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Digital Assets and SEC Regulation

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Digital Assets and SEC Regulation

SUMMARY

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In recent years, financial innovation in capital markets has fostered a new asset class—digital assets—and introduced new forms of fundraising and trading. *Digital assets*, which include *crypto-assets*, *cryptocurrencies*, or *digital tokens*, among others, are digital representations of value made possible by cryptography and distributed ledger technology. Regardless of the terms used to describe these assets, depending on their characteristics, some digital assets are subject to securities laws and regulations.

Securities regulation generally applies to all securities, whether they are digital or traditional. The Securities and Exchange Commission (SEC) is the primary regulator overseeing securities offerings, sales, and investment activities. The SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The existing securities regulatory regime generally aligns with this mission, and the SEC's digital asset regulation generally follows the same regime. The SEC has used existing authorities to evaluate new product approval, provide individual regulatory relief, and solicit public input for policy solutions more tailored to digital assets.

Digital assets have a growing presence in the financial services industry. Their increasing use in capital markets raises policy questions regarding whether changes to existing laws and regulations are warranted and, if so, when such changes should happen, what form they should take, and which agencies should take the lead. The current innovative environment is not the regulatory regime's first encounter with changing technology since its inception in the 1930s. Some technological advancements led to regulatory changes, whereas others were dealt with through the existing regime.

The general consensus is that regulatory oversight should be balanced with the need to foster financial innovation, but securities regulation's basic objectives should apply. In addition, some believe that certain digital asset activities that may appear similar to traditional activities nonetheless require adjusted regulatory approaches to account for particular operating models that may amplify risks differently. In general, policymakers contending with major financial innovations have historically focused on addressing risk concerns while tailoring a regulatory framework that was flexible enough to accommodate evolving technology. Current developments that raise policy issues include the following:

Initial coin offerings (ICOs). ICOs as a digital asset fundraising method can be offered in many forms using existing public and private securities offerings channels. Although ICOs may be useful fundraising tools, they raise regulatory oversight and investor protection concerns.

Digital asset "exchanges." Some industry observers perceive digital asset trading platforms as functional equivalents to the SEC-regulated securities exchanges in buying and selling digital assets. But these platforms are not subject to the same level of regulation, suggesting that they may be less transparent and more susceptible to manipulation and fraud.

Digital asset custody. Custodians provide safekeeping of financial assets and are important building blocks for the financial services industry. Digital assets present custody-related compliance challenges because custodians face difficulties in recording ownership, recovering lost assets, and providing audits, among other considerations. The SEC is aware of the challenges and is engaging stakeholders to discuss potential issues and solutions.

Digital asset exchange-traded funds (ETFs). ETFs are pooled investment vehicles that gather and invest money from a variety of investors. ETF shares can trade on securities exchanges like a stock. Currently, digital assets themselves are generally not sold on SEC-regulated national exchanges. However, if portfolios of digital assets were made available as ETFs, they may be sold on national exchanges. The SEC has not yet approved any digital asset ETFs because of market manipulation and fraud concerns.

Stablecoins in securities markets. Stablecoins are a type of digital asset designed to maintain a stable value by linking its value to another asset or a basket of assets. Issues concerning stablecoins include market integrity, investor protection, payments, financial stability, and illicit activity prevention. Three legislative proposals relating to securities regulation were discussed at a House Committee on Financial Services hearing: the first proposal (H.R. 5197) would subject stablecoins to securities regulation; the second draft proposal would limit public company executives' access to stablecoins; and the third proposal (H.R. 4813) would prevent "Big Tech" firms from offering financial services or issuing digital assets.

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What Are Digital Assets?

Digital assets are assets issued and transferred using distributed ledger or blockchain technology.[1] They are often referred to as *crypto-asset*, *digital token*, or *cryptocurrency*, among other terminology.[2] Digital assets can be securities, currencies, or commodities. Although market participants use different terms to describe them, financial regulators have stated that—regardless of what they are called—financial activities, services, and market participants must adhere to applicable laws and regulations. In the case of digital assets, depending on their characteristics, this can include securities laws and regulations.[3] One key difference between digital and traditional assets is an asset's ownership and exchanges of ownership. Whereas traditional assets are generally recorded in private ledgers maintained by central intermediaries, digital assets' ownership and exchange are generally recorded on a decentralized digital ledger.

Digital Assets as Securities

The Securities and Exchange Commission (SEC) is the primary regulator overseeing securities offers, sales, and investment activities, including those involving digital assets. However, not all digital assets are securities. In general, a security is "the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others."[4] When a digital asset meets the criteria defining a security, it would be subject to securities regulation. For example, most of the initial coin offerings (ICOs) are securities, but Bitcoin is not a security, mainly because it does not have a central third-party common enterprise.[5]

Market intermediaries (e.g., investment advisers, trading platforms, and custodians) involved with digital asset investment, trading, and safekeeping could also be subject to relevant securities regulation. Securities regulations could apply if the intermediaries are directly engaged in the security-based digital asset transactions or if they use digital assets (including non-security-based digital assets) to facilitate securities transactions.[6]

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[1] U.S. Securities and Exchange Commission (SEC), *Framework for "Investment Contract" Analysis of Digital Assets*, April 3, 2019, at https://www.sec.gov/files/dlt-framework.pdf. For more information on blockchain technology, see CRS Report R45116, *Blockchain: Background and Policy Issues*, by Chris Jaikaran.

[2] Board of the International Organization of Securities Commissions, *Issues, Risks and Regulatory Considerations Relating to Crypto-Asset Trading Platforms*, May 2019, at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD627.pdf.

[3] SEC, "Leaders of CFTC, FinCEN, and SEC Issue Joint Statement on Activities Involving Digital Assets," public statement, October 11, 2019, at https://www.sec.gov/news/public-statement/cftc-fincen-secjointstatementdigitalassets#_ftn4.

[4] For more details, see SEC, *Framework for "Investment Contract" Analysis of Digital Assets*, April 3, 2019, at https://www.sec.gov/files/dlt-framework.pdf.

[5] SEC Division of Corporate Finance Director William Hinman, "Digital Asset Transactions: When Howey Met Gary (Plastic)," speech delivered at Yahoo Finance All Markets Summit: Crypto, San Francisco, CA, June 14, 2018, at https://www.sec.gov/news/speech/speech-hinman-061418.

[6] For example, a digital asset securities trading platform could be subject to securities regulation. Bitcoin is not a security, but the Bitcoin exchange-traded fund share is a security, and would be subject to securities regulation. In addition, as SEC Chairman Jay Clayton has stated, "regulated financial entities that allow for payment in cryptocurrencies, allow customers to purchase cryptocurrencies on margin or otherwise use cryptocurrencies to facilitate securities transactions should exercise caution, including ensuring that their cryptocurrency activities are not undermining their anti-money laundering and know-your-customer obligations." SEC Chairman Jay Clayton, *Chairman's Testimony on Virtual Currencies: The Roles of the SEC and CFTC*, February 6, 2018, at https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-

This report focuses on digital assets and activities that are subject to securities regulation. It discusses the objectives and policy rationale of securities laws and regulations; SEC initiatives to address specific regulatory challenges arising from certain unique digital asset features that raise questions concerning the adequacy of the existing regulatory framework; and policy issues for congressional and industry consideration in five selected areas: initial coin offerings, stablecoins, digital asset exchange-traded funds, digital asset custody, and digital asset trading.

Securities Regulation Background

Securities regulation generally applies to all securities and related intermediaries, whether they are digital or traditional. This section broadly discusses the objectives and policy rationale behind securities laws and regulations.

Congress established the SEC and the main framework for capital markets and securities regulation to restore market confidence after the stock market crash of 1929.[7] The regulatory framework's key objectives are to promote disclosure of important market-related information, maintain fair dealing, and protect against fraud.[8] As a result, the existing securities regulatory regime focuses on disclosure-based rules, an antifraud regime, and rules governing securities market participants (e.g., exchanges, broker-dealers, and investment advisors).[9] The SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.[10]

For example, one of the cornerstones of securities regulation—the Securities Act of 1933—is often referred to as the "truth in securities" law.[11] As the phrase suggests, disclosures allow investors to make informed judgments about whether to purchase specific securities by ensuring they receive financial and other significant information on securities offered for sale. The SEC does not make investment recommendations.[12] The disclosure-based regulatory philosophy is consistent with Supreme Court Justice Louis Brandeis's famous dictum that "sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[13]

The current developments in digital asset trading and fundraising are not the first time securities regulators have had to accommodate new technology. Capital markets infrastructure has experienced continuous innovation since the securities regulatory framework was first formed in the 1930s. For example, securities trading platforms experienced a major revolution in the late 1960s and early 1970s, when trading processes shifted from paper and pen-based manual settlements in isolated markets to electronic platforms, which incorporate new data-processing and communications technologies that link all markets together.[14] Congress responded to these

commission.

[7] The framework was established in the Securities Act of 1933 (P.L. 73-22) and the Securities Exchange Act of 1934 (P.L. 73-291). The terms *capital markets* and *securities markets* are used interchangeably in this CRS report.

[8] SEC, "What We Do," at https://www.sec.gov/Article/whatwedo.html.

[9] SEC Chairman Jay Clayton, "Remarks at the Economic Club of New York," New York, NY, July 12, 2017, at https://www.sec.gov/news/speech/remarks-economic-club-new-york.

[10] SEC, "About the SEC," at https://www.sec.gov/about.shtml.

[11] 15 U.S.C. §§77a et seq.

[12] SEC, *Registration Under the Securities Act of 1933*, at https://www.sec.gov/fast-answers/answersregis33htm.html.

[13] Louis Brandeis, "What Publicity Can Do," *Harper's Weekly*, December 20, 1913. For more on securities disclosure, see CRS In Focus IF11256, *SEC Securities Disclosure: Background and Policy Issues*, by Eva Su.

[14] Excerpt from Wyatt Wells, "Certificates and Computers: The Remaking of Wall Street, 1967 to 1971," *Business History Review*, vol. 74, no. 2 (Summer 2000), p. 193, at https://hbswk.hbs.edu/archive/the-remaking-of-wall-street-

advancements by amending Section 11A of the Securities Exchange Act to establish a national market system.[15] The congressional objectives were to encourage efficient, competitive, fair, and orderly markets that are in the public interest and protect investors.[16]

The SEC's Current Regulatory Approach

Although digital assets as a capital market innovation evolved quickly, the SEC to date has not been active in promulgating new digital-asset-specific rules. One rationale for this approach is that, because it is uncertain how the characteristics and use of digital assets will evolve, highly prescriptive regulations could become obsolete, and potentially inefficient.[17]

The SEC's current regulatory framework that governs traditional and digital securities include the Securities Act of 1933,[18] the Securities Exchange Act of 1934,[19] the Investment Company Act of 1940,[20] and the Investment Advisers Act of 1940.[21] It has also used existing tools and a number of initiatives besides rulemaking to address specific regulatory issues arising from certain unique digital asset features. The SEC's approaches include the following:

- **Innovation office.** The SEC created the Strategic Hub for Innovation and Financial Technology (FinHub) in 2018 to engage in financial technology (*fintech*), consolidate and clarify communications, and inform policy research. In 2019, FinHub conducted outreach meetings in multiple cities and published a framework for analyzing whether a digital asset is a security.[22]
- **Enforcement.** The SEC has brought enforcement actions against securities token issuers and digital asset traders and asset managers, among others. The SEC established a new Cyber Unit and increased its monitoring of and enforcement actions against illicit cyber-based transactions.

1967-to-1971; Testimony of former SEC Chairman Arthur Levitt, in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Preserving and Strengthening the National Market System for Securities in the United States*, hearings, 106th Cong., 2nd sess., May 8, 2000, at https://www.sec.gov/news/testimony/ts082000.htm; and Bob Pisani, "Man Vs. Machine: How Stock Trading Got So Complex," CNBC, September 13, 2010, at https://www.cnbc.com/id/38978686.

[15] 15 U.S.C. §78k-1 and P.L. 94-29.

[16] The Securities Acts Amendments of 1975 (P.L. 94-29) states that "It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure: economically efficient execution of transactions; fair competition among broker-dealers, among exchanges, and between exchanges and other markets; ready availability of quotation and transaction information to broker-dealers and investors; the ability of broker-dealers to execute orders in the best market; and an opportunity, consistent with the other goals, for investors to execute orders without the participation of a dealer."

[17] For example, statements by Jay Baris, Partner at Shearman & Sterling LLP. See page 46 of SEC FinHub Forum transcript at Bloomberg, *Securities and Exchange Commission Fintech Forum: Distributed Ledger Technology and Digital Assets*, June 3, 2019, at https://www.bgov.com/core/news/#!/articles/PSJCX08JMDC0.

[18] P.L. 73-22.

[19] P.L. 73-291.

[20] P.L. 76-768.

[21] P.L. 76-768. For more details on the SEC's existing regulatory framework see SEC, *The Laws That Govern the Securities Industry*, at https://www.sec.gov/answers/about-lawsshtml.html.

[22] SEC, *Framework for "Investment Contract" Analysis of Digital Assets*, at https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

- **No-action letters.** The SEC uses no-action letters to provide relief for digital-asset-related businesses and to signal its regulatory intentions to capital markets.[23] For example, the SEC issued a no-action letter to TurnKey Jet, a business-travel startup, stating that its issued tokens are not securities.[24] This was the SEC's first no-action letter for an ICO. The letter triggered a wave of industry discussions and could set a precedent for future digital asset activities.
- **Solicitation for public input.** The SEC released a letter to the industry in March 2019 to solicit public input regarding digital asset custody.[25] The comments may help the SEC understand the challenges the industry faces and assess investor-protection risks.
- **New product approval.** The SEC could approve or reject new digital asset products. For example, the SEC has reviewed Bitcoin ETF proposals in recent years and has consistently rejected such proposals as of 2019.[26]

Issues Raised by Digital Assets in the Securities Regulation Context

Digital assets and their use in capital markets are a growing presence in the financial services industry's development. They raise policy questions, including whether new digital-asset-related practices have outgrown or are sufficiently overseen by the existing regulatory system; how the regulatory frameworks can achieve a level playing field where the same businesses and risks could be subject to the same regulation;[27] and how to protect investors without hindering innovation.[28]

A fundamental understanding of innovative trends and the appropriate timing of the related policy actions are also important for digital asset regulation. In analyzing technological changes, some commentators suggest that society tends to overestimate a technology's effects in the short run and underestimate its effects in the long run.[29] This illustrates the delicate balance between social pressure for change and the appropriate timing for policy responses in the face of innovation.

This section explains key examples of digital asset developments and use cases, focusing on policy issues and legislative proposals in the securities regulation context. The most salient digital asset-related policy issues include regulatory oversight and investor protection.

[23] No-action letters are official communications stating a regulator does not expect to take enforcement actions against particular companies in certain situations.

[24] SEC, "Response of the Division of Corporate Finance," April 3, 2019, at https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm.

[25] SEC, "Engaging on Non-DVP Custodial Practices and Digital Assets," March 12, 2019, at https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206.

[26] For more on ETFs, see CRS Report R45318, *Exchange-Traded Funds (ETFs): Issues for Congress*, by Eva Su.

[27] Sabine Lautenschläger, "Digital Na(t)ive? Fintechs and the Future of Banking," speech at European Central Bank Fintech Workshop, Frankfurt, Germany, March 27, 2017, at https://www.bankingsupervision.europa.eu/press/speeches/date/2017/html/se170327_1.en.html.

[28] Some believe that reduced regulation could foster financial innovation. For example, the Token Taxonomy Act of 2019 (H.R. 2144) proposes the exemption of digital tokens from securities regulation.

[29] For example, the theorem of Amara's law. Oxford Reference, *Oxford Essential Quotations*, 2016, at https://www.oxfordreference.com/view/10.1093/acref/9780191826719.001.0001/q-oro-ed4-00018679.

Regulatory Oversight. Digital asset issuers and investors face a steep learning curve in comprehending the regulatory landscape and determining how or if securities laws apply to them.[30] It may not always be clear whether a digital asset is a security subject to SEC regulation. Multiple agencies apply different regulatory approaches to digital assets at the federal and state levels. For example, for certain digital assets, the SEC treats them as "securities," the Commodity Futures Trading Commission treats them as "commodities," and the Internal Revenue Service treats them as "property."[31] State regulators oversee digital assets through state money transfer laws, and the Treasury Department's Financial Crimes Enforcement Network monitors digital assets for anti-money laundering purposes.

Investor Protection. Digital asset investors—which may include less-sophisticated retail investors, who may not be positioned to comprehend or tolerate high risks—may be especially vulnerable to new types of fraud and manipulation, leading to questions about investor protection. First, there appears to be high levels of scams and business failures. A 2018 study from Satis Group, a digital asset advisory firm, found that 81% of ICOs were scams and another 11% failed for operational reasons.[32] Second, many digital asset companies offering securities do not comply with SEC registration and disclosure obligations, potentially affecting investors' ability to understand their risk exposures.[33] Third, the high volatility of digital assets' valuations can potentially result in large gains and losses, the risk of which may not be well understood by less-sophisticated investors. Lastly, digital assets operate outside the traditional financial system and thus may not offer common types of transaction protections. For example, banks may have the option to halt or reverse suspicious transactions and associate transactions with the users' identities, but a digital asset transaction is generally irreversible through such intermediaries.

Initial Coin Offerings

Businesses raise funding from capital markets through securities offerings, such as stocks, bonds, and digital assets. ICOs are a new fundraising mechanism in which projects sell their digital tokens in exchange for fiat currency (e.g., dollars) or cryptocurrency (e.g., Bitcoin).[34] A typical ICO transaction involves the issuer selling new digital "coins" or "crypto tokens" to individual or institutional investors. Investors pay for these tokens with either cryptocurrencies or traditional currencies. ICOs are often compared with initial public offerings (IPOs) of the traditional financial world because both are methods by which companies acquire funding. The main difference is that ICO investors receive digital assets in the form of virtual tokens or the promise of future tokens, unlike IPO investors who receive an equity stake representing company ownership. These coins or tokens are new digital currencies each company creates and sells to the public. Coin purchasers could redeem the coins for goods or services from crypto enterprises or

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[30] CRS In Focus IF11004, *Financial Innovation: Digital Assets and Initial Coin Offerings*, by Eva Su.

[31] For example, Bitcoin is not a security but a commodity, overseen by the CFTC's general anti-fraud and manipulation oversight and enforcement authority. CFTC, *Customer Advisory: Understand the Risks of Virtual Currency Trading*, at https://www.cftc.gov/sites/default/files/idc/groups/public/@customerprotection/documents/file/customeradvisory_urvct121517.pdf.

[32] Satis Group, *Crypto-asset Market Coverage Initiation: Network Creation*, July 11, 2018 at https://research.bloomberg.com/pub/res/d28giW28tf6G7T_Wr77aU0gDgFQ.

[33] Financial Industry Regulatory Authority, *Initial Coin Offerings (ICOs)—What to Know Now and Time-Tested Tips for Investors*, Investor Alert, August 16, 2018, at http://www.finra.org/investors/alerts/initial-coin-offerings-what-to-know.

[34] SEC, "Investor Bulletin: Initial Coin Offerings," July 25, 2017, at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings.

hold them as investments hoping the coins would increase in value. Although every crypto enterprise is different, they generally make transfers without an intermediary or any geographic limitation.[35]

Industry practitioners are increasingly using the term *security token offerings* (STOs) to describe ICOs.[36] This change of terminology reflects the industry's acceptance that many ICOs are securities offerings and thus subject to securities laws and regulations.[37] Securities laws require all securities offers and sales to either be registered under their provisions (as a public offering) or qualify for an exemption from registration (as a private offering).[38] ICOs can take many forms. They can be listed on national exchanges as public offerings or be issued pursuant to the private securities offering exemptions. Operational and regulatory conditions—including investor access, maximum offering amounts, and filing requirements—differ depending on the type of offering an ICO selects.[39] **Table 1** illustrates examples of ICO fundraising options. ICOs could potentially use all the existing securities offering venues. They have already reportedly been issued under several of the private exemptions (e.g., Regulation D, Regulation Crowdfunding, and Regulation A).[40] Although public offering ICOs are possible, as of year-end 2019, no ICOs have yet issued under this method. The previously discussed policy issues relating to regulatory oversight and investor protection also apply to ICOs.[41]

Table 1. Comparison of Selected ICO Securities Offerings Options

Type of Offering	Maximum Amount	Key Filing Requirements	Investor Access
Public Offering	No limit	Full SEC registration requirements, including, but not limited to, Regulation S-K (nonfinancial disclosure), S-X (financial disclosure), and S-T (electronic filing regulations).	Full Access

[35] SEC Chairman Jay Clayton, "Statement on Cryptocurrencies and Initial Coin Offerings," December 11, 2017, at https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

[36] Roger Aitken, "After 'Crypto's Winter', ICOs Growing Less But Maturing With Shift To STOs," *Forbes*, March 8, 2019, at https://www.forbes.com/sites/rogeraitken/2019/03/08/after-cryptos-winter-icos-growing-less-but-maturing-with-shift-to-stos/#3e666a687bcf.

[37] Terminologies change or evolve relatively rapidly in the digital assets industry. Other illustrative examples include Initial Exchange Offerings (IEOs), which are ICOs launched exclusively on digital trading platforms. SEC Division of Corporate Finance Director William Hinman, "Digital Asset Transactions: When Howey Met Gary (Plastic)," speech delivered at Yahoo Finance All Markets Summit: Crypto, San Francisco, CA, June 14, 2018, at https://www.sec.gov/news/speech/speech-hinman-061418.

[38] SEC, *Federal Securities Laws*, at https://www.sec.gov/page/federal-securities-laws?auHash=B8gdTzu6DrpJNvsGlS1-JY1LnXDZQqS-JgJAgaSXimg.

[39] For more details on public and private securities offerings, see CRS Report R45221, *Capital Markets, Securities Offerings, and Related Policy Issues*, by Eva Su.

[40] Paul Vigna, "SEC Clears Blockstack to Hold First Regulated Token Offering," *Wall Street Journal*, July 10, 2019, at https://www.wsj.com/articles/sec-clears-blockstack-to-hold-first-regulated-token-offering-11562794848, and Francine Mckenna and Katie Marriner, "ICO offerings way down, but some still using SEC back door to raise funds," *MarketWatch*, October 26, 2019, at https://www.marketwatch.com/story/ico-offerings-way-down-but-some-still-using-sec-back-door-to-raise-funds-2019-10-22?mod=francine-mckenna.

[41] For more on ICO legal background, see CRS Report R45301, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, by Jay B. Sykes.

Type of Offering	Maximum Amount	Key Filing Requirements	Investor Access
Initial Public Offering (IPO) On-Ramp	No limit, but subject to emerging growth company status eligibility	Scaled-down SEC registration, including test-the-waters provisions, two years rather than three years of audited financial statements, and certain reduced executive compensation disclosure provisions, among others.	Full Access
Regulation A-Tier 1	$20 million within 12 months	Form 1-A (an offering circular that contains information about the offering and the related risks, use of proceeds, business description, and financial statements, among other things). Financial statements disclosed in a Tier 2 offering must be audited, whereas financial statements disclosed in a Tier 1 offering can be unaudited.	Full Access
Regulation A-Tier 2 (Mini-IPO)	$50 million within 12 months		Nonaccredited investors subject to investment limits
Regulation Crowdfunding	$1,070,000 within 12 months	Form C (include two years of financial statements that are certified, reviewed, or audited, as required). Scaled disclosure requirements for offerings of $107,000 or less, $107,000-$535,000, and more than $535,000.	Does not specify accredited investor status, but subject to a range of investor income, net worth, and investment amount limitations
Regulation D-Rule 504	$5 million within 12 months	Form D (a brief notice that generally includes only the names and addresses of key personnel and some details about the offering).	Full Access
Regulation D-Rule 506	No limit	Form D	No more than 35 sophisticated but nonaccredited investors—506(b)

Source: Congressional Research Service (CRS), based on Securities and Exchange Commission's (SEC's) reporting.

Notes: The descriptions in the table apply to general conditions only; they are not inclusive of all conditions and exceptions. For more on defining *accredited investors*, see CRS In Focus IF11278, *Accredited Investor Definition and Private Securities Markets*, by Eva Su. For a more detailed listing of securities offerings, see Table 1 of CRS Report R45221, *Capital Markets, Securities Offerings, and Related Policy Issues*, by Eva Su.

Digital Asset "Exchanges"

About 300 platforms are offering digital asset trading and referring to themselves as "exchanges," as of December 2019.[42] A platform that offers trading in digital asset securities and operates as an "exchange" (as defined in the federal securities laws) must register with the SEC as a national securities exchange or obtain exemption.[43] However, many such platforms are registered as money-transmission services (MTSs) instead of SEC-regulated national securities exchanges. MTSs are money transfer or payment operations that are mainly subject to state, rather than

[42] CoinMarketCap, "Top 100 Cryptocurrency Exchanges by Trade Volume," at https://coinmarketcap.com/rankings/exchanges.

[43] The SEC states that "if a platform offers trading of digital assets that are securities and operates as an 'exchange,' as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration." For more details, see SEC, "Statement on Potentially Unlawful Online Platforms for Trading Digital Assets," March 7, 2018, at https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

federal, regulations.[44] Because MTS regulations were not designed with digital asset trading activities in mind, some argue that they are insufficient in regulating the transfer of digital assets.[45] In addition, these services raise investor-protection concerns because they are not subject to the more rigorous oversight as national securities exchanges.[46] The SEC issued a statement in 2018 clarifying that the online platforms for buying and selling digital assets that qualify as securities could be unlawful.[47]

These digital asset trading platforms face problems with fraud and manipulation. Some think applying SEC regulation would help, but others are concerned that regulation could stifle financial innovation.[48]

Digital Asset "Exchanges" Versus National Securities Exchanges

Although current technological advancements may seem to have blurred the terminology used, certain platforms trading digital assets that are securities appear to behave as functional equivalents to national securities exchanges. For example, these platforms bring together buyers and sellers, execute trades, and display prices. However, there are differences, such as the blockchain-enabled trading platforms operating without a central database and the fact that not all digital assets trading on platforms are securities.

The general consensus among domestic and international securities regulators regarding digital assets is that regulatory oversight should be balanced with the need to foster financial innovation. However, if digital asset trading platforms are buying and selling securities and fall within the SEC's regulatory regime, then securities regulation's basic objectives should arguably continue to apply.[49] In addition, some international authorities believe that, although digital asset trading platforms may face issues similar to traditional exchanges, regulatory approaches may still need to be adjusted to account for particular operating models that may amplify risks differently.[50] In general, policymakers contending with major financial innovations have historically focused on

[44] Marco Santori, "What Is Money Transmission and Why Does It Matter?," *Coin Center,* April 7, 2015, at https://coincenter.org/entry/what-is-money-transmission-and-why-does-it-matter.

[45] Peter Van Valkenburgh, "The Need for a Federal Alternative to State Money Transmission Licensing," *Coin Center Report,* January 2018, at https://coincenter.org/files/2018-01/federalalternativev1-1.pdf.

[46] A national securities exchange is a securities exchange that has registered with the SEC under §6 of the Securities Exchange Act of 1934. See SEC Fast Answers, *National Securities Exchanges,* at https://www.sec.gov/fast-answers/divisionsmarketregmrexchangesshtml.html.

[47] The SEC states that "if a platform offers trading of digital assets that are securities and operates as an 'exchange,' as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration." For more details, see SEC, "Statement on Potentially Unlawful Online Platforms for Trading Digital Assets," March 7, 2018, at https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

[48] SEC Commissioner Hester Peirce, *How We Howey,* May 9, 2019, at https://www.sec.gov/news/speech/peirce-how-we-howey-050919.

[49] SEC, *Statement on Digital Asset Securities Issuance and Trading,* November 16, 2018, at https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading, and Board of the International Organization of Securities Commissions, *Issues, Risks and Regulatory Considerations Relating to Crypto-Asset Trading Platforms,* May 2019, at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD627.pdf.

[50] G7 Working Group on Stablecoins, *Investigating The Impact of Global Stablecoin,* October 2019, at https://www.bis.org/cpmi/publ/d187.pdf.

addressing risk concerns while tailoring their regulatory framework flexibly to accommodate evolving technology.[51]

The differences between digital asset "exchanges" and the SEC regulated national securities exchanges could include transparency, fairness, and efficiency.[52] These are principles guiding the national securities exchange regulation, yet they are perceived as lacking for digital asset "exchanges."

Many digital asset "exchanges" are reportedly exaggerating their volumes on a routine basis to attract more participation.[53] Investors are perceived to have no idea whether the trading volume and prices reflect real activities or market manipulation. To take the more frequently studied digital asset Bitcoin for example,[54] one study shows that 95% of Bitcoin's trading volume displayed on digital asset price and volume aggregator CoinMarketCap.com is either fake or non-economic in nature.[55] Another widely cited academic study illustrates the scale of potential damage that digital asset market manipulations could create, underlining the investor-protection concerns in the digital asset space. The study argues that a single market manipulator likely fueled half of Bitcoin's 2017 price surge that pushed its price close to $20,000.[56] The activities were reportedly carried out through the largest digital asset "exchange" at that time, Bitfinex, and used a stablecoin called Tether to boost the demand for Bitcoin. For this alleged manipulation, Bitfinex and Tether faced a class complaint seeking a total of $1.4 trillion in damages.[57] Although Bitfinex and Tether rebutted the study, calling it "bogus,"[58] they are currently under investigation by federal and state regulators.[59]

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[51] 17 C.F.R. §§202, 240, 242, and 249. SEC, "Regulation of Exchanges and Alternative Trading Systems," 70844-70951, December 22, 1998, at https://www.federalregister.gov/documents/1998/12/22/98-33299/regulation-of-exchanges-and-alternative-trading-systems.

[52] For a more detailed list of principles relating to trading, see International Organization of Securities Commissions, *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation*, May 2017, at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD562.pdf.

[53] Olga Kharif, "On Crypto Exchanges, The Trades Don't Always Add Up," *Bloomberg*, July 25, 2019, at https://www.bloomberg.com/news/articles/2019-07-25/on-crypto-exchanges-the-trades-don-t-always-add-up.

[54] Bitcoin is a commodity rather than a security and is under the CFTC's general anti-fraud and manipulation oversight and enforcement authority. CFTC, *Customer Advisory: Understand the Risks of Virtual Currency Trading*, at https://www.cftc.gov/sites/default/files/idc/groups/public/@customerprotection/documents/file/customeradvisory_urvct121517.pdf. The SEC generally regulates securities transactions and their related intermediaries. The SEC does not have direct oversight of transactions in non-security currencies or commodities. SEC Chairman Jay Clayton, *Chairman's Testimony on Virtual Currencies: The Roles of the SEC and CFTC*, February 6, 2018, at https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission.

[55] Bitwise Asset Management, *Presentation to The U.S. Securities and Exchange Commission*, March 19, 2019, at https://www.sec.gov/comments/sr-nysearca-2019-01/srnysearca201901-5164833-183434.pdf.

[56] John Griffin and Amin Shams, *Is Bitcoin Really Un-Tethered?*, SSRN, October 28, 2019, at https://ssrn.com/abstract=3195066.

[57] Phillip Rosenstein, "$1.4T Bitcoin Manipulation Case Preposterous, Tether Says," *Law360*, November 15, 2019, at https://www.law360.com/articles/1220333/, and New York Attorney General, "Attorney General James Announces Court Order Against 'Crypto' Currency Company Under Investigation For Fraud," press release April 25, 2019, at https://ag.ny.gov/press-release/2019/attorney-general-james-announces-court-order-against-crypto-currency-company.

[58] Bitfinex, "Bitfinex Anticipates Meritless and Mercenary Lawsuit Based on Bogus Study," October 5, 2019, at https://www.bitfinex.com/posts/423.

[59] The Department of Justice (DOJ), Commodity Futures Trading Commission (CFTC), and New York Attorney General's office are reportedly investigating whether Tether was used to prop up Bitcoin's price. Shiraz Jagati, "How Severe Is Roche Freedman's Lawsuit Against Tether and Bitfinex?" *Cointelegraph*, October 11, 2019, at

Given the scale of such issues, some have questioned whether digital asset trading warrants more regulatory safeguards that protect investors and promote more efficient market operations.[60] It is difficult to predict the extent to which an SEC-regulated digital asset national exchange would have mitigated the market manipulations, or if the SEC's regulatory framework is the best fit for addressing all the digital-asset-trading-related policy concerns.[61] Still, digital asset "exchanges" under the current operating environment appear vulnerable to misconduct.[62] The Bitcoin price manipulation study's author, a finance professor with a background in forensics, said that "years from now, people will be surprised to learn investors handed over billions to people they didn't know and who faced little oversight."[63]

Current State of Play

The SEC took its first enforcement action against an unregistered digital asset "exchange" in 2018. The SEC stated that the platform "had both the user interface and underlying functionality of an online national securities exchange and was required to register with the SEC or qualify for an exemption," but was perceived to have failed to do so.[64]

Some of the largest digital asset "exchanges" have developed a system to rate digital assets based on the probability that they could be defined as securities.[65] These "exchanges" reportedly hope that by so doing they could exclude securities-based digital assets from their unregistered trading platforms, thus circumventing SEC securities regulation. This action is part of the digital asset industry's self-regulation discussion that is gaining momentum. For example, an international law firm's 2018 survey showed that the vast majority of the respondents thought the industry should formalize self-regulation and subject that self-regulation to regulatory oversight.[66]

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https://cointelegraph.com/news/how-severe-is-roche-freedmans-lawsuit-against-tether-and-bitfinex, and Matt Robinson and Tom Schoenberg, "Bitcoin-Rigging Criminal Probe Focused on Tie to Tether," Bloomberg, November 20, 2018, at https://www.bloomberg.com/news/articles/2018-11-20/bitcoin-rigging-criminal-probe-is-said-to-focus-on-tie-to-tether. For more on the SEC's discussions of the alleged manipulation, see SEC, *Release No. 34-87267 File No. SR-NYSEArca-2019-01*, October 9, 2019, at https://www.sec.gov/rules/sro/nysearca/2019/34-87267.pdf.

[60] For example, SEC Chairman Jay Clayton reportedly commented that "if [investors] think there's the same rigor around that price discovery as there is on the Nasdaq or New York Stock Exchange ... they are sorely mistaken ... we have to get to a place where we can be confident that trading is better regulated." Jeff Cox, "SEC Chairman Says He Doesn't See Bitcoin Trading on a Major Exchange Until It Is 'Better Regulated,'" CNBC, September 20, 2019, at https://www.cnbc.com/2019/09/19/jay-clayton-delivering-alpha.html. For more discussions on regulatory concerns, see Office of the New York State Attorney General, *A.G. Schneiderman Launches Inquiry Into Cryptocurrency "Exchanges*," April 17, 2018, at https://ag.ny.gov/press-release/2018/ag-schneiderman-launches-inquiry-cryptocurrency-exchanges.

[61] For example, the CFTC regulates the trading of digital assets that are commodities.

[62] Office of the New York State Attorney General, *A.G. Schneiderman Launches Inquiry Into Cryptocurrency "Exchanges*," April 17, 2018, at https://ag.ny.gov/pressrelease/ag-schneiderman-launches-inquiry-cryptocurrency-exchanges.

[63] Matthew Leising and Matt Robinson, "Lone Bitcoin Whale Likely Fueled 2017 Price Surge, Study Says," *Bloomberg*, November 4, 2019, at https://www.bloomberg.com/news/articles/2019-11-04/lone-bitcoin-whale-likely-fueled-2017-price-surge-study-says.

[64] SEC, "SEC Charges EtherDelta Founder With Operating an Unregistered Exchange," press release, November 8, 2018 at https://www.sec.gov/news/press-release/2018-258.

[65] Dave Michaels, "Cryptocurrency Exchanges Including Coinbase to Rate Digital Assets," *Wall Street Journal*, September 30, 2019, at https://www.wsj.com/articles/cryptocurrency-exchanges-including-coinbase-to-rate-digital-assets-11569835801.

[66] The surveys are conducted in March and April of 2018, 62 professionals completed the survey. Most respondents (61%) held executive titles or identified as investors or traders. Respondents were primarily based in the United States and ranged in age from their 20s to 50 and older. Foley & Lardner LLP, *2018 Cryptocurrency Survey*, at

Many digital asset trading platforms also reportedly sought to obtain exemptions from the SEC to operate as alternative trading systems (ATS).[67] ATSs are "dark pools" that do not publicly display the size and price of their orders.[68] ATSs face fewer regulatory requirements than national exchanges, but they must register as broker-dealers and meet certain SEC and Financial Industry Regulatory Authority (FINRA) compliance and filing requirements, such as custody, books and records, and regulatory examinations.[69] However, any ATS that transacts more than 5% of the trading volume of any security, which also trade on the national securities exchange system, could face stricter "order display" and "first access" rules that effectively integrate that ATS in part into the national market system.[70]

A number of the largest digital asset "exchanges" (e.g., Coinbase, Gemini, Bitstamp, and ItBit) have obtained state-level regulatory licenses (BitLicense) from New York State's Department of Financial Services.[71] The license requirements include certain investor protection, market fraud and manipulation prevention, and illicit activity prevention measures.[72]

Digital Asset Custody

Custodians provide safekeeping of financial assets. They are financial institutions that do not have legal ownership of assets but are tasked with holding and securing assets, among other administrative functions.[73] The SEC's custody rules impose requirements designed to protect client assets from the possibility of being lost or misappropriated. Custodians are important building blocks for the financial services industry. The custody industry for traditional assets is large and concentrated. In the past 90 years, financial custody has evolved from a system of self-custody to one in which major custodians provide asset custody for client accounts. Today, four banks (BNY Mellon, J.P. Morgan, State Street, and Citigroup) service around $114 trillion of global assets under custody.[74]

Digital-asset custody has recently attracted regulatory attention because the SEC custody rules could pose unique challenges for custodians of digital assets. The custody rules were developed for traditional assets, which are easier than digital assets to secure and produce tangible tracks of physical existence or records. Digital assets generally lack physical existence or records produced by intermediaries, as seen in traditional assets such as gold or bank accounts. Common practice in the digital asset industry so far focuses on safeguarding private keys, unique numbers assigned mathematically to digital asset transactions to confirm asset ownership.[75] This practice raises the

https://www.foley.com/files/uploads/Foley-Cryptocurrency-Survey.pdf.

[67] JD Alois, "Here Is The List of SEC Approved Alternative Trading Systems," *Crowdfund Insider*, April 23, 2019, at https://www.crowdfundinsider.com/2019/04/146721-here-is-the-list-of-sec-approved-alternative-trading-systems/

[68] SEC, *Alternative Trading Systems (ATSS)*, at https://www.investor.gov/additional-resources/general-resources/glossary/alternative-trading-systems-atss.

[69] SEC, *Alternative Trading System ("ATS") List*, at https://www.sec.gov/foia/docs/atslist.htm.

[70] 17 C.F.R. §§202, 240, 242, and 249.

[71] Robert Gutmann, Jonathan Knehr, Phillip Rapoport, and Ross Stevens, *Buying Bitcoin*, February 1, 2019, at https://ssrn.com/abstract=3346668.

[72] New York State Department of Financial Services, *Virtual Currency Business Activity (BitLicense)*, at https://www.dfs.ny.gov/apps_and_licensing/virtual_currency_businesses.

[73] §17(f) of the Investment Company Act and 17 C.F.R. §§270.17f-1-270.17f-7; 17 CFR §275.206(4)-2 and the SEC Customer Protection Rule or Rule 15c3-3 under the Securities Exchange Act of 1934 (P.L. 73-291).

[74] Fidelity Digital Assets, *Custody in the Age of Digital Assets*, October 2018, at https://www.fidelitydigitalassets.com/bin-public/060_www_fidelity_com/documents/FDAS/custody-in-the-age-of-digital-assets.pdf.

[75] Some financial institutions offer digital asset custody services. These service providers also consider the control of

question of how possession or control of a digital asset should be defined for regulatory purposes. The challenges include but are not limited to, for example, that a digital asset could have multiple private keys or that a single private key does not exist. As such, some believe the digital asset custody definition should go beyond the verification of the keys to incorporate holistic custody views.[76]

Regulators are currently evaluating whether custody requirements should be adjusted to account for digital assets' unique operational characteristics. The SEC released a letter to the industry in March 2019 to solicit public input regarding digital asset custody.[77] The SEC summarized a number of policy issues, including the use of distributed ledger technology (DLT) to record ownership, the use of public and private cryptographic key pairings to transfer digital assets, the ability to restore or recover digital assets once lost, the generally anonymous nature of DLT transactions, and the challenges posed to auditors in examining DLT and digital assets.[78]

On July 8, 2019, the SEC and FINRA, a self-regulatory organization, issued a joint statement to outline considerations for digital asset securities custody.[79] They acknowledged the challenges of applying custody requirements to digital assets and stated that there are initiatives underway to solicit input from market participants that could help develop new ways to establish "possession or control" for digital asset securities.[80]

Digital Asset Exchange-Traded Funds

ETFs are pooled investment vehicles that gather and invest money from a variety of investors.[81] ETFs combine features of both mutual funds and stocks and can trade on national exchanges. Some industry practitioners hope that the ETF structure could incorporate digital assets.[82] Individual investors typically buy digital assets, for example, Bitcoins, from other owners or through digital asset trading platforms and other intermediaries.[83] Individual investors currently

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the private keys as the control of the digital assets. European Financial Reporting Advisory Group, *EFRAG Research Project on Crypto-Assets Analysis of Scope – Initial Coin Offerings and Custodial Services*, May 22, 2019, at https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F1904050854507613%2F06-01%20-%20TEG%20Issues%20paper%20on%20scope%20of%20crypto-assets.pdf. For more on the general background of private keys and custody requirements, see Debevoise & Plimpton LLP, *Custody of Digital Assets: Centralized Safekeeping of Decentralized Assets under the Investment Advisers Act*, December 17, 2018, at https://www.debevoise.com/~/media/files/insights/publications/2018/12/20181217_custody_of_digital_assets.pdf, and Fidelity Digital Assets, *Custody in the Age of Digital Assets*, October 2018, at https://www.fidelitydigitalassets.com/bin-public/060_www_fidelity_com/documents/FDAS/custody-in-the-age-of-digital-assets.pdf.

[76] Swen Werner, Managing Director, Global Product Manager at State Street, "What Is Custody of Digital Assets?", *Global Custodian*, at https://www.globalcustodian.com/blog/custody-digital-assets/.

[77] SEC, "Engaging on Non-DVP Custodial Practices and Digital Assets," March 12, 2019, at https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206.

[78] SEC, "Engaging on Non-DVP Custodial Practices and Digital Assets."

[79] SEC Division of Trading and Markets and FINRA Office of General Counsel, *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, July 8, 2019, at https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities.

[80] SEC Division of Trading and Markets and FINRA Office of General Counsel, *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, July 8, 2019.

[81] For more on ETFs, see CRS Report R45318, *Exchange-Traded Funds (ETFs): Issues for Congress*, by Eva Su.

[82] David Weisberger, "The Case for a Bitcoin ETF," *Coindesk*, November 23, 2019, at https://www.coindesk.com/the-case-for-a-bitcoin-etf.

[83] Kevin Voiget, "How to Invest in Bitcoin," June 14, 2019, at https://www.nerdwallet.com/blog/investing/how-to-

cannot directly purchase digital assets (e.g., Bitcoins) from the SEC-regulated national securities exchanges.[84] Some have proposed allowing retail investors to buy or sell digital assets on regulated exchanges through the exchange-traded fund (ETF) structure—where, instead of directly trading digital assets, the investors would buy or sell publicly traded ETF shares with values linked to underlying digital assets. This section discusses potential Bitcoin ETFs' policy implications for the digital asset industry.

Bitcoin ETF Proposals

As mentioned previously, some digital assets are securities subject to securities laws and regulations. But digital assets could also be structured as securities products, even if the underlying assets are not securities. The proposed Bitcoin ETFs are the most prominent example. Although Bitcoin is not a security,[85] Bitcoin ETFs would be securities products with value linked to the underlying Bitcoins and are subject to securities regulation, including the Investment Company Act of 1940 and Investment Advisers Act of 1940. The digital asset industry has submitted many Bitcoin ETF proposals with the hope of gaining access to more retail investors, but, as of the end of 2019, the SEC has not approved a Bitcoin ETF.[86]

The SEC repeatedly stated in its rejections that Bitcoin ETF proposals did not meet standards governing national securities exchanges.[87] Specifically, the SEC stated that the proposals have not met the requirements in Section 6(b)(5) of the Exchange Act that order national exchanges to be "designed to prevent fraudulent and manipulative acts and practices."[88]

The agency articulated its rationale in a 2018 staff letter that listed challenges related to a Bitcoin ETF. In addition to market manipulation concerns, major Bitcoin ETF challenges included valuation and pricing, custody, and liquidity.[89] For example, all ETFs must frequently value their portfolio assets. The valuation process determines what investors should pay for the ETF shares and how the ETFs perform. Some worry that the Bitcoin ETFs would not be able to obtain the information necessary to adequately value the digital assets given the high volatility and fragmentation of the markets.

Bitcoin ETFs also have supporters. One institutional investor argues that ETFs provide a familiar and convenient way for investors to invest in digital assets, enabling them to participate in digital asset trading and partake in the potential financial gains brought by technological advancements,

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invest-in-bitcoin/.

[84] However, two commodities trading platforms—Chicago Board Options Exchange (Cboe) and CME Group—offer Bitcoin futures trading.

[85] SEC Division of Corporate Finance Director William Hinman, "Digital Asset Transactions: When Howey Met Gary (Plastic)," speech delivered at Yahoo Finance All Markets Summit: Crypto, San Francisco, CA, June 14, 2018, at https://www.sec.gov/news/speech/speech-hinman-061418.

[86] Mike Murphy, "SEC Rejects Latest Proposal to Create Bitcoin ETF," *MarketWatch*, October 9, 2019, at https://www.marketwatch.com/story/sec-rejects-latest-proposal-to-create-bitcoin-etf-2019-10-09.

[87] For example, see SEC, *Release No. 34-87267, Self-Regulatory Organizations; NYSE Arca, Inc.; Order Disapproving a Proposed Rule Change, as Modified by Amendment No. 1, Relating to the Listing and Trading of Shares of the Bitwise Bitcoin ETF Trust Under NYSE Arca Rule 8.201-E*, October 9, 2019, at https://www.sec.gov/rules/sro/nysearca/2019/34-87267.pdf.

[88] 15 U.S.C. §78f(b)(5).

[89] SEC staff letter, *Engaging on Fund Innovation and Crypto-currency Related Holdings*, January 18, 2018, at https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm. For more information on custody, see "Digital Asset Custody" section of the report. Liquidity refers the ease of buying and selling securities without affecting the price.

despite the potential trade-offs with respect to investor protection.[90] In a public statement about a dissenting vote on a disapproved Bitcoin ETF proposal, SEC Commissioner Hester Peirce stated that certain Bitcoin ETF proposals do satisfy the Section 6(b)(5) statutory requirements and that the disapproval may dampen innovation and inhibit institutionalization.[91]

Stablecoins in Securities Markets

Stablecoins are a type of digital asset designed to maintain a stable value by linking its value to another asset or a basket of assets, typically collateralized by fiat currencies or facilitated by algorithms.[92] The best-known example of a proposed stablecoin is Facebook's Libra proposal (see discussion below).[93] Since it was first announced in mid-2019, Libra has generated many policy concerns, inspired new considerations for comparable use cases from the private and public sectors, and fueled discussions of other global stablecoins.

A stablecoin arrangement's individual components are complex, leading to many crosscutting policy discussions. The Financial Stability Board, an international financial authority, characterizes a stablecoin's components as the following:

> Entities/structures involved in issuing stablecoins; entities/structures that manage assets linked to the coins; infrastructure for transferring coins; market participants/structures facing users (e.g., platforms/exchanges, wallet providers) and the governance structure for the arrangement, including the role and responsibilities of a possible governance body and the underlying stabilisation mechanism used for the stablecoin.[94]

Stablecoin-related policy concerns vary; they include, market integrity, investor protection, financial stability, monetary policy, payments, and illicit activity prevention.[95] Some of these concerns are outside of the scope of this report, which focuses on securities regulation. In addition to securities regulators, other regulatory authorities—central banks, payment system regulators, and financial crime enforcement entities—have been involved in stablecoin monitoring and oversight.

Facebook's Libra Proposal

Facebook's planned stablecoin Libra attracted congressional attention after it was announced on June 18, 2019. At related congressional hearings, Facebook received multiple questions regarding whether Libra is an ETF and how it should be regulated.[96] These questions arose because to

[90] Jordan Clifford, "The Road to a Bitcoin ETF," *Medium*, August 14, 2018, at https://medium.com/scalar-capital/the-road-to-a-bitcoin-etf-4364b07a7e15.

[91] SEC Commissioner Hester Peirce, "Dissent of Commissioner Hester M. Peirce to Release No. 34-83723; File No. SR-BatsBZX-2016-30," July 26, 2019, at https://www.sec.gov/news/public-statement/peirce-dissent-34-83723.

[92] Financial Stability Board, *Regulatory Issues of Stablecoins*, October 18, 2019, at https://www.fsb.org/wp-content/uploads/P181019.pdf.

[93] For more details, see CRS Insight IN11183, *Libra: A Facebook-led Cryptocurrency Initiative*, by Rebecca M. Nelson and David W. Perkins.

[94] Financial Stability Board, *Regulatory Issues of Stablecoins*, October 18, 2019, at https://www.fsb.org/wp-content/uploads/P181019.pdf.

[95] G7 Working Group on Stablecoins, *Investigating The Impact of Global Stablecoin*, October 2019, at https://www.bis.org/cpmi/publ/d187.pdf.

[96] U.S. Congress, House Committee on Financial Services, *Examining Facebook's Proposed Cryptocurrency and Its Impact on Consumers, Investors, and the American Financial System*, hearing, 116th Cong., 1st sess., July 17, 2019, at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=404001 and U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Examining Facebook's Proposed Digital Currency and Data Privacy*

create the stablecoin, Libra would be backed by reserve assets, including bank deposits and short-term government securities.[97] New Libra tokens could only be created or destroyed by authorized sellers. Some industry practitioners argue that Libra's proposed operational structure is similar to the creation and redemption process used by ETFs.[98] Facebook acknowledged at the House hearing that Libra uses operational mechanisms that are similar to ETFs, but stated its view that it is still a payment tool and not an investment vehicle.[99]

If deemed an ETF, Libra must comply with the SEC's regulatory regime governing securities, investment advisors, and investment companies. SEC approval would be required to launch the project. The SEC is reportedly evaluating whether Libra's structure makes it an ETF.[100]

Stablecoin-Related Legislative Proposals

The House Financial Services committee discussed three stablecoin-related securities proposals at an October 2019 House Committee on Financial Services hearing.[101]

- The Managed Stablecoins are Securities Act of 2019 (H.R. 5197) proposes to subject stablecoins to securities regulation by amending the statutory definition of the term *security* to include a new category of securities called "managed stablecoins." The bill would define a managed stablecoin as a digital asset that has either (1) a market value that is determined, in whole or significant part, by reference to the value of a pool or basket of assets that are held, designated, or managed by one or more persons; or (2) holders that are entitled to obtain payment which is determined, in whole or in significant part, on the basis of the value of a pool or basket of assets held, designated, or managed by one or more persons. Because managed stablecoin issuers are generally perceived as not acknowledging their stablecoins as securities, this bill would remove regulatory uncertainty by stating that a managed stablecoin is a security and therefore subject to securities regulation.
- The second legislative proposal would limit public company executives' ability to own managed stablecoins.[102] This draft proposal incorporates the same "managed stablecoins" definition, but would take a slightly different approach by delisting a public company if its directors and executives either (1) received compensation in managed stablecoin; (2) bought or sold a managed stablecoin; or (3) were affiliated

Considerations, 116th Cong., 1st sess., July 16, 2019, S. Hrg.116-71 (Washington: GPO, 2019), at https://www.banking.senate.gov/hearings/examining-facebooks-proposed-digital-currency-and-data-privacy-considerations.

[97] Libra Association, Libra White Paper, 2019, at https://libra.org/en-US/white-paper/.

[98] Dave Nagid, "Most Interesting ETF Filing Ever: Libra," ETF.com, June 25, 2019, at https://www.etf.com/sections/blog/most-interesting-etf-filing-ever-libra?nopaging=1. For details on ETF structure and operations, see CRS Report R45318, *Exchange-Traded Funds (ETFs): Issues for Congress*, by Eva Su.

[99] U.S. Congress, House Committee on Financial Services, *Examining Facebook's Proposed Cryptocurrency and Its Impact on Consumers, Investors, and the American Financial System*, hearing, 116th Cong., 1st sess., at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=404001.

[100] Dave Michaels and Lalita Clozel, "SEC Weighs Whether to Regulate Facebook's Libra," *Wall Street Journal*, July 13, 2019, at https://www.wsj.com/articles/sec-weighs-whether-to-regulate-facebooks-libra-11563015601.

[101] U.S. Congress, House Committee on Financial Services, *An Examination of Facebook and its Impact on the Financial Services and Housing Sectors*, hearing, 116th Cong., 1st sess., October 23, 2019, at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=404487.

[102] U.S. Congress, House Committee on Financial Services, *Discussion Draft*, at https://financialservices.house.gov/uploadedfiles/bills-116pih-listingofsecurities.pdf.

- with a person who bought or sold a managed stablecoin after the date of the security's registration.
- Lastly, the Keep Big Tech Out of Finance Act (H.R. 4813) would prevent large technology firms like Facebook from offering certain financial services or issuing digital assets.

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