July 11, 2023

The Honorable Patrick McHenry
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Glenn Thompson
Chairman
Committee on Agriculture
U.S. House of Representatives
Washington, D.C. 20515

The Honorable David Scott
Ranking Member
Committee on Agriculture
U.S. House of Representatives
Washington, D.C. 20515

Re: Concerns About Provisions in the Digital Asset Market Structure Discussion Draft

Dear Chairmen McHenry and Thompson and Ranking Members Waters and Scott:

Regardless of whether one supports or opposes the Digital Asset Market Structure Discussion Draft ("Discussion Draft"), below are a number of key issues raised that should be carefully considered.[1]

As an initial matter, it must be recognized that the Commodity Futures Trading Commission ("CFTC") is an important financial regulatory agency with mandates and missions that are critical to the functioning of the financial system and economy. For example, every single American depends on the CFTC to ensure that vital commodities are available in cities and towns across America at the right time, in the right amounts, and at prices that reasonably reflect actual supply and demand. That includes cereal for breakfast, bread for school sandwiches, beef for their BBQs, heating oil for their homes, and gas for their cars and trucks to get to work and travel. In addition to those kitchen table concerns, the CFTC's regulation of the derivatives markets is crucial to every farmer in the country who often depend on those markets for hedging their risks.

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

Adding yet more mandates on the CFTC, especially when it is currently underfunded, will inevitably but decidedly compromise the agency's ability to fulfill its vital roles that all Americans depend on and benefit from. Indeed, fully funding the CFTC should be the priority and only then should there be any consideration given to adding more work. With that in mind, the Discussion Draft raises a number of key issues that all members should carefully consider.

1. The CFTC Lacks the Necessary Investor Protection Mandates to Effectively and Seamlessly Regulate Cryptocurrencies.

Investor protection has been at the core of U.S. securities laws and regulations, as well as the ethos and mission of the Securities and Exchange Commission ("SEC")—indeed, its governing statute requires it to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation—for nearly 90 years. While the CFTC does have some ***customer*** protection mandates, the agency's mission—to promote the integrity, resilience, and vibrancy of the U.S. derivatives markets through sound regulation—lacks the investor protection mandate that we have in our securities markets. These differences are largely due to the different types of participants in each market. While retail investors have always been active, and indeed critical to, in the securities markets, specifically the equities markets, they have not traditionally participated in the more complex derivative markets.

The CFTC regulates commodity and derivatives markets, which historically are overwhelmingly dominated by very large institutions with very little retail investor participation – think of them as wholesale markets. As a result, the CFTC's role has mostly been as a referee between very large and very well-funded purchasers and producers seeking price discovery and hedging in their commercial enterprises. The existing CFTC regulatory framework was established, designed, and implemented to facilitate hedging, price discovery, and trading strategies between large, sophisticated entities and financial institutions. The CFTC's regulation of trading in these markets reflects these differences. Specifically, for example, derivatives trading lacks order routing practices and best execution requirements that are critical to protecting retail investors in the securities markets. In addition, the securities law framework includes other standard investor and market protections such as a broker-dealer regulatory regime that governs the interactions and conflicts of interest between broker-dealers and retail investors.

While the Discussion Draft attempts to recreate an investor protection regime at the CFTC similar to the existing broker-dealer regulatory regime that has governed our securities markets for decades, it falls woefully short of protecting investors. For example, broker-dealers registered with the SEC and FINRA are participants in SIPC insurance, which insures individual investors against losses up to $500,000 in the event of a failure or bankruptcy of their broker-dealer. No such insurance system exists amongst CFTC-regulated participants nor is one established in the Discussion Draft. Likewise, broker-dealers under securities law are mandated to obtain independent, third-party audits of their financial statements. Again, no such requirement exists in the Discussion Draft for digital commodity exchanges or digital commodity broker-dealers. The

Discussion Draft also lacks key order routing and best execution requirements for digital commodity exchanges or broker-dealers executing customer orders and does not prohibit exchanges or their affiliates from trading on their own platforms against their own customers. The Discussion Draft also lacks basic investor rights to bring suit against digital commodity exchanges and broker-dealers that are available in the securities regulatory regime.

These are only a few reasons why the attempt to recreate a SEC-like broker-dealer regulatory regime at the CFTC to regulate so-called digital commodities will not only not work, but will result in decades of massive investor harm, protracted legal battles, and agency rulemakings and guidance to develop a regulatory regime that will still not be remotely comparative to existing protections in securities law.

2. **This Is an Unfunded Mandate and Main Street Consumers, Commodity Markets, Farmers and Other Commodity Producers Will Pay the Price.**

For years, the CFTC has been chronically underfunded with less than 700 employees (compared to the SEC's approximately 4,500 employees). Frankly, it does not have the funding to fulfill all of its current statutory mandates. Nevertheless, on top of that, the Discussion Draft would make the CFTC the de facto regulator of crypto exchanges and broker-dealers and charge them with implementing numerous resource intensive and lengthy notice-and-comment rulemakings. During and after that, the CFTC is also somehow supposed to implement, interpret, and enforce those rules. Yet, the Discussion Draft ***provides no funding*** to the already strapped agency charged with regulating and overseeing the vast and complex derivatives markets, including the $400 trillion (notational value) swaps markets, futures, and options.

In FY23, Congress set the CFTC's budget at $365 million. In testimony before the Senate Agriculture Committee, CFTC Chair Benham stated that the CFTC would need roughly $120 million over three years to implement provisions of FTX-endorsed crypto legislation under consideration in the U.S. Senate at the time. The CFTC mandates in the Discussion Draft are far more numerous and onerous on the CFTC, requiring even more resources than the CFTC Chair called for in response to Senate legislation (which we believe was significantly underestimated).

Without very significant funding appropriated for the CFTC in this Discussion Draft (estimated to be approximately $70 million more each year), the draft is little more than a list of unfunded mandates that would come at the cost of the CFTC's important existing work ensuring that vital commodities are available to the American people and policing the derivatives markets, which play a vitally important role for farmers, producers, and in our commodities markets. And because those commodity markets ultimately have a profound impact on the prices that all Americans pay for goods, the public at large stands to suffer widespread harm from inadequate oversight.

3. **Manipulative Wash Trading Will Still Run Rampant in Crypto Markets with Adverse Consequences for Investors.**

Due to the global nature of the trading of cryptocurrencies, there is nothing in the Discussion Draft that will curb the rampant, manipulative wash trading that has become a feature of crypto markets.[2] Long used by unscrupulous traders, wash trading is a form of market manipulation where a trader and/or affiliates create the appearance of high trading interest and trading volume by placing buy and sell orders in the market without actually in effect taking a position.

In securities law, wash trading is strictly prohibited and enforced as securities fraud. However, in crypto markets it has quickly become a frequent mainstream practice. Experts have suggested that a majority of the trading volume in Bitcoin are wash trades and that as much as 95% of that trading could be due to wash trading.[3] Without account-ID information and verification by crypto exchanges, among other things, manipulative wash trading will remain a core predatory feature of crypto markets, preventing accurate price discovery in crypto markets and victimizing retail investors who are lured into the crypto markets through the phony volume and pricing that wash trading creates.

4. **The Digital Commodity Exchange Requirements Lack Meaningful Investor Protections.**

The Discussion Draft grants broad authority to digital commodity exchanges to have "reasonable discretion in establishing the manner in which the digital commodity exchange complies with core principles described in [Section 404]." This is no more than the appearance but not the reality of investor and market protection rules. Allowing digital commodity exchanges to use their "discretion" when complying with "core principles" is nothing more than the latest version of long-discredited industry self-policing, a euphemism for no policing at all. Relying on what is supposed to be a regulated industry to regulate itself is always perilous, but it is reckless given the crypto industry's demonstrated and widespread lawlessness.

Unlike exchange or broker-dealer regulation in the securities regulatory regime, the Discussion Draft does not require ***any*** specific policies regarding order routing practices or best execution requirements in executing customer orders. The Discussion Draft also does not prohibit an entity operating a digital commodity exchange from trading on their own platform against their own customers. The draft would only require "informational partitions" between the operations of

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[2] Lin William Cong, Xi Li, Ke Tang, and Yang Yang, *Crypto Wash Trading*, NATIONAL BUREAU OF ECONOMIC RESEARCH (December 2022), https://www.nber.org/papers/w30783 ("[w]e find that the wash trading volume, on average, is as high as 77.5% of the total trading volume on unregulated exchanges…these estimates translate into wash trading of over 4.5 trillion USD in spot markets and over 1.5 Trillion in USD in derivatives markets in the first quarter of 2020 alone").

[3] *See e.g.* Bitwise Asset Management, Presentation to the SEC (Mar. 19, 2019), srnysearca201901-5164833-183434.pdf (sec.gov); *see also* Javier Paz, More than Half of All Bitcoin Trades Are Fake, FORBES (Aug. 26, 2022), https://www.forbes.com/sites/javierpaz/2022/08/26/more-than-half-of-all-bitcoin-trades-are-fake/?sh=1a9340576681.

the exchange and any affiliated trading on the exchange. If this were permitted in the securities markets, a stock exchange could establish a hedge fund that trades on its own exchange and against the stock exchange's own customers.

These types of conflicts of interest are all but impossible for regulators to police with "informational partitions" and that is why they are prohibited in securities exchange law. Additionally, despite the well-documented patterns of loss of crypto assets due to hacking and cybercrime, the Discussion Draft does not require digital commodities exchange to comply with ***any*** cybersecurity standards. In the securities markets, exchanges and alternative trading systems must comply with Regulation Systems, Compliance, and Integrity (Reg SCI) to monitor the security and technological infrastructure of the exchange. These are a vital and irreplaceable customer, market, and financial system protections.

5. The Unprecedented Provisional Safe Harbor Will Be Used as a License to Rip Off Investors for Years.

This is a shocking and irresponsible provision. The provisional safe harbors offered to crypto entities in Sections 105 and 106 of the Discussion Draft would ensure the lawlessness within the crypto industry continues at the very least until the joint rulemakings in Section 104 are complete, which will almost certainly take years. These sections would handcuff the ability of the CFTC and/or SEC from bringing otherwise appropriate, necessary, and lawful enforcement actions or even continue already existing enforcement actions against any entity that submits a provisional registration.

For example, there have been media reports that one of the biggest Ponzi schemes of all-time, FTX, has considered restarting their exchange in an effort to recoup more assets for stakeholders in bankruptcy. Under these provisions, FTX could submit a provisional registration to the CFTC and comply with the limited requirements for registration and thereby force the existing SEC/CFTC enforcement actions against FTX to stop until all joint rulemakings are completed. According to the terms of the Discussion Draft, as long as a crypto exchange submits a form to the CFTC and agrees to not commingle customer funds, they have carte blanche to front-run and trade against their customers; not comply with best execution or net capital requirements; and operate generally in a legal immunity-zone.

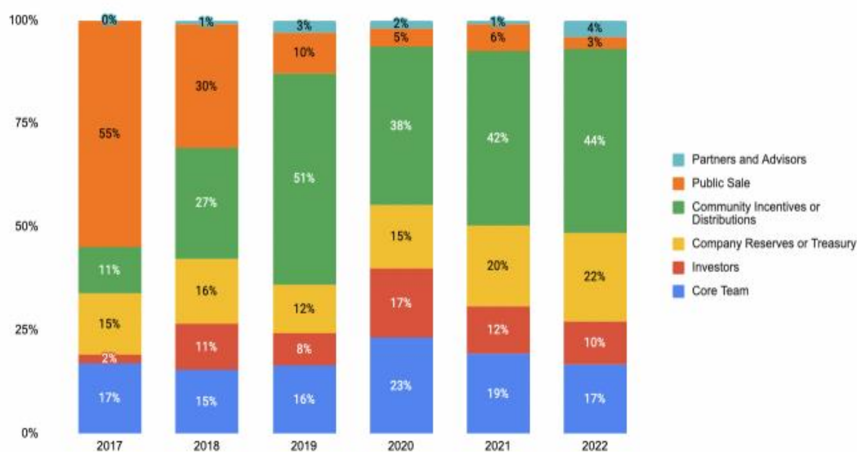
These provisional registrations would shield bad actors in the crypto industry for years until the joint rulemakings proposed in the Discussion Draft are finalized. It is worth observing that there are still a half-dozen rules mandated by Congress from the 2010 Dodd-Frank Act that have yet to be finalized. If the Dodd-Frank Act had a provision such as the one in the Discussion Draft, it would have enabled the predatory behavior by financial institutions to continue until all rulemakings were completed and Americans would still be getting ripped off some 13 years later.

6. The SEC Digital Asset Framework Lacks Requirements for Audited Financial Statements and Ensures No Crypto Tokens will be Governed by the SEC.

The limits in Section 201 of the Discussion Draft related to capital formation for digital asset issuers are similar to the limits in the SEC's Regulation A Tier 2 exempt offerings.[4] However, Regulation A also requires disclosure of two years of audited financial statements, while the limits in Section 201 for digital asset issuers conspicuously do not require any audited financial statements at the time of the offering. Given that audited financials are among the most important investor and market protections associated with a wide range of offerings, the failure to require independent, third-party audited financial statements in the Discussion Draft for digital asset issuers, digital commodity exchanges, and digital commodity broker-dealers is a glaring and troubling omission.

Further, the digital asset issuer requirements and limitations would likely result in very few registrations with the SEC and drive larger crypto projects overseas. A recent trend in digital token allocation for blockchain projects is to rely more on community incentive structures that give away or airdrop tokens to the public rather than relying on selling tokens to the public (see Figure 1 below). For example, token allocations significantly declined from the Initial Coin Offering days of 2017 when approximately 55% of a blockchain project's tokens were sold to the public. That number has decreased to roughly 3% in 2022, while tokens reserved for community incentives or distributions have risen from 11% in 2017 to 44% in 2022. Following these trends, it is likely that only the very largest blockchain projects would exceed the $75 million offering threshold because only a small percentage of tokens are sold to the public or investors.

Figure 1.



Source: Liquifi[5]

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[4] *See* SEC, Overview of Capital-Raising Exemptions, https://www.sec.gov/education/smallbusiness/exemptofferings/exemptofferingschart.

[5] Robin Ji, Token Vesting and Allocations Industry Benchmarks, Liquifi (June 8, 2022), https://www.liquifi.finance/post/token-vesting-and-allocation-benchmarks.

Similarly, any large blockchain project that anticipates raising more than $75 million would be best served raising the funds overseas and waiting until the project is sufficiently "decentralized" to list on a digital commodity exchange under the CFTC regulatory regime established by the Discussion Draft. Then, these projects could raise funding without having to register with the SEC and quickly list on a digital commodity exchange under CFTC oversight with few if any investor, market, or financial stability protections.

7. The Proposed Self-Certification Process Is a Rubber Stamp for the Transition of Cryptocurrency from Security to Commodity That Will Foreclose Meaningful SEC Review.

The self-certification process established in the Discussion Draft for a cryptocurrency project to submit certification to the SEC that the project is sufficiently decentralized ties the hands of the SEC to adequately challenge any self-certification. Under this provision, after a filing has been made, the SEC would have 30 days to rebut a certification, or it would automatically go into effect. With roughly 20,000 existing crypto tokens and no funding in the bill for the substantial additional SEC staff required to review such certifications so quickly, the SEC will not have the resources necessary to keep up with the number of filings that would bombard the agency, let alone conduct a comprehensive analysis of a cryptocurrency project within 30 days. In effect, this provision means that innumerable cryptocurrency projects will be unleashed on the unsuspecting public with no regulatory review.

Under the Discussion Draft, the SEC does have the ability to stay the certification for 90 days, in which time they may put the filing out for public comment for 30 days. However, this 30-day comment period provides very little time for potential commenters to assess and provide meaningful comments to the SEC. As you know, Members of the Financial Services Committee have repeatedly raised concerns about the adequacy of even 60- and 90-day comment periods for recently proposed rules by the SEC. If those objections had any merit, then they would have to view this provision as grossly deficient. Additionally, because it can take weeks if not longer for a proposal to be published in the Federal Register, the SEC will likely have as few as 30 to 45 days left in the 90-day stay extension to consider all commentor submissions. Requiring the SEC to adequately consider potentially up to thousands of comments on a particular decentralization filing within such a time frame is unreasonable and would almost certainly result in violations of the Administrative Procedure Act ("APA"). That will likely result in endless litigation where courts are forced to reconcile the APA requirements with the unreasonably short time period, all compounded by a lack of funding and staff.

8. Broad CFTC Authority to Exempt Any Digital Commodity Exchange or Broker-dealer From Any Provision of the Discussion Draft, Including Commingling Requirements and Other Critical Customer Protections, Is Extremely Problematic.

The Discussion Draft grants the CFTC nearly limitless authority to exempt any digital commodities exchange or broker-dealer from any provision of the bill, including important

prohibitions on commingling of customer funds and other critical customer, investor, market, and financial stability protections. Despite the apparent intent to recreate spot exchange and broker-dealer regulatory regimes similar to what exist in our securities markets within the CFTC, Section 404 and 406 of the Discussion Draft would give the CFTC broad authority to exempt any entity from the provisions of those sections if it is in the public interest ***or*** if the entity "is subject to comparable, comprehensive supervision and regulation by the appropriate government authorities in the home country of the exchange." In general, outsourcing regulation and enforcement in the financial markets to foreign regulators poses huge investor protection and systemic stability risks. And this exemptive authority is particularly problematic because many crypto exchanges are based in countries that have historically lacked strong financial regulatory systems.

Outsourcing the protection of U.S. customers, investors, markets, and stability to foreign regulators has proven woefully inadequate in the past and Americans have paid a very high price for the many failures of those foreign regulators. Authorizing that to happen again in the crypto space would be wildly inappropriate.

9. State Preemption

The Discussion Draft would largely preempt state securities and blue-sky laws, negating their ability to protect their own citizens from financial products that meet the state definition of an investment contract or security. As happened with predatory subprime mortgages in the years before the 2008 financial crash, there are states that provide or might want to provide greater consumer, investor and financial stability protections for their citizens. In fact, New York does that now with its BitLicense, which protected the citizens of New York from the FTX collapse. If New York law was preempted as this Discussion Draft would do, untold numbers of New Yorkers would have lost their money to the alleged FTX criminal scheme.

It's important to note that states like Alabama and Texas have led the way in bringing enforcement actions against crypto financial intermediaries and issuers in valiant efforts to protect their own citizens from predatory and fraudulent crypto investment schemes. The Discussion Draft would substantially reduce a state's ability to enforce their securities laws and protect their citizens.

10. Adding "Innovation" to the SEC's Mandate Will Impair the SEC's Ability to Protect Investors, Markets, and Capital Formation While Generating Endless Litigation.

The inclusion of the term "innovation" within the SEC's rulemaking mandate in Section 504 is not limited to crypto regulations. The addition of this term would have far broader implications than just crypto regulation. It by definition downgrades the SEC's primary and overwhelming duties to protect investors and markets while promoting capital formation. It would also result in endless litigation because it would provide yet another avenue to challenge existing SEC rules and new proposed rules in the courts.

Moreover, it is based on the mistaken premise that innovation is always a good in and of itself. As has been made painfully clear, that is simply not true. For example, a pharmaceutical company can innovate ways to make pain-killer medicine more addictive so they can sell more of the drug, thereby increasing the company's profits, but that does not mean that it is good for the country or in the public's interest. The crypto phenomenon itself proves the point: It rests on certain technological innovations such as the development of blockchain, yet it has so far been deployed with overwhelmingly harmful consequences for investors without any attendant benefits or valuable "uses." Just because something is novel or innovative does not make it useful or valuable to society.[6] To put such "innovation" on a co-equal status with the SEC's existing overwhelmingly important mandates would be unwise in the extreme.

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In conclusion, we hope these comments are helpful as both committees continue their work to understand how crypto securities and commodities should fit into our existing financial regulatory system that has helped to foster the broadest, deepest, and most liquid markets in the world. However, it must be recognized those markets are not preordained to remain the preeminent markets in the world. They are because they have the trust and confidence of investors and customers worldwide and that is largely due to their faith in those markets being well-regulated.

Unfortunately, the Discussion Draft would seem to be creating new market structures that are not well-regulated if regulated at all. Enacting weak, loophole-ridden regulation (including reintroducing the discredited and failed concept of industry self-regulation that prevailed before the 2008 crash) rather than genuine regulation that prioritizes the public interest virtually guarantees a disaster. That risks killing the golden goose (our markets) that laid the golden egg (a vibrant, growing economy funded by those markets). Nothing less than our economy and financial system are at stake, which is why we hope members, regardless of what they think about the Discussion Draft, take these thoughts into account as the process moves forward.

Sincerely,

Dennis Kelleher
Co-founder, President, and CEO

CC: Members of the House Committee on Agriculture
Members of the House Committee on Financial Services

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6 *See* Jemima Kelly, *Crypto shows we shouldn't venerate 'innovation' for its own sake*, FINANCIAL TIMES, June 22, 2023, https://www.ft.com/content/970cbab3-b3f6-44eb-bed3-f688caf094e8.