus-big-crypto-john-reed-stark/?published=t, see also SEC.gov | Crypto Assets

[27] Thomas Lee Hazen, Tulips, Oranges, Worms, and Coins—Virtual, Digital, or Crypto Currency and the Securities Laws, 20 N.C. J. L. & Tech. 493, 503 (2019).

[28] SEC.gov | What's Past is Prologue: Enforcing the Federal Securities Laws in the Age of Crypto

to whiskey, cosmetics, self-improvement courses, and pay phones, as well as a surprising number of creatures: earthworms, beavers, chinchillas, and even cattle embryos."[29]

In his testimony before the United States House of Representatives Financial Services Committee Subcommittee on Capital Markets this past May, John Reed Stark detailed several important SEC cases that should have served as early warnings to the crypto industry that federal judges would apply the federal securities laws, including *Howey*, to digital asset offerings.[30] These include SEC v. Kik,[31] SEC v LBRY,[32] and SEC v. Terraform Labs.[33] In all three of these cases, judges also rejected the Due Process and Fair Notice defenses that crypto defendants frequently assert.

The SEC has used "multiple distribution channels to share its message and concerns regarding crypto, digital trading platforms, initial coin offerings, and other digital asset products and services over the past decade."[34] The SEC first made investors aware of the dangers of investing in cryptocurrency in 2013 when the Office of Investor Education and Advocacy issued an Investor Alert on "Ponzi Schemes Using Virtual Currencies."[35] A year later, the same office issued an Investor Alert on "Bitcoin and Other Virtual Currency-Related Investments."[36] In 2017, the Commission released a Section 21(a) Report of Investigation that looked at the facts and circumstances of The DAO, which offered and sold approximately 1.15 billion DAO tokens in exchange for a total of approximately 12 million Ether ("ETH") over a one-month period in 2016.[37] The SEC applied the Howey Test to the DAO tokens and concluded they were securities under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"). While The DAO and DAO tokens were no longer operational at the time due to a high-profile hack that had resulted in the theft of most of the tokens, the Commission chose to release the report so as "to advise those who would use a Decentralized Autonomous Organization ("DAO Entity"), or other distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws."[38] In 2019, the SEC released a "Framework for 'Investment Contract' Analysis of Digital Assets," which provided additional details on when a digital asset has the characteristics of an investment contract and "whether offers and sales of a digital asset are securities transactions."[39]

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[29] Id

[30] HHRG-118-BA16-Wstate-StarkJ-20240507.pdf (house.gov)

[31] https://www.sec.gov/news/press-release/2019-87

[32] https://www.sec.gov/litigation/litreleases/lr-25060

[33] https://www.sec.gov/news/press-release/2023-32

[34] Stark, "Big Crypto's Bogus Demands." BIG CRYPTO'S BOGUS DEMANDS FOR "REGULATORY CLARITY" – The FinReg Blog (duke.edu)

[35] U.S. Securities and Exchange Commission, "Ponzi Schemes Using Virtual Currencies," accessed January 9, 2023, https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf.

[36] U.S Securities and Exchange Commission, "Investor Alert: Bitcoin and Other Virtual Currency-Related Investments," May 17, 2013, https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investor-39.

[37] U.S. Securities and Exchange Commission, "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO," July 25, 2017, https://www.sec.gov/litigation/investreport/34-81207.pdf.

[38] Ibid.

[39] U.S. Securities and Exchange Commission, "Framework for 'Investment Contract' Analysis of Digital Assets," April 3, 2019, https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

The SEC has also publicized its position on cryptocurrency in countless enforcement actions,[40] multiple speeches,[41] congressional testimony,[42] and several official SEC statements[43] and proclamations.[44] Chair Gensler has spoken frequently about the perils and illegality of crypto lending platforms and decentralized finance,[45] warning that their failure to register with the SEC may violate U.S. securities laws.[46] In one interview, Gensler said:

> *"The law is clear, it's not about waving a wand. Congress spoke about this in 1934 . . . When a [digital] platform has securities on it, it is an exchange, and it's a question of whether they're registered or they're operating outside of the law, and I'll leave it at that."*[47]

On September 8, 2022, Chair Gensler gave a speech reflecting on the flexibility of the securities laws and the SEC's consistency in applying those laws to cryptocurrency.[48] Gensler noted that of the 10,000 different cryptocurrencies in the market, "the vast majority are securities."[49] Gensler went on to note that the SEC has spoken with a "pretty clear voice" when it comes to cryptocurrency, "through the DAO Report, the Munchee Order, and dozens of enforcement actions, all voted on by the Commission" and that "[n]ot liking the message isn't the same thing as not receiving it."[50]

In January 2023, the nonprofit Better Markets released a report detailing the SEC's strong record on crypto regulation and enforcement.[51] The report identifies the SEC's three-pronged strategy to bring the crypto industry into compliance with federal securities laws: (1) publicly urging the industry to come in and speak with the agency in order to come into compliance, (2)

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[40] U.S. Securities and Exchange Commission, "Crypto Assets and Cyber Enforcement Actions," November 4, 2022, https://www.sec.gov/spotlight/cybersecurity-enforcement-actions.
[41] Gary Gensler, "Remarks Before the Aspen Security Forum," (speech, Washington D.C., August 3, 2021), https://www.sec.gov/news/speech/gensler-aspen-security-forum-2021-08-03.
[42] Gary Gensler, "Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee," (speech, Washington, D.C., May 26, 2021), https://www.sec.gov/news/testimony/gensler-2021-05-26.
[43] Jay Clayton, "Statement on Cryptocurrencies and Initial Coin Offerings," U.S. Securities and Exchange Commission, December 11, 2017, https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.
[44] U.S. Securities and Exchange Commission, "Statement on Potentially Unlawful Online Platforms for Trading Digital Assets," March 7, 2018, https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.
[45] Michael McSweeney, "Gensler Sets SEC Sights on DeFi, Crypto Lending and More in Expansive Speech on Regulation," *The Block*, February 10, 2023, https://www.theblock.co/post/113416/gensler-speech-crypto-defi-lending-sec.
[46] Ben Werschkul, "Crypto Platforms that Don't Register with the SEC do Business 'Outside the Law': Gensler," *Yahoo News*, March 4, 2022, https://finance.yahoo.com/news/crypto-platforms-dont-register-with-sec-outside-the-law-gensler-164215740.html.
[47] McSweeney, "Gensler Sets SEC Sights."
[48] Gensler, "Kennedy and Crypto."
[49] Id.
[50] Id.
[51] Better Markets, "The SEC's Excellent Record on Crypto: Regulation & Enforcement," *Better Markets*, January 25, 2023, https://bettermarkets.org/wp-content/uploads/2023/01/BetterMarkets_SEC_Record_On_Crypto_01-25-2023.pdf.

selectively bringing enforcement actions, and (3) using its authority to "deny crypto firms' requests to unlawfully engage in certain types of activities."[52]

In February 2023, Chair Gensler warned the crypto industry that it was time to register their offerings with the SEC, and that the "runway is getting awfully short."[53]

b. Recent Enforcement Actions

The runway finally ran out in the summer of 2023, when the SEC brought enforcement actions against the largest cryptocurrency platforms in the U.S. This marked a clear shift in strategy for the SEC, who rather than play a game of whack-a-mole with the tens of thousands of crypto issuers, decided that a better use of their limited enforcement resources was in targeting the platforms where most crypto investors bought and sold their tokens. In complaints against Binance[54] and Coinbase,[55] the SEC alleged that these companies combined the functions of an exchange, broker, dealer, and clearing agency without complying with the registration provisions of the federal securities laws applicable to any of those functions.[56] The SEC made similar allegations against Kraken in November 2023.[57] Central to all three cases is the assertion that they were listing at least one unregistered security.

These cases are still being litigated, but most of the SEC's charges survived motions to dismiss, with the respective judges once again affirming the applicability of *Howey* to digital asset offers and sales.

On August 24, 2024, a U.S. District Court Judge in the Northern District of California denied cryptocurrency exchange Kraken's motion to dismiss in the SEC's case against them for acting as an unregistered broker, dealer, exchange, and clearing agency with respect to what the SEC refers to as "crypto asset securities."[58] The SEC's complaint alleged that 11 tokens listed on Kraken are unregistered securities. The judge's decision focused on two of these tokens, ALGO and SOL, the native tokens of the Algorand and Solana blockchains, respectively. The court found that the SEC plausibly alleged ALGO and SOL were offered or sold on Kraken as investment contracts. In so doing, the judge rejected, as other courts have, Kraken's argument that an investment contract requires "post-sale obligations" from the issuer to the purchaser who bought the token on a secondary marketplace, like Kraken. The court was clear that investment contracts are not limited to actual contracts and that the *Howey* test applies regardless of whether the transaction is on a primary or secondary market.

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[52] Ibid., 3.
[53] SEC Chair Gary Gensler Blames Kraken for 'Choosing' Not to Follow the Law - Decrypt
[54] SEC.gov | SEC Files 13 Charges Against Binance Entities and Founder Changpeng Zhao
[55] https://www.sec.gov/newsroom/speeches-statements/www.sec.gov/news/press-release/2023-102
[56] The SEC's complaint against Binance also alleged that the company commingled certain customer assets and attempted to evade U.S. securities laws by announcing sham controls that they disregarded so that they could keep high-value U.S. customers on their platforms.
[57] SEC.gov | SEC Charges Kraken for Operating as an Unregistered Securities Exchange, Broker, Dealer, and Clearing Agency
[58] SEC's Case Against Kraken Will Proceed to Trial, California Judge Rules (coindesk.com)

On March 27, 2024 Judge Katherine Polk Failla, of the U.S. District Court for the Southern District of New York, denied Coinbase's motion to dismiss the SEC lawsuit against them, finding that the agency had a "plausible" case against the exchange (Judge Failla did dismiss the claim that Coinbase acted as an unregistered broker through its crypto wallet).[59] In her ruling, Judge Failla noted that "the "crypto" nomenclature may be of recent vintage, but the challenged transactions fall comfortably within the framework that courts have used to identify securities for nearly eighty years."[60] Judge Failla's analysis focused on the "full set of contracts, expectations, and understandings" surrounding its [the crypto asset's] sale and distribution – frequently referred to using the shorthand "ecosystem." The Judge also rejected Coinbase's arguments that there needs to be a "formal contract between transacting parties for an investment contract to exist under *Howey*," and that an investment contract cannot be present if the investor purchases the token in a secondary market transaction where the issuer is not the seller. In rejecting the latter argument, Judge Failla also rejected the approach adopted by Judge Analise Torres in SEC v. Ripple Labs.

c. SEC v. Ripple

The Ripple case is an important plot line in the crypto industry's crusade against the SEC, because it is one of the few cases where the SEC had even a partial loss. However, the case's relevance is quickly diminishing due to several other courts rejecting the legal arguments marshalled by Judge Torres to find that certain sales of the cryptocurrency XRP were not investment contracts. Nonetheless, it is worth briefly summarizing Judge Torres' ruling and subsequent case law that disregards key aspects of her ruling.

On July 13, 2023 Judge Analisa Torres of the United States District Court for the Southern District of New York ruled on cross-motions for summary judgement filed by the SEC and Ripple in relation to ongoing litigation that dates back to December 2020.[61] Judge Torres' ruling argues that a determination of an unlawful offer and sale of securities in violation of Section 5 of the Securities Act of 1933 should hinge on the facts and circumstances by which the *sale* was made. Judge Torres notes that in the original *Howey* case and its progeny, which have come to define the term "investment contract", "the subject of the investment contract was a standalone commodity, which was not itself inherently an investment contract." Thus, Judge Torres points to "the plain words of Howey", which make clear that an investment contract for purposes of the Securities Act means a *contract, transaction[,] or scheme*." (emphasis added by Judge Torres). Judge Torres states that "XRP, as a digital token, is not in and of itself a "contract, transaction[,] or scheme" that embodies the Howey requirements of an investment contract."

With this analysis established, Judge Torres then assesses the three categories of alleged unregistered XRP offer and sales conducted by Ripple:

- Institutional Sales under written contracts for which it received $728 million;

[59] Securities and Exchange Commission v. Coinbase, Inc. et al, No. 1:2023cv04738 - Document 105 (S.D.N.Y. 2024) :: Justia
[60] Id.
[61] SEC vs Ripple 7-13-23.pdf (uscourts.gov)

- Programmatic Sales on digital asset exchanges for which it received $757 million; and
- Other Distributions under written contracts for which it recorded $609 million in "consideration other than cash."

Judge Torres found that only the "Institutional Sales" constituted the unregistered offer and sale of an investment contract, as all three prongs of the *Howey* Test were satisfied. For the Programmatic Sales, whereby Ripple sold XRP via cryptocurrency exchanges, Judge Torres ruled these did not constitute investment contracts because the third prong of the *Howey* Test (expect profits solely from the efforts of the promoter or a third party) was not satisfied because buyers were not aware they were buying XRP from Ripple and because Ripple "did not make any promises or offers because Ripple did not know who was buying the XRP."

Judge Torres' ruling was largely viewed as a victory for cryptocurrency exchanges because the tokens they list are similar to XRP in that they are not in and of themselves a "contract, transaction, or scheme." Thus, if they are not listing investment contracts, they cannot be accused of operating an unregistered securities exchange. However, it is important to note acknowledge footnote 16 in Judge Torres' ruling, which says:

> *"The Court does not address whether secondary market sales of XRP constitute offers and sales of investment contracts because that question is not properly before the Court. Whether a secondary market sale constitutes an offer or sale of an investment contract would depend on the totality of circumstances and the economic reality of that specific contract, transaction, or scheme."*

Judge Torres' ruling flips securities law on its head. The securities laws were established to protect retail investors in the wake of companies raising money from the public during the 1920s based upon poor, absent, and misleading disclosures, which contributed to the stock market crash of 1929 and the resulting Great Depression. The result of Judge Torres' ruling is that wealthy and sophisticated institutional token investors get the protections provided by the securities laws while retail investors do not. This outcome is counter to the purpose and intent of securities laws.

Thankfully, Judge Torres' emphasis that a cryptocurrency buyer in the secondary market must know the identity of the seller in order for there to be an expectation of profit has since been ignored and rejected by multiple federal judges, including two of her fellow judges in the Southern District of New York. As noted above, Judge Failla declined to draw a distinction between token purchases directly from an issuer and tokens purchased in a secondary market transaction, noting, "Howey does not recognize such a distinction as a necessary element in its test of whether a transaction constitutes an investment contract, nor have courts, in the nearly eighty years of applying Howey, read such an element into the test. Rather, under Howey, the Court must consider the "economic reality" of the transaction to determine whether that transaction is an investment contract."[62]

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[62] Securities and Exchange Commission v. Coinbase, Inc. et al, No. 1:2023cv04738 - Document 105 (S.D.N.Y. 2024) :: Justia

Judge Torres' logic was also rejected by Judge Jed Rakoff of the United States District Court for the Southern District of New York in SEC v. Terraform Labs Pte. On July 31, 2023, Judge Rakoff denied Terraform Labs Pte and founder Do Kwon's motion to dismiss charges by the SEC that the company and its founder orchestrated a multi-billion-dollar fraud involving the development, marketing, and sale of various cryptocurrencies.[63] With respect to the Luna token, Judge Rakoff found that a common enterprise and expectation of profit existed because Terraform labs used proceeds from LUNA coin sales to develop the Terraform blockchain and represented that these improvements would increase the value of the LUNA tokens. With respect to the Ripple decision, Judge Rakoff said the following:

> *"It may also be mentioned that the Court declines to draw a distinction between these coins based on their manner of sale, such that coins sold directly to institutional investors are considered securities and those sold through secondary market transactions to retail investors are not. In doing so, the Court rejects the approach recently adopted by another judge of this District in a similar case, SEC v. Ripple Labs Inc., 2023 WL 4507900 (S.D.N.Y. July 13, 2023)."*[64]

d. eToro Settlement

On September 12, 2024, crypto trading platform eToro USA LLC agreed to the entry of a SEC cease-and-desist order and agreed to pay $1.5 million to settle charges that it operated as an unregistered broker and unregistered clearing agency in connection with its trading platform that facilitated buying and selling certain crypto assets as securities.[65] While the order did not identify specific tokens the SEC believed to be unregistered securities, the order did note that eToro would henceforth only support trading in Bitcoin, Bitcoin Cash, and Ether. Presumably, the SEC agreed to this action because they believe these three tokens are commodities, not securities, although the Commission has not explicitly acknowledged this interpretation. In the SEC's press release, Enforcement Director Grewal stated that the settlement "offers a pathway for other crypto intermediaries."[66] Of course, an additional pathway to resolve SEC charges for crypto exchanges would be to register with the SEC.

e. NFTs

Last month, it was reported that non-fungible token (NFT) marketplace OpenSea received a Wells Notice from the SEC.[67] OpenSea's CEO went on X to say that the SEC believes OpenSea is listing a security, which would make them an unregistered securities exchange.[68] NFTs are digital tokens recorded on a blockchain that can be sold and traded. There is also a specialized form of NFT, "soulbound" tokens, which are non-transferrable and

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[63] https://assets.bwbx.io/documents/users/iqjWHBFdfxIU/rwwEEo0YbENc/v0
[64] Id.
[65] SEC.gov | eToro Reaches Settlement with SEC and Will Cease Trading Activity in Nearly All Crypto Assets
[66] Id.
[67] OpenSea Expecting SEC Lawsuit Over NFTs Being Securities, Says CEO - Decrypt
[68] Devin Finzer (dfinzer.eth) on X: "OpenSea has received a Wells notice from the SEC threatening to sue us because they believe NFTs on our platform are securities. We're shocked the SEC would make such a sweeping move against creators and artists. But we're ready to stand up and fight. Cryptocurrencies have long" / X

represent a person's reputation and accomplishments similar to an enhanced resume. Most blockchain tokens are designed to be "fungible" (i.e., interchangeable). The best-known example of such a token is Bitcoin; one Bitcoin is interchangeable with another. By contrast, NFTs represent ownership of "non-fungible" (i.e., unique) items. NFTs can represent assets ranging from digital artwork and music files to real property titles.

As with the broader cryptocurrency market, the NFT market has experienced a major decline over the past two years.[69] The fall in NFT prices was inevitable and predictable, as nearly anyone can create an NFT from scratch at little to no cost. Unlike tangible art or collectibles, the supply of potential NFTs is infinite.

NFTs and the ownership they are supposed to represent in the digital world present legal challenges and cause confusion. Data stored on a blockchain is simply computer code. For the Bitcoin blockchain, the data stored represents the history of every Bitcoin transaction. NFTs are also computer code, i.e., they are not digital art. Each NFT is assigned a unique identifier directly linked to one blockchain address, and the owner of each NFT is simply the blockchain address where each NFT resides.

Because an NFT is only a token on a blockchain that links to an underlying asset, the owner or possessor of the NFT does not automatically have intellectual property rights in the underlying asset.[70] Without the necessary rights to sell the underlying asset, anyone minting or more accurately, creating, NFTs may face infringement complaints from the copyright owner. Many companies in the NFT business are aware of the legal perils and are taking steps to address issues related to intellectual property rights.[71]

As has been publicized by technologists and in the popular press: "With NFTs, the thing you've bought does not tend to give you ownership of the underlying item (image, game asset, etc.) in any way you would normally transfer physical or digital art."[72] Rather, NFTs contain links to an asset hosted elsewhere and they do not convey ownership of the copyright, storage, or usage rights to the asset itself. As explained by software programmer Molly White, when someone buys an NFT, "[t]hey've paid to have their wallet address etched into a database alongside a pointer to something."[73]

Because it is technically possible for anyone to make an NFT of any image even if he or she doesn't own the copyright for the image, there have been numerous instances of "counterfeit" NFTs trading on secondary platforms like OpenSea. In December 2022, researchers from the online art community, DevianArt, found approximately 25,000 digital

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[69] The Rise and Fall of NFTs – Forbes Advisor Australia

[70] Archer, Christopher C. and Anastasia Dergacheva. "NFTs: Key Considerations for Rights Clearance." *Morgan Lewis*, 10 Feb. 2022, https://www.morganlewis.com/blogs/sourcingatmorganlewis/2022/02/nfts-key-considerations-for-rights-clearance. And

[71] "Yuga Labs acquires CryptoPunks and Meebits and gives commercial rights to the community." *Yuga Labs*, 11 Mar. 2022, https://mirror.xyz/0xEc9f53fA69682833FBd760C104B5D61aE29221E0/Km81y6Mc3O5LzS0wnrghVIV0HnZgLOd4wsnfcGw3_2I.

[72] NFTs Don't Work the Way You Might Think They Do | WIRED

[73] Id.

images that had been turned into NFTs and sold without the permission of the original artists.[74]

In June 2022, the U.S. Attorney's Office for the Southern District of New York brought charges in the first ever case of alleged insider trading in NFTs.[75] A former employee at OpenSea traded NFTs that he allegedly knew would soon be featured on OpenSea's homepage, and thus appreciate in value.

Some NFTs could be considered "securities" subject to SEC regulations. Specifically, an NFT could be classified as a security if it meets *Howey's* definition of investment contract. In May 2021, NBA Top Shot creator Dapper Labs was sued for allegedly selling its NFTs as unregistered securities.[76] NBA Top Shot is a basketball collectibles platform that allows users to buy, sell, and trade video highlights, called Moments, as NFTs. At issue in the lawsuit is whether the Top Shot NFT collectibles are investment contracts, and therefore securities. In February 2023, United States District Judge Victor Marrero denied Dapper Labs' motion to dismiss the amended complaint.[77] As noted by Judge Marrero: "When a person purchases a Moment, the owner does not acquire any rights to the basketball highlight depicted by the NFT or the underlying artwork or other intellectual property, and thus does not acquire any rights to exploit the highlight with the express permission of the NBA, NBAPA, and Dapper Labs."[78]

Judge Marrero found "that Plaintiffs' allegations render each consideration under Howey facially plausible." As to the first prong of *Howey*, both parties agreed that there was an investment of money. For the second prong, common enterprise, the Court found that Plaintiffs adequately allege horizontal commonality. For the final *Howey* prong, "a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others," the Court found that "Defendants' public statement and marketing materials objectively led purchasers to expect profits." In June 2024, Dapper Labs settled the lawsuit for $4 million; as part of the settlement, plaintiffs can no longer claim that Top Shot NFTs are securities.

On August 28, 2023, the Securities and Exchange Commission charged, and subsequently settled with, Impact Theory, for conducting an unregistered offering of securities in the form of NFTs.[79] The SEC alleged that the three tiers of NFTs offered and sold by the company, known as KeyNFTs, were unregistered investment contracts, per *Howey*. Impact Theory used the NFT offering proceeds for "development," "bringing on more team," and "creating more projects."[80] The company communicated extensively via Discord to promote their NFTs: "In advance of the Offering, Impact Theory hosted several live speaking events on Discord (a voice, video, and

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[74] OpenSea's NFT Free-for-All - WSJ
[75] "Former Employee Of NFT Marketplace Charged In First Ever Digital Asset Insider Trading Scheme." *Department of Justice, U.S. Attorney's Office, Southern District of New York*, 1 June 2022, https://www.justice.gov/usao-sdny/pr/former-employee-nft-marketplace-charged-first-ever-digital-asset-insider-trading-scheme.
[76] Crawley, Jamie. "Dapper Labs Sued on Allegations NBA Top Shot Moments Are Unregistered Securities." *CoinDesk*, 14 Sep. 2021, https://www.coindesk.com/markets/2021/05/14/dapper-labs-sued-on-allegations-nba-top-shot-moments-are-unregistered-securities/.
[77] 2023.02.22 Dapper MTD Order.pdf (dropbox.com)
[78] friel-v-dapper-labs-inc.pdf (skadden.com)
[79] Impact Theory, LLC (sec.gov)
[80] Id.

text communication service), [and] posted recordings of those events on the company's Discord channels for the public to view."[81]

The SEC also relied on statements made by KeyNFT investors on the company's discord channel to demonstrate that purchasers expected a return on their investment: "Given these statements, numerous prospective and actual purchasers of KeyNFTs stated on Impact Theory's Discord channels that they viewed KeyNFTs as investments into the company and understood Impact Theory's statements to mean that the company's development of its projects could translate to appreciation of the KeyNFTs' value over time."[82]

In September 2023, the SEC charged, and settled with, Stoner Cats 2 LLC (SC2) for conducting an unregistered offering of securities in the form of NFTs called Stoner Cats.[83] The proceeds from the sale of Stoner Cat NFTs were used to build an animated web series. In their order, the SEC highlighted several aspects of the Stoner Cats offering that revealed "[I]nvestors in Stoner Cats NFTs had a reasonable expectation of obtaining a profit based on SC2's [the issuer] managerial and entrepreneurial efforts."

1. There was a secondary market for Stoner Cats holders to trade and profit off their NFTs.
2. The SEC also points to the fact that Stoner Cats NFT "owners" did not actually control the intellectual property associated with Stoner Cats.
3. Secondary market re-sales of Stoner Cats generated royalties for the original issuer (SC2).
4. SC2 used social media to promote the profit potential of Stoner Cats NFTs.

Last month, Miami federal court judge Federico Moreno denied, in part, Shaquille O'Neal's motion to dismiss in a class action lawsuit that alleges O'Neal and Astrals LLC engaged in the offer and sale of unregistered securities in the form of Astrals NFTs and the related Galaxy token.[84] Judge Moreno applied the elements of *Howey* to the Astrals NFTs and concluded that "plaintiffs have plausibly alleged that they were led to reasonably expect profits from the Astrals purchases."[85]

In the press release announcing the charges against Stoner Cats 2 LLC (SC2), Gurbir S. Grewal, Director of the SEC's Division of Enforcement, stated:

> *"Regardless of whether your offering involves beavers, chinchillas or animal-based NFTs, under the federal securities laws, it's the economic reality of the offering – not the labels you put on it or the underlying objects – that guides the determination of what's an investment contract and therefore a security."*[86]

[81] Id
[82] Id
[83] https://www.sec.gov/litigation/admin/2023/33-11233.pdf
[84] Order on Motion to Dismiss for Failure to State a Claim – #91 in Harper v. O'neal (S.D. Fla., 1:23-cv-21912) – CourtListener.com
[85] Id.
[86] SEC.gov | SEC Charges Creator of Stoner Cats Web Series for Unregistered Offering of NFTs

While most NFTs are likely digital collectibles that do not meet all elements of *Howey*, the above examples reveal that there are clearly *some* NFTs that are investment contracts. Like the recent approach taken by the SEC with respect to fungible tokens (cryptocurrencies), the OpenSea Wells Notice suggests that the Commission may now be focusing its efforts on the large platforms where NFTs are bought and sold.

III. Exchange Traded Products

Another case that the crypto industry likes to tout as evidence of the SEC's crypto overreach is Grayscale v. SEC, whereby the D.C. Circuit ruled that the Commission's decision to deny the listing of Grayscale's proposed Bitcoin exchange traded product (ETP) was arbitrary and capricious.[87] The ruling paved the way for the listing of 11 spot Bitcoin ETPs in January 2024.[88] However, the D.C. Circuit's ruling was based on principles of administrative law, not securities law. The Court agreed with Grayscale's claim that the SEC failed to treat "like cases alike by denying the listing of Grayscale's proposed bitcoin ETP and approving two bitcoin futures ETPs."[89] An important element of this ruling that has received little attention is that it is the CFTC who put the SEC in the position of having to treat "like cases alike."

On Friday, December 1, 2017, the Chicago Mercantile Exchange Inc. ("CME") and the CBOE Futures Exchange ("CFE") self-certified new contracts for cash-settled Bitcoin futures products.[90] The self-certification process allows designated contract markets ("DCMs") to list new derivative products one day after submitting in writing to the Commodity Futures Trading Commission ("CFTC") that the product complies with the Commodity Exchange Act ("CEA") and CFTC regulations.[91] Self-certification requires the listing exchange to verify the new contract is not readily susceptible to manipulation and there was ample evidence at the time, ignored by the CFTC, that Bitcoin, and therefore, Bitcoin futures, could be manipulated.[92] The CFTC subsequently acknowledged the problem when it filed a civil complaint in 2022 against the cryptocurrency exchange Gemini "for making false or misleading statements of material facts or omitting to state material facts to the CFTC in connection with the self-certification of a bitcoin futures product."[93] The complaint alleges that in the months leading up to the self-certification of the CFE cash-settled Bitcoin futures contract in December 2017, Gemini engaged in a systematic effort to deceive the CFTC about the trading volume on the Gemini exchange and in the Gemini Bitcoin Auction. The trading volume on Gemini had direct bearing on whether CFE's Bitcoin futures contract could be manipulated because the contract settled based upon the price of Bitcoin from the Gemini Bitcoin Auction.

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[87] 22-1142-2023-08-29.pdf (justia.com)
[88] SEC Approves Bitcoin Exchange-Traded Products (ETPs) (congress.gov)
[89] 22-1142-2023-08-29.pdf (justia.com)
[90] Also, on December 1, 2017, the Cantor Exchange self-certified a new contract for bitcoin binary options. *See* U.S. COMMODITY FUTURES TRADING COMM'N, CFTC BACKGROUNDER ON SELF-CERTIFIED CONTRACTS FOR BITCOIN PRODUCTS (2017), https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/bitcoin_factsheet120117.pdf.
[91] 17 C.F.R. § 40.2 (2018).
[92] I detailed my concerns in a law review article, https://scholarship.law.unc.edu/ncbi/vol23/iss1/8/
[93] https://www.cftc.gov/PressRoom/PressReleases/8540-22

Shortly before the listing of Bitcoin futures contracts in 2017, the SEC rejected an initial application to list a spot Bitcoin ETP.[94] The Commission's disapproval was premised on its funding that the proposal did not comply with the Securities Exchange Act's Section 6(b)(5), which, among other requirements, stipulates that the rules of a national securities exchange be designed "to prevent fraudulent and manipulative acts and practices" and "to protect investors and the public interest."[95] The SEC's main concern was that because the asset underlying the proposed ETPs was unregulated and traded on unregulated platforms, a spot Bitcoin ETP could be easily manipulated.

After Bitcoin futures came to market in December 2017, the SEC received a flood of new ETP applications that all proposed to track the price of Bitcoin futures. The issuers and exchanges behind these new applications argued that because Bitcoin futures were regulated by the CFTC and traded on regulated futures exchanges, the SEC can feel comfortable that an ETP tracking the price of Bitcoin futures cannot be manipulated. The SEC eventually agreed, and in 2022, "two bitcoin *futures* ETPs were approved by the SEC and, for both products, the applicable listing exchange had a surveillance sharing agreement with the Chicago Mercantile Exchange ("CME") that allayed the SEC's antifraud concerns."[96] However, the Commission continued to deny the approval of spot-Bitcoin ETPs until the DC Circuit ruled that it was arbitrary and capricious to approve an ETP tracking Bitcoin futures but deny an ETP tracking spot Bitcoin.

When the Commission eventually approved the listing and trading of spot Bitcoin ETPs in January, Chair Gensler issued a begrudging statement implying that the only reason the Commission was doing so was because of the DC Circuit's ruling. He further attempted to warn investors that further crypto-related ETPs would not be forthcoming by stating that, "today's Commission action is cabined to ETPs holding one non-security commodity, bitcoin," and that it "should in no way signal the Commission's willingness to approve listing standards for crypto asset securities."[97] However, several months later, the Commission approved eight Ethereum ETPs for listing and trading on SEC-regulated exchanges.[98] Chair Gensler did not provide a detailed explanation for the Commission's decision, but the threat of litigation likely played a role, as the Commission had already approved Ether futures ETPs. Furthermore, the SEC approved the applications under the rules for commodity-based trust shares, which implies the Commission considers Ether a commodity and not a security.

The SEC's approval of Bitcoin and Ether ETPs is the biggest development in the crypto industry since FTX's collapse. Bitcoin ETPs have total assets under management of $61.01 billion – BlackRock's IBIT being the biggest beneficiary of this demand – making them the fastest-growing ETPs or ETFs in the history of such products.[99] In many ways, the demand for crypto ETPs is an indictment of spot cryptocurrency and the platforms that facilitate spot crypto

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[94] https://sites.law.duke.edu/thefinregblog/2018/01/12/sec-stands-firm-against-new-bitcoin-etf-proposals/

[95] 15 U.S.C. § 78f(b)(5) (2009).

[96] SEC approves Spot Bitcoin ETP, opening new pathway to Bitcoin investment - A&O Shearman (aoshearman.com)

[97] SEC.gov | Statement on the Approval of Spot Bitcoin Exchange-Traded Products

[98] SEC Approves Spot Ether ETFs | Troutman Pepper

[99] https://www.etf.com/topics/spot-bitcoin, and Bitcoin ETF blowout wows even BlackRock's Larry Fink | Fox Business and Bitcoin ETF blowout wows even BlackRock's Larry Fink | Fox Business

trading. This is because unlike other Commodity ETPs, where it is unfeasible or undesirable for an investor to acquire the underlying – most investors don't want to hold on to corn, gold, wheat, oil and so on – it is easy for investors to acquire and store Bitcoin or Ether because they are digital assets. There are dozens of online exchanges where investors can acquire these tokens in exchange for fiat currency and many of these exchanges will also custody investors' crypto as well. Investors can also store their crypto in a digital wallet or choose to keep their private key offline. Given this critical difference between crypto and other commodities that underlie ETPs, it is fair to wonder why a Bitcoin or Ether ETP is even needed. The truth is that they serve no economic purpose other than to provide a means to speculate on the price of Bitcoin or Ether without having to acquire actual Bitcoin or Ether.

Approving the listing of Bitcoin and Ether ETPs was a mistake, and I believe the SEC had sufficient legal grounds to deny the listing applications. Rather than detail the technical reasons why, I will simply point to Commissioner Caroline Crenshaw's dissent on proposed rule changes to list and trade Bitcoin ETPs and note that I agree with all of her arguments.[100] The nonprofit Better Markets was rightly critical of the SEC after they approved the listing of spot Ether ETPs.[101] They highlighted that the SEC's decision came one week after "the Department of Justice charged two brothers with exploiting the integrity of the Ethereum blockchain to fraudulently obtain $25 million worth of cryptocurrency in 12 seconds," which suggests the Ethereum blockchain has "features that make it make it vulnerable to fraud and manipulation."[102]

While the collapse of FTX and the subsequent crypto winter did not spill into the broader financial statement, that outcome was not preordained. In October 2022, the Financial Stability Oversight Council warned:

> *"Crypto-asset activities could pose risks to the stability of the U.S. financial system if their interconnections with the traditional financial system or their overall scale were to grow without adherence to or being paired with appropriate regulation, including enforcement of the existing regulatory structure."*[103]

The current global crypto market cap of ~$2 trillion is larger than the value of subprime mortgages in the U.S. in March 2007 ($1.3 trillion), and we have never had "appropriate regulation."[104] And with the launch of Bitcoin and Ether ETPs, the SEC has built a superhighway connecting the traditional financial system with the crypto economy - regulatory filings revealed that Goldman Sachs and Morgan Stanley purchased a total of more than $600 million in spot Bitcoin ETPs during the second quarter of 2024 – such that a problem in one can easily spill into the other. [105]

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[100] https://www.sec.gov/newsroom/speeches-statements/crenshaw-statement-spot-bitcoin-011023
[101] The SEC Endangers Investors by Approving Spot Ether ETPs | Better Markets
[102] Id
[103] Financial Stability Oversight Council, *Report on Digital Asset Financial Stability Risks and Regulation 2022* (Washington, D.C.: Financial Stability Oversight Council, 2022) https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf.
[104] Associated Press, "Will Subprime Mess Ripple through Economy?" *NBC News,* March 13, 2007, https://www.nbcnews.com/id/wbna17584725.
[105] Goldman Sachs, Morgan Stanley took stakes in US spot bitcoin ETFs in Q2, filings show (yahoo.com)

Policymakers and market participants have already identified potential points of failure. On September 03, 2024, the FBI issued a public service announcement warning:

> *"North Korean malicious cyber actors conducted research on a variety of targets connected to cryptocurrency exchange-traded funds (ETFs) over the last several months. This research included pre-operational preparations suggesting North Korean actors may attempt malicious cyber activities against companies associated with cryptocurrency ETFs or other cryptocurrency-related financial products."*[106]

This announcement has renewed concerns[107] about the role of Coinbase, who is the custodian of choice for eight of the eleven spot Bitcoin ETPs[108] and eight of the nine newly approved Ether ETPs.[109] If a bad actor "were to gain access to Coinbase's systems, they could potentially target over 70% of the Bitcoin held in ETFs, posing a significant threat to the market."[110]

Now that the SEC has permitted the listing of two crypto ETPs, it will be harder for them to deny applications to list additional crypto-related ETPs unless a court has found that the cryptocurrency in question is an unregistered security. The intermediaries – issuers, listing exchanges, custodians, and authorized participants – who stand to financially benefit from additional products coming to market have an incentive to demand that the SEC approve an ever-greater variety of crypto ETPs. Just last week, Grayscale announced the creation and launch of Grayscale XRP Trust[111], which has led to speculation that they will eventually seek to convert the Trust to a XRP ETP.[112]

If the industry gets its way, we could soon see hundreds of single token ETPs, inverse token ETPs, leveraged token ETPs, and token index ETPs. All these products would have as an underlying a purely speculative asset that is "wholly unconnected to the productive purpose that defines finance: helping businesses, individuals, and governments raise, save, transmit, and use money for socially and economically useful ends."[113] Just as complex and speculative derivatives played a central role in the 2008 financial crisis by amplifying risk, obscuring true asset values, and spreading financial instability throughout the global economy, so too could crypto ETPs and crypto derivatives in the next crisis.

IV. The Risks of Cryptocurrency Custody and SEC Efforts to Address These Risks

[106] North Korea Aggressively Targeting Crypto Industry with Well-Disguised Social Engineering Attacks (ic3.gov)
[107] https://x.com/EleanorTerrett/status/1831352537670131890
[108] How we keep digital assets safe (coinbase.com)
[109] Coinbase Named As Trusted Partner and Custodian of Eight Ethereum ETFs, Says CEO Brian Armstrong - The Daily Hodl
[110] https://medium.com/@BlockchainLycan/coinbase-the-leading-custodian-for-bitcoin-amid-security-concerns-730a0dc69018
[111] Grayscale Investments® Launches Grayscale® XRP Trust (globenewswire.com)
[112] Ripple's XRP Rises 8% on Grayscale Trust News (coindesk.com)
[113] Todd H. Baker, "Let's Stop Treating Crypto Trading as If It Were Finance," *The CLS Blue Sky Blog*, November 29, 2022, https://clsbluesky.law.columbia.edu/2022/11/29/lets-stop-treating-crypto-as-if-it-were-finance/.

a. Overview

Blockchain technology's unique attributes compelled the SEC and other regulatory agencies to issue new guidance and, in some case, new rules and regulations designed to address the novel risks present in the use of blockchain by regulated entities and in regulated markets. Some examples are SEC Staff Accounting Bulletin 121,[114] the SEC's Special Purpose Broker-Dealer (SPBD) release, and the SEC's proposed safeguarding rule. Before diving into more detail on these examples, it is important to understand how custody works on a public blockchain. In what follows, I borrow heavily from Professor Adam Levitin's excellent paper: "Not Your Keys, Not Your Coins: Unpriced Credit Risk in Cryptocurrency."[115] Professor Levitin's paper draws a direct line between how custody operates on a blockchain and the business models of cryptocurrency exchanges, which will help inform my analysis of SAB 121, the SPBD release, and the proposed safeguarding rule.[116]

b. How Custody Works on the Blockchain

Cryptocurrencies such as Bitcoin and Ethereum are purely digital assets. The cryptocurrency exists only as an entry on an append-only distributed ledger called a blockchain that associates a cryptocurrency balance with a network address on the blockchain. The blockchain tracks the association of cryptocurrency with cryptographic keys—an alphanumeric string of characters—rather than who "owns" the keys.

Undertaking a transaction in the cryptocurrency—that is, to change the network address associated with some amount of cryptocurrency on the blockchain—requires a paired public key and a private key (password). These keys are each associated with an address on the blockchain. The public key is a large numerical value used for encrypting the transaction while the private key is a password that is used to verify the authorization of the transaction.

To transfer cryptocurrency into a blockchain address, a transferor must digitally sign the transaction with the private key of the address from which the cryptocurrency is being sent and the public key of the recipient address and broadcast the transaction to the blockchain network. The transaction is verified through a cryptographic hashing process called mining.

Cryptocurrencies vary in how they incentivize network participants to engage in mining. The key detail here is that without the private key, it is impossible to access cryptocurrency associated with a blockchain address. Thus, if a key is lost, so too is access to the cryptocurrency.

Critically, the private key can be used by anyone who has access to it, not just by its "owner." While the key is the authorization device for transactions on the blockchain, the mining system only checks the validity of the key, not the authorization for the key's use in the transaction. Each cryptocurrency runs on its own blockchain, and each cryptocurrency blockchain address has its own public and private key. Thus, if an individual owns both Bitcoin and Ethereum, the individual

[114] https://www.sec.gov/rules/policy/2020/34-90788.pdf
[115] Not Your Keys, Not Your Coins: Unpriced Credit Risk in Cryptocurrency | Texas Law Review
[116] Professor Levitin graciously granted me permission to quote from his paper without having to footnote it every time.

will have two separate sets of keys because there are two separate blockchains involved, one for each cryptocurrency.

Investors need to keep their private keys somewhere when they are not using them. Investors store their private keys in crypto wallets. While a private key can be written down on paper and stored physically until it needs to be used, cryptocurrency investors generally store their keys in crypto wallets. Crypto wallets are encrypted software programs. Typically, the investor would enter a password in order to unencrypt the private key, which would then be used to authorize a transaction on the blockchain.

There are two types of crypto wallets: unhosted and hosted. An unhosted wallet – also referred to as a "self-hosted" wallet – involves storage of the customer's private keys in some format in the customer's possession. This might be in the form of a non-custodial software wallet such as a wallet app on the investor's phone or computer, a thumb drive, or even a scrap of paper. While an unhosted wallet lets the investor retain possession of the private key, it also poses a risk of loss. If the investor loses the scrap of paper, the thumb drive, or the digital device, the key and thus the access to the cryptocurrency is lost forever. Unhosted wallets are also attractive to "illicit actors due to anonymity, the lack of limits on portability, mobility, transaction speed, and usability."[117] Another risk is that transactions between two unhosted wallets operate fully outside the regulatory perimeter.

In contrast, a hosted or custodial wallet puts the customer's private keys in the custody of a third party, generally a cryptocurrency exchange. With a hosted wallet, the exchange has possession of the private keys, and the customer accesses them using a password or other security protocol provided by the exchange. These security protocols might let a customer who forgot a password still access his private keys. Additionally, if the hosted wallet provider were to lose the keys, it would be liable to the customer.

Unhosted and hosted wallets can either be "hot" or "cold." A cryptocurrency hot wallet is a digital wallet connected to the internet, allowing users to quickly and easily access and transact their cryptocurrency. This type of wallet is convenient for frequent trading and spending but is more vulnerable to cyberattacks and hacking due to its online presence. In contrast, a cold wallet is not connected to the internet, storing cryptocurrency offline, typically on a hardware device or a piece of paper. Cold wallets are considered more secure against online threats, making them ideal for long-term storage of large amounts of cryptocurrency, although they are less convenient for regular transactions. Cryptocurrency exchanges will use a mix of hot and cold wallets, but the exact details are confidential due to security concerns.

Cryptocurrency investors use hosted wallets for several reasons: concerns about losing their own unhosted wallets; avoiding fees for transferring funds between wallets; the transactional ease offered through hosted wallets that are integrated with an exchange; access to additional income-generating services such as lending and staking ventures that exchanges offer customers with hosted wallets; and greater ease at converting cryptocurrency to fiat currency or vice versa, which

[117] Updated Guidance for a Risk-Based Approach for Virtual Assets and Virtual Asset Service Providers (fatf-gafi.org)

requires a service that can route fiat payments from a bank account or settle them into a bank account, something that is not possible on an unhosted wallet alone.

Cryptocurrency exchanges will generally offer custodial services for hosted wallets for their customers. This means that the customer is giving the private keys—and hence access to the associated cryptocurrency—to the exchange for safekeeping. While the exchange might be contractually limited in what, if anything, it can do with the private keys, the private keys are in the control of the exchange and can only be accessed by the customer using the exchange's security protocols.

Rather than leave each customer's account segregated, exchanges will often transfer the customers' cryptocurrency to one or more omnibus accounts for which it alone holds the private key(s). Using omnibus accounts has several operational benefits for the exchange. Among other things, it lets the exchange keep down mining fees for transactions through bundling and netting. The customer's interest is then tracked solely on the exchange's books and records rather than on the blockchain. The SEC's complaint against Coinbase provides a succinct explanation for how customer traders are handled:

> *"Coinbase requires that customers seeking to buy, sell, or trade through the Coinbase Platform and Prime create an account on coinbase.com and transfer their crypto assets or fiat currency to Coinbase. Once assets are transferred to Coinbase, Coinbase credits the customer account with the corresponding amounts in Coinbase's internal ledger. The Coinbase internal ledger individually tracks each deposit and withdrawal of crypto assets and fiat currency for each customer, but Coinbase otherwise commingles customer funds and crypto assets that are similar in nature."*[118]

Thus, the customers' interests in the cryptocurrency are merely tracked on the exchange's own ledger, not the blockchain. If the customer were to look at his account statement on the exchange, however, the account statement would indicate what is in the exchange's own ledger, not the blockchain, such that without doing an audit of the blockchain, the transfer of the cryptocurrency from the customer's own private key to an omnibus account controlled by the exchange's own private key would not be visible to the customer. This is why some crypto platforms hire independent auditors to conduct what's known as a "proof of reserves," which is simply a review to ensure customer account balances are backed by real cryptocurrency on the blockchain. However, there are severe limitations[119] to using proof of reserves to assess the health of a crypto platform – it ignores a platform's liabilities amongst other problems – and several firms that provided proof of reserves stopped doing so after they came under public and regulatory scrutiny.[120]

The current approach to crypto custody by exchanges poses risks for cryptocurrency investors, as many discovered in the wake of multiple failures in the cryptocurrency industry throughout 2022, FTX being the most notable. Operating this way also puts cryptocurrency exchanges in the role of performing multiple functions that are required to be kept separate in

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[118] https://www.sec.gov/files/litigation/complaints/2023/comp-pr2023-102.pdf at 23
[119] Proof of reserves is proof of nothing (coppolacomment.com)
[120] Accounting firms aim to replace 'dangerous' Proof of Reserves approach used by crypto giants – DL News

traditional securities markets. Cryptocurrency exchanges frequently serve as the broker, the dealer, the exchange, the clearing agency, and the custodian; and as discussed previously, the SEC has begun to crack down on this behavior.[121] In addition, large crypto exchanges may also have a venture arm that invests in projects whose tokens end up being listed on the exchange.[122] Combining all these functions within one entity creates enormous conflicts of interest that could lead to customer and investor harm, as we saw most clearly in the FTX collapse.

Cryptocurrency exchanges operating in the US, including the former FTX.US, claim that they only list digital assets that are commodities, not securities. The Commodity Futures Trading Commission (CFTC) regulates commodity derivatives markets, but they do not have the legal authority to regulate commodity spot (cash) markets (this is why FTX.us did not offer derivatives products but the main FTX.com exchange out of the Bahamas did). Thus, there is no federal regulation of cryptocurrency exchanges other than for anti-money laundering purposes.

Nor is there any sort of Federal Deposit Insurance Corporation or Securities Investor Protection Corporation insurance to protect cryptocurrency exchange customers. Likewise, there is no specialized regime for resolving failed cryptocurrency exchanges. Accordingly, there is no statutory prioritization of the claims of exchanges' customers, unlike those of depositors in bank insolvencies. This has resulted in millions of customers of failed cryptocurrency exchanges becoming unsecured creditors in the bankruptcy process. Customers who held one Bitcoin on FTX when it collapsed thought they would get one Bitcoin back from the estate. Instead, customers are being treated as unsecured creditors, meaning they will receive $16,871 for each Bitcoin they held on FTX, which was the price as of Nov. 11, 2022 (the day FTX filed for bankruptcy). Considering that Bitcoin is currently trading at ~ $60,000, customers will miss out on gains of roughly $43,000.[123]

c. SEC Staff Accounting Bulletin 121

The unique risks involved in crypto custody prompted SEC staff in the Division of Corporation Finance and the Office of the Chief Accountant to release SAB 121 in 2022.[124] The bulletin acknowledges that these risks are "not present in arrangements to safeguard assets that are not crypto-assets, including technological, legal, and regulatory risks and uncertainties." The staff elaborates on each of these:

- **"Technological risks** – there are risks with respect to both safeguarding of assets and rapidly-changing crypto-assets in the market that are not present with other arrangements to safeguard assets for third parties;"
- **"Legal risks** – due to the unique characteristics of the assets and the lack of legal precedent, there are significant legal questions surrounding how such arrangements would

[121] *See* SEC v Coinbase, SEC v Binance, SEC v Kraken.
[122] See Coinbase CEO downplays VC arm's role in token listing, clarifies 'not a lawyer' - CoinGeek and Coinbase caught listing 8 crypto tokens without disclosing its investment (protos.com)
[123] FTX Customers Fight for What's Left of Their Crypto - WSJ
[124] SEC.gov | Staff Accounting Bulletin No. 121

be treated in a court proceeding arising from an adverse event (e.g., fraud, loss, theft, or bankruptcy); and"

- **"Regulatory risks** – as compared to many common arrangements to safeguard assets for third parties, there are significantly fewer regulatory requirements for holding crypto-assets for platform users or entities may not be complying with regulatory requirements that do apply, which results in increased risks to investors in these entities."[125]

The staff believe these risks are significant enough that it warrants requiring SEC registrants that maintain "the cryptographic key information necessary to access the crypto-assets" of its customers to present a liability on its balance sheet to reflect its obligation to safeguard the crypto-assets held for its platform users" and that "it would be appropriate for [the firm] to recognize an asset at the same time that it recognizes the safeguarding liability, measured at initial recognition and each reporting date at the fair value of the crypto-assets held for its platform users."

SAB 121 makes it clear that the staff's intention is to provide investors and other users of financial statements with the information necessary to make an informed "capital allocation" decision, and in the staff's opinion, the risks posed by providing custodial services for crypto assets are so severe that disclosure is a necessary remedy. I agree. However, by forcing firms to reflect crypto assets held in custody on their balance sheet, SAB 121 disincentivizes insured depository institutions from providing crypto asset custody because they would have to hold capital against such activity. Typically, assets under custody are not included on a custodian's balance sheet since they belong to the customers.

SAB 121 is one of the few issues that unites the crypto and banking industries. After the Government Accountability Office (GAO) issued an opinion that found SAB 121 met the Congressional Review Act's (CRA) definition of a rule and should have been submitted to Congress,[126] members of the House and Senate submitted a joint resolution of disapproval to nullify the rule. The resolution passed in both chambers but was vetoed by President Biden on May 31, 2024.[127] In his signing statement, the President noted that reversing "the considered judgment of SEC staff" "risks undercutting the SEC's broader authorities regarding accounting practices."[128]

I agree with President Biden's veto, but this issue should never have come to his desk. As long as cryptocurrency is legal in the U.S., these assets need to be custodied somewhere (most investors do not want to self-custody their crypto). From an investor protection standpoint, federally regulated banks are arguably the safest place for investors to keep their crypto. The danger in letting banks provide crypto custody is that it may open the door for banks to engage in additional crypto-asset activities that may threaten their safety and soundness and, potentially, financial stability. This is not a hypothetical risk. Last year, "three banks that engaged in crypto activities—

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[125] Id.
[126] Securities and Exchange Commission—Applicability of the Congressional Review Act to Staff Accounting Bulletin No. 121 | U.S. GAO
[127] A Message to the House of Representatives on the President's Veto of H.J.Res. 109 | The White House
[128] Id.

Silvergate Bank, SVB, and Signature—all experienced runs and had to be placed into voluntary liquidation or receivership."[129]

The federal banking agencies have broad discretion to limit bank activities that cannot be conducted in a safe and sound manner, and under the Biden administration, the agencies issued several interpretive letters that require banks to first inform their regulator before engaging in crypto asset activities and a joint statement that suggests banks are not permitted to hold crypto-assets on their balance sheet.[130] There is still room for the banking agencies to limit the scope of bank-permissible activities, but crypto asset custody should be kept in scope. Accordingly, I encourage the SEC to revisit SAB 121 and assess if there are other ways to accomplish their goal of informing investors about the risks associated with a firm's crypto asset custodial activities without having this activity reflected on the balance sheet. One possibility is to require disclosure in a footnote to the financial statements. I am heartened by recent reports that SEC accounting staff are working with firms to address the risks associated with crypto custody and granting exemptions to SAB 121 in limited circumstances, but this process should be more transparent and conducted subject to formal guidance put forward by the Commission.[131]

d. Special Purpose Broker Dealer Release

As the crypto market grew in size, SEC registered broker-dealers began to raise "questions concerning the application of the federal securities laws and the rules of the Financial Industry Regulatory Authority ("FINRA") to the potential intermediation—including custody—of digital asset securities and transactions."[132] The SEC and FINRA first attempted to provide clarity to these market participants in 2019 with the "Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities," also known as the "Four Step Process."[133] The statement reiterates that an "entity that buys, sells, or otherwise transacts or is involved in effecting transactions in digital asset securities for customers or its own account is subject to the federal securities laws, and may be required to register with the Commission as a broker-dealer" and become a member of FINRA. And if the entity is a broker-dealer, "it must comply with broker-dealer financial responsibility rules, including, as applicable, custodial requirements under Rule 15c3-3 under the Securities Exchange Act of 1934 (the "Exchange Act"), which is known as the Customer Protection Rule." Importantly, the Joint Staff Statement did not preclude registered broker-dealers from providing custody for "digital asset securities" provided they can comply with all elements of the Customer Protection Rule, and it also noted that registered broker-dealers operating alternative trading systems (ATSs) that do not at any time exercise any level of control over the digital asset securities being sold or the cash being used to make the purchase are exempt from the Customer Protection Rule.

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[129] RI_Banking-Unfinished-Business-Financial-Reform_Brief_082024.pdf (rooseveltinstitute.org)

[130] Joint Statement on Crypto-Asset Risks to Banking Organizations, Bd. Of Govs. Of the Fed. Rsrv. Sys., Fed. Deposit Ins. Corp, Off. Of the Comptroller of the Currency, (January 3, 2023), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf. Last Accessed January 16, 2023, see also Reiners, Lee and Gazi, Sangita, Wanted: A Prudential Framework for Crypto-Assets (January 17, 2023). Arkansas Law Review, Available at SSRN: https://scholarworks.uark.edu/alr/vol76/iss2/6/

[131] SEC Surprisingly Details Exemptions From SAB 121, Further Muddying the Waters - Unchained (unchainedcrypto.com)

[132] SEC.gov | Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities

[133] Id.

The Customer Protection Rule requires broker-dealers to safeguard customer assets and to keep customer assets separate from the firm's assets, thus increasing the likelihood that customers' securities and cash can be returned to them in the event of the broker-dealer's failure. The Joint Staff Statement acknowledges that crypto's unique risks may make complying with the Customer Protection Rule difficult: "the manner in which digital asset securities are issued, held, and transferred may create greater risk that a broker-dealer maintaining custody of them could be victimized by fraud or theft, could lose a "private key" necessary to transfer a client's digital asset securities, or could transfer a client's digital asset securities to an unknown or unintended address without meaningful recourse to invalidate fraudulent transactions, recover or replace lost property, or correct errors"[134] The Statement also acknowledges that just because a broker-dealer (or its third party custodian) maintains the private key does not mean that "no other party has a copy of the private key and could transfer the digital asset security without the broker-dealer's consent."

On December 23, 2020 the SEC released "Custody of Digital Asset Securities by Special Purpose Broker-Dealers" to "encourage innovation around the application of the Customer Protection Rule to digital asset securities."[135] The SPBD release makes clear that its intention is to ensure that broker-dealers performing the full set of broker-dealer functions with respect to digital asset securities – including maintaining custody of these assets – do so "in a manner that addresses the unique attributes of digital asset securities and minimizes risk to investors and other market participants."[136] According to the release, these "unique attributes" necessitate requiring a broker-dealer engaged in digital asset securities activity to limit "its business to digital asset securities to isolate risk" and to have "policies and procedures to, among other things, assess a given digital asset security's distributed ledger technology and protect the private keys necessary to transfer the digital asset security."[137]

The SPBD release acknowledges that it "may not be possible for a broker-dealer to establish control over a digital asset security with the same control mechanisms used in connection with traditional securities" and that the "manner in which digital assets, including digital asset securities, are issued, held, or transferred may create greater risk that a broker-dealer maintaining custody of this type of asset, as well as the broker-dealer's customers, counterparties, and other creditors, could suffer financial harm." These risks include the possibility that the "broker-dealer could be victimized by fraud or theft, could lose a "private key" necessary to transfer a client's digital assets, or could transfer a client's digital assets to an unintended address without the ability to reverse a fraudulent or mistaken transaction."

The SPBD release states that "a broker-dealer that maintains custody of a fully paid or excess margin digital asset security for a customer must hold it in a manner that complies with Rule 15c3-3, including that the digital asset security must be in the exclusive physical possession or control of the broker dealer." The release also clarifies that a SPBD must limit its business to "dealing in, effecting transactions in, maintaining custody of, and/or operating an alternative trading system

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[134] Id.
[135] Commission Statement and Request for Comment: Custody of Digital Asset Securities by Special Purpose Broker-Dealers
[136] Id.
[137] Id.

for digital asset securities" in order "to shield traditional securities customers, counterparties, and market participants from the risks and consequences of digital asset security fraud, theft, or loss."

In May 2023, Prometheum Capital was approved as the first special purpose broker-dealer ("SPBD"), making it the first SEC registered custodian for digital asset securities under the federal securities laws.[138] In December 2023, FINRA approved the company to offer clearing and settlement services in addition to custody services.[139] Prometheum's parent company, Prometheum Inc., also owns Prometheum ATS, a broker-dealer and SEC registered ATS. Combined, these entities will allow Prometheum to provide a regulated framework for the trading, clearance, settlement, and custody of digital asset securities.

On September 10, 2024, tZERO announced that they were the second entity to obtain a special purpose broker dealer license.[140] The company's press release noted that now, compliant digital security issuers "can fully utilize the power of transformational blockchain infrastructure and engage with tZERO as a one-stop shop for digital asset security issuance and a range of compliant secondary trading modalities, including continuous automated trading, auctions and block trades for a range of private assets."[141] The company goes on to state that receiving the SPBD license advances their "long-standing position that many digital assets in the market constitute securities under existing legal frameworks and require fully-developed infrastructure, including broker-dealer led custody, to effectively exist and migrate into a regulated securities environment."[142]

On September 11, 2024, Prometheum Capital officially launched its custody platform for institutional investors, and they now provide custodial services for Optimism (OP), The Graph (GRT), Ethereum (ETH), Uniswap (UNI), and Arbitrum (ARB).[143] There has been wild speculation that the SEC granted a SPBD license to Prometheum Capital in order to "obstruct congressional efforts towards legislation."[144] These rumors are unfounded and appear politically motivated.[145] Prometheum and tZERO's ability to meet the rigorous application requirements to obtain a SPBD license proves that it is possible for crypto intermediaries to follow the federal securities laws and points the way for a compliant path forward for crypto in the United States.[146]

e. Safeguarding Advisory Client Assets Proposal

[138] Crypto Firm Prometheum Capital Gets Special Purpose Broker Dealer With SEC - Bloomberg
[139] Prometheum Receives FINRA Approval for Expanded Crypto Services - Unchained (unchainedcrypto.com)
[140] tZERO Receives Landmark Approval To Custody Digital Securities and Support End-to-End Digital Securities Lifecycle in the United States (prnewswire.com)
[141] Id
[142] Id
[143] Prometheum Capital Launches its Custody Platform for Digital Asset Securities | Business Wire
[144] Blockchain Association Calls for Investigation into SEC Approval of Prometheum Ember Capital as Special Purpose Broker-Dealer - Blockchain Association (theblockchainassociation.org)
[145] I asked Prometheum's co-CEO, Aaron Kaplan, about this rumor and additional rumors of ties to the Chinese Communist Party on my podcast, The FinReg Pod: https://open.spotify.com/episode/3sAJOtpkmJTFeAEciKFI1J
[146] Prometheum co-CEO, Aaron Kaplan, described the application process in testimony before the House Financial Services Committee last June: Prometheum Hearing Document - 6-11-23 (house.gov)

In February 2023, the SEC proposed new rules and amendments to rule 206(4)-2, the Commission's custody rule, under the Investment Advisers Act of 1940.[147] The Dodd-Frank Act gave the SEC authority to expand the advisers' custody rule to apply to all assets, not just funds or securities, but they had yet to exercise this authority. While the proposal applies to all assets that registered investment advisers custody on behalf of their investors, the text makes it clear that the SEC's primary motivation in updating the safeguarding rule is the emergence of cryptocurrency as an investable asset class.

The proposal expands and enhances the role of qualified custodians when registered investment advisers custody assets on behalf of their investors. The Commission's goal is to ensure that advisers don't inappropriately use, lose, or abuse investors' assets.

The proposed rule retains the definition of a "qualified custodian" but imposes additional conditions on banks and savings associations as well as foreign financial institutions to qualify as "qualified custodians." The proposal reiterates that a qualified custodian must maintain "possession or control" of client assets and requires advisers with custody of a client's crypto assets "to ensure those assets are maintained with a qualified custodian that has possession or control of the assets at all times."

Once again, the SEC acknowledges the unique challenges associated with the custody of crypto assets and provides details on how a qualified custodian of crypto assets can meet the "possession or control" requirements. The proposal states: "while we understand that it is possible for a custodian to implement processes that seek to create exclusive possession or control of crypto assets (e.g., private key creation, maintenance, etc.), it may be difficult actually to demonstrate exclusive possession or control of crypto assets due to their specific characteristics (e.g., being transferable by anyone in possession of a private key)." Thus, the proposal focuses on whether the "the qualified custodian is required to participate in a change in beneficial ownership" of a crypto asset.

The Commission acknowledges that it may be challenging for firms that are currently providing crypto custody services – most of whom are registered as state-chartered trust companies – to comply with the safeguarding rule. This is because "most crypto assets, including crypto asset securities, trade on platforms that are not qualified custodians," and these platforms "require investors to pre-fund trades, a process in which investors transfer their crypto assets, including crypto asset securities, or fiat currency to such an exchange prior to the execution of any trade" so that the platform can directly settle all trades they receive. Given how these crypto platforms operate, the SEC concedes that "an adviser with custody of a crypto asset security" would be "in violation of the current custody rule because custody of the crypto asset security would not be maintained by a qualified custodian from the time the crypto asset security was moved to the trading platform through the settlement of the trade." In a statement accompanying the proposal's release, SEC Chair Gary Gensler said: "Make no mistake: Based upon how crypto platforms generally operate, investment advisers cannot rely on them as qualified custodians."[148]

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[147] SEC.gov | SEC Proposes Enhanced Safeguarding Rule for Registered Investment Advisers
[148] SEC.gov | Statement on Proposed Rules Regarding Investment Adviser Custody

Critics of the proposed safeguarding rule have decried it as an effort to "shadow ban" registered investment advisers from offering their clients crypto assets.[149] And the proposal leaves some doubt as to whether state-chartered trust companies meet the definition of qualified custodian.[150] However, if crypto platforms were to simply register with the SEC as a broker-dealer, which should have already happened given that they are listing investment contracts, then they would meet the definition of qualified custodian.

The SEC reopened the comment period for the safeguarding rule in August 2023 and the rule has yet to be finalized.[151] I encourage the SEC to clarify that state-chartered trust companies do not qualify as qualified custodians. Trust company charters have a natural appeal to crypto exchanges because the "traditional activities of a trust company — holding financial assets on behalf of customers — are analogous to certain of the core activities conducted by cryptocurrency exchanges and providers of digital wallet services."[152] They are also regulated less stringently than other kinds of qualified custodians, such as banks and broker-dealers, because they typically are regulated by just the state regulator who chartered them. State trust companies are also subject to less onerous capital requirements than banks.

Unfortunately, several stated-chartered trust companies engaged in crypto custody have experienced significant problems. In June 2023, Nevada's Financial Institutions Division placed Prime Trust, an uninsured state-chartered crypto trust company, in receivership.[153] In a bankruptcy court filing, the company revealed that it lost access to $45 million worth of crypto locked in its wallet.[154]

The cryptocurrency exchange Gemini is also registered as a trust company in New York, and in October 2023, they were sued by the New York Attorney General for defrauding customers of $1.1 billion as part of its Gemini Earn program.[155] The lawsuit noted that, "Gemini has long sought to differentiate itself from other cryptocurrency companies by claiming to embrace legal regulation and encouraging its customers to place a heightened degree of trust and confidence in Gemini and its products."[156]

Multiple states are now courting the crypto industry by passing favorable legislation that creates entirely new types of charters or makes it easier for crypto firms to obtain a state trust charter.[157] State financial regulators do not have the resources to ensure these novel entities are following all the rules and regulations and not placing customer assets at risk, as Prime Trust and Gemini demonstrate. Therefore, state-chartered trust companies should not meet the definition of qualified custodian in the SEC's final safeguarding rule.

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[149] How the SEC Could Cripple Crypto Venture Capitalists — The Information
[150] SEC Proposal Could Bar Investment Advisers From Keeping Assets at Crypto Firms (coindesk.com)
[151] SEC.gov | SEC Reopens Comment Period for Enhanced Safeguarding Rule for Registered Investment Advisers Proposal
[152] The trust company — an old tool for a new age | Reuters
[153] https://www.coindesk.com/policy/2023/06/27/nevada-places-crypto-custodian-prime-trust-into-receivership/
[154] https://unchainedcrypto.com/prime-trust-lost-8-million-investing-in-terrausd/
[155] Attorney General James Sues Cryptocurrency Companies Gemini, Genesis, and DCG for Defrauding Investors (ny.gov)
[156] nysoag-complaint-against-gemini-et-al.pdf
[157] See States take lead on crypto bank charters and digital asset rules | American Banker

f. Reflecting on the SEC's Efforts

Many within the cryptocurrency sector assert that current securities laws, formulated long before blockchain technology emerged, are ill-suited to the nuances of digital assets. Nevertheless, as previously mentioned, most cryptocurrency transactions in the U.S. do not utilize blockchain. Using advanced technology as a justification for ignoring regulations is a convenient distraction from the truth: the business models of cryptocurrency platforms are fundamentally at odds with federal securities laws. As Professor Hilary Allen testified before this Subcommittee, "it is entirely possible for a blockchain-based technology business to comply with existing investor protection and financial stability regulation."[158] The choice not to comply is primarily an economic one.[159]

Contrary to the assertion that SEC crypto-related enforcement actions and rulemaking amount to a "shadow ban" on the asset class, the Commission has adopted a flexible approach that seeks to bring the cryptocurrency sector within a regulatory framework that safeguards investors from fraud and market manipulation. The Commission has also demonstrated a willingness to allow traditional securities markets intermediaries to engage in digital asset securities activity provided appropriate guardrails are in place that account for the unique risks associated with blockchain and distributed ledger technology. But there is little the SEC can do if cryptocurrency issuers refuse to register their offering with the SEC when it meets the definition of "investment contract." Congress tasked the SEC with enforcing the securities laws, an investment contract is a security under the federal securities laws, and the Supreme Court has defined what an investment contract is. The SEC has little discretion in the matter.

V. FIT21's Fatal Weaknesses

In my written testimony before this Subcommittee last March, I noted that the best way to close the gap in cryptocurrency spot market regulation is to have Congress carve out cryptocurrency from the definition of a commodity in the Commodity Exchange Act and recognize cryptocurrencies as securities under a special definition to the securities laws.[160] This does not mean that the requirements currently applicable to securities issuers and intermediaries must apply to crypto firms on a one-for-one basis. One area for potential compromise is a tailored disclosure regime for cryptocurrencies that qualify as securities. The information a cryptocurrency investor would want in order to make an informed investing decision is different than what an investor in a corporate equity would want. Therefore, I encourage the Commission to use its existing authority to develop tailored disclosures for crypto asset securities.[161]

[158] HJAHFSCTestimony (house.gov)

[159] Owen Lau, an analyst at Oppenheimer & Co. estimates that if Coinbase loses its case vs. the SEC, it "could potentially shave as much as 30% off of its revenue." See, https://www.bloomberg.com/news/articles/2024-09-03/how-coinbase-went-from-dc-kids-table-to-political-power-seat

[160] Hearing Entitled: Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem | Financial Services Committee (house.gov)

[161] Even Chairman Gensler has acknowledged the merit of this idea: *"Given the nature of crypto investments, I recognize that it may be appropriate to be flexible in applying existing disclosure requirements. Tailored disclosures exist elsewhere — for example, asset-backed securities disclosure differs from that for equities".* See, SEC.gov |

I will not elaborate here on my proposal to have Congress grant the SEC exclusive oversight over crypto markets other than to note that even SEC Commissioner Hester Peirce agrees with me that the CFTC is ill-suited to regulate crypto spot markets. In a 2023 speech at the Digital Assets at Duke conference,[162] Commissioner Peirce stated:

> *"Some people within crypto would prefer to see regulatory authority over token disclosures and spot markets given to the Commodity Futures Trading Commission ("CFTC"). The CFTC's retail experience is more limited than the SEC's. Moreover, if the CFTC were given regulatory authority over crypto spot markets, would there soon be calls for the CFTC to regulate other spot markets, such as wheat, oil, and corn markets? Adding crypto to the CFTC's remit also would stretch the small agency's resources."*[163]

The U.S. House of Representatives ignored Commissioner Peirce's advice when it passed the Financial Innovation and Technology for the 21st Century Act (FIT21) on May 22, 2024.[164] The bill gives primary regulatory authority over crypto markets, via a rubber stamp self-certification process, to the CFTC, and guts the *Howey* Test and federal securities laws in the process.

At its core, the bill reflects the belief that many cryptocurrencies evolve over the course of their lifetime, from centralized to decentralized, and that a different regulatory regime should apply once this mystical threshold is passed. When a digital asset is certified as "decentralized," it becomes a digital commodity subject to CFTC jurisdiction.

The bill attempts to define decentralization from a technical and economic perspective. However, decentralization exists along a spectrum, as many in the crypto industry have already acknowledged. In January 2024, the CFTC's Technology Advisory Committee's (TAC) subcommittee on Digital Assets and Blockchain Technology – many subcommittee members work in the crypto industry – released a report on Decentralized Finance that identified five major dimension of decentralization: access, development, governance, finances, and operations.[165] The report found: "Most DeFi systems are not completely decentralized or centralized, but instead fit on a multi-level spectrum of (de)centralization (varying along each of the functional and technical dimensions), creating a challenge in trying to meet certain industry calls for either regulators or industry to coalesce around a particular defined level of decentralization for all business and technology models that would make it "sufficiently decentralized."

Kennedy and Crypto. See also, https://www.theblock.co/post/314246/sec-should-customize-forms-mark-uyeda?utm_source=m6-labs.beehiiv.com&utm_medium=newsletter&utm_campaign=ripple-s-lawyer-slams-sec-wazirx-hacker-moves-6-5m-in-eth

[162] The 2025 conference will be held Feb 5-7, 2025 on Duke's campus: Home - Duke Digital Assets Conference (digitalassetsatduke.org)

[163] https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-duke-conference-012023

[164] https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=409277

[165] Statement of Commissioner Christy Goldsmith Romero on CFTC's Digital Assets and Blockchain Technology Subcommittee Release of Decentralized Finance Report | CFTC

From a technical perspective, the Bill says a blockchain system is decentralized as long as "no person" during the previous 12-month period had the unilateral authority to "control or materially alter the functionality of the blockchain system," or the unilateral authority to restrict any other person's ability to use the blockchain system."[166] The problem with this technical definition of decentralization is that it is nearly impossible to know ex-ante if these conditions are met. There have been several instances in which blockchains have been altered after vulnerabilities were exposed. For example, the Ethereum blockchain was exploited via a smart contract called The DAO in June 2016, which led to a hard fork in the Ethereum blockchain that was publicly supported by the Ethereum Foundation and Ethereum's creator Vitalik Buterin.[167] You could argue that in this example, no one person "unilaterally" forked the Ethereum blockchain, but this points to a flaw in bill's language as being too narrowly construed. In addition, there have been other instances when attackers have gained more than 51% of a blockchain network's computing power and used it rewrite the transaction history.[168]

Furthermore, the bill is wrong to focus on decentralization from the blockchain's perspective instead of the asset or protocol perspective. Blockchain is just the settlement layer, and while each blockchain will have its native token, the majority of cryptocurrencies are smart contracts that leverage a specific blockchain network (ERC-20 is a common token standard for Ethereum smart contracts). For example, the stablecoins USDT (Tether) and USDC (Circle) exist on multiple blockchains, and both entities have the ability to freeze addresses. Other non-stablecoin tokens can similarly be influenced by the issuer or a related party.

The bill defines economic decentralization as: "no digital asset issuer or affiliated person beneficially owned, in the aggregate, 20 percent or more of the total amount of units of such digital asset."[169] The 20% threshold is intentionally high. There have been several examples of venture capital firms controlling less than 20% of governance tokens and still exerting considerable influence over a digital asset.[170] In addition, the bill's definition of "Decentralized System" includes language permitting alterations to the codebase by the issuer and affiliated person for purposes of addressing "vulnerabilities, errors, regular maintenance, cybersecurity risks, or other technical changes to the blockchain system."[171] However, if the issuer maintains the ability to make changes to the codebase, for whatever reason, then clearly the digital asset is not decentralized.

To help digital asset developers reach "decentralization", the bill allows issuers to raise initial funds to build their project through a newly created SEC registration exemption that is significantly more generous than existing registration exemptions and opens the door for significant investor harm. Under Section 301, a new Section 4(a)(8) exemption would be created

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[166] Text - H.R.4763 - 118th Congress (2023-2024): Financial Innovation and Technology for the 21st Century Act | Congress.gov | Library of Congress
[167] The DAO Hack: How a $60M Ethereum Attack Shaped Crypto History (coindesk.com)
[168] Once hailed as unhackable, blockchains are now getting hacked | MIT Technology Review
[169] Text - H.R.4763 - 118th Congress (2023-2024): Financial Innovation and Technology for the 21st Century Act | Congress.gov | Library of Congress
[170] See Crypto VC Firm A16z's Role in Uniswap Vote Sparks Debate Over Concentration of Voting Power (coindesk.com)
[171] Text - H.R.4763 - 118th Congress (2023-2024): Financial Innovation and Technology for the 21st Century Act | Congress.gov | Library of Congress

that allows an issuer of digital assets to raise $75 million per offering – 15 times as much as the equity crowdfunding exemption, and far in excess of the approximately $18.3 million raised in the 2014 Ethereum initial coin offering.[172] Non-accredited investors can purchase digital assets under the exemption provided that their purchases over a 12-month period do not exceed 10% of their income or net worth. Furthermore, "an intermediary or digital asset issuer may rely on a purchaser's representation concerning" their annual income and net worth.

If true decentralization is even possible, it does not take $75 million to achieve. While I do not believe a new exemption should be created, if there is to be one, it should be limited to $5 million, which is the same as the current crowdfunding exemption. In addition, general solicitation should be prohibited, and digital asset issuers should have to demonstrate their plans to achieve decentralization when applying for the exemption.

Once a cryptocurrency is believed to be sufficiently decentralized, the bill would allow "any person" to "certify to the SEC that the blockchain system to which a digital assert relates is a decentralized system." Allowing anyone to make the certification guarantees that the SEC will be inundated with certification requests. And given that the SEC only has 60 days to rebut a certification, it is likely that many digital assets will be certified as decentralized that likely don't meet the definition. Stacking the deck against the "appropriate securities regulation of crypto assets that should fall under the SEC's jurisdiction" all but "guarantees many asset issuers and traders will flood the system seeking registration under the CFTC."[173]

FIT21's self-certification process for classifying a digital asset as decentralized and thus exempt from federal securities laws undermines the very purpose of the *Howey* test, which is to "prevent parties from structuring transactions to evade the securities laws."[174] Not only could this decentralization framework "allow crypto firms to largely continue with dangerous business practices as usual; it could also enable traditional financial firms to evade more robust regulatory oversight by claiming their products and platforms meet this decentralization rubric (e.g. "slap a blockchain on it").[175]

To make matters worse, Title II of FIT21 - Clarity for Assets Offered as Part of an Investment Contract - creates new opportunities for issuers (not just of digital assets) to escape SEC registration requirements by clarifying that "the term 'security' does not include an investment contract asset."[176] The crypto industry has consistently argued that the object of an investment contract is distinct from the investment contract itself (e.g., orange groves are not a security but when packaged with a management contract it constitutes an investment contract). Courts and the SEC have not disputed this assertion; therefore, it is unnecessary to include this language in the bill and doing so invites "non-crypto actors to use this new terminology to evade coverage of the Howey Test for their investment products and activities as well."[177]

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[172] History of Crypto: The ICO Boom and Ethereum's Evolution (cointelegraph.com)
[173] 2HR 4763 (Crypto Markets Bill) Opposition Sign-On Letter.UPDATED.docx (ourfinancialsecurity.org)
[174] Wendy Gerwick Couture, The Risk of Regulator Arbitrage: A Response to Securities Regulation in Virtual Space, 74 Wash. & Lee L. Rev. Online 234, 236 (2018).
[175] https://ourfinancialsecurity.org/2023/06/statement-statement-for-the-record-to-the-house-financial-services-committee-in-response-to-the-hfsc-recent-hearing-on-digital-assets/
[176] BILLS-118hr4763rfs.pdf (congress.gov)
[177] 2HR 4763 (Crypto Markets Bill) Opposition Sign-On Letter.UPDATED.docx (ourfinancialsecurity.org)

While the professed purpose of FIT21 may be to "provide regulatory clarity and robust consumer protections…for the digital asset ecosystem," the bill does neither.[178] I have additional concerns about FIT21, but in the main, the bill was clearly drafted to make current conflict-laden and predatory business models legal. In fact, the bill contains an expansive safe harbor for crypto firms currently being sued by the SEC via a "notice of intent to register" provision. The bill allows for entities that have filed a notice of intent to register as a digital asset trading system, a digital asset broker, a digital asset dealer, a digital commodity exchange, digital commodity broker, or digital commodity dealer to "be exempt from Commission rules and regulations pertaining to registering as a national securities exchange, broker, dealer, or clearing agency, for activities related to a digital asset."[179] In short, should FIT21 become law, the SEC's allegations that Coinbase, Kraken, and Binance are all operating an unregistered securities exchange, broker, dealer, and clearing agency will no longer be ripe. Finally, the bill explicitly excludes decentralized financial activities from its provisions,[180] ensuring that a parallel financial system will be allowed to grow outside the regulatory perimeter and without any investor protection.

VI. Conclusion

I realize that giving the SEC additional authority under its present leadership is unpalatable to some members of this committee. However, SEC chairs come and go. The American people are looking to Congress to exercise foresight in determining how to regulate the crypto industry for the long-term. This requires lawmakers to look at the core competencies at the relevant agencies. The SEC was endowed with a mandate to protect investors, and investor protections are sorely lacking in crypto markets.

I applaud the committee's focus on this crucial task, but it is worth noting that this is not a race. The crypto industry is eagerly pointing to favorable regulatory regimes abroad as an example for U.S. lawmakers to follow, and warning that if the U.S. does not act quickly, new and existing crypto firms will set up shop overseas. However, getting it right is more important than being first. Passing financial regulatory legislation is hard, and once in place, it tends not to change absent some future crisis. Passing FIT21 into law will be a Pyrrhic victory when it fuels a 2008-style financial crisis down the road. I urge you and your colleagues to consider a different path.

[178] House Passes Financial Innovation and Technology for the 21st Century Act with Overwhelming Bipartisan Support | Financial Services Committee

[179] BILLS-118hr4763rfs.pdf (congress.gov)

[180] Sec. 409 and Sec. 509 of FIT21 exempt decentralized finance activities from the Securities Exchange Act of 1934 and the Commodity Exchange Act.