EXAMINING THE CRYPTOCURRENCIES AND ICO MARKETS

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND INVESTMENT

OF THE

COMMITTEE ON FINANCIAL SERVICES

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WEDNESDAY, MARCH 14, 2018

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

EXAMINING THE CRYPTOCURRENCIES AND ICO MARKETS

Wednesday, March 14, 2018

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
SECURITIES, AND INVESTMENT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:06 a.m., in room 2128, Rayburn House Office Building, Hon. Bill Huizenga [chairman of the subcommittee] presiding.

Present: Representatives Huizenga, Hultgren, Stivers, Wagner, Hill, Emmer, MacArthur, Davidson, Budd, Hollingsworth, Maloney, Sherman, Scott, Himes, Ellison, Foster, Sinema, Vargas, and Gottheimer.

Also present: Representative Hensarling.

Chairman HUIZENGA. The committee will come to order. And without objection, the Chair is authorized to declare a recess of the committee at any time. The hearing is entitled "Examining the Cryptocurrencies and ICO Markets."

I now recognize myself for 4 minutes to give an opening statement.

The cryptocurrency and initial coin offering (ICO) markets have grown rapidly in recent years, and actually it is more like recent months. Specifically ICOs have been increasingly used by companies to raise capital for their business and products. To that end, people often equate them with a new type of initial public offering or an IPO; however, an ICO is not an IPO.

ICOs, whether they represent offerings of securities or not, offer potential for entrepreneurs to raise more effective, transformative, and efficient funding for an innovative project as opposed to a traditional IPO.

Although an ICO has the same characteristics of raising capital and accessing new sources of investment, it does not involve an investment in some amount of equity in a company, which is afforded under an IPO, nor does it offer the same amount of investor protections.

The size of the ICO market has grown exponentially in this past year and the Token Report estimates that approximately $6.6 billion was raised in coin offerings. In 2018 alone, just in the first few months, 480 ICOs are estimated to have raised $1.66 billion.

Cryptocurrencies and ICOs provide an innovative vehicle for startups to potentially access capital and grow their businesses. Early investors in some cryptocurrencies have experienced massive

gains, and the ever-increasing number of ICOs has created opportunities for investors to diversify their portfolios in cryptocurrencies.

Since the surge in popularity or crypto craze, there has been considerable attention attracted both by investors seeking to diversify their portfolios and startup enterprises in search of additional access to capital and to grow their businesses.

This is also rightly garnered attention of the regulators. Additional scrutiny has surrounded the cryptocurrency and IPO markets due to the number of fraudulent IPOs that have raised money with no intention of ever providing a product or a return to the ICO purchasers.

A soon to be published MIT study of the ICO market estimates that $270 million to $317 million of the money raised by coin offerings has, quote, "likely gone to fraud or scams," end quote, according to MIT Professor Christian Catalani.

The SEC (U.S. Securities and Exchange Commission) has the authority to bring enforcement actions against ICOs for any violation of the Federal securities laws. As part of this increased scrutiny of the ICOs, the SEC recently announced actions against two virtual currency organizations for engaging in unregistered securities offerings.

Additionally, the SEC suspended trading in three issuers claiming involvement in cryptocurrency and blockchain technology. The Wall Street Journal also recently reported that the SEC has issued, quote, "dozens of subpoenas and information requests to technology companies and advisors involved in ICOs," closed quote, including, quote, "demands for information about the structure for sales and presales of the ICOs," closed quote.

Further, on March 7 of this year, the SEC broadened its series of notice statements to exchange-type activity, warning that online trading platforms may also be violating the Federal securities laws.

According to the statement, "If a platform is providing a mechanism for trading assets that are classified as securities under the Federal securities laws, then the platform is operating as an exchange and must register with the SEC as a national securities exchange."

Today's hearing will examine the economic efficiencies and potential capital formation opportunities that cryptocurrencies and ICOs potentially offer to businesses and investors, and review the adherence to applicable laws so that investors receive the full protections afforded by the Federal securities laws.

Additionally, the hearing will consider the current regulatory approach that regulators such as the SEC are using to monitor and oversee cryptocurrencies and ICOs and how to achieve further regulatory clarity in these markets.

As further action on how to regulate cryptocurrency and ICO markets is considered, it is important that innovation in the area of digital currencies and capital formation are not stifled while ensuring that consumers are protected, fraud is prevented, and securities laws are followed.

The Chair now recognizes the gentleman from Minnesota, Mr. Ellison, for 2–1/2 minutes for an opening statement.

Mr. ELLISON. Mr. Chairman, thank you for calling this important hearing today. As important as it is, there are some other things happening that I want to address.

The Senate is voting today to roll back some of the rules for the biggest banks in the country. Think about that for a minute. Just 10 years after big banks crashed the economy, Senate Republicans and some Dems want to roll back the rules that we put in place to prevent the next crash.

My colleagues may have forgotten about how bad the crash was, but I haven't. Millions of people lost their jobs. One in 54 homes was in foreclosure. $2.6 trillion vanished from America's retirement accounts. So why on earth are we going back there? Supporters of the bill say this is just about helping out the small community banks. No, no, not buying it.

Community banks are doing pretty well. We are not saying they don't need some attention, but this is not about them. The FDIC (Federal Deposit Insurance Corporation) says that 96 percent of them are profitable and these profits are higher than ever.

Again, I want to be attentive and responsive to community banks, but this is not about the small banks. The banks that are going to benefit here, these are banks that got close to $50 billion in bailout money during the crisis and banks that can put their name on a football stadium.

Some of these provisions in this bill roll back the rules for the very largest banks like Citigroup and JPMorgan Chase. This bill increases the chance of another crash and the nonpartisan Congressional Budget Office says the bill will increase the likelihood of another bailout.

I am disappointed that the Senate is likely to pass this bill today, and I can promise this committee that I will do everything in my power to stop it when it comes over to the House.

And I yield back. Thank you.

Chairman HUIZENGA. The gentleman yields back.

The gentleman from Illinois, the Vice Chairman of the committee, Mr. Hultgren is recognized for 1 minute.

Mr. HULTGREN. Thanks, Chairman Huizenga. Thank you all for being here.

According to CoinMarketCap.com, there are over 1,500 different cryptocurrencies for capitalization estimated at $350 billion. That is a staggering amount of money.

As this market develops, Congress has a responsibility to ensure that investors are protected without unduly limiting opportunities for growth. Some of our most respected technology companies have expressed at least some uncertainty regarding cryptocurrencies. This is a complicated topic.

For example, Google just announced it is banning ads promoting cryptocurrencies, exchanges, wallets, initial coin offerings, and firms providing advice. Congress needs a strong understanding of the technology and its application before we can understand how it fits into our existing regulations and how the laws we have on the books may encourage or inhibit an efficient market.

For example, do we need clarification of what a cryptocurrency exchange is and if this word implies any investor protections? The SEC staff made this point the other day when noting, and I quote,

"many online trading platforms appear to investors as SEC registered and regulated marketplaces when they are not," end quote.

Similarly, Chairman Clayton has expressed skepticism about no initial coin offerings being registered. There are a lot of questions in this. I think it important that we are having this hearing today.

My time has expired, and I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

The Chair now recognizes the gentleman from California, Mr. Sherman for 2–1/2 minutes.

Mr. SHERMAN. Unfortunately, our colleague, distinguished Ranking Member was unable to be here this morning, and I ask unanimous consent to enter into the record the statement of the gentlelady from New York.

Chairman HUIZENGA. Without objection.

Mr. SHERMAN. Cryptocurrencies are a crock. What social benefit do they provide? They allow a few dozen men in my district to sit in their pajamas on the couch all day and tell their wives they are going to be millionaires.

They help terrorists and criminals move money around the world. They help tax evaders. They help startup companies commit fraud, take the money and 1 percent of the time they actually create a useful business. But then again, I daresay that some tiny percent of all larceny and crime helps finance something that turns out to be useful.

It hurts the U.S. Government in two ways. Our ability to have the dollar be the chief means of international finance is what has underpinned our ability to impose sanctions and stop tax cheating. And furthermore, when we have people take risk we don't encourage gambling. We encourage investment in the real economy.

But when you buy a Bitcoin are you financing a new factory? No. You are gambling on its value for no social benefit. Now, I know that these cryptocurrencies are popular. They are popular with guys who want to sit in their pajamas and tell their wives they are going to be millionaires.

And they are popular with those who have read "Atlas Shrugged" and "Fountainhead" and believe that these are the new canons, the new divinely inspired documents of our age.

But they are harmful and they are harmful in one other way, and that is—and I am going to mispronounce the word, seigniorage is the benefit that the U.S. Government gets by issuing currency. It is the float. It is the fact that we do not pay interest on newly created dollars.

We lose that as well. And the Fed was able to return well over $50 billion to our Treasury in many of the recent years. We undercut that.

And then finally, we have these initial coin offerings deliberately naming themselves to lie to the public and convey the image that it is like an initial public offering. They stole the intellectual property and trademark of legitimate investing and applied it to a fixed fraudulent gambling scheme of no social benefit.

Aside from that, I think it is a good idea. I yield back.

Chairman HUIZENGA. The gentleman yields back.

And gentlemen on our panel, you are in for a lively conversation. No, this is not a Senate hearing about Dodd-Frank reform. You are

in the right place. We are here to talk about cryptocurrencies and blockchain technologies. But we are here to welcome today a great panel.

And Mr. Mike Lempres, who is the Chief Legal and Risk Officer for Coinbase; Dr. Chris Brummer, who is a Professor of Law from Georgetown University Law Center; Mr. Robert Rosenblum, Partner at Wilson Sonsini Goodrich & Rosati; and Peter Van Valkenburgh, Director of Research for Coin Center.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. Having read the testimony, there is far more than 5 minutes of information in each one of yours, so good luck as you consolidate that down.

We will then have a question period and we will without objection put your written testimony into the permanent record and part of the record as well.

So with that, Mr. Lempres, you are recognized for 5 minutes.

STATEMENT OF MIKE LEMPRES

Mr. LEMPRES. Thank you and good morning, Chairman Huizenga, Ranking Member Maloney, and members of the subcommittee. Thank you for the opportunity to address this important topic at a significant time.

My name is Mike Lempres and I am the Chief Legal and Risk Officer at Coinbase, the Nation's leading digital currency exchange and wallet service.

I commend you for holding this hearing on a technology that could transform capital formation, innovation, and our economy. It has tremendous potential.

To fulfill that potential, we believe that responsible regulation is required, but the technology's incredible benefits could also be stifled by regulatory or legal missteps. I am pleased to testify this morning on behalf of Coinbase. We view ourselves a as leader in the legitimatization and maturation of the crypto economy.

We provide an onramp for acquiring, trading, and holding digital currencies. Through our strategy of operating the most trusted and easiest-to-use digital exchange and wallet, we have grown dramatically. We have very strong cybersecurity protections and compliance practices to ensure that we remain the most trusted company in this space.

Our cybersecurity program is state-of-the-art and remains the critical core of our business.

Similarly, our compliance program is designed to build upon the highest levels of compliance in our industry. In addition to our formal regulatory role, Coinbase continuously shares its expertise to make sure that our ecosystem is clean and compliant. We train more law enforcement agencies globally than anyone.

I plan to discuss three items today: The model of the Coinbase exchange; our view on ICOs; and the broader regulatory environment. The Coinbase exchange operates a spot exchange that offers the ability to buy and sell four digital currencies.

We do not offer margin or derivatives trading. There are more than 1,400 currencies and tokens available, and we limit our trading to four that have regulatory clarity: Bitcoin, Ether, Litecoin, and Bitcoin Cash. Part of the reason we trade only those four as-

sets is that each has been determined by regulators to be a virtual currency and therefore we believe not a security.

One of today's questions is how to approach ICOs. Coinbase currently does not trade ICOs or any other security tokens. Despite that, we believe that ICOs are inevitable and full of tremendous potential.

We believe they can unlock the ability of entrepreneurs anywhere in the United States to raise money on a level playing field. Entrepreneurs won't need to know funders in Silicon Valley or New York to access vibrant sources of capital.

At the same time, there is a need for responsible regulation to ensure investor protection. We welcome that regulation.

In order to fully enable ICOs, investors must have confidence in the integrity of the market. For this reason, we support enforcement actions where they are necessary to weed out bad actors and to protect investors.

At the same time, we need to be sure that we are not chilling good innovation brought about by new technology and good actors.

We believe there is no need for Congress to create a new regulator or a new regulatory scheme because Federal regulators already have sufficient authority to oversee this space effectively. There are at least four Federal regulatory agencies that can effectively protect investors and the markets: The SEC, the CFTC (Commodity Futures Trading Commission), FinCEN (Financial Crimes Enforcement Network), and the Federal Trade Commission.

In addition, this Federal regulatory regime exists alongside vibrant State regulations.

With respect to the U.S. regulatory environment, it is important to stress that not all tokens are alike and regulators need to be able to distinguish between various tokens to enable innovation. This requires regulators to coordinate and provide clear guidance to market participants.

For example, some tokens may be a commodity and others a security. The SEC and CFTC should be able to draw a line to determine whether a token should be treated as a commodity or a security for compliance purposes.

The agencies have done this before when new asset classes emerge, for example, in addressing stock indices and swaps. As mentioned in the beginning, we operate the most trusted and easiest-to-use platform to access digital currencies. We believe that trust is enhanced through partnership with regulators.

At Coinbase, we are committed to working with you, the SEC, the CFTC, and other regulators to help shape a responsibly regulated market. We believe the decisions you are making now will help determine the future of innovation and capital formation. That future is not 20 years away. It is almost here today.

Thank you for this opportunity to discuss these issues, and I look forward to answering your questions.

[The prepared statement of Mr. Lempres can be found on page 48 of the appendix.]

Chairman HUIZENGA. Thank you.

With that, we go to Dr. Brummer, who is recognized for 5 minutes.

STATEMENT OF CHRIS BRUMMER

Dr. BRUMMER. Chairman Huizenga, members of the subcommittee thank you so much for inviting me here to testify at this hearing. My name is Chris Brummer and I am the Agnes and Williams Research Professor at Georgetown University Law Center. And I am here today solely in my capacity as an academic and I am not testifying on behalf of any entity.

We are blessed in the United States to have one of the safest, deepest, and most liquid capital markets in the world. One of the reasons for this success is our system of information sharing and dissemination to investors.

The disclosure system embodied in the Securities Act of 1933 is largely one where promoters share among other things material information publicly about the company, the management and the securities being offered, as well as the intended use of the proceeds. This information is then filed with the Securities and Exchange Commission where it is vetted, scrubbed, and analyzed.

Most ICO disclosures, by contrast, are facilitated by unregulated white papers focusing largely on the existing technology or technology under development to be financed via an offering.

There is, as a result, a large gap between the disclosures and many of the registered filings such as an S-1, and the information provided in most white papers. And this raises a number of red flags, to say the least.

For our purposes today, I would like to highlight briefly some of the key disclosures one would expect and likely need in order for buyers of ICO tokens, whether they are investors seeking to profit or technology users seeking to support and participate in an innovative product, in order to make a purchase in an informed manner.

These disclosures are relevant, especially relevant, I believe, as ICOs transition from technical expert ecosystems to the disruption of instruments that are ever more likely to attract everyday investors and the retail public.

Disclosure number one, promoter's location. At least one study has noted that in roughly 32 percent of ICOs, it is not possible to identify the issuing entities' or promoters' origin. This creates serious information asymmetries on the part of the investor.

Without knowing the issuing entities' or promoters' origins it becomes impossible to know or identify what rules and legal protections might be afforded to investors. Further, investors have few means by which to contact relevant public authorities in the case of fraud, theft, or loss.

ICO white papers should therefore set out a detailed statement beyond a simple P.O. Box of where the issuer, as well as its key management, are located.

Disclosure number two, problem in proposed technology solution. For most of the history of U.S. securities laws, no information was more important for investors than an issuer's financial statements. But ICOs tend to serve a different purpose from IPOs of the 1930's.

Instead of funding industrial companies transitioning to a more mature cycle of development, ICOs involve products developed by startups identifying technology-based problems and proposing the sale or financing of technology-based solutions. And in return for

financing, promoters offer coins of varying currency, utility, or securities features.

For most of these offerings, as a rule, is not the company's past performance or even financial statements that is most important. Instead, it is the ventures technology proposition. Consequently, ensuring that investors, including retail buyers, understand the basic contours of the underlying technology solution is paramount as ICOs become a more popular means of fundraising.

To that end, you can envision a number of important reforms. An optimal disclosure system for IPOs would require, to the extent possible, a plain English description of the technology problem and solution.

Furthermore for larger fundraises, more technical parts of the white paper would ideally be subject to a system of third-party validation, what could be termed a technology audit.

And meanwhile, all code, regardless of the size of the fundraise, would be posted to a public code repository such as GitHub so potential buyers can either diligence the code itself or other proxies for the strength of the code.

Promoters should avoid hyperbole when describing their solutions, an endemic problem in many white papers, and should be required to identify an objective basis for all forward-looking statements.

Along these lines, disclosures should be made as to whether post-ICO financial statements will be provided to token holders. A description of the token is also useful.

Promoters should be able to disclose whether or not and how the IPO ownership of the company's protocol, as well as to detail with specificity, what legal rights holders of the tokens will enjoy, as well as how the tokens will be traded and on what system.

They should also be required to provide disclosures for blockchain governance and the basic risk factors impacting not only the token itself but the industry at large. Thank you.

[The prepared statement of Dr. Brummer can be found on page 42 of the appendix.]

Chairman HUIZENGA. Thank you.

Mr. Rosenblum, you are recognized for 5 minutes.

STATEMENT OF ROBERT ROSENBLUM

Mr. ROSENBLUM. Chairman Huizenga, honorable members, first of all, let me thank all of you for holding this hearing. I think it is timely. I think it is very, very important and I think many people in the industry, those who want to get things right, will very much welcome your participation and your interest in the topic. So again, thank you for holding the hearing.

I am a partner at the law firm of Wilson Sonsini Goodrich & Rosati, a Palo Alto law firm that is generally recognized as being a leading advisor to technology firms, to life sciences firms, and the like. I am the head of the firm's blockchain and cryptocurrency practice.

Now, I do need to say that I am appearing here on my own behalf, not on behalf of my law firm, not on behalf of any client. However, thank you for having me anyway.

In our capacity as being among if not the leading tech firm, we obviously handle a great number of initial coin offering and similar transactions. We represent a large number of ICO issuers, we represent a large number of funds that invest in initial coin offerings, we represent a large number of entities, often very sophisticated entities, that are investing in initial coin offerings.

I will give you a quick observation that, about 9 months ago or so, the ICO market really started to become significant in the United States. I was concerned, as some of the comments we have already heard, as to whether there was really a there there.

As I will talk about in a couple of moments, I think there really are some very important things happening in this market and again I think that is why it is so important for this subcommittee to be focusing on these issues.

I actually have two basic proposals or two basic suggestions for this subcommittee: First, I think in the near term, Congress could greatly help the markets, the ICO markets, to facilitate good ICOs and to help guard against fraud.

By authorizing the SEC or by authorizing and encouraging the SEC and other appropriate Federal regulators to both modify and amend their rules to better assist ICO issuers in meeting the requirements of the Federal securities laws.

As Dr. Brummer says, there are already a number of disclosure issues, there are already a number of registration requirements to securities issuers. They don't work well. They are not geared toward ICOs and to tokens and so the SEC can be doing a lot more. Although they are trying very hard, they can do a lot more to amend their rules and modify their rules and I think this committee can help.

I think in the longer term, this committee can lead the way toward having a more unified disclosure approach, registration approach, overall legislative approach to how we handle ICOs and token use in the United States.

Truthfully, I think it is too early to know exactly what the contours of that legislation are going to look like at this point. Again, we are only 9 months in really to ICOs.

The industry is so dynamic and changing so quickly that I think it would be premature at this point to try to actually craft that legislation, but I do think that there are basic principles that can help us inform what that legislation will look like when you are able to get to it.

I think there are three things though that in all of your legislative activities that we should be keeping in mind. One is there is tremendous innovation in the blockchain and cryptocurrency community. And by the way, cryptocurrency is a bit of a misnomer.

There are some tokens, Bitcoin, Ether, for example, that really are cryptocurrencies. There are a number of other tokens, and those are most of those that we will probably be talking about today that have very specific purposes on very specific platforms, designed to do very special things.

Second, there are tremendous capital-raising techniques and I hope during this hearing we will be able to discuss why those capital-raising techniques or opportunities are so significant and potentially so valuable to the U.S. economy.

Third, there is no getting around the fact that there is significant fraud, significant opportunities for market manipulation, significant opportunities for loss of privacy and data breaches. And those need to be part of and considered in any regulatory and legislative response. With that, let me end my remarks and thank you so much.

[The prepared statement of Mr. Rosenblum can be found on page 55 of the appendix.]

Chairman HUIZENGA. Thank you.

Mr. Van Valkenburgh, you are recognized for 5 minutes.

STATEMENT OF PETER VAN VALKENBURGH

Mr. VAN VALKENBURGH. Thank you, Chairman Huizenga and members of the committee. I am Peter Van Valkenburgh, Director of Research at Coin Center, an independent non-profit that is focused on the cryptocurrency public policy space. Today, I will start by describing the fundamental innovation of Bitcoin, then discuss the differences between cryptocurrencies and ICOs, and finally describe the regulatory landscape for these technologies.

The fundamental innovation of Bitcoin is digital scarcity. So in the physical world a thing like gold is scarce because you can hold it in your hand. You can ask a lab to tell you that it is real and when you hand it to somebody else they have it and you don't. But in the digital world, how can we know that a Bitcoin is scarce?

We know that there are only 16.9 million Bitcoins in the world right now because their distribution and movements are described with perfect accuracy on a public ledger called the Bitcoin Blockchain. Anyone can independently read and mathematically authenticate the data in the blockchain just like anyone can independently verify the scarcity of gold.

Now that digital scarcity can then be employed by innovative people for a variety of innovative purposes. A token that is scarce and transferrable from person to person can be used as money just like any other portable and transferable good throughout history from gold to seashells. That, in a nutshell, is Bitcoin.

But a scarce token can also be automatically redeemable for a digital good or computing service provided by the same network of participants who verify the blockchain. And these are projects like Ethereum, Filecoin, and Blockstack and they are beginning to compete with incumbent service providers like Amazon, Facebook, and Google.

A scarce token can also represent a legal agreement or a financial asset. So a public company or investment fund could issue and track its shares as tokens on a blockchain.

Now, these blockchains are just records. Whether they are about money, assets, or computation, but rather than relying on a handful of corporations running vulnerable datacenters to keep the record, a blockchain version of the record relies on an open network of thousands, potentially millions of participants who have skin in the game and independently verify and secure that data.

Those records will always be available until every last participant goes offline. In other words, they will likely always be available.

And those records will be accurate unless every participant has their individual computer hacked. In other words, they will likely always be accurate. It is this revolutionary-decentralized architecture that makes these systems effectively unhackable, at least using traditional methods of attack.

Especially pertinent to today's hearing, these technologies are also employed for capital formation. Scarce tokens like Bitcoin and Ether already exist in the world and they are in use. But other coins and tokens are merely theoretical because the software that will enable them has yet to be designed and built.

Recently, various developers have raised money to fund the development of new blockchain software projects by selling a promise of future tokens to willing investors in so-called initial coin offerings or ICOs.

From a regulatory standpoint, there is a fundamental distinction that must be made between, on the one hand, scarce tokens that exist on a blockchain and are used for payment or to obtain computing services, and, on the other hand, promises of future tokens representing the hopefully profitable efforts of a developer.

The former, things like Bitcoin and Ethereum, they are effectively digital commodities. They are scarce items that may have value on open markets as money, as investments, or as inputs for valuable commercial and industrial processes. They are commodities, just digital.

The latter, promises of future tokens, are securities. Promises from issuers to investors that efforts will be put forward to create profits. Now, both have investor protection risks, but they are distinct risks that are best addressed in different ways. A commodity-like token has no issuers upon whom investors rely.

But the token does trade on speculative commodities markets. Policing these markets for fraud and manipulation is critical for investor protection. A promise of future tokens is a security with an issuer upon whom investors rely. Mandating accurate disclosure from these issuers is, as we have said, critical for investor protection.

So the sensible and emerging investor protection regime is nothing new even though the underlying assets may seem like science fiction. The CFTC should use its existing authority to police commodities, spot markets for fraud and manipulation and the SEC should manage and mandate disclosures from issuers making securities offerings.

But if policymakers get the line between commodity tokens and securities offerings wrong or if it isn't made clear by regulators, it will destroy the viability of these innovations and cede leadership in this technology to the rest of the world. Thank you and I look forward to your questions.

[The prepared statement of Mr. Van Valkenburgh can be found on page 76 of the appendix.]

Chairman HUIZENGA. Thank you, and I appreciate all of your input.

We are going to start with a 5-minute question period for myself. I recognize myself here. I want to try to cover a couple of quick things. Investor protections, first and foremost, the SEC versus the CFTC, and then use of blockchain technologies.

So on that investor protections part, maybe Dr. Brummer you could illuminate for us here a little bit on what current protections you see or lack of current protections that are in place to really protect Mr. and Mrs. 401(k). We have institutional investors, sophisticated investors, and then we have more retail investors.

So if you could address that quickly please?

Dr. BRUMMER. At this point in time, the SEC is working on really operationalizing some of its own powers and authority under the 33 Act, 34 Act, and the 40 Act for the mom-and-pops, for the investors who are increasingly having exposure to cryptocurrency markets, for the better in some instances, and for ill in others.

There is a regulatory vacuum currently. That regulatory vacuum extends, to some extent, to the spot market in cryptocurrency. I think that where there are financial products that under traditional analyses would tend to be identified as commodities there are questions about disclosure that are required to be asked.

I think that even in the securities law space the infrastructure on which many of these tokens are currently being traded are not entirely subject to the SEC's oversight. So there are rules that are in place but it is a mishmash.

Chairman HUIZENGA. I am going to get to Mr. Rosenblum here because you had said that, here is how I have encapsulated it here.

The SEC is trying to do its job to protect investors and you say it needs to modify the rules to help facilitate ICOs but you say it is premature to draft legislation.

Now, both Chairmen Clayton and Giancarlo had said, along with their current counterparts from the Department of Treasury and Federal Reserve and others, that they may come to Congress here in the coming months and we know that this has moved very quickly.

In the last 9, 10 months we have seen this explosion of it. This panel, this Congress is not going to sit by idly with a lack of protection for investors and you have heard some of my colleagues express some skepticism of the legitimacy of cryptocurrencies and certainly ICOs.

So I want to look at what, very quickly, what the role Congress may be to play in this and what chilling effect it may have from your opinion quickly.

Mr. ROSENBLUM. Yes, thank you, sir. First, I think that there are, in particular, two parts of the legislation. I think there is an immediate set of legislation that needs to happen to authorize the SEC and other regulators to amend modified rules consistent with investor protection but also to facilitate capital development or capital investment.

That is not to say there won't also be additional grants of power or additional protections that Congress adds but what my other point is, this industry is moving so very rapidly.

It is very difficult to know, here is one example, if you take blockchain, which has a tremendous capacity to store, record, and retain information and you mix that with artificial intelligence which is certainly something people are trying to do today. The capacity of artificial intelligence combined with the blockchain to potentially lead to tremendous new marketing, tremendous new busi-

ness opportunities, tremendous scientific and sociological advances is tremendous.

However, the opportunity to advance our agility to use that same technology for a manipulative conduct or a data breach, and for all sorts of other, what I will refer to as nefarious conduct, is really hard to predict right now. And so what I don't want to do is lock us into a system too early.

And I will give you one more—

Chairman HUIZENGA. And I don't disagree, and unfortunately I am running out of time. We will be able to hopefully explore this with some other questions.

Mr. Lempres, I would like to get to you very quickly. Do you believe that there are any certain instances where initial coin offerings should not be regulated as an offering of securities?

Mr. LEMPRES. Thank you for the question. It is difficult to answer because it is hard to imagine all the circumstances under which ICOs might be offered. I think that speaking on behalf of Coinbase, we do not support any initial coin offerings at the current time because we are not sure the way the regulatory structure is and inventory treatment is.

It would be appropriate—

Chairman HUIZENGA. In your written testimony you talked about the CFTC quite a bit, the SEC not so much, and I have had some express that they believe the CFTC has been more flexible and open and receptive to ICOs and in blockchain. I don't know if that has been your experience as you have viewed it.

Mr. LEMPRES. Yes. Let me say, our experience is we are waiting for the dust to settle between the CFTC and the SEC before we will actively engage in supporting ICOs.

Chairman HUIZENGA. OK.

Mr. LEMPRES. And once the rules are clear we will move in. We think there is tremendous potential. We want to be there to support it. I will say that there is an important distinction between what is a security and what is a commodity. They perform different functions and they do deserve to be treated differently.

Chairman HUIZENGA. Yes. I am well over my time. There is no doubt though a token is not gold and a commodity as such, so I think that is some of the struggle that we have. So with that the Chair recognizes the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. And Chairman Huizenga you have opened up a line of discussion here that I would like to follow up on.

Mr. Lempres, in your testimony, you said that you believed there is no need for Congress to create a new regulatory regime. You have said you felt that the Federal authorities already had that authority and that it was basically just a lack of coordination.

But Mr. Lempres, both the SEC's Chairman Clayton and the CFTC Chairman Giancarlo have told me that neither one of them, the SEC nor the CFTC, have any regulatory authority. And, as a matter of fact, they said what regulation there is at the State level they are regulating these entities as if what they refer to as money transmitters.

So it seems to me that there is some type of regulatory shortfall here and if you ask me it is a little bit of that and not just a lack of coordination. So you see my point there?

Mr. LEMPRES. Yes, Congressman, thank you, I do. What I would say is that there are sufficient authorities in place today. And I would point out that there is a long—

Mr. SCOTT. So you are saying that the Chairman of the SEC and the Chairman of the CFTC are wrong?

Mr. LEMPRES. Of course not—

Mr. SCOTT. They say that that is not so.

Mr. LEMPRES. No. What I am saying, though, is I think in context what is happening is when you talk about money transmission licenses, that covers a portion of our activity as a business. We are in many ways an integrated business, a portion of which is licensed by the States for money transmission purposes.

Mr. SCOTT. Yes, but it is done at the State level. There is none at the Federal level.

Mr. LEMPRES. Well, respectfully, Congressman, I would also point out that, again staying at the State level, we have a BitLicense with New York State, which is indeed a comprehensive consumer protection license that covers crypto activity within the State of New York.

On the Federal level, I would respectfully say there is regulation of commodity markets just the way there is regulation of commodity markets everywhere else and that this new asset, which is not a physical thing that you hold in your hand, still has many of the characteristics of a commodity.

Mr. SCOTT. Well, my time is getting short, I want to—there is so much here. This is an exciting new area, and we are discovering a lot here but let me switch to the ICO issue.

Now Mr. Rosenblum, in your testimony, you said you believe it is too early for Congress and the Federal regulators to enact a comprehensive legislative or regulatory scheme governing cryptocurrency.

Now, I can assure you I am the Co-chairman of the FinTech Caucus and I can assure you that none of us on that caucus or on this committee want to be killing good innovation, especially one that is raising, as this is, billions of dollars of capital because it is very important for everyone to know and as CSPAN is broadcasting this, but it is important to know that as of February 2018 individuals and businesses raised $1.66 billion through initial coin offerings or ICOs.

So I agree with you, Mr. Rosenblum. However, going back to the SEC and the CFTC, they have not proposed rules regarding the regulations of cryptocurrency and other digital assets and instead have relied on informal rulemaking or enforcement actions.

So I want to ask you in particular Mr. Rosenblum, and others on the panel, what in your minds could the Federal regulators be doing better and do you believe that enforcement actions and other formal guidance are sufficient to regulating these emerging and exciting digital assets?

Mr. ROSENBLUM. Congressman Scott, thank you for the question. I agree with the point that you are moving toward or that you are suggesting here, which is regulation by enforcement in an area

that is as complicated and dynamic as this, is not the appropriate way to regulate.

Enforcement is necessary, of course, however, I do agree with you entirely that we need clearer guidelines, a clearer understanding of how the SEC's registration rules, its market trading rules, its exchange rules, its investment company and investment advisor rules should apply and do apply. And that is not something you can do by regulation through enforcement.

And that is again one of the reasons I think this subcommittee and this hearing is so important to this process because we do need more guidance on precisely those areas.

Mr. SCOTT. Thank you, Mr. Rosenblum.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the Vice Chairman of the committee, Mr. Hultgren for 5 minutes.

Mr. HULTGREN. Thank you, Chairman Huizenga.

Thank you all for being here. I appreciate your work and this is something that we are all interested in learning as much as we can.

I want to address my first question to Mr. Lempres if I could? Your testimony mentions that you store more than $20 billion worth of digital currency and have traded over $150 billion in assets.

In light of the January 2018 hack of the Coincheck cryptocurrency exchange wherein $534 million was stolen, I have a few questions for you related to that cybersecurity side of this. I wonder what cybersecurity standards does Coinbase adhere to?

Mr. LEMPRES. So thank you for the question. And the reason I am hesitating, this is not my area of expertise, and I apologize when we get into this stuff. But I will say that our cybersecurity protocols are, I believe, state-of-the-art.

That we have an entire team, obviously, that does nothing but work with cybersecurity. Approximately 99 percent of the assets that we hold are held offline in what is known as cold storage, which makes them virtually immune to hack.

We do have a hot wallet process for, in effect, if you think about it, the cold storage is akin to a vault, the hot wallet is akin to a teller window at a bank. The hot wallet is online obviously and we have that amount fully insured to protect the consumers and investors as to that.

Mr. HULTGREN. Are there any, if you know about it and we can follow up in writing, too, or you can let us know who the person is that you recommend with Coinbase that we talk to, but is Coinbase legally required to follow any Federal cybersecurity laws and regulations, for example, financial institutions and some service providers are subject to Gramm-Leach-Bliley?

Securities exchange and other SROs are subject to SEC's Reg SCI (Regulation Systems Compliance and Integrity). Are there any other Federal cybersecurity laws or regulations that already apply to Coinbase and others like you?

Mr. LEMPRES. Yes, first off, I am more than happy to get you the name—

Mr. HULTGREN. That would be great.

Mr. LEMPRES. —Of the head of our security. And second, I believe the cybersecurity standard that we most adhere to is New York State's standard through their BitLicense, which takes quite a lot of work.

Now, we are also working with a few of the big four accounting firms to develop appropriate standards to make sure everything is SOC 2 and other standards.

Mr. HULTGREN. OK. I think you answered this, but maybe just for clarification? In the event of a hack of your platform that results in the loss of assets, is there a guarantee that is provided to the purchasers of the assets through your platform?

Do you have any legal responsibility for safekeeping of client's assets? And what other protections are afforded for your customers in the event that the hot wallet is hacked? You mentioned that but I—maybe just go into a little bit more detail on that if you have any?

Mr. LEMPRES. Sure. So again, we do hold a little bit of fiat currency, USD—United States dollars. Those are held in banks which do have FDIC insurance as to those dollars.

As to our cryptocurrencies, there is no Federal insurance program to which we belong. We have attempted to create a degree of comfort amongst our customers by insuring the hot wallet amount. I will note that to date we have not been hacked. We have never had to make a payment out under those insurance policies.

Mr. HULTGREN. OK. Hope it continues that way. Your testimony also mentions that the exchange only support four assets because each has been determined by regulators to be a virtual currency and therefore not a security. However, you go on to note that regulators are not providing enough clarity for other cryptocurrencies.

How did you establish the regulatory and legal certainty for those four currencies that you currently support or have; do the SEC or the CFTC individually provide guidance for those four currencies? Or did Coinbase make a determination about these four currencies based on the SEC-CFTC guidance?

Mr. LEMPRES. Yes. We have received some guidance certainly as to those four examples. The CFTC has explicitly found and in fact published a primer that listed three of those assets as cryptocurrencies. The fourth, Bitcoin Cash is a hard fork which is in effect a derivative of Bitcoin. It would be covered by the same reasoning.

Mr. HULTGREN. OK.

Mr. LEMPRES. There are some court cases that refer to them as cryptocurrencies and the SEC itself has distinguished between cryptocurrencies and securities. Specifically in the DAO Report they referred to Ether as a cryptocurrency in the context of discussing securities.

Mr. HULTGREN. OK. You also mentioned in your statement, and I am out of time, so we will—if that is OK if I can follow up? And I have questions for others. Sorry 5 minutes goes way too fast, but thank you all for being here. Again, we want to understand this as much as we can, but grateful for your testimony. And we will follow up with other questions if that is all right.

With that, I will yield back.

Chairman HUIZENGA. The gentleman yields back.

And it may behoove the Chair at this time to note that we will be having an opportunity to forward questions through the Chair to the panel. And depending on our time, as well, and participation we may be able to get to a second round of some questioning so—with your indulgence.

So we will continue to move along. And with that, Mr. Ellison from Minnesota is recognized for 5 minutes.

Mr. ELLISON. Thank you.

And now let us talk about cryptocurrencies a little bit. In my meetings with constituents over the last several months, I have had many of them say, "hey, what is going on with this cryptocurrency? I heard that it started at really low valuation; now it is really high and it is up and down. Should I get into it?"

I am like, "well, look, I am no investor. I can't tell you what you should do," but it did occur to me that I should ask you experts. If somebody who is not sophisticated in this area wants to invest, what should they know in advance? Could you all talk about what the hazards might be for an unsophisticated investor in this area?

Dr. BRUMMER. So that is a great question. It is an important question. And I would certainly say that given the complexity of many of these instruments it is very dangerous.

One of the disclosures that I had suggested would be really critical, particularly as retail investors become more interested in this space, is to understand what the risks are when it comes to investing. It is not only that they can lose a lot of their money but they can lose all of it, and that it is not just the specific venture itself that creates risk.

It is not even the cyber risks or the potential for hacking. But it is a very dynamic ecosystem, that there are certain kinds of changes in the nature of the technology where, say, Internet-based principles become embedded in the blockchain and leave some of the blockchain technologies that we are depending on now rather obsolete where the tokens tied to them then become ultimately worthless.

That these are the kinds of risks that retail investors themselves may not necessarily understand even where they may have some basic—and if not only hazy understanding—of the technology itself. And as a result, because just like you, I will sometimes go to the gym and people will ask me, so tell me about bitcoin.

I think that that is always the sign of trouble, of sometimes either a potential for investors to not be properly informed about where they are putting their hard-earned savings and, as a result, there is a need for much more fulsome communications with those who are seeking or who may be interested in participating in those markets.

Mr. ELLISON. So over the course of 2017 we saw some precipitous increase in value. We saw some drop. We exchanged a lot. What do you think is driving some of those swings? Is it regulation or the threat or the possibility of it?

Dr. BRUMMER. I think it is a product of speculation. I think it is a product of—

Mr. ELLISON. Bubble?

Dr. BRUMMER. —Yes, of a bubble certainly. It is a product of investors who are money chasing investments instead of investors

chasing money. It is a product of inadequate disclosure. And as a result, I think, just to echo some of the comments here on the panel, that regulation can be very healthy for those markets.

It can help to address some of the spikes in volatility and the patterns of fear, the bubbles. But that action is needed now.

Mr. ELLISON. So we are—yes sir?

Mr. VAN VALKENBURGH. I would only add that we have had a long history of technology bubbles. I think a lot of what is happening in blockchain technology looks rather like the dot com bubble of the late 1990's, early 2000's.

And I think that is important for Main Street investors to understand, and educational programs from the CFTC like LabCFTC and educational advisories from the SEC are critical because in the late 1990's it would have been extremely correct to say that Pets.com is overvalued, extraordinarily overvalued and they are going to blow all their money on a Super Bowl ad. And there are some projects in our space that look like that.

But it would also be incorrect to say that Amazon.com was overvalued. And I think that is why we see the froth in these markets because a lot of these projects, say Filecoin or Ethereum or Zcash, are challenging major multinational corporations.

And if any of them succeed they will be in the future as valuable and as critical as the infrastructure that those corporations created. But that is a highly speculative bet.

Mr. ELLISON. I only have time for one last question from one last person. So we are talking about regulation here in the United States the discussion is on, but what about other countries and how does that impact this conversation? Anybody?

Dr. BRUMMER. So we have been looking particularly over at Georgetown, some of my colleagues and other people certainly on the panel, at how interoperable are rules and approaches? The CFTC I know has been very interested in terms of information transfers, information exchanges between regulators.

I think that one important component to these projects—LabCFTC was mentioned; I think that is certainly an important and healthy program, but to think through also how do we include more than just a market access component to those agreements and to push our regulators to also incorporate in the FinTech space questions of a coordinated regulatory design, information sharing, and enforcement?

And I think that that would help to make sure that we can export some of our best values and approaches abroad and to take best lessons learned overseas and to incorporate them here.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the Chair recognizes the gentleman from Ohio, Mr. Stivers, for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman. I really appreciate you holding this very important hearing on a topic that has a lot of people's attention.

The first question I have, and I am going to try to ask three questions, we will see how it goes—is to Dr. Brummer. Can you talk a little bit about the promise of blockchain technology?

Let us take a couple steps backward and talk about the promise of blockchain technology to make our financial system more trans-

parent and efficient and—well, not transparent—efficient. And what blockchain technology can mean, both for financial transactions and other things in our economy?

Dr. BRUMMER. I think that the value in blockchain technology, and it is very useful for us all to remember that blockchain technology has its applications not only in the financial space but in other ecosystems, everything from pharmaceuticals and health and real estate and property.

But it provides a platform whereby, in a very decentralized format, you can create a systems, a ledger, a methodology, and mechanism for tracking things and transactions in a way that is extraordinarily difficult to tamper with. And it allows for the disintermediation of certain kinds of folks in the middle that allow for a cheaper transaction experience.

I think that precisely because it is embedded in online technologies the ability to fully lever—or right now I am going to talk about the upside for just a moment, because I have certainly been emphasizing that there are—

Mr. STIVERS. And I would like you to wrap this up in about 15 seconds.

Dr. BRUMMER. In 15 seconds.

Mr. STIVERS. Keep going, but—

Dr. BRUMMER. Yes. The difficulty is that to the extent to which you are operating online there is more that the Federal regulators can do in terms of investor protection, but it also then raises questions. Someone had mentioned money transmitter laws as to how do you coordinate—

Mr. STIVERS. That is my third question. We will get to that in a second. So—

Dr. BRUMMER. All right.

Mr. STIVERS. So my second question is for Mr. Van Valkenburgh. Can you help us understand the difference between a token that is used as a commodity and the promise of tokens that becomes a security? And if you can do it in about 2 minutes that would be great because we have 5.

Mr. VAN VALKENBURGH. It is a great challenge and happy to try and answer. Thank you for having me. So we have a flexible test in the U.S. for what is a security. It is derived from a case called the Howey case. And that test can be applied for promises of future tokens.

What you are really looking for are two things, an expectation of profits—I am simplifying—reliant on the efforts of an issuer or third-party promoter.

So that is why this promise of future tokens is critical to thinking about why an ICO is a security even though other things might not be because we have a definable or discernible issuer who is promising to build something of profound economic value, but we are relying on them to actually keep that promise. And that is why it fits the test for an investment contract or a security.

Now, a digital commodity might be a digital commodity for a number of reasons. We use commodities for money. We use commodities as investments. We use commodities as inputs for commercial industrial processes. And the same thing is true of digital

commodities like Bitcoin or Ethereum or Filecoin, once Filecoin is built.

Now, it is important to note that Filecoin is raising money to build itself, but once it is built it will be a commodity.

And I will just quickly go through those three because they are great examples of what I mean by digital commodity. Bitcoin is nothing but something that is scarce and transferrable person-to-person. And that is why I make the metaphor to gold. It is very different than gold, but like gold I could hand it to another person and if that is valuable on markets that may be valuable and used as a medium of exchange or a store of value.

Now—

Mr. STIVERS. And I want to do one more question and I have 58 seconds, so if you could—

Mr. VAN VALKENBURGH. Yep, yep.

Mr. STIVERS. —Give me the other two quickly?

Mr. VAN VALKENBURGH. Ethereum is a computing system on the Internet and in order to get access to that computing system to get useful results you use Ether as a fuel to power that engine on the Internet. It is a commodity like oil.

Mr. STIVERS. And the last one?

Mr. VAN VALKENBURGH. And Filecoin, the last one, is rather like digital real estate. So you use Filecoin to get storage on the Internet. So it is a commodity like real estate, if you want to think of real estate as a commodity, measured in gigabytes instead of square feet.

Mr. STIVERS. Great, thank you.

And one last question for the whole panel, and I know this is slightly off topic but because it has come up, if folks could comment on whether they feel like FinCEN's 2013 guidance on the appropriate level of anti-money laundering and Know Your Customer safeguards are appropriate. Or do you think that they are being abused out in the system? Do you think there is more information needed on those issues?

If we could just go down the panel, anybody that is interested in answering that one?

Mr. VAN VALKENBURGH. I think it is a very sensible piece of guidance. It was written early on in the space and it created a lot of clarity, especially for exchanges. And that is why all U.S. exchanges that I am aware of are collecting information on their customers and filing suspicious activity reports and keeping the financial system transparent even if it is cryptocurrency.

Mr. STIVERS. Thank you.

I yield back, Mr. Chairman.

Chairman HUIZENGA. With that, the Chair recognizes the Ranking Member of the committee, Mrs. Maloney, for 5 minutes.

Mrs. MALONEY. Thank you. My apologies. I had to Chair for the Democrats another meeting, but this is an incredibly important issue. Thank you, Mr. Chairman, for calling it.

Mr. Lempres, as you know, my good friend and colleague Mr. Cleaver sent letters last month to the Bitcoin Foundation and the digital Chamber of Commerce asking what they are doing to prevent extremist groups like those involved in the White Nationalist

Movement from using cryptocurrencies to fund their campaigns of hate?

And I have also seen evidence that cryptocurrencies are used heavily by sex traffickers to sell women. So this is a big problem and one that Ann Wagner and I have been working on.

As Coinbase is one of the largest cryptocurrency exchanges in the world, what are you doing to prevent these extremists from using your exchange to fund their activities? Do you have a set of standards or—thank you.

Mr. LEMPRES. Yes, thank you for the question. Let me first off say that we take that very seriously. Specifically with regard to hate groups, for example, we have a specific section of our terms of use that we rely on and we kick people off the platform anytime we see anything that constitutes—

Mrs. MALONEY. Thank you.

Mr. LEMPRES. —Either encouraging or facilitating hate on there, through our network.

Speaking more broadly on bad actors and the things we do to track them down, one of the nice things about this technology is it actually gives you insights that you can't get in any other financial instrument currently because of the nature of the blockchain, which is an immutable permanent record that is publicly available.

We use both internally developed and commercially available blockchain analytic tools which actually give us quite a bit of insight into connections between individuals. If, for example, we identify some kind of bad node or some bad activity, we can track to see who has touched that and what relationship they would have with anybody else who might have touched that.

I should mention that we are members of the Bank Secrecy Act Advisory Group. We work very closely with FinCEN. We file an awful lot of SARs. We have, just to show how important we view this space, nearly 20 percent of our total employees are dedicated toward compliance.

Mrs. MALONEY. Thank you. And as I have said before, I am extremely concerned about virtual currencies because a lot of average people are using it and believing that it is an investment tool. They are pouring their life savings into virtual currencies and they stand to lose a lot of money when this bubble eventually bursts.

Some people are treating these things as investments, not as currencies. And that is a huge problem because there are no investor protections like we have for stocks and bonds.

So I am working on a bill that would regulate virtual currencies but not the technology, that have the characteristics of an investment like we have always regulated investments with robust investor protections, including disclosures, which will be regulated by the SEC.

So Professor Brummer, let me start by asking you a question. Do you believe that the definition of a security in current law encompasses all virtual currencies?

Dr. BRUMMER. No, I don't believe so. The Howey test, which is long the standard for evaluating nontraditional financial products in determining whether or not they fall within the SEC's regulatory perimeter, establishes several key characteristics and benchmarks that have to be satisfied.

And I think that when you apply them to some of these virtual currencies like Bitcoin you get less than fulsome results according to those benchmarks.

Mrs. MALONEY. So if we wanted to regulate virtual currencies that are being treated as investments and to require adequate disclosures to investors would Congress need to expand the SEC's authority, in your opinion?

Dr. BRUMMER. They would need to expand the SEC's authority, yes.

Mrs. MALONEY. And I liked the part of your testimony where you describe what kinds of disclosures should be made to people who invest in initial coin offerings. And I agree that the SEC can tailor the required disclosures so that they are appropriate for digital tokens and virtual currencies, which are different from traditional securities.

Do you think that requiring these kinds of basic disclosures would stifle innovation in this space or harm the development of the blockchain technology?

Dr. BRUMMER. I really don't think so. The kinds of things like I outlined, adding mailing addresses—

Mrs. MALONEY. And I have 15 seconds left. Professor Brummer—

Chairman HUIZENGA. I am being generous with the time.

Mrs. MALONEY. Oh, no, I know my colleagues need time, too. What do you think of the idea of subjecting virtual currency exchanges to minimum cybersecurity standards? Do you think this is necessary in light of the huge cybersecurity risks that virtual currency exchanges face?

Dr. BRUMMER. I think that would be extremely helpful. Cyber-security is perhaps the number one challenge facing our financial markets infrastructure providers and, to the extent to which you want to provide those financial services, you should be subject to certain kinds of high expectations about the cybersecurity of your operations.

Mrs. MALONEY. My time is more than expired. Thank you so very much.

Thank all of you. Thank you.

Chairman HUIZENGA. With that, the Chair recognizes the gentleman from Minnesota, Mr. Emmer, for 5 minutes.

Mr. EMMER. Thank you, Mr. Chair, appreciate it.

Appreciate all of you being here. This is a huge topic that cannot possibly be even scratched, in my mind, in 5 minutes with each of the people that are up here. I have a whole litany of questions, which I know my office will follow up through the Chair with each of you.

I think where I want to go this morning after listening to you, because I find myself maybe not with my colleagues on some of this. I have a problem with, "Government is here to help us and we need more Government. We are going to have to go into this new frontier and we have to have more regulation."

I heard at the beginning we have a regulatory vacuum. That scares me to death. I tend to trust people before I distrust them. I tend to believe that people are in these things for good, that they are trying to improve their own lives and hopefully the lives of people around them, that old adage of "A rising tide lifts all boats."

And yet I hear elected officials who don't have any concept of what we are dealing with here and how exciting it is talking about oh, my gosh, we have to run in. We have to regulate. We have to create more Government infrastructure. And by the way, I respectfully disagree with the idea that that won't act as a wet blanket on this amazing new technology.

What we are talking about here is blockchain. Blockchain technology applies all over the place. It can solve some of our cybersecurity issues.

These are open transactions where—and Milton Friedman, of all people, predicted this back in 1999 when he said there will come a day in the financial services space where you will be able to do this over the Internet where A will have a transaction with B and it will be entirely open for people to see. But A won't know B and B won't know A.

You can know that and you can see things. I think Mr. Lempres was talking about how you can see things through the blockchain that are going on.

I love the fact that Mr. Rosenblum talked about examples of blockchain technology outside of this space. And I will tell you in Minnesota we have a company called BanQu that is using blockchain to provide digital identities to unbanked and underbanked individuals in order to build a credit history and access capital.

That is something that Democrats and Republicans should be celebrating here in Congress, not going, "oh, my gosh, this is terrible. We don't understand it. We need a new policeman or we have to take the policemen we already have and give them even more powers to start to invade this space and perhaps frustrate the development."

I have concerns. I realize there has to be some regulation, but it is the balance. And I have heard from the panel that we have regulation already in place; we just need clarity.

Mr. Lempres, why don't I start with you? You talked about we have to be able to say what is a security in this space? What is a commodity? I would add what is currency because these are all important definitions to whether or not certain agencies are within their jurisdiction.

And to have you say two things, really scared me. One, that you haven't made any offerings because you don't have the certainty you need to know whether or not you can start to work in this space and second, to say that 20 percent of your workforce is working on compliance, that is nothing to be celebrating from this side of the table in my mind.

So I would just ask you what about clarity in this area and what about the balance that I am concerned with?

Mr. LEMPRES. Yes, thank you for raising it. It is obviously a very, very important issue. I can tell you that from our standpoint what we really need more than any particular approach is to know what that approach is going to be from the Government so we can plan and we can move.

This system innovates very quickly and just knowing where the lanes are is extremely helpful for us.

Mr. EMMER. If I can interrupt real quick?

Mr. LEMPRES. Yes.

Mr. EMMER. I am sorry because I am thinking of a conference that I was at last week, one of our very important and respected secretaries made a statement about everybody needs to register.

There is no clarity around the law so all of a sudden people who are looking at being in this space or getting into this space, I heard from more people there after that comment that we can't start our business in the United States. We are going to have to go somewhere else to start it. Does that concern you?

Mr. LEMPRES. It does, although I will say that the entire world is struggling with these same issues. And with regard to the percentage of our team that is focused on compliance, the biggest piece of that is focused on Bank Secrecy Act and Know Your Customer obligations, these people are concerned about money laundering and counterterrorism and things like that.

And that is an important element no matter which country we are operating in, and certainly in any developed country we will have those expectations.

Mr. EMMER. And we should work with all of you to understand better those things that would work. I would just leave you with this. Right now this system gives advantage to the individual and not to the Government, and I am worried about giving advantage to the Government and taking away liberty from the individual. So hopefully we will be able to meet that balance as we go forward.

Thank you, Mr. Chair.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the Chair recognizes the gentleman from Illinois, Mr. Foster, for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman. And before I begin my testimony I would like to ask unanimous consent to enter into the record a letter on behalf of Congresswoman Sinema from an Arizona-based blockchain company in support of this committee's investigation into this area.

Chairman HUIZENGA. Without objection.

Mr. FOSTER. Thank you. Distributive ledger technology has tremendous promise and the value of a non-falsifiable ledger will have broad applicability to financial and non-financial transactions. It could reduce transaction cost, increase transparency, and provide for instant and final settlement in the areas ranging from cash transactions to real property records to securities.

It also provides a platform for more speculative transactions, such as Bitcoin, that are backed by nothing more than perhaps their scarcity and the belief that there will, at some point, be a greater fool to take them off their hands at some unknown price in the future.

But nonetheless, much of our daily lives will soon involve something like blockchain, so I think it is past time that Governments around the world have a look at these digital tokens and figure out where and how they should be used.

And it strikes me there are three fundamental questions that I would like your reaction to that we have to face. The first is will there be a mechanism to bust trades or not? In the case of the Flash Crash, for example, the CFTC had very clear rules in place under which case market gyrations would result in trades being

broken. There is no such mechanism, for example, in Bitcoin where if someone steals your Bitcoin codes they have it and you cannot get it back.

Similar questions arise if a hacker absconds with the contents of your vault. Is there a higher authority that you can go to to break that trade? So that is the fundamental design question that I think you face and that we face as regulators.

Second, is there a need for something equivalent to a consolidated audit trail? In the securities space we have learned by bitter experience of the need, if we are going to detect and prevent market manipulation, we need to have an electronic record of the timing and the beneficial owner behind every transaction. That could be designed into digital entities like this or it could not be.

And third, related, is the authentication of participants. Will there be a mechanism if necessary an order of the regulator to unveil the identity of counterparties and issuers? That is something that could be present or could not be in any of these.

And so I was wondering if you have a reaction to you think we should address those three issues: Busting trade, consolidated audit trail, and authentication of participants. I am just happy to go down the line here.

Mr. LEMPRES. Sure, I am happy to start with that. Busting trades is tough—there are technological challenges to that. Once these trades occur or a transaction occurs, it has occurred. There is no opportunity for settlement 24 hours later or something else where you can look at it and pull it back. So that is a challenge.

Mr. FOSTER. Yes, but there are technological means of doing that where every transaction would be conditional on the fact that some trusted set of entities haven't publicized a code that invalidates the trade.

Mr. LEMPRES. Yes, it—

Mr. FOSTER. There are technologic ways of doing that but everyone has to understand that it is not like cash. If you steal cash it is yours, all right? And, with the exception of serial numbers and so on, you pretty much own that cash. But it could be designed differently and—all right. Then—

Mr. LEMPRES. No, it absolutely could be. It absolutely could be.

Mr. FOSTER. Right, so the consolidated audit trail?

Mr. LEMPRES. Yes, unless those two items are put together the authentication of participants and any consolidated audit trail issue—certainly if you are trading on our platform we have information on it.

We have your bank account information. Typically we have a lot of Know Your Customer information so we know the individuals. We know where they are. We verify their identity. We know the source of funds. We know quite a lot about them. And there is an immutable record once it is created.

So in many ways we have—while it is not a consolidated audit trail in exactly the terms you are looking at, we have much of that information gathered on our platform that we are able to reconstitute it if it becomes necessary.

Mr. FOSTER. OK. All right.

Dr. Brummer, you want to take a swing at those?

Dr. BRUMMER. Other than saying that I am sympathetic with your objectives, I would have to defer to Mr. Lempres as to how the internal operations work on it.

Mr. FOSTER. OK.

Mr. Rosenblum?

Mr. ROSENBLUM. Sir, I think to take all of your questions we have to step back and look at a couple things. There are a number of different currencies and there are a number of different items being traded here. And there are a number of different places in which they get traded.

So if you are talking about Bitcoin or other things that we will view as pure currencies, which is probably where this question starts from, I think there are one set of answers to those questions. I promise to get to those.

But the second thing, though, is when we are talking about the new tokens and things that are being developed for particular platforms, those are very different. And there are at least two places where those can be traded, one is on the platform itself, second is on exchanges, most likely exchanges registered with the SEC.

When we talk about exchanges registered with the SEC, I think your notion of having all three of those things exist will absolutely happen. I think the question of if we move—and I think with well-regulated, well-thought out platforms, that type of, at least to a large extent, all three things that you are talking about, identifying customers, having a consolidated audit trail, and being able to bust trades can happen on those platforms.

I think when we move to something like Bitcoin, there I think you have a much more difficult problem with this because that genie is already way out of the bottle. And the ability to trade Bitcoin throughout the world is very difficult to put in at least to Know Your Customer rule or an identification rule.

For example, you have a wonderful consolidated audit trail. You can follow Bitcoin throughout the trail. You just don't know who it was who held it. So that one, I think, is the one that is going to be much more challenging for this subcommittee.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the gentleman from Ohio, Mr. Davidson, is recognized for 5 minutes.

Mr. DAVIDSON. Thank you, Chairman, and I thank you all for your expertise on the topic in the rapid expiration of 5 minutes has been duly noted. So I will try to crank through this.

I really appreciate the dialog that has been had about the differentiation between commodities and securities, and Mr. Van Valkenburgh, I wanted to spend a little bit of energy on that because as these securities are offered, in a way, I think you did a good job of highlighting what might look like a commodity with a test.

But many times when people go to market, these aren't shares in a company. If you think of them as an equity they are non-voting shares and some of them aren't even committed to a dividend. And those that are committed to have some return in their structure, how is it that I make money for it, in some ways it looks almost like a bond.

So could you say, look, if we were filing for securities, which people haven't done yet, part A plus part D, part S, what does that look like to treat it as a security in common frame of reference for folks?

Mr. VAN VALKENBURGH. Thank you, Congressman. I would first start out by saying that there are several developers who have sold their tokens through Reg D filings and they are not selling the tokens in that case. They are selling a promise, an investment contract in the true meaning and spirit of the Howey test wherein they are going to make efforts, people will rely on those efforts and the outcome will be something profitable.

But the outcome in many of these cases is a brand new decentralized computing system that has baked into it tokens which can achieve some functionality.

Once that system is built and the investors who bought in, say, a Reg D offering, is given the tokens, those tokens to me, assuming the network is functioning, that people are now relying on the blockchain instead of the issuer. They are relying on a blockchain the issuer created for proof of ownership for the functionality that that blockchain creates.

At that point, it looks more like a commodity. At that point, maybe you can do something useful with the token like use it in an engine for cloud storage or use it in an engine for computation or hold it as a valuable and scarce commodity like gold or salt or things like that.

Mr. DAVIDSON. Thank you. And in that sense shares have many of the same features, and, of course, they are treated as securities.

Mr. Rosenblum, I want to spend a little bit of time talking about a lot of the companies that raise this capital are early-stage companies. And historically one of the paths to capital for early-stage venture.

Venture is often considered smart money. You get the benefit of lots of experience helping small, early-stage companies navigate to scale up. ICOs don't always have those features. Last year it was estimated that startups raised about $4 billion in ICOs. Can you talk a little bit about the concerns with respect to venture versus ICOs?

Mr. ROSENBLUM. Thank you, Congressman. Actually let me say one quick thing. I am the only one on the panel who has not been asked about security versus commodity, so if somebody at some point wants to ask me, you are going to get a very different answer from me on that question than the other panelists.

To answer your question, sir, one of the things we have seen in the ICO market to date has been a large number of people, a large number of companies raising money in ways that any securities lawyer would have told you, and truthfully did tell you, that you shouldn't do.

So for example, Dr. Brummer's suggestions about how to improve a white paper to me make—I understand the notion, but no rational securities lawyer will advise their client to sell off a white paper. We always sell off of a private placement memo—

Mr. DAVIDSON. Right.

Mr. ROSENBLUM. —Or a disclosure document. We always have risk factors. We always take all the steps you need to for an ICO

in exactly the same way that we do in a private placement for any other security.

And so one of the things we have seen, and then I will—and I know time is short, sir, but one of the things we have seen are market practices that have been detrimental to the long-term development of the ICO market.

Mr. DAVIDSON. Yes, thank you for that. And I think a very good distinction, and I like that you hooked back in this notion, of a white paper and how soft that is versus a private placement memorandum. And I guess to your point, if I could hear your perspective on commodities versus securities, I would appreciate that as we close.

Mr. ROSENBLUM. Oh, thank you. Thank you so much for the invitation. So I think that the notion of trying to decide what is a security and what isn't a security is something that would lead the market to distraction.

To take the notion that once something becomes functional, once a platform becomes functional you no longer have a security that has to be wrong. You can be still relying very extensively on the efforts of the promoters. Trying to draw a line on when it is that you are no longer significantly relying on the efforts of promoters is so very difficult and so convoluted and so open to second guessing.

My suggestion is don't even bother. Come up with a simple, easy system to use eventually that is going to apply to all of these things regardless of whether they are a security or not.

Mr. DAVIDSON. Thank you.

And thank you, Chairman, for the additional seconds, and I yield.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the gentlelady from Missouri is recognized, Mrs. Wagner, for 5 minutes.

Mrs. WAGNER. I thank the Chairman very much.

Mr. Lempres, in your testimony you stated, and I quote, "we need to be sure that we are not killing good innovation brought about by new technology and good actors. For example, the State of New York requires a BitLicense, which has been unpopular causing companies to end their business relationships in the State."

Mr. Lempres, let me start off by asking you two questions. Since Coinbase is one of four companies who have received a BitLicense, do you believe New York's model was appropriate for all industry participants? And second, what lessons can we learn from New York's attempt to regulate the virtual currency market?

Mr. LEMPRES. Yes. Thank you for asking, and we are one of four companies that has received it. I think an obvious lesson is New York made a very ambitious effort by the State to regulate in this space.

The fact that they have only issued four licenses answers the question to a certain extent. They have chilled activity in the State of New York.

Having said that, when you are at the scale that we are at now and the number of individuals and institutions that we are dealing

with now, we do benefit from the comprehensive regulatory scheme the State of New York has put in so that people do trust more.

We are doing the kinds of things they want to see when we have people who are used to dealing with financial institutions, and the State of New York is in effect treating, through its BitLicense, us and other companies the way they treat financial institutions. I think that sends a message to the market.

So for a company of our size and again, there are four that have this license, we have found benefits in dealing with the State of New York on this. I would note that there are hundreds or thousands of companies in our space and obviously only four of them are operating in New York under that authority.

Mrs. WAGNER. What are other State laws that regulate cryptocurrencies?

Mr. LEMPRES. So we have 40 licenses in 38 States so they are primarily money transmission licenses that we deal with but they lead to full exams. We have, I believe had 28 exams to current various States coming into our offices.

Mrs. WAGNER. OK. Switching topics somewhat, I wanted to talk about compliance a little bit. As a registered MSB, Coinbase is required to submit suspicious activity reports, or SARs, to FinCEN. Mr. Lempres, I understand that Coinbase includes blockchain analytics when filing their SARs. Can you explain to the committee how including this information allows FinCEN to get a more complete picture of what is going on?

Mr. LEMPRES. Yes, and thank you. So you are correct in all of your parts there. Yes, we do file SARs with FinCEN and that we do include blockchain analytic information where it is helpful in that SAR.

And the reason we do that is simply to do everything we can to put into context the information—we have access to information, that many Federal agencies don't see on a day-to-day basis. We see it all the time. We try to tie it together to present as accurate and complete a picture we can so that if further investigation is warranted they at least have the broader context in which it is operated.

Mrs. WAGNER. And to follow up, can you talk about how Coinbase coordinates with law enforcement and how your Know Your Customer program was developed?

Mr. LEMPRES. Sure. So we are quite proud of our involvement with law enforcement. We have a group, our global intelligence unit, it's focus is exclusively on law enforcement coordination and education. We train, I believe, more law enforcement agencies globally than anyone.

We have trained hundreds of State and local agencies. And when I was talking about training, it is essentially how the blockchain works, how cryptocurrencies work.

Mrs. WAGNER. Right.

Mr. LEMPRES. What information is there and how a case can be put together if they need to put a case together.

Mrs. WAGNER. Mr. Van Valkenburgh, in your testimony you mentioned that there is friction and mismatch between new technology and old regulatory structures when it comes to State-by-State money transmission regulation. Can you explain, sir, how the

current State regulatory approach poses issues with regard to cryptocurrency exchanges?

Mr. VAN VALKENBURGH. Yes, thank you. The first thing I would say is these are naturally global technologies. They work on the Internet so when people use them they necessarily cross borders. And a company like, say, Coinbase, will have customers not only in every State but probably across the world. And that means that compliance, when it is done at a more local level, is very burdensome and often redundant.

The 40th background check that your company gets will probably not make you more likely to be secure or to have a good reputation. It is just extra.

Now, the other friction or mismatch between State money transmission licensing and these technologies, especially at the exchange level, is that money transmission licensing relatively exclusively focuses on this idea of transmission from A to B, not on the idea of custody as clearly defined but on the idea of transmission.

And there are all sorts of people in the world who are developing these technologies who facilitate transmission because they write highly innovative software that help power these new blockchain technologies. They are critical to this innovation. And they don't take custody of consumer funds, so they don't actually put customers in risk.

But depending on how a various State money transmission licensing statute is drafted, you could interpret it to say that that software writing activity is included as money transmission. And the penalties for being an unlicensed money transmitter are very grave.

So if we could cleanup that statutory language State-by-State to make it clear, folks that hold people's Bitcoin, like my colleagues' company Coinbase, are licensed.

But people who don't actually hold it are not subject to a licensing requirement. That would be a very positive signal from the U.S. that we are willing to protect innovation where it doesn't endanger consumers.

Mrs. WAGNER. I thank you all for your testimony. My time is way expired. Thank you for your indulgence—

Chairman HUIZENGA. We have been somewhat generous today on that, knowing how do you unravel this in 5 minutes is very difficult.

And still while we are in this first round, welcome back Mr. Sherman, who is recognized for 5 minutes.

Mr. SHERMAN. Thank you.

The currency is both a store, a value, one you hope appreciates, and a medium of exchange. So let us focus on the medium of exchange. Is there any reason why I would need a cryptocurrency to pay for my groceries or anything else? Why wouldn't that be adequately served by using dollars?

Yes, Mr. Van—yes.

Mr. VAN VALKENBURGH. Thank you, Congressman. No, not yourself I believe, sir, because you and I are—

Mr. SHERMAN. You are assuming I am not a terrorist or a criminal and I thank you for that.

Mr. VAN VALKENBURGH. No, I am assuming you are an American citizen, which I think is a pretty safe assumption.

Mr. SHERMAN. Oh, that one is safe. The other two are questionable. Go ahead.

Mr. VAN VALKENBURGH. You and I have the benefit of a well-functioning and extremely important financial infrastructure that surrounds us every day of credit cards, of bank accounts and most Americans do find it not too difficult to become banked. We have an unbanked problem in this country but it is not nearly as profound as other parts of the world.

In other parts of the world—

Mr. SHERMAN. Now, is there any part of the world where the unbanked couldn't just as easily have access to transactions in real currencies rather than cryptocurrencies?

Mr. VAN VALKENBURGH. So there are parts of the world where real currencies in those countries are being basically debased by their Governments or hyperinflated or they just don't have actual purchasing power because of—

Mr. SHERMAN. Right. So you could use dollars, euros, Swiss francs. Why are those not the adequate substitute?

Mr. VAN VALKENBURGH. If you can find access to cash in your region of the world, U.S. dollars, that might be a very good means of exchange, but those will trade at extreme premiums. My only point is that cryptocurrencies are accessible. They are accessible financial tools only on the basic precondition that someone has a smartphone and an Internet connection.

And I think there are regions of the world where people will sooner have smartphones and Internet connections than they will have access to a valuable and secure financial services from companies.

Mr. SHERMAN. I wonder if someone else can comment on that? I don't think on the tallest mountain of Tibet there is somebody with a $100 bill that they are holding onto. And on every cellphone there is a way to use dollars or euros, so does someone else have a comment?

Mr. ROSENBLUM. Mr. Sherman, thank you for the questions. I want to divide your question into two different parts. One part relates to things like Bitcoin and other currencies, which is really what you are discussing.

Second part is going to relate to tokens and similar types of things that have—instruments that have specific purposes on specific platforms that people can earn and generate in ways that you could not do with cash.

Mr. SHERMAN. I have limited time—focus on what can't you do with cash?

Mr. ROSENBLUM. In a platform, for example, where we have a buyer of property, sellers, and then we have third parties who are performing important services to the platform to help the platform run, to help validate services, to help do other functions that are—

Mr. SHERMAN. And why can't these platforms use dollars?

Mr. ROSENBLUM. Because there is nobody who is going to pay them. What happens on these platforms is that the platform itself—

Mr. SHERMAN. Wait a minute. I have a bank. I pay them one way or another.

Mr. ROSENBLUM. No, no, see, you have to find a source. You have to find somebody who would have or who would be in the business of paying them and that costs money. So what you see in these platforms, what you see—

Mr. SHERMAN. Sir, I have lived my whole life. I am as old as almost anybody in the room.

Mr. ROSENBLUM. Oh, sir, that is very kind of you to say, but—

Mr. SHERMAN. And various intermediaries have handled my financial transactions my entire life and none of them have gone hungry.

Mr. ROSENBLUM. We are talking about a very different business model. And that is one of the things that is so important about this and what is so important about this—

Mr. SHERMAN. —We know that this is a good method for terrorists, criminals, and tax evaders. So the question is, is there some great social purpose that cannot be met in any other way? And I will want to hear from a different witness, and I don't see one volunteering.

Dr. BRUMMER. Honestly I think it is an important question because you are getting ultimately to this question as to whether or not many of these cryptocurrencies, and I think the vast majority of the cryptocurrencies tied to ICOs are really just means by which you are raising capital as opposed to currency.

I will say—

Mr. SHERMAN. Raising capital but unregulated—

Dr. BRUMMER. Oh, absolutely.

Mr. SHERMAN. —Doing an IPO but calling it an ICO—

Dr. BRUMMER. One of the key responses I was trying to mark for Mr. Rosenblum when discussing the adequate disclosures or the kinds of disclosures that one would like to see in a white paper is precisely in order to beef up those white papers so that they become more compliant with the expectations of our securities law, which I think is an expectation that all securities lawyers would enjoy.

But I am very sympathetic to that.

Mr. SHERMAN. But if I buy an ICO and the company sells great pizza and eventually makes billions, I don't get any of that. I am not a stockholder?

Mr. ROSENBLUM. But sir, the important thing on those tokens is the company that creates the platform may not have any financial success on the platform. And the fact that the platform becomes very successful may not redound to the benefit of the entity that created the platform.

Mr. SHERMAN. OK. Perhaps we will have another hearing after some major terrorist event financed by cryptocurrencies, and I yield back.

Chairman HUIZENGA. The gentleman yields back.

With that, the gentleman from Connecticut, Mr. Himes, is recognized for 5 minutes. Currently pass, OK.

We have some people potentially in transit, but if it is OK with my colleagues we would like to go on to a second round, which ba-

sically means I get to ask another question finally after having a number of them.

And Mr. Rosenblum, you asked for it. So differences between a commodity and a security?

Mr. ROSENBLUM. So in this case, as I said before, it is very difficult to know where one begins and one ends. The notion of saying, something has usage if we go back to the citrus groves that were at issue in the Howey test, there is no doubt that the citrus groves had usage. They really produced citrus fruit that people really sold. Didn't mean that the participation interest in those were anything other than securities.

The problem that we face is that I can draw a line for you that says when the promoter's efforts on the platform become less important than the commercial usage of the platform in driving the token value, probably it is no longer security under Howey.

What I cannot tell you is a good test or a good set of factors to look at that tell you with any great certainty when you get to that point. So the thing that I keep suggesting to people on this is I think that in the long run we shouldn't worry about that issue.

We shouldn't worry about the distinction between this is a commodity, this is a security, and how they travel back and forth between each other. But instead have a simple system, move to an environment where you have a simple system that works for both and we don't have to have lawyers like me argue with other lawyers and argue with the courts and argue with the SEC over which side of the line it is.

Dr. BRUMMER. So can I just jump in for one quick observation in response to something that you said, which I think is really quite useful? When you think about the citrus groves in the Howey case, this famous Howey case, you had oranges. The oranges themselves were commodities.

It was the combination of the oranges of a service contract basically with an opportunity to invest in them. It is the combination of it all where the whole is greater than the sum of its parts. And then you end up in the world of a security.

However, I would say that there is a difference in terms of how commodities are regulated under the CEA. And how securities are regulated. And securities regulators, for example, tend to put a little bit more of an emphasis on disclosure, the relationship that the SEC has with infrastructure providers and other market participants. There is a different level of reliance in the commodities world versus the securities world.

And these are things that I think that you, as a committee, really ought to take into consideration when you are drafting any potential legislative response.

And I would like to also emphasize that when we think about a commodity, one of the commonalities between the commodities world and securities world is an awareness that digital things tend to be more abstract and therefore they tend to be a little bit harder to understand and as a result there is a bit more attention that is focused and placed on those products.

Gold is the quintessential commodity because it is finite. People tend to like shiny objects. And it is universally identified as some-

thing that has value. Here we are debating a lot of that, and as a result our regulatory authorities and you as a—

Chairman HUIZENGA. And so based on those regulatory authorities, and we saw my colleague, Mr. Emmer, talk a little bit about this, and I see the natural tension. You have people saying there is no way I want any Governmental regulation on this. In fact, we came up with it. Get out of it. This is a fire free zone and we like it that way.

Government bureaucracies and agencies tend not to view the world through those lenses and I think there is a certain Governmental responsibility to protect those investors versus a known investor or a unique investor that is sophisticated in that.

And I have a minute left here, and I am going to be tight on this 5 minutes here, but I am curious, and anybody can answer this, will a Governmental central bank in any system recognize and utilize a cryptocurrency? Because I think until that point, this is going to be a bit of an outlier.

And whether it would be some small country or some others, it seems to me the only way that there is going to be an ultimate legitimization of cryptocurrencies is whether a central bank somehow recognizes it. Anybody?

Mr. ROSENBLUM. Mr. Chairman, I think several countries in Europe, for example, and in Latin America have already thought about and are already considering digitizing their currency. So I think that that is something that may very well happen.

I wonder though whether to at least—

Chairman HUIZENGA. But that is a little bit different. That is a Governmental-created currency versus a non-Governmental currency at this point, right?

Mr. ROSENBLUM. That is right, but I wonder what the difference is. Once we have moved away from the Bretton Woods Treaty, and once we have currencies floating freely around with each other. I think in one sense what we are worried about is that Bitcoin isn't backed by a state actor and that is about it.

Chairman HUIZENGA. OK.

With that, the gentleman from Georgia is recognized for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman. And, again, I am so excited about this new cutting edge, what I call the new frontier of our financial service industry and it is an exciting time for us.

But let me give you all this scenario. We have millions of new investors who are literally pouring their savings into virtual currencies here, and it is a wonderful thing. As I said before, it is burgeoning up. It is billions of dollars in capital being raised.

But then these facilities in this virtual currency are facilities that store and they transfer these digital assets for investors which are known as digital wallets. But here is the problem. These digital wallets have become targets for hackers.

And hackers are using social media, phone calls, and ads on search engines to fool investors into providing them with sensitive personal information that they can use to gain access to accounts at digital wallet providers and steal literally thousands of dollars' worth of virtual currencies. Hackers have also targeted the digital

wallets themselves, exploiting the vulnerabilities in their cybersecurity systems.

This was brought to my attention by SEC Chairman Clayton. He has pointed out that digital wallets storing or transacting digital assets that are securities, can trigger other registration requirements under the Federal security laws, including broker-dealer, transfer agents, or clearing agency registration.

So panel, what I want to ask you is what are the benefits to investors of digital wallets registering with the SEC? Would that help to defer? These are the kinds of technical and complex questions that present us as Members of Congress because it all falls on our shoulders. And most certainly we want to be responsive.

And as I said before, Co-chairman of the FinTech Caucus I am very proud of this industry. But I also know, for example, the OCC may come there. They are flirting from one position to the other of doing a special order charter for FinTechs. And then you have all these regulators boxing around how to identify them.

But all this comes to our lap, and if they are registered with the SEC should these digital wallets be subject to enhanced cybersecurity protocols such as Chairman Clayton said, as the SEC's regulatory systems compliance and integrity of Reg SCI? We are dealing here with an opportunity to get it right before we get it wrong.

So tell me, Mr. Van Valkenburgh?

Mr. VAN VALKENBURGH. Thank you, Congressman. I think the testimony of both Chairman Clayton and Chairman Giancarlo before the Senate Banking Committee is extremely important to take a look at, to think about how those two regulators are construing the space.

Chairman Clayton, as you rightly said, talked about tokens that are securities either because the token does represent a legal agreement, it is a company saying these are shares of our stock, or because the token is a speculative promise of future efforts, fits the Howey test.

But Chairman Clayton also talked about what he called pure cryptocurrencies. He used the term on several occasions. And the Chairman suggested that those are outside of SEC jurisdiction and if you look at one of his responses to the questions he said, "Do not misconstrue me saying that is outside of our jurisdiction as asking for more jurisdiction."

And I think that is probably because the colleague sitting to his left was Chairman Giancarlo of the CFTC, an organization that has expertise in policing markets for scarce commodities, which pure cryptocurrencies, I would argue, very much are. So I think we want to look to the institutional competencies of these two different agencies to protect investors.

And that means the CFTC will continue to use its existing authority to police spot markets for fraud and manipulation if the spot market is trading commodities and the SEC will ensure that only tokens that are securities are traded only on ATSes or national securities exchanges, which will have to go through all of those cybersecurity requirements.

Now, where there might be a gap, if there is any gap, is the fact that the spot markets for cryptocurrencies are policed by the CFTC

ex post, not supervised by the CFTC ex ante, for things like transparency, cybersecurity standards, and the like. Instead, they are supervised by the States in a patchwork approach that includes the BitLicense and others.

It might be time to rationalize and Federalize that supervision of cryptocurrency markets.

Mr. SCOTT. And so if you saw those two agents—

Chairman HUIZENGA. I am sorry. The gentleman's time has expired.

Mr. SCOTT. All right. Thank you, sir.

Chairman HUIZENGA. With that, the gentleman from North Carolina, Mr. Budd, is recognized for 5 minutes.

Mr. BUDD. Thank you, Mr. Chairman. And again, thanks to each of you for being here today.

Peter, I want to publicly thank you for the private briefing that you and Jerry gave several weeks back and just say how helpful that was and just to encourage any other members, staff on either side of the aisle just to reach out. You guys have been very helpful in bringing us up to speed on this, so thank you again.

Mr. VAN VALKENBURGH. Thank you.

Mr. BUDD. So I want to make a statement and then ask a few questions. One, regulation in this space is something that the U.S. we have to get right because poor or rushed policy with respect to cryptocurrency and tokens, in my opinion, it really threatens America's leadership in finance and in technology.

So we have to be careful to avoid missteps. This technology has potential to become something great, so I just think that we should move with caution here.

And on that note, I am curious about an idea that I have heard and being floated around as a potential regulation scheme for cryptocurrencies. So this idea would divide cryptocurrencies into securities and non-securities with security coins being regulated as securities and non-security coins being regulated as commodities.

So the obvious difference between the two being the security coins would offer dividends or equity or anything that did not, again, be on the other side, would be on the commodity side. So I am curious, Peter, to get your thoughts on this idea first.

And then Dr. Brummer, if you have any thoughts if you could answer that as well?

Mr. VAN VALKENBURGH. Thank you, Congressman. The first thing I would point out is that this is a global technology, and U.S. laws are not a good fit for both the innovators and the investors as far as protecting them but also enabling markets, these technologies will move to other jurisdictions.

The Congressman is, I think, correct that a sensible way of dividing these markets is between things that are more commodity-like and more security-like. And in the U.S. the flexible test for a security, the Howey test, is the tool for doing that.

But it is not the tool globally. In Europe, for example there is more of a black letter law approach than a flexible test. Certain things have been identified in various European jurisdictions as securities and they are more of what you suggested, things that clearly offer a dividend or capital return on investment.

Finding a more bright line test may be useful, although the SEC's flexibility with the Howey test can be very helpful in going after schemes that pretend to not be securities by not offering those formal things.

So finding a way forward is not easy, but probably worth considering because at the moment you see many more of these truly innovative capital formation opportunities moving over to Europe. You see a lot in Switzerland. You see a lot in Germany. And these are not countries with lax securities regulations. These are just countries with a more certain legal test.

So I think guidance from the SEC as to how they will interpret the Howey test with respect to token sales, they have already had a lot of very deliberate statements that have been very helpful, but further guidance might be helpful, especially with respect to exactly how you draw the line. And it might look more like what Europe is doing these days.

Dr. BRUMMER. So I guess my first response is that Europe's approach on this is very much uncertain, number one.

Number two, they don't have a definition in place firmly for virtual currencies under MiFID and other European Union regulations and rules. And they are grappling with these same issues just as we are today. And there is an enormous amount of uncertainty as to how that is going to just play out.

I think when it comes to the commodity securities question, I agree with Peter. Maybe there is a little bit more of a difference of tone. Institutional competence is extremely important when thinking about who should be regulating different financial products.

My testimony today emphasized the question of disclosure. And I think that even when it comes—I think that Bitcoin is not the same as gold and I think that people intuitively understand it a lot less.

And so this creates very important questions as to what kinds of disclosures should be related to pure cryptocurrencies that may legally, under current law, resemble a commodity or be classified as as a commodity as opposed to a security because the disclosure process available under the CEA is more or less of a buyer beware approach versus a much more fulsome approach adopted under the SEC.

And so a decision has to be made as to not just the competence but even under existing rules no matter which, excuse the pun, side of the coin you may fall, there will be subsequent rulemaking required in order to adopt and to adapt your existing regulatory processes to a virtual currency. And I think that it is important that people recognize this, that there is going to be work that will have to be done, both on the SECs and as well as under the CFTCs in order get it right.

Mr. BUDD. Thank you both.

I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

The gentleman from Connecticut is recognized for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman. I will yield my time to Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Himes. I appreciate that.

Mr. Van Valkenburgh, you hit it on the head as to what I think we have an obligation both to this burgeoning industry here, as well as to the safety of the American people. All this technology that we have being applied in very sensitive areas makes us become almost a servant of the machine technology that was created to serve us.

And we have to get this right in terms of what I think is a delicate balance of the right regulation that really helps to solve the problem. We have hackers out there that are at work and damaging great careers and jobs and just the lives of the American people. And they look to us here in Congress to try to solve that.

And so when I brought that issue you brought up how the CFTC and the SEC would work together in working with this, which presents another problem that we have. And let me ask you in that situation the great need for harmonization because that is the problem we have.

When we have these regulators involved and you have several regulatory agencies, it puts your industry in somewhat of an awkward position trying to figure out and try to make sure that they are both coming at it the same way. So would you recommend that whatever we do, knowing these different agencies, that Congress put in whatever we do a rule for harmonization?

Mr. VAN VALKENBURGH. Yes. I do think harmonization is critical. Chairman Giancarlo, when he talks about policing authority over these spot markets for commodities, emphasizes that they don't have any ex-ante authority. They don't have the ability to supervise beforehand. They are not the regulator on point.

And as I was briefly saying earlier, the regulator on point is largely the States, whether it is through the BitLicense or through money transmission licensing. And so it is not just anarchic as between Federal agencies potentially. It is anarchic as between Federal agencies and various State regulators.

I think State-by-State money transmission licensing is both the biggest impediment to the technology because of the profound and redundant and nonproductive costs that it imposes on the industry and on the ecosystem. And it also is not an adequate way to protect consumers or investors.

I think we need to start a conversation in Congress about Federal pre-emption of State money transmission licensing law that would also include sensible investor protections for those who become licensed by a Federal authority.

And Chairman Giancarlo, in his testimony before the—I believe it was before the Ag Committee not Banking Committee in the Senate said what that will look like will be data reporting, capital requirements, cybersecurity standards, measures to prevent fraud and price manipulation and anti-money laundering and Know Your Customer protections.

That is a sensible package to require from intermediaries in our cryptocurrency space, and it is the low-hanging fruit from a harmonization standpoint of what Congress can do soon.

Mr. SCOTT. Thank you very much, Chairman.

Chairman HUIZENGA. The gentleman yields back the time.

So I would like to thank our witnesses for today. I thought this was illuminating in so many various areas and completely befud-

dling in others, which—welcome to Congress I guess. But it was very helpful and thank you for this.

I believe that this is probably hello not good-bye. We are going to be continuing to have this conversation.

I do have—without objection, I would like to submit the following statement for the record, a statement from Liquid M Capital, Inc. without objection, so moved.

Without objection, all members will have 5 legislative days within which to submit additional written questions for the witnesses to the Chair, which I will then forward on to you all. And I would just ask our witnesses to please respond as promptly as possible.

And without objection, all members will have 5 legislative days within which to submit extraneous materials for the Chair for inclusion into the record as well.

So again, thank you very much for your time and your attention to this and your insights. And this hearing is adjourned.

[Whereupon, at 12:07 p.m., the subcommittee was adjourned.]

A P P E N D I X

March 14, 2018

GEORGETOWN LAW

Written Testimony of

Chris Brummer
Agnes N. Williams Professor of Law
Faculty Director, Institute of International Economic Law
Georgetown University Law Center

Before the United States House of Representatives
Committee on the Financial Services
Subcommittee on Capital Markets, Securities and Investment

"What Should Be in an ICO White Paper?"

Wednesday, March 14, 2018
10:00 am
2128 Rayburn House Office Building

GEORGETOWN LAW

What Should Be in an ICO White Paper?

Chairman Huizenga, Ranking Member Maloney, and Members of the Subcommittee:

Thank you for inviting me to testify at this hearing. My name is Chris Brummer. I am the Agnes N. Williams Research Professor of Law at Georgetown University Law Center, and the Faculty Director of the Institute of International Economic Law, where I teach courses in securities law and international financial regulation, among other topics.[1] I am here today solely in my academic capacity and am not testifying on behalf of any entity.

The rising popularity of Initial Coin Offerings—and an accompanying spate of fraud and market volatility—has prompted an important debate here in Washington, D.C., and indeed around the world, about proper government responses to ICOs and cryptocurrencies more generally.[2] Some of the most pressing questions involve the appropriate division of authority between the CFTC and SEC, and whether their authority should reach deep into the heart of the cryptocurrency ecosystem, the spot market.[3] Still others contemplate whether or not an entirely new or alternative regulatory regime is needed for cryptocurrency and token fundraises, not only here but also in Europe and elsewhere.[4]

My task today is a comparably more modest venture. Given the complexity and heterogeneity of ICOs, and the limitations of our time, I believe it's important to start with the basics, and contemplate just what kind of informational features, backstops and

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[1] Georgetown's Institute of International Economic Law is the focal point for the study of law and international economic policy at Georgetown University, and hosts dialogues, lectures, conferences and executive training for senior government officials and private sector professionals on issues relating to financial regulation, trade, tax and monetary affairs. For more, see http://iielaw.org.

[2] See, e.g., Jason Rowley, *ICOs delivered at least 3.5x more capital to blockchain startups than VC since 2017*, at https://beta.techcrunch.com/2018/03/04/icos-delivered-at-least-3-5x-more-capital-to-blockchain-startups-than-vc-since-2017/; Oscar Williams-Grut, *Only 48% of ICOs were successful last year — but startups still managed to raise $5.6 billion*, at http://www.businessinsider.com/how-much-raised-icos-2017-tokendata-2017-2018-1.

[3] Brian Fung, *U.S. regulators say they don't have enough power over cryptocurrency*, at http://www.chicagotribune.com/business/ct-biz-sec-cftc-cryptocurrency-exchanges-20180206-story.html.

[4] Chris Brummer, *Whatever challenges the US faces in regulating cryptocurrencies, the EU has far more*, at https://chrisbrummer.com/whatever-challenges-the-us-faces-in-regulating-cryptocurrencies-the-eu-has-far-more.

rigor one would like to see in an ICO fundraise, and then reflect on the sufficiency of existing regulatory tools.

With that in mind, my written comments below focus on *disclosure*. Evidence of fraud is rife in many ICOs, necessitating welcome responses by regulators,[5] but an awareness of the need for better policing of these markets is not in itself sufficiently instructive as to what one would like to see affirmatively disclosed in ICOs, whatever the overlying regulatory architecture. And this is a critical issue for this subcommittee, and the greater regulatory community. Disclosure has long been the bedrock of U.S. securities laws, which have relied on information to serve as the primary tool with which to empower investors to make appropriate, informed risks with their life savings, and by extension allocate capital efficiently in the economy.

The disclosure system embodied in the Securities Act of 1933 is largely one where promoters share, among other things, material information publicly about their company, management, and securities being offered, as well as their intended use of proceeds. This information is then filed with the Securities and Exchange Commission. Most ICO disclosures, by contrast, are facilitated via currently unregulated "white papers" focusing largely on the existing technology or technology under development or to be financed via the offering.[6] There is, as a result, a large gap between the disclosures required in an S-1 (and arguably Form 1-A) and that which is provided in most white papers.

For our purposes today, I would like to highlight some of the key disclosures one would expect, and likely need to have for buyers of ICO tokens—whether they are investors seeking to profit or technology users seeking to support and participate in an innovative product—to make a purchase in an informed manner.[7] These disclosures are especially relevant, I believe, as ICOs transition from technical expert ecosystems to the distribution of instruments that are ever more likely to attract everyday investors and the retail public:

- Promoter's Location and Contact Information
- Problem and Proposed Technology Solution
- Description of Token
- Qualifications of Technical Team
- Industry Risk Factors

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[5] See, e.g., *Joint Statement by SEC and CFTC Enforcement Directors Regarding Virtual Currency Enforcement Actions*, at https://www.sec.gov/news/public-statement/joint-statement-sec-and-cftc-enforcement-directors.

[6] I note "mostly" since disclosure can also occur outside of the white paper, in "virtual" public roadshows—for example, Ask Me Anything (or "AMA") sessions on Reddit, Telegram, or Slack—where the development team answers questions submitted by the public in real-time.

[7] Importantly, these are not concerns relegated exclusively to realm of law professors and regulators. At least one entrepreneur has ventured similar observations. See Andrew J. Chapin, *What to Look for in an ICO White Paper*, available at https://hackernoon.com/what-to-look-for-in-an-ico-white-paper-successful-token-54eba3787139

Promoter's Location. At least one academic study has noted that in roughly 32% of ICOs, it is not possible to identify the issuing entity's or promoter's origin.[8] This creates serious information asymmetries on the part of the investor. Without knowing the issuing entity's or promoter's origins, it becomes impossible to know or identify what rules and legal protections might be afforded to investors. Further, investors have few means by which to contact relevant public authorities in case of fraud, theft or loss. ICO white papers should, therefore, set out a detailed statement (beyond a simple P.O. box) of where the issuer as well as its key management are located. Without a verifiable geographical address, ICO white papers should not be permitted for use in raising funds.

Problem and Proposed Technology Solution. For most of the history of U.S. Securities law, no information was more important for investors than the issuer's financial statements. By being able to scrutinize balance sheets, cash flow- and income statements, investors could evaluate a company's past performance, make informed guesses about its future performance and profitability, and make an estimation of the value of a company's securities. And precisely because of the centrality of financial statements in securities offerings, an entire ecosystem of third party auditors, accountants and credit rating agencies were developed and relied on to ensure the accuracy of financial statements and their compliance with best practices.

ICOs tend to serve a different purpose from most traditional IPOs. Instead of funding industrial companies transitioning into a more mature cycle of development, ICOs involve products developed by startups identifying technology-based problems (like limited or volatile cloud storage needs) and proposing the sale or financing of technology-based "solutions" (like a peer-to-peer platform for buying and selling cloud storage space). In return for financing, promoters offer coins with varying currency, utility or securities features.

For most of these offerings, it is not a company's past performance, or even financial statements, that are the window through which value is perceived, but more the venture's technology proposition. Consequently, ensuring that investors (including retail buyers) understand the basic contours of the underlying technology solution is paramount as ICOs become more popular means of fundraising.

To that end, an optimal disclosure system for ICOs would require to the extent possible a "plain English" description of the technology problem and solution.[9] Furthermore, for

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[8] Dirk Zetzsche et. al, The ICO Gold Rush, It's a Scam, It's a Bubble, It's a Super Challenge for Regulators, Working Paper (Nov. 16, 2017), 12.

[9] Securities Act Rule 421(d) requires issuers of securities to write the cover page (front and back, inside and outside), summary and risk factors section of prospectuses in Plain English. For shorter white papers, or Form 1-A, there should be consideration of extending the rule throughout the document for investors unfamiliar with the sector.

larger fundraises, the more technical parts of the white paper would ideally be subject to a system of third party validation (what I will term a "technology audit") confirming that the solution disclosed in the white paper complies with sound engineering and mathematical principles. ICO promoters could be required to disclose just what if any third party audit of their solution was conducted (and if there was no such audit, then this, would be affirmatively disclosed), the material features of that auditing system, and the results of the audit. Meanwhile, all code, regardless of the size of the fundraise, would be posted to a public code repository, such as Github, so potential buyers can either diligence the code itself or other proxies for the strength of the code.

Promoters should avoid hyperbole when describing their solutions, an endemic problem in white papers—and should also be required to identify an objective basis for all forward-looking statements. Along these lines, disclosures should be made as to whether post-ICO financial statements will be provided to token holders.

Description of the Token. Just as a clear description of the technology should be required, so should an adequate description of the token. Tokens can have a variety of different qualitative and economic features.[10] With such variety, token descriptions should indicate the intended use of the coins issued in the offering, their quantity, when and whether the founders or advisors will hold reserve coins, and how they may choose to liquidate them (including whether there are any restrictions on their ability to sell). If the tokens will be based on a technological format that must comply with certain rules, such as the ERC20 standard, the disclosures should clarify what that means to a typical holder. If special efforts will be made to list a token on a regulated exchange or alternative trading system (or ATS), or if there are trading restrictions on the security, those facts should be disclosed in a manner that is clear to the prospective token holder. Finally, promoters should be required to disclose the IP/ownership of the company's protocol (including which elements have been borrowed from elsewhere), as well as detail with specificity what legal rights holders of the tokens enjoy.

Blockchain Governance. Investors should be informed as to how the supporting infrastructure operates, and how it will impact the governance of the token. Along these lines, the consensus mechanism for a virtual currency's blockchain should be disclosed, along with an overview of how governance decisions and other decisions effecting the network (e.g., software upgrades) will be coordinated among the various stakeholders (e.g., developers, users, miners).

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[10] Some offerings more closely resemble traditional perks-based crowdsales, and offer tokens or coins that provide for access to specific services or features. These so-called utility tokens can also serve as the means to compensate or otherwise incentivize contributors, users, developers and other active participants in a network of like-minded technology users that is commonly called an ecosystem or community. Other tokens, by contrast, are built with more overt securities attributes offering participation interests, dividends, and promises of a management team to expend efforts in search of profits for the token holder. Still others, are adopting convertible characteristics that offer rights to vote on the technological direction of the token, or the right to exchange the coins for other coins in the future.

Qualifications of the technical team. Information about the business experience of executive officers and directors is a common disclosure requirement in registered offerings.[11] They give investors a sense of the quality of management, and likely success of the company once a company goes public. In ICOs, where firms have limited histories and the technology at issue may be exotic, similar information about the offering's technical team can be especially valuable. Coders have varying backgrounds, with some more (and much less) qualified, credentialed or experienced than others. In order to provide investors with some sense as to the expertise and credibility of the white paper, founders should be required to provide all material information relating to key engineering experience, skills, qualifications and other relevant attributes. Where relevant, developers should also be required to provide links to their previous work on a public code repository.

Risk factors. ICOs should include disclosures concerning the most significant risk factors affecting token holders in the offering document. Although most investors likely realize that even successful ventures might be later disintermediated by more efficient upstarts, a token holder may be surprised to find that the product does not yet function as intended or may develop a new use or purpose altogether depending on the development of the technology or, perhaps even less predictably, the wishes of the participants in the ecosystem. Holders should also understand the larger sectoral risks as well, including changes in the industry that could relegate some blockchain designs to more niche roles in the sector, and render many tokens worthless. Critically, buyers must be made fully aware of their potential vulnerability to hacking, data-loss, and disruption, as well as legal issues like privacy concerns and data portability across borders.[12]

I want to stress that there are undoubtedly additional, somewhat more technical disclosure requirements that would make sense under U.S. securities laws, though I believe it useful to start with the most obvious first as a basis of our discussion today. I appreciate your time and look forward to your questions.

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[11] 17 CFR 229.401

[12] See *Hackers Have Walked Off With About 14% of Big Digital Currencies*, available at https://www.bgov.com/core/news/#!/articles/P2R7QI6S972B

Written Testimony of
Mike Lempres

Chief Legal and Risk Officer
Coinbase, Inc.

before the

House Committee on Financial Services

Subcommittee on Capital Markets, Securities,
and Investment

Hearing on:
"Examining the Cryptocurrencies and ICO Markets"

March 14, 2018

Good morning Chairman Huizenga, Ranking Member Maloney and members of the Subcommittee:

Thank you for the opportunity to address this important topic at a significant time. My name is Mike Lempres, and I am the Chief Legal and Risk Officer at Coinbase, the nation's leading digital currency exchange and wallet service. I commend you for holding this hearing on a technology that could transform capital formation, innovation and our economy. Moreover, I commend you for holding this hearing now because this technology is in an early, vulnerable state. It has tremendous potential. To fulfill that potential, we believe that responsible regulation is required. At the same time, we want to help ensure that the technology's incredible benefits are not inadvertently stifled by regulatory or legal missteps.

I am pleased to testify this morning on behalf of Coinbase. For those of you who are not familiar with Coinbase, allow me to explain who we are and how we fit into this extraordinary ecosystem. Coinbase was founded in 2012 with a mission to create an open financial system for the world. From our inception, we sought to operate transparently under regulation and view ourselves as a leader in the legitimization and maturation of the crypto economy. We provide an onramp for acquiring, trading and holding digital currencies. Through our strategy of operating the most trusted and easiest to use digital currency exchange and wallet, we have grown dramatically. We now serve over 20 million customers; we store more than $20 billion worth of digital currencies; we have traded over $150 billion in assets; we support business in 32 countries; and we have more than 250 employees in three offices (with full time contractors, we have nearly 1,000 dedicated personnel). We have received over $225 million in funding from some of the nation's leading venture capital and financial service firms.

We operate a spot exchange that offers the ability to buy and sell four digital currencies. There are more than 1,400 currencies and tokens available, yet we limit our trading to four that have regulatory clarity: Bitcoin ("BTC"), Ether ("ETH")[1], Litecoin ("LTC") and Bitcoin Cash ("BCH").

We have very strong cybersecurity protections and compliance practices to ensure that we remain the most trusted company in this space. Our cybersecurity program is state of the art and it is the critical core of our business. Similarly, our compliance program is designed to build upon the highest levels of compliance in our industry. One measure of our commitment to compliance is the fact that nearly 20% of our employees work in our compliance group. Our Know Your Customer ("KYC") and Bank Secrecy Act ("BSA") programs are particularly well supported, and we have been recognized for this by being the only digital currency company serving on FinCEN's Bank Secrecy Act Advisory Group ("BSAAG").

[1]Ether has been recognized by both the CFTC and the SEC as a virtual currency. Ether is considered by many to be more functional than Bitcoin and is used as the backbone of many emerging blockchain-based projects. New ether tokens are mined by nodes validating new blocks in the blockchain -- similar to bitcoin -- and are not issued by a central entity to raise funds.

We have been registered as a money service business with FinCEN since 2013. Another federal agency, the CFTC, has asserted jurisdiction over our spot market based on their authority related to fraud and market manipulation. In addition, we have 40 licenses in 38 states. Most of these licenses are money transmission licenses. Significantly, we are one of only four companies that hold a Bitlicense from New York State's Department of Financial Services, the nation's only license specific to cryptocurrency regulation and supervision.

In addition to our formal regulatory role, Coinbase continuously shares its expertise to make sure our ecosystem is clean and compliant. We train more law enforcement agencies globally than anyone, even the Department of Justice. We have a team of individuals who offer expert training on cryptocurrencies and the blockchain to the world's leading law enforcement agencies, including: the Federal Bureau of Investigation, Drug Enforcement Agency, Marshals Service, U.S. Postal Service, Department of Homeland Security, U.S. Secret Service, Internal Revenue Service's Criminal Investigative Division, Europol, Interpol, Scotland Yard, the Royal Canadian Mounted Police, the Swiss Federal Police, the Spanish Federal Police and many state and local agencies.

Coinbase Exchange:

Coinbase operates a digital currency exchange that primarily serves institutional customers. The exchange only operates a spot exchange; there is no margin or derivatives trading. Coinbase is very deliberate about which tokens it supports on the exchange. Currently, the exchange supports only four assets (BTC, ETH, LTC and BCH). Part of the reason we trade only those four assets is that each has been determined by regulators to be a virtual currency and therefore not a security. We are studiously avoiding listing tokens that could be determined to be securities because we are not currently licensed to trade securities and cannot take the risk of inadvertently trading an asset that is later found to be a security. Not all exchanges give such a priority to compliance with the laws, and many assets are currently available to investors outside of regulatory oversight.

At Coinbase, we have worked to bring clarity to the issue of what assets we can support since 2016. To help potential market participants, we published our Digital Asset Framework to provide transparency about how we consider listing new assets. A key factor in our framework analysis is a determination that the potential new asset is not a security under U.S. law. The absence of regulatory clarity has slowed our willingness and ability to list new assets.

I should note again that the CFTC oversees our market for investor protection purposes, specifically to look for fraud and market manipulation by market participants. We welcome that oversight.

Our View on ICO's:

We currently do not trade ICO's or any other security tokens. Despite that, we believe that security tokens are inevitable and full of tremendous potential. They can provide a much more efficient and effective method of capital formation. They can help spur innovation, launch new companies, create new jobs, and generate growth in the U.S. economy. Moreover, they can allow broader participation in capital markets by investors and companies. This means they can unlock the ability of entrepreneurs anywhere in the U.S. to raise money on a level playing field. Entrepreneurs won't need to know funders in Silicon Valley or New York to access vibrant sources of capital. At the same time, there is a need for responsible regulation to ensure investor protection. We welcome that regulation.

In order to fully enable ICO's, investors must know they have the same kinds of protections when investing in ICOs as they have when investing in more traditional securities. Investors must have confidence in the integrity of the market. For this reason, we support enforcement actions where they are necessary to weed out bad actors and to protect investors. This is particularly important in the early stages of markets before they reach full maturity. I cannot speak directly to recent SEC enforcement actions because I do not know all the facts. However, it is important the SEC take enforcement actions when necessary to protect against bad actors, protect investors and help maintain public confidence in markets.

At the same time, we need to be sure that we are not killing good innovation brought about by new technology and good actors. Unfortunately, the current regulatory environment -- in particular regulation by enforcement without enough clear guidance on what is permissible -- is harming healthy innovation in the U.S. There is so much uncertainty about the definition of a security and the scope of regulatory control that the market is being chilled. This is bad for everyone because the technology won't stop - it will simply move overseas and we will miss out on the opportunity to cultivate the benefits in the U.S.

For us, the chilling effect can be shown by the difficulty of determining with certainty when a token is not a security. Because we seek to comply with all applicable laws and regulations, we simply cannot take the risk that a token is later found to be a security.

A Comprehensive Federal Regulatory Regime Exists Today:

We believe there is no need for Congress to create a new regulator or a new regulatory scheme because federal regulators already have sufficient authority to regulate this space effectively. There are at least four federal regulatory agencies that can effectively protect investors and the markets:

- the SEC has authority over securities transactions;
- the CFTC has authority over spot markets in commodities for fraud and market manipulation, and it has full authority over commodity derivatives transactions;

- FinCEN has full authority for Know Your Customers (KYC) and Anti Money Laundering (AML) matters; and
- the Federal Trade Commission ("FTC") has authority for false advertising and certain consumer protection.

In addition, this federal regulatory regime exists alongside vibrant state regulations. As mentioned, we hold 40 licenses in 38 states, including a Bitlicense in New York state. That Bitlicense is intended to be a comprehensive consumer protection regime specific to operators of digital currency businesses.

Regulators Need to Provide Clear and Consistent Guidance:

Although regulatory coverage is deep and broad, it is not clear where one regulator's authority ends and transitions to another. This leads to a lack of clarity for companies who must make decisions prospectively about which regime applies at what time to each asset. Much clarity would come from coordination amongst regulators on this issue. Instead, today's environment calls to mind the parable of the blind mice and the elephant - each agency looks at tokens from its own narrow perspective:

- the SEC says these assets, particularly ICO's, are probably securities;
- the CFTC says tokens are commodities, unless they are securities;
- the IRS says they are property;
- FinCEN says tokens are money; and
- other agencies see tokens through their own lens.

This lack of coordination can be shown by the inconsistent tax treatment that hinders the development of this new asset class. The IRS views these assets as property and taxes them as such. This treatment undercuts the relative efficiency of tokens in raising capital.[2] It appears that, even issuing a security token that is compliant with all SEC obligations, will lead to tax treatment at the much higher rates that attach to property, which may be taxed as income. This relatively adverse tax treatment will chill the market for an otherwise compliant security token.

More fundamentally, under current practices, it is difficult to determine whether a token is a commodity or a security. The SEC and CFTC could easily draw a line to determine whether a token should be treated as a commodity or a security for compliance purposes. The agencies have done this before when new asset classes emerge, for example in addressing stock indexes (generally narrow-based indexes are securities, broad-based indexes are commodities, with mathematical way to make determination) and swaps (generally the SEC has jurisdiction over swaps with securities as the underlying asset, the CFTC retains jurisdiction over all other

[2] IRS consideration of digital currency as property also hinders the development of the asset as a currency. By way of example, in purchasing a $3 cup of coffee with digital currency a consumer is exposed to being taxed on a capital gain and would be expected to track the basis of the fractional amount of currency used to make the small purchase.

swaps). Agency coordination will enable companies to develop stronger compliance programs and will empower the many benefits of these tokens.

The dividing line that defines securities comes from the 72 year old case of SEC v. W.J. Howey Co. (328 U.S. 293 (1946). *Howey* dealt with the sale of real estate contracts for the development of a citrus grove for housing. It's a long way from cryptocurrencies in 2018, but the basic principles behind the *Howey* test can still work. One challenge of the *Howey* test is that different analysts can apply the same facts and reach different conclusions. The difficulty of accurately predicting an agency's *Howey* analysis chills responsible exchanges. We cannot take the risk of supporting an asset that is later determined to be a security. The agencies should provide guidance about the application of *Howey* to distinguish between what is and is not a security. In order to provide clarity in this very important distinction, the agencies will have to distinguish utility tokens from investment contracts and other forms of security.

This New Technology Can Offer Utility Separate from Investment:

One way in which tokens may differ from traditional asset classes is that these assets can offer a path to utility. In other words, tokens can be used to purchase access to services, and their value can be determined by the worth of those services. For example, tokens can be used to access or acquire data storage space or to pay users to receive advertising. These utility tokens provide access to goods or services provided by decentralized networks or ecosystems of users rather than services provided by individual companies.

The emerging new technology of utility tokens is well beyond anything that existed at the time of *Howey*, and they do not fit neatly into that framework. Congress should insist that the SEC and CFTC coordinate, as they have in the past, to clarify how companies, markets and investors can determine whether an individual token is a security or a commodity. The agencies can clarify rules around what constitutes a security in this space by looking at issues such as whether there is a central issuer and the role of investment contracts at the time of issuance. There are new applications, but the basic principles remain consistent with today's regulatory framework.

The U.S. is a World Leader in this Important New Technology:

The U.S. is perfectly positioned to take advantage of the benefits of this new technology. We are the most innovative and entrepreneurial country on earth. If permitted, capital will flow into this country because we are the best place on earth to create companies that meet new opportunities. This will create benefits for both U.S. investors and entrepreneurs. However, capital in this space can move around the world nearly without friction. If the U.S. does not provide a clear, thoughtful regulatory environment, the investment can move very quickly to other countries.

Conclusion:

As mentioned at the beginning, we operate the most trusted and easiest to use platform to access digital assets. As our markets mature and go ever more mainstream, being the most trusted is more important than ever. We believe that trust is enhanced through partnership with regulators.

Thank you for addressing this important innovative technology early enough in its development to help guide it to spur new capital formation and protect investors. Clarifying the U.S. legal and regulatory system to meet those twin goals will lead to innovation, job creation and increased U.S. competitiveness.

At Coinbase, we are committed to working with you, the SEC, the CFTC and other regulators to help shape a responsibly regulated market. We believe the decisions you are making now will help determine the economic future of innovation and capital formation in the future. That future is not 20 years away; it's almost here now.

Thank you for this opportunity to discuss these issues today. Please consider us a resource if we can be of any help as you address these issues. I look forward to answering your questions today.

Testimony on
"Examining the Cryptocurrencies and ICO Markets"
by
Robert Rosenblum
Partner, Wilson Sonsini Goodrich & Rosati

Before the
Capital Markets, Securities and Investment Subcommittee
of the
House Committee on Financial Services
United States House of Representatives
March 14, 2018

Chairman Huizenga, Ranking Member Maloney, and Honorable Members of the Subcommittee, I am honored to be here today, and I am delighted that the Subcommittee is holding this hearing. I believe that Congress should pass legislation in the near term that will authorize and direct regulators to modify or eliminate regulations that needlessly impede the innovation and capital formation opportunities offered by the development of blockchain and cryptocurrency technologies,[1] while at the

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[1] One of my clients describes a blockchain, non-technically but helpfully, as a spreadsheet that resides on no single computer but that is accessible from any computer. In this formulation, the terms "cryptocurrency," "coins" and "tokens," which I generally refer to as "**tokens**" or as "**cryptocurrency**," are things that are tracked on the spreadsheet, and they can generally have almost any properties the token developer sets. In general, the company that issues the tokens or a related entity or foundation (collectively, the "**Token Company**") also develops a blockchain-based platform that permits the tokens to be used in connection with specified types of commercial transactions, such as the purchase and sale of certain goods or services. The platform also may permit users to earn tokens by performing some service that is useful to the platform, such as by verifying the accuracy of information, or by providing information, that is relevant to the platform.

same time assuring that appropriate provisions are in place to protect token investors and token users.

I also believe that in the longer term, Congress should pass legislation establishing a comprehensive legislative and regulatory system governing blockchain and cryptocurrency in the United States. While I believe it is currently too early to know exactly what such a system would look like, I believe there are some principles and approaches that Congress can identify now, and that these can serve as a framework to begin developing that legislation.

My goal today is to describe the legislation that I believe Congress should adopt as soon as reasonably possible, and to also describe a framework for the more comprehensive legislation Congress may enact in the future.

Introduction

At the outset, I would like to introduce myself, and to briefly describe why I am so pleased to have the privilege of appearing before this Subcommittee today. I am a partner in the Washington DC office of the Palo Alto-based law firm Wilson Sonsini Goodrich & Rosati. Wilson Sonsini generally is recognized as the premier legal adviser to technology, life sciences and other growth enterprises worldwide. The views I present today are my own, and are not necessarily the views of Wilson Sonsini or of my partners and other colleagues. I also am not appearing here today on behalf of any client or any third party, and my clients might not agree with all or parts of my testimony.

I am the head of Wilson Sonsini's Blockchain and Cryptocurrency practice. I represent a large number of companies in their coin and token

offerings (often referred to as initial coin offerings, or "**ICOs**").[2] I also represent, among others, institutional investors in connection with their investments in ICOs, private funds that invest in ICOs, companies that assist issuers in conducting ICOs, and companies that will provide advice to ICO investors. I have practiced in the securities and financial services field for over 30 years, and during that time I have represented public and private companies, private funds, registered funds, investment advisers, broker-dealers, fintech companies, law firms and a variety of other companies. I started my career at the Securities and Exchange Commission ("**SEC**").

Blockchain Innovation. In the ten months or so since ICOs started becoming wide spread in the United States and throughout the world, I have had the pleasure of working with some amazingly talented and creative entrepreneurs who hope to use blockchain technology and tokens to:

- solve difficult issues, ranging from improving internet security to helping low- and moderate-income people obtain credit;
- create new types of businesses, such as businesses that permit individuals to determine whether and how to release private information, and to compensate those individuals for releasing that information; and
- dramatically reshape existing businesses, such as: (i) the way electrical power is delivered in the United States and other

[2] The terms "initial coin offering" and "ICO" are something of a misnomer. They likely are meant to refer to a public offering of tokens to the retail public. However, the SEC takes the position that most tokens are securities, and that it generally is illegal to sell tokens to the retail public unless, for example, the tokens are publicly registered or are qualified for public sale under Regulation A+. As a result, most initial offerings of tokens in the United States now involve private placements to accredited investors. In addition, in many of these offerings, the issuer actually sells an agreement to deliver tokens at some point in the future; this agreement often is referred to as a simple agreement for future tokens, or "**SAFT**." For convenience, I will refer to the initial sale of both tokens and SAFTs as an ICO, regardless of whether the sale is public or private, and regardless of whether the instrument sold is a token or a SAFT.

developed countries, as well as the way it is delivered in third-world countries that lack developed power grids; (ii) the way people use and interact with each other through social media; and (iii) the way people determine the validity of the news they read and hear about.

Capital Formation Opportunities. I also have had the opportunity to represent Token Companies and token investors in what may be a new type of capital raising transaction that seems to potentially offer significant benefits to both. Until recently, a company that wanted to raise venture capital or other early-stage financing might sell common or preferred stock, convertible debt or other securities that give investors an economic interest in the company. A company seeking to raise traditional venture capital financing often is limited to raising small amounts at the earliest stages (often in the range of $1 million to $2 million), and the amount it can raise in later rounds (such as series A rounds and beyond) often is based on a negotiated valuation of the company (which does not necessarily reflect a fair valuation of the company).

ICOs may appropriately give certain Token Companies the ability to raise significantly more money than they could in traditional venture capital financings. Tokens generally do not provide holders any economic or voting rights in the company that sold them.[3] Instead, the value of the tokens is intended to increase or decrease in tandem with the increasing or

[3] At least in the early stages of most platforms, however, the token investors still may rely to a significant extent on the Token Company, such as to continue to develop, maintain and operate the platform; to market the platform to new users; perhaps to make continuing improvements to the platform, and perhaps to take other actions such as listing the tokens on an exchange or otherwise assisting in providing liquidity for the tokens. In addition, many Token Companies retain a significant number of the tokens, many of which they may sell or otherwise release in the future.

This is a key reason that the Securities and Exchange Commission ("**SEC**") takes the position that most or virtually all tokens are securities. Investors in tokens pay money or other compensation for the tokens, they seek to profit through an increase in the value of the tokens, and they rely to a significant extent on the efforts of the Token Company for the expected increase in the value of the tokens. See *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).

decreasing commercial success of the platform: as more people use the platform to engage in the intended commercial activities, more people need to purchase or obtain tokens to engage in those commercial activities, and this increasing demand for tokens should cause the value of the tokens to increase.

The value of the tokens, therefore, often is tied to investors' expectations of the likely commercial demand for the tokens, and the value investors assign to the tokens in an ICO often is largely independent of the value of the Token Company that issued them.[4] If token investors expect the platform to be commercially successful, investors may be willing to invest significantly more in the related tokens than they would be willing to invest in equity or debt securities of the Token Company; in such a case, the Token Company is able to raise more money in an ICO than in a traditional venture financing transaction.[5]

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[4] For example, and entirely hypothetically, consider a commercially successful token-based platform that permits users to rent construction equipment from entities that have construction equipment that is not currently being used, and that requires the rental payments to be made in tokens. The company that created the platform and issued the tokens may find that in its location it is not able to profitably rent out its unused construction equipment, and instead the commercial success of the platform may be based on the success of other entities renting construction equipment in other locations. The token holders would be largely indifferent to the lack of commercial success by the token-issuing company.

[5] An important, if challenging, point to keep in mind is that in many cases the Token Company does not "own" the platform, and the Token Company may or may not derive significant revenues from the platform it created. For example, many platforms are forms of marketplaces where many sellers and buyers of particular goods or services come together. In those types of platforms, the Token Company that created the platform may profit by, for example, providing goods and services on the platform, performing services for compensation on the platform, or holding tokens related to the platform that may over time appreciate in value. On the other hand, if the platform is successful but the Token Company is not a successful competitor on the platform, the Token Company may not get much or any revenue from the platform, even though other participants on the platform might generate significant revenue from it.

Of course, token platform models take many forms, and some platforms are set up specifically to provide continuing revenue streams to the Token Company that created the platform. For example, some Token Companies may be the exclusive provider of services on the platforms they create, or they may charge fees on platform transactions or activity regardless of their role in the transaction.

ICO investors effectively are able to crowdfund the development of the platform (a type of crowdfunded project finance), may be able to get liquidity in the tokens far sooner than they can get liquidity in a traditional startup or venture capital investment, and may also use the tokens to transact business on the related platform.

Fraud and Misconduct Concerns. Unfortunately, as various recent SEC and CFTC actions have demonstrated, blockchain and cryptocurrency technology also offer opportunities for fraud and a variety of other potential misconduct. As a result, I believe that there needs to be an appropriate and tailored regulatory scheme that encourages and facilitates innovation and capital formation, while at the same time guarding against fraud and other misconduct. I believe Congress should play an important role in establishing that regulatory scheme.

A Suggested Two-Step Legislative Approach

I believe it is too early for Congress and the federal regulators to enact a comprehensive legislative or regulatory scheme governing cryptocurrency. With a few exceptions, widespread efforts to develop tokens and token platforms began in earnest late last spring, so that for the most part we have had less than a year's experience with tokens and token platforms.

To date, we have seen a number of token and SAFT offerings, but we have very few examples of functioning token platforms. Outside of Bitcoin, Ether and a few other general purpose cryptocurrencies, we have very few examples in the United States of freely tradeable or freely-trading tokens. We do not yet have any tokens that have been publicly registered or that are qualified under Regulation A+. And we don't yet have any exchanges or alternative trading systems that are authorized to trade tokens that are securities.

All of these things will happen, and they hopefully will start to happen fairly soon. Once they do, the markets will undoubtedly develop in ways we can't predict, we likely will find unexpected regulatory barriers and hurdles, and we may find that we need significantly new ways of combatting concerns like money laundering, data falsification, and identity theft.

We also don't have a clear sense of the types of uses blockchain technology can be used for, so we don't yet know all the parameters that need to be considered in developing well-tailored legislation. As one example, artificial intelligence, or AI, may be combined with the significant capabilty of blockchain systems to obtain and store information; this opens the possibility of entirely new businesses and scientific advancements based on predicting individual or group behavior or attributes to ever-greater degrees of accuracy, and in ever-widening spheres of activity. On the other hand, it also opens the possibility of nefarious actors using the same technology to improperly manipulate individual or group behavior, to fraudulently obtain and misuse confidential personal and business information, and to potentially manipulate trading and other markets and activities that rely on particular people (such as stock analysts and market makers) receiving and acting upon accurate information.

As a result, I believe that we don't know enough - yet - about the emerging cryptocurrency markets and businesses to develop a comprehensive legislative or regulatory framework. There is a significant risk that even the best-intentioned framework will have unanticipated negative consequences.

We see this law of unintended consequences, perhaps, with New York's "Bitlicense" statute, which requires issuers and exchanges to obtain a special license to issue or trade cryptocurrency in New York State. The statute was written at a time when Bitcoin was essentially the only major cryptocurrency, and arguably an underlying premise of the statute is that all cryptocurrency will be currency that can be used for purchases and sales of any goods or service – that is, that all cryptocurrency will be like Bitcoin.

It turns out that most cryptocurrency is not like Bitcoin and instead is intended to be used only for specific purposes primarily on one or more designated token-based platforms. As a result, very few businesses have sought or obtained a Bitlicense, and perhaps the most significant impact of the Bitlicense statute is that many token issuers now exclude New York residents -- often alone among United States citizens -- from participating in their token or SAFT offerings.

Also, cryptocurrency is a global phenomenon, and different countries do and will regulate cryptocurrency differently. It would be extremely helpful for major countries to develop legislative and regulatory approaches to cryptocurrency that at least mesh well with each other. A country that regulates cryptocurrency in a significantly different and more onerous manner than other countries faces the risk, like New York State, that many issuers of cryptocurrency will simply avoid that country. On the other hand, given the potential dangers and risks of fraud and from nefarious actors in the blockchain and cryptocurrency industry, the United States and other responsible countries should not engage in a "race to the regulatory bottom" either.

I believe that there is important legislation that Congress can and should consider now, and I believe that Congress and others should begin thinking about what a comprehensive legislative and regulatory approach to cryptocurrency eventually might look like. I will address both of these in the remainder of my testimony. And I again thank the Subcommittee for holding this hearing, because I believe this hearing is an important step to moving forward on both legislative efforts.

Current Legislative Focus

I believe that Congress could immediately provide significant and appropriate assistance to emerging blockchain and cryptocurrency companies by passing legislation that achieves three aims: (1) appointing a single federal regulator, presumably the SEC, to have primary jurisdiction

over ICOs, tokens and token-related platforms (collectively, "**Token Activities**"); (2) authorizing and directing the SEC and other federal regulatory agencies to modify or waive various of their rules and regulations as they apply to Token Activities; and (3) preempting certain state substantive laws, such as State money transmitter laws and State securities registration provisions, as they apply to Token Activities.

Need for a Primary Federal Regulator. In addition to the innovation and capital formation opportunities that Blockchain and Token Activities offer, they sadly also offer the potential for fraud and other misconduct. Federal and state regulators naturally and appropriately will attempt to regulate against bad conduct that arguably falls within their spheres of influence. As a result, we already have seen the SEC, the CFTC and FinCEN assert jurisdiction over aspects of Token Activities, and it would not be surprising to see other federal regulators assert jurisdiction as well.

Congress should clarify that a single federal regulator has primary jurisdiction over Token Activities. This will provide regulatory certainty to the markets, and will help the token industry avoid unnecessary regulatory costs and burdens trying to comply with multiple regulatory schemes each aimed at addressing the same underlying Token Activities. The most likely federal regulator to have primary authority would seem to be the SEC, because the capital raising, investor protection and market regulation aspects inherent in regulating Token Activities all seem to fall well within the SEC's statutory and regulatory expertise, and because the SEC already is deeply involved in thinking about and regulating Token Activities.

To be clear, the CFTC, FinCEN and other regulators should retain their important regulatory roles in the regulation of Token Activities. Some tokens or agreements related to tokens may be futures contracts or swaps that properly are regulated by the CFTC. Some token platforms may in effect be money services businesses that quite properly fall within the ambit of FinCEN. And certainly the Department of Treasury, the Internal Revenue Service, federal banking regulators and other federal regulators will have important roles in the regulation of tokens and cryptocurrency.

Nonetheless, I believe it will be helpful to the cryptocurrency markets, and to federal regulators, for Congress to clarify that the SEC is the primary regulator of Token Activities.

Authority for the SEC to Modify and Waive Rules. As I discussed earlier, ICOs present a novel form of capital raising, in which the token investor's primary concerns are the likely future commercial viability of the related token platform, and (usually) the ability of the Token Company to develop, maintain and operate the token platform and the token economy. This is very different from the situation in traditional capital raising techniques, such as the sale of stock and bonds, in which investors are primarily concerned with the future economic activities and well-being of the company that issued the stock or bonds. Not surprisingly, a securities-regulatory scheme developed for stocks and bonds does not fit perfectly for tokens and token platforms.

I believe that Congress should authorize the SEC to, and direct the SEC to, modify or waive existing rules and regulations, as appropriate and with due regard for investor protection, to facilitate Token Activities. Examples of some rules and regulations that should be waived or modified include:

- Registration Provisions: Many Token Issuers will eventually register their tokens, either in a full public offering on Form S-1, or under Regulation A+. This will permit the tokens to be freely tradeable. However, there are still a number of outstanding questions and issues regarding how registration will work, including:
  - Clarifying that Regulation A+ is available to Token Companies (the SEC staff has indicated informally that it is);
  - Modifying the requirement that an issuer have a registered transfer agent, since there are no registered transfer agents for tokens, and the notion of a transfer agent is seemingly needless in a blockchain context, since all sales and

purchases of tokens on the blockchain are publicly visible (even if the identity of each holder is not known);

- Modifying the prospectus delivery rules to permit a Token Company to satisfy this requirement by posting the prospectus on the relevant platform;
- Expressly permitting the Token Company to offer through the prospectus tokens that are "mined," that are earned by platform users for providing services to the platform, or that otherwise are generated algorithmically by the platform, rather than sold out of the Token Company's inventory of tokens;
- Clarifying the ability of the Token Company and the platform to rely on the prospectus to permit the commercial use of the tokens on the platform;
- Clarifying that Token Companies may use the prospectus for a "continuing offer" of tokens, which would cover all of the Token Company's token sales, all token uses on the platform and all of the token generation events on the platform for as long as the prospectus was current;
- Permitting additional latitude for selling token holders to sell their tokens under Regulation A+. Currently, the value of the tokens owned and sold by selling token holders in an initial Regulation A+ offering cannot exceed 30% of the total value of tokens sold. In some cases, Token Companies may have sold significant numbers of tokens to accredited investors in a private placement prior to the Regulation A+ qualification, and it may be beneficial for the Token Company to be able to qualify those tokens under Regulation A+, even if the value of those tokens exceeds the current 30% limit; and
- Permitting "air drops" and other free distributions of tokens pursuant to the prospectus.

- Trading Rules: In order for many token platforms to function efficiently, users of the platform will need to be able to buy and

sell tokens, and the Token Company may need to sell and receive tokens on a continuous basis. The SEC should amend its rules to:

- Permit the Token Company to sell tokens at the same time that it may receive tokens for performing services or selling goods on the platform, notwithstanding Regulation M and Rule 10b-18 under the Securities Exchange Act of 1934, which generally prohibit an issuer from buying and selling its own securities at the same time. These simultaneous purchases and sales might be subject to appropriate and tailored requirements to limit the opportunity for manipulation of the price of the tokens;
- Permit the Token Company to offer a link to one or more registered token exchanges or alternative trading systems that permit platform users to buy and sell the tokens needed to use that platform, without forcing users to leave the platform, go to the exchange to buy or sell the tokens, and then come back to the platform to continue engaging in the commercial activities for which the platform is designed;
- Permit the Token Company and other platform service providers that are regularly engaged in commercial activities on the platform, which require them to buy, hold and sell tokens (which may be securities), to do so without being deemed to be a broker or a dealer that needs to register with the SEC and FINRA; and
- Permit intermediaries to act as finders and receive compensation, including in the form of tokens, for introducing to the Token Company accredited investors who invest in the tokens in a private placement, without the finder being required to become a registered representative of a broker-dealer. Such a finder should, however, be subject to disclosure and antifraud rules.

- Exchange and Alternative Trading System Rules: Currently, there are no exchanges or alternative trading systems authorized to trade tokens that are securities. The SEC and FINRA should be encouraged to be flexible in authorizing exchanges and alternative trading systems, notwithstanding concerns such as, for example:
  - Limited initial trading volume and difficulty of valuing cryptocurrency. In many ways, these types of issues pose a "chicken-and-the-egg" problem; the regulators may be reluctant to approve token markets until there is (for example) more trading volume and better pricing mechanics, but trading volume and pricing mechanics will improve only when there are trading markets; and
  - Clearance and settlement, registrar and transfer agent functions will take very different forms in token trading than in trading in more conventional securities.

In addition, the SEC and FINRA should be encouraged to authorize exchanges and alternative trading systems for tokens that permit trading of any freely-tradeable tokens, including tokens that are freely tradeable after a designated period of time pursuant to Rule 144 or Regulation S under the Securities Act or 1933, and not just of tokens that are freely tradeable by virtue of being publicly registered or qualified under Regulation A+.

- Investment Company and Investment Adviser Rules: The SEC should be encouraged to address various issues that arise under the Investment Company Act and the Investment Advisers Act, including the following:
  - The SEC should make it clear that tokens held by the Token Company that issued them should not cause the Token Company to have to register as an investment company. In general, a company that holds a significant portion of its assets in the form of securities may be an investment company, such as a mutual fund, and may need

to register under the Investment Company Act. Since the SEC treats most tokens as securities, and since many Token Companies hold a significant number of tokens that they intend to issue in the future, some Token Companies could be deemed to be investment companies simply by holding their own tokens;

- The SEC should revise the custody rules to accommodate tokens. Both investment companies and investment advisers are subject to a requirement that, in general, they hold assets with a bank, a broker or another qualified custodian. The admirable purpose of these custody rules is largely to prevent theft by insiders. Transferring ownership of tokens to a bank or other custodian poses difficulties and risks that are not generally present with other securities, including the risk associated with someone hacking the custodian's token wallet, and the difficulty of making fairly frequent purchases and sales of tokens, especially in volatile markets, when the orders must (for example) be sent to the custodian, so the custodian may execute the order or transfer the tokens to another party so that the order may be executed. The SEC should work with the industry to develop other methods, perhaps based on blockchain technology, to meet the objectives of the custody rule while also permitting more effective trading of cryptocurrency; and
- The SEC should reconsider recent statements of its Staff suggesting that it would not approve registration statements of registered funds that seek to engage in cryptocurrency trading. The Staff raised valid considerations, such as concerns related to the valuation and liquidity of tokens, that might apply to mutual funds and exchange traded funds, which need daily liquidity and accurate daily pricing of their assets. But these concerns should not prevent closed-end funds and business

> development companies from investing in tokens, since these funds do not make daily offers and sales of their securities, and therefore are less directly affected by the lack of liquidity and lack of pricing sources for tokens. Also, retail and other investors might be far better protected if they were able to invest in a diversified token fund with professional investment management, rather than investing in individual tokens without professional investment management assistance.

My suggestions here are not intended to imply that the SEC is not trying to do some of these things already. They are. But Congressional authorization and direction could still be very helpful.

Authority for Other Federal Regulators to Modify and Waive Rules. As I discussed above, even with the SEC as the primary regulator of Token Activities, other federal regulators will still have important roles in regulating various aspects of Token Activities. These other federal regulators also should be authorized and directed to modify and waive applicable rules and regulations, as appropriate, to facilitate Token Activities, consistent with investor and token holder protection; consistent with privacy, anti-money laundering and similar concerns; and with a view to minimizing systemic risks (such as could exist in the future if systems develop to permit highly leveraged trading in tokens or in synthetic token instruments).

In addition, the Department of Treasury should be authorized and directed to adopt rules and regulations that clarify the taxation of tokens and token transactions, and that facilitate the use of tokens to compensate and reward employees of, and independent contractors to, a Token Company. Currently, each time a U.S. taxpayer sells a token or other cryptocurrency – whether for dollars or other fiat currency, or in exchange for another type of cryptocurrency or tokens – that transaction may give rise to taxable income. This adds significant costs and accounting burdens to buyers and sellers of cryptocurrency.

The Department of Treasury should consider alternatives such as developing a "like-kind exchange" rule for tokens and cryptocurrency, so that (for example) exchanges of tokens and cryptocurrency are not taxed until they are exchanged for dollars or other fiat currency.

Similarly, sales of tokens by a Token Company (whether in a private or public sale of tokens) generate income to the Token Company that often is immediately subject to tax. The Department of Treasury also should consider rules that would permit a Token Company to better match the recognition of income from selling tokens to the expenses of developing the platform on which the tokens will be used; those development efforts may take years.

There also are myriad tax and tax deferral issues involved with granting SAFTs and tokens to employees and independent contractors. The Department of Treasury and the Department of Labor should work with the cryptocurrency industry to help address these tax issues, so that Token Companies can more easily use tokens for employee incentives, and in some cases as employee compensation.

Preemption of State Money Transmitter and Similar Laws. A number of States have laws that require businesses that transmit money to satisfy registration and substantive requirements. A principal, although not an exclusive, focus of many of these statutory schemes is to require money transmitters to conduct anti-money-laundering ("**AML**") and similar checks on customers and to maintain sufficient reserves to meet their payment obligations.

Many of these State laws are sufficiently broad that many Token Companies and their related platforms could fall within those laws. The cost and time of attempting to comply with the laws of all 50 States can be prohibitive, and since the vast majority of Token Companies intend to offer their platform throughout the United States – and often throughout the world – it is reasonable for a single federal regulatory money transmission scheme to apply to virtually all Token Companies and their platforms.

I propose that Congress expressly preempt these State laws, and give the SEC, in consultation with FinCEN, the sole responsibility of determining when, and to which token-related entities and platforms, AML and similar requirements should apply. As FinCEN recently noted, the SEC already is responsible for applying AML and similar requirements to brokers, exchanges and other regulated entities, and it likely would be most efficient and effective for the SEC to make similar determinations for Token Companies, token platforms, token markets, and other token-related entities.

State laws also should be preempted with respect to capital and other substantive requirements. Token platforms typically should not be subject to capital requirements, because typically (at least today) those platforms do not act as a principal in the transmission of tokens from one user to another; as a result, there generally should not be a risk that the platform's (or Token Company's) lack of resources will affect the completion of a token transaction, which makes capital requirements unnecessary. If the SEC determines that there are certain token-related entities that perhaps should have capital requirements applied to them (in addition to the capital requirements already applicable to regulated entities), the SEC should adopt rules or seek Congressional approval to impose those capital requirements.

Federal Preemption of State Securities Registration Provisions. I propose that States be preempted from imposing substantive registration requirements on Token Companies that publicly register their tokens on Form S-1. Under Section 18 of the Securities Act of 1933, many tokens that are registered in a public offering on Form S-1 would not be eligible for preemption from State registration, and the registration statement for those tokens would need to be approved by the SEC and the securities commissions of each of the 50 States. By contrast, Regulation A+ -- which mandates a less comprehensive disclosure regime than is applicable to public offers on Form S-1 -- does provide Token Companies with preemption from State registration requirements.

There are significant costs and time delays in seeking 50 additional reviews and approvals of a registration statement already approved by the SEC, and given the SEC's (proposed) federal preeminence in regulating Token Companies and other token-related entities, it does not seem that any potential benefits from those additional reviews outweigh their costs. This is particularly true since virtually all tokens will be used throughout the United States (and often throughout the world), so that no single State or group of States should have a unique interest in registering token offers. Also, as indicated above, there is no obvious reason to offer Token Companies preemption from State registration provisions pursuant to Regulation A+, and to not offer the same preemption for public offerings on Form S-1.

Longer-Term Legislative Focus

As I discussed earlier, I believe it is too early to enact comprehensive legislation governing the blockchain and cryptocurrency industry. I do think, though, that even at this early juncture, Congress can begin identifying key themes that the comprehensive legislation should contain. Here are some thoughts about those themes:

- Simplicity. Any comprehensive legislative scheme should be simple and inexpensive.
  - The system that exists today, which is generally a private placement of a SAFT or of tokens, and which in many cases will be followed by a public offering on Form S-1 or under Regulation A+, is complicated and time consuming. A comprehensive legislative scheme should permit Token Companies to prepare and post a standardized, simple and informative disclosure form, and then beginning selling tokens to the public;
  - To follow up on the last point, the registration statements and prospectuses that will be used in the near term will be

lengthy documents that almost no retail investor likely ever will read cover to cover. A comprehensive legislative approach should identify the token-related information that is important for token investors and token users, and should encourage Token Companies to deliver that information in a format most likely to be obtained and understood by those investors and users; and

- The comprehensive legislative scheme should generally avoid causing Token Companies or others to have to make fine legal distinctions as to whether a particular token is or is not a security, and at what point in the future the token might stop being a security. In general, the legislative scheme should apply to virtually all Token Companies and to most tokens;[6]

- Tailored. Any comprehensive legislative scheme should be carefully tailored to address the needs of token investors and token users.
  - For example, as I discussed earlier, a token investor and a token user have very different interests than an investor in a company's common stock or debt. Any disclosure requirements imposed on Token Companies or others should be tailored to address only information that is relevant;

[6] It is important to be cautious on the goal of having the legislative scheme apply to all tokens. Some tokens are just digital representations of common or preferred stock, or of debt securities. These tokens are really just a form of book entry security, and likely should be regulated in the same way as any other equity or debt security. Similarly, tokens may not be eligible for the type of comprehensive legislative scheme described in the text if, for example, the tokens give holders the right to participate in profits, revenue, dividends or other income from a particular company or business, or give holders the right to convert their tokens into equity, debt or similar securities. As a starting point, Congress might limit the availability of the comprehensive legislative scheme to tokens that are securities solely because they are "investment contracts" as defined in *Howey* and subsequent cases. In fairness, this approach may inadvertently exclude some categories of tokens that ought to be able to rely on the contemplated comprehensive statutory scheme, so this approach should be viewed only as a starting point for discussion.

- As an example of the last point, current disclosure regimes, rightly, place great importance on audited financial statements of the issuer of common stock or debt securities. The financial statements of a Token Company may be much less important to token investors and token users, especially over time if the Token Company's participation in the token platform and the token ecosystem is greatly diminished, or if the Token Company has escrowed or otherwise segregated sufficient assets to support the operations of the token platform and token ecosystem for the foreseeable future; and
- On the other hand, a comprehensive legislative scheme may need to address issues unique to Token Companies, such as what obligations, if any, a Token Company and its Board owe to token holders (although admittedly this may be a State law corporate issue as opposed to a federal question), and what rights, if any, token holders should have to participate in the operation and management of the related token platform.

- Protective. In addition to protecting the interests of token investors and token users, a comprehensive legislative scheme also should guard against systemic risks posed by blockchain and cryptocurrency technologies, including by: (i) appropriately balancing privacy concerns with law enforcement needs; (ii) balancing free speech rights with the need to protect the integrity of data and information stored on the blockchain and accessible to AI and other technologies; and (iii) balancing capital formation and innovation goals with the need to guard against manipulative or coercive marketing or other tactics. These may well be some of the most challenging parts of creating a comprehensive legislative scheme governing blockchain and cryptocurrency technology, and we likely are only at the earliest stages of even being able to identify the

potential issues, much less to develop sound policy and legislative responses to them.

CONCLUSION

Thank you again for the opportunity to testify before you today. I am delighted this Subcommittee is focusing on blockchain and cryptocurrency technologies, and I believe your leadership can greatly facilitate the continued development of these technologies, while at the same time appropriately protecting investors in these technologies and users of these technologies. I would be delighted to answer any questions. Also, as you move forward with your work on these issues, if you think I may be of any assistance, I would be delighted to help.

TESTIMONY OF

Peter Van Valkenburgh

Director of Research of Coin Center

BEFORE THE

United States House of Representatives Committee on Financial Services
Subcommittee on Capital Markets, Securities, and Investment

"Examining Cryptocurrencies and ICO Markets"

March 14, 2018

I am Peter Van Valkenburgh, Director of Research at Coin Center, an independent nonprofit focused on the public policy questions raised by cryptocurrencies and open blockchain networks.[1]

The fundamental achievement of Bitcoin[2] and follow-on cryptocurrencies[3] is digital scarcity. We know there are only 16.9 million bitcoins in the world right now because their distribution and movements are described with perfect fidelity on a public ledger that anyone can independently read and mathematically authenticate.[4] That ledger is called the Bitcoin blockchain.[5] Just as anyone who owns an ounce of gold can independently assay the metal and

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[1] Based in Washington, D.C., Coin Center is the leading independent non-profit research and advocacy center focused on the public policy issues facing cryptocurrency and decentralized computing technologies like Bitcoin and Ethereum. Our mission is to build a better understanding of these technologies and to promote a regulatory climate that preserves the freedom to innovate using permissionless blockchain technologies. We do this by producing and publishing policy research from respected academics and experts, educating policymakers and the media about blockchain technology, and by engaging in advocacy for sound public policy. *See* Coin Center, *Our Work*, https://coincenter.org/our-work.

[2] Bitcoin was first described in a white paper circulated over Internet mailing lists in late 2008. The author(s) used a pseudonym, Satoshi Nakamoto. Satoshi Nakamoto, "Bitcoin: A Peer-to-Peer Electronic Cash System" (2008), https://bitcoin.org/bitcoin.pdf. The Bitcoin network itself did not begin running on the Internet until January 3, 2009 when the first block in the bitcoin blockchain was mined. *See* "Block 0" Bitcoin Block Explorer, (last accessed Dec, 2015) http://blockexplorer.com/block/000000000019d6689c085ae165831e934ff763ae46a2a6c172b3f1b60a8ce26f

[3] The software that powers the Bitcoin network is open source. That means that it can be freely copied and modified without seeking a copyright license or paying the original creators. Because of this openness, several thousands of cryptocurrency and token projects have emerged by borrowing software code or developing new software inspired by Bitcoin. While there are now thousands of cryptocurrency projects, only a handful are actively used online and have more than a trivial total value. *See* https://en.wikipedia.org/wiki/List_of_cryptocurrencies.

[4] The total supply, distribution, and full history of all bitcoin transactions can be observed by running the bitcoin core software client on an Internet connected computer. Alternatively, one can visit a website that publishes the data in the blockchain in a more convenient and easy to access format. *See, e.g.*, http://blockchain.info. *See* https://blockchain.info/charts/total-bitcoins for an up to the minute accurate tally of the total number of bitcoins in circulation. New bitcoins are released to network participants who perform verifiable work securing the blockchain according to a diminishing schedule that is described in the bitcoin software. Ultimately, this schedule dictates that there will only ever be 21 Million bitcoins in circulation.

[5] The bitcoin blockchain is broken up into blocks. Each block comprises the authoritative list of bitcoin transactions that settled in a given period that is, on average, 10 minutes long. For an up to date list of recent blocks and the transactions included within them, see https://blockchain.info/blocks.

have proof that what they hold is real, scarce, and valuable, anyone can check the data in the Bitcoin blockchain and verify that bitcoins they've received are provably scarce and valuable.[6]

An open set of computers running the free Bitcoin software works together to store, update and verify that blockchain 24 hours a day, 365 days a year. Anyone can join that network of computers and independently check the work of every other participant, independently store their own copy of the blockchain, and independently contribute computing power to validate the integrity of that data.[7] Honest and verifiable contributions to help secure the network are rewarded with automated payments in bitcoins, and attempts at fraud are revealed and punished by automatically withholding bitcoin-denominated rewards and ignoring fraudulent transactions. This is how these networks establish trust in the integrity of the record, and, by extension, trust in the inherent scarcity of bitcoins or any other token, coin, or unit whose distributions and movements are tracked on an open blockchain.

This digital scarcity can enable a wide variety of new, follow-on innovations:

- A scarce token can be developed to be nothing more than *scarce* and *transferrable* person to person. That, in a nutshell is Bitcoin.[8] Because it is transferable and scarce it can be used as money just like other portable and scarce goods throughout history have been used as money—from gold to seashells.

[6] Truly verifying that data requires familiarity with cryptographic functions used to sign and chain together the relevant transaction data going back to the beginning of the network in 2009. This is not easy for a lay person, however it is a deterministic technical process that any expert in the field of cryptography can perform, much like any expert metallurgist could verify the quality of an ounce of gold via chemical analysis.

[7] Participating in this verification is known as mining. For a comprehensive explanation of the mining process *See infra* Attachment 2, *Framework for Securities Regulation of Cryptocurrencies*, Appendix 1. The Bitcoin Mining Mechanism: Proof of Work Consensus.

[8] To to quote François Velde of the Chicago Federal Reserve, "Bitcoin is a system for securely and verifiably transferring bitcoins."

- A scarce token can be developed that is *automatically* redeemable for a digital good or service (like cloud storage or digital identity credentialing) that is provided by the same open network that keeps the blockchain. Projects like Ethereum, Filecoin, or Blockstack follow this model and they may soon challenge centralized computing service providers like Amazon, Facebook, and Google that specialize in the provision of services like cloud storage, social networking, or digital identity.[9]
- A scarce token can be developed as a representation of a legal agreement or financial asset: a public company could track its shares as tokens on a blockchain,[10] or a network of banks could settle accounts by trading tokens that represent debt obligations on their balance sheets.[11]
- A scarce token could even represent a real world identity document like a diploma, a driver's license, or a deed to land.[12]

Looking at it one way, these blockchains are just records, whether they be records about money, assets, identity, or computation. But rather than relying on a variety of major corporations or institutions to keep track of these important records in data centers that each have the potential to go offline or get hacked, a token-powered blockchain version of the record relies on an open network of thousands or potentially millions of economically motivated participants. Those records will be available until every participant goes offline. In other words,

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[9] *See infra* Attachment 1, *What are Appcoins?*
[10] *See, e.g.*, Cade Metz, "Overstock Begins Trading its Shares via the Bitcoin Blockchain" *Wired* (Dec. 2016) https://www.wired.com/2016/12/overstock-com-issues-stock-via-bitcoin-blockchain/.
[11] *See, e.g.*, Adam Kissack, *Utility Settlement Coin: A Pioneering Form Of Digital Cash* (Sep. 2017) https://www.clearmatics.com/utility-settlement-coin-pioneering-form-digital-cash/.
[12] *See, e.g.*, Laura Shi, "The First Government To Secure Land Titles On The Bitcoin Blockchain Expands Project" *Forbes* (Feb. 2017) https://www.forbes.com/sites/laurashin/2017/02/07/the-first-government-to-secure-land-titles-on-the-bitcoin-blockchain-expands-project/#4b232e1f4dcd.

they will likely always be available. Additionally, those records will have fidelity unless every participant has their individual computer hacked and compromised. In other words, they will likely always have perfect fidelity. It's this revolutionary architecture that makes these systems effectively unhackable, at least using traditional methods of attack.

Especially pertinent to today's hearing, these technologies have also been employed for capital formation.[13] Scarce tokens like bitcoin and ether already exist in the world and are used as currencies or to obtain computing resources and services from the decentralized networks that power them. Other scarce tokens, however, are merely theoretical, because the software that will enable them has yet to be built. Recently, various developers have raised money to fund the development of their new blockchain software projects, by selling a promise of future scarce tokens to willing investors in a so-called initial coin offering or "ICO." The pitch is simple: If you give me money today, I'll give you a blockchain token in the future that will be redeemable for valuable computing services.

From a regulatory standpoint there is a fundamental distinction to be made between, on the one hand, scarce tokens that exist today and are used for payment or to obtain computing services, and, on the other hand, *promises* of future scarce tokens that represent the hopefully profitable efforts of a developer. The former (things like bitcoin and ethereum) are effectively digital commodities: scarce items that may have value on open markets as money, investments, or inputs for valuable commercial and industrial processes. They are commodities, just digital.

[13] By some estimates, ICOs raised a cumulative $5.6 billion last year for early stage blockchain software companies. *See* Fabric Ventures and Token Data, *The State of the Token Market* (Jan. 2018) https://static1.squarespace.com/static/5a19eca6c027d8615635f801/t/5a73697bc8302551711523ca/1517513088503/The+State+of+the+Token+Market+Final2.pdf.

The latter, tokens promised in so called initial coin offerings, are securities: promises from issuers to investors that efforts will be put forward to create a profitable enterprise.[14]

Both have investor protection risks, but distinct risks that are best addressed in different ways. A commodity-like token has no issuers upon whom investors rely, but it trades on speculative spot markets. Policing these markets for fraud and market manipulation is critical for investor protection. A promise of future tokens is a security with an issuer upon whom investors rely. Mandating accurate risk disclosures and transparency from these issuers is critical for investor protection. The sensible and emerging investor protection regime is nothing new even though the underlying assets may seem like science fiction: it is the existing investor protection authority of the CFTC to supervise commodities derivatives markets and police spot markets for fraud and manipulation,[15] in conjunction with the existing authority of the SEC to mandate disclosure from issuers making public securities offerings.[16]

Where there are frictions and a mismatch between new technologies and old regulatory structures, is state-by-state money transmission regulation. Today, commodity-like token spot markets, known generally as cryptocurrency exchanges, are in some states regulated as money transmitters like Western Union or Paypal. This is not ideal for entrepreneurs because

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[14] For a comprehensive look at why some cryptocurrencies and tokens likely don't qualify as securities under the relevant legal tests while others do qualify as securities, see Attachment 2, *Framework for Securities Regulation of Cryptocurrencies*.

[15] "[T]he CFTC DOES have enforcement jurisdiction to investigate through subpoena and other investigative powers and, as appropriate, conduct civil enforcement action against fraud and manipulation in virtual currency derivatives markets and in underlying virtual currency spot markets." Chairman J. Christopher Giancarlo, *Written Testimony of Chairman J. Christopher Giancarlo before the Senate Banking Committee, Washington, D.C.* (Feb. 2018) *available at* http://www.cftc.gov/PressRoom/PressReleases/opagiancarlo37.

[16] "There should be no misunderstanding about the law. When investors are offered and sold securities – which to date ICOs have largely been –they are entitled to the benefits of state and federal securities laws and sellers and other market participants must follow these laws." Chairman Jay Clayton, *Chairman Jay Clayton Testimony before the Senate Banking Committee on Virtual Currencies: The Roles of the SEC and CFTC* (Feb. 2018) *available at* https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission.

obtaining money transmission licenses from 53 states and territories is costly and duplicative. This is also not ideal for consumers or investor protection, because money transmission regulation focuses only on the risks of custodying customer funds while in transmission, not in running highly liquid markets in commodity-like assets. As Chairman Giancarlo and Chairman Clayton have both suggested, it may be time to revisit the wisdom of a state-by-state approach. [17] A federal solution might be desirable both to reduce barriers to entry and enhance competition amongst exchanges, and also to better protect investors.

Thank you and I look forward to your questions.

[17] "[C]onsideration should be given to shortcomings of the current approach of state-by-state money transmitter licensure that leaves gaps in protection for virtual currency traders and investors. Any proposed Federal regulation of virtual currency platforms should be carefully tailored to the risks posed by relevant trading activity and enhancing efforts to prosecute fraud and manipulation. Appropriate Federal oversight may include: data reporting, capital requirements, cyber security standards, measures to prevent fraud and price manipulation and anti-money laundering and 'know your customer' protections. Overall, a rationalized federal framework may be more effective and efficient in ensuring the integrity of the underlying market." Chairman J. Christopher Giancarlo, *Written Testimony of Chairman J. Christopher Giancarlo before the U.S. Senate Agriculture, Nutrition, and Forestry Committee, Washington, D.C.* (Feb. 2018) *available at* http://www.cftc.gov/PressRoom/PressReleases/opagiancarlo38. *See also* Chairmen Jay Clayton and J. Christopher Giancarlo, "Regulators Are Looking at Cryptocurrency" *Wall Street Journal* (Jan. 2018) https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363.

Attachment 1:

Peter Van Valkenburgh and Jerry Brito, "What are Appcoins?" *Coin Center* (Oct. 2016)

What are Appcoins?

Cryptocurrencies and open blockchain networks have created a new way to raise money to develop and maintain novel products and services—whether devices on the Internet of Things, new cloud services on the Internet, or even financial products and investments. This is an unprecedented form of crowdfunding that may raise various legal and policy questions. Developers and investors are eager to have answers to these questions so that they can safely take advantage of this innovative model.

How It Works

Let's take a common web service as an example: cloud storage. The traditional model for building this service is Dropbox, which allows users to pay Dropbox a monthly fee to store their files on the company's Internet-connected hard drives so that the files can be available anywhere. Dropbox is a private company that raised money from private investors to finance the development of the service, and the service is built on private company-owned infrastructure (e.g. server farms) that connects to the open Internet.

Two things can be different than this traditional model when an open blockchain network is employed. (1) Developers get paid differently. Instead of raising money from investors, developers can use a blockchain to keep track of a scarce token, sometimes called an "appcoin" (short for application coin). Developers can sell or give away that token to people who want to use the storage service or those who want to support its development. The sale of these tokens can finance the development or maintenance of the service, and that sale can happen before, during, or after the development of the service. (2) The service is peer-to-peer. The users of the cloud storage service, themselves, comprise the infrastructure that powers the service (there is no server farm) and individual users can be rewarded for their contributions to that infrastructure (e.g. the spare space on their individual Internet-connected hard drives) with the token.

These Tools Offer a New Way to Fund Open Platforms

A closed platform for messaging (e.g. Apple's iMessage or Google's Hangouts) only allows users to message other registered users of the service while an open platform (e.g. email or SMS text messaging) allows users to message anyone with an Internet- or cellular-connected device. With closed platforms necessary software may be proprietary, access may come with a fee, and various services may not interoperate (e.g. music purchased on iTunes can not be moved to Google Play if the user decides to switch from one music store platform to the other). A

traditional company, once built, may not have a motivation to open up their platform.

Open platforms have proved difficult to create because it has been historically difficult to monetize them even if they become successful—by nature they are public goods. Now, however, the developers of a cloud storage service can incorporate a scarce access-token, an appcoin, into the design, distribute that token to users, retain some amount of the token for themselves, and if the platform proves popular, the token (alongside the holdings of the developers) will grow in value and remunerate the developers for providing a public good. This new model challenges the concept of equity as traditionally understood, and carries entirely different risks and rewards.

Appcoin Crowdfunding is Happening Now

Developers of these services and their potential investors are already moving to take advantage of these new opportunities. Services for cloud storage are being developed by IPFS, Storj, Swarm, and may be supported by tokens (Filecoin, Storjcoin, or Ether respectively). Services for cloud computing power are being developed by Ethereum, Counterparty, and others, while utilizing tokens (Ether and XCP respectively). Services for content-curation and attribution are being developed by Steemit, Mediachain, and others (some, like Steemit, are already supported by a token, others are not but may wish to include tokens in the future). This list is incomplete and new projects and new developers emerge weekly. Simultaneously, investors interested in helping finance applications built on open networks have begun looking at whether they can buy and hold tokens rather than take ownership interests in the firms developing these networks.

Attachment 2:

Peter Van Valkenburgh, "Framework for Securities Regulation of Cryptocurrencies" *Coin Center* (Jan. 2016).

Omitted from Print Copy to Save Paper. Please see electronic copy or visit:
https://coincenter.org/entry/framework-for-securities-regulation-of-cryptocurrencies

March 12, 2018

The Honorable William Huizenga
Chairman
Subcommittee on Capital Markets,
Securities and Investments
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Carolyn Maloney
Ranking Member
Subcommittee on Capital Markets,
Securities and Investments
2129 Rayburn House Office Building
Washington, DC 20515

Re: Written Testimony before the Subcommittee on Capital Markets, Securities and Investments

Dear Hon. William Huizenga and Hon. Carolyn Maloney,

Liquid M Capital would like to submit the attached as written testimony before the Subcommittee on Capital Markets, Securities and Investments of the House Financial Services Committee for the Committee's March 14 hearing entitled "Examining the Cryptocurrencies and ICO Markets." Liquid M is very familiar with the regulatory challenges faced by FinTech firms that are issuing and trading digital assets and using blockchain technology. We would like to thank the Committee for their efforts in addressing these regulatory challenges and for the opportunity to submit this written testimony.

Please do not hesitate to call me at 646-595-1737 or our counsel, Richard B. Levin of Polsinelli PC at 202-772-8474 if you have any questions regarding the petition or any other matter.

Very truly yours,

Vincent R. Molinari
Chief Executive Officer
Liquid M Capital, Inc.

STATEMENT OF VINCENT MOLINARI

Chairman Huizenga, Ranking Member Maloney, and the distinguished members of the Committee, thank you for the opportunity to submit testimony for the record. I offer my testimony as a representative of Liquid M Capital, Inc. ("Liquid M"), a financial technology ("FinTech") company and broker-dealer registered with the U.S. Securities Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA"). Liquid M is the operator of an alternative trading system ("ATS") for the secondary trading of digital assets that are securities.[1] Given our experience in the industry, we commend the Chair and the Ranking Member for holding this hearing on this important issue and the role of Congress in helping to ensure that FinTech and the growing field of digital assets are properly regulated. As stated recently by Chairman Giancarlo of the U.S. Commodity Futures Trading Commission ("CFTC"), "[w]e are entering a new digital era in world financial markets."[2]

We believe it is critical for regulators to foster the value of innovation in FinTech without stifling it through unclear regulations. Chairman Clayton of the SEC and Chairman Giancarlo of the CFTC both noted in recent testimony before the Senate Banking Committee the great potential that distributed leger technology has to revolutionize the financial services industry.[3] We echo these sentiments and support the critical role of regulators in ensuring that this revolutionary technology is able to develop in a sustainable manner that benefits both industry participants and protects consumers.

For the purposes of this testimony, we will limit our comments to the securities laws of the United States because it is the area in which we have the most experience. The SEC has been very active over the past year, making its position on the regulation of digital assets increasingly clear through informal means, including enforcement actions and policy statements.[4] We agree with the SEC in their belief that most, if not all, digital assets that have been issued to the public through initial coin offerings ("ICOs") and other means qualify as securities, and therefore must only be offered pursuant to a registration with the SEC or an exemption from registration. While we believe the existing laws can be

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[1] The terminology used by the FinTech industry and regulators to refer to these types of assets has varied between agencies, including property with the IRS, cryptocurrency with the CFTC, and digital assets with the SEC. For the purposes of this testimony, we will refer to such assets as digital assets.

[2] Written Testimony of Chairman J. Christopher Giancarlo before the Senate Banking Committee, Washington, D.C. (February 6, 2018) *available at:* http://www.cftc.gov/PressRoom/PressReleases/opagiancarlo37 ("Giancarlo Testimony").

[3] *See* Written Testimony of Chairman Jay Clayton before the Senate Banking Committee, Washington, D.C. (February 6, 2018), *available at:* https://www.banking.senate.gov/public/_cache/files/a5e72ac6-4f8a-473f-9c9c-e2894573d57d/BF62433A09A9B95A269A29E1FF13D2BA.clayton-testimony-2-6-18.pdf ("Clayton Testimony"); Giancarlo Testimony.

[4] *See* Munchee Inc., Securities Act Release No. 10445 (Dec. 11, 2017) *available at:* https://www.sec.gov/litigation/admin/2017/33-10445.pdf; *SEC v. REcoin Group Foundation, LLC, DRC World Inc. a/k/a Diamond Reserve Club, and Maksim Zaslavskiy,* 17 Civ. [ ] (Sept. 29, 2017) (Complaint); Public Statement, SEC Chairman Jay Clayton Statement on Cryptocurrencies and Initial CoinOfferings, SEC (Dec. 11, 2017), *available at:* https://www.sec.gov/news/public-statement/statementclayton-2017-12-11.

applied to the regulation of blockchain technology and digital assets, we believe there is a need to modernize the laws to keep pace with these new technologies and to not stifle innovation.

A. The SEC has taken important first steps in regulating digital assets.

Our commitment to the regulation of these new technologies as securities is evidenced by the petition for rulemaking by the SEC we filed on March 13, 2017, asking the SEC to publish a concept release and proposed rules for public comment on changes to existing rules to better address the regulation of digital assets.[5] As we noted in the petition, we support the SEC's efforts to perform its core duties: (i) to protect investors; (ii) to maintain fair, orderly, and efficient markets; and (iii) to facilitate capital formation.[6] The SEC has taken significant steps over the past year to provide guidance to the industry regarding the regulation of digital assets, through enforcement actions, investigative reports, investor alerts, testimony, and public speeches. Such actions, have played an important role in shaping innovation and indicating to the industry that the sale and dissemination of digital assets cannot occur without regulation.[7] Though valuable first steps, we believe the size and continuing expansion of this industry demands more tailored and comprehensive regulation.

B. The financial services industry needs clearer rulemaking regarding the regulation of digital assets.

We believe the existing rules that apply to the sales of securities and the exemptions from registration with the SEC, such as Rule 506 of Regulation D, and Regulation A, though helpful, do not fully meet the needs of companies seeking to issue digital assets. While the securities laws have served our capital markets well since their adoption on the 1930s, Congress and the SEC have recognized that at times those laws require amendments to address technological innovations.[8]

SEC enforcement actions have provided some guidance regarding when digital assets are securities, but have not fully addressed the needs of the financial services industry. Liquid M believes the publication of a concept release regarding the regulation digital assets is a meaningful first step in providing guidance to the industry. However, such guidance will only prove beneficial if it is followed by

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[5] *See* Petition for Rulemaking (Mar. 13, 2017), *available at:* https://www.sec.gov/rules/petitions/2017/petn4-710.pdf. At the time this petition was published, Liquid M operated as Ouisa Capital, LLC.

[6] Michael S. Piwowar, Acting Chairman, SEC, Remarks at the "SEC Speaks" Conference 2017: Remembering the Forgotten Investor (Feb. 24, 2017), *available at:* https://www.sec.gov/news/speech/piwowar-remembering theforgotten-investor.html.

[7] *See* supra note 4; *see also* Clayton Testimony; Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017) (the "DAO Report"), *available at:* https://www.sec.Qov/litiQationlnvestregort/34-81207.pdf; Dave Michaels and Paul Vigna, SEC Chief Fires Warning Shot Against Coin Offerings, Wall Street Journal. Nov. 9, 2017, *available at:* https://www.wsi.comlarticles/sec-chief-fires-warning-shot-against-coinofferings1510247148?mq=prod/accounts-wsi.

[8] Congress has historically taken opportunities to update federal securities laws, including the Securities Act Amendments of 1975, the National Securities Markets Improvement Act of 1996, and the Jumpstart Our Business Startup Act of 2012.

the SEC adopting a new rule on the regulation of digital assets – Regulation DA.[9] We believe that FinTech and the regulation of digital assets present the SEC with an opportunity to satisfy its statutory duties by engaging in a constructive dialogue with the industry on how to regulate digital assets.

The current guidance on the regulation of digital assets as securities requires a facts and circumstances based analysis by qualified counsel to determine if an asset is a security and if a firm's activities require registration as a broker-dealer, an exchange, or an ATS. Such analysis is often cost prohibitive to the early stage companies that drive much of the innovation in FinTech. Further, issuers are restricted by the current regulatory framework for securities offerings, which include artificially low caps on the funds that may be raised or the number of holders of record. We believe the existing securities laws need to be amended to promote capital formation, and the SEC needs to amend existing rules or adopt new rules specifically tailored to digital assets. Should the Committee desire a more thorough evaluation of current regulations and how they may be modified to better regulate the issuance of digital assets, we are happy to provide it.

C. Issuers of digital assets prior to guidance to the DAO Report should be provided an opportunity to remediate their potentially illegal offerings.

Though the lack of regulatory clarity creates difficulties for companies seeking to raise capital in the future, billions of dollars have been raised through ICOs over the past year that were more than likely sold in a manner that was not compliant with federal securities laws. We do not believe the majority these issuances were deliberately not compliant, but were rather the result of a lack of regulatory clarity. As the SEC's position on ICOs has become clear, FinTech firms have learned that digital assets generally must registered with the SEC or sold pursuant to an exemption from registration. However, this position was not clear to the industry prior to the publication of the DAO Report. Recognizing this issue, LiquidM submitted a petition for rulemaking to the SEC on January 23, 2018, asking the agency to offer issuers of digital assets that were sold in possible violation of the securities laws the opportunity to remediate their offerings.[10]

We encourage the SEC to provide an opportunity for issuers of digital assets through ICOs that took place prior to the publication of the DAO Report the opportunity to remediate their potentially illegal offerings. While we believe there are still uncertainties regarding the regulation of digital assets and blockchain, the regulatory climate has become increasingly clear in recent months following the publication of the DAO Report and various recent enforcement actions by the SEC against ICO issuers.[11]

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[9] We believe that the current regulatory challenges surrounding digital assets are analogous to challenges presented by the promulgation of electronic communications networks ("ECNs") in the mid-1990s that prompted the SEC to publish a concept release on how to regulate ECNs and other ATSs. The concept release afforded the industry an opportunity to engage in a productive discussion with the SEC staff on how to regulate ECNs and other ATSs, and eventually resulted in the adoption of Regulation ATS in 1998, which established how ECNs, ATSs, and exchanges would be regulated going forward and provided meaningful guidance to innovative firms that were launching ATSs.

[10] *See* Petition for Rulemaking (Jan. 23, 2018), *available at:* https://www.sec.gov/rules/petitions/2018/petn4-719.pdf.

[11] *See* supra note 4.

We propose that the SEC offer issuers of digital assets that may have violated the securities laws the opportunity to remediate their offerings by retroactively engaging in the appropriate filings under Rule 506 of Regulation D, Regulation A, or Regulation CF. This type of retroactive registration should be accompanied by a right of rescission to all purchasers of the digital assets or the chance to receive a new form security that was offered in compliance with the securities laws. This SEC provide issuers with a 180 day window to remediate their initial offerings by engaging in either an appropriate registration or exemption under the federal securities laws. We believe that by affording FinTech firms the opportunity to remedy their conduct, the SEC will be able to advance its interests in regulating securities while fostering innovation and regulatory compliance, meeting the agency's regulatory mandates.

D. The innovative nature of the technology demands an innovative approach to regulation.

We believe that the innovative nature of this industry demands an innovative approach to regulation. Though there has been guidance from the SEC regarding the treatment of digital assets as securities, we believe that there is likely a middle ground between the view that all tokens are securities and that all tokens are not securities. Though we agree that a majority of the tokens issued to date through ICOs have many of the attributes of securities and should be regulated as such, a rapidly expanding number of platforms in the FinTech space are being created that operate using a native digital asset, functioning as a currency, for the exchange of value on their platform. We believe regulations either need to be created or modified to better suit this type of business model, as registering digital assets as securities is impracticable for these companies.

We have identified three examples of offering structures that we believe would be compliant with securities law. It is important to note that in all cases, the digital asset must include a digital currency that has attributes like Bitcoin, including being distributed in exchange for work and not issued through some type of presale or crowd sale. First, we believe that a company could issue an equity security that would pay a dividend in a digital currency. Second, we believe that a company could issue a bond that would be sold as a security and then repaid in digital currency. Finally, we believe a company could issue a profit participation interest that would be paid in digital currency. To be compliant with federal integration doctrine, we believe that each example must be include the option for the purchaser to be paid in the digital currency, fiat currency, or a combination of the two. Innovative offering structures like these will help the issuances of digital assets to fit within securities laws, while also meeting the needs of the novel, innovative technology that is being developed in this space.

E. Conclusion

Innovation drives the American economy, and distributed leger technology is at the heart of innovation in the financial services industry. While the SEC has taken important steps to provide guidance to FinTech firms on the regulation of digital assets, and our capital markets are the most dynamic in the world, there is a need for a more thorough update to the regulatory framework. Congress has amended the federal securities laws in the past to keep up with market changes, and we believe that the current developments with digital assets necessitate a similar amendment. It is critical

regulators take thoughtful steps to better regulate digital assets in order to promote innovation and to ensure the protection of the public. If Liquid M or we can be of any further assistance to you in this matter, please do not hesitate to contact me.

Sweetbridge

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SWEETBRIDGE
515 E. Grant Street, Suite 150
Phoenix, Arizona 85004

March 13, 2018

The Honorable Kyrsten Sinema
U.S. House of Representatives
1725 Longworth House Office Building
Washington, D.C. 20515

Dear Representative Sinema:

America is the world's technology leader. From automobiles to airplanes, computers to smartphones, the Internet to apps, America has been at the forefront of technological innovation for over a century. But today it is on the verge of ceding this elite status by failing to embrace and promote blockchain and cryptocurrency technology.

Blockchain technology enables the cryptographically-secure recording of transactions on a decentralized network of computers. By requiring each computer to approve a transaction before it is locked onto the network, a blockchain eliminates the need for intermediaries that have traditionally been relied upon to verify a transaction. Cryptocurrencies operate similarly to government-issued fiat currencies in that they represent a digital medium of exchange allowing owners to transfer value to others without the need for a bank or lending institution.

Cryptocurrencies have captured the imagination of American businesses, entrepreneurs, investors, and consumers. This ground-breaking technology will revolutionize global trade, governance, and economics, unleashing asset liquidity and providing access to affordable financing. Unfortunately, the true potential of cryptocurrencies and blockchain has been overshadowed by focus on Bitcoin's price volatility, fly-by- night coin offerings, and allegations of fraud.

Federal regulators have responded to these issues with a myriad of overlapping and confusing rules that leave many innovators, including Sweetbridge, unsure of how to offer their products to American consumers in adherence to the law. Federal regulators cannot agree on who has jurisdiction and how to approach the technology. While the SEC is ramping up enforcement actions against cryptocurrency sales, the CFTC has entered into a cooperative agreement with the United Kingdom to promote information sharing about blockchain, has not objected to the sale of Bitcoin futures products, and has authorized employees to trade cryptocurrencies.

Federal regulators cannot even agree on the status of cryptocurrencies – the SEC classifies cryptocurrencies as a security, the CFTC treats them as a commodity, the IRS has classified them as property for income tax purposes, and Treasury's

Financial Crimes Enforcement Network (FinCEN) has declared them currency for money transmitter licensing requirements. Innovators must also contend with a similarly cumbersome patchwork of state laws.

The sale of cryptocurrencies through ICOs and the exchange of cryptocurrencies on secondary markets have garnered the lion's share of regulators' attention. While many cryptocurrencies are designed, sold and traded like securities and should be regulated as such, many cryptocurrencies – or more correctly, digital tokens – are not designed to and do not function as securities.

Sweetbridge is a not-for-profit alliance of global blockchain projects designed to streamline global supply chain management, provide liquidity to supply chain and individual assets, and engineer new ways for businesses and government to engage in commerce. The Sweetbridge platform is utilized through a dual token model. Bridgecoin is a stable currency pegged to government-issued currency such as the U.S. dollar or euro and programmed for commercial exchange. Sweetcoin is a discount token that enables an individual, business, or government to borrow against their assets with reduced or eliminated fees, including low interest rate liquidity. Unlike many of the cryptocurrencies on the market today, the Sweetbridge tokens obtain their value through customers' use of the platform. Also unlike many of the recent ICOs, which were initiated to raise capital on the promise of a future blockchain product that never materialized, the Sweetbridge platform is ready to launch, and the tokens are an integral part of the platform's functionality.

Sweetbridge is not unique in its design and use of digital tokens. Many other innovators are designing blockchain products that enable the purchase of goods or services, consumer lending, mortgages and real estate transactions, record management, supply chain operations, identity management, and much more. But many American innovators are leaving the United States and not offering their products to American customers, instead launching their blockchain projects in foreign countries that have embraced the technology. In the absence of clarity from federal regulators, particularly the SEC, Sweetbridge will be forced to join them. While this may satisfy the regulatory goal to protect retail buyers from bad actors, it will have a longer-term effect of driving good actors with significant innovations that could provide real value to consumers offshore.

The Capital Markets, Securities, and Investment Subcommittee hearing on March 14, 2018, entitled "Examining the Cryptocurrencies and ICO Markets" presents an important and timely opportunity for members of Congress to examine the myriad of federal regulations that are preventing many blockchain innovators from offering their products to American customers. I commend the subcommittee for engaging in this much-needed oversight and encourage Congress to explore ways to provide regulatory clarity and guidance to American innovators like Sweetbridge.

Thank you for your attention to this issue. I look forward to working with you and your colleagues to overcome the regulatory barriers to blockchain innovation.

Sincerely,

Scott Nelson
Chairman and CEO

Questions for the Record
Responses Respectfully Submitted by Mike Lempres
Chief Legal and Risk Officer
Coinbase, Inc.

Examining Cryptocurrencies and ICO Markets
Subcommittee on Capital Markets, Securities, and Investments
Committee on Financial Services
March 14, 2018

Rep. Emmer:

1. To what extent do regulators need to clarify so-called utility tokens and other products in this space are commodities or at least not securities, and are simple enforcement actions enough to get there?

Current regulatory uncertainty around the line between security tokens and non-security tokens has chilled innovation in the digital asset marketplace, particularly among firms that are focused on regulatory compliance.

Regulation through enforcement, while understandable as a first step while regulators gain an understanding of a new asset class, is an insufficient regulatory approach to the security versus non-security issue. First, regulation by enforcement is by its nature retrospective, making it difficult to know whether a particular structure will incur liability in the future. Second, regulation by enforcement does not offer a good framework with which to analyze new products; market participants can only see which tokens the regulators believe **are** securities, not which tokens **are not** securities. Third, regulation by enforcement is inherently arbitrary in terms of which tokens are ultimately the subject of an enforcement action; with an estimated 1,400 tokens in circulation currently, there is no way for the regulators to address every token. Each of these issues makes guidance from the regulators -- through speeches, no-action letters, published guidance, and notice and comment rulemaking -- a much preferable method than enforcement actions alone.

2. Specifically, what is the difference between a token that operates as a commodity and one that operates as a security?

We believe that a token that operates as a commodity, rather a security, may have at least two key differences. First, the primary purpose of the commodity token would be actual use, which would increase the functionality of the platform for which it is issued. We believe that a token so designed and used would be less likely to meet the definition of an "investment contract" as set forth by the Supreme Court in SEC v. W.J. Howey.[1] In contrast, a token that is issued for the

[1] 328 U.S. 293 (1946). Under the Howey test, an investment contract is defined as an

purpose of investment, rather than consumption, would be more likely to be deemed a security under Howey.

Second, we believe that a token would operate as a commodity if the value of that token did not derive primarily from the entrepreneurial or managerial efforts of others. Most platforms that issue tokens are very decentralized, with minimal involvement or direction from the sponsor. Moreover, token holders may be dispersed, and only identifiable by a blockchain address. We believe that these factors would make it difficult for those token-holders to join together to effect change or to exercise meaningful control, and that this characteristic, especially if coupled with a lack of a central sponsor, would make it more likely that such tokens would operate as a commodity.

3a. Many have discussed the concept of a "utility token," where the token is issued solely for use on the platform of the company. Do you believe that such a "utility token" could theoretically exist without necessarily being a security?

Yes. We believe that a token that is issued solely to be used on the platform for which it was issued could be defined as a "utility" token. As discussed in response to Question 2, we believe that a token whose purpose is actual use rather than investment may be more likely to not meet the Howey test.

3b. Do you think that at one point an ICO could be a security at time of issuance and then theoretically become a commodity once the company's platform has been developed for the token to be used on?

Yes. The intended structure and functionality of a token may change over time, especially if the token is issued before the underlying platform has been fully developed. As such, a token that may be deemed to be an investment contract (and therefore a security) under the Howey test at the time of the token's issuance may no longer be deemed to be a security as the platform becomes fully operational, and the utility of the token increases. For example, if a token is issued before the underlying platform is operational, and if the token is intended to be used solely or primarily in connection with that platform, that token may be less of a utility token initially than when the platform becomes fully operational. Similarly, if changes to the token are made after it is issued to further disaggregate the operation of that token, e.g., to further limit the ability of a core group of persons to make changes to the functionality of that token, then this may also cause the token to be deemed a commodity rather than a security.

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investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. The Securities Exchange Act of 1934 defines a security to include, among other things, an investment contract, and the SEC has previously used the Howey test in determining whether a token is an investment contract, and therefore a security. See, e.g., Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Securities Exchange Act Release No. 81207 (July 25, 2017).

To the extent a token is issued that is ultimately deemed a commodity, rather than a security, one of the challenges is to determine the appropriate treatment of a token before it becomes a commodity. For example, a token that is initially deemed to be a security would have to be registered under the appropriate securities laws (or find an exemption from registration). However, if that token is subsequently deemed to be a commodity, the securities laws (and any corresponding registration statements) will no longer be applicable, and the token will transition from regulation as a security to regulation as a commodity. Coinbase is unaware of precedent for this kind of transition, and believes that it highlights the difficulty of definitively classifying a token prior to its ultimate end state.

3c. Does something like the Simple Agreement for Future Tokens (SAFT) help properly address this distinction between the security issuance and the utilization of tokens on a platform?

Coinbase believes that SAFT helps in addressing the distinction between a token at the time of issuance versus its ultimate utilization. Under the SAFT framework, an investor will fund a token issuer so that the issuer can develop utility tokens, which will be delivered to investors once functional. In most cases, Coinbase believes that the interest created by a SAFT is an investment contract. While it has been asserted that the fully functional tokens issued pursuant to a SAFT may not be securities, the utility tokens may be linked back to the SAFT agreement, especially if those tokens have been purchased at a discount pursuant to the SAFT agreement. As such, we believe that further clarification as to the regulatory status of a SAFT token is needed.

4. The CFTC has created LabCFTC, which is similar to what in other jurisdictions is known as a regulatory sandbox. Do you believe that the SEC should create a similar regulatory sandbox for digital assets that are securities?

Response:

The LabCFTC regulatory sandbox has been a beneficial avenue for fintech firms to discuss emerging issues with regulators. Coinbase would support similar efforts by the SEC in approaching fintech innovations. In particular, Coinbase would encourage a regulatory sandbox approach that could allow firms to offer and trade digital assets that may fall within the definition of a security.

Rep. Hultgren

1a. Your testimony mentions that you store more than $20 billion worth of digital currencies and have traded over $150 billion in assets. In light of the January 2018 hack of the Coincheck cryptocurrency exchange wherein $534 million was stolen, I have a handful of questions for you

related to cybersecurity. What cybersecurity standards does Coinbase adhere to, if any? For example, does Coinbase adhere to the NIST Cybersecurity Framework?

Coinbase is currently required to adhere to the following standards or frameworks that involve cybersecurity:

PCI-DSS
GLBA
NY Bitlicense
NY CCR
GDPR
FFIEC

Coinbase additionally voluntarily aligns to the following standards or frameworks that involve cybersecurity:

NIST Cybersecurity Framework (Note: this framework, unlike other items listed in this section, is not prescriptive, rather it is a framework for thinking about security)
Center for Internet Security Controls
Privacy Shield: While serving as a data transfer mechanism, Privacy Shield requires specific data protection controls related to cybersecurity. Coinbase has applied for EU-U.S. Privacy Shield certification.

1b. Is Coinbase legally required to follow any federal cybersecurity laws or regulations?

Please refer to the previous answer.

1c. In the event of a hack of your platform that results in the loss of assets, do you provide any guarantee to those who purchase assets through your platform? Do you have a legal responsibility for the safekeeping of your clients' assets? What protections are afforded to your customers in the event their Coinbase digital wallet is hacked?

Response:

Coinbase considers all customer digital assets on our platform to be held under a custodial arrangement. As a result, we do have a legal responsibility to maintain those customer assets in a safe manner.

Coinbase maintains insurance policies that exceed the full value of digital assets held in our hot wallets at any point in time. In the event of a hack of Coinbase, these policies would be triggered to cover losses.

2a. Your testimony mentions that the exchange only supports four assets because each has been determined by regulators to be a virtual currency and therefore not a security. However, you go onto note that regulators are not providing enough clarity for approximately another 1,500 cryptocurrencies. How can the SEC/CFTC improve upon their process for providing guidance about whether a cryptocurrency is a security or a commodity? For example, why is it important for them to look at whether there is a central issuer and the role of investment contracts in providing guidance?

Response:

The SEC and CFTC to date have provided most guidance on the status of digital assets as securities or commodities through enforcement actions, including the SEC's DAO Report. Both CFTC and SEC Chairmen have provided additional guidance through speeches, and the CFTC provided further guidance through the LabCFTC's primer on virtual currencies. This constellation of guidance, however, has only addressed a handful of digital assets with any degree of specificity.

The speed at which this market has developed have put the regulators in a difficult position. Coinbase applauds the SEC and CFTC for their efforts to date to provide some degree of guidance without issuing blanket statements that could squelch the still-developing digital asset market. However, comprehensive regulation in this area is probably not feasible at this point in time because the marketplace is still developing; the lead time for proposed regulations, public comment periods, and final regulation drafting would make any regulation outdated by the time it becomes effective.

Coinbase would encourage the SEC and CFTC to use informal measures at their disposal, such as no action relief, to help the industry develop under agreed upon conditions that would allow financial innovation while still providing the market integrity and consumer protection that the securities and commodities laws are designed to protect.

Coinbase would also encourage the SEC and CFTC to establish a framework between the agencies to define their jurisdictional scopes in the context of digital assets -- much as the agencies have done in the past in the context of stock indices and swaps. Because regulations on trading securities, spot commodities, and commodity derivatives are fundamentally different, market participants and exchanges need a framework when determining what regulatory regime will apply to a given asset.

2b. Would there be value in the SEC/CFTC providing specific guidance for whether or not an individual cryptocurrency is a security or a commodity?

Response:

Coinbase would certainly welcome guidance on whether individual tokens are securities or commodities. The more points of reference there are for understanding the dividing line between the SEC and CFTC's jurisdictions, the better that the market will be able to offer new products that can be created, traded, and used in a regulatorily compliant manner. However, guidance on a larger framework would be better than guidance on individual tokens, given that there are an estimated 1,400 tokens in existence today and certainly more to come as the industry develops.

RESPONSE TO
QUESTION FOR THE RECORD FROM
THE HONORABLE RANADLL HULTGREN,
UNITED STATES HOUSE OF REPRESENTATIVES

BY

Robert Rosenblum
Partner, Wilson Sonsini Goodrich & Rosati

September 18, 2018

On March 14, 2018, I had the privilege of testifying before the Capital Markets, Securities and Investment Subcommittee of the House Committee on Financial Services. It is my further privilege to respond to a follow up question from that testimony posed by Congressman Hultgren. For convenience, I will repeat the text of Congressman Hultgren's question, and my response will follow that question. The views I present here are my own, and are not necessarily the views of Wilson Sonsini Goodrich & Rosati, the law firm for which I work, or of any of my partners or colleagues at Wilson Sonsini. The views I present here also do not necessarily represent the views of any client of Wilson Sonsini.

Question: In July of 2017, the SEC's Division of Enforcement released a report on its investigation of The DAO and Slock.it for potential violation of federal securities laws. I understand the Division of Enforcement has since used this report as the basis for additional actions.

1. Is there anything in the report that requires clarification? I believe it's important that market participants, at a minimum, understand the expectations of the Division of Enforcement, especially in this unchartered territory.

Response: In my view, the Securities and Exchange Commission's ("**SEC**" or "**Commission**") Division of Enforcement's DAO report (the "**DAO Report**") was a very helpful first step in expressing the views of the Commission on the regulatory treatment of cryptocurrency in the United States. Of critical importance, the DAO Report made it clear that cryptocurrency could be a security if it met the test set forth by the Supreme Court in *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).

Since the DAO Report, the SEC has brought a number of enforcement actions against participants in the cryptocurrency markets. Most of these actions have appeared to involve what might be described as "garden variety" fraud, such as actions against cryptocurrency issuers that made false or misleading statements about how they intended to use the proceeds of their cryptocurrency offerings. More recently, the SEC brought an action against a cryptocurrency hedge fund for substantive violations of, among others, the Investment Advisers Act of 1940 and the Investment Company Act of 1940,[1] and the Commission brought an action against the sponsor of a web site that sold cryptocurrency for substantive violations of, among other things, the broker-dealer registration provisions of the Securities Exchange Act of 1934.[2]

Notwithstanding these SEC enforcement actions, there are a number of enforcement-related questions that are still unclear, and that are causing confusion in the cryptocurrency markets. Among these are:

- What is the Division of Enforcement's view on cryptocurrency issuers who may have offered cryptocurrency to retail investors in violation of Section 5 of the Securities Act of 1933, but who did not engage in fraudulent conduct? To date, we have seen only one (relatively modest) enforcement action against such an issuer.[3] Does this mean that the Division of Enforcement generally has decided not to take action against these issuers, and especially against these issuers who completed their offerings prior to the release of the DAO Report?
- What is the Division of Enforcement's view on exchanges and other secondary trading platforms that permit US investors to buy and sell cryptocurrency in secondary transactions? To date, we have seen only one enforcement action against such a platform, and the Commission alleged there only that the sponsor was an illegally unregistered broker, and did not

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[1] In the Matter of Crypto Asset Manager LP and Timothy Enneking, Securities Act Release No. 10544 (Sept. 11, 2018).

[2] In the Matter of Tokenlot LLC, Lenny Kugel and Eli L. Lewitt, Securities Act Release No. 10543 (Sept. 11, 2018).

[3] In the matter of Munchee Inc., Securities Act Release No. 10445 (Dec. 11, 2017) (settled cease and desist order finding that the respondent violated Section 5 of the Securities Act of 1933 because the respondant's "utility" tokens were securities by virtue of being an investment contract).

also allege that the platform was an illegally unregistered exchange.[4] The SEC also has not yet approved any applications for an alternative trading system (often thought of as a "mini-exchange") for cryptocurrency. Does this mean that the Division of Enforcement largely has decided not to take action against unregistered cryptocurrency exchanges, at least until the Commission authorizes a cryptocurrency alternative trading system?

- Notwithstanding the DAO Report and subsequent Staff statements to the effect that most types of cryptocurrency appears to be securities, there are still a number of cryptocurrency participants who take the position that that their cryptocurrency is a "utility token" that is not a security. While the DAO Report and other Staff statements make it clear that whether a cryptocurrency is or is not a security is a fact-based inquiry, it appears that the Staff's view that most types of cryptocurrency are securities differs from the views of some market participants who have concluded that a number of types of cryptocurrency are in fact not securities. Does this mean that the Division of Enforcement believes that there are, in fact, many types of cryptocurrency that are in fact not securities?

In addition to the open questions about the views of the Division of Enforcement, there are significant questions about the views of other SEC divisions.

- As noted earlier, the Division of Trading and Markets has still not approved an alternative trading system for cryptocurrency trading, and that Division has not publicly discussed, for example, the types of listing standards, clearance and settlement systems, trade reporting and other important features it would expect to see in a successful alternative trading system application.
- The Division of Corporation Finance has yet to approve a registration statement or a Regulation A+ offering for cryptocurrency, and that Division has not publicly discussed the information that it thinks is needed for a successful offering.
- In a related vein, many of the platforms on which cryptocurrency will be used, as well as the underlying blockchains for cryptocurrency, present potential broker-dealer, transfer agent, clearing agency and Regulation M issues (among others), and the Division of Trading and Markets has not publicly discussed its views on any of those issues.

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[4] In the Matter of Tokenlot LLC, Lenny Kugel and Eli L. Lewitt, Securities Act Release No. 10543 (Sept. 11, 2018).

- The Division of Investment Management sent a letter to the Investment Company Institute in January expressing its views that, due to uncertainties in valuation and liquidity in the cryptocurrency markets (among other reasons), it would not permit registrations of cryptocurrency funds.[5] While this letter has the advantage of clearly stating the Staff's views, it also is debatable whether the best answer for the markets and the investing public is to completely prohibit retail investors from having access to an important class of professional investment management services as they seek to invest in cryptocurrency.
- In addition, there still are a number of open questions that the Division of Investment Management has not addressed, such as how can registered investment companies that inadvertently and unintentionally receive cryptocurrency deal with their custody and other obligations, and how can investment advisers that advise clients on cryptocurrency meet a variety of their statutory and regulatory obligations, including their custody rule obligations.
- The Division of Investment Management also has not expressed its views on whether a cryptocurrency issuer can become an investment company simply by holding its own cryptocurrency (if the cryptocurrency is a security, and the value of that cryptocurrency exceeds 40% of the company's total non-cash assets, the company could be deemed to be an investment company).

Finally, it is worth noting that on September 13, 2018, SEC Chairman Jay Clayton issued a statement (similar to a statement made by a number of other regulators) that SEC Staff statements are non-binding and create no enforceable rights against the Commission or other parties; instead, only the Commission itself can adopt rules with the force of law.[6] While this statement is undoubtedly true, and generally reiterates the long-standing understanding of SEC practitioners, this statement does have the (perhaps inadvertent) effect of calling into question the continuing validity of a number of recent Staff statements – and statements by the Chairman and by individual Commissioners – on cryptocurrency, many of which have been very important.

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[5] Engaging on Fund Innovation and Cryptocurrency-related Holdings, SEC Staff Letter to Paul Schott Stevens, President & CEO, Investment Company Institute (January 18, 2018).

[6] SEC Chairman Jay Clayton, Statement Regarding SEC Staff Views (September 13, 2018).

For example, William Hinman, the Director of the Division of Corporation Finance, recently gave a speech in which he suggested, among other things, that in his view the Etherium blockchain's native token, Ether, should not be treated as a security.[7] The market has generally understood that this was not a Commission statement, and instead a statement by a Staff member – albeit a very senior and important Staff member. The industry has to a large extent relied on Director Hinman's statements, especially in the absence of any Commission statements suggesting that the Commission disagrees with Director Hinman. Chairman Clayton's statement could have the (possibly unintended) effect of negating the views expressed by Director Himnan, and more broadly undermining the ability of Director Hinman and other senior Staff members to provide useful guidance that the industry can feel comfortable relying upon (at least unless and until the Commission provides different substantive guidance).

Put another way, before Chairman Clayton's statement, the general view in the cryptocurrency industry (and more broadly) might be summarized as "we can rely on Staff statements unless and until the Commission makes a contrary statement." Following Chairman Clayton's statement, there is at least some view in the industry that might be summarized as "we cannot rely on any Staff statements unless and until the Commission confirms the Staff's view." I don't believe that is what Chairman Clayton intended, and it might be helpful for the Chairman to provide additional guidance on how he believes the public should view statements such as Director Hinman's.

In summary, the DAO Report was a helpful first step in explaining the Commission's views on the appropriate treatment of cryptocurrency under the federal securities laws. As discussed above, however, there are number of important questions that the Commission and the SEC Staff have continued to leave open, often to the detriment of the cryptocurrency community. And recently, the Chairman has introduced uncertainty as to the Staff's ability to even address these questions. It would be extremely helpful for the Commission to publicly address the types of issues I have highlighted here, and to clarify the Staff's role in providing guidance to the cryptocurrency community (and to the investing public more broadly).

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[7] William Hinman, Director, SEC Division of Corporation Finance, *Digital Asset Transactions, When Howey Met Gary (Plastics)* (Jun. 14, 2018).

Please feel free to contact me if I can provide any additional assistance or information. Thank you for the opportunity to present my views on these important subjects

COIN CENTER

Date: 4/20/2018

From: Peter Van Valkenburgh
Coin Center
718 7th St NW,
Washington, DC 20001
peter@coincenter.org

To: The Honorable Tom Emmer
315 Cannon House Office Building
Washington, DC 20515

Dear Congressman Emmer,

Thank you for the opportunity to testify before The House Financial Services Committee Subcommittee on Capital Markets regarding cryptocurrencies and ICOs. In response to your additional questions, I would like to submit the following for the record:

1. **To what extent do regulators need to clarify so-called utility tokens and other products in this space are commodities or at least not securities, and are simple enforcement actions enough to get there?**

   While the SEC has done a thorough job explaining that some token sales *do* qualify as securities issuance (both in the 21a report on The DAO and subsequent enforcement actions) at no point has the SEC openly declared that any open blockchain token or cryptocurrency *does not* qualify as a security. The flexibility and subjectivity of the relevant legal test for securities leaves this area uncertain. This uncertainty persists even though there are good reasons why neither of the following—at the very least—should qualify securities under a reasonable interpretation of the relevant test: (a) highly decentralized cryptocurrencies such as bitcoin and (b) tokens widely utilized for decentralized computing applications such as ether.

   Enforcement actions alone will never generate clarity on this subject unless either (a) every token is deemed a security and enforced against or (b) an enforcement action against a utility or commodity-like coin or token is challenged in court and the SEC loses that challenge. Neither of these outcomes is desirable given that they would make the US a uniquely hostile home for innovation in financial and decentralized computing technologies.

   As an alternative, the SEC could issue interpretive guidance further delineating the line

between securities and non-securities (as they did with, for example, condominium developments in the 1970s[1]) or letters of no-action to specific token projects/developers (as they did with, for example, professional sports seat licenses[2]).

2. **Specifically, what is the difference between a token that operates as a commodity and one that operates as a security?**

Two qualities separate a token that operates as a commodity from one that operates as a security. Those qualities are (1) usefulness and (2) decentralization.

Usefulness: tokens can either be valuable as a claim on profits derived from the future efforts of an issuer or they can be valuable as an item useful in commerce. Useful in commerce may mean that the token is used as a store of value and medium of exchange because of its mathematically and cryptographically verified scarcity and its transferability over peer-to-peer networks. In other words, Bitcoin and other currency-like tokens are useful. Useful in commerce may alternatively mean that the token can be utilized as a fuel for powering a decentralized application.

Decentralized applications, in general, are computer systems that can provide digital services (data storage capacity, computation, shared data verification and distribution) to users on the internet without requiring reliance on any particular intermediary or service provider. For example, rather than relying on Dropbox, the company, to store files, a user of a decentralized storage application would acquire the storage token and use it power an automated engine that will encrypt, copy, and distribute their files such that they are stored redundantly and in fragments across hundreds or thousands of participant computers across the Internet. Each person or business running these participant computers is incentivised to provide these storage resources because the automated engine also distributes tokens as a reward for honest and verifiable resource provision. In this sense the token is less like a currency (a medium of exchange between two consenting persons in commerce) and more like a fuel (a material necessary to power some automatically regulated engine for performing work). In both the case of a physical currency (e.g. gold) and the case of a physical fuel (e.g. oil) we rightly treat these assets as commodities because they provide their holder with a value derived from use in commerce (rather than some promise of future profits derived from an issuer's efforts).

Decentralization: If a token was useful but that functionality was entirely contingent on the continued efforts of a company then there would still be a colorable case for treatment of that token as a security.

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[1] SEC, *Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development*, (1973) https://www.sec.gov/rules/interp/1973/33-5347.pdf.
[2] SEC, *No Action, Interpretive and/or Exemptive Letter: The Ticket Reserve, Inc.* (2003) https://www.sec.gov/divisions/corpfin/cf-noaction/ticketreserve091103.htm

Imagine, for example, if Dropbox created 50,000 units of Dropbox Coin, promised not to create any more, allowed for or created mechanisms for secondary trading of dropbox coin, and promised that dropbox coin would always be redeemable for some percentage of the total amount of cloud storage available on Dropbox. In some ways Dropbox Coin would be a voucher, loyalty point, or closed-loop gift card. However, unlike loyalty points, our hypothetical Dropbox Coin is freely traded and it has a speculative future value that's based on the continued growth and vitality of Dropbox as a company (if they expand their server capacity then each coin will entitle the holder to more storage). Holders are still relying on promises made by Dropbox and if the company goes out of business the coin will be worthless.

Compare this hypothetical with Bitcoin or Ethereum. Both Bitcoin and Ethereum are services (online payments and shared computing, respectively) and both allow for fractional ownership of a scarce token used by the network (bitcoins and ether, respectively). Unlike the Dropbox Coin example, however, no entity corporate or otherwise is essential to the future functionality of the service and value of the token. Each service is powered by open source software that is developed openly and without restrictive copyright protection by hundreds of unafiliated developers. Each service is maintained by thousands of unafiliated persons running that software on Internet-connected computers (e.g. miners). If Dropbox was to shutter, the coin would go away. There is no entity whose departure from the space would gravely affect the continued functioning of the bitcoin or ethereum networks.

Thus at least some tokens, Bitcoin and Ether among them, are both useful in commerce and free of any reliance on a third party for that usefulness. These factors together make them much more like gold or oil (useful in commerce and not dependent on any particular person or corporation to guarantee that usefulness) than like securities (valuable primarily as investments and reliant on some discernible person or corporation to deliver promised profits).

3. **Many have discussed the concept of a "utility token," where the token is issued solely for use on the platform of the company. Do you believe that such a "utility token" could theoretically exist without necessarily being a security?**

   Yes. If the token possessed both the qualities described in the earlier answer, usefulness and decentralization, then it does not fit the relevant test for classification as a security.

   a. **Do you think that at one point an ICO could be a security at time of issuance and then theoretically become a commodity once the company's platform has been developed for the token to be used on?**

      Yes. If a developer wants to build a decentralized app that will be

token-powered, and if they want to raise money by pre-selling some number of the tokens that will one day be a fuel for that app, then that presold promise of future tokens may fit the relevant tests for classification as a security. The tokens themselves are not securities; the security is the contractual promise of tokens itself. Imagine, for example, that I took investor funds and promised to use them to build an orange grove and then deliver to my investors some fraction of the total oranges that I intend to grow every year. The agreement for future oranges is a speculative investment contract in my talents as a farmer. The oranges, once delivered, however, are certainly not securities.

b. Does something like the Simple Agreement for Future Tokens (SAFT) help properly address this distinction between the security issuance and the utilization of tokens on a platform?

Yes, a SAFT contract is designed to be treated as a security because it is, in many ways, an investment contract between buyers and the developers upon whom buyers rely. The tokens delivered, should they meet the requisite usefulness and decentralization described earlier, are anticipated by the drafters of the SAFT to not be securities. The SEC has not explicitly sanctioned this approach, however. If the SEC chose to offer clarity with regard to which tokens are not securities (as discussed in the first answer), then useful and decentralized tokens derived initially through SAFT sales should also be designated as non-securities; the fact that they were initially sold through a SAFT should not be relevant to the question of classification once the network is functioning and the token is useful and decentralized.

4. The CFTC has created LabCFTC, which is similar to what in other jurisdictions is known as a regulatory sandbox. Do you believe that the SEC should create a similar regulatory sandbox for digital assets that are securities?

In general, the term regulatory sandbox is used to describe efforts recently undertaken by financial regulators in the UK and Singapore. These sandboxes allow a firm with an innovative product or service to petition their regulator to be exempt from the standard set of rules that would otherwise apply and instead enter into an enforceable compliance agreement tailored to the specific firm, its product, and the risks it generates (and doesn't generate) for consumers. This provides some real benefits to companies: they can find more flexible paths toward financial regulatory compliance, and work with regulators to sensibly tailor their compliance obligations.

At present, no U.S. regulator offers this sort of sandbox approach. The CFTC's LabCFTC is a more modest attempt at encouraging innovation and greater legal certainty. It focuses on providing a point of contact for innovators within the agency, an open dialog about regulatory issues, and educational materials for regulators, innovators, and the

general public. It does not, however, allow innovators systematic means by which to enter into compliance agreements or be exempted from the standard set of CFTC rules that otherwise apply.

US innovators would be more competitive and better regulated if there were more efforts like LabCFTC underway in other agencies. However, a true sandbox approach (as found in the UK and Singapore) would be of even greater benefit. A true sandbox approach would, however, likely require legislation that would empower agencies to create binding compliance agreements and bind agencies to follow those agreements once established.

Thank you for being generous with your time, and please do not hesitate to reach out if you have any further questions or concerns.

Sincerely,

Peter Van Valkenburgh

Director of Research, Coin Center