

Written Testimony of
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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").

¹Ether 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.