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How to Improve Regulation of Crypto Today—Without Congressional Action—and Make the Industry Pay For It

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Abstract

For the past decade, the development of appropriate regulatory standards for the crypto industry has been hampered by interminable debates over whether particular digital assets are securities or commodities or something else. The recent crash in crypto prices and the collapse of several crypto firms have prompted renewed calls for better regulation. The fact is the industry today does not comply with investor protection standards comparable to other financial markets, and hundreds of thousands of people have suffered losses. But there is no consensus on the path forward to achieve better regulation. Crypto industry participants have long complained of a lack of regulatory clarity, and have argued that existing securities and derivatives laws do not really fit. Others—including Chairman Gary Gensler of the Securities and Exchange Commission (SEC) —say the problem is a lack of compliance with existing legal requirements, and certainly industry participants have exploited jurisdictional gaps. Some are looking to Congress to intervene, but views diverge greatly on what kind of legislation is needed.

In this paper, we propose that the SEC and the Commodity Futures Trading Commission (CFTC) jointly create and oversee a new self-regulatory organization (SRO), similar to the Financial Industry Regulatory Authority (FINRA) or the National Future Association (NFA). The mission of this new SRO would be to protect investors and financial markets by developing and enforcing much-needed standards for the crypto industry. Creating an SRO overseen jointly by the SEC and CFTC could avoid the need to litigate whether digital assets are securities or commodities; it could develop standards common to platforms trading different types of crypto assets. An SRO would not involve changing our traditional standards for securities and derivatives, nor would it undermine the authority of either the SEC or the CFTC. An SRO could also be a means to determine whether further legislation is actually needed and could help build consensus on what that legislation should look like. The work of an SRO could also be funded by the industry. SROs recognized by the SEC and CFTC have been and continue to be critical to the regulation of our securities and derivatives markets.

To be clear, the industry-initiated efforts to date that have been labeled "self-regulatory organizations" fall far short of what we envision. An SRO can succeed only if the government aggressively supervises its work—including by exercising control of its leadership, approving all SRO rules, and ensuring that the SRO enforces those rules. The SEC and the CFTC could create such an SRO today, under existing law, without Congressional action. While the agencies may not have the formal power to require crypto firms to join the SRO, we believe they could create powerful incentives to encourage membership and compliance with SRO rules. The responsible members of the crypto industry would have every reason to join such a well-regulated SRO once created.

The recent crash in crypto prices and the collapse of several crypto firms has increased the calls for better regulation of the crypto industry. This is as it should be: the industry does not comply with investor protection standards comparable to other financial markets, and hundreds of thousands of people have suffered losses. But there is no consensus on the path forward to achieve better regulation. Crypto industry spokespeople have long complained of a lack of regulatory clarity, and have argued that existing securities and derivatives laws do not really fit.[1] Although Congress has increased its attention on the issue, members hold a wide range of views, from those who are skeptical of crypto generally and want stronger measures, to those who are concerned that regulation could inhibit potentially transformative innovation.[2] Some proposals would expand the jurisdiction of the Commodity Futures Trading Commission (CFTC) to cover the cash or spot market in the trading of crypto assets that are not considered securities, addressing a major gap in our existing framework. One of those proposals, by Senators Cynthia Lummis (R-Wyoming) and Kirsten Gillibrand (D-New York), would also cover a range of other subjects—including creating a new category of assets for regulatory purposes—so-called "ancillary assets" as to which both the SEC and the CFTC would have jurisdiction, regulating stablecoin issuers, addressing various tax issues pertaining to crypto-assets and other matters.[3] In contrast, Securities and Exchange Commission (SEC) Chairman Gary Gensler contends that the problem is not that we need new laws; it is instead a lack of compliance by the industry with the existing rules. "There is no reason,"

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1. *See, e.g.*, Michael Lavere, *FTX President: Crypto Space Needs Greater Regulatory Clarity*, Cryptoglobe, (Sept. 19, 2022) https://www.cryptoglobe.com/latest/2022/09/ftx-us-president-crypto-space-needs-greater-regulatory-clarity/; Matt Levine, *Crypto Wants Some SEC Rules*, Bloomberg (Sept. 13, 2022), https://www.bloomberg.com/opinion/articles/2022-09-13/crypto-wants-some-sec-rules?leadSource=uverify%20wall; Alex Nguyen and Allyson Versprille, *Coinbase Petitions SEC to Propose Rules for Trading*, Bloomberg (July 21, 2022), https://www.bloomberg.com/news/articles/2022-07-21/coinbase-petitions-sec-to-propose-rules-for-crypto-trading#xj4y7vzkg (citing Coinbase, *Letter re Petition for Rulemaking – Digital Asset Securities Regulation* (July 7, 2021), https://assets.ctfassets.net/c5bd0wqjc7v0/5NRidtW8lvwVEfSHpndWQm/78f95afa4f0ebaaefb303e1a4f172d03/Coinbase_petition_for_SEC_rulemaking.pdf); Pete Schroeder & Katanga Johnson, *Crypto executives urge light touch as Congress mulls new regulation*, Reuters (Dec. 8, 2021), https://www.reuters.com/markets/europe/us-risks-chilling-regulations-crypto-industry-warns-congress-2021-12-07/ ("Top executives from six major cryptocurrency companies including Coinbase and Circle on Wednesday urged Congress to provide clearer rules for the booming $3 trillion industry[.]") (citing U.S. House Committee on Financial Services, *Digital Assets and the Future of Finance: Understanding the Challenges and Benefits of Financial Innovation in the United States* (Dec. 8, 2021), https://financialservices.house.gov/events/eventsingle.aspx?EventID=408705); *see also* Mengqi Sun, *Crypto Industry Can't Hire Enough Lawyers*, The Wall Street Journal (April 22, 2022), https://www.wsj.com/articles/crypto-industry-cant-hire-enough-lawyers-11650879002 ("The [crypto] industry has been expanding rapidly…and many are embracing the stance that they want regulatory clarity.").

2. *See* Jason Brett, *Congress Has Introduced 50 Digital Asset Bills Impacting Regulation, Blockchain, And CBDC Policy*, Forbes (May 19, 2022), https://www.forbes.com/sites/jasonbrett/2022/05/19/congress-has-introduced-50-digital-asset-bills-impacting-regulation-blockchain-and-cbdc-policy/?sh=3cdd7f274e3f; J.C. Boggs et al., *Congress' Crypto Crash Course*, King & Spalding (May 26, 2022), https://www.kslaw.com/news-and-insights/congresss-crypto-crash-course (discussing different legislative proposals); *see also* Ezra Klein, *The Way the Senate Melted Down Over Crypto Is Very Revealing*, The New York Times (Aug. 12, 2021), https://www.nytimes.com/2021/08/12/opinion/senate-cryptocurrency.html (discussing differences of opinion that surfaced during debate over Inflation Reduction Act); Jeff Stein & Jacqueline Alemany, *Cryptocurrency brawl bogs down infrastructure bill, as Yellen and White House fight changes*, The Washington Post (Aug. 6, 2021), https://www.washingtonpost.com/politics/2021/08/06/crypto-bitcoin-infrastructure-senate/ (same).

3. Lummis-Gillibrand Responsible Financial Innovation Act, S.4356, 117th Cong. (2022), https://www.gillibrand.senate.gov/imo/media/doc/Lummis-Gillibrand%20Responsible%20Financial%20Innovation%20Act%20%5bFinal%5d.pdf (hereinafter Lummis-Gillibrand); *see* Digital Commodities Consumer Protection Act of 2022, 117th Cong. (2022), https://www.agriculture.senate.gov/imo/media/doc/crypto_bill_section_by_section1.pdf. (hereinafter Stabenow et al.); *see also* Jesse Hamilton & Coindesk, *Senators Unveil Sweeping Crypto Regulation Plan that would Place "Ancillary Assets" under the CFTC*, Fortune (June 7, 2022), https://fortune.com/2022/06/07/crypto-regulation-plan-law-gillibrand-lummis-stablecoin-cftc-securities-ancillary-assets/; Joe Light, *Senate Bill Would Give Washington Huge Powers Over Crypto*, Barrons (May 11, 2022), https://www.barrons.com/articles/senators-lummis-gillibrand-crypto-regulation-draft-bill-51652226407.

Gensler recently argued, “to treat the crypto market differently from the rest of the capital markets just because it uses a different technology.”[4]

The Biden administration has recently focused on these issues. The Executive Order on Ensuring Responsible Innovation in Digital Assets issued in March 2022 called on financial regulators “to consider the extent to which investor and market protection measures within their respective jurisdictions may be used to address the risks of digital assets and whether additional measures may be needed.”[5] In September, the Treasury Department issued a report as required by the Executive Order that discussed the risks of crypto-asset products and platforms in great detail, and calls on regulators to continue to “aggressively pursue investigations” and enforcement actions, and continue to issue supervisory guidance, although it did not comment on pending legislative proposals.[6] On October 3, 2022, the Financial Stability Oversight Council (FSOC) issued another report required by the Executive Order that recommended legislation to address “regulatory gaps” with respect to crypto assets. It recommended that “Congress pass legislation that provides explicit rulemaking authority over the spot market for crypto assets that are not securities” as well as legislation to regulate stablecoins. In addition, it recommended Congress “develop legislation that would create authority for regulators to have visibility into, and supervise, the activities of all of the affiliates and subsidiaries of crypto-asset entities, in cases in which regulators do not already possess such authority.” It did not provide or endorse any specific proposals in these areas, however, and the prospects for adoption of new legislation in the near term remain uncertain.[7]

One option that can provide a path forward in this policy and regulatory fog that would not require new legislation and could be implemented now is the creation of a new self-regulatory organization or SRO—that is, a private organization similar to the Financial Industry Regulatory Authority (FINRA, formerly the NASD), formed and supervised by regulators, whose mission would be to protect investors and financial markets by developing and enforcing much-needed standards for the crypto industry.

Two things should be said about SROs at the outset: first, they have been an important feature of our securities and derivatives regulatory systems for decades, and second, the words “self-regulatory” should not be equated with lax standards. On the contrary, our country’s SROs have been central to the development and implementation of strong standards, as well as enforcement of those standards against industry participants. But we are speaking only of those SROs formally recognized and overseen by the SEC and CFTC.

A new SRO for crypto could be created today under the joint jurisdiction of both the SEC and the CFTC. The two agencies have the authority to create such an entity without new legislation. A jointly supervised SRO could create standards for crypto trading platforms that are consistent as between the SEC and the CFTC and that could apply to all assets traded on such platforms. By developing such standards, we could avoid getting bogged down in the debate over whether any particular crypto-asset is a

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4. Gary Gensler, *The SEC Treats Crypto Like the Rest of the Capital Markets*, The Wall Street Journal (Aug. 19, 2022) https://www.wsj.com/articles/the-sec-treats-crypto-like-the-rest-of-the-capital-markets-disclosure-compliance-security-investment-mutual-fund-protections-blockfi-bankruptcy-bitcoin-11660937246

5. The White House, *Executive Order on Ensuring Responsible Innovation in Digital Assets* (Mar. 9, 2022), https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/ (hereinafter the “Executive Order”).

6. Department of the Treasury, *Crypto-Assets: Implications for Consumers, Investors, and Businesses*, n.179 (Sept. 2022), https://home.treasury.gov/system/files/136/CryptoAsset_EO5.pdf (hereinafter the “EO Consumer Protection Report”).

7. Financial Stability Oversight Council, *Report on Digital Asset Financial Stability Risks and Regulation*, 112-117 (October 2022), https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf (hereinafter the “FSOC Report”). *See infra*, text at notes 47-56 for discussion of regulatory gap with respect to the spot market for crypto assets that are not securities.

security, a commodity or something else.[8] Jurisdictional disputes between the SEC and the CFTC would be greatly diminished. An SRO would not involve changing our traditional standards for securities and derivatives, nor would it undermine the authority of either the SEC or the CFTC. An SRO could be a means to determine whether further legislation is needed and could help build consensus on what that legislation should look like.

We should note that we do not envision the SRO setting standards for the regulation of stablecoin issuers, as we believe those should be set by banking regulators.[9]

Another advantage of an SRO is that neither Congress nor the SEC or CFTC needs to foot the bill. SROs are funded by their industry participants, and the crypto industry could effectively be required to pay for the development and implementation of much needed improvements in regulation.

Many voices in the industry have proposed the creation of a self-regulatory organization. In 2018, four U.S. cryptocurrency exchanges—Bitstamp, bitFlyer, Bittrex, and Gemini—formed the Virtual Commodity Association (VCA) as an "industry-sponsored, self-regulatory organization to oversee virtual commodity marketplaces."[10] Shortly thereafter, ten institutional trading firms created the Association for Digital Asset Markets (ADAM), which is "focused on bridging the gap between firms in digital asset markets and regulators."[11] Recently, Coinbase, one of the largest exchanges, said that a "dedicated self-regulatory organization should be established to strengthen the oversight regime and provide more granular oversight of [marketplaces for digital assets]."[12]

We do not regard the work of organizations like VCA or ADAM as a model for what we are suggesting. These organizations do not reflect the structure we are proposing, which would be an SRO directly and closely supervised by the SEC and the CFTC, whose rule proposals would be approved by those agencies, and which could ensure enforcement of its rules against its members. As we discuss below, the proof is in the pudding, so to speak: the standards proposed by industry organizations to date are inadequate and illustrate the need for the SRO process to be under the close supervision of regulators. The SEC and the CFTC would both need to be actively engaged in the organization of the SRO and would have an ongoing

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8. *See, e.g.*, Paul Kiernan, *Crypto Security Debate Goes to Court*, The Wall Street Journal (May 26, 2022), https://www.wsj.com/articles/the-crypto-security-debate-goes-to-court-11653518489.

9. We refer here to those stablecoins backed by fiat-currency and which do not pay interest or dividends, which represent most of the stablecoin market and are essentially payment instruments. As we have written in a separate paper, we believe issuers of those stablecoins can and should be regulated under existing banking laws. However, the SRO standards would apply to the trading, lending or borrowing of stablecoins in the secondary market. *See* Howell E. Jackson, Timothy G. Massad & Dan Awrey, *How we can regulate stablecoins now—without congressional action*, The Brookings Institution (Aug. 16, 2022), https://www.brookings.edu/research/how-we-can-regulate-stablecoins-now-without-congressional-action/.

10. Virtual Commodity Association, https://virtualcommodities.org. While we believe that this paper presents the first comprehensive proposal for a regulated crypto-asset SRO, we note that Brian Quintenz, former commissioner of the CFTC, has also raised the possibility of creating an SRO to set standards for the spot market trading of crypto-assets. Brian Quintenz, *Keynote Address before the DC Blockchain Summit* (Mar. 7, 2018), https://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz8. In addition, former CFTC chair J. Christopher Giancarlo suggested formation of an SRO to oversee crypto, although its exact scope was unclear. J. Christopher Giancarlo, et al., *Peer-to-Peer Governance: Why Cryptocurrency SROs Can Work*, Bloomberg (Feb. 11, 2021), https://news.bloomberglaw.com/securities-law/peer-to-peer-governance-why-cryptocurrency-sros-can-work ("The work of a cryptocurrency SRO could yield additional fiscal savings by reducing redundancies of overlapping state and federal regulatory initiatives."). Neither provided specifics on whether and how such an SRO would be overseen by regulators. Lummis-Gillibrand also proposes a joint SRO but directs it to develop rules only on best execution of transactions. *See infra* note 75.

11. Derek Andersen, *Self-regulatory Organizations Growing Alongside New US Crypto Regulation*, Cointelegraph (Apr. 18, 2022), https://cointelegraph.com/news/self-regulatory-organizations-growing-alongside-new-u-s-crypto-regulation.

12. Faryar Shirzad, Chief Policy Officer, Coinbase, *Digital Asset Policy Proposal: Safeguarding America's Financial Leadership*, Coinbase (Oct. 14, 2021), https://blog.coinbase.com/digital-asset-policy-proposal-safeguarding-americas-financial-leadership-ce569c27d86c. We do not agree, however, with Coinbase's suggestion that there should be a single federal regulator and new regulatory framework for digital assets.

role in overseeing SRO activities and coordinating with respect to the supervision of member firms and enforcement activities. As a formal matter, the SEC and the CFTC may not have the power to require firms to join the SRO, but we believe they could create powerful incentives to encourage membership and compliance with SRO rules, as discussed herein.[13]

This paper outlines the case for a new SRO for the crypto industry. Part I describes how the SEC and CFTC could create a crypto industry SRO under current law. Part II describes how an SRO could develop and enforce much needed standards in the crypto industry, particularly for the trading, lending, borrowing and custody of crypto assets. Part III describes some of the advantages of, and possible objections to, our approach. Part IV discusses why the SRO standards should apply to DeFi protocols as well as centralized intermediaries. Part V provides a conclusion.

1. A New Crypto SRO Could be Created Today, Under Existing Authority

Our system of federal securities regulation has relied on SROs since its origin following the stock market crash of 1929. According to Joel Seligman in *The Transformation of Wall Street*, William O. Douglas, who was then chairman of the SEC and later served on the Supreme Court, was the driving force behind the creation of the SRO model. In the late 1930s, Douglas believed it was "impractical, unwise and unworkable" for the SEC directly to regulate the six thousand or so O-T-C brokers and dealers trading in 1938. Since they were not centralized on a few stock exchange floors, but could "make a market" in an over-the-counter security anywhere in the country, "the problem of direct government regulations…is a little bit like trying to build a structure out of dry sand."[14]

But Douglas rejected the idea of the SEC blessing the purely voluntary approach that some in the industry advocated. Instead, the SEC "could not compromise on its enforcement role."[15] The only way that self-regulation could work, Douglas said, was for the "government [to] keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used."[16] The Maloney Act amended the Securities Exchange Act to provide for self-regulatory organizations to operate under the supervision of the SEC.[17] The SEC retained authority not just to abrogate an association's rules but also to promulgate its own rules directly, among other powers.[18]

The approach has been part of the genius behind the regulatory framework that has resulted in the U.S. securities markets becoming the strongest and deepest in the world. Shortly after passage of the Maloney Act, the SEC approved the registration of the National Association of Securities Dealers (NASD),

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13. *See* discussion *infra* note 115.

14. Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance 185 (1982) (quoting Abe Fortas's recollection of Douglas's attitude, and George Matthews's testimony at Congressional hearings on SRO concept. *Regulation of Over-the-Counter Markets: Hearings Before the Committee on Banking and Currency*, 75th Cong. 6 (1938) (testimony of George C. Matthews)).

15. Ibid.

16. Ibid. Seligman attributes the quote to Douglas, Democracy and Finance 82 (1940).

17. Maloney Act, Pub.L. No. 719, 52. Stat. 1070 (1938) (codified at 15 U.S.C. §78o-3). The statutory language here speaks of a national securities association being "[a]n association of brokers and dealers," terms which are defined elsewhere as firms doing business in securities. Even without reliance on the SEC's considerable exemptive powers, this definition arguably embraces many crypto-asset firms that transact in products that meet the SEC's definition of securities. Broker-dealers are not generally prohibited from engaging in other activities, so the fact that some members of the SRO also transacted with products that are not securities would not, by itself, preclude them from being members of a national securities association. As explained below, rules of conduct of a national securities association can also extend beyond regulatory requirements of the SEC.

18. Ibid.

which remained for decades the most prominent SRO for U.S. securities firms. Within two years of its formation, its membership exceeded 80% of the over-the-counter brokers registered with the SEC.[19]

In the Commodity Futures Trading Commission Act of 1974, the CFTC was granted the authority to oversee self-regulatory associations of futures professionals.[20] Shortly thereafter, Leo Melamed, then chairman of the Chicago Mercantile Exchange (CME), persuaded other industry leaders that the creation of such an organization would be beneficial to the industry.[21] Then, working with Congress to adopt additional statutory amendments, Melamed and his colleagues supported the creation of the National Futures Association (NFA), which was registered with the CFTC as an SRO in the fall of 1981. The scope of the NFA's responsibilities has been expanded through multiple legislative amendments over the years.[22]

Today, the best-known SROs are FINRA,[23] which is the successor to the NASD, and the NFA, which regulates intermediaries in the futures and derivatives industry.[24] Both develop and write standards and enforce those standards against their members. The SEC oversees the work of FINRA and the CFTC oversees the work of the NFA.

There are numerous other SROs. Most securities and derivatives exchanges are also recognized by the SEC and CFTC as self-regulatory organizations. For example, the SEC lists two dozen exchanges as having self-regulatory responsibilities, including the New York Stock Exchange and NASDAQ.[25] The CFTC similarly relies on the derivatives exchanges such as the CME to perform self-regulatory functions.[26]

Neither the SEC nor the CFTC could perform its mission without the work of these organizations. Each commission approves rules that the SROs develop; it can also direct an SRO to abrogate, amend or adopt a rule.[27] Each commission has authority as to what responsibilities to delegate to SROs under its jurisdiction, and this can change over time. For example, when the Dodd Frank Wall Street Reform and Consumer Protection Act gave the CFTC substantial new authority for overseeing the over-the-counter swap market,[28] the CFTC directed the NFA to take on significant new responsibilities to assist it in carrying out that authority.[29]

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19. Seligman, *supra* note 15, at 186. Seligman says brokers had an economic incentive to join because NASD members got wholesale pricing when purchasing a security from another NASD member; non-members got the same price as the public.

20. Commodity Futures Trading Commission Act, Pub.L. 93-463, § 17, 88 Stat. 1389 (1974) (codified as amended at 7 U.S.C. § 21).

21. Melamed's recollection in his autobiography of what it took to persuade the industry might characterize some in the crypto industry: "It was much easier to convince the federal bureaucracy of the need for self-regulation than it was to convince the futures industry of the need for regulation. Most of [sic] futures industry players didn't feel the need for another sheriff on the block. It was as if the last of the commodity robber barons of the world I had inherited in the 1960s were still clinging to their heritage of unregulated mayhem, a heritage where might made right and the money belonged to those who were clever enough to grab it." He recalls having to "lecture" them that "our industry must grow up." LEO MELAMED, ESCAPE TO THE FUTURES 308-09 (1996).

22. For a brief history of the NFA, see https://www.nfa.futures.org/About/nfa-history.html.

23. *See* FINRA, *About FINRA*, https://www.finra.org/about.

24. *See* NFA, *About NFA*, https://www.nfa.futures.org/About/index.html.

25. For a list of SEC-registered exchanges, see https://www.sec.gov/rules/sro.shtml.

26. For more information on CFTC-registered exchanges, see https://www.cftc.gov/IndustryOversight%20%20%20%20%20%20%20%20%20/IndustryFilings/index.htm.

27. 15 U.S.C § 78s(c); 7 U.S.C § 21(k).

28. Dodd Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111-203, Subtitle A, 124 Stat. 1376 (2010).

29. *See* CFTC, *Dodd-Frank Act*, https://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm. *See also supra,* note 23.

The statutory authority is clear: an association of brokers and dealers may be registered with the SEC as a national securities association under Section 15A of the Securities Exchange Act of 1934 (the "Exchange Act"), and an association of "persons" may be registered with the CFTC as a futures association under Section 17 of the Commodity Exchange Act (the "CEA").[30] The relevant provisions of the Exchange Act and the CEA are very similar. For example, both statutes provide that the rules of the SROs must be designed to "prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade," and "in general, to protect the public interest."[31] Each statute also says SRO rules must "remove impediments to and perfect the mechanism of the [market]."[32] Each statute gives the relevant regulatory agency the authority to review and approve the SRO's charter, by-laws, membership and other governance documents.[33]

Both statutes provide the regulatory agencies with the power to approve who may become a member of an SRO.[34] The laws also require that an SRO have the power to discipline members, which can include fines and suspension or expulsion from the industry.[35] Each of the SEC and the CFTC has the authority to review disciplinary proceedings.[36] Each also has the power to suspend or revoke membership of any person in an SRO,[37] and to remove any officer or director of an SRO who has "willfully failed to enforce the rules of the association, or has willfully abused his [sic] authority."[38] An SRO must have a board of

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30. 15 U.S.C. § 78o-3(a); 7 U.S.C. § 21(a).

31. 15 U.S.C. § 78o-3(b)(6); 7 U.S.C. § 21(b)(7). The language of the Exchange Act reads slightly differently from that of the CEA: the rules of SROs organized under the Exchange Act must aim "to protect *investors* and the public interest" (emphasis added). In some contexts, the SEC and the CFTC have taken somewhat different approaches to addressing similar regulatory concerns, with the SEC inclined to a more rules-based approach and the CFTC favoring principles-based regulation. These differences and the potential for regulatory harmonization between the two commissions has long been the subject of reform efforts. *See, e.g.*, GAO, *Financial Regulation: Clearer Goals and Reporting Requirements Could Enhance Efforts by the CFTC and SEC to Harmonize Their Regulatory Approaches* (Apr. 2010) (GAO Report 10-410). See also Stephania Palma & Patrick Jenkins, *SEC Chair Urges "One Rule Book" for Crypto to Avoid Gaps in Oversight*, Financial Times (June 24, 2022), https://www.ft.com/content/b9466a10-a2a6-412d-acf4-086609283df2.

32. Ibid. The Exchange Act requires SRO rules to "perfect the mechanism of a free and open market and a national market system," while the CEA mandates that SRO rules "perfect the mechanism of free and open futures trading." Each statute also lists further independent objectives. Under the Exchange Act, for instance, SRO rules must also "foster cooperation and coordination" among securities professionals, must not allow "unfair discrimination between customers, issuers, brokers, or dealers," must prevent profit- and rate-fixing, and must not exceed the regulatory authority conferred by the statute. 15 U.S.C. § 78o-3(b)(6).

33. 15 U.S.C. § 78o-3(a); 7 U.S.C. § 21(a). While the CEA explicitly lists corporate governance documents that prospective SRO registrants must provide, the Exchange Act uses broader and more open-ended language; national securities associations registering under the Exchange Act must file "such other information and documents as the [SEC], by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78o-3(a); *see also* 17 CFR § 240.15Aa-1 (providing for national securities association registration form X-15-AA-1); 17 CFR §240.6a-1; SEC Form 1 (requiring national securities exchanges to provide, among other things, corporate governance records).

34. 78 U.S.C. § 78o-3(g); 7 U.S.C. § 21(b)(2)-(4).

35. 15 U.S.C. 78o-3(b)(7); 7 U.S.C. 21(b)(8).

36. 15 U.S.C. § 78s(d); 7 U.S.C. § 21(h).

37. 15 U.S.C. § 78o-3(h)(2); 7 U.S.C. § 21(l)(2).

38. 7 U.S.C. § 21(l)(3). The Exchange Act uses similar but slightly different language: the SEC may remove any officer or director of an SRO who has "willfully violated…[SEC] rules or regulations…[or] willfully abused his [sic] authority." 15 U.S.C. § 78s(h)(4).

directors that includes persons not affiliated with members,[39] and it must assess dues on its members to fund its work.[40]

There is precedent for an SRO that is common to both the SEC and the CFTC. For example, although the bulk of the NFA's responsibilities are subject to the oversight of the CFTC, it is also recognized as a "limited purpose national securities association" under the Exchange Act for purposes of regulating the activity of brokers and dealers in security futures products.[41] There were specific amendments made to the laws under the Commodity Futures Modernization Act of 2000 to address the fact that security futures products fall under the jurisdiction of the SEC but are traded on derivatives exchanges overseen by the CFTC.[42]

The SEC and CFTC also have broad authority to decide who can be a member of an SRO. Although the Exchange Act provides that only brokers and dealers can be members of a registered national securities association, the SEC has exemptive authority to waive this requirement.[43] The CEA has no comparable limitation on who can be a member of an SRO. Both statutes provide that the SRO must set rules for membership,[44] and that those rules can be reviewed and approved by the regulatory agencies.[45] Thus, the SEC and the CFTC could determine the appropriate membership in a new crypto SRO without the need for such members to be otherwise registered with either agency.

2. A New Crypto SRO Could Strengthen Regulation of Crypto Exchanges and Other Trading Intermediaries

While the crypto industry poses several regulatory challenges, we believe an SRO is particularly well suited to address the lack of standards for intermediaries such as exchanges, lending platforms, brokers, dealers, and custodians, as well as decentralized platforms performing equivalent functions. We have strong regulations governing exchanges, brokers and other intermediaries in our securities and derivatives markets. Those regulations, developed and enforced by the SEC and the CFTC in conjunction with their respective SROs over several decades, have helped to make our securities and derivatives markets the deepest and most robust in the world. The regulations promote transparency, integrity in trading and investor protection. They are designed to prevent fraud and manipulation, provide adequate disclosure and reporting, ensure proper handling of investor assets, prevent conflicts of interest, and ensure operational resiliency.

But much of the trading activity that takes place in the crypto industry does not comply with such standards. We believe that is for two reasons.

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39. 15 U.S.C. § 78o-3(b)(4); 7 U.S.C. § 21(b)(11).

40. 15 U.S.C. § 78o-3(b)(5); 7 U.S.C. § 21(b)(6). The Exchange Act extends the power to collect dues to "issuers and other persons using any facility or system which the [national securities] association operates or controls." 15 U.S.C. § 78o-3(b)(5).

41. 15 U.S.C. § 78o-3(k). Under Section 19 of the Exchange Act, the NFA must file proposed rule changes concurrently with both the SEC and the CFTC. 15 U.S.C. § 78s(b)(7). The SEC must also consult with the CFTC regarding any rule-changes that national securities associations or exchanges propose that affect security futures products. 15 U.S.C. § 78s(b)(9).

42. Commodity Futures Modernization Act, H.R. 4541, 106th Cong. Title II (2000).

43. 15 U.S.C. § 78mm(a).

44. 15 U.S.C. § 78o-3(b)(3), (g); 7 U.S.C. § 21(b)(2)-(4).

45. 15 U.S.C. § 78s(b); 7 U.S.C. § 21(j).

First, there is a gap in the law that results in neither agency having sufficient authority.[46] The SEC has authority over crypto-assets that are deemed securities, and exchanges that are trading crypto-assets that are securities should register with the SEC absent an exemption. None have done so, despite the urgings of SEC Chairman Gensler.[47] One likely reason for this substantial lack of compliance is disagreement among practitioners as to how the definition of the term "securities" applies to crypto-assets, a matter that is currently tied up in litigation, as explored below.[48] For now, however, the SEC's jurisdictional reach over crypto-assets remains unclear.

If a crypto-asset is not a security, there is no federal regulator with authority to set standards for trading in the spot market—that is, the buying and selling of crypto-assets for immediate delivery.[49] A crypto-asset that is not a security may in fact be a commodity, although that is not a simple question either. The Commodity Exchange Act includes a long definition of commodity that has not been amended since 2010 and, not surprisingly, does not refer to crypto-assets. But in 1974 language was added that extended the reach of the definition beyond an enumerated list of agricultural products, so as to give the CFTC flexibility in responding to market developments. The definition includes "all other goods and articles…and all services, rights, and interests…in which contracts for future delivery are presently or in the future dealt in."[50] The CFTC first asserted that virtual currencies like bitcoin could be commodities in 2014 and was subsequently upheld in court.[51] But the language itself is subject to varying interpretations,

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46. *See, e.g.*, Timothy Massad, *It's Time to Strengthen the Regulation of Crypto-Assets*, The Brookings Institute, (Mar. 2019), https://www.brookings.edu/research/its-time-to-strengthen-the-regulation-of-crypto-assets/ and the FSOC Report, *supra* note 7, at 88-89.

47. *See* Sander Luz, *SEC Chair Gensler Threatens Action Against Unregistered Crypto Exchanges*, Decrypt (May 18, 2022), https://decrypt.co/100806/sec-chair-gensler-threatens-action-against-unregistered-crypto-exchanges (citing Chairman Gensler's testimony before the House Appropriations Committee, *FY 2023 Budget Request for the Federal Trade Commission and the Securities Exchange Commission* (May 18, 2022); https://appropriations.house.gov/events/hearings/fiscal-year-2023-budget-request-for-the-federal-trade-commission-and-the-securities); *see also* Paul Kiernan, *The $2 Trillion Cryptocurrency Market Is Drawing Interest from Investors, Scrutiny from U.S. Regulators*, The Wall Street Journal (Jan. 2, 2022), https://www.wsj.com/articles/the-2-trillion-cryptocurrency-market-is-drawing-interest-from-investors-scrutiny-from-u-s-regulators-11641119404. Chair Gensler has said that most crypto-assets traded today are in fact securities and that their issuance and distribution should comply with the securities laws. While one can debate how many of the existing crypto-assets that are traded are securities, surely some would be deemed securities if put before a court of law, and yet neither the offering nor subsequent trading of such tokens is taking place in accordance with the securities laws.

48. The SEC generally applies the standards from a 1946 Supreme Court case known as "Howey" to determine if a crypto-asset is an investment contract which in turn means it is a security. Four prongs must be met: there must be (i) an investment of money, (ii) in a common enterprise, (iii) with the expectation of profit, (iv) from the managerial efforts of others. SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

49. The spot market is sometimes called the "cash" market because trades are often settled in cash, but the term is not precise since futures, options and swap contracts are often settled in cash. In the case of crypto, spot market trades are often settled with stablecoins or in exchange for other cryptocurrencies. We are simply distinguishing the spot market from the market for crypto derivative instruments such as futures, options and swaps. As noted earlier, some of the recent legislative proposals would expand the authority of the CFTC over this portion of the crypto market. *See supra*, text at note 3.

50. 7 U.S.C. § 1a(9).

51. In his capacity as chairman of the CFTC, one of the authors testified before Congress in 2014 that virtual currencies could be commodities, a position based on this clause. *See* CFTC Chairman Timothy Massad, *Testimony before the U.S. Senate Committee on Agriculture, Nutrition and Forestry* (Dec. 10, 2014), https://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6. In 2015, the CFTC found that Bitcoin and several other virtual currencies qualified as commodities. *In re Coinflip, Inc.*, CFTC No. 15-29 at 3 (cited in CFTC press release 7231-15, https://www.cftc.gov/PressRoom/PressReleases/7231-15); *see also In re BFXNA Inc.*, CFTC Docket 16-19, at 5-6 (June 2, 2016). Since then, multiple courts have agreed with the CFTC's reasoning. *See, e.g.*, *Commodity Futures Trading Comm'n v. My Big Coin Pay, Inc.*, 334 F. Supp. 3d 492, 497 (D. Mass. 2018) (hereinafter the "My Big Coin Pay case"); *Commodity Futures Trading Comm'n v. McDonnell*, 287 F. Supp. 3d 213, 224-25 (E.D.N.Y. 2018).

and thus the determination of which crypto-assets are commodities for purposes of CFTC oversight can be debated.[52]

Even if a crypto-asset is a commodity, that does not give the CFTC the authority to regulate spot market transactions in such crypto-assets. The CFTC has authority to regulate derivatives based on commodities—such as bitcoin futures and swaps—but its authority over associated spot market trading is very limited. It has the power to bring enforcement actions for fraud and manipulation in the spot market and to regulate certain retail leveraged transactions, but it does not have the authority to prescribe standards under which exchanges, brokers or dealers should operate.[53] The scope of even this fraud and manipulation authority with respect to spot market transactions also depends on the interpretation as to which crypto-assets are commodities.[54]

To make matters more complicated, the Commodity Exchange Act classifies commodities into different categories, which include "security" and "non-security" commodities. The CFTC's power varies depending on the classification of a commodity, and questions of jurisdiction as between the SEC and the CFTC can arise depending on such classification.[55]

Many in the industry would argue that the problem is a failure of the SEC and CFTC to provide clarity as to whether a crypto-asset is a security or a commodity.[56] But the question is how the agencies could provide such clarity in a way that would be respected and binding. The traditional approach is through enforcement actions, and the SEC is doing just that. It has brought enforcement actions alleging that various crypto-assets are securities. These include its lawsuit concerning Ripple's XRP,[57] as well as a recent enforcement action accusing a Coinbase employee of insider trading, in which the SEC alleged that at least nine tokens traded on the exchange were securities.[58] If the agency prevails in these cases, a victory may provide greater certainty as to what is a security. But final resolution of these actions will take

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52. The issue turns largely on the interpretation of the phrase in the definition of commodities noted above: "all other goods and articles…and all services, rights, and interests…in which contracts for future delivery are presently or in the future dealt in." There has been debate over whether a virtual currency is a commodity (i) only if there is a contract for future delivery on that particular virtual currency at the time of determination; (ii) as long as there could be a contract for future delivery on that particular virtual currency at some point in time; or (iii) as long as that virtual currency belongs to a "category" of crypto-assets as to which there are then such contracts. There is also a view that the words pertaining to contracts for future delivery modify only "services, rights and interests" and not "goods and articles." That would mean a crypto-asset could be a commodity as long as it falls within "goods or articles," even absent a contract for future delivery. A district court took the view that the third interpretation is correct in the My Big Coin Pay case. *See* discussion *supra* note 52. For a discussion of these issues, *see* American Bar Association, ***Derivatives and Futures Law Committee's Innovative Digital Products and Processes,*** *Subcommittee Jurisdiction Working Group, Digital and Digitized Assets: Federal and State Jurisdictional Issues* 68-75 (Dec. 2020), https://www.americanbar.org/groups/business_law/publications/blt/2021/03/cryptocurrencies/ (hereinafter, "ABA Working Group Paper").

53. *Compare* 7 U.S.C. § 9 (CEA's general anti-fraud provisions) *and* 17 C.F.R. §§ 180.1-2 (CFTC anti-fraud and anti-manipulation rules) *with* 7 U.S.C. § 21 (providing for registration of futures associations but not for registration of cash market exchanges, brokers, or dealers).

54. *See* discussion *supra* note 52.

55. *See* ABA Working Group Paper, *supra* note 53, at 75-81.

56. *See, e.g.*, sources cited *supra* note 1; *see also* Mengqi Sun, *As Bitcoin Market Expands, Demand for Regulatory Guidance Grows*, The Wall Street Journal (April 7, 2022), https://www.wsj.com/articles/as-bitcoin-market-expands-demand-for-regulatory-guidance-grows-11649374686.

57. *See, e.g.*, Dave Michaels, *Ripple's Legal Brawl With SEC Could Help Settle When Cryptocurrencies Are Securities*, The Wall Street Journal (Feb. 2, 2022), https://www.wsj.com/articles/crypto-industry-hopes-looming-legal-brawl-will-thwart-secs-regulation-push-11643724002; Nathaniel Popper, *Cryptocurrency Company Ripple is Sued by S.E.C.*, The New York Times (Dec. 21, 2020), https://www.nytimes.com/2020/12/21/technology/ripple-cryptocurrency-sec-lawsuit.html.

58. Complaint, *Securities and Exchange Commission vs. Ishan Wahi, Nikhil Wahi, and Sameer Ramani* (W.D. Wash. July 21, 2022), https://www.sec.gov/litigation/complaints/2022/comp-pr2022-127.pdf.

time and the outcome is uncertain. And even if the SEC wins, will it provoke waves of compliance? Or is it more likely to lead to a "whack-a-mole" type challenge for the agency, where it will have to bring case after case to change behavior, especially if industry participants respond to each case by tweaking tokens, protocols or activities in an attempt to distinguish them from rulings where the SEC has prevailed?[59]

Another path forward would be for the two agencies to get together and promulgate a common understanding. There are certainly examples of the agencies having reached jurisdictional accords with respect to particular products. But these have typically pertained to a much narrower set of products, and have involved lengthy, and sometimes very contentious, negotiations.[60] The volume of crypto-assets and the speed with which the technology is evolving would add further complexity if the agencies attempted such an approach. If the agencies tried that path and succeeded in reaching agreement, we expect the issues would end up in court anyway, because some market participants would surely challenge the agencies' interpretations. In one well-known case, the SEC and the CFTC negotiated an accord allocating jurisdiction over security-related futures, but a court declined to follow it.[61] Adopting standards through a rule-making would help, but would not preclude court challenges.

Moreover, even if there is greater clarity as to which crypto-assets are securities, there will still be no federal regulator with sufficient authority over the spot market for digital assets that are not securities.[62]

The second reason that investor protection standards are weak, however, is simply lack of compliance with the law. We believe the gap in regulatory authority, colorable claims that at least some crypto-assets fall into this gap, and the limited enforcement resources of regulators all have created substantial incentives not to comply. Compliance creates costs, and a competitive disadvantage in relation to those that choose not to comply beyond cost; compliance potentially means a longer time to market, restrictions on product terms or marketing methods, greater disclosure, and other restrictions. In the current environment, we suspect that many are simply deciding it is better for business not to comply.

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59. Under Chairman Jay Clayton's leadership, the SEC did succeed in exerting jurisdiction over one form of digital asset—initial coin offerings (ICOs). *See* SEC, *Spotlight on Initial Coin Offerings*, https://www.sec.gov/ICO. It is possible that the Commission will have similar success with its more recent enforcement actions. But the doctrinal questions are more challenging in reaching digital assets that make greater use of smart contracts and distributed decision-making, and so it is not clear that the SEC's successful strategy with respect to ICOs can be replicated elsewhere. Moreover, there is a practical problem of providing SEC guidelines on the ever-increasing number of tokens being launched.

60. See the discussion of the Shad-Johnson Accord *supra* note 62*. See also* ABA Working Group Paper *supra* note 53, at 264-70.

61. The Shad-Johnson Accord, which was named after the respective chairmen of the SEC and CFTC who negotiated it, allocated jurisdiction over securities-related futures, but an appellate court declined to follow it because the language was not part of the law. The language was later incorporated into the law. *See Board of Trade of the City of Chicago v. Securities and Exchange Commission*, 677 F. 2d 1137 (7th Cir. 1982); Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, app. E, 114 Stat. 2763 (2000); ABA Working Group Paper, *supra* note 53, at 104-06, 265.

62. Many crypto marketplaces refer to being regulated at the state and federal levels because they are subject to state money transmitter laws. These laws originated in the telegraph era when companies like Western Union transferred money by wire. They vary dramatically by state but typically have some combination of the following types of requirements: an application for a license which requires basic information about the business and personnel; minimum net worth (often in the $5,000 to $100,000 range and often increasing depending on number of locations), posting of security; and in some cases, restrictions on investments. Registration under such state laws triggers a requirement to register with the Secretary of the Treasury, which then makes these businesses subject to anti-money laundering requirements of the Federal Crimes Enforcement Network and some very modest consumer protection standards, principally pertaining to disclosure of fees. These state and federal requirements, taken together, however, are nowhere near the regulatory frameworks for our securities and derivatives markets. See Dan Awrey, *Bad Money*, 107 CORNELL L. REV. 1 (2020) https://www.cornelllawreview.org/2020/12/01/bad-money/ and Andrew P. Scott, "Telegraphs, Steamships and Virtual Currency: An Analysis of Money Transmitter Regulation," Congressional Research Service (August 20, 2020) https://crsreports.congress.gov/product/pdf/R/R46486. See also the FSOC Report, *supra* note 7, at 98-99, which says such laws "are not designed for the purpose of comprehensively mitigating vulnerabilities arising from the potential failure of a large, interconnected platform, or for other purposes, such as market integrity."

As a result, the distribution, trading, lending, and borrowing of crypto-assets today, and in many cases the crypto-assets themselves, lack the kinds of investor protections and market conduct standards comparable to those in our securities and derivatives markets. We think these shortcomings are a major problem. The report recently issued by the Treasury Department pursuant to the Executive Order—*Crypto-Assets: Implications for Consumers, Investors and Businesses*—provides a detailed inventory of the types of abuses and problems created by this lack of standards, such as market manipulation, fraud, theft, scams, conflicts of interest, lack of transparency, hacks and operational failures and the FSOC Report provides an extensive discussion of the potential risks to financial stability arising from this lack of regulation.[63]

Recent incidents also provide ample examples of why such standards are needed. The bankruptcy filings of major players in the cryptocurrency space—Voyager Digital Holdings Inc. and Celsius Network LLC—have revealed that many investors misunderstood the nature of their holdings and the risk of losses to which they would be imposed if counterparties become insolvent.[64] The bankruptcy proceeding of Three Arrows Capital, which reportedly became the largest crypto hedge fund in a short time, will no doubt yield many similar stories: "What started with speculation on a few well-known coins such as Bitcoin and Ether became an interdependent industry of tokens linked to other tokens, crypto companies acting like banks offering depositors double-digit yields, and lots of borrowing by traders looking to juice their returns."[65] The collapse of the Anchor lending protocol, which offered unsustainable 20% rates of return to depositors of Terra, the algorithmic stablecoin that sank in value, is but one more example of inadequate disclosure and lack of investor protection standards.[66]

The problems are evident even without pointing to failures such as those. Consider Coinbase's recent announcement that acknowledged that customers could lose all the crypto in their accounts in the event Coinbase ever filed for bankruptcy, because customers would be general unsecured creditors and their assets would be considered part of the overall estate.[67] In our securities markets, investors are protected in the event of the bankruptcy of a broker-dealer by the Securities Investor Protection Corporation.[68] In our derivatives markets, there is a well-developed set of rules governing the treatment and protection of customer assets in the event of a bankruptcy of a commodities broker.[69] While an SRO could not create a

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63. *See* EO Consumer Protection Report, *supra*, note 6 and FSOC Report, *supra*, note 7. Note 115 of the EO Consumer Protection Report also cites a report of the Federal Trade Commission that said that more than 46,000 people had reported losing more than $1 billion to crypto scams in the period from January 1, 2021 to March 31, 2022. FTC, *Reports show scammers cashing in on crypto craze*, (Jun. 2022), https://www.ftc.gov/news-events/data-visualizations/data-spotlight/2022/06/reports-show-scammers-cashing-crypto-craze.

64. See Becky Yerak & Akiko Matsuda, *For Crypto Customers, a Long Battle Ahead in Bankruptcy*, Wall Street Journal (Aug. 1, 2022), https://www.wsj.com/articles/for-crypto-customers-a-long-battle-ahead-in-bankruptcy-11659379620.

65. Justina Lee, Muyao Shen, & Ben Bartenstein, *How Three Arrows Capital Blew Up and Set Off a Crypto Contagion,* Bloomberg (July 12, 2022), https://www.bloomberg.com/news/features/2022-07-13/how-crypto-hedge-fund-three-arrows-capital-fell-apart-3ac?sref=hU7uPhn8.

66. *See, e.g.*, Alexander Osipovich & Caitlin Ostroff, *Crash of TerraUSD Shakes Crypto. "There Was a Run on the Bank*,*"* The Wall Street Journal (May 12, 2022), https://www.wsj.com/articles/crash-of-terrausd-shakes-crypto-there-was-a-run-on-the-bank-11652371839. See also the FSOC Report, *supra* note 7, at 38-53, for a discussion of the potential financial stability risks that can arise from failures such as Three Arrows Capital and Terra.

67. Coinbase Global, Inc., Quarterly Report (Form 10-Q) (May 10, 2022) at 83, https://d18rn0p25nwr6d.cloudfront.net/CIK-0001679788/89c60d81-41a2-4a3c-86fb-b4067ab1016c.pdf; *See also* Paul Kiernan, *Coinbase Says Users' Crypto Assets Lack Bankruptcy Protections*, The Wall Street Journal (May 12, 2022), https://www.wsj.com/articles/coinbase-says-users-crypto-assets-lack-bankruptcy-protections-11652294103.

68. *See* SiPC, *About SiPC*, https://www.sipc.org/about-sipc/.

69. *See* Vincent E. Lazar & Kathryn Trkla, *CFTC Overhauls Its Commodity Broker Bankruptcy Rules*, Business Law Today (Jan. 22, 2021), https://businesslawtoday.org/2021/01/cftc-overhauls-commodity-broker-bankruptcy-rules/.

SIPC-like federal insurance scheme, which would require new legislation, it could consider protections that do not require legislative action, such as requiring segregation of assets in bankruptcy remote trusts.

Or take wash trading, the practice of someone trading with themselves (or with an affiliate under common control) to inflate trading volume or increase the price of a financial instrument. This is clearly prohibited in our securities and derivatives markets,[70] but not in crypto spot market trading. But it has been estimated to represent 50-90% of the trading on crypto markets.[71] The CFTC used its power to bring enforcement cases based on fraud and manipulation to fine Coinbase over wash trading.[72] The shocking part of this case was not that Coinbase had failed to prevent wash trading by its customers, but that Coinbase itself had engaged in wash trading! While the CFTC's action was welcome, one of the CFTC's commissioners publicly noted her concern that the case could give the public the false sense that the CFTC regulates Coinbase when it does not have that power.[73] An SRO could not only prohibit wash trading; it could also address whether exchanges should even be able to engage in proprietary trading.

Or consider the New York Attorney General's "Virtual Markets Integrity Initiative" which examined the stated policies of thirteen crypto platforms, which found that "virtual asset trading platforms have not...implemented common standards for security, internal controls, market surveillance protocols, disclosures, or other investor and consumer protections...Accordingly, customers...face significant risks."[74] Although the study was done in 2018, we doubt that these weaknesses have been cured.

While we support the SEC and the CFTC in their efforts to enforce the laws, we believe that reliance on traditional enforcement strategies may not be enough to bring reasonable standards to the industry within a reasonable amount of time. Moreover, enforcement of existing law will not fill the gap with respect to regulation of the spot market for tokens that are not securities, where neither the SEC nor the CFTC has jurisdiction.

Finally, there is the possibility that Congress will take action to redefine jurisdictional lines or alter traditional securities and derivatives categories. Both the Lummis-Gillibrand proposal and another proposal by Senators Stabenow (D-Michigan), Boozman (R-Arkansas), Booker (D-New Jersey) and Thune (R-South Dakota) would provide the CFTC with greater authority,[75] but they differ significantly in how they achieve that, with the Lummis-Gillibrand approach involving a more dramatic change to our

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70. 15 U.S.C. § 78(i); 7 U.S.C. § 6(c).

71. *See* Lin William Cong et al., *Crypto Wash Trading* (July 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3530220 (estimating that wash trades account for 70 percent of volume on unregulated cryptocurrency exchanges); *see also* Jialan Chen et al., *Do Cryptocurrency Exchanges Fake Trading Volume?* 586 PHYSICA A 126405 (Jan. 15, 2022); Matthew Hougan, et al., *Economic and Non-Economic Trading In Bitcoin: Exploring the Real Spot Market For The World's First Digital Commodity*, Bitwise Asset Management (May 24, 2019), https://www.sec.gov/comments/sr-nysearca-2019-01/srnysearca201901-5574233-185408.pdf (study demonstrating that "95% of reported trading volume in bitcoin is fake or non-economic in nature"); 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=11ea350b6681; *see also* Steve Inskeep et al., *How "wash trading" is perpetuating crypto fraud*, NPR (Sept. 23, 2022), https://www.npr.org/2022/09/23/1124662811/how-wash-trading-is-perpetuating-crypto-fraud.

72. *In re Coinbase, Inc.*, CFTC Docket 21-03 at 3-5 (Mar.19, 2021) (cited in CFTC press release 8369-21, *CFTC Orders Coinbase Inc. to Pay $6.5 Million for False, Misleading, or Inaccurate Reporting and Wash Trading* (Mar. 19, 2021), https://www.cftc.gov/PressRoom/PressReleases/8369-21.

73. Dawn D. Stump, CFTC Commissioner, *Concurring Statement Regarding Enforcement Action Against Coinbase, Inc.* (Mar. 19, 2021), https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement031921.

74. Barbard D. Underwood, *Virtual Markets Integrity Initiative Report* 1, Office of the New York State Attorney General (Sept. 18, 2018), https://ag.ny.gov/sites/default/files/vmii_report.pdf.

75. *See* Lummis-Gillibrand and Stabenow et al., *supra*, note 3.

traditional securities and derivatives categories.[76] But there is also a risk that new legislation will result in standards significantly weaker than those in the securities and derivatives markets, particularly given the increasing political clout of the industry.

In this context, we think creating an SRO can strengthen investor protection standards in the industry, without undermining or compromising the authorities or enforcement efforts of either the SEC or the CFTC, and without requiring new legislation. It is a solution that does not require determining—or proving in a court of law—that any particular crypto asset is a security, a commodity or some new category such as an ancillary asset. It is a solution that avoids the risk of allowing the tail to wag the dog—that is, of altering traditional securities or derivatives rules in an effort to bring crypto into the regulatory perimeter, which then might confuse or undermine the application of such standards in other contexts.

The SRO would have as its members crypto exchanges, lending platforms, brokers, dealers and custodians involved in the trading or custody of crypto-assets. The SRO would develop standards for trading and custody that its members would agree to observe for all assets they handle except to the extent the trading or custody of those assets or their activities are already governed by the securities or commodities laws.[77] The standards would be drawn from the standards we use in the securities and derivatives markets, but modified to address some of the novel or unusual aspects of crypto, such as the manner in which custody can be handled.

Such an SRO could fulfill the suggestion made recently by SEC Chair Gensler that the SEC and the CFTC should develop a single "rule book" for crypto exchanges to protect investors regardless of the classification of the asset being traded.[78]

The areas in which an SRO could develop standards, which exist in our securities and derivatives markets, could include the following:

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76. *Id*. Lummis-Gillibrand would define a new category of "ancillary assets" that would include digital assets that do not have many of the typical attributes of securities, such as an interest in profits or voting rights. Offerings of such assets would need to meet certain new disclosure requirements to be prescribed by the SEC, but ongoing reporting would cease once a certain level of decentralization is achieved. The CFTC would also have certain authority over the trading of such assets. Lummis-Gillibrand also proposes that one or more associations of "digital asset intermediaries" can be registered as self-regulatory organizations if approved by both the SEC and the CFTC. "Digital asset intermediaries" are defined as entities that have a license, registration or authorization pursuant to the legislation or certain other specified federal laws that "may conduct market activities relating to digital assets" as well as licensed stablecoin issuers, but excluding depository institutions. Lummis-Gillibrand et al., *supra* note 3, at Sec. 101 (adding new section 31 U.S.C. § 9801(3)). An SRO is directed to develop rules only with respect to best execution of transactions by its members. *Id* at Sec. 805 (adding new section 31 U.S.C. § 9807(f)). It may also make "initial determinations of the legal character of a digital asset" upon request of a member. *Id.* (adding new section 31 U.S.C. § 9807(g)). It can prohibit members from dealing with any "nonmember professional" except at the same prices and on the same terms and conditions as are accorded to the public. *Id.* at Sec. 803 (adding new section 31. U.S.C. § 9806(f)). In addition, it may bring enforcement actions against and make examinations of members. *Id* (adding new sections 31 U.S.C. §§ 9806(h), 9807(b)). The Stabenow bill also mandates that brokers, dealers, and custodians of digital assets register with a registered futures association. Stabenow et al., *supra*, note 3, at Sec. 4 (adding new section 7 U.S.C. § 7b-4(i)). The bill establishes a registration process for digital asset platforms, and it allows the CFTC to delegate authority over that process to the SRO. *Id.* The SRO would promulgate its own rules (subject to CFTC review), as well as policing any applicants seeking to register with the CFTC to ensure that they meet disclosure, risk management, customer protection, energy consumption, and customer asset segregation requirements, among other things. *Id.* (adding new section 7 U.S.C. § 7b-4). The proposed legislation also defines "digital asset trading facilities," which operate like exchanges, and mandates that those facilities craft their own rules (subject, again to CFTC review) governing market protection, disclosure of information, and disciplinary procedures, as well as other areas. *Id.* (adding new section 7 U.S.C. § 7b-4(b)(2), (d)).

77. With appropriate oversight from the SEC and CFTC, an SRO could adopt rules of conduct requiring member firms to execute all transactions in digital assets on an SRO-member platform, bringing in even digital assets that might not currently be subject to the jurisdiction of either the SEC or CFTC.

78. *See, e.g.*, Palma & Jenkins, *supra* note 32.

- protection and custody of customer assets;
- governance standards (including fitness standards for directors and officers);
- conflicts of interest (including prohibitions or limitations on the ability of trading platforms to engage in proprietary trading or having financial interests in listed assets);
- financial resources, including capital and margin;
- recordkeeping and periodic public disclosures;
- execution and settlement of transactions in a competitive, open, efficient and timely manner
- pre- and post-trade transparency requirements;
- prevention of fraud, manipulation and abusive practices (including prevention of wash trading);
- disclosures to customers, including regarding fees and recourse, and dispute resolution;[79]
- risk management practices;
- operational resilience, cybersecurity standards, and business continuity and disaster recovery policies; and
- know your customer (KYC), anti-money laundering (AML) and combating financial terrorism (CFT) standards.[80]

An SRO could also consider whether existing securities and derivatives disclosure standards should be fine-tuned with respect to crypto-assets. Georgetown Law Professor Chris Brummer has argued that Regulation S-K, the SEC's primary disclosure regulation, is both "over-inclusive and under-inclusive" with respect to crypto: "it fails in some instances to account for critical aspects of the digital assets ecosystem, and in others imposes obligations with little to no relevance, creating both a lack of clarity and inefficiency in compliance."[81]

We recognize that creating standards in all these areas would take time, but we believe an SRO could follow a "peeling the onion" type of strategy, where some low hanging fruit could be addressed first, like prohibiting wash trading and other abusive practices and requiring greater transparency and record-keeping, and taking on more difficult areas over time.

We note that one area in which there are federal regulatory standards for centralized exchanges and certain other crypto participants is anti-money-laundering (AML) compliance, due to the efforts of the Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Treasury. We applaud its efforts to get crypto exchanges and other participants to register with it as money services businesses (MSBs) and

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79. We recognize that some have been critical of FINRA's arbitration proceedings for investor disputes involving securities transactions. *See, e.g.*, Mark Egan et al., *Arbitration with Uninformed Consumers*, Harvard Business School Finance Working Paper No. 19-046 (May 11, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3260442. Whatever concerns one might have about FINRA arbitration proceedings as currently implemented, the point to recognize is that consumers investing in crypto-asset markets now have no mechanism for supervised dispute resolution. Moreover, the most stringent system of oversight currently under debate for crypto-assets—full compliance with SEC requirements—implicitly contemplates the application of FINRA arbitration requirements. Conceivably a crypto-asset SRO might adopt better arbitration rules, but whatever rules they adopt would most likely be an improvement upon the status quo.

80. See *also* Massad, *supra* note 47.

81. Chris Brummer, Georgetown Law School, *Testimony before the Agriculture Committee of the U.S. House of Representatives, Subcommittee on Commodity Exchanges, Energy, and Credit* (June 23, 2002), https://docs.house.gov/meetings/AG/AG22/20220623/114931/HHRG-117-AG22-Wstate-BrummerC-20220623-U1.pdf.

to enforce AML standards.[82] FinCEN has penalized several entities for failure to follow these standards.[83] It has also issued a proposal, which is still pending, for enhanced standards on convertible virtual currencies and digital assets that have legal tender status.[84] But its work would be greatly enhanced by the creation of overall regulatory standards for such entities as well as by bringing the crypto industry within a fully supervised environment. As the Acting Director of FinCEN recently noted, "as the digital world increasingly becomes the financial world—and *vice versa*—we need a regulatory regime to match, one that accounts for crypto and other digital assets, evolution in the payments space, and other innovations that are driving the creation of new products, services, and delivery channels."[85] FinCEN does not have the resources to be constantly monitoring what various crypto actors are doing. Simply requiring greater transparency and record keeping, prohibiting wash trading and other manipulative practices, and having enforcement capabilities behind those standards would greatly enhance the ability of FinCEN and other law enforcement agencies to ensure that AML and combating the financing of terrorism (CFT) standards are upheld and that violations are identified and prosecuted.

We envision a single crypto SRO. Although there are multiple SROs in both the securities and derivatives worlds, including securities and derivatives exchanges recognized as SROs for certain functions,[86] we believe one SRO is the proper way to develop standards for crypto-assets at the outset. It would be premature at best to recognize exchanges as SROs before such standards are developed.

There is also the question of whether an entity would need to be a member of both the new crypto SRO and an existing securities or derivatives SRO. We envision these questions to be among those that the SEC and the CFTC will need to address in terms of particular facts and circumstances, just as they will need to address the exact scope of the SRO's standards relative to existing securities and derivatives regulations. For example, if an entity is engaged in crypto activities for which it is registered with the SEC or the CFTC—as, for instance, a derivatives or securities exchange—then it has acknowledged a duty to comply with SEC or CFTC requirements applicable to such activities.[87] We assume the SEC and CFTC

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82. AML standards include MSB registration requirements, 31 U.S.C. § 5330; 31 C.F.R. § 1022.380, AML program maintenance requirements, 31 U.S.C. § 5318(a)(2), (h); 31 C.F.R. § 1022.210(a), currency transaction reporting requirements for transfers of more than $10,000, 31 U.S.C. § 5313(a); 31 C.F.R. § 1010.311, and suspicious activity reporting requirements, 31 U.S.C. § 5318(g)(1); 31 C.F.R. § 1022.320(a)(2*). See also supra* note 61.

83. *See*, *e.g.*, FinCEN, *FinCEN Penalizes Peer-to-Peer Virtual Currency Exchanger for Violations of Anti-Money Laundering Laws* (Apr. 18, 2019), https://www.fincen.gov/news/news-releases/fincen-penalizes-peer-peer-virtual-currency-exchanger-violations-anti-money; FinCEN, *First Bitcoin "Mixer" Penalized by FinCEN for Violating Anti-Money Laundering Laws* (Oct. 19, 2020), https://www.fincen.gov/news/news-releases/first-bitcoin-mixer-penalized-fincen-violating-anti-money-laundering-laws.

84. *See Threshold for the Requirement to Collect, Retain, and Transmit Information on Funds Transfers and Transmittals of Funds that Begin or End Outside the United States, and Clarification of the Requirement to Collect, Retain, and Transmit Information on Transactions Involving Convertible Virtual Currencies and Digital Assets with Legal Tender Status*, 85 Fed. Reg. 68,005 (Oct. 27, 2020), https://www.federalregister.gov/documents/2020/10/27/2020-23756/threshold-for-the-requirement-to-collect-retain-and-transmit-information-on-funds-transfers-and.

85. Him Das, Acting Director of FinCEN, *Prepared Remarks at the American Bankers Association/American Bar Association Financial Crimes Enforcement Conference* (Jan. 13, 2022), https://www.fincen.gov/news/speeches/prepared-remarks-fincen-acting-director-him-das-delivered-virtually-american-bankers.

86. For a list of SEC-registered exchanges that qualify as SROs, see SEC, *Self-Regulatory Organization Rulemaking*, https://www.sec.gov/rules/sro.shtml. For more information regarding CFTC-registered SRO exchanges, see CFTC, *Industry Filings*, https://www.cftc.gov/IndustryOversight/IndustryFilings/index.htm. While it is possible to imagine the creation of more specialized SROs down the road, as a first step, we believe that a single organization would be more practical and appropriate. To be sure, including many different kinds of crypto-asset firms into the SRO creates heterogeneity of interests and perhaps challenges on reaching agreement among SRO members, and we anticipate that, particularly in the initial stages of organization, leadership for the SRO will have to play a strong role in generating consensus and will also have to proceed in a manner that gains the confidence of both the SEC and the CFTC.

87. 15 U.S.C. § 78o-3(b)(2); 7 U.S.C. § 21(b)(1).

would decide to what extent the crypto SRO's standards should apply, given that the activity is already subject to securities or derivatives regulations. We think the question of membership in the SRO—who exactly should the SEC and the CFTC prod to join the SRO—is a parallel issue to be decided by the agencies as well. We do not, however, regard membership in one SRO as an automatic exemption from membership in another. Particularly in situations where a firm is engaged in activities for which it is registered with one of the regulators as well as crypto activities outside of that registration (to the extent that is permissible under the law), we would think membership in the new crypto SRO, and compliance with its standards, would be required. Finally, we do not underestimate that questions pertaining to membership and scope would be challenging, but we should not shirk from the task for that reason. We suggest the agencies take a broad view of both, but also set priorities by targeting for membership some key market participants and focusing at the outset on rule-making areas of greatest need as discussed below. The fact is standards in the crypto industry are woefully inadequate and less than perfect steps forward will be necessary to fix that.

3. Some Advantages and Likely Objections to the Proposal

We turn now to some advantages, as well as likely objections, to the proposal.

The first advantage is that an SRO process could bring together the necessary expertise to develop meaningful, workable standards. One of the challenges in crypto is that those who understand our regulatory framework for securities and derivatives may not have sufficient understanding of crypto technology, and those with knowledge of the technology often do not understand the regulatory and policy issues. We believe an SRO is a good way to bring that collective expertise together.

The second advantage is that the SRO process would occur under the authority of the SEC and the CFTC, thus ensuring that it would remain accountable to the public interest. The regulatory agencies would be actively involved in overseeing its work. They would approve the governance, selection of directors and membership criteria. They would approve any rules, ensuring that the standards are robust and are then enforced.

A third advantage is that the process of having an SRO formulate standards can begin now, without new legislation. No new authority is needed. While SRO rules must be consistent with the requirements of otherwise applicable federal laws,[88] these organizations have wide discretion to implement rules that fulfill statutory goals and routinely adopt measures that go beyond the express statutory or regulatory mandates of either the SEC or CFTC.[89] While the capacity of SROs to adopt rules is not unlimited,[90] the

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88. *See, e.g.*, Section 19(b)(2)(C)(1) of the Exchange Act, 15 U.S.C. § 78s(2)(C)(1).

89. *Cf.* SEC, *Order Approving Rule Changes: Self-Regulatory Organizations*, Release No. 34-92590 at 57 (Aug. 8, 2021) ("Exchanges have historically adopted listing rules that require disclosures in addition to those required by Commission rules"); *Self-Regulatory Organizatoins*, 86 Fed. Reg. 44424, 44438 (Aug. 12. 2021) (same) (citing Nasdaq IM-5250-2; LTSE Rule 14.425(a)(1)(C)); ; *see also* Heath P. Tarbet, *Self-Regulation in the Derivatives Markets: Stability Through Collaboration*, 41 NW J. INT'L L. & BUS. 175, 194-95 (2021) ("SROs are able to respond to new market conditions with speed and flexibility, which is important during periods of innovation. SROs in particular are adept at applying principles-based regulation to developing scenarios.") *See also* Quintenz, *supra* note 11 (describing how the NFA began regulating the retail foreign exchange markets seven years before the CFTC began doing so).

90. *See, e.g.*, Section 15A(b)(6) of the Exchange Act, 15 U.S.C. § 78o-3(b)(6) (prohibiting national securities association rules that attempt to regulate "matters not related to the purposes of [the 1934 Act]").

scope of delegation to SROs is broad and seems to cover the substantive matters outlined above.[91] There is statutory authority for SRO rules limiting the ability of SRO members to transact business with non-member firms.[92] An SRO for the crypto industry could conceivably develop a similar standard of requiring its members to transact only with other entities and protocols adhering to SRO standards.

Fourth, an SRO process could develop common standards for trading and other activities without getting bogged down in the question of whether a particular asset is a security, a commodity or something else. Indeed, since some platforms may be trading or lending both securities and commodities, it could help avoid regulatory inconsistency, achieving the goal of "one rule book."[93] Once again, we are not suggesting any change to the standards of what is a security or a commodity, but rather an approach that seeks to achieve investor protection without the distraction and delay entailed in litigating that question.

A fifth advantage is that the SRO process could inform the development of new legislation, identifying with greater precision the issues that need to be addressed and areas where new statutory language is needed. We do not underestimate the challenge of SRO members arriving at agreement on meaningful standards applicable to crypto asset trading.[94] But we think this is a more promising path, particularly given the challenges of building a consensus around new legislation.[95] The SRO's work can help identify gaps in, or the need for amendments to, current law. It will also reduce the risk that a legislative consensus is built around an approach that might not have been sufficiently tested.

Sixth, we believe the SRO process can be conducted in a way that does not conflict with or undermine the application of existing law, whether through existing regulation or the initiation or prosecution of enforcement actions. The SRO standards would be formulated so as not to apply to subject matter already covered by an existing SEC or CFTC rule. For example, if a crypto exchange were registered with the SEC as a securities exchange or with the CFTC as a derivatives contract market, then, to the extent its activities were governed by those rules, the SRO standards would not apply.[96] Similarly, SRO rules would not prevent or interfere with enforcement actions that provide greater clarity as to the application of existing law. But insofar as market participants agreed to abide by the SRO process, and the SRO enforces its rules, the agencies could refrain from bringing enforcement actions.

Seventh, standards developed through an SRO process are much easier to change than those promulgated by new legislation. The standards can be refined in light of experience gained through their application and in light of market evolution.

Finally, the work would be funded by the industry. It would not require new budgetary authority nor would it use agency resources committed to other priorities.

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91. *See, e.g., id.* (authorizing national securities association rules "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest").

92. *See* Section 15A(e) of the Exchange Act, 15 U.S.C. § 78o-3(e) (authorizing restrictions on transactions with nonmember professionals).

93. *See* Palma & Jenkins, *supra* note 32.

94. Of course, in some instances, the SEC and CFTC could resolve these disputes and impose a single standard, but the SRO would have an opportunity to frame the decision and suggest practical solutions.

95. *See, e.g.*, Paul Kiernan, *Senators Propose Industry-Friendly Crypto Bill*, The Wall Street Journal (June 7, 2022), https://www.wsj.com/articles/senators-to-propose-industry-friendly-cryptocurrency-bill-11654592401 (quoting both critics and supporters of Lummis-Gillibrand draft bill).

96. Admittedly, on the CFTC side, it is less likely that a spot platform and a derivatives exchange would operate as a combined entity.

We turn next to some possible objections to the proposal.

The first is that an SRO is not needed because industry trade associations, such as the Association for Digital Asset Markets (ADAM) and Global Digital Finance (GDF), already have developed codes of conduct or standards and this would be no different.[97] We strongly disagree. Even a brief perusal of such codes shows that while the intent may be laudable, the content is far too weak, vague, and unenforceable to match the kind of strong standards SROs have implemented in our securities and derivatives markets.[98]

For example, in regard to conflicts of interest, ADAM's code says members will "identify, and take appropriate steps to address" conflicts.[99] It goes on to say "the nature of any conflict of interest will depend on the nature of a Member's business…Each Member is responsible for identifying the conflicts that pertain to its own business and disclosing them and/or addressing them as appropriate."[100] It then specifically acknowledges that a Member operating a trading platform may issue its own digital assets, in which case the Member "will adopt and disclose policies to address conflicts of interest that may arise… ."[101] Similarly, it acknowledges such a Member may trade on its own platform and says it should disclose such activities and "institute appropriate organizational and information barriers to limit access to, and trading on the basis of, information relating to Client orders[.]"[102] Thus, it does not prohibit any activity—even ones in which the member would clearly have a conflicting economic interest—nor even provide any specifics for deciding whether a conflict is acceptable or what policies are appropriate.

Similarly, in regard to custody, the GDF code says "we will treat our customers fairly…We will take reasonable steps to ensure that [client assets] are subjected to asset custody and safekeeping approaches that are suitable and provide the requisite level of security for crypto-assets."[103] Thus, it does not provide any assurance that client assets will be segregated or otherwise protected from other claims.

These are not isolated examples. The codes are replete with similarly vague, permissive language. The codes are far weaker than our standards for securities and derivatives exchanges. They illustrate the fact that an industry process that is not tightly overseen by regulators will not suffice.

A second, related possible objection is that the SRO process will be captured by the industry, and especially its dominant players,[104] and the SRO will not produce anything much stronger than those voluntary codes. We think the short answer is to remember former Chairman Douglas's admonition to "keep the shotgun behind the door."[105] That is, there is no doubt that the risk of industry self-interest

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97. *See* ADAM, *Code of Conduct* (Nov. 12, 2019), https://www.theadam.io/wp-content/uploads/2021/11/ADAM-Code-of-Conduct.pdf; GDF, *Code of Conduct*, https://www.gdf.io/code/.

98. Ibid.

99. ADAM, *supra* note 98, at § V(A).

100. Ibid.

101. Ibid. at §V(D).

102. Ibid. at §V(e).

103. GDF, *supra* note 98, at Pt. 1, § 1.4(a), (c), https://www.gdf.io/wp-content/uploads/2021/02/0010_GDF_Overarching-Principles_Proof-V2-130819.pdf.

104. We would note that this same concern also exists with respect to legislative action, particularly in light of the increased political activity that many industry participants have undertaken. *See, e.g.,* Hailey Fuchs and Caitlin Oprysko, *New crypto group grades lawmakers' industry friendliness*, Politico (Sept. 8, 2022) https://www.politico.com/newsletters/politico-influence/2022/09/08/new-crypto-group-grades-lawmakers-industry-friendliness-00055763 and Brian Slodysko and Fatima Hussein, *Crypto comes to Washington: Will the millions buy influence?*, AP News (May 12, 2022) https://apnews.com/article/cryptocurrency-technology-congress-d1ae06ce59b93007cf96ad7658dc55f2.

105. *See* sources cited *supra* notes 15–17.

leading to weak standards will exist. A 1973 report of the Senate Subcommittee on Securities expressed this risk well:

> The inherent limitations in allowing an industry to regulate itself are well known: the natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a façade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anticompetitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation.[106]

As repeated studies have found, self-regulation works only if regulators consistently use or threaten to use their authority to create incentives for it to work.[107] The SRO process we are proposing will be similarly dependent on strong oversight by regulators. As noted above, its governance, membership and development and implementation of standards will be overseen and approved by both the SEC and the CFTC;[108] they—and only they—can ensure that the process and outcomes are accountable to the public interest and robust.[109] While this oversight will require resources, it may be a way to redeploy and leverage some of the resources that are currently being allocated to crypto industry enforcement efforts.[110]

No doubt, for certain matters, direct engagement by the SEC and CFTC will be essential. While the SRO would be expected to supervise its members and enforce its own rules in the first instance, the SEC and CFTC would need to play a role in ensuring that SRO enforcement in these areas was rigorous and effective, a role that both commissions currently play with respect to existing SROs like FINRA and the NFA.[111] For serious violations, involving infractions of federal statutes, enforcement actions by the

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106. *See* Seligman, *supra* note 15, at 440.

107. Ibid. *See also* Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAWYER 1347 (2004), https://www.jstor.org/stable/40688239.

108. *See supra* notes 28-46 and accompanying text.

109. It is also important to distinguish our proposal from the context in which Japanese regulatory authorities authorized in 2018 the creation of the Japan Virtual Currency Association (JVCEA) as a self-regulatory organization of Japanese virtual exchange. Gavin Raftery et al., *Japanese Financial Services Agency accredits the Japan Virtual Currency Exchange Association as a Self-Regulatory Organization*, BakerMcKenzie Blockchain Blog (Nov. 13, 2018), https://blockchain.bakermckenzie.com/2018/11/13/japanese-financial-services-agency-accredits-the-japan-virtual-currency-exchange-association-as-a-self-regulatory-organization/. Although the JVCEA was formally subject to supervision and oversight by the Japanese Financial Services Authority, the agency did not, until very recently, imposed strict oversight of the JVCEA. Leo Lewis et al., *Japan struggles with self-regulation during crypto meltdown*, Financial Times (July 17, 2022), https://www.ft.com/content/75a05077-6ac8-4365-a8c5-28fc8928b505. While the JVCEA was established in the aftermath of scandals, such as the failure of Mt. Gox, the Japanese government was at the time also engaged in an effort "to become a worldwide leader" in blockchain technologies. *See* Marta Gonzalez, *Blockchain in Japan* 7, EU-Japanese Centre for Industrial Cooperation (2018), https://www.eu-japan.eu/sites/default/files/publications/docs/blockchaininjapan-martagonzalez.pdf. In the United States today, the primary incentive for government action is the establishment of an appropriate regulatory structure for digital assets.

110. We also note that the International Organization of Securities Commissions has developed principles for regulation and standards for assessing implementation of those principles which cover self-regulation, and in particular the issue of dealing with conflicts of interest. See Objectives and Principles of Securities Regulation, International Organization of Securities Commissions 5 (May 2017), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD561.pdf and Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation, International Organization of Securities Commissions 55-61 (May 2017), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD562.pdf.

111. For example, the SEC has extensive authority to oversee FINRA's enforcement activities. Most directly, the SEC reviews FINRA's enforcement actions, any of which it can overturn if it disagrees. 15 U.S.C. § 78s(d); FINRA, *Enforcement: Rules and Guidance*, https://www.finra.org/rules-guidance/enforcement. On the flipside, the SEC also has the tools to prevent under-enforcement: the SEC may remove overly lenient FINRA officers, 15 U.S.C § 78s(h)(4), and it could even (theoretically) revoke FINRA's registration statement if the SRO failed to "enforce compliance" with its own rules. 15 U.S.C. § 78s(h)(1).

agencies (rather than the SRO) would likely be more appropriate,[112] with referrals to the Department of Justice for criminal prosecution in egregious cases.[113] Procedures for cooperating in enforcement matters have been developed for existing SROs and could serve as a model for enforcement efforts of an SRO dedicated to crypto-assets, as government involvement in certain enforcement actions is necessary and appropriate. The ability of the SEC and the CFTC to intervene on important enforcement matters offers some assurance that SRO will remain vigilant in its own oversight.

A third possible objection is that an SRO will not be able to exercise sufficient authority over the marketplace because crypto exchanges or other intermediaries cannot be forced to join.[114] We think a combination of regulatory "carrots and sticks" can be brought to bear to address these risks—carrots in the form of incentives and sticks in the form of the exercise by the SEC and CFTC of their existing enforcement authorities. Plus, as mentioned above, the SRO may be able to limit the capacity of members firms to do business with non-member firms, thus encouraging entry into the regulated market. Particularly if a number of large crypto-asset platforms, such as Coinbase, committed themselves to join the SRO, the incentives for other firms to follow suit will be considerable.

Firms will have an incentive to join the SRO because there will be a marketplace advantage to doing so. If there is sufficient publicity around the process, we believe firms that support the process will have an advantage. Investors are likely to have greater confidence in such firms; membership in the SRO and compliance with SRO standards will help in attracting business. Moreover, the firms will benefit from greater regulatory certainty. That is because the SEC and the CFTC can refrain from taking enforcement actions against firms that participate and abide by the SRO's standards (insofar as they might otherwise bring an enforcement action for not abiding by such standards). They can do this through the issuance of no-action letters or exemptive relief if necessary, written so as to be conditioned on full compliance to avoid the risk that firms espouse support but do not actually comply.[115]

Firms that choose not to join or abide by SRO standards would not only face the potential market disadvantage that could arise from not complying. They also would be vulnerable to enforcement actions insofar as their activities may be in violation of the law and are not covered by no-action letters or exemptive relief pertaining to those complying with the SRO's rules. Indeed, the regulatory agencies could focus their enforcement resources on those that do not comply.

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112. *See* Securities and Exchange Commission, Division of Enforcement, *Enforcement Manual* §§ 2.2.2.5, 5.6.2 (Nov. 28, 2017), https://www.sec.gov/divisions/enforce/enforcementmanual.pdf ("Enforcement Manual"). Last year, FINRA referred hundreds of fraud and insider trading cases to the SEC. *See* FINRA, *On the Front Lines of Customer Protection*, https://www.finra.org/rules-guidance/enforcement/customer-cooperation; *see also* Roadmap to FINRA's Investigation and Enforcement Process, Practical Law Practice Note w-001-3966; FINRA, *Disciplinary Actions Online*, https://www.finra.org/rules-guidance/oversight-enforcement/finra-disciplinary-actions-online; Remarks of Chair Mary Jo White, *All-Encompassing Enforcement: The Robust Use of Civil and Criminal Actions to Police the Markets* (March 31, 2014), https://www.sec.gov/news/speech/2014-spch033114mjw#_ftnref3 ("Many insider trading cases, whether criminal, civil or both, start out as a referral to the SEC from FINRA").

113. FINRA, *Fraud Stoppers: FINRA's Market Investigations Team* (March 22, 2022), https://www.finra.org/media-center/finra-unscripted/market-investigations-group ("[FINRA]…send[s] referrals to criminal authorities such as the FBI and U.S. Attorney's Office."); Roadmap to FINRA's Investigation and Enforcement Process, Practical Law Practice Note w-001-3966.

114. As mentioned earlier, firms would not be required to join the crypto-asset SRO in the same way that SEC-registered broker-dealers are required to join a national securities association, although the threat of SEC or CFTC enforcement actions against firms that do not comply with SRO rules could be a powerful inducement. In the future, especially if the SRO proves successful, Congress may well choose to impose such a requirement, thereby mandating membership for crypto-assets firms. That would, however, presumably require the creation of statutory definitions of crypto-asset and regulated firms.

115. See 15 U.S.C. § 78mm(a). For example, the SEC could exempt SRO members from otherwise applicable SEC requirements for custodial arrangements or other rules that are not well suited for digital assets, but only if the member complied with alternative SRO requirements that provide comparable protections.

A fourth objection is the fear that SRO standards would be "lighter touch" than existing securities or derivatives rules, or that the creation and application of SRO standards would imply that the agencies are conceding that existing rules cannot be applied. We think the process can be managed to avoid those risks, though we acknowledge this will require strong oversight by the agencies. First, the SRO standards would need to be approved by both agencies, so a "lighter touch" would result only if both agencies approved weak rules. Second, the agencies need not concede any jurisdictional authority in agreeing to a process that develops and then enforces SRO standards. On the contrary, they could retain and use their authority to the extent a crypto firm or developer chose not to abide by SRO standards, or the SRO failed to adopt strong standards or enforce them.[116] And, of course, the commissions retain the latitude to discipline the SRO itself if the organization does not effectively and consistently enforce its rules.

Finally, one might ask whether the SEC and the CFTC will be able to cooperate well enough to oversee a joint SRO together. What if the commissions disagree?[117] To be sure, the history of SEC-CFTC collaboration has not always been exemplary.[118] And it is possible that inter-agency disagreements would hamper the launch of an SRO and trigger the need for congressional intervention. But arguably, the creation of an SRO could actually facilitate coordinated action between the SEC and the CFTC as the onus would fall on the organization to propose regulatory structures and supervisory practices that would gain the support of both commissions. Indeed, rather than being an impediment to joint SEC-CTFC actions, an SRO could be the vehicle through which agreement is achieved.[119]

4. SRO Standards Should Apply to DeFi Intermediaries as Well as Centralized Intermediaries

The explosive growth of DeFi,[120] or decentralized finance, raises a challenge for an SRO process. It is one thing to bring together corporate entities that own or operate centralized crypto exchanges, lending platforms or broker/dealer operations. But what about DeFi platforms where one can also buy, sell, borrow, or lend crypto-assets, or other DeFi protocols that perform functions equivalent to those performed by entities subject to the SRO standards?

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116. The ability of the SEC and CFTC to monitor SRO enforcement of SRO rules will also be critical in persuading the SEC and the CTFC to delegate supervisory authority to the SRO in the first instance.

117. Some may say potential source of disagreement could be differences in basic regulatory philosophies—the SEC being more rules-based and the CFTC more principles-based—or differences in the kinds of investors (retail versus institutional) who have traditionally participated in securities markets as compared to derivatives markets. But although the Commodity Exchange Act has core principles, the CFTC issues numerous rules pursuant to them; and there may be increasing retail interest in crypto derivatives.

118. For example, in the case of the Shad-Johnson Accord between the SEC and the CFTC, the agencies could not agree on the allocation of jurisdiction over futures and options on futures on individual securities and banned trading of such contracts until agreement could be reached. But they never did agree; Congress grew tired of waiting and repealed the ban in 2000. *See* sources cited *supra* notes 61 and 62; *see also* ABA Working Group Paper, *supra* note 53, at 105.

119. The question, of course, is not whether an SRO would ensure perfect cooperation, but rather whether the creation of an SRO would increase the likelihood of SEC-CFTC cooperation compared to the status quo, where coordinated efforts have been quite limited and, arguably, industry participants have been able to exploit agency rivalries. We note also that the FSOC Report's fourth recommendation is that "regulators continue to cooperate with each other in the supervision of crypto-asset entities" but does not provide any specific suggestions. *See* FSOC Report, *supra* note 7, at 116.

120. *See* Stacy Elliot, *DeFi Trading Volume on Large DEXs Has Jumped 550% in 2021 So Far: Chainalysis*, Decrypt (Nov. 9, 2021), https://decrypt.co/85570/defi-dex-trading-volume-chainalysis-report-2021; *see also* Sam Roose, *What is DeFi?*, The New York Times (Mar. 18, 2022), https://www.nytimes.com/interactive/2022/03/18/technology/what-is-defi-cryptocurrency.html.

We believe the SRO should develop standards for those DeFi platforms as well. The rule that "same function, same (or similar) rules" should apply, because the objectives of the standards are no different. Or, as the FSOC Report noted, "[R]egulatory frameworks remain applicable to crypto-asset platforms and activities regardless of any characterization or assertion of decentralization."[121]

The issue, in our view, is not whether it would be in investors' interests to apply such standards to DeFi platforms. It should go without saying that investors should be as protected from fraud and manipulation, front-running, conflicts of interest or other risks on a DeFi platform as they are on a centralized exchange. The recent collapse of the Anchor lending protocol, which offered high rates of return on Terra, the algorithmic stablecoin that itself crashed, caused losses for hundreds of thousands of investors.[122] The role of a DeFi platform in this case underscores the need for regulatory oversight of this space.[123] The only question is one of means, not ends: how does one apply and enforce those rules if there is no centralized entity operating the platform, or if it is unclear whether there are controlling persons who effectively are responsible for its operation? Who represents the DeFi platforms in the SRO process, and who ensures compliance?

We think the answer to the question of how to apply standards to DeFi platforms is exactly the reason why we need an SRO: ultimately, the industry should be tasked with developing an answer that is acceptable to regulators. Unfortunately, instead of being proactive by devising a solution, some in the industry seem to take the position that DeFi should be unregulated because it is "decentralized"—or at best, that it should be unregulated unless and until the government figures out how to regulate DeFi. Consider, for example, the responses to the SEC's recent proposal that would bring more automated trading systems that trade Treasury and other government securities within the regulatory perimeter.[124] The proposal did not even mention crypto-assets, but some in the crypto community thought it might presage an effort to regulate DeFi platforms; indeed, the same was suggested by SEC Commissioner Hester Peirce who dissented from the proposal.[125] Some in the crypto industry submitted comment letters addressing this risk, and one example is the comment letter from Andreessen Horowitz (also known as a16z), the leading crypto venture capital firm, which criticized the SEC because "the proposal does not on its face address how a protocol governed by a distributed community could even comply with the applicable registration requirements."[126] Instead of asserting it is solely the SEC's responsibility to figure that out, we think the industry should step up to that challenge.

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121. FSOC Report, *supra* note 7, at 116.

122. *See* Osipovich & Ostroff, *supra* note 67.

123. As we noted earlier, we have proposed that the issuance of stablecoins should be the subject of banking supervision, *see* discussion *supra* note 10, but we have also recognized that the trading of stablecoin tokens on centralized or DeFi platforms would require a separate system of regulation, such as the SRO approach we set forth here.

124. Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, 87 Fed. Reg. 15496 (proposed Jan. 26, 2022), https://www.sec.gov/rules/proposed/2022/34-94062.pdf.

125. SEC Commissioner Hester Peirce, *Rip Current Rulemakings: Statement on the Regulatory Flexible Agenda* (June 22, 2022), https://www.sec.gov/news/statement/peirce-statement-regulatory-flexibility-agenda-062222 (accusing ATS proposal of threatening to regulate crypto-assets via "unmarked back door"); *see also* Commissioner Peirce, *Dissenting Statement on the Proposal to Amend Regulation ATS* (Jan. 26, 2022), https://www.sec.gov/news/statement/peirce-ats-20220126; Jamie Crawley, *Hester Peirce Warns Proposed SEC Reform of Securities Trading Platforms Could Threaten DeFi*, Coindesk (Feb. 1, 2022), https://www.coindesk.com/policy/2022/02/01/hester-peirce-warns-proposed-sec-reform-of-securities-trading-platforms-could-threaten-defi/.

126. Jai Ramaswamy, Chief Legal Officer, & Miles Jennings, General Counsel, a16z Crypto/A.H. Capital Management, L.L.C., Comment Letter on Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade

A first step is to tackle what is meant by the term "DeFi" or decentralization. It is used in the crypto industry to describe a variety of arrangements and factors. This can include decentralized methods of governance, with respect to the distribution of control rights to modify a platform or protocol; balance sheet decentralization, or the distribution of rights to control assets; and transaction processing decentralization, or the number of parties involved in verifying, clearing, and settling transactions. The degree to which any of these dimensions is decentralized or distributed can vary, over time; there are no commonly agreed-upon standards as to when to label a platform or protocol "DeFi." Indeed, the collapse of some firms and protocols following the most recent crash in crypto prices triggered a debate as to whether the failed firms were examples of "DeFi" or "CeFi"—that is, centralized finance.[127] When the Wall Street Journal suggested that the failure of firms like Celsius exposed the weaknesses of DeFi,[128] others argued that firms like Celsius had a traditional, centralized corporate ownership structure and it was CeFi firms that failed, not DeFi.[129] But although Celsius had a conventional corporate structure, it nevertheless described itself, and some crypto commentators described it, as being a leading example of "DeFi" in the years before its collapse, thus exemplifying the vagueness of the term.[130]

Moreover, there is no doubt that even if a protocol is not run by a centralized entity, there are entities and individuals involved in its development and potentially wielding influence over its evolution. To what extent should developers of protocols be charged with a responsibility to work compliance into protocols designed to perform regulated financial processes, and how could such a standard be enforced? What about the "foundations" that effectively act as indirect operators or monitors of protocols? They are often standing by ready to intervene in the case of a hack, outage or other problem, and may have engineers, lawyers and other staff, despite a protocol claiming to be "decentralized."[131] What about those who hold administrative keys or a large share of governance tokens, particularly before those have been widely distributed? One need only look at how outages or hacks are addressed in practice to see that there is

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U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities 3 (Apr.18, 2022), https://www.sec.gov/comments/s7-02-22/s70222-20124045-280177.pdf.

127. *See, e.g.*, Michael J. Casey, *CeFi Broke. But DeFi Is Not Without Blame*, Coindesk (July 15, 2022), https://www.coindesk.com/layer2/2022/07/15/cefi-broke-but-defi-is-not-without-blame/.

128. Jon Sindreu, *DeFi 's Existential Problem: It Only Lends Money to Itself*, The Wall Street Journal (June 30, 2022), https://www.wsj.com/articles/defis-existential-problem-it-only-lends-money-to-itself-11656503840.

129. Dan Morehead, *DeFi Worked Great*, Pantera Capital Blockchain Letter (July 12, 2022), https://panteracapital.com/blockchain-letter/defi-worked-great/.

130. Alex Mashinsky, CEO of Celsius, said Celsius was one of the innovators of DeFi because it used smart contracts and open ledgers to allow users to earn the highest yield on their crypto assets, and that Celsius "straddle[d]" the worlds of DeFi and CeFi. Alex Mashinsky, *The Best of Both Worlds: How Celsius Straddles Both CeFi and DeFi*, Medium (Jan. 26, 2021), https://mashinsky.medium.com/the-best-of-both-worlds-how-celsius-straddles-both-cefi-and-defi-d15325c61814. CryptoNews called Celsius a "leading DeFi platform" in June 2020 and Forkast News described it as "one of the largest DeFi platforms in the world" in August 2021. Aisshwarya Tiwari, *DeFi'ing the Odds; Celsius Network Reports Over $1 Billion Cryptocurrency Deposits*, CryptoNews (June 5, 2020), https://crypto.news/defi-celsius-network-1-billion-cryptocurrency/; Lachlan Keller & Yihui Xie, *Celsius Network grows 1,900% this year, US$20B AUM*, Forkast News (Aug. 25, 2021), https://forkast.news/headlines/celsius-network-grows-1900-year-us20b/. Similar statements were made on other sites. *See, e.g.*, Kayleigh Charlotte, *The Top 5 DeFi Platforms You Need to Know About*, Blocksocial (Feb. 26, 2020), https://www.blocksocial.com/top-5-defi-platforms-to-know/; Crypto Ryan, *How to Use Celsius Network (Review and Guide for 2021*), Cryptoryancy (Oct. 28, 2021), https://www.cryptoryancy.com/celsius-network-review/ ("Celsius is a decentralized finance (DeFi) cryptocurrency lending platform[.]").

131. *See, e.g.* Compound Labs, *Our Team*, https://compoundtreasury.com/team (list of short bios of popular DeFi protocol's team of executives and engineers); Balancer, *About Balancer Protocol and Labs*, https://docs.balancer.fi/getting-started/faqs/about-balancer-protocol-and-labs (synopsis describing "team" of roughly 30 employees). Maker, *Contact Us*, https://makerdao.com/en/contact (providing contact information for "foundation" and links to "job opportunities"). See also FSOC Report, *supra* note 7, at 63 and 73 regarding how "nominally decentralized" DeFi arrangements can have a concentration of governance tokens.

often a process where a solution is devised by a relatively small group, even if it is then subject to the vote of a larger class of token holders.[132]

We also believe that centralized exchanges and other intermediaries operated by corporate entities will have an incentive to develop standards that apply to DeFi protocols so that there is a level playing field. They will not want to see DeFi protocols gain an unfair advantage by not having to comply with standards to which their own businesses are subject. At this stage, we do not know the proper solution, but we believe an SRO is a right way to get started. Even if the task of extending SRO oversight to DeFi platforms is especially challenging, that is no reason for the SRO not to start with imposing regulatory oversight over other aspects of crypto-asset trading for which effective supervisory solutions are easier to specify and implement.

5. Conclusion

For the past decade, the development of appropriate regulatory standards for the crypto industry has been hampered by interminable debates over whether particular digital assets are securities or commodities or something else. Industry participants have exploited these jurisdictional gaps and neither the SEC nor the CFTC has been able to develop a coherent and comprehensive approach to supervising this increasingly important sector of our financial markets. By combining forces through a joint SRO, the SEC and CFTC can offer an efficient and attractive path forward, and one that is ideally suited to draw on the expertise of industry participants, but within an organizational structure that we can be confident will advance the public good.

The SEC and the CFTC can also draw on the resources of existing SROs in implementing this approach. One could imagine staff from FINRA and the NFA being seconded to help, especially in the early phases. And while our approach can be implemented without new legislation, it could also be advanced by Congress: for example, although there appears to be increasing support for legislation to provide federal regulation of the spot market for non-security crypto assets, which will help strengthen regulation, that will not eliminate the jurisdictional issues as to whether a crypto asset is a security or a commodity or something else. Rather than tackle that issue, Congress could include in such legislation a directive to the SEC and CFTC to form a joint SRO and could require any entity or protocol engaged in the trading, lending, borrowing or custody of crypto assets to comply with its standards.

Fundamentally, our approach will depend on strong leadership from the SEC and CFTC, and it will succeed only if the agencies are vigilant in their oversight of an SRO's work. But we believe that would be effort well spent.

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132. *See, e.g.* Will Gottsegen, *DeFi Exploit Siphons $45 Million from PancakeBunny, Crashes Token Price*, Decrypt (May 20, 2021), https://decrypt.co/71585/pancakebunny-defi-exploit (describing DeFi protocol team's response to hack); Anna Hirtenstein, *Crypto Hackers Stole More Than $600 Million from DeFi Network, Then Gave Some of It Back*, The Wall Street Journal (August 11, 2021), https://www.wsj.com/articles/poly-network-hackers-steal-more-than-600-million-in-cryptocurrency-11628691400?mod=article_inline (same); Jeff Benson, *Grim Finance Hacked for $30 Million in Fantom Tokens*, Decrypt (December 19, 2021) https://decrypt.co/88727/grim-finance-hacked-30-million-fantom-tokens (same); Andrew Asmakov, *Avalanche DeFi Platform Vee Finance Suffers $35M Hack* (Septmber 21, 2021) https://decrypt.co/81400/avalanche-defi-platform-vee-finance-suffers-35m-hack (same); McKenzie Sigalos, *Solana Suffered Its Second Outage in a Month, Sending Price Plunging*, CNBC (June 1, 2022), https://www.cnbc.com/2022/06/01/solana-suffered-its-second-outage-in-a-month-sending-price-plunging.html (describing DeFi blockchain's response to outage).

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