Chairman Green, Ranking Member Emmer, and Members of the Subcommittee, thank you for the opportunity to appear before you today. My name is Christine Parker and I am a partner in the New York office of the law firm Reed Smith. Prior to joining Reed Smith, I was a counsel at Sullivan and Cromwell and before joining Sullivan and Cromwell, I spent several years on the legislative staff of Senator Chuck Schumer.

My practice focuses on regulatory, enforcement and transactional matters related to commodities, derivatives, and digital assets. I routinely advise both regulated and unregulated digital asset market participants in connection with matters related to the Commodity Exchange Act and Commodity Futures Trading Commission (“CFTC”) regulations, as well as related Securities and Exchange Commission (“SEC”) and prudential requirements.

I also advise market participants in the development of digital assets and related technologies including token sales, market infrastructure, trading, clearing, and settlement solutions on distributed ledger technology. In particular, I focus on trading platforms and exchanges. Given my practice, I have had the opportunity to engage with a variety of both federal and state regulators, on behalf of my clients.

Key Observations

Based on my background as a former Congressional staffer and my experience in working with various regulatory agencies, including during the implementation of Title VII of Dodd-Frank, and advising a variety of both U.S. and non-U.S. market participants seeking to develop crypto-related products, I have the following observations that are relevant for your consideration:

- It is very difficult to determine how a particular digital asset should be characterized, from a regulatory perspective, if it’s not Bitcoin or Ethereum. As a first step, we must look to the underlying features of the token, including any issuances of the token, to determine if the token is a commodity\(^1\), a security\(^2\), neither or both. Ultimately, the determination of

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\(^1\) Cryptocurrency and digital assets are not directly addressed in the CEA’s definition of “commodity.” But the CFTC has maintained that virtual currencies can constitute commodities since 2015. Under the CEA, the definition of “commodity” encompasses the traditional agricultural commodities (e.g., wheat and cotton) as well as “all other goods and articles . . . and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt.” 7 U.S.C. § 1a(9).

\(^2\) The SEC’s definition of “security” encompasses the traditional securities that come to mind (e.g., stocks and bonds) but also includes a catch-all provision for other financial instruments that constitute “investment contracts.” See 15
whether a digital asset constitutes a commodity or security is a fact-intensive inquiry that must be conducted on a case-by-case basis. There is no formal guidance or framework to make these assessments.

- In addition, there is not a unitary regulatory agency that has authority over digital assets, such as cryptocurrencies. The current regulatory regime in the U.S. includes both federal and state regulators, depending on the characteristic of the digital asset. This creates significant uncertainty for market participants that are looking to bring new products to market.

- That may be heartening to those who don’t like cryptocurrencies or think that this is a sign of a deliberate and well-functioning regulatory regime, but in fact, the opposite is true. The lack of regulatory clarity and uncertainty harms U.S. retail investors that want access to active and liquid digital asset derivatives trading platforms, which exist offshore, but not in the U.S.

- With the recent growth in mainstream institutional and retail customers now actively entering (or looking to enter) the crypto economy, there will be a significant increase in pressure on regulators to approve digital asset products that satisfy the commercial needs of market participants, while complying with our existing financial regulatory regimes.

- Unfortunately, absent explicit support from relevant members of Congress, U.S. regulators will not be in a position to meet the demands of the market and will continue to be unwilling to approve new products for retail and/or institutional customers.

- Part of the current situation stems from the presence of retail customers in markets that were designed for institutional customers. However, the more significant issue is that regulators view the lack of support from Congress for digital assets as a message to them that they should not certify, approve, or support digital asset-related products in any meaningful way, including through formal rulemakings.

- As a result, regulators are not comfortable approving traditional regulated products based in crypto, which could provide more transparency into crypto markets, given Congress’ general ambivalence towards the crypto markets. Because of this hesitancy, there are a lack of regulated products that are commercially attractive to market participants that also provide retail investors the level of customer protection they need to safely access these markets.

- Unfortunately, the end result is that U.S. retail and institutional customers obtain access to the traditionally regulated products they want on foreign exchanges, through the use of the

internet and a VPN, without the benefit of the U.S.’s customer protection regulatory regime.³

- This is a losing proposition for U.S. crypto markets and market participants. The solution is not to continue to shadow ban these markets, but offer them in the U.S. under an appropriate regulatory regime.

➢ Please provide up to date information regarding the rapid growth and adoption of cryptocurrency investments:

While the size of the cryptocurrency market is far smaller than other more established asset classes, the market continues to grow and the rate of innovation continues to increase. Right now, we are in the memeification/gamification stage of crypto, which has exploded during the pandemic. While it’s tempting to write off crypto as nothing more than the buying and selling of tokens, the technology underpinning crypto (the respective blockchain networks) and the corresponding uses cases for this technology (decentralized finance or DeFi) will be transformational.

It is important to remember that federal and state regulators have been focused on trading in digital assets for a number of years before this current phase of the market. For example, in June 2015, the New York Department of Financial Services issued virtual currency regulation under the New York Financial Services Law that imposed a number of significant regulatory requirements (including KYC/AML obligations) on market participants that offered virtual currency-related businesses from New York or to New York residents.⁴

That same year, the CFTC determined that virtual currencies, specifically Bitcoin, constituted commodities, finding that “Bitcoin and other virtual currencies are distinct from ‘real’ currencies, which are the coin and paper money of the United States or another country that are designated as legal tender, circulate, and are customarily used and accepted as a medium of exchange in the country of issuance.”⁵

The SEC established as early as 2017 that cryptocurrency may constitute a “security,” triggering its jurisdiction.⁶ So both state and federal regulators have been actively engaged in the crypto markets for the past several years. In addition, foreign regulators in Europe and Asia have also been actively engaged in creating workable regulatory frameworks for digital assets.

³ In these markets, “institutional” market participants generally refers to proprietary traders who are trading their own capital; it does not refer to regulated intermediaries trading on behalf of retail customers.
⁴ 23 NYCRR 200.3(a), “No Person shall, without a license obtained from the superintendent …, engage in any Virtual Currency Business Activity.”
⁵ In re: Coinflip d/b/a Derivabit, CFTC, Dkt. No. 15-29, Order n.2. The CFTC has since maintained its position and its staff published further guidance in 2018 stating “[B]itcoin and other virtual currencies are properly defined as commodities.” CFTC Staff Advisory No. 18-14, Advisory with respect to Virtual Currency Derivative Product Listings (May 21, 2018), https://www.cftc.gov/sites/default/files/idc/groups/public/%40lrlettergeneral/documents/letter/2018-05-18-14_0.pdf. Courts have also routinely found that virtual currencies can be considered commodities under the CEA’s definition. See, e.g., CFTC v. McDonell, 287 F. Supp. 3d 213 (E.D.N.Y. 2018).
It may seem early in the development timeline of digital assets and blockchain technology, but as global regulators have been very active in these markets, innovators have been working hard to create new applications and products for the crypto markets. One common theme among innovators and developers in the crypto industry is the desperate need for regulatory certainty. It can take a significant amount of time, money and resources to navigate one regulatory regime and in the crypto market, it often requires navigating multiple state and federal regulators.

Regulatory uncertainty is not unexpected, given how quickly the crypto markets have evolved. However, as discussed above, U.S. market participants will not hesitate to look for foreign markets (even if unregulated) to access the products they want, if they are not available on U.S. exchanges or trading platforms. In addition, innovators will not hesitate to develop new blockchain-based technology solutions in a foreign jurisdiction that provides more regulatory certainty.

To better understand the various federal and state regulatory regimes that govern digital assets, I strongly urge Members and staff of this Subcommittee to review the White Paper prepared by the American Bar Association, which provides a comprehensive explanation of federal and state laws that may apply to the creation, offer, uses, and trading of digital assets in the U.S. Notably, the White Paper also recommends an analytic framework for considering potential issues of jurisdictional overlap between the CFTC and the SEC under the separate federal statutes they each are responsible for administering.7

➢ Address the investor protection and systemic risk concerns presented by this rapidly evolving sector:

To better understand the risks posed by the current crypto market structure, it is helpful to have a high-level understanding of how the crypto markets developed in the U.S.

The quick answer is that the first crypto asset to be made available for trading was Bitcoin, as a commodity under the jurisdiction of the CFTC. As a commodity, and unlike a security, the purchase and sale of Bitcoin (i.e., spot/cash and forward trades)8 is largely unregulated at the federal level.9 Spot and forward transactions are typically over-the-counter transactions between two market participants; they are not exchange traded transactions like derivatives on commodities (i.e., futures contracts) or securities. The CFTC has limited anti-fraud and anti-manipulation authority over spot and forward trades, but does not otherwise regulate these markets or market participants.


8 Although not defined in the CEA, a spot trade consists of a cash transaction with immediate delivery of and payment for the physical commodity, although settlement within two days is generally permitted. A forward contract is a transaction where a commercial buyer and seller agree upon delivery of a specified quality and quantity of physical commodity at a specified future date. The parties will specify delivery location, time, and amount, and they may agree on a price in advance or that the price will be determined at the time of delivery.

9 Traditionally, the commodity markets were designed for institutional customers, not retail customers, while the securities markets were designed for both institutional and retail customers.
In response to demand from retail customers, a number of crypto firms developed spot exchanges to allow retail customers to buy and sell crypto. Although these exchanges are not subject to full market oversight from the CFTC and the SEC like CFTC-regulated derivatives exchanges and SEC-regulated securities exchanges, they do require money transmission licenses, which are subject to regulatory requirements of the Department of Treasury and state banking regulators, and enforced by the Financial Crimes Enforcement Network (“FinCEN”).10 In totality, spot crypto exchanges are subject to AML / KYC obligations, cybersecurity requirements11, business continuity and disaster recovery procedures, capital requirements (for the money transmission licenses), and the anti-fraud and anti-manipulation authority of the CFTC.12

Although crypto exchanges are subject to some regulation (e.g., as money transmitters), retail investors can nonetheless access these markets without having their knowledge or experience assessed, having to meet a minimum net-worth threshold requirement or having any requirement to cap their investment in cryptocurrency at a particular proportion of their net worth. This makes it possible for inexperienced retail investors to invest too heavily in the crypto markets. There may be a requirement for risk warnings to be furnished to investors, but when it comes to investing in crypto, it is essentially just “buyer beware.”

➢ Identify areas where more transparency and oversight are needed to better understand how this asset class is developing:

As noted above, the traditional market regulators do not have clear oversight into the predominantly-retail centralized and decentralized cryptocurrency exchanges. These exchanges may seem regulated securities or derivatives markets to the typical retail investor, however, because the cryptocurrencies trading on them are commodities (until determined to be securities on a case by case basis by the SEC or a court), neither the CFTC nor SEC (or any other regulator) has authority to impose rules such as registration, reporting, and recordkeeping on these spot exchanges. While these markets generally continue to function well, the absence of federal oversight creates significant barriers to federal regulators in observing and understanding these markets in real time.13

Given that cryptocurrency markets will continue to attract retail investors and the likelihood that—whether in the US or in foreign jurisdictions—the use of cryptocurrencies will continue to scale,

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10 Any company involved in the transfer of cryptocurrencies from one person to another typically functions as a regulated business subject to the federal Bank Secrecy Act (“BSA”). The BSA applies to “financial institutions” and is the primary federal statute that governs anti-money laundering (“AML”) efforts, outside of associated criminal prohibitions. FinCEN has the authority to implement, administer, and enforce compliance with the BSA. See FINCEN, FIN-2013-G001, APPLICATION OF FINCEN’S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES (2013), https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf, at 3.
11 The risks related to cybersecurity in the digital asset ecosystem, while always present, have diminished over time, as the crypto community now has very effective custody and security solutions, combined with sophisticated blockchain analytics to trace assets and identify bad actors. Although it may be impossible to deter sophisticated bad actors, these tools have been relatively effective in preventing and deterring cyber-intrusions and recovering stolen assets.
12 See In re: Coinbase, CFTC, Dkt. No. 21-03.
13 As noted below, one solution would be to impose federal preemption over these markets and create a regulatory sandbox to allow the regulators to determine how best to regulate retail customers in these markets.
it is important for both lawmakers and the relevant regulators to become subject matter experts in the asset class and its corresponding use cases, and develop legislation and rules to create a regulatory framework that will allow innovative products to come to the market while protecting retail customers.

Finally, certain risks arise from crypto products with embedded derivatives, such as margined spot trading and derivatives trading. The use of leverage amplifies the potential downside for investors, which makes these products riskier for retail customers. These products are immensely popular with retail customers, but not available in the U.S. because of the lack of regulatory approval. As a result, U.S. retail (and institutional customers) trade these products on a number of non-U.S. exchanges, without the typical customer protection features deployed by regulated U.S. exchanges. If offered on a regulated basis in the U.S., we would expect to see limits on leverage (or minimum margin) combined with risk warnings, mandatory stop-loss functionality, and other measures used to address the risk to retail investors.

➢ Discuss potential policy solutions to the concerns raised by this new asset class:

First, we need new regulators to regulate new markets, new market participants and new products. I refer this Committee to the work of Professor Chris Brummer and his data addressing the lack of diverse financial regulators. His work raises a number of compelling issues that are caused by the lack of diverse financial regulators, which creates serious problems from the “standpoint of participatory democracy and economic inclusion.” The unique aspects of the crypto market require innovative and forward-thinking regulation to both protect consumers and to foster responsible innovation. There are other uses for digital assets and blockchain; more generally, which should be made available to everyone in the U.S. To ensure that we have crypto (and blockchain) for all, we need to have leadership and staff in our financial agencies that reflects the full diversity of our country. Access to investment opportunities in the financial markets is a key mechanism to creating generational wealth in the U.S. We need regulators who will focus on diverse communities who are underbanked and lack meaningful access to these markets.

Second, regulators must feel empowered to deploy the tools they currently have to allow market participants to offer both commercially attractive and reasonably regulated crypto products to U.S. retail customers. Otherwise, these customers will continue to seek out liquidity from off-shore trading platforms and exchanges that offer more attractive products, without the benefit of the customer protection benefits from the U.S. regulatory regime. This can be accomplished without additional legislation from Congress, and can bolster the existing regulatory regime in the interim.

However, in the near future we need more clarity around the regulatory characterization of crypto assets and we need to minimize the overlapping state and federal regulatory regimes. On one hand, the New York Department of Financial Service has been the leading crypto regulator over the past

14 https://www.brookings.edu/events/where-are-the-black-financial-regulators/
15 What do the data reveal about (the absence of Black) financial regulators? Available at: https://www.brookings.edu/research/what-do-the-data-reveal-about-the-absence-of-black-financial-regulators/
16 I would also like to draw the Committee’s attention to the recent article addressing the business and regulatory imperatives of senior management and board diversity at financial services firms by Douglas E. Harris. See Boosting Financial Services C-Suite and Board Diversity Is A Business And Regulatory Imperative, Futures and Derivatives Law Report, Volume 41, Issue 5, (May 2021).
six years and other regulators, particularly the CFTC and the SEC can learn from their example. However, the reliance on state money transmission licenses is difficult, unwieldy and time-consuming and creates customer protection issues for retail customers. Federal preemption, potentially starting with a cross-agency regulatory sandbox, could address many of these issues and a safe harbor could give Congress and regulators a chance to evaluate which model works best. Ultimately, Congress will need to pass legislation to create comprehensive and meaningful regulation of the crypto spot markets and to create a logical framework to determine the regulatory characterization of digital assets.

Looking ahead:

As the crypto markets continue to evolve, the pace of innovation continues to increase. As a practitioner, I see two immediate areas of growth: the use of non-fungible tokens (NFTs) in the gaming environment and DeFi, more generally.

The explosion in NFTs this year has centered on digital art, but I foresee a much broader use case in video games, as users will look to NFTs and other forms of tokens to allow them to utilize their assets across gaming ecosystems. This will create new cross-selling and branding opportunities for the gaming community and will lead to interesting intersections and synergies between the gaming industry and the crypto industry.

Second, crypto enables or fuels the growth in DeFi. While a number of recent FinTech innovations depend on a partnership with a regulated banking institution, DeFi seeks to disrupt this model entirely by eliminating the regulated intermediary. However, our current regulatory regime centers around regulated intermediaries, not regulated activities. I expect it will be a significant challenge for regulators to understand the deployment of smart contracts in the blockchain to enable financial transactions such as trading and lending.

Therefore, I urge Members of this Committee to continue engaging with market participants and thought leaders to learn about crypto and blockchain more generally, to ensure the regulators have the support they need to manage, support and regulate these new developments in a manner that fosters innovation, while protecting retail customers.

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17 In general terms, an NFT is a digital representation of a transaction relating to an asset (which asset may be digital or tangible), which is encapsulated in a digital token recorded on a blockchain ledger. It is an important to note that NFTs are not, as much commentary around the subject suggests, necessarily intended as a means of ‘selling’ or transferring legal ownership and NFTs can take a number of different legal forms. As with all digital assets, NFTs are an emerging digital asset class and there is no specific regulation yet regarding NFTs.