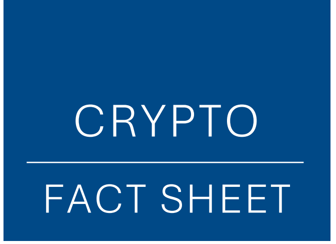

Seven Questions on the Pro-Crypto, Anti-SEC Financial Innovation and Technology for the 21st Century Act (FIT 21)

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The U.S. benefits from the broadest, deepest, and most liquid financial markets in the world. Those markets fuel U.S. business creation and expansion, creating jobs, wealth, and economic growth. However, it must be recognized that those markets are not preordained to remain the preeminent markets in the world. Their global status is due to the trust and confidence of investors and customers worldwide, and that is largely due to their belief that those ***markets are well-regulated***. Investors know their investments might lose money, but they have a high confidence that they won't be lied to, that the markets won't be manipulated, and that their money will not be ripped off. That's because they know those markets are regulated and policed by the Securities Exchange Commission (SEC), the most effective cop on the markets beat for 90 years.

The preeminence of those markets – and our economy that depends on them – is what is at stake with changes to the regulatory system that has worked for American business and the American people for almost a century. That's why people need to ask the hard questions about the pro-crypto, anti-SEC market structure legislation that was recently passed by the House of Representatives. It would make major and dramatic changes in how the U.S. markets are regulated and raise serious concerns about investor, consumer, market, and financial stability protections, all of which could easily erode investor faith, trust, and confidence in those markets.

Thus, whether one supports or opposes FIT 21, it raises very serious questions that should concern everyone and should be thoroughly considered, including the following:

1. Is the FIT 21 Act Deregulation Disguised as Regulation?

FIT 21 claims to modernize the longstanding regulation of securities by creating an entirely new financial category for crypto digital assets called "investment contract assets," which it then excludes from the definition of a "security." This exclusion almost certainly will eliminate SEC regulation and oversight of such investment contracts and will inevitably lead to the financial industry creating numerous other "investment contract assets" to avoid SEC jurisdiction. Thus, people should ask why it is appropriate or necessary to exclude digital assets from the longstanding test for determining whether a financial product is an investment contract and therefore a security? For almost 80 years, the courts have applied the Supreme Court's *Howey* test to determine if new investment schemes are, in fact, securities and, therefore, properly regulated by the SEC. FIT 21 removes digital assets from the framework that has governed investment contracts for decades and

that has ensured that when an investment is a security, investors receive the full protections of the securities laws.

The definition of investment contract assets under FIT 21 includes digital assets that can be transferred directly between individuals without an intermediary and recorded on a secure public ledger. By not classifying these assets as "securities," issuers are exempt from SEC registration, disclosure, and antifraud requirements. This regulatory exclusion – which is really just wholesale deregulation - would likely result in a surge of asset issuances, sales, and trading without appropriate transparency, disclosure, and guardrails, or the protection of much of the securities laws.

This disguised deregulation is reminiscent of the strategies employed by the financial industry in the Commodities Futures Modernization Act of 2000 (CFMA), which aimed to prevent the proper regulation of swaps and other derivatives. Lessons from the CFMA of 2000 highlight the potential dangers of taking action like that proposed in FIT 21. The CFMA led to rapid growth in the derivatives market in the early 2000s but also introduced significant systemic risks due to the lack of oversight. This deregulation was a driving factor behind the 2008 financial crisis, demonstrating the perils of inadequate regulation of so-called novel, innovative financial products. Similarly, FIT 21 claims to streamline regulations for digital assets, potentially opening loopholes for issuers to avoid regulation, reminiscent of the unregulated derivatives before the financial crisis. The reduced oversight will lead to a lack of transparency, increased fraud, and systemic risks. Given the troubling parallels with the CFMA and the subsequent 2008 financial crisis, balancing claimed innovation within a necessary regulatory framework is crucial to avoid repeating catastrophic mistakes like those that led to the 2008 financial crash and the Great Recession.

2. Is the CFTC Being Given Sufficient Resources to Prevent Main Street Consumers, Commodity Markets, Farmers, and Other Commodity Producers from Paying the Price of Deregulation?

FIT 21 removes jurisdiction, authority, and oversight of crypto digital asset securities from the SEC and gives it to the Commodity Futures Trading Commission (CFTC), which has been chronically underfunded for years and already lacks the resources to do the important mission they are already mandated to do. For example, the CFTC's budget for 2024 remains unchanged from 2023 at $365 million (compared to the SEC's 2023 budget of $2.1 billion), and it has less than 700 employees (compared to the SEC's approximately 4,500 employees). FIT 21 would substantially increase the CFTC's responsibilities, making it the de facto regulator of countless new crypto exchanges and broker-dealers, and it would charge the agency with implementing numerous resource-intensive and lengthy notice-and-comment rulemakings. The CFTC will also have to implement, interpret, and enforce those rules.

While FIT 21 authorizes the CFTC to collect a fixed amount of registration and annual fees from exchanges and brokers, those funds are capped at an annual maximum of $40,000,000, regardless of the number of registered exchanges and brokers or the actual workload imposed. This fixed cap is especially problematic given the hundreds of exchanges currently offering bitcoins and the need for the CFTC to hire staff, draft regulations, acquire technology, and enforce the provisions of the bill and the new rules. Adding insult to injury, the bill only allows the collection of these fees for four years, at which point this funding will be cut off. This is grossly insufficient for an agency already

underfunded and unable to fulfill its current mission of regulating and overseeing the vast and complex derivatives markets, including futures, options, and the $400 trillion (notional value) swaps markets.

Without significantly more funding ***appropriated*** for the CFTC in advance of being required to fulfill substantial new responsibilities by FIT 21, the CFTC won't just be unable to regulate the new crypto products and entities. It also won't be able to do its important existing work, which will be impaired and compromised to the detriment of the American people. That work includes policing the derivatives markets, which play a vitally important role for farmers, producers, and in our commodities markets, ultimately ensuring that vital commodities are available to the American people at the right time and at reasonable prices. And because those commodity markets ultimately have a profound impact on the prices that all Americans pay for goods, the public at large will suffer widespread harm from the inadequate CFTC oversight that will result if it is forced to divert its finite time, attention, and resources to crypto. Therefore, shouldn't Congress first prioritize fully funding the CFTC before considering any new mandates?

3. Will The Proposed Self-Certification Process Be a Rubber Stamp for the Transition of Crypto from Security to Commodity That Will Foreclose Meaningful SEC Review?

FIT 21 creates a self-certification process whereby a cryptocurrency project can submit a certification to the SEC that the project is decentralized and, therefore, outside the jurisdiction of the SEC. Under this provision, after a filing has been made, the SEC would have 60 days to rebut a certification, or it would automatically go into effect. With approximately 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 60 days. In effect, this provision means that innumerable cryptocurrency projects will be unleashed on the unsuspecting public with no regulatory review.

4. Given That the CFTC Lacks the Necessary Investor Protection Mandates to Effectively Regulate Crypto, Doesn't FIT 21 Expose Investors and Our Markets to Heightened Risks?

Investor protection has been at the core of U.S. securities laws and regulations and is the bedrock of the U.S. markets, engendering and sustaining investor trust and confidence to place their hard-earned money in our markets. That is also the ethos and mission of the SEC—indeed, its governing statute requires it to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation—for nearly 90 years. The SEC's investor protection mission is especially relevant here because most people put money into cryptocurrencies hoping for a return on investment. These investors deserve the protection of the securities laws no less than other investors.

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 exists in – and is fundamental to – our securities markets.

These differences are largely due to the different types of participants in each market. While retail investors have always been active in, and indeed critical to, 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. That's why 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 FIT 21 attempts to recreate an investor protection regime at the CFTC similar to the existing exchange and broker-dealer regulatory regimes that have 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 among CFTC-regulated participants nor is one established in the bill. 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 bill for digital commodity exchanges or digital commodity broker-dealers. The bill also lacks key order routing and best execution requirements for digital commodity exchanges or broker-dealers executing customer orders and does not include any affirmative fiduciary duty or other standard of care owed by any cryptocurrency entity to any customer. The bill 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 just a few reasons why attempting to recreate an SEC-like broker-dealer regulatory regime at the CFTC for so-called digital commodities will fail. This approach will lead to decades of massive investor harm, protracted legal battles, and extensive agency rulemakings and guidance releases to develop a regulatory regime. Even after all this effort, the resulting regulatory regime will not remotely compare to the existing protections in securities law.

5. Does the FIT 21 Act Have Digital Commodity Exchange Requirements With Meaningful Investor Protections?

FIT 21 grants broad authority to digital commodity exchanges to have "reasonable discretion in establishing the manner in which the digital commodity exchange complies with [the CFTC's] core principles described in [Section 504]." This, on its face, guarantees weak investor protections. 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, FIT 21 does not require ***any*** specific policies regarding order routing practices or best execution requirements in executing customer orders. Additionally, despite the well-documented patterns of loss of crypto assets due to hacking and cybercrime, the bill does not require digital commodity exchanges to comply with ***any*** cybersecurity standards. In stark contrast, 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.

The bill would also enable digital commodity exchanges to change the rules and policies that govern the conduct of the exchange, the brokers operating on the exchange, and investors investing through the exchange in the middle of the night, without transparency or the opportunity for notice and comment. While this behavior has been commonplace among unregulated crypto exchanges – unilateral suspension of trading in certain tokens without notice, suspension of investors' rights to withdraw money from the exchange, and delisting certain tokens on a whim – all that anti-investor conduct is strictly prohibited by the SEC in the securities markets. The securities laws mandate that if an exchange wants to change its rules or policies it must first file that rule change with the SEC and provide an opportunity for the public to comment on the effects of those changes. The SEC also has the ability to approve or disapprove those rule changes if they are not in the public interest, enable fraudulent or manipulative practices, or fail to comply with other requirements applicable to exchange rules.

As crafted, FIT 21 would enable exchanges to largely govern themselves and change their rules or policies at any time and with no input whatsoever from brokers who operate on the exchange or investors who invest through the exchange. The bill also does not provide the CFTC with any authority to halt any rule or policy change, yet these are vital and irreplaceable customer, market, and financial system protections.

6. Isn't the Broad Authority Granted to the CFTC to Exempt Any Digital Commodity Exchange or Broker-dealer From Any Provision of the Bill, Including Commingling Requirements and Other Critical Customer Protections, Extremely Problematic?

FIT 21 grants the CFTC nearly limitless authority to exempt any digital commodity 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 those that exist in our securities markets within the CFTC, Section 504 and 506 of FIT 21 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, as we have detailed elsewhere. And this exemptive

authority is particularly problematic because many crypto exchanges are based in countries that have historically lacked strong financial regulatory systems or places where there is the form or appearance of regulation without the substance or reality of regulation.

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 a recurrence of that debacle in the crypto space would be wildly inappropriate.

7. Should FIT 21 Preempt State Investor Protection Laws

FIT 21 would preempt state securities and blue-sky laws, negating a state's 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 had been preempted as this bill would have ensured, untold numbers of New Yorkers would have lost their money in the 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. FIT 21 would substantially reduce a state's ability to enforce their securities laws and protect their citizens.

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After more than 15 years since the creation of Bitcoin, and billions of dollars in venture capital investment, the promised golden goose has yet to yield any golden eggs. In fact, not only has cryptocurrency come up empty on its promises, but it also is yet to be determined if any cryptocurrency will ever yield any substantive use case in the future. Instead of delivering golden eggs, the cryptocurrency industry has exposed its users to significant financial risks. Cryptocurrency users have lost billions of dollars due to "hacks, scams, and exploits." The volatile nature of cryptocurrencies makes them particularly susceptible to manipulation and security risks.

Despite these concerns, the crypto industry is actively pushing legislation to regulate cryptocurrency in its favor, even though the majority of Americans do not support or trust it. Overall, only 17% of U.S. adults say they have ever invested in, traded, or used a cryptocurrency. The United States, as the model of global financial stability, owes its strength to well-thought-out financial regulations that underpin the strongest markets in the world. Foreign investors flock to U.S. markets because of their reliability and the security provided by these robust regulatory frameworks. If Congress decides to side with terrorists, rogue states, and criminals by passing a crypto industry-friendly legislation, it risks undermining this stability. In doing so, they should symbolically invite FTX's former CEO, Sam Bankman-Fried, to any signing ceremony, highlighting the absurdity of prioritizing the interests of a controversial, predatory, and largely distrusted industry over the well-being and security of the general public. This would underscore the peril of compromising the golden eggs of financial stability and global investor confidence for the demonstrably false promises of the crypto industry.

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