

July 12, 2019

## Memorandum

**To:** Members, Committee on Financial Services

**From:** FSC Majority Staff

**Subject:** July 17, 2019 hearing entitled “Examining Facebook’s Proposed Cryptocurrency and Its Impact on Consumers, Investors, and the American Financial System”

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The Committee on Financial Services will hold a hearing at 10:00 a.m. on Wednesday, July 17, 2019, in Room 2128, Rayburn House Office Building entitled, “Examining Facebook’s Proposed Cryptocurrency and Its Impact on Consumers, Investors, and the American Financial System.” This will be a two-panel hearing with the following witness:

### Panel One:

- David Marcus, Chief Executive Officer, Calibra

### Panel Two:

- Chris Brummer, Agnes N. Williams Research Professor Director, Institute of International Economic Law, Georgetown University Law Center
- Katharina Pistor, Edwin B. Parker Professor of Comparative Law at Columbia Law School
- The Honorable Gary Gensler, Professor of the Practice of Global Economics and Management, MIT Sloan School of Management, Senior Advisor to the Director, MIT Media Lab, & Co-Director of MIT’s Fintech@CSAIL
- Robert Weisman, President, Public Citizen

## Background

Cryptocurrency has been generally defined as a digital medium of exchange that uses encryption techniques to control the creation of monetary units and to verify the transfer of funds.<sup>1</sup> Cryptocurrency uses blockchain, which is a shared digital ledger that records transactions in a public or private network. Such networks can consist of individuals, financial entities, or other businesses.<sup>2</sup>

On June 18, 2019, Facebook announced its plans to develop a new cryptocurrency, called Libra, and a digital wallet to store this cryptocurrency, called Calibra. According to a white paper released by Facebook, Libra will be built on blockchain, backed by a reserve of assets, and governed by the Libra Association.<sup>3</sup> The Libra Association (“Association”), which is currently comprised of Facebook and 27

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<sup>1</sup> Price Waterhouse Copper website, *Making sense of bitcoin, cryptocurrency and blockchain* at

<https://www.pwc.com/us/en/industries/financial-services/fintech/bitcoin-blockchain-cryptocurrency.html>

<sup>2</sup> Government Accountability Office, *FINANCIAL TECHNOLOGY: Additional Steps by Regulators Could Better Protect Consumers and Aid Regulatory Oversight*, GAO-18-254 (March 2018).

<sup>3</sup> *Introducing Libra*, Libra (last accessed 07/02/2019), <https://libra.org/en-US/white-paper/#introducing-libra>

other members,<sup>4</sup> is an independent, not-for-profit organization headquartered in Geneva, Switzerland. Its members will be charged with being “validator nodes” to verify Libra transactions within the Libra blockchain. By the target launch date of early 2020, Facebook hopes to have recruited over 100 firms into the Association.

According to Facebook, Association transactions will be “fully backed” by a combination of bank deposits and short-term government securities that will be held in the Libra Reserve. New Libra tokens will only be created when certain authorized resellers purchase them from the Association with assets other bank deposits and securities. Libra tokens can only be destroyed when authorized sellers sell them back to the Association in exchange for the underlying assets. The interest from the assets in the Libra Reserve will first help fund operating expenses and then be used to pay dividends to investors in the “Libra Investment Token.” Facebook intends to sell Libra Investment Tokens to members of the Association and other investors to fund its startup costs.

According to Federal Reserve Board Chairman Jerome Powell, in testimony on July 10, 2019 before the House Financial Services Committee, “Libra raises many serious concerns regarding privacy, money laundering, consumer protection and financial stability.”<sup>5</sup> Chairman Powell also stated that the project “cannot go forward” these concerns.

Calibra, a Facebook subsidiary, will operate a digital wallet for the Association. The wallet will be available in 2020 through Facebook Messenger, Whatsapp, and as a standalone internet application available on smartphones.<sup>6</sup> Facebook plans to expand the use of Calibra to other services like bill pay.

**Investor Protections Implications.** The Federal securities laws that protect investors apply to securities, including stocks, bonds, notes and investment contracts, regardless of whether they are digital assets. In April 2019, the Securities and Exchange Commission (SEC) issued guidance on when a digital asset is an “investment contract” under the so-called “Howey test.”<sup>7</sup> Under that test, an investment contract exists when there is: 1) an investment of money, 2) a common enterprise, and 3) a reasonable expectation of profits derived from the efforts of others.<sup>8</sup> If a digital asset meets this test, it is a security and must either register with the SEC or meet an exemption.<sup>9</sup>

The Libra Investment Token could amount to a security under the Howey test since it will be sold to investors to fund startup costs and will provide them with dividends. The Libra token itself may also be a security, but Facebook does not intend to pay dividends and it is unclear if investors would have a “reasonable expectation of profits.” However, it is also possible that the offer and sale of Libra could be integrated into the offering of the Libra Investment Token, thereby deeming both securities.<sup>10</sup>

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<sup>4</sup> The 28 members of the Libra Association are Mastercard, PayPal, PayU (Naspers’ fintech arm), Stripe, Visa, Booking Holdings, eBay, Facebook/Calibra, Farfetch, Lyft, MercadoPago, Spotify AB, Uber Technologies, Inc., Iliad, Vodafone Group, Anchorage, Bison Trails, Coinbase, Inc., Xapo Holdings Limited, Andreessen Horowitz, Breakthrough Initiatives, Ribbit Capital, Thrive Capital, Union Square Ventures, Creative Destruction Lab, Kiva, Mercy Corps, and Women’s World Banking.

<sup>5</sup> Pete Schroeder and Trevor Hunnicutt, *4-Fed chief calls for Facebook to halt Libra project until concerns addressed*, CNBC at, <https://www.cnbc.com/2019/07/10/reuters-america-update-4-fed-chief-calls-for-facebook-to-halt-libra-project-until-concerns-addressed.html>.

<sup>6</sup> Calibra, Facebook Newsroom (last accessed Jul. 2, 2019), <https://newsroom.fb.com/news/2019/06/coming-in-2020-calibra/>

<sup>7</sup> Framework for “Investment Contract” Analysis of Digital Assets, SEC (last accessed Jul, 2, 2019), [https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#\\_ednref5](https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_ednref5); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (first establishing the “Howey test”).

<sup>8</sup> *Id.*

<sup>9</sup> See e.g., Regulation D, which provides an exemption for sales to financially sophisticated investors. 17 CFR 230.501.

<sup>10</sup> See e.g., *In re Kik Interactive*, Complaint, SEC, Case No. 19-cv-5224 (Jun. 4, 2019), online at <https://www.sec.gov/litigation/complaints/2019/comp-pr2019-87.pdf>

If a digital asset is a security and not exempt from registration, the issuer must make certain full and fair disclosures and provide prospective investors information necessary to make an informed investment decision. Issuers must also disclose “information about the issuer’s financial condition, the identity and background of management, and the price and amount of securities to be offered ....”<sup>11</sup> Those who act as intermediaries to buy and sell the security, such as exchanges and brokers, and those with custody of the security may also have to comply with certain regulations intended to protect investors from fraud and other misconduct.

The securities laws also govern investment companies, which issues securities to investors in exchange for money that it invests on a collective basis in other securities.<sup>12</sup> The performance of the investment company is based on, but not identical to, the performance of the securities and other assets that the investment company owns. Exchange-Traded Funds (ETFs) are a type of investment company, which can be redeemed by the fund, like mutual funds, but also allow investors to trade throughout the day on an exchange at market prices. If an asset is an investment company and not exempt from registration, it must comply with regulations designed to minimize conflicts of interest, including regular disclosure of their financial condition and investment policies to investors. Like ETFs, Libra will be redeemable by certain authorized resellers and bought and sold in the open market.

While Libra and Calibra will be based in Switzerland, the U.S. federal securities laws may still apply if sold or used by U.S. persons.<sup>13</sup>

**Consumer Protection Implications.** The way cryptocurrencies are sold, exchanged, or marketed can subject cryptocurrency exchanges or other related businesses to certain consumer protection laws. For example, Title X of the Dodd-Frank Act grants the Consumer Financial Protection Bureau (CFPB) certain rulemaking, supervisory, and enforcement authorities to implement and enforce certain laws that protect consumers from “unfair, deceptive, or abusive acts and practices.” These authorities apply to a broad range of financial industries and products and could apply to cryptocurrency exchanges. Although the CFPB has not exercised regulatory authority regarding the cryptocurrency industry, it is accepting cryptocurrency-related complaints and has indicated it would enforce consumer financial laws in appropriate cases. In addition, the Federal Trade Commission (FTC) has brought several enforcement actions against cryptocurrency promoters and mining operations due to potential violations of the Federal Trade Commission Act. All states have various laws against deceptive acts and practices, and state regulators can use their enforcement authorities against cryptocurrency-related businesses.<sup>14</sup>

Furthermore, the Electronic Fund Transfer Act of 1978 (EFTA) requires traditional financial institutions engaging in electronic fund transfers to make certain disclosures about fees, correct errors when identified by the consumer, and limit consumer liability in the event of unauthorized transfers. It is unclear if EFTA protections apply to cryptocurrency transactions.

**Data Privacy & Security Implications.** It is unclear which data privacy laws will apply to the Association and Calibra.<sup>15</sup> Facebook has not detailed how it intends to capture users’ consent, only that personal data

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<sup>11</sup> *SEC v. Cavanagh*, 1 F. Supp. 2d 337, 360 (S.D.N.Y. 1998), aff’d, 155 F.3d 129 (2d Cir. 1998).

<sup>12</sup> *Fast Answers*, SEC, (last accessed Jul,2, 2019), <https://www.sec.gov/fast-answers/answersmfinfohtm.html>

<sup>13</sup> See e.g., *In re Certain Bitcoin/Ether Tracking Certificates*, File No. 500-1, SEC (Sept. 9, 2018), online at <https://www.sec.gov/litigation/suspensions/2018/34-84063-o.pdf>

<sup>14</sup> CRS, *Cryptocurrency: The Economics of Money and Selected Policy Issues*, <https://www.crs.gov/Reports/R45427>.

<sup>15</sup> If the Association is viewed as a financial institution under Title V of the Gramm Leach Bliley Act, it would be required to send privacy notices and allow users to opt-out of the sharing of non-personal with affiliates. FTC, *How To Comply with the Privacy of Consumer Financial Information Rule of the Gramm-Leach-Bliley Act*, last accessed July 1, 2019 at <https://www.ftc.gov/tips-advice/business-center/guidance/how-comply-privacy-consumer-financial-information-rule-gramm>.

will be shared to combat fraud, for research and data analytical improvements, and as required by law. To access Libra and Calibra, users must provide valid government identification.<sup>16</sup> However, without more clarified consent measures, revealed in the terms of service, users may be unaware how their data could be used.<sup>17</sup>

Cryptocurrency exchanges are also frequently targeted by cyberattacks and data breaches.<sup>18</sup> To facilitate its cryptocurrency transactions, Facebook intends to manage and hold a detailed digital repository of social, financial, and governmental data, which may further increase their hacking risks. Facebook has had issues with safeguarding its users' information in the past. For example, Cambridge Analytica, a political consulting firm had access to more than 50 million Facebook users' private data which it used to influence voting behavior.<sup>19</sup> As a result, Facebook expects to pay fines up to \$5 billion to the Federal Trade Commission (FTC), and remains under a consent order from FTC for deceiving consumers and failing to keep consumer data private.<sup>20</sup> In addition, within the last year alone, Facebook has: insecurely stored user passwords dating back to 2012;<sup>21</sup> paid unsuspecting teenagers to download spyware;<sup>22</sup> experienced a hack of nearly 50 million accounts;<sup>23</sup> and experienced a software bug that granted third party access to 6.8 million users' photos.<sup>24</sup>

**Systemic Risk Implications.** The Dodd-Frank Act seeks to reduce systemic risks by enhancing the Federal Reserve's (Fed) regulatory authority over banks and nonbanks. Large banks are automatically subjected to more stringent standards, whereas nonbanks and financial market utilities require designation by the Financial Stability Oversight Council, as systemically important financial institutions before being subjected to enhanced oversight by federal regulators.<sup>25</sup>

There are several uncertainties surrounding Libra's development that make it difficult to determine its status as a bank or nonbank under Dodd Frank, including: (1) how the cryptocurrency is secured (2) the extent to which there are measures to prevent and respond to dramatic shifts of value in the Libra Reserve, and (3) whether authorized sellers for the Libra Reserve should be labeled as broker dealers. Although Libra is planning to have bank features such as allowing users to make deposits, providing loans, and requiring users to deposit currency, unlike a traditional bank, Libra tokens would not be federally insured.<sup>26</sup> When considering Libra's proposed structure, tokens' tethering to government-backed

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<sup>16</sup> Nick Statt, *Facebook's Calibra is a Secret Weapon for Monetizing its New Cryptocurrency*, The Verge, last accessed July 1, 2019 at <https://www.theverge.com/2019/6/18/18682838/facebook-digital-wallet-calibra-libra-cryptocurrency-kevin-weil-david-marcus-interview>.

<sup>17</sup> Matthew S. Schwartz, *When Not Reading The Fine Print Can Cost Your Soul*, NPR, last accessed July 1, 2019 at <https://www.npr.org/2019/03/08/701417140/when-not-reading-the-fine-print-can-cost-your-soul>; see also, Jason Constine, *Facebook announces Libra Cryptocurrency: All You need to know*, TechCrunch, last accessed July 1, 2019 at <https://techcrunch.com/2019/06/18/facebook-libra/>.

<sup>18</sup> See also Brian Barrett, *Hack Brief: Hackers Stole \$40 million from Binance Cryptocurrency Exchange*, Wired, last accessed July 1, 2019 at <https://www.wired.com/story/hack-binance-cryptocurrency-exchange/>.

<sup>19</sup> Kevin Granville, *Facebook and Cambridge Analytica: What You Need to Know as Fallout Widens*, (March 19, 2018).

<sup>20</sup> <https://www.nytimes.com/2019/02/14/technology/facebook-ftc-settlement.html>

<sup>21</sup> Zack Whittaker, *Facebook admits it stored 'hundreds of millions' of account passwords in plaintext*, TechCrunch, last accessed July 1, 2019 at <https://techcrunch.com/2019/03/21/facebook-plaintext-passwords/>.

<sup>22</sup> Josh Constine, *Facebook pays teens to install VPN that spies on them*, TechCrunch, last accessed July 1, 2019 at <https://techcrunch.com/2019/01/29/facebook-project-atlas/>.

<sup>23</sup> Louise Matsakis, *Everything We Know About Facebook's Massive Security Breach*, Wired, last accessed July 1, 2019 at <https://www.wired.com/story/facebook-security-breach-50-million-accounts/>.

<sup>24</sup> Tomer Bar, *Notifying our Developer Ecosystem about a Photo API Bug*, Facebook for Developers, last accessed July 1, 2019 at <https://developers.facebook.com/blog/post/2018/12/14/notifying-our-developer-ecosystem-about-a-photo-api-bug/>.

<sup>25</sup> Jeffrey M. Stupak, *Financial Stability Oversight Council (FSOC): Structure and Activities*, CRS, last accessed July 1, 2019 at <https://www.crs.gov/Reports/R45052>.

<sup>26</sup> Lee A. Sheppard, *Libra is a Bank*, TaxNotes, last accessed July 1, 2019 at <https://www.taxnotes.com/opinions/libra-bank/2019/06/27/29ntp>.

currencies, and Facebook’s intended global reach for the product, it may be too risky for the Association to be an unsupervised entity without endangering the financial system.<sup>27</sup>

**Monetary Policy Implications.** To fulfill its dual mandate of low inflation and maximum employment, the Federal Reserve (Fed) manipulates the money supply by putting cash into the system when it buys securities or taking cash out of the system when it sells securities. The level of money in the economy dictates the short-term benchmark interest rate, the price paid by banks to borrow money in the bank lending market, which determines all other lending rates. The Fed can transmit monetary policy in this manner because it has a monopoly on the money supply, which consists of U.S. currency or cash, and checking and savings account balances. If another currency not under government control, such as cryptocurrency, becomes widely used and viable, this could adversely impact the Fed’s monetary policy because the Fed would lose its monopoly on controlling inflation and inflation targeting through manipulating cash in the system.

**National Security Implications.** The Bank Secrecy Act and related U.S. anti-money laundering regulations provide transparency into potentially harmful activity within the financial system.<sup>28</sup> To keep our nation and economy secure, regulated entities, including cryptocurrency exchangers and transmitters, are required to know their customers<sup>29</sup> and monitor transactions, ensuring that they can identify and report suspicious activity to appropriate authorities. These laws ensure that law enforcement can detect and defeat money laundering, terrorist finance, fraud, tax evasion, and other financial crimes.<sup>30</sup>

Libra and Calibra present several issues of national security concern. First, it is unclear how parties will ensure that the user or beneficial owner of a currency or wallet is accurately identified – especially for those without verifiable identity – and that transactions can be tied to that individual or entity. Second, it is unclear which compliance standards, if any, will be for vetting new users and transactions of Libra tokens. These risks may be enhanced as the Association shifts to the decentralized, permission-less model.<sup>31</sup> Bad actors may take advantage of the open access to build their own exchanges and wallets and conduct their own transactions. Once a user (legitimate or fraudulent) has access to Libra, their tokens and identity could travel anywhere in the borderless ecosystem, exchangeable for anything of value (including other crypto and fiat currencies). It is unclear, too, how the Association would manage issues like sanctions enforcement, stolen asset recovery, and tax collection and crimes.

**H.R.\_\_\_\_, Keep Big Tech Out of Finance Act.** The discussion draft will prohibit large platform utilities, like Facebook, from becoming chartered, licensed or registered as a U.S. financial institution (e.g. like taxpayer-backed banks, investment funds, and stock exchanges) or otherwise becoming affiliated with such financial institutions. The bill will also prohibit large platform utilities from establishing, maintaining, or operating a digital asset that is intended to be widely used as medium of exchange, unit of account, store of value, or any other similar function as defined by the Federal Reserve. The draft bill is intended to maintain a firewall between commerce and banking. It is also intended to prevent the establishment of an alternative financial currency controlled by large, private, for-profit companies with little government oversight, which might rival the U.S. dollar.

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<sup>27</sup> Theodore Schleifer, *Facebook may have too many users for its cryptocurrency to fail — even if you don’t trust it*, Recode, last accessed July 1, 2019 at <https://www.vox.com/recode/2019/6/18/18682748/facebook-cryptocurrency-libra-calibra-analysis>.

<sup>28</sup> “What Is the Bank Secrecy Act, and Why Does It Exist?” Julie Stackhouse, “On the Economy” blog, Federal Reserve Bank of St. Louis, April 24, 2018. <https://www.stlouisfed.org/on-the-economy/2018/april/what-bank-secrecy-act-why-exist>

<sup>29</sup> “KYC: 3 Steps to Know Your Customer” Trulioo.com, March 20, 2019. <https://www.trulioo.com/blog/kyc/>

<sup>30</sup> “Prepared Remarks of FinCEN Director Kenneth A. Blanco, delivered at the 11th Annual Las Vegas Anti-Money Laundering Conference and Expo” Financial Crimes Enforcement Network, August 14, 2018. <https://www.fincen.gov/news/speeches/prepared-remarks-fincen-director-kenneth-blanco-delivered-11th-annual-las-vegas-1>

<sup>31</sup> *Introducing Libra*, Libra (last accessed 07/02/2019), <https://libra.org/en-US/white-paper/#introducing-libra>