



# Cryptocurrencies and the Next SEC Chair

December 7, 2020

## To the Members and Staff of the United States Senate:

Given my research in digital technologies and regulatory modernization,<sup>1</sup> which I have regularly shared in Senate testimony and in reports to the Congress, I would like to bring to your attention the growing policy concern of the lack of coherent framework for cryptocurrency-based and blockchain financial services solutions developed in the United States. The imminent nomination and confirmation process of the next Chair of the Securities and Exchange Commission (SEC) brings urgency to these considerations for the Members and staff of the U.S. Senate.

Lack of U.S. regulatory clarity on digital assets has been increasingly restraining innovation, while the aggressive approach of the People's Republic of China (PRC) threatens U.S. leadership in this industry. I have detailed in my academic research how the PRC systematically blocks foreign applications into its own country while exporting PRC-made technologies, costing the U.S. economy trillions of dollars in revenue. This allowed the PRC to eclipse the U.S. in revenue and downloads for mobile applications by 2016,<sup>2</sup> and it stands ready to do the same on blockchain fintech solutions. Our unresolved regulatory climate on digital assets will require an SEC Chair who acknowledges the plight of the industry and stands ready to work with Congress to preserve U.S. leadership in the crypto race.

Congress united only days ago to pass the Holding Foreign Companies Accountable Act (S.945) on a bipartisan basis and send it to the President for signature. You recognized the threat posed by lack of regulatory clarity around opaquely owned Chinese companies publicly listed on U.S. exchanges, and took action to defend American investors and U.S. public companies. The confirmation process for the next SEC Chair will be your next opportunity to show the same bipartisan resolve. This letter describes what is at stake and suggests the best way forward.

## Overview

A Biden administration has promised technocratic competence, bipartisan cooperation, and "building back" American economic power that can compete with and win against China. The U.S. cryptocurrency and blockchain industry wants to be included in that vision. The next SEC Chair will be critical, and the Senate should consider the role of cryptocurrency as part of the confirmation process.

Because of the lack of a coherent regulatory framework for digital assets, the U.S. crypto industry faces a maze of financial and regulatory institutions with competing agendas vying to assert jurisdiction over new financial innovation. The SEC, a consequential financial regulator since 1934, asserts the power to declare any digital asset to be a security – even if fails to meet the technical definition. The unconsidered impact can be fatal for a crypto start-up, and the mere chance of such an outcome adds risk and cost to U.S. companies that is driving

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<sup>1</sup> Roslyn Layton. "The Signs and Symptoms of Regulatory Obsolescence." American Enterprise Institute. October 25, 2019.

<https://www.aei.org/research-products/report/the-signs-and-symptoms-of-regulatory-obsolescence-in-network-industries/>

<sup>2</sup> See p. 158. Layton, R. (2017). *Which Open Internet Framework Is Best for Mobile App innovation? An empirical inquiry of net neutrality rules around the world*. Aalborg University Press. Ph.D. Series for The Technical Faculty of IT and Design, Aalborg University.

<https://doi.org/10.5278/vbn.phd.engsci.00181>

some to consider moving overseas. Meanwhile, the PRC is already rolling out a digital yuan to millions of users and preparing to win the crypto race as the U.S. stumbles.

Will the next SEC Chair understand the urgent need for regulatory clarity to keep the U.S. competitive in blockchain innovation, or will the regulatory confusion that defined the tenure of outgoing SEC Chair Jay Clayton continue to hand advantages to China?

## Industry Consensus: Lack of Regulatory Clarity is Harming U.S. Competitiveness

At least eight U.S. regulatory bodies have asserted authority to regulate digital assets<sup>3</sup> -- each with a different definition. These agencies were invented at different times for different problems and rely on rules which never anticipated a blockchain environment. This is not to say that there should be no accountability in financial innovation, but the right policy should focus on achieving the objective in the most efficient, least intrusive way. Policymakers should think intelligently about the function they are trying to perform, not copy-paste their bureaucracy on anything that moves.

The SEC has the biggest regulatory sword to wield over crypto companies, due to a legal framework that is nearly a century old and empowers the agency to determine if a digital asset is a security or not. The SEC makes such determinations on any digital asset it wants, relying entirely on the so-called "Howey test", based on a 1946 Supreme Court ruling<sup>4</sup> related to securities legislation from the 1930s<sup>5</sup>. These rules never imagined blockchain solutions or a new global financial infrastructure. Most critically, under these rules, the SEC doesn't have to consider the use case of a digital asset when making a potentially fatal determination for a blockchain solution. This has piled cost and risk upon innovators which choose to operate in the United States versus the streamlined regimes in the United Kingdom, Japan, Singapore and other places.

The outdated rules allow the SEC to bulldoze one of the core innovations of the technology – the open-source utility token, an essential tool for applying blockchain solutions to a wide swath of the real economy. Enterprise software companies are using tools like these to develop products that will revolutionize cross-border commerce, supply chains, and payment settlements. As U.S. legal experts have increasingly argued<sup>6</sup>, the SEC has no restraints under these old rules on declaring any digital asset a security, including an open-source, open-ledger utility token with no resemblance to an investment contract. This has been the case with XRP<sup>7</sup>, an open-source token used by U.S. enterprise software developers like Ripple, R3 and others to develop payment solutions for banks and other customers. XRP has been under a bewilderingly persistent enforcement threat by the SEC throughout Chairman Jay Clayton's tenure, and the development climate in the U.S. has been harmed for these products. Conversely, senior SEC officials declared only days apart in 2018 that Bitcoin<sup>8</sup> and Ether<sup>9</sup>, the two leading and best-known mined cryptocurrencies, are not securities, causing their value to soar. Through a

<sup>3</sup> These regulatory bodies are the Securities and Exchange Commission (SEC), the Financial Crimes Enforcement Network (FATF), the Office of Foreign Assets Control (OFAC), the Office of the Comptroller of the Currency (OCC), the Commodities Futures Trading Commission (CFTC), the Financial Action Task Force (FATF), the Department of Justice (DOJ) and the Internal Revenue Service (IRS).

<sup>4</sup> *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293 (1946)

<sup>5</sup> The Securities Act of 1933 (15 U.S.C. § 77b) and the Securities Exchange Act of 1934 (15 U.S.C. § 78a et seq)

<sup>6</sup> Godellas, Basil V. "When it Comes to Analyzing Utility Tokens, the SEC Staff's "Framework for 'Investment Contract' Analysis of Digital Assets" May Be the Emperor Without Clothes (Or, Sometimes an Orange Is Just an Orange)." Winston & Strawn LLP. October 28, 2019.

<https://www.winston.com/en/crypto-law-corner/when-it-comes-to-analyzing-utility-tokens-the-sec-staffs-framework-for-investment-contract-analysis-of-digital-assets-may-be-the-emperor-without-clothes-or-sometimes-an-orange-is-just-an-orange.html>

<sup>7</sup> "Your Questions About XRP Answered." XRP Ledger <https://xrpl.org/overview.html> (Accessed December 4, 2020)

<sup>8</sup> "SEC chairman: Cryptocurrencies like bitcoin are not securities." (Interview with SEC Chairman Jay Clayton) *CNBC*. June 6, 2018.

<https://www.cnbc.com/video/2018/06/06/sec-chairman-cryptocurrencies-1-ke-bitcoin--not-securities.html>

<sup>9</sup> Irrera, Anna. "U.S. SEC official says ether not a security, price surges." *Reuters*. June 15, 2018. <https://www.reuters.com/article/us-cryptocurrencies-ether/u-s-sec-official-says-ether-not-a-security-price-surges-idUSKBN1JA30Q>

concerted effort, Chinese crypto miners have since gained majority control of both cryptocurrencies.

The deliberate lack of regulatory clarity embraced by Clayton as a cornerstone of his crypto policy approach has ultimately favored China and other U.S. rivals while disadvantaging American companies. This approach retained the SEC's primacy over other regulatory bodies on the fate of the crypto industry, but steadily eroded U.S. leadership as the best place to do business. This must change in the next administration.

## The Clayton Effect: China Winning the Crypto Race

While never acknowledging the harm caused by the lack of regulatory clarity, outgoing SEC Chairman Clayton has treated cryptocurrencies and other fintech startups like flies, swatting at the industry with more than 50 enforcement actions and openly suggested more, some of them dubious and short sighted. This contrasts with SEC Commissioner Hester Peirce who sees crypto as the next great technology<sup>10</sup> and has expressed impatience at the pace of regulatory change. Again, the issue is not that poor conduct should not be addressed; it's a question of priorities. For years, the SEC has done busy work while the Chinese government has exploited America's stock exchanges and U.S. technology.

On crypto, China has laid the groundwork to capture the fruits of U.S. innovation and use its own digital currency to unseat the dollar<sup>11</sup>. Chinese crypto miners have expanded blockchain ledgers so much that they now control the two biggest cryptocurrencies – Bitcoin and Ether. A tracking map by the University of Cambridge in the U.K. indicates China's grip on Bitcoin's hash rate is at about 65%<sup>12</sup>. As a key part of China's concerted efforts, its central bank has already begun distributing its own digital yuan<sup>13</sup> to be used at thousands of retailers – with nearly a fifth of residents in Shenzhen city testing the technology today. They have planted a flag in controlling global value of traded coins and are scaling their enormous domestic marketplace for mass adoption of the technology. Yet again, on a technological breakthrough they had nothing to do with inventing, China is full-steam ahead on making it their own.

It is only a matter of time before China's digital currency is offered to billions across the globe coupled with Chinese payment solutions copied from U.S. innovators. The U.S. won't be able to block the proliferation of digital yuan. It can only win by making a better solution and getting to market first. For the last four years, the regulatory mess here at home has made that increasingly difficult to imagine.

The new report from Congress' bipartisan U.S.-China Economic and Security Review Commission (USCC)<sup>14</sup> provided a solid basis for the passage of S.945. The report noted that 217 Chinese companies are listed on U.S. exchanges with a total market capitalization of \$2.2 trillion, including 13 Chinese state-owned enterprises. According to the USCC, these companies endanger U.S. national security through censorship and surveillance, evade American standards of transparency, and jeopardize the wealth of American investors. The SEC has not been able to perform oversight on the audits of any of these companies because of systematic blocking by the Chinese government. Meanwhile the number and size of these Chinese companies has ballooned.

<sup>10</sup> Brett, Jason. "U.S. Senate Votes In 'Crypto Mom' Hester Peirce at SEC through 2025." *Forbes*. August 6, 2020.

<https://www.forbes.com/sites/jasonbrett/2020/08/06/us-senate-votes-in-crypto-mom-hester-peirce-at-sec-through-2025>

<sup>11</sup> Ehrlich, Steve. "Not A Cold War: China Is Using A Digital Currency Insurgency to Unseat the US Dollar." *Forbes*. October 15, 2020.

<https://www.forbes.com/sites/stevenehrlich/2020/10/15/not-a-cold-war-china-is-using-a-digital-currency-insurgency-to-unseat-the-us-dollar>

<sup>12</sup> "The Bitcoin Mining Map." Cambridge Centre for Alternative Finance. University of Cambridge. [https://cbeci.org/mining\\_map](https://cbeci.org/mining_map) (Accessed December 4, 2020.)

<sup>13</sup> Layton, Roslyn. "In The Cryptocurrency Race, Washington Stumbles While China Pulls Ahead." *Forbes*. October 21, 2020.

<https://www.forbes.com/sites/roslynlayton/2020/10/21/in-the-cryptocurrency-race-washington-stumbles-while-china-pulls-ahead>

<sup>14</sup> "Chinese Companies Listed on Major U.S. Stock Exchanges." U.S.-China Economic and Security Review Commission. October 2, 2020.

<https://www.uscc.gov/research/chinese-companies-listed-major-us-stock-exchanges>

These are hard lessons for a powerful regulator like the SEC, but it demonstrates the need for a strong SEC leader who acknowledges problems and has the vision to tackle them before they are out of control. The crypto industry – and the millions of American business owners and consumers alike who stand to benefit – is depending on the next Administration to provide that to them as Clayton’s tenure did not.

## Why Democrats and Republicans Can Agree on This

In the 1990s, there was a divided government between a Democratic White House and a Republican Congress. The Clinton Administration understood early that reaching bipartisan agreement on issues like technological innovations was vital, and by meeting him in the middle on this, the Congressional Republicans delivered on promises to spur economic expansion and nurture American enterprise. A major result was the 1997 framework for e-commerce<sup>15</sup> enacted by the Clinton Administration after two years of bipartisan work. It sparked the last major technological revolution in how the world does business, and it started with American innovation. Imagine the harm to our economy if we’d embraced regulatory confusion instead.

Putting aside the polarization of an election year, the two parties are mostly united on the fundamentals around this issue. Democrats and Republicans agree on the need to revive economic growth, particularly when American innovation can be a catalyst for it. Both sides agree on the challenge posed by China and have made it a priority for the U.S. to win the race on technology innovation. There is a clear consensus on fighting criminal behavior in the digital space. And both parties bring a particular vision to a solution for crypto regulation which complement each other. Having the right SEC leadership on this issue will be a win-win for both parties.

Republicans understand the need to rein in the administrative state, especially when the law is so unclear as with crypto. The deliberate lack of regulatory clarity at Clayton’s SEC has allowed regulators to simply find new things to regulate with self-perpetuation as the endgame, not channeling benefits of innovation to consumers. Republicans should insist on an SEC Chair that acknowledges the regulatory chaos that crypto faces in the United States and pledges faster collaboration on clarity even if it means ceding some of the agency’s control over digital assets. If a Democratic appointee shares these priorities, he or she should get an outstretched hand from pro-market Republicans.

Democrats are right in seeking consumer protections for potential victims of criminal activity related to digital assets. There has been good coordination between the crypto industry and law enforcement agencies like the Financial Crimes Enforcement Network (FinCEN) at Treasury, and continued inter-agency coordination needs to be encouraged, including with the SEC. But the regulatory environment to fight criminal activity is far better than it is for American businesses developing the B2B and consumer products that will fuel economic efficiencies and growth. As mentioned, the Clinton Administration did both in the right balance, worked across the aisle<sup>16</sup>, and delivered tremendous results for the American people.

Ultimately, the Administration and the Congress can only decisively resolve this matter through legislation. Many in this revolutionary new industry are eager to see that happen very soon. But with the immediate task of vetting and confirming the next leader of the SEC, it is vital to ensure that the new leadership is committed to working closely with you and other agencies to end the regulatory chaos, preserve U.S. leadership, stop benefiting the

<sup>15</sup> Clinton, President William J. Gore, Vice President Albert. “A Framework for Global Electronic Commerce.” The White House. July 1, 1997. <https://clintonwhitehouse4.archives.gov/WH/New/Commerce/read.html> (White House Archival Site)

<sup>16</sup> Magaziner, Ira C. “Creating a Framework for Global Electronic Commerce.” *Future Insight*. The Progress and Freedom Foundation. July 1999. <http://www.pff.org/issues-pubs/futureinsights/fi6.1globeconomiccommerce.html>

PRC, and win the race to market.

Sincerely,

A handwritten signature in blue ink, appearing to read "Roslyn Layton", with a long horizontal flourish extending to the right.

**Roslyn Layton, PhD**

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