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before the

U.S. Senate Committee on Agriculture, Nutrition and Forestry

"Stakeholder Perspectives on Federal Oversight of Digital Commodities"

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Mr. Chairman and Ranking Member Klobuchar, members of the committee and staff, thank you for inviting me to testify today.

Introduction

I welcome this hearing as an opportunity to rethink our approach to the question of how should we regulate digital assets. Congress needs to pass legislation, but the latest proposal—the Clarity Act—is not the right approach.

The need to improve federal regulation has been apparent for years. The lack of federal regulation for the spot market in so-called digital commodities—or digital tokens that are not securities—has led to a high degree of fraud, manipulation and lack of investor protection, as well as rampant speculation. I have spoken about this gap since shortly after I became chairman of the Commodity Futures Trading Commission (CFTC) in 2014 and we declared bitcoin to be a commodity.[1]

Meanwhile, industry representatives have repeatedly claimed that the lack of clarity in regulation is stifling innovation, driving talented individuals and businesses offshore, and causing the United States to fall behind.

But despite the obvious need for investor protection, and the many calls for clarity, there has not been a consensus on the way forward.

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[1] *See* Timothy Massad, *It's Time to Strengthen the Regulation of Crypto-Assets*, The Brookings Institute, p. 2 (Mar. 2019), https://www.brookings.edu/research/its-time-to-strengthen-the-regulation-of-crypto-assets/ (hereinafter "Massad 2019"). I have also spoken about this gap in numerous Congressional appearances. *See for example* my testimony before the Subcommittee on Digital Assets, Financial Technology and Inclusion of the U.S. House of Representatives Financial Services Committee and the Subcommittee on Commodity Markets, Digital Assets and Rural Development of the U.S. House of Representatives Committee on Agriculture, "The Future of Digital Assets: Measuring the Regulatory Gaps in the Digital Asset Market," May 10, 2023, https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408754 ("2023 Testimony").

The problem is most of the legislative proposals to date have taken us down the wrong road. Whether it was Lummis-Gillibrand, FIT 21 or the latest proposal—the Clarity Act—they have all assumed that legislation can draw a simple, fixed line between so-called digital securities and digital commodities that will provide the desired clarity forever. They have proposed rewriting the securities laws in various ways to achieve this objective. The latest proposal—the Clarity Act—also has many exemptions from existing law and other incentives to promote investment in digital assets. But this approach will not achieve clarity, nor the regulation that we need, and it will undermine existing regulation of our securities and commodities markets.

We need a different approach. It starts with recognizing a few fundamental facts.

First, this is a technology, not an asset class. We often speak of "digital assets," but there is no specific asset class that is distinctly "digital." Tokenization and blockchain are already being used in various ways and the use cases will expand. Some of the most valuable use cases will be in tokenizing traditional securities. We are already seeing tokenized money market funds and stocks.

Second, whether something in digital or tokenized form is a security, a commodity or neither cannot be easily defined by a paragraph or two in a statute. The appropriate regulation should depend on considering a number of factors like what the token represents, whether there is an issuer, whether the transaction involves raising capital, and whether it is even a financial instrument. Legislation can set some general principles, but it should not try to write definitive rules.

Third, the technology and use cases are rapidly evolving. We should not lock in statutory definitions that will prove obsolete soon, nor tie regulators' hands.

Fourth, a principal reason for the lack of clarity is our fragmented regulatory system. Most jurisdictions have one financial market regulator, which can make it easier to deal with innovations that cross product or other jurisdictional lines. The single regulator comes up with new rules to address the innovation. We have two market regulators, the Securities and Exchange Commission (SEC) and the CFTC, neither of whom has the authority to regulate the spot market for digital assets that are not securities. The crypto industry has taken advantage of this gap by arguing that most digital assets are not securities and can therefore be issued and traded without regulation. If, however, we create a regulatory framework for the spot market for non-security tokens, the stakes on classification choices will be lower, and they will be easier to address.

Finally, we are in a different place today than the last few years. The primary regulatory response to date—court cases that seek to interpret the Howey test to show that a particular token is a security—has not been sufficient. It was a whack-a-mole strategy even when the particulars of a case made sense, as I wrote almost four years ago.[2] It required the SEC to bring one case

[2] *See* Massad, Timothy G. and Howell E. Jackson. "How to Improve Regulation of Crypto Today—Without Congressional Action—and Make the Industry Pay For It." *Hutchins Center Working Paper*, no. 79, October 2022 ("Massad-Jackson 2022"), p. 10.

after another to set standards—especially if industry participants constantly tweak tokens, protocols or activities to distinguish them from rulings where the SEC prevailed.

But the SEC has already abandoned "regulation by enforcement" and is actively engaged in exploring ways to customize rules and facilitate innovations involving blockchain and tokenization efforts. Congress should therefore not fight the last war. It should not try to displace or override what the SEC is already doing, but rather build on that work.

All of these factors argue for a different approach. Legislation should advance the goals of the Clarity Act in a different manner. It should (i) establish regulatory oversight over the non-security spot market without rewriting the definition of securities, (ii) set forth general principles for classification and regulation and (iii) mandate the ways by which the SEC and CFTC should work together to address these issues.

Two years ago, Jay Clayton, the former SEC chair appointed by President Trump, and I said that the critical way forward was to have Congress require the SEC and CFTC to work together to develop joint standards, and apply those standards to any intermediary that trades bitcoin or Ether—the two most economically significant tokens whose status as non-securities is generally agreed upon.[3] That is the jurisdictional "hook". In this way, we wrote, we can establish a regulatory framework over all relevant platforms "without first debating classification of each token or Congress pursuing tortured rewriting of existing definitions of securities and commodities." The rules would apply to *all tokens* traded on such platforms, with the proviso that the SEC would retain jurisdiction over tokens that were securities. We warned that rewriting existing law "might fail to bring clarity and inadvertently undermine decades of regulation and jurisprudence as they apply to traditional securities and commodities markets." [4]

The Clarity Act, like similar proposals before it, unfortunately does exactly the things we warned against. It is not a question of whether it "might" fail to bring clarity and undermine decades of regulation. It is clear that it would, as I explain below.

It is vital for legislation to mandate that the SEC and CFTC work together, and to set forth the means for doing so, to ensure we develop consistent regulatory requirements and can properly address the sometimes difficult line-drawing questions. This should include but not be limited to mandating joint rulemaking, within minimum time frames. It should include creation of a jointly overseen self-regulatory organization to administer rules on trading of digital assets (similar to what was contemplated in the Lummis-Gillibrand proposal). [5] It could also mandate a joint committee with shared staff, or the appointment of common commissioners to lead reform efforts. For decades, there have been proposals to merge the two agencies.[6] We may not wish

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[3] See also text at note 20.

[4] *See* Clayton, Jay and Timothy Massad. "A Path Forward for Regulating Crypto Markets." *Wall Street Journal*, 7 July 2023 , and also Clayton, Jay and Timothy Massad, "How to Start Regulating the Crypto Markets—Immediately." *Wall Street Journal*, 4 December 2022.

[5] *See* Massad-Jackson 2022, note 2. I also proposed the SRO concept in my testimony in May 2023. *See* note 1. *See also* Lummis-Gillibrand Responsible Financial Innovation Act , S. 4155, 118th Congress ("Lummis-Gillibrand), Title VI, at https://www.congress.gov/bill/118th-congress/senate-bill/4155.

[6] There have been many proposals over the years calling for a merger of the two agencies or at least better coordination between them because of gaps in oversight, lack of coordination, inefficiencies or other problems

to take that radical step, but legislation must set forth the mechanisms by which they should work together.

An SRO does not mean the industry would govern itself. Consistent with U.S. practice since the 1930s, this SRO would be closely supervised and overseen by regulators—in this case, by the SEC and the CFTC jointly. [7]

My testimony proceeds as follows:

First, I discuss two principles that should inform market structure legislation: it must do no harm to our existing markets, and it should be kept simple.

Second, I discuss why I believe the current approach—as exemplified by the Clarity Act, as well as earlier legislative proposals—violates both these principles and why it will not achieve the desired objectives. I provide several examples of the failings, and in particular the risk of undermining our existing capital markets, the foundation of the American economy. Further detail is provided in Appendix I.

Third, I explain the alternative approach I am suggesting, which is similar to what former SEC Chair Jay Clayton and I advocated two years ago.

Fourth, I discuss the risks of illicit activity, a subject that unfortunately gets very little attention in these proposals, as well as the risk of financial instability arising from this sector.

Finally, I conclude with a discussion of the President's crypto activities, which should not be ignored in any discussion of how to regulate the digital asset market.

The Importance of Doing No Harm and Keeping Things Simple

There have been several proposals for the principles that should inform market structure legislation. These typically refer to the goals of achieving clarity and promoting innovation.[8] I suggest two other principles that are critical: do no harm and keep it simple.

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arising from having two market regulators. *See, for example,* Report of the President Task Force on Market Mechanisms (under Treasury Secretary Nicholas Brady in 1988) recommending greater coordination; the U.S. Treasury, Blueprint for a Modernized Financial Regulatory Structure (under Treasury Secretary Henry Paulson in 2008) recommending a merger; The Group of Thirty Report: Financial Reform: A Framework for Financial Stability, (chaired by former Federal Reserve Board chairman Paul Volcker in 2009), recommending a merger; the U.S. Government Accountability Office, Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System (2009), recommending merger or better coordination; the Financial Crisis Inquiry Commission Report of 2011 (highlighting problems caused by having two regulators); and the U.S. Treasury, A Financial System That Creates Economic Opportunities: Capital Markets, (under Treasury Secretary Steve Mnuchin in 2017), calling for greater harmonization. This is a good time to take a simple step to institutionalize greater cooperation.

[7] *See* Massad-Jackson 2022, note 2, p. 4-7.

[8] *See* French Hill and Glenn GT Thompson, "A Blueprint for Digital Assets in America," Coindesk, April 4, 2025. https://www.coindesk.com/opinion/2025/04/04/a-blueprint-for-digital-assets-in-america.
Chairs Hill and Thompson proposed six principles, the first two of which were to promote innovation and provide clarity for the classification of assets. *See also* "Scott, Lummis, Tillis, Hagerty Release Principles for Market

Do no harm means making sure that any digital asset market structure legislation does not undermine our existing capital and derivatives markets. The U.S.'s $120 trillion equity and debt markets, together with our derivatives markets, are the foundation of the U.S. economy and the envy of the world. They directly impact the health and well-being of our citizens and our businesses. Their depth, liquidity and diversity has been the source of great innovation over the years—and probably more useful innovation since the launching of bitcoin fifteen years ago than has come from digital asset technology. Their strength and integrity rests on a legal regulatory framework that has been gradually and thoughtfully created over almost 100 years.

For all the talk about the innovative potential of digital asset technology, it is vital to maintain perspective about its relative role in our economy and the fact that it is a *technology*, not an asset class.

For example, consider that the collective market capitalization of the "Magnificent Seven" companies—Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla—is $16 trillion today. At the time bitcoin was launched in early 2009, two of these companies were not even public, and the other five had a collective market capitalization of just over $300 billion. Their collective growth (of over 5,000%) and the incredible innovation they have brought over that period is due in part to the strength of our capital markets.

Or consider the importance of the U.S. commodity futures and options markets—which is well known to this committee. These markets dominate global trading and are used around the world for price discovery, risk management and liquidity purposes. The Treasury futures market alone had an average daily notional value of contracts traded of $774 billion in 2024.[9] The world's oil markets depend on West Texas Intermediate and Brent crude oil futures contracts. Commercial hedgers and farmers depend on a wide variety of physical commodity futures products in the U.S. markets for crop prices and livestock costs.

Legislation that rewrites the definition of a security, or that creates new exemptions from regulation, in order to promote digital asset technology can easily undermine our securities markets. It can create fractures in the legal underpinnings of our markets that lead to evasion and destabilizing regulatory arbitrage as market participants seek to take advantage of new standards to avoid compliance obligations. I point out examples of how the latest proposal would do this below.[10]

Structure Legislation," June 24, 2025, https://www.banking.senate.gov/newsroom/majority/scott-lummis-tillis-hagerty-release-principles-for-market-structure-legislation. With all due respect, I believe their first principle exemplifies the wrong approach to trying to achieve "clarity": "A clear, economically rational line distinguishing digital asset securities from digital asset commodities should be fixed in statute, contemplating existing law and providing predictability, enhanced legal precision, and much-needed regulatory certainty."

[9] https://www.cmegroup.com/articles/files/2025/ir-liquidity-review-2024.pdf

[10] The desire to rewrite the definition of a security or revise the Howey test has been motivated in large part not by the *absence* of legal clarity as to what constitutes a security, but rather by a *dislike* of recent judicial decisions as to that standard. The fact is the SEC won most of its cases as to what constitutes a security, particularly in the context of primary offerings. A submission for a recent SEC roundtable documented in detail how the Howey test has been consistently applied in digital asset cases. *See* Lee Reiners, Prepared Statement for SEC's Crypto Task Force March 21, 2025 Roundtable titled "How We Got Here and How We Get Out – Defining Security Status" and Responses to

Similarly, if we adopt legislation that assigns the CFTC new responsibilities for overseeing trading of digital assets that are deemed to be commodities, and we fail to provide the agency with sufficient resources or support, that will inevitably detract from its ability to oversee the traditional commodity futures markets (in addition, of course, to making it difficult to regulate these new markets effectively).

If the CFTC is to have new responsibilities for the digital commodity spot market, it will need not only sufficient monetary resources; it will benefit from working more closely with the SEC because of the SEC's much deeper experience with regulation of retail markets. Moreover, having the CFTC work with the SEC will help minimize the risk that this new precedent--where the CFTC is involved in regulating a commodity spot market for the first time—leads to proposals or requests that it regulate *other* commodity spot markets.

Regarding the classification issue, it will be *easier* to determine whether a digital asset is a security or not if we fill the basic gap in regulation. Today, if a token is not deemed to be a security, then there is no investor protection framework that applies to the token. If we create reasonable regulation of the spot market for non-security digital assets, including appropriate disclosure requirements, then that reduces the importance, from an investor protection standpoint, of concluding that a token is a security. No longer will the choice be between securities regulation and no regulation. There is a long line of jurisprudence where courts have essentially created a "fifth prong" to the Howey test: where an alternative regulatory scheme exists, courts have said it is less critical to conclude that something is a security. In particular, this will make it easier to develop regulatory standards for investment contracts that incorporate tokens that are not traditional securities but are digital commodities, as I discuss below.

In addition, part of achieving clarity requires making sure that rules are technologically neutral. That is, if it is not clear *how* one complies with the law in the case of digital technology—as opposed to simply being unwilling to do so—regulators can and should address that. Whether the rules pertain to standards for tokenizing "real world assets," custody, clearing and settlement, recording and transfer of financial products or other areas, regulations should be technologically neutral. Once again, because these issues will arise for both the SEC and CFTC, the rules should be as consistent as possible.

The keep it simple principle calls for choosing a path forward that is most likely to achieve these goals most efficiently, with least risk of inadvertent harm. That means writing legislation that is not overly complicated, that establishes general principles, and that leaves to an administrative process the development of more detailed rules or guidance. Unfortunately, the Clarity Act, like other proposals previously issued, does not do this.

The Weaknesses of the Current Approach

"Security Status" Questions in SEC Commissioner Hester Peirce's February 21, 2025 Statement Titled "There Must Be Some Way Out of Here." https://www.sec.gov/files/ctf-input-reiners-2025-3-18.pdf

Most of the market structure legislative proposals that have been made to date have the faults that former SEC Chair Jay Clayton and I spoke of two years ago. They would undermine existing regulation and not achieve clarity. This is especially evident with the latest proposal, the Digital Asset Market Clarity Act of 2025 or the Clarity Act. It is an extremely complicated, 236-page bill. It is difficult to comprehend fully how its various provisions will interact. It will incentivize lawyers to spend huge amounts of time developing ways to exploit its provisions and engage in regulatory arbitrage strategies on behalf of their clients, in order to take advantage of lesser compliance burdens. (I was a corporate lawyer for 25 years with one of the top firms in the world and am very familiar with how complex legislation can be very susceptible to regulatory arbitrage.) In addition, it will not bring adequate regulation to the spot market in digital tokens that are not securities, nor give regulators the flexibility to address its shortcomings as they become obvious.

I have attached an appendix describing this in detail. I will summarize some key points here:

Classification Scheme Will Undermine Securities Regulation and Fail to Provide Clarity. The Clarity Act proposes to distinguish digital assets that are securities from those that are commodities through a scheme that rests partly on circularity: it defines "digital commodities" in part by excluding most securities, which is appropriate, but it separately redefines securities so that some securities are now digital commodities. It does this by rewriting the definition of "investment contract" to exclude "investment contract assets."[11] Those are defined as digital commodities sold as part of an investment contract.

The distinction between an "investment contract" and an "investment contract asset" is one the crypto industry has long sought. Implementing it in the manner proposed in the Clarity Act will likely lead to evasion and regulatory arbitrage. Even SEC Commissioner Hester Peirce (who has called for more crypto-friendly rules) has counseled against this type of approach, as discussed in the Appendix. But if the two agencies are working together, then it is easier to develop rules or guidance that address these situations. That is, the agencies can address when does an offering of an investment contract involve something that is and should continue to be treated as a security, and when does it involve something that is or will become a digital commodity, and make sure the appropriate rules apply.

In addition, the Clarity Act's definition of digital commodity excludes other categories of tokens currently traded on crypto trading platforms such as Coinbase. This means that platforms will be able to list unregulated tokens alongside regulated ones, which will result in confusion and lack of investor protection in trading, as discussed below.

Given the plethora of use cases we have already seen, it is also unlikely that the Clarity Act's definitions will cover all the uses and questions that will arise.

Broad Exemption from Securities Registration Requirements. The Clarity Act creates an exemption from the Securities Act for offerings to raise funds for the creation of "mature blockchain systems."[12] The conditions on the use of this exemption are lax—for example, one

[11] Clarity Act, Section 201.
[12] See Clarity Act, Section 202, and text at note 43.

need only have an "intent" to create such a system. There is little consequence if one does not actually build such a system. There is not even be a prohibition on general solicitation (that is, making offers to the public) as a condition for utilizing the exemption, as there typically is for private offerings. This and other minimal conditions mean the exemption will likely be used to evade registration requirements (as Commissioner Peirce has warned, as discussed in the Appendix). Moreover, there is no need for such an exemption since there are plenty of other exemptions that can be used to raise money.

Overly Broad DeFi Exemption Will Lead to Migration of Regulated Activity to an Unregulated Zone. The Clarity Act creates an exemption from the Securities Exchange Act and the Commodity Exchange Act for certain "decentralized finance" or "DeFi" activities that is massive in scope.[13] It would exempt from regulation activities related to a blockchain system or a decentralized finance trading protocol. A decentralized finance trading protocol refers to a software protocol, but the exemption refers not simply to developing or publishing such a protocol. It includes "constituting, administering, maintaining or otherwise distributing" such a protocol or a blockchain system. Creative lawyers will surely push for very expansive interpretations of those words. Moreover, the exemption generally pertains to "digital assets," not simply "digital commodities". Digital assets are defined broadly to cover essentially any token, and could include tokenized securities. Thus, one could imagine a large intermediary like Goldman Sachs creating a platform for the trading of tokenized securities that would not be subject to the requirements of the Securities Exchange Act.[14] In short, it will permit and encourage the migration of activity that is currently regulated to so-called "DeFi" platforms that are unregulated.

Regulation of "Spot Market" in Digital Commodities is Weak in Several Ways. Although the Clarity Act gives the CFTC the authority to regulate the spot market in digital commodities and requires certain intermediaries to register, the regulation it creates is far weaker than what is needed or than what we have for securities and derivatives markets today. Here are a few examples:

a. *Platforms Could Trade Non-regulated Tokens*. Platforms like Coinbase or Kraken would be subject to regulation if they trade at least one "digital commodity." But the regulation is likely to cover only a small portion of all the tokens they currently list and trade (which today is in the hundreds) or could list and trade (hundreds of thousands of tokens are created each year). That is because the definition of "digital commodity" is narrower than what is currently listed and traded, and the platforms would not be prohibited from trading these other unregulated tokens.

b. *Platforms Aren't Required to Own What Their Customers Buy.* The Act doesn't require trading platforms like Coinbase or Kraken to own the digital assets that their

[13] See Clarity Act, Sections 309 and 409, and text at note 46

[14] An institution like Goldman Sachs would need to avoid having "unilateral control" of such a platform, but there are a variety of ways that could be accomplished as discussed in the Appendix. The latest version of the Clarity Act published just a few days ago proposes a very slight narrowing of the corresponding exemption from the Commodity Exchange Act in Section 409, but it did not change the Securities Exchange Act exemption in Section 309.

customers acquire.[15] Most crypto trading today is "off-chain" —that is, it occurs through such platforms, which keep ledger accounts for their customers. It is not actually on a blockchain. The Act does not require the platforms to actually hold all the bitcoin that their ledger accounts say their customers own—which was one of the fraudulent practices that led to FTX's collapse.

c. *Platforms Aren't Prohibited from Engaging in Proprietary Trading.* The Act does not prohibit such trading platforms from engaging in their own proprietary trading, which can result in taking advantage of customers' orders.[16] What appears to be a prohibition is toothless because of the many exceptions to it. Our regulated securities and commodity derivatives exchanges are prohibited from doing this.

d. *The Act does not prohibit other conflicts of interest.* The Act has a general provision on conflicts of interest but does not contain any specifics, and leaves it up to the platforms to implement.[17] This means, for example, that platforms can have economic interests in the tokens they list, or investments in other businesses that might pose conflicts. We impose much tighter conflicts regulation on securities and commodity derivatives exchanges.

Control Standards are Very Weak. The Act contains several provisions that provide exemptions from regulation if something is decentralized or not controlled by a person, but the standards used to measure control are lax and contrary to longstanding securities jurisprudence. They are also difficult to even measure. There are many aspects of this, discussed in detail in the Appendix.

An Alternative Approach[18]

The alternative approach envisioned would involve Congress passing legislation that is designed to achieve several objectives. The **first** is to establish federal regulatory oversight of the spot market for digital commodities without rewriting the securities laws. Congress would:

— mandate that any trading or lending platform that trades or otherwise deals in bitcoin or ETH would be subject to the new regulatory framework as would any broker or dealer and certain other intermediaries, unless the platform or intermediary is registered with the SEC or CFTC as a securities or derivatives intermediary. (There could be de minimus exceptions for small actors.)

— mandate the core principles of that framework, which would serve as the basis for rules developed by the agencies. The core principles would be similar to those used in our securities and derivatives markets and those in the Clarity Act (though with appropriate revisions to correct the weaknesses in the Clarity Act noted earlier, such as with conflicts

[15] See text at note 49.
[16] See text at note 53.
[17] See text at note 55.
[18] I have benefited from conversations with Prof. Howell Jackson of Harvard Law School regarding this section. The statements and any errors are my responsibility only.

of interest). This would include principles on preventing fraud and manipulation, protecting customer assets, ensuring adequate disclosure, reporting and record keeping requirements, governance standards and operational resilience, among others; [19]

— mandate that those rules would apply to *all* digital asset tokens traded or used on or by any such platform or intermediary; and

— authorize a self-regulatory organization or SRO, to be jointly supervised by the SEC and CFTC, to enforce those rules.

This approach enables Congress to fill the gap in regulation, and provide the SEC and CFTC with the necessary authority, by using a simple way of resolving what has otherwise been a difficult problem: how does one define "non-security digital asset tokens" in order to create regulatory oversight of that market, without rewriting securities laws in ways that undermine traditional protections? The way to do so is for Congress to require that any trading platform or other intermediary transacting in bitcoin or Ether would be subject to this new spot market regulation. This will ensure that any significant intermediary is covered. [20] The rules would then apply to *all* digital asset tokens in which any such intermediary transacts, subject to certain carve outs. Any digital asset token that is deemed a security would not be included, could not be traded on a digital commodity exchange and would remain subject to the securities laws.

The questions of classification—of when is a digital token a security or something else—would still be addressed, but the federal regulatory framework for the spot market can be effectively and immediately established without resolving all those line-drawing questions permanently. The development of regulations implementing the core principles could be the subject of joint rule-making by the agencies or by the CFTC with input from the SEC. A jointly-supervised SRO could enforce those rules, with the agencies still retaining their authority, as is the practice today in our securities and commodities markets.

Second, the legislation would set general principles for resolving classification questions but leave the task of developing rules and guidance to the agencies. Once again, a joint process would be ideal; but alternatively the SEC could be given the lead responsibility as it already is doing. (It could also have the equivalent of a "right of first refusal" to determine that a digital asset token is a security and therefore must be traded on an SEC-registered platform or by an SEC-registered intermediary.) The principles could include factors such as (i) does the token represent an interest in a business (whether debt, equity or voting); (ii) does the transaction involve capital raising; and (iii) is there an ongoing issuer who can provide disclosure.

The issues pertaining to the treatment of investment contracts incorporating tokens that do not have the characteristics of traditional securities (such as not representing an interest in a business) in particular deserve the more nuanced approach that the SEC is already trying to bring to bear, versus writing a hard and fast line in legislation. A process where the agencies work

[19] See *also* Massad and Jackson (2022), *supra,* note 2, for a discussion of core principles for an SRO.

[20] Because bitcoin and ETH represent so much of the total crypto trading, any platform of consequence would be covered. But of course, other assets as to which there is a consensus that they are not securities could also be included for purposes of this jurisdictional provision.

together will be even better. If an investment contract incorporates something that is more like a digital commodity than a security, then we want to make sure that appropriate disclosure, trading and other rules apply to that "thing" particularly as it becomes more widely distributed. Regulatory requirements regarding a token might change over time or depending on context—disclosure and rules that apply to an initial offer and sale of a token, or to subsequent offers and sales where there is an issuer, may be different than in a resale context, particularly where the sale is not by a related person. But legislation should leave regulators with ample discretion to balance such factors and consider legitimate policy concerns, including the risk of cannibalization of traditional securities markets.

As noted above, the stakes of these classification choices will be much lower once a regulatory system for the spot market in digital commodities is in place. While the SEC would still rely on the Howey test and the other jurisprudence in this area, no longer will the choice be securities regulation or no regulation.

Although it is not expressly articulated as a fifth prong of the Howey test, Supreme Court cases have made clear that the existence of an alternative regulatory scheme can be an important factor in concluding that a financial instrument is not a security. For example, in Marine Bank v. Weaver, the Supreme Court held that neither a federally insured certificate of deposit nor a related agreement constituted a security in part because the CD was subject to a robust, alternative regulatory regime, and therefore it lacked the risk typically associated with a security.[21] Similarly, in International Brotherhood of Teamsters v. Daniel, the Supreme Court overturned a lower court ruling that held that participation in a non-contributory, compulsory pension plan was an investment contract and subject to the protections of the securities laws. The court said that the argument that securities regulation should apply was undercut by the fact that such plans are subject to extensive regulation under the Employee Retirement Income Security Act of 1974.[22] The existence of an alternative regulatory scheme reduces the importance, from an investor protection standpoint, of concluding that something is a security.

In addition to distinguishing between digital assets that are securities and those that are commodities, the agencies would also clarify when tokens are neither and are not financial instruments. This will minimize the risk that limited regulatory resources are focused on tokens that are not economically significant. The legislation should, however, consider to what extent consumer protection guidelines are needed for such other tokens, particularly given the scams and frauds that have occurred with meme coins.

The legislation would also create a process whereby entrepreneurs can receive clarity as to the appropriate classification of new digital assets within a reasonable period of time. This could be done through a joint SRO. For example, Lummis-Gillibrand provided that a member of a jointly-supervised SRO contemplated by the legislation could make a request of the SRO for "an initial determination of the legal character of a crypto asset as a security, an ancillary asset, a commodity . . .or as otherwise provided by law,"[23] which could be subject to review by the agencies.

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[21] Marine Bank v. Weaver, 455 U.S. 551 (1982)
[22] Teamsters v. Daniel, 439 U.S. 551 (1979)
[23] Lummis-Gillibrand, Section 603.

If the SEC and CFTC cannot reach agreement, the Secretary of the Treasury could be given authority to resolve disputes. Courts should be instructed to defer to these classification procedures.

Third, the legislation should direct the SEC and CFTC to develop technologically-neutral rules with respect to the use of tokenization and blockchain technology and to make such rules as consistent as possible between the agencies. Whether it is in the context of standards for the process of tokenizing an asset, reconciling blockchain and traditional ledger record-keeping, custody, clearance and settlement or AML/CFT compliance, securities and commodities rules should make it possible to utilize the technology efficiently. Rules should recognize the distinctive features of the technology and ensure that regulatory objectives are still met, even if in a different manner. But the rules need not promote the technology—let the market decide where it is useful.

Fourth, the legislation would authorize the creation of a new SRO and set forth provisions for its structure, governance and responsibilities. It would draw on the precedents that exist in both the Securities Exchange Act and the Commodity Exchange Act, except that this SRO would be jointly and closely governed by the SEC and CFTC. The board of governors should be diverse, and include not only representatives of digital asset market participants, but also traditional financial institutions, academics, public interest organizations, and others. The SEC and CFTC would approve the board of governors, the SRO's rules and its budget (though funding can be imposed on the industry consistent with our traditional SRO practice). Strong controls and governance provisions like these are critical to ensure the SRO is not vulnerable to capture by the industry. While a new SRO would be mandated, the SEC and the CFTC can draw on the expertise and staffing of existing SROs such as the Financial Industry Regulatory Association (FINRA) and the National Futures Association (NFA) in forming the entity.

Lummis-Gillibrand contained language for multiple "customer protection and market integrity authorities"—essentially SRO-like entities that would have been jointly overseen by the SEC and CFTC, and the bill drew on precedents in the Securities Exchange Act and Commodity Exchange Act regarding some issues of structure and governance.[24] While the purpose and responsibilities I am envisioning are somewhat different, those provisions could be a starting point for what is contemplated here. There could also be multiple SROs for the purpose of enforcing rules, as Lummis-Gillibrand contemplated, but the agencies may want certain functions left to a single, "head" SRO. This would be similar to what we have today with the Financial Industry Regulatory Authority and the National Futures Association, with exchanges often recognized as SROs as well for purposes of enforcing the rules on their own platforms.

Fifth, the legislation should not create a broad exemption for decentralized finance or DeFi. It should instead express the view that, because DeFi activity is a small part of the digital asset world today, the priority is the regulation of centralized intermediaries and the development of appropriate rules generally for the use of digital technologies. The legislation could also express the view that developing or publishing software is not in and of itself to be regulated. But because DeFi activity could grow quickly, we should put some broad guardrails around its

[24] See Lummis-Gillibrand, Title VI.

potential development. This could include making it clear that regulators have the authority to take action if decentralized protocols are being used as a means to evade rules that apply to centralized actors, or if such protocols are being used to migrate regulated activity to an unregulated sphere. It should also require the SEC and the CFTC to prepare a study and recommendations to Congress on the regulation of actors in the DeFi world. Ultimately, we should neither favor nor inhibit DeFi activity but make sure that regulatory objectives are achieved even if in a different manner. See also the discussion in the appendix.

Sixth, the legislation should address illicit finance risks, as discussed below.

The approach outlined above is a pathway to achieving investor protection quickly and comprehensively, and providing the necessary clarity to the industry. Congress would provide the overall direction and principles and give the agencies the authority and flexibility to carry out the job, building on the work the agencies are already doing.

Illicit Finance Risks

It is surprising to me how little is said about the risks of illicit finance in these three market structure proposals. When the GENIUS Act and STABLE Act were being considered recently, proposals were made to expand the authority of the Treasury Department to address illicit finance, particularly in decentralized finance activities. It is my understanding that sponsors of stablecoin legislation responded that those subjects should be addressed in market structure legislation instead. However, the Clarity Act did not do so. Similarly, Lummis-Gillibrand contains an entire title on combating illicit finance which calls for useful studies and research and creates an inter-agency working group, but it does not provide any significant new authority.[25]

The legislation should give the Treasury Department and market regulators ample authority with respect to preventing the use of digital assets for illicit finance or evasion of sanctions. This should include requiring crypto intermediaries to comply with the Bank Secrecy Act (BSA) and the International Emergency Powers Act (IEEPA), but it should not be limited to that because digital assets can be transferred on decentralized blockchains without the involvement of an intermediary. The authority needs to be broad and flexible for that reason.

In 2023, the Treasury Department proposed several ways in which its authority should be expanded, which could be included in this legislation. Among other things, it should make clear that Treasury has the authority to create a new sanctions tools, analogous to Correspondent Account or Payable-Through Account (CAPTA) sanctions, to deploy in the cryptocurrency space. Treasury's existing CAPTA authorities enable Treasury to prohibit U.S. correspondent accounts and transaction processing for certain financial institutions that have operated in the financial services sectors of certain economies or facilitated transactions for a designated entity, without requiring that all property and interests of the institution be blocked. Congress should make clear that these tailored authorities can be extended to foreign crypto exchanges and other crypto intermediaries.

[25] See Lummis-Gillibrand, Title III.

In addition, Congress should give OFAC the ability to block stablecoin transactions to the same extent as its existing power to block US dollar transactions, and extend BSA and IEEPA jurisdiction to foreign crypto intermediaries with U.S. touchpoints (though with possible provision for substituted compliance in the case of BSA obligations). Treasury should also have flexible authority to require domestic crypto actors that are not registered as money service businesses to comply with the BSA and IEEPA where such actors have the necessary control or authority to achieve regulatory objectives, such as custodial wallet providers. It should have authority to address the role of mixers, tumblers and other devices used to disguise identity. That can be coupled with a recognition that rules must strike a balance between preventing illicit finance and respecting individuals' privacy.

We also need creative approaches in the context of DeFi protocols. One is that suggested by Rebecca Rettig and Michael Mosier (former Acting Director of FinCEN and former Associate Director of OFAC, respectively) which is to require certain businesses that (a) are necessary to the transmittal of communications about DeFi transactions, (b) transmit a material portion of such communications and (c) offer this service for profit to take on additional illicit finance risk management practices, without becoming "financial institutions" subject to the BSA.[26] Similar responsibilities could be extended to businesses that are "front-ends" to, or that otherwise facilitate use of, DeFi protocols.

In general, the authority needs to be broad and flexible also because we do not know exactly how the sector and technology will evolve.

Financial Stability Risks

A comprehensive regulatory framework is also needed to minimize potential risks to financial stability. While the digital asset sector may be small in relation to the entire financial system today, it can grow quickly, and certainly proponents of the technology believe it will. Moreover, financial stability risks can arise from interconnectedness or contagion risks even when the scale of activity is not that large. To date, crypto trading has been characterized by rampant speculation and high volatility, contributing to dramatic price swings. Highly leveraged activity multiplies the risk, as does the lack of transparency. These factors can contribute to the build-up of risks and exposures that can escape prudential oversight. The pseudonymity of the blockchain is not equivalent to a regulatory framework that provides regulators with sufficient knowledge as to leverage, exposures and interconnections among institutions. The lack of a regulatory framework also allows for trading practices that can amplify risks: excessively leveraged trades; wash trading and other fraudulent and manipulative schemes that distort prices; centralized exchanges that can engage in front-running of customer orders or have interests in the tokens they list; and exemptions from regulation for so-called decentralized activity that allow for migration of regulated activity to an unregulated sphere. While detection of potential financial stability risks is never assured, the absence of a comprehensive regulatory framework means the job is nearly impossible.

[26] This proposal also contemplates designating truly autonomous DeFi protocols as "critical infrastructure" that would be subject to oversight. See Rettig, Rebecca, Michael Mosier and Katja Gilman, "Genuine DeFi as Critical Infrastructure: A Proposal for Combating Illicit Finance Activity in Decentralized Finance," January 29, 2024.

The President's Crypto Business Ventures

As we consider legislation to regulate the crypto markets, we cannot ignore the actions by President Trump to personally profit from crypto. These actions violate the ethical standards we have always expected our presidents to follow, and are especially of concern at a time when regulation of digital asset technology is such a prominent public issue.

The Trump meme coins were issued two days before inauguration and five days before the issuance of the Executive Order on Strengthening American Leadership in Digital Asset Technology.[27] It is hard to imagine an action that could have been more contrary to the spirit and opening words of that order, which is to "promote United States leadership in digital assets" and "responsible growth and use of digital assets."[28] The meme coins have been described as a "classic meme-coin pump and dump scheme."[29] They appear to serve no purpose other than the personal enrichment of the president. In the words of Vitalik Buterin, the creator of Ethereum, they are vehicles for "unlimited political bribery," because those seeking to curry favor with the Administration—whether they be individuals, companies or countries—may purchase the coins, knowing the President will profit from their actions, while they can still deny that seeking government favoritism was their purpose. Instead, they can claim they were merely speculating on a digital asset.[30] Crypto entrepreneur Justin Sun was reportedly one of the biggest investors in the token. He also is reported to have invested a total of $75 million in World Liberty Financial, including a $45 million investment in late January, 2025. The SEC lawsuit against him was dismissed in late February.[31]

Some have not even bothered to claim a purpose other than seeking influence. Texas transportation firm Freight Technologies Inc. announced the issuance of $20 million of bonds to finance the purchase of $TRUMP memecoins as an "effective way to advocate for fair, balanced, and free trade between Mexico and the US".[32] The reports concerning the dinner that the President held for the top 220 holders indicate he spent little time there and had little of substance to say, which suggests his crypto agenda is more about making a profit.

The Trump Organization's acquisition of World Liberty Financial and its issuance of a stablecoin is equally inappropriate and shocking, particularly as Congress works to pass

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[27] United States, Executive Office of the President [Donald J. Trump]. Executive Order 14178: Strengthening American Leadership in Digital Financial Technology. 23 January 2025. *Federal Register*, vol. 90, no. 20, pp. 8647-8650 ("Executive Order 14178").

[28] *Ibid.*

[29] Khalili, Joel. "The Trump Memecoin's 'Money-Grab' Economics." *Wired*, 20 January 2025 (citing interview with Jacob Silverman).

[30] Turner Wright, "Vitalik Buterin takes aim at "unlimited political bribery" using tokens," Cointelegraph, January 23, 2025, at https://cointelegraph.com/news/vitalik-buterin-unlimited-political-bribery-tokens

[31] Northrop, Katrina and Vic Chiang, "Who is Justin Sun, the Chinese Billionaire at Trump's Crypto Dinner?", The Washington Post, May 23, 2025, https://www.washingtonpost.com/world/2025/05/23/trump-crypto-dinner-justin-sun/

[32] "Freight Technologies Secures up to USD $20 Million to Create an Official Trump Token ($TRUMP) Treasury," Freight Technologies press release, April 30, 2025, https://fr8technologies.com/press-release/freight-technologies-secures-up-to-usd-20-million-to-create-an-official-trump-token-trump-treasury/

stablecoin legislation.[33] WLF's transactions are continuing at a fast pace: the investment firm MGX acquired $2 billion in WLF's stablecoin to make an investment in leading crypto exchange Binance. This took place shortly before the SEC dismissed its enforcement case against Binance and its founder Changpeng Zhao.[34] This purchase made the WLF stablecoin one of the largest in the market.[35] Another United Arab Emirates-related entity, Aqua 1 Foundation, recently invested $100 million in WLF tokens.[36] The various other business ventures that have been discussed in the press—such as the acquisition of bitcoin mining capacity—further suggest that the priority of the Administration is not promoting crypto innovation but promoting the President's personal enrichment.

This activity creates a cloud over the crypto industry, and over the enterprise of developing market structure legislation. Only Congress can address this and I strongly encourage Congress to do so.

Conclusion

The strength of our securities and commodities laws is in their flexibility, in their focus on function, and their ability to evolve with changes in financial markets and developments in new financial instruments. We need a new approach that builds on those strengths and does not undermine existing regulation.

Thank you for the opportunity to testify. I would be happy to take your questions.

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[33] The WLF stablecoin is technically issued by another firm, Bitgo, and thus WLF would likely not even be subject to the provisions of the GENIUS Act if passed. But that does not make the arrangement any less of a conflict of interest. See "USD-1, the Blueprint for Bitgo's Stablecoin as a Service," Bitgo press release, March 28, 2025, https://www.bitgo.com/resources/blog/usd1-the-blueprint-for-bitgos-stablecoin-as-a-service/

[34] Frederico Maccioni, "Trump's stablecoin chosen for $2 billion Abu Dhabi investment in Binance, co-founder says," Reuters, May 1, 2025, https://www.reuters.com/world/middle-east/wlfs-zach-witkoff-usd1-selected-official-stablecoin-mgx-investment-binance-2025-05-01/#:~:text=Speaking%20at%20a%20crypto%20conference,the%20world's%20biggest%20crypto%20exchange; Alexander Osipovich, "SEC Dismisses Lawsuit Against Binance," The Wall Street Journal, May 29, 2025, https://www.wsj.com/finance/currencies/sec-dismisses-lawsuit-against-binance-cce1dcae

[35] https://coinmarketcap.com/view/stablecoin/

[36] "Aqua 1 Announces $100M Strategic World Liberty Financial Governance Token Purchase to Help Shape and Accelerate Decentralized Finance Adoption," Reuters, June 26, 2025, https://www.reuters.com/press-releases/aqua-1-announces-100m-strategic-world-liberty-financial-governance-token-purchase-to-help-shape-and-accelerate-decentralized-finance-adoption-2025-06-26/

Appendix

How the Clarity Act Would Undermine Existing Regulation and Not Provide Adequate Regulation of the Digital Asset "Spot Market"

This Appendix provides more detail on the weaknesses of the Clarity Act discussed above. While I agree with certain goals of the Act—providing clarity in classification of the uses of digital technology and providing regulation of the spot market in non-security digital assets—I believe its provisions will not bring the desired clarity, nor sufficient regulation. Most important, I believe its provisions will undermine existing regulation of our securities and derivatives markets. The examples below focus in particular on that aspect. I also briefly note how other market structure proposals have addressed some of these issues for comparative purposes.

The "Classification Schemes" in these Proposals Will Not Provide Clarity Nor Sufficient Regulation of the Spot Market in Non-security Tokens. They Will Also Undermine Securities Regulation. The Clarity Act's classification scheme rests on circularity: it defines digital commodities so as to exclude most securities but separately redefines securities so that some securities are now digital commodities. It does this by rewriting the definition of "investment contract" to exclude "investment contract assets."[37] Those are defined as digital commodities sold as part of an investment contract.

Even SEC Commissioner Hester Peirce has recently warned of the dangers of carving out "investment contract assets" from the definition of securities in the context of secondary sales—and the dangers are obviously even greater if done generally:

> [T]reating all secondary sales of crypto assets as being free of the investment contract runs the risk of facilitating bad behavior: the dumping of crypto assets bought as part of an investment contract on retail investors while the crypto asset lacks function and its associated network or application remains centralized (and thus subject to information asymmetry concerns). If the initial holders are out of the picture because they have sold their crypto assets, the investment contract is unenforceable, and the issuer can dump its crypto assets too and walk away—wealthy and unaccountable—for completing the project.[38]

As noted earlier, it would be much better to develop guidance or rules as to when it is appropriate to distinguish between an investment contract and an investment contract asset, so

[37] Clarity Act, Section 201.

[38] Commissioner Hester Peirce, "New Paradigm: Remarks at SEC Speaks," May 19, 2025, at https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-sec-speaks-051925-new-paradigm-remarks-sec-speaks

that context, risks of regulatory arbitrage, appropriate disclosure rules and so forth can be taken into account.

It is worth noting that FIT 21 had an even more complicated classification scheme. It created two new categories of assets: restricted digital securities and digital commodities, the former to be regulated by the SEC and the latter by the CFTC. The test to determine how a token was classified had three components: the level of decentralization and functionality of the digital asset's associated blockchain system; how the digital asset was acquired by the holder; and who holds the digital asset (e.g., an issuer vs. an unaffiliated third party). This was an unworkable, subjective point-in-time test that would have bifurcated the market in particular tokens, could have meant the classification changed over time, and depended on information that wasn't available. It was roundly criticized and thus it is no surprise that it was discarded.

Lummis-Gillibrand created a new category called "ancillary assets" that were intangible assets issued in connection with an investment contract. It then classified those ancillary assets, subject to meeting certain criteria, as commodities.[39] It thus effectively carved out "investment contract assets" from the definition of investment contract.

The Clarity Act's definition of digital commodity is also vague, and its exclusions will likely mean the Act will only cover a small fraction of the tokens currently traded in the spot market—which means the regulation created by the Act will not be sufficient. The basic definition is a digital asset "intrinsically linked" to a blockchain and whose value "is derived from or is reasonably expected to be derived from a blockchain."[40] That could include just about any token. The exclusions, however, include one for "collectibles"—which likely includes meme coins—and digital assets that have value separately from their relationship to a blockchain system. In my conversations with staff involved in drafting the bill as well as experienced lawyers, no one knows for sure what the definition will cover, but they agree that universe is likely much smaller than what is listed and traded today.

Centralized platforms like Coinbase and Kraken each list several hundred tokens, for example. Although these platforms would be regulated as "digital commodity exchanges" under the Clarity Act, that Act does not prohibit them from listing and trading tokens that are not "digital commodities" and thus are not subject to regulation. That would mean a lack of investor protection and confusion on the part of the public: if you trade on a platform like Coinbase, some products are regulated and some are not, and you may not know which are which. Regulated platforms should not be allowed to trade products that are exempt from regulation.

Lummis-Gillibrand, which created a different classification scheme as noted above, also would have likely resulted in a regulatory scheme that would not cover all the digital tokens currently traded by existing centralized platforms.

[39] Lummis-Gillibrand, Section 501.
[40] Clarity Act, Section 103(a)(4).

The problem would be even greater with respect to decentralized exchanges or trading protocols that are exempted from regulation under these proposals.[41] The number of tokens that can be traded on those platforms is much, much larger since hundreds of thousands of tokens are created each year—Coingecko estimated that 600,000 were created in January of 2025 alone.[42] The solution is to curtail the broad exemption for DeFi in the Act.

The Clarity Act Creates New Exemptions From the Registration Requirements of the Securities Act That Are Not Justified and Will Undermine the Basic Framework of the Securities Laws.
The new exemptions from registration under the Securities Act are meant to be used for offerings to raise funds for the creation of "mature blockchain systems." They are further examples of the weakness of the bill because (i) the exemptions give preference to such offerings without justification; (ii) the conditions to their use will not ensure that the intended purpose is achieved; and (iii) the exemptions can be used to evade securities law registration requirements generally.

The Act creates a new Section 4(a)(8) of the Securities Act which exempts the offer and sale of an investment contract containing a digital commodity for the development of a blockchain system that is, or is intended to become, a "mature blockchain system."[43] The amount of funds that can be raised is quite high—$75 million over a 12-month period, or $300 million over four years. There is no apparent reason to create this special exemption. We have not traditionally created exemptions that are solely for a particular technology or business. There are many other private offering exemptions that can be and have been used to raise money for digital asset projects. To the extent that there is insufficient clarity as to the status of a native token of a blockchain once created, that could be achieved without creating a special exemption for the offering.

It is particularly troubling, however, that the exemption is available simply if one "intends" to create a mature blockchain system. There is no requirement that the funds actually be used for that purpose, and there appears to be no significant adverse consequence if the issuer fails to create a mature blockchain system.

In the same speech noted above, Commissioner Hester Peirce has warned that this type of exemption can easily be used to evade the securities laws:

> Companies looking at capital raising options might even be tempted to use such crypto asset sales instead of other capital-raising methods: promise to build a network or functional product, do a crypto asset presale to venture capitalists, stop developing the network or product once they have sold out to retail, and plow the proceeds of the initial crypto asset sale into building their actual business.[44]

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[41] The Clarity Act has a very broad exemption for "DeFi" activities, as did FIT 21, as discussed below. Lummis-Gillibrand prohibited regulated crypto asset exchanges from using decentralized platforms for trading unless such platforms met certain "risk-management" standards, but those did not appear to pertain to the tokens traded, and as noted earlier it did not generally regulate decentralized platforms. See Lummis-Gillibrand, Section 404.
[42] https://www.coingecko.com/research/publications/bobbys-crypto-aggregate-2025-02
[43] Clarity Act, Section 202.
[44] See note 38.

Note that Commissioner Peirce's example pertains to a secondary sale. The risks are even worse under the Clarity Act because it specifically exempts primary sales based on such promises.

The conditions on use of the exemption do not limit its possible damage nor justify its existence. While there is a requirement to provide certain disclosures, the SEC could provide guidance of this sort without creating a new exemption. Another condition is that after the completion of the transaction, a purchaser does not own more than 10 percent of the outstanding units. This suffers from the many flaws in the Act's treatment of "control" discussed below. The exemption also does not prohibit a general solicitation—that is, making offers to the public—nor does it contain limits on type or number of investors.

Lummis-Gillibrand contained a different regime for offers and sales related to ancillary assets.[45] Ancillary assets could be distributed in connection with an offer or sale of a security under an investment contract and could then be classified as commodities and subject to different disclosure requirements. While this was a narrower exception, it would likely have given rise to similar efforts to use it for purposes other than what its authors intended.

"DeFi" Exemptions Will Undermine Existing Regulation. The Clarity Act creates an exemption from the Securities Exchange Act and the Commodity Exchange Act for certain "DeFi" activities that is massive in scope.[46] (FIT 21 had a very similar exemption.) It is not simply for the development, or autonomous operation, of a software program for which the code is public—the type of exemption that some in the crypto industry have argued for. Rather, it covers a broad range of activities "in relation to the operation of a blockchain system or in relation to a decentralized finance trading protocol." For example, the exemption covers "developing, publishing, constituting, administering, maintaining or otherwise distributing" a decentralized finance trading protocol, a "liquidity pool" or software that "facilitate[es] an individual user's own personal ability to keep, safeguard or custody" digital assets. It is unclear what "constituting, administering, maintaining" mean in this context but one can be certain that creative lawyers will push for expansive interpretations. Moreover, the exemption is generally not limited to activities related to "digital commodities" but is instead applicable to "digital assets," which are defined as "any representation of value" recorded on a distributed ledger or similar technology. That would include tokenized securities, tokenized derivatives and other tokenized financial instruments.

Thus, a variety of intermediation or trading activities pertaining to conceivably any financial instrument in tokenized form could become exempt from the securities and commodities laws. This will encourage migration of all sorts of activities that are currently regulated to so-called "DeFi" platforms, and regulators will be powerless to stop it.

Lummis-Gillibrand also had an exemption for certain decentralized activities, though not quite as broad. The proposal also imposed some obligations on regulated crypto asset exchanges and futures commission merchants that transacted with or routed orders through such decentralized

[45] Lummis-Gillibrand, Section 501.
[46] Clarity Act, Sections 309 and 409.

platforms. But it did not impose those obligations on all businesses that might facilitate use of such platforms, nor set standards for such platforms generally.

There is no justification for broad DeFi exemptions. A principal argument often made is that activity that is autonomous and does not involve human actors exercising custody or discretion does not pose the same risks. But there are several flaws in this argument.

The first is that such an exemption—as with the use of the term "DeFi" generally—can cover all sorts of protocols, processes, activities and services that can vary tremendously with respect to the degree to which they are automated, decentralized or distributed, and with respect to the degree to which firms or human actors exercise control or discretion. Even with so-called autonomous protocols, there are centralization vectors or means of exercising control and discretion, such as administrative keys that permit modification of code or restrictions on access.[47] But in addition, these exemptions include activities that facilitate the use, distribution and operation of those autonomous protocols and that are offered or run by businesses, including "front-end" services. Those businesses may exercise control and discretion in various ways and can and should be touchpoints for regulation where necessary to achieve regulatory objectives.

For example, under the Clarity Act, one could imagine Goldman Sachs or some other large institution "administering" or "maintaining" a decentralized finance trading protocol that is for the trading of tokenized securities. Such an institution would need to structure the platform so that it is not in unilateral control, but this could be done by vesting a veto or certain other limited control rights in members or participants of the platform. (See discussion below of control issues.)

Secondly, while automation and ability for users to control assets may reduce certain types of risks that are often the targets of regulation, they may introduce others, and we must ensure that the regulatory goals of consumer and investor protection, market integrity and transparency, financial stability and prevention of financial crime are achieved, even if in a different manner. A simple example is to imagine a "decentralized" or automated platform for the trading of Treasury securities that becomes a dominant, and indeed systemically important, platform given the importance of the Treasury securities market. Even if such a platform truly was automated and not subject to the control of a human operator, and even if participants engaged in self-custody, we would still want to make sure various regulatory goals were achieved.

Proponents of making wholesale exceptions for "DeFi" also often ignore the fact that the "trad fi" world has experienced waves of automation before. We developed regulatory responses to automation and can do so again, even if this is a somewhat different type of automation. Our securities and derivatives markets have gone from manual floor trading to highly automated

[47] For an excellent discussion and analysis of the many ways that DeFi protocols and services are not decentralized, and instead have various types of what have been called "centralization vectors"—that is, ways in which some degree of control or discretion is exercised, including administrative keys that permit modification of code or restricting access, see Shuler, Katrin, et al. "On DeFi and On-Chain CeFi: How (Not) to Regulate Decentralized Finance." *Journal of Financial Regulation*, vol. 10, no. 2, 2024.

processes in just a few decades. Our rules have generally kept pace with an increasing diversity of trading platforms, faster speed, and less human involvement.[48]

Another argument that is made for a DeFi exemption is that the amount of "DeFi" trading of crypto is very small relative to trading on centralized platforms, so we should focus on the latter and not worry about the former. But the DeFi world could grow, and grow quickly, and an exemption written into a statute would be hard to change. The relatively small amount of activity today argues for regulators prioritizing the regulation of centralized platforms, not for exempting DeFi activity through legislation. Similarly, the right to self-custody of assets does not justify such a massive exemption.

DeFi protocols that engage in providing financial market services or transactions should meet, or have outcomes consistent with, the requirements we impose through regulation on similar "trad fi" services and transactions, even if the manner of meeting those requirements might vary.

These Proposals Fail to Create Adequate Regulation of the Spot Market for Digital Commodities in Many Other Ways as Well. Even to the extent that some tokens are deemed to be digital commodities, and platforms that trade even one digital commodity are required to register with the CFTC as a digital commodity exchange, the regulation that applies to those platforms is quite weak in numerous ways. Indeed, the drafters seem to have ignored the lessons of the collapse of FTX. Here are some examples:

These proposals do not appear to require the regulated exchanges to own the digital commodities (or other tokens) that their customers purchase and purportedly hold. The Clarity Act has a financial resources provision that requires exchanges to have "adequate financial. . . resources," including an amount "necessary to meet the financial obligations of the digital commodity exchange to all customers".[49] A separate provision requires the exchange to "treat and deal with all money, assets, and property that is received by the . . . exchange, or accrues to a customer, . . as belong to the customer".[50] Lummis-Gillibrand has similar provisions.[51] These provisions appear to mean that if a customer transfers a digital asset, such as bitcoin, to an exchange, the exchange must keep that digital asset or own a corresponding amount of it. But if the customer transfers dollars to the exchange and then purchases bitcoin, the exchange need only have value equivalent to the bitcoin so purchased.[52] Thus, a digital commodity exchange need not actually own the digital assets its customers think they own.

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[48] As an example, internalizers in the securities markets could be thought of as having certain similarities to the automated market makers of the digital asset world: they are large broker-dealers who fill orders from their own inventory rather than routing them to public exchanges. Internalizers have been made subject to order routing, best execution and payment for order flow requirements. Under Regulation SCI, an internalizer that operates a system critical to market infrastructure can be designated an SCI Entity which is then required to maintain robust cybersecurity, disaster recovery and reporting systems. While internalizers are centralized entities that provide a clear point of attachment for regulations, the regulatory response to them is an example of how we have responded to automation in the past and can do so again.

[49] Clarity Act, Section 404(c)(12).

[50] *Ibid.*, Section 404(d).

[51] Lummis-Gillibrand, Section 404.

[52] While the drafting is unclear, it may be that the exchange must have bitcoin in an amount equal to any *appreciation* on such bitcoin once purchased, but not for the original amount.

This risk reflects the fundamental characteristic of centralized platforms: trading is not "on-chain". That is, centralized platforms keep ledger accounts as to their customers' assets, much as a traditional exchange or bank would. They can have omnibus blockchain accounts in which they may hold—or claim to hold-- digital assets for multiple customers. But under these proposals the platforms need not actually own the assets. This is a significant risk.

Like its predecessor, the Clarity Act does not prohibit proprietary trading by digital commodity exchanges. Today's digital commodity exchanges often engage in their own proprietary trading, which leads to conflicts of interest with respect to the services they provide customers. They can front-run customer orders or take advantage of their customers in other ways. Our securities and derivatives laws generally prohibit securities and derivative exchanges from engaging in proprietary trading, and the same should be the case with digital commodity exchanges. Although the Clarity Act contains a prohibition on such activity, it contains an exception that swallows the rule. The exception covers trading that "is not solely for the purpose of the profit of the exchange," which an exchange could easily claim and regulators will be hard pressed to contest it. Indeed, transactions that "manage the credit, market and liquidity risks associated with the digital commodity business" as well as transactions "related to the operational needs" of the business of the exchange or its affiliate are explicitly excluded from the prohibition and thus eligible.[53]

Lummis-Gillibrand, issued in 2023, contained a prohibition on proprietary trading with only a "market-making" exception. FIT 21 contained a prohibition with a broader exception, and the Clarity Act broadened the exceptions even further.[54] The increasing breadth of the exceptions to the rule suggests the industry is getting its way.

The proposals do not prohibit other conflicts at digital commodity exchanges, such as having economic interests in the tokens they choose to list or in other ventures. Although the Clarity Act has general language requiring mitigation of conflicts of interest, exchanges are given substantial discretion in implementing the requirement.[55] Some crypto trading platforms have investments in other businesses, and this could mean they have investments or economic interests in the tokens (or issuers of the tokens) they list. This could lead to conflicts of interest in the determination of whether to list such tokens and how they should be traded or regulated. The other proposals have similarly not had strong prohibitions on conflicts of interest.

The Clarity Act's Control Tests Are Lax, Difficult to Verify and Contradict Longstanding Securities Law Principles. In addition to the control metric in the exemption for primary offerings to finance—or to promise to finance—mature blockchain systems, the Clarity Act has various other provisions related to showing the absence of control, such as the criteria for certifying a mature blockchain system.[56] All of these are flawed. Many of these flaws were also in FIT 21.

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[53] Clarity Act, Section 404. See proposed Section 5(i)(B)(2) of the CEA.
[54] Lummis-Gillibrand, Section 404; FIT 21, Section 504.
[55] Clarity Act, Section 404. See proposed Section 5(i)(c)(11) of the CEA.
[56] Clarity Act, Section 205.

The first problem is that the test for the absence of control in several places contradicts decades of securities law regulation by combining two concepts that are traditionally distinct, separate measures of control—that of a "group of persons" and being "under common control." A group can exist by virtue of an agreement (whether or not written) or other understanding, whereas common control refers to structural relationships among entities, such as sister subsidiaries. By combining these two concepts—in the Clarity Act, a group of persons must themselves be under common control to trip the standard—the Act creates a weak standard.[57] One could have an agreement or understanding among several persons to exercise control, but if they themselves are not under common control—i.e., not already part of the same corporate family—there would be no control, and no violation of the standard.

The measure of control is weak in another respect: a person or group of persons under common control must own or be able to direct the voting of 20% or more of the units of the digital commodity or voting power, respectively, in order for there to be control.[58] This 20% threshold also contradicts longstanding securities law interpretations, in which control depends on facts and circumstances, but a 5% threshold triggers a presumption of control for purposes of being required to file a form 13D or 13G.[59]

Moreover, the test further weakens the notion of control by providing that control does not exist unless a person or group of persons under common control has *"unilateral authority"* (emphasis added) to restrict access, alter the blockchain or direct the voting of 20% or more of the voting power.[60] A person or group could therefore have effective control simply by vesting a veto power or similar right in some other person or group that might be difficult or unlikely to ever be exercised. One could do this in multiple ways, such as requiring a supermajority where it is difficult to achieve such consensus or exercise such power, or vesting the right in friendly hands (particularly easy to do given the Act's ignorance of what a "group" traditionally is in securities laws), etc. Nevertheless, the mere existence of the veto would mean that "unilateral authority" did not exist.

Similarly, no person or group of persons under common control can have "*unique* permission or privilege to alter the functionality, operation or rules of the blockchain system" (emphasis added). This standard could also be avoided by creation of a veto right. In addition, the standard allows alterations that "address errors, regular maintenance or cybersecurity risks" or that are adopted through a "decentralized governance system" anyway.[61]

Perhaps the biggest—and certainly most ironic-—problem in the whole construct of a "mature blockchain system" and the control standards in the Clarity Act is the assumption that control can even be measured when information as to the beneficial ownership of tokens is not available.

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[57] This change to basic standards of control in the securities laws runs throughout the Clarity Act. In addition to appearing several places in the definition and certification process for a mature blockchain system, it is also found in the definitions of a decentralized governance system (Section 101), a decentralized finance trading protocol (Section 103) and a blockchain control person (Section 412).

[58] This is in the context of certifying a mature blockchain system. *See* Section 205. The percentage for use of the primary offering exemption is 10%, which is still twice the 13D/13G standard. *See* Section 202.

[59] *See* Rule 405 under the Securities Act.

[60] Clarity Act, Section 205.

[61] Ibid.

How can one even apply the metrics when blockchain addresses are pseudonymous and beneficial ownership is not known? Ownership that exceeds the metrics or thresholds is therefore easy to disguise, which means the Act's requirements can be easily evaded.