To:

U.S. Department of the Treasury

Date:

8 August 2022

Re: Request for Comment on Ensuring Responsible Development of Digital Assets. (Docket TREAS-DO-2022-0014-0001)

Coinbase Global, Inc. (Coinbase) welcomes the opportunity to comment on the U.S. Treasury Department's request for comment on "Ensuring Responsible Development of Digital Assets" (the RFC). Our response addresses both the questions asked in the RFC, as well as President Biden's Executive Order on "Ensuring Responsible Development of Digital Assets" (the Executive Order) issued on March 9, 2022.

The RFC comes at a critical inflection point, with an enormous opportunity in front of the United States to lead the world in digital asset innovation, and to harness its benefits for the American people, including in promoting efficiency, empowerment, inclusion, and economic freedom. However, that future is not preordained – policymakers must choose to create it by providing needed clarity, especially with regard to regulation. Unlocking this potential informs our thoughts in this paper.

The RFC and the Executive Order both reflect the important underlying tenet that the United States must maintain its competitive advantage in technology in order to preserve our economic and national security. We agree with this assessment, and urge the Treasury Department to work across the government to ensure U.S. leadership in digital asset and crypto markets innovation.

We understand that the process that the Biden Administration has launched through the EO and this RFC is complex. We appreciate the efforts of all the public officials involved, and very much hope our contributions help advance your important work.

Sincerely,

Faryar Shirzad Chief Policy Officer Coinbase Global, Inc.

Summary of Recommendations:

As described below, Coinbase believes the following recommendations are key to the global competitiveness of the United States in digital asset markets:

- Regulatory Clarity: Coinbase believes that everyone consumers, developers, platforms, and the future of web3 benefits from thoughtful digital asset regulation. As President Biden recognized in the Executive Order, the Administration needs to create, in partnership with Congress, a regulatory structure that appropriately regulates digital asset service providers (DASPs) and digital asset markets. Innovation will be unlocked from regulatory certainty that provides consistent and clear rules to ensure a level playing field and strong consumer protections.
 - At the Agency Level: Although the Commodities Futures Trading Commission (CFTC) has jurisdiction over digital asset commodities and the Securities and Exchange Commission (SEC) has jurisdiction over digital asset securities, additional clarity is needed to promote innovation.
 - We support legislative efforts to provide the CFTC with the authority it needs to regulate digital asset commodity spot markets.
 - We also believe that it is time for the SEC to engage with industry and the public in a rulemaking process to create clear regulations that allow for the development of a digital asset securities market in the United States. To advance the conversation, we recently <u>petitioned the SEC</u> to begin rulemaking in this area; that petition is attached here.
 - Stablecoins: We are supportive of legislation to establish a regulatory framework for stablecoins, provided the structure provides regulatory clarity, allows for innovation by non-bank issuers, and that the legislation provides flexibility subject to appropriate safeguards for requirements placed on trading platforms.
 - *Global Regulation*: We believe the United States can and should play a leadership role to ensure all global providers play by similar rules.
- Modernizing the Approach to Taxation of Digital Assets: The lack of guidance on critical U.S. tax matters impedes expansion of digital asset markets within the United States, creates incentives for users to transact on non-U.S. platforms, and leads to confusion as different market participants report identical items differently. Coinbase has identified a number of specific issues that need clarity from the IRS, specifically related to how and when certain activities are taxed, including staking, mining, minting, realized/unrealized gains and losses, and decentralized finance (DeFi) activities. At the same time, blockchain technology

can be used to facilitate tax compliance. We urge Congress and the Administration to work with industry and take steps to modernize taxation of crypto.

Coinbase: What is Our Role in the Cryptoeconomy?

Coinbase plays an integral role in the global cryptoeconomy as the largest and only publicly-traded crypto exchange in the United States. Coinbase was founded in 2012 as an easy and trusted place to buy and sell Bitcoin. Since then, Coinbase has helped fuel the development of an entire industry with thousands of different blockchains, tokens, and projects. Today, we offer much more than bitcoin trading, enabling 98 million verified users in over 100 countries to easily and securely invest, spend, save, earn, and use crypto. We currently list 210 assets for trading and 341 assets for custody on our platform, all of which undergo rigorous legal, compliance, and security review before being added to the platform. We have also invested in more than 300 teams and projects in recent years through Coinbase Ventures, building everything from layer 1 protocols, web3 infrastructure, centralized on-ramps, decentralized finance, NFTs, metaverse technologies, developer tooling, and more.

Our mission is to increase economic freedom in the world. In order to do that, we have worked to build a company that is the most trusted, secure, and compliant onramp to the cryptoeconomy. Our early focus on regulatory compliance, consumer protection, and innovation has helped drive growth in both our products and services, and with our consumer base. We are a leading provider of end-to-end financial infrastructure and technology for the cryptoeconomy. Coinbase Global, Inc. (COIN) is a public company registered with the SEC and began trading on the Nasdaq in April 2021. Our primary operating company, Coinbase, Inc., and our affiliates (collectively, "Coinbase") make up one of the largest digital asset financial infrastructure platforms in the world, including our exchange for digital assets.

We power the cryptoeconomy by combining the best of both emerging blockchain technology and traditional finance to create trusted and easy-to-use products for the industry. We have built a robust backend technology platform to support the global, real-time, and 24/7/365 demands of crypto asset markets. We invest heavily in regulatory compliance. We are also working with regulators around the world to shape policy, and have pioneered industry-leading security practices for safeguarding crypto assets. Our early focus on trust and usability has allowed us to become the primary onramp to the cryptoeconomy from the fiat-based financial system.

Nearly 100 million users around the world rely on Coinbase to provide a safe, trusted, and easy-to-use crypto account to buy, sell, store, spend, earn, and use crypto assets. We also offer a comprehensive solution that combines advanced trading, custody services, and financing for roughly 13,000 institutional customers. On top of our retail and

institutional services, we provide technology and services, such as Coinbase Cloud, that enable more than 230,000 developers to build crypto-based applications and securely accept crypto assets as payment. These numbers reflect our belief that crypto can and will be based on the following three pillars:

<u>Crypto as...</u>

- 1. A new financial system. Crypto is opening up a new financial system. This means creating new digital tools and services that enable people to expand their use of crypto beyond buying, selling, or storing in a safe and compliant way. The needs of our customers are evolving: On average, 54% of our monthly transacting customers engaged in activities beyond buying and selling crypto, including the use of stablecoins and other tokens as payment methods. We are building products accordingly, and supporting external projects that drive new financial use cases. Decentralized finance, smart contracts, and other new technologies will drive innovation and exponentially expand opportunities to improve our financial system in the United States and across the globe.
- 2. An app platform. Crypto and blockchain technologies will provide the next app platform. Fundamental to crypto is the decentralization of ownership, which gives individuals the opportunity to develop new financial and non-financial applications, like non-fungible tokens (NFTs). Coinbase is building tools that enable individuals, institutions, and app developers to plug into the existing crypto infrastructure to create new products, as well as benefit from the distribution and use of these products. By supporting both the development of and access to these new applications, Coinbase can help fuel the development of web3.
- 3. **An investment.** We want to empower everybody to achieve economic freedom through investing in and using crypto. At Coinbase, we believe we can enable customers to buy, sell, and hold crypto in a safe, informed, and compliant way. The world of crypto has expanded far beyond Bitcoin to include assets with diverse use cases and characteristics, and we are working to give consumers the tools they need to make informed decisions, including participating in Earn campaigns to learn about new crypto assets.

Current Trends in Digital Asset Markets: How to Build Through the Downturn

The cryptoeconomy is a fair, accessible, efficient, and transparent system that leverages digital assets built on blockchain technology to transfer value or ownership. Digital asset trading platforms like Coinbase have emerged to meet the demand from users in the United States and around the world for access to innovative digital assets and products.

Trading markets are developing rapidly and maturing. Crypto markets are developing breadth and depth, matching other traditional financial markets. Institutional market

participants are rapidly adopting digital assets as part of their overall investment strategy, which brings professionalization, diligence, depth, and orderly price discovery to markets. Recent efforts of leading companies across the digital asset space to adopt federally regulated instruments, including ETFs, futures, and derivatives also represent a major evolution in these markets. Unfortunately, the lack of regulatory clarity has caused some of these efforts to meet regulatory resistance for unclear policy reasons – ultimately to the detriment of investors.

Even in the current market downturn, digital assets are demonstrating healthy characteristics of other markets. The downturn has shown that crypto markets are more closely correlated with traditional financial markets than first thought – today, markets are treating crypto like a growth tech stock. The de-risking taking place in crypto is in line with the de-risking taking place across financial markets. All of these are healthy signals of advancement on the adoption curve.

Coinbase has noticed several trends in this downturn. While certain projects have failed, the ecosystem does not appear to be systemically risky. Moreover, despite the sudden and dramatic downturn in prices and important market moving events, the market has proved relatively resilient. Most DeFi protocols have performed well, with few forced automatic liquidations. On-chain borrowing and lending protocols like Dai, Aave, and Compound were able to continue providing credit through smart contracts. Stablecoins backed by transparent short term assets have seen an increase in adoption.

Efforts to make blockchains faster and cheaper are still proceeding at a rapid pace, with Ethereum's merge and layer-2 developments with optimistic rollups. Protocols that follow the crypto tenets of decentralization, transparency, and collaboration are robust and prosper even in market downturns. We expect to see a further flight to quality. That's healthy for the market.

Moreover, interest in crypto continues to build. Coinbase and BlackRock announced on August 4th a new collaboration that gives BlackRock's Aladdin trading customers access to crypto markets through Coinbase.¹ This will create new access points as institutional crypto adoption continues to accelerate. Moreover, it has been reported that Brevan Howard Asset Management has raised more than \$1 billion for a crypto hedge fund – the largest such fund to date.² Other significant investments and projects are launching, even in a down market, all speaking to the strength and resilience of this market.

¹ Coinbase Block, Coinbase Selected by BlackRock; Will Provide Aladdin Clients Access to Crypto Trading and Custody via Coinbase Prime, Aug. 4, 2022, *available at* <u>https://blog.coinbase.com/coinbase-selected-by-blackrock-provide-aladdin-clients-access-to-cry</u> pto-trading-and-custody-via-b9e7144f313d.

² Michael Bodley, Breven Howard Scores Largest Crypto Hedge Fund Launch Ever, Aug. 4, 2022, *available at <u>https://blockworks.co/brevan-howard-scores-largest-crypto-hedge-fund-launch-ever</u>.*

We see crypto winters as an opportunity to build. We continue to be confident about the future and opportunities for crypto. Indeed, although the capital market aspects of crypto are critical, digital assets are no longer about simply buying, trading, selling, and speculating on Bitcoin. The benefits of these assets are many and the list of use cases is growing. It is imperative that the federal government adopt policies that promote responsible innovation in digital assets. In turn, we believe thoughtful regulation will enable consumers to unlock the potential of this new ecosystem.

Ten Key Crypto Benefits

- <u>Access.</u> Anyone, anywhere with an internet connection can directly access digital asset networks. Access is not limited by education, race, geography, age, or any other personal characteristic. Coinbase strives to make it easy and safe to access the cryptoeconomy, but today's market for Bitcoin and other tokens is just the beginning. The activity we will see in the future will be based on individuals owning and controlling their digital life.
- 2. <u>Equity.</u> The traditional financial system has long been inequitable for many populations for a number of reasons. Recent studies have shown that populations historically underrepresented in traditional finance are turning to the cryptoeconomy to find avenues for economic opportunity.³ This stands in contrast to the traditional financial system where Black and Hispanic communities are underrepresented.⁴ Crypto allows for a fairer system, where the potential for discrimination and disparities is significantly reduced.
- 3. <u>Individual ownership.</u> Crypto assets are fundamentally different from traditional financial assets because they allow for simple and secure individual ownership without the need for a complex web of intermediaries to record ownership and confirm transactions. In the crypto economy, consumers control their financial assets; participants can maintain their own addresses or accounts on the distributed ledger, and can complete their transactions (*e.g.*, payments or remittances) directly using software, rather than indirectly relying on intermediaries. This processing model can improve settlement certainty, reduce

³ See 16% of Americans Say They Have Ever Invested in, Traded or Used Cryptocurrency, Andrew Perrin (Nov. 11, 2021),

https://www.pewresearch.org/fact-tank/2021/11/11/16-of-americans-say-they-have-ever-invested -in-traded-or-used-cryptocurrency/.

⁴ Stocks are Soaring, and Most Black People are Missing Out, Stan Choe, Oct. 12, 2020, *available at* <u>https://apnews.com/article/virus-outbreak-race-and-ethnicity-business-us-news-ap-top-news-69</u> fe836e19a8dfe89d73e8e4be6d480c.

processing times, lower fees, and minimize system demands on centralized entities.

- 4. <u>Enhanced transparency.</u> Distributed ledgers are simultaneously hosted across multiple systems with no central authority. Recording a transaction requires consensus in accordance with the distributed ledger's technology: for example, via a computationally intensive cryptographic problem (*i.e.*, "proof of work") or validation by the community of digital asset owners (*i.e.*, "proof of stake"). The distributed nature of this validation process and the accessibility of the ledger provides enhanced transparency, as well as a readily accessible means of auditing past transactions.
- Increased resiliency. Because distributed ledgers are simultaneously hosted across multiple systems, they are highly resistant to corruption and cyberattacks. An effective attack would require extraordinary resources and intense coordination. System failures of well established blockchain protocols are extremely unlikely.
- 6. <u>Efficiency</u>. Digital assets, distributed ledger technology, and smart contracts can be designed to automatically execute transactions if specific conditions are met (*e.g.*, release of collateral upon repayment of a loan). This enables real-time processing, which reduces counterparty risk and the risk of transaction delays or failures to clear transactions.
- <u>Lower transaction costs.</u> New entrants to the digital asset economy can immediately benefit from lower transaction costs when sending and receiving payments or holding digital assets. For example, an individual who wants to send money to family overseas can eliminate the standard remittance fee of 6.5%⁵ by using crypto instead of the legacy fiat remittance and correspondent banking infrastructure.
- <u>Continuous operation.</u> Digital assets and distributed ledgers are in continuous operation, allowing transactions to be processed and validated 24 hours a day, 365 days a year.
- 9. <u>Creator control.</u> Crypto can empower a new generation of creators who own their content and maintain life-time monetization of it. For instance, crypto is increasingly enablinging artists and other creators to release their products directly to consumers and receive credit for their creation beyond initial sale.

⁵ See An Analysis of Trends in Cost of Remittance Services, Remittance Prices Worldwide Quarterly, Issue 36 (Dec. 2020), https://remittanceprices.worldbank.org/cites/default/files/rpw, main_report_and_appay_g42020

10. <u>Micro-transactions.</u> Crypto's efficiency, coupled with its ability to transact in much smaller amounts, will allow for micro-payments that are impractical under traditional payments systems. These small transactions can have big impacts. At the individual level, for example, we could see this technology allowing hourly workers to be paid in real-time. This would help many workers avoid the high interest rates they often pay to payday lenders while waiting weeks for the close of a pay period to receive their paychecks.

Beyond Trading: What is Web3 and Why Does It Matter?

Even as the traditional trading markets continue to mature, the broader digital asset ecosystem is only beginning to develop. Web3 represents a paradigm shift in how we all interact with the internet, and that shift will unleash unprecedented innovation and economic freedom. The first iteration of the internet, or Web 1.0, was static content (e.g. a website describing a company's goods and services). In the era of Web 2.0, social media and mobile companies enabled users to interact with internet content in a dynamic way. Web 3.0 is the next evolution, driven by crypto and blockchain technology. Crypto is the transformational ingredient because it can combine content, payments, and identity on decentralized platforms that are owned and controlled by individual consumers.

Web3 is a trustless, permissionless, and decentralized internet that leverages blockchain technology. Web3's defining feature is ownership. Whereas the first iteration of the commercial internet (web1) was read-only for most users, and web2 allowed users to both read & write on centralized platforms (e.g., Twitter, Facebook, YouTube), web3 gives users full ownership over their content, data, and assets via blockchains. It empowers users to read-write-own.

Web3 is developing quickly and is resulting in an advanced technology sector with direct consumer use applications. The United States must leverage our competitive advantages, including access to talent and financing, know-how, and rule of law, in order to facilitate and benefit from the solutions that will help solve some of the world's biggest challenges.

The use cases are numerous, and continue to develop:

- In payments, digital assets will provide accessibility. With current solutions, users pay high transaction costs, limiting the flow of value through the digital economy. With digital assets, users can transfer value at lower cost over distributed networks in the form of tokens.
- For content creators, digital assets will provide transparency and monetization to creators and consumers. Currently, content creators cannot track engagement

and share in revenue without relying on an aggregator. Digital tokens allow any creator – not just major labels or studios – to issue, track, and earn from their content.

- In social media, digital assets will change governance. Digital assets will give users the ability to vote on future policies like content moderation, store their own content, and exercise data rights.
- In gaming, digital assets will allow for custody and portability. With current solutions, users cannot store or transfer digital goods/experiences to other users or different gaming services. In web3, users can buy and sell digital goods with other users as tokens, or transfer them between different services.
- In business, decentralized autonomous organizations (DAOs) will reinvent how people work. For example, a global talent pool could use a DAO to work on their own time and receive ownership stakes in the networks in which they choose to participate. Early service DAOs are crypto focused, and it will take time for DAOs to integrate beyond the purely digital realm. That said, one can envision a future, for example, of a ride hailing app being replaced by a DAO that pairs drivers with riders, while paying drivers an ownership stake in the network – an entirely new model.
- For the supply chain, digital assets solve the problem of contractor transparency. Current supply chain efforts rely on disparate systems to identify and track contractors, including subcontractors and country of origin. This is acute in the military. In web3, the military and key suppliers can transact directly with digital assets that represent trusted credentials and are tracked on an immutable blockchain.
- In cloud services, digital assets can help solve the problem of pooling. Current cloud service solutions involve building centralized infrastructure at scale that is costly, and may be vulnerable or unreliable. In a digital asset ecosystem, tokens can reward suppliers who pool underutilized storage or computing capacity as part of a decentralized cloud service, and track their contributions.

The U.S. Government can support development of web3 through engagement with stakeholders to develop policy that supports innovation. Below, we offer policy recommendations and considerations as the Treasury Department considers the future of the cryptoeconomy.

Recommendation #1: Regularity Clarity

The United States needs a regulatory regime that provides for consistent and clear rules across our financial regulators to ensure a level playing field and strong consumer protections. Most importantly, the role of regulators must be clarified to avoid consumer confusion, regulatory uncertainty, and unnecessary litigation.

- The CFTC should be given clear authority to regulate spot markets, not just futures and derivatives markets, for digital asset commodities.
- At the same time, the SEC should create rules of the road for digital asset securities so that the crypto securities markets can develop.
- Any digital assets that are not digital asset commodities or digital asset securities should be allowed to flourish as part of the web3 ecosystem.

The single biggest barrier to crypto innovation in the United States is the lack of a clear, efficient, and consistent regulatory structure for digital assets, exchanges, and other businesses that interact with digital assets. America is falling behind in adopting these core principles, best practices, and key components. We currently rely on a multitude of state and federal laws, some passed nearly a century ago, and a regulatory system that is among the most fragmented in the world. Our existing laws were not written to facilitate efficient and comprehensive oversight of a financial system that is evolving into a new era defined by blockchain technology and digital assets. Existing securities regulations do not accommodate the efficiency, seamlessness, and transparency of digital asset markets, and digital assets that are commodities are not subject to a comprehensive federal regulatory regime. Simply put: applying old rules to new markets, market participants, and assets will needlessly lock in old business models and market structures and not help us achieve the potential of this technology to redefine daily life.

That is not to say that crypto is not regulated. The industry must comply with a myriad of regulations, both at the state and federal level. Coinbase and its subsidiaries, for example, currently have nearly 50 regulators in the United States alone, including:

- 42 state banking regulators from which we have money transmitter licenses;
- 15 states in which we are authorized to engage in consumer lending;
- The New York Department of Financial Services, which regulates our primary crypto trading entity (under a "BitLicense") and our primary custody entity (under a New York Trust Charter);
- The Treasury's Financial Crimes Enforcement Network (FinCEN), which regulates us as a money services business;
- The Treasury's Internal Revenue Service (IRS), which requires us to report crypto transactions;

- The Commodity Futures Trading Commission (CFTC), which has anti-fraud and anti-manipulation authority over digital asset commodity spot markets, regulates derivatives markets, and regulates our Designated Contract Market. We are also seeking registration as a CFTC-regulated Futures Commission Merchant; and
- The Securities and Exchange Commission (SEC), which regulates our two (dormant) broker-dealer entities.

In addition, Coinbase operates under the same rules as other businesses in having obligations to operate in a fair, transparent way. These requirements are administered by the above agencies, along with:

- The Federal Trade Commission (FTC), which enforces federal consumer protection laws to prevent fraud and unfair or deceptive business practices;
- The Consumer Financial Protection Bureau (CFPB), which enforces consumer financial protection laws; and
- The Department of Justice (DOJ), which has general law enforcement powers and which works with companies like Coinbase to use the blockchain for investigative purposes, including to prevent situations of money laundering, illicit finance, and terrorist finance.

Despite the number of regulators, the regulatory uncertainty associated with the complex and overlapping jurisdictions of the various regulators poses substantial challenges to the industry. The uncertainty does not just impact a major centralized exchange like Coinbase; it hits the small projects and founders who are developing the next big thing, but who may not have the legal capacity to untangle the complexity and uncertainty of the U.S. regulatory landscape.

We applaud President Biden for issuing an Executive Order that recognizes the need for coordinated policymaking on crypto and digital assets in the U.S. Not all crypto activity is the same and not all digital assets are created equal. Digital assets have different characteristics and different risks; some function like a currency used for payments, some perform like commodities that provide utility and functionality, some operate like securities for debt and equity, and some look like none of the above. A one-size-fits-all model of regulation does not work, and only serves to blunt important innovation. It is, therefore, critical that policymakers take a calibrated and targeted approach to the regulation of digital assets and only apply rules relevant to the function of a particular digital asset. To this end, policymakers should engage with industry and other key stakeholders to deeply understand both the technology, and the implications of the technology, on today's and tomorrow's markets for both retail and institutions.

The Critical Need for Regulation from the SEC

Although assets listed on Coinbase's exchange are not securities, we imagine that a market for digital asset securities could be created. To do so, we need clarity, engagement, and updated regulation from the SEC to answer critical questions.

Coinbase filed a <u>petition for rulemaking</u> with the SEC on July 21 requesting that the Commission propose and adopt new rules to govern the regulation of securities that are offered and traded via digitally native methods. The petition calls for public input through the notice and comment process, as many of the unresolved issues are complicated, and arriving at efficient and effective solutions requires a broad understanding of the technology underpinning developing market practices and products. Further, the petition calls on the Commission to work with market participants to consider how appropriately tailored interpretive guidance and no-action relief could facilitate new activities within existing regulatory frameworks.

The petition focuses on three primary challenges related to applying existing rules to digital asset securities:

- 1. Lack of explicit definitions of a security that reflects the realities of digital assets;
- 2. Requirements that are unclear in the context of, or fundamentally incompatible with, the operation of digital asset securities; and
- 3. Requirements that are technically possible to apply, but are either unnecessary or overly burdensome as compared to potential alternative and more efficient rules.

The petition calls on the Commission to engage stakeholders in an open and transparent process. The petition asks 50 detailed questions that are critical to resolving these issues. Concepts highlighted in the petition include:

Classification of digital assets as securities:

- The Commission needs to provide clarity, in the context of digital assets, on what constitutes a security.
- This can be done through a rule, through an offering exemption, or through other regulatory actions provided that the definition is predictable, consistent, and replicable, and thus applicable by all market participants..

Issuance of digital asset securities

• <u>Registration and exemptions:</u> Our petition asks the SEC to consider whether there is a need to establish appropriate registration rules for digital asset security issuers, particularly when the "issuer" is not structured in a manner similar to a traditional public company.

• <u>Relevant disclosures:</u> The SEC should consider tailoring the disclosure requirements for digital asset securities offerings so that investors are not unduly exposed to novel risks.

Trading digital asset securities:

• The SEC should consider providing a pathway for platforms to trade digital asset securities alongside non-securities, while recognizing that additional intermediaries are not necessary by permitting transactions to settle in real-time on blockchains.

<u>Custody of digital asset securities</u>: Existing custody rules are fundamentally incompatible with digital asset securities.

- <u>Digital asset trading platforms:</u> The SEC should consider modifying rules to:
 - Allow platforms to custody assets to facilitate and settle trades;
 - Modernize the need for clearing, which may be unnecessary with straight through processing of trades; and
 - Consider how to address the immutability of transactions that cannot be reversed in the case of fraud or error.
- Broker-dealers:
 - The SEC should consider establishing a pathway for broker-dealers to provide proof that a broker-dealer is securely holding customer assets, in a manner consistent with both the risks and benefits of crypto assets, while facilitating the trading in which customers wish to engage.
- Transfer agents:
 - The SEC should consider whether to permit transfer agents to leverage the efficiency or accuracy of the blockchain in fulfilling their obligations, specifically allowing transfer agents to leverage a blockchain as its official stockholder registry.

Stablecoins

Stablecoins are digitally native payment instruments designed to maintain a stable value compared to an external commodity or currency, such as the U.S. dollar. They could be the foundation of a new era of innovation in financial services - faster, cheaper and fairer for everyone. However, not all stablecoins are created equal – some are financially and technologically sound, and others really should not be called stablecoins at all.

Having a well-designed regulatory framework for stablecoins is critical to the success of the digital asset ecosystem. Coinbase supports the Administration's efforts and those of many in Congress to create a regulatory regime for stablecoins that will promote consumers' confidence in stablecoins as payment instruments, and we are looking

forward to reviewing legislative text. We believe both banks and non-banks should be allowed to issue stablecoins provided they both meet certain criteria. However, stablecoins should not be subject to a one-size-fits-all regulatory approach. Like all financial instruments, specific design choices can present different tradeoffs of benefits and risks that need to be understood and appropriately addressed by financial regulators.

It is critical policymakers get this right. Policy choices about stablecoins will fundamentally shape the future of the global financial system as it transitions to digitally native environments. Making good decisions requires understanding the different types of stablecoins and the arrangements underlying them.

Coinbase recently released a <u>whitepaper</u> describing different types of stablecoin arrangements and how they operate, the current and future potential uses of stablecoins, the potential policy consequences, and benefit/risk tradeoffs of regulatory choices. Our whitepaper explains how different stablecoin arrangements operate, the current and potential uses of stablecoins, and how to consider regulatory approaches that balance their potential benefits against their risks. We offer this whitepaper to help raise awareness of the underlying issues, and to ground policy discussions in a solid, factual understanding of what stablecoins are and how stablecoin arrangements work.

Our policy recommendations:

- Regulatory frameworks should not impose a one-size-fits-all approach;
- Fiat-backed stablecoins should meet rigorous requirements to support consumers' confidence; and
- There should be space for continued experimentation with other types of stablecoins, within guardrails for consumer protection and financial stability.

Global Regulation of Digital Asset Service Providers

Policymakers around the world are considering how best to write rules related to crypto. Many countries understand that crypto is borderless, and their emerging rules reflect a healthy acceptance that they are competing for this dynamic new industry and the jobs it will create. We believe the U.S. has an important role to play in writing these new rules: we must promote global regulation that reflects America's commitment to innovation, competition, rule of law, and fair play. Companies should not get a free pass in certain jurisdictions, while others work hard to be compliant and safe. New rules should be conducive to innovation, as well as protect consumers, safeguard financial stability, prevent financial crimes, and promote responsible innovation. These rules should also be nimble in that they can address any new opportunities and risks emerging from this rapidly developing technology.

Many important markets around the world – including the European Union, Germany, Switzerland, United Kingdom, Australia, Brazil, Singapore and others – have moved, or are in the process of moving, forward to develop workable regulations.

A critical central component of a workable regulatory regime is the regulation of digital asset service providers (DASPs) like Coinbase. We define a DASP as any legal entity that conducts the following operations on behalf of its customers/clients: (i) exchange between digital assets and fiat currencies; (ii) exchange between one or more digital assets; or (iii) safe keeping and administration of digital assets. There are different approaches to date:

- Earlier this summer, the EU reached agreement on a regulatory framework for stablecoin issuers and DASPs, and more generally, extending the AML regime to digital assets.
- The UK has taken important steps towards developing regulations on stablecoins and plans to move forward on a broader regulatory framework for digital assets. In the interim, it is developing a bespoke AML regime and integrating the crypto industry into their financial promotions regulatory regime.
- In Asia, several markets have progressed elements of a regulatory framework, including Japan and Singapore. For example, Singapore has a crypto licencing regime already in place, which it continues to adapt and refine. Other markets, like the Philippines, have licensing regimes for DASPs and are developing detailed crypto regulatory frameworks.
- In the Middle East, we observe impressive progress both to support and to regulate the crypto industry. In the UAE, work is under way to provide regulatory clarity both at the Emirate level, and within the international Free Zones. For example, in the ADGM in Abu Dhabi there is already a crypto regulatory framework in place, and Dubai has recently established a new dedicated crypto regulator (VARA), which will promulgate rules before the end of 2022.
- Turkey has used the EU's MiCA framework as a starting point for developing their own legislative process for digital assets.
- In South America, Brazil has been working for the past few years to advance a legislative framework for digital assets and DASPs generally, with a possible passage as early as Q4 2022.

Different jurisdictions have their own existing laws, regulatory authorities, rulemaking processes, and outlook on the path forward. Nonetheless, we believe every jurisdiction, including the U.S., should have common core principles and best practices, including:

- 1. Protecting consumers
- 2. Safeguarding financial stability
- 3. Preventing financial crimes
- 4. Promoting responsible innovation.

The following key components associated with these principles and best practices would provide an effective regulatory framework for digital assets and the provision of digital asset services:

- 1. Regulatory classification
- 2. Licensing & authorization
- 3. Supervisory powers
- 4. Activities of DASPs (issuance, custody, exchange & trading, clearing & settlement)
- 5. Governance & conflicts
- 6. Risk management
- 7. Capital, liquidity & resilience
- 8. Market integrity
- 9. Consumer protection and marketing
- 10. Anti-money laundering (AML) and sanctions.

Finally, it is important the framework be dynamic so that (1) the rules are sufficiently flexible and regulators can be nimble/agile in the application of the rules, and (2) any regulatory approach is technology neutral, with activities treated consistently, based on risk. The market is at an early stage of development across the world, and a flexible, risk-based and proportionate approach to regulation will secure innovation for the future, while maintaining financial stability, consumer protection and market integrity.

Protecting the Onramp to Web3

Self-hosted (or personal) wallets are the future of ownership in the U.S. and are the onramp to web3. Personal wallets will enable individuals to hold value ranging from real estate tokens to utility tokens to decentralized ID tokens (decentralized IDs allow individuals to share specific information with third parties as needed while maintaining control over the use of their personal information). It is important that the U.S. government create policy related to personal wallets that is rooted deep in technological understanding of blockchain and the importance of protecting individual privacy. The policy must be finely tailored so consumers do not feel incentivized to use offshore, unregulated crypto providers in order to avoid government surveillance, while at the same time ensuring law enforcement has the tools necessary to quickly and effectively respond to evolving threats.

The development of decentralized IDs and validation techniques for personal information will help on both fronts: it will give users powerful tools for engaging in the cryptoeconomy in a safe way, while allowing legitimate law enforcement needs to be met. The crypto industry is leading efforts to develop standards for decentralized IDs, but the government can help by promoting adoption across industries and government entities. Decentralized IDs will make everything from healthcare to financial services more efficient

by allowing entities to trust verification by third parties that have already onboarded a specific customer.

In addition to supporting the growth and use of decentralized IDs and the emerging web3 stack, U.S. policy must recognize the need for and enable interoperability and the ability to move seamlessly across the ecosystem. Interoperability is necessary for decentralized protocols to interact with each other and other networks. Entrenching the dominance of major players, like we've seen in social media and other web2 ecosystems, should be avoided. Avoiding "lock-in" effects, in particular, is key, as well as ensuring consumer protection, consumer financial protection laws, data privacy, and data security.

Protecting Consumers

The mission of Coinbase is to increase economic freedom in the world. We dedicate substantial resources to providing the safest, most compliant crypto experience of any U.S. exchange. We also provide consumers financial literacy information, educating our customers how they can benefit from the crypto economy. Our customers are at the core of what we do, and consumer protections are always top of mind. We support consumer protections in this space.

As regulators focus on how to best protect consumers in crypto, they should carefully consider the information that consumers need to make informed decisions. The basic principles of providing clear, accurate information (that is not false or misleading), and acting honestly and fairly, help establish a baseline standard. Regulators have had an appropriate focus in this area. Most recently, one market participant came under scrutiny regarding its misleading claims regarding purported insurance on their deposit accounts.⁶

Consumer finance regulations should encourage a level playing field by requiring continuous updates of any material risks associated with the service, including any changes to its fee structure or regulatory status. As web3 protocols become more decentralized and participants govern various aspects of the protocol, including fee structures, a clear disclosure regime helps put the community on notice that changes will need to be clearly disclosed. If pricing or fees may vary, this should be made clear to consumers prior to the consumers confirming the transaction.

Regulators must always remember that while the crypto economy includes some well-established, large companies that are able to devote significant resources to customer service, it also includes many early-stage start-up companies that are not yet operating at scale. We encourage regulators to tailor their approach for early-stage entities so that the regulatory response matches the marketplace risk.

⁶ See US Fed, FDIC accuse Voyager Digital of 'false and misleading' insurance claims, The Block (July 28, 2022).

Recommendation #2: Modernizing the Approach to Taxation of Digital Assets

Our tax system has not kept pace with crypto innovation. Currently, there is a gap in mainstream tax policy for crypto, which hinders growth, liquidity, and U.S. leadership in the cryptoeconomy. The lack of guidance on critical U.S. tax matters impedes expansion of these markets within the United States, creates incentives for users to transact on non-U.S. platforms, and creates confusion as different market participants report identical items differently. We urge Congress and the Administration to take steps to modernize taxation of crypto.

The tax code is complex; so is crypto. Combining the two will take a deep understanding of both. Coinbase wants to partner with policymakers to help determine the best way to modernize the tax code and other laws in order to accommodate this quickly evolving technology. The infrastructure bill last year was a good example of well intentioned ideas, but poor outcomes based on a lack of technical knowledge about blockchain technology. Coinbase supports reporting crypto income to the IRS, but the current state of the law creates regulatory uncertainty. We appreciate the constructive work of the Treasury Department to help provide clarity, and hope these efforts can be a model for broader work that is necessary to develop sound tax policy for this emerging ecosystem.

Coinbase is committed to making it as easy as possible for our customers to understand and file crypto taxes. U.S. taxpayers are required to report crypto sales, conversions, payments, and income to the IRS, and these transactions may be taxed as either capital gains/losses or as ordinary income. We have introduced a tax center to help our customers understand and file their crypto taxes with ease and confidence, showing them a personalized summary of their taxable activity on Coinbase, broken out over time by realized gains/losses and miscellaneous income. Customers can use these amounts to prepare and file their taxes either with their personal accountants or directly with tax prep software.

While companies like Coinbase are working hard to help our customers meet their tax obligations, the government should be investigating how crypto may provide a better way to ensure tax compliance in the future. Blockchain technology can fundamentally change the tax reporting paradigm, as transfers and payments are recorded to a decentralized public ledger, versus to the private ledger of a broker or middleman. Accordingly, much of the information the IRS would seek through traditional information reporting may be or could be made available on the public ledger itself. Identification tokens and smart contracts can be used to impose and collect transaction level taxes. Taxpayers prefer simplicity and finality – a new tax reporting and compliance framework that attributes tax residency and provides immediate tax identity to taxing authorities will enhance tax compliance and ease anxiety among crypto market participants about running afoul of tax laws. Sales and other transactional taxes can be collected and remitted upfront. Income

taxes can be collected and withheld pending final determination of tax liabilities similar to the existing but cumbersome withholding tax framework.

For this reason, Congress and the Treasury Department ought to consider alternatives for account documentation beyond properly completed W-series forms (like Forms W-8 series and W-9). Further, given the use cases for cryptocurrency as a medium for payment, a consistent de minimis rule for Form 1099 reporting (for example, \$600 similar to the 1099-MISC and the 1099-K) would reduce the compliance burden for participants and processing burden for the IRS. In DeFi specifically, reporting alternatives to the Form 1099 ought to be considered to address that market participants may not possess (or be able to solicit and receive) full tax documentation for participants and recipients.

The lack of detailed regulatory guidance on the tax treatment of cryptocurrency and digital assets, particularly with DeFi transactions, has created uncertainty within the crypto ecosystem for how to properly apply tax and tax information reporting to such transactions. We recommend the use of identity tokens and some form of transaction tax to solve for many of the gaps that currently exist in applying tax to DeFi transactions. We want to work with the IRS to potentially create or leverage digital identities that will protect consumer privacy, while also enabling tax compliance.

Coinbase has prepared a whitepaper outlining tax issues policymakers should consider in the digital asset space; it is attached here. We appreciate the willingness of the Treasury Department to engage on these important issues, and look forward to continuing to do so moving forward.

Conclusion

Coinbase knows well these are complicated issues, made harder because 20th century laws weren't designed for 21st century innovations like web3. For this reason, we appreciate President Biden for his leadership through the Executive Order, and are grateful the Treasury Department is taking steps to carry it out, including through this RFC.

Crypto can deliver a more fair, accessible, efficient, and transparent system to transfer value and ownership. If allowed to flourish, the potential for web3 is almost limitless – better access, more equity, cheaper services, creator control. Well-designed regulation of digital assets will provide the market the certainty and workability it needs to power that innovation. Smart regulation benefits consumers, developers, and platforms by providing clear rules of the road that allow the benefits of crypto to shine. We urge the Administration to: (1) create a coordinated approach to regulation for digital asset service providers and digital asset markets; and (2) provide clarity as to the tax treatment of digital assets.



Appendices

SEC Petition Stablecoin Whitepaper Tax Whitepaper

July 21, 2022

Vanessa A. Countryman Secretary U.S. Securities and Exchange Commission 100 F Street, NE Washington, DC 20549-1090

Re: Petition for Rulemaking – Digital Asset Securities Regulation

Dear Ms. Countryman:

Coinbase Global, Inc. ("Coinbase") is filing this petition¹ with the U.S. Securities and Exchange Commission ("Commission" or "SEC") requesting that the Commission propose and adopt rules to govern the regulation of securities that are offered and traded via digitally native methods, including potential rules to identify which digital assets are securities. Digitally native securities are recorded and transferred using distributed ledger technology and do not rely on centralized entities or certificated forms of ownership that characterize traditional financial instruments.² Transactions in these securities (henceforth "digital asset securities") are executed and settled in real time, permanently recorded on blockchains, and visible with equal access to all market participants. This is a paradigm shift from existing market practices, rendering many of the Commission rules that govern the offer, sale, trading, custody, and clearing of traditional assets both incomplete and unsuitable for securities in this market.

The U.S. does not currently have a functioning market in digital asset securities due to the lack of a clear and workable regulatory regime. Digital assets that trade today overwhelmingly have the characteristics of commodities. Coinbase, like many other exchanges, has intentionally and conscientiously steered well clear of securities to ensure that we are able to operate in full compliance with applicable laws and regulations. However, new rules facilitating the use of digital asset securities would allow for a more efficient and effective allocation of capital in financial markets and create new opportunities for investors.

Globally, many jurisdictions are actively pursuing regulation that meets the specific needs of the crypto market, ensuring investors are well-protected. For example, the EU recently reached agreement on Markets in Crypto Assets (MiCA) regulation first proposed in 2020, and countries and markets such as Australia, Brazil, Dubai, Hong Kong, Switzerland, and the United Kingdom have taken important steps towards establishing (or have already established) regulations around crypto.³

¹ See 17 C.F.R. 201.192(a).

² In this petition we are focused on "native" digital asset securities—that is, digital asset securities that exist on a distributed ledger, only in tokenized form. Many, but not all, of the considerations discussed herein would apply similarly to digital asset securities that represent a tokenized version of a traditional security (e.g., tokenized common stock).

³ Council of the EU, *Digital finance: agreement reached on European crypto-assets regulation (MiCA)* (June 31, 2022),

https://www.consilium.europa.eu/en/press/press-releases/2022/06/30/digital-finance-agreement-reached-oneuropean-crypto-assets-regulation-mica/; Australian Government, The Treasury, *Crypto asset secondary service providers: Licensing and custody requirements (Consultation Paper)* (Mar. 21, 2022), https://treasury.gov.au/consultation/c2022-259046; Chamber of Deputies, Projeto de Lei Nº 4401, De 2021,

The SEC, however, has not yet taken constructive steps in this direction. Despite the well-recognized growth and rapidly developing practices in the digital asset ecosystem, and the Commission's stated view that some digital assets are securities, the Commission has yet to constructively engage with digital asset market participants on the design of a workable regulatory framework, let alone propose any new rules governing this activity. Moreover, as of the publication of its most recently updated regulatory agenda on June 22, 2022, the Commission has not indicated any intention to do so.⁴

Instead, the Commission appears to be following an enforcement-first approach to addressing crypto-related regulatory challenges. Indeed, the Commission recently announced that the Enforcement Division's Crypto Assets and Cyber Unit would soon double in size.⁵ Leading with enforcement actions before ensuring regulatory clarity results in arbitrary outcomes with limited value as guiding precedent. Several parties have been the subject of extensive investigation while others—with nearly identical products or services—have apparently been subject to none. This approach has led to both confusion and the uneven treatment of market participants.

Rather than initiate new rulemaking, Chair Gensler has repeatedly stated through speeches and testimony that the vast majority of digital tokens are securities, and has asked issuers and exchanges that offer, sell, and trade them to come in and register.⁶ We disagree that the majority of digital assets are securities. For those digital assets that are securities, registration under the current rules is, for many market participants, either not possible or not economically viable given the associated and unnecessary compliance burdens. Additionally, when existing regulations are unworkable, some market participants may be less willing to invest the resources necessary to follow the rules. Failure to resolve these shortcomings leaves investors unprotected due to a lack of regulatory clarity, prevents market participants from leveraging the efficiencies new technology can offer, and materially impairs capital formation in the blockchain technologies that underlie digital assets. This is wholly inconsistent with the SEC's mission.

⁽Aug. 21, 2021), <u>https://www.camara.leg.br/propostas-legislativas/1555470</u>; Dubai Financial Services Authority, *Consultation Paper No. 143, Regulation of Crypto Tokens* (Mar. 8, 2022),

https://dfsaen.thomsonreuters.com/sites/default/files/net_file_store/CP143_Regulation_of_Crypto_Tokens.p_df; Legislative Council of Hong Kong, Anti Money Laundering and Counter-Terrorist Financing (Amendment) Bill, (June 24, 2022), https://www.gld.gov.hk/egazette/pdf/20222625/es32022262516.pdf; Swiss Federation, Federal Act on the Adaptation of Federal Law to Developments in Distributed Electronic Ledger Technology (Jan. 14, 2021), https://fedlex.data.admin.ch/eli/fga/2020/2007; HM Treasury, Government Sets Out Plan to Make UK a Global Cryptoasset Technology Hub, (Apr. 4, 2022),

https://www.gov.uk/government/news/government-sets-out-plan-to-make-uk-a-global-cryptoasset-technology -hub.

⁴ The Commission submitted its agenda of rulemaking actions pursuant to the Regulatory Flexibility Act on April 26, 2022, to the Regulatory Information Service Center for inclusion on the Unified Agenda of Federal Regulatory and Deregulatory Actions. The agenda that was published did not indicate any rulemaking actions to be considered in the current agenda (next 12 months) or the long-term agenda that relates to digital asset regulation.SEC, *SEC Announces Spring 2022 Regulatory Agenda* (June 22, 2022), https://www.sec.gov/news/press-release/2022-112.

⁵ SEC, SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit (May 3, 2022), https://www.sec.gov/news/press-release/2022-78.

⁶ See, e.g., Sander Lutz, SEC Chair Gensler Threatens Action Against Unregistered Crypto Exchanges (May 18, 2022),

https://decrypt.co/100806/sec-chair-gensler-threatens-action-against-unregistered-crypto-exchanges (stating to the House Financial Services and General Government Subcommittee that "[t]he crypto exchanges

should come in and register . . ."); Public Statement, Chair Gary Gensler, SEC, 2021 Aspen Security Forum: The View from the SEC: Cryptocurrencies and National Security (Aug. 3,

^{2021), &}lt;u>https://www.youtube.com/watch?v=tusQLLCgrDs</u> (inviting digital asset trading platforms to "come in, register, work with the SEC.").

In October 2021, we issued our *Digital Asset Policy Proposal – Safeguarding America's Financial Leadership* through which we hoped to initiate a broad and wide-ranging conversation about the role digital assets play in our economic future.⁷ As part of that proposal, we offered a bold idea to regulate digital assets under a separate framework with a single regulator as a way to ensure that investors are properly protected and innovation can occur without, what we believe, may be restricting and cumbersome labels of security and commodity. Our proposal would require a government-wide focus to create a fundamentally new and comprehensive regime for digital assets. We remain committed to continuing the discussion about the right way to regulate_digital assets. This petition, however, is more specific. We are seeking a transparent and collaborative process to engage directly with the SEC as a means to initiate a discussion about what the SEC can do within its own authority to provide clarity and certainty regarding the regulatory treatment of digital asset securities.

Coinbase firmly believes that a new regulatory framework is needed to ensure that the SEC can fulfill its responsibility to oversee the digital asset securities markets. We respectfully petition the Commission to propose new rules for the offer, sale, registration, and trading of digital asset securities. Existing rules, unchanged, do not achieve the goals of the Commission when applied to digital asset securities. Following the well-established rulemaking process would allow for input from a wide range of stakeholders, advance the goals of transparent and orderly policy development, and result in clear rules and fair notice to all market participants.

Now is the time for the Commission to begin a public dialogue. The recent collapse of the TerraUSD stablecoin, the bankruptcy of crypto-lenders such as Celsius, ongoing questions about the efficacy of how digital asset markets operate, and the potential onset of another crypto winter can help inform a regulatory path forward. The lessons learned can be used to reinforce the best practices, and guide the industry in building new infrastructure and product offerings. Establishing regulatory guardrails is critical to the future success of digital asset innovation in the United States.

As an initial step, the Commission should solicit input from the public. Many of the unresolved issues are complicated, and developing effective and efficient solutions will require a broad understanding of the technology underpinning developing market practices and products. We believe that we and other market participants will also benefit from an open discussion. The Commission has historically published concept releases for large, novel, or complicated issues, commensurate with the issues related to regulation of digital assets; such public engagement would be an appropriate model to follow here.⁸

As part of this process, the Commission should also consider whether appropriately tailored interpretive guidance and no-action relief could be used to facilitate new activities within existing regulatory frameworks. Doing so will provide the Commission with an opportunity to assess the efficacy of emerging market practices with the ability to later promulgate rules, if appropriate. Any such guidance and other relief must avoid imposing new requirements or exercising policy-making authority that is more appropriately conducted through notice and comment rulemaking pursuant to the Administrative Procedure Act.

⁷ Coinbase, *Digital Asset Policy Proposal – Safeguarding America's Financial Leadership*, (Oct. 2021), <u>https://assets.ctfassets.net/c5bd0wqjc7v0/7FhSemtQvq4P4yS7sJCKMj/a98939d651d7ee24a56a897e2d37e</u> <u>f30/coinbase-digital-asset-policy-proposal.pdf.</u>

⁸ SEC, Concept Release on Equity Market Structure (Jan. 14, 2010),

https://www.sec.gov/rules/concept/2010/34-61358.pdf; SEC, Concept Release on the U.S. Proxy System (July 14, 2010), https://www.sec.gov/rules/concept/2010/34-62495.pdf.

It is imperative that the Commission start this process now. Digital asset securities have not yet been widely offered on regulated platforms because the existing rules do not accommodate them. Until the Commission provides regulatory certainty and a workable framework for digital asset securities, it is not feasible for market participants to "come in and register."⁹ And the inability to do so risks not only stunting the development and growth of this market, but also invites those least committed to regulatory compliance to exploit existing ambiguities.

If the U.S. fails to act alongside the efforts of other jurisdictions, global market practices will conform to rules tailored to the preferences of foreign authorities. And once market participants begin implementing foreign rules, the regulatory options available to the Commission will become more limited in order to avoid substantially raising compliance costs of U.S. firms operating internationally. The U.S. has historically been the world's leader in maintaining and regulating unparalleled capital markets; action is needed to preserve that position for the digital asset securities market.

As the only U.S. public company that operates a digital asset trading platform, Coinbase understands the value of market oversight through clear and workable regulation, and we welcome opportunities to work with policymakers to build a safe, open, and fair crypto ecosystem. We believe appropriately tailored regulation is essential to encouraging capital formation in the digital asset industry, protecting digital asset customers and investors, and facilitating the wider adoption of digital asset technology. We do not currently trade or facilitate trading in digital asset securities because of a lack of clear and workable regulation. But we would consider doing so through our SEC-registered securities broker-dealer subsidiaries¹⁰ once rules are in place that can accommodate the technological manner in which digital asset securities would be offered, sold, traded, custodied, and cleared.

In petitioning the Commission for rulemaking we recognize that existing regulatory questions will be challenging to solve. We know because we have spent more than a year thinking about how to do it. Last October we published a set of principles that we believe should underpin a regulatory framework.¹¹ And now we offer views on a set of detailed questions that we believe should be answered as part of the process necessary to implement an effective regulatory framework for digital asset securities that promotes the SEC's mission, achieves key regulatory objectives, and encourages innovation that benefits market participants.

Our petition focuses only on areas in which we believe we have expertise, and should not be viewed as a comprehensive list of issues and questions related to the regulation of digital asset securities. For example, regulation pertaining to the Investment Company Act of 1940 and the Investment Advisers Act of 1940 would benefit from consideration through a similar process that solicits the input from knowledgeable market participants. We encourage the Commission to initiate a process to solicit input from areas of the market not covered by our petition.

⁹ Gary Gensler, Prepared Remarks of Gary Gensler On Crypto Markets Penn Law Capital Markets Association Annual Conference (Apr. 4, 2022),

https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422.

¹⁰ Coinbase Securities, Inc. and Coinbase Capital Markets Corp.

¹¹ See, e.g., Coinbase's Digital Asset Policy Proposal (#dApp) at

https://assets.ctfassets.net/c5bd0wqjc7v0/7FhSemtQvq4P4yS7sJCKMj/a98939d651d7ee24a56a897e2d37e f30/coinbase-digital-asset-policy-proposal.pdf.

Key Considerations

There are three primary challenges when applying existing rules to digital asset securities:

- 1. Lack of clarity regarding how to determine whether a digital asset is a security;
- 2. Requirements that are fundamentally incompatible with the operation of digital asset securities; and
- 3. Requirements that are technically possible, but unnecessary or overly burdensome as compared to potential alternative and more efficient rules.

Although Coinbase, and other digital asset trading venues, have identified a number of digital assets that are clearly not securities, and therefore may trade without SEC registration, there are other assets that are harder to classify relying on the SEC's application of the *Howey* and *Reves* tests. Many of the questions we ask below highlight the challenge of identifying which of these digital assets, if any, fall within the Commission's jurisdiction, the lack of clarity with existing regulatory requirements, and the ways in which the existing regulatory requirements are fundamentally incompatible with the operation of digital asset securities.

Other questions reflect requirements for which compliance is possible, but otherwise not well-suited to digital asset securities premised on distributed-ledger technology. For example, custody requirements contemplate a broker-intermediated model—such as national securities exchanges use today—that is unnecessary for real-time settlement on blockchains. Each of the questions is also fundamentally tied to the determination of whether a digital asset is a security. Certainty on the applicable regulatory framework would not only provide greater protection for investors, but also permit the formation of an efficient digital asset market environment.

Finally, in addressing these questions, we believe the Commission should consider the following:

1. Not All Digital Assets Are Securities

Most digital assets are designed to enable simple functions that provide economic gates to commercial applications and services. They are not securities. Their value is determined by adoption and use, and the disclosures that token holders need are materially different from those of a public company. The issuer registration, disclosure, and listing requirements for securities are currently tailored to the issuers of debt and equity in public companies. But most digital assets—coins and tokens that trade on exchanges like Coinbase—do not represent ownership stakes in complicated public companies or pay a return to investors through dividends or interest.

The Commission should provide clarity regarding which digital assets, if any, are securities. The lack of clarity creates a risk that issuers of non-security digital tokens will feel compelled to comply with public company reporting requirements that are unnecessary, may lead to investor confusion, and may render innovative blockchain projects not economically viable despite the value they could bring to users and the broader economy.

2. Needed Disclosures Are Different

The SEC disclosure regime has historically focused on ensuring that investors have material information necessary to make an informed investment decision. Current disclosure

requirements, however, do not cover a number of features unique to digital assets that would undoubtedly be considered important when making an investment decision. For example, investors would likely find information about the risk of a network attack, what kind of governance rights are embedded in which tokens, who has the ability to change the code underlying the assets or the network, and other features that do not exist with respect to traditional securities to be material. Additionally, investors would benefit from comparable disclosures across each digital asset security to assist in identifying differences among investment opportunities. At the same time, the operations of a digital asset issuer are typically less complex than those of a large public company, so investors would likely not require the same level of disclosure in several areas relevant to traditional public companies to make an informed decision.

3. Real-Time Settlement of Financial Transactions is Possible

Digital assets and blockchain technology hold the promise of a more efficient and resilient plumbing for financial transactions. This new infrastructure is being built, from the start, to enable peer-to-peer operability with straight-through-processing between different types of service providers. The decentralized structure prevents any one service provider from being the sole gate between market participants. The result is enhanced competition, more seamless services, faster settlements, greater transparency, and the opportunity to automate complex financial transactions. The opportunity to eliminate unnecessary gates and layers of intermediation should ultimately lead to enhanced investor protections (for example by improving market transparency by recording transactions on a public blockchain), improved functionality, and lower transaction costs.

Today's rules, however, do not allow for securities markets to take advantage of these improvements. For example, existing custody rules do not contemplate real-time settlement of transactions on blockchains. They are tailored for trades that typically take two days to settle through a series of intermediaries who must manage default during that period. Real-time settlement on blockchains obviates this need, allowing counterparties to redeploy their capital immediately, improving the allocative efficiencies of markets relative to current practices. Other rules, particularly those promulgated by Regulation National Market System ("NMS"), do not contemplate digitally native securities, and do not provide a clear compliance path for blockchain transactions.

4. Fewer Market Intermediaries Are Required

Another important innovation of digital asset markets is the ability to conduct reliable transactions without the need for third-party intermediaries. Trading platforms like Coinbase offer direct access to both retail and institutional traders, letting them execute transactions 24 hours a day, seven days a week. However, rules designed for securities markets trading predate blockchain technology, when the only way to create trust in the financial system was to require the use of separate intermediaries, such as brokers, custodians, exchanges, market makers, transfer agents, and clearing agencies, each with conflicting interests and incentives. Ensuing regulations were premised on the existence of, and need to regulate these intermediaries, enshrining them and their role in law.¹²

¹² For additional exploration of the existing regulatory framework, and why it is not properly tailored for digital asset markets, *see* Coinbase's Digital Asset Policy Proposal (#dApp) at <u>https://assets.ctfassets.net/c5bd0wqjc7v0/7FhSemtQvq4P4yS7sJCKMj/a98939d651d7ee24a56a897e2d37e</u> <u>f30/coinbase-digital-asset-policy-proposal.pdf</u>.

Historical intermediation models should be permitted where they continue to add value, but not required when they do not or other methods achieve the same goal. For example, intermediaries should not be required when a transaction can be completed through alternative technological means that achieve the same regulatory objective. Just as regulatory and legislative developments were necessary to address the transition from a paper-based financial system to a computer-based system, a modernization effort is needed today to address the novel features and benefits of blockchain technology.

Key Questions

Each of these goals cannot be achieved without rethinking and reframing specific parts of existing securities regulation so that it is more efficient and effective for digital asset securities in the context of distributed-ledger technology. In the following sections, we provide an outline to frame the topic and follow with a number of questions that we believe are important to consider as part of any rulemaking exercise. We have views with respect to each and over time will seek to further share our perspectives. We strongly encourage other market participants to do the same. Our "answers" are just one of many relevant voices, and we hope for and expect a robust discussion that productively informs the Commission and its Staff.

I. Classification of Digital Assets as Securities

The threshold question in the development of a regulatory framework for digital asset securities is the determination of whether a particular digital asset is in fact a security, and thus subject to the Commission's jurisdiction and the securities laws.¹³ The Commission has taken the view that if a digital asset is a security, its regulatory oversight applies to all aspects of the lifecycle of the security and the parties that are involved in it, including the initial offering of that digital asset as well as any subsequent trading by investors and their dealings with intermediaries.¹⁴

The determination of whether a non-traditional asset (such as a digital asset) is a security relies heavily on legal tests developed by case law and ultimately Supreme Court decisions. Where the characteristics of an instrument do not clearly fit into one of the well-settled terms, the SEC and federal courts typically analyze whether the instrument is a "security" through the lens of the

¹³ A "security" is defined in the federal securities laws by reference to lists of instruments that include, for example, stocks and notes like bonds issued by companies. *See* Section 2(a)(1) of the Securities Act (defining a security as "[A]ny note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim.") Despite differences, the Supreme Court has indicated that the definitions of "security" under the Securities Act and the Exchange Act are treated the same. *SEC v. Edwards*, 540 U.S. 389, 393 (2004), citing *Reves v. Ernst & Young*, 494 U.S. 56, 61 n.1 (1990). In addition, the "elements of *Howey* are also applicable to the [Investment Company Act]." *SEC v. Banner Fund Int'l*, 211 F.3d 602, 614 n.* (D.C. Cir. 2000).

¹⁴ See U.S. Sec. & Exch. Comm'n, Chair Gary Gensler Letter to Sen. Warren (Aug. 5, 2021), <u>https://www.warren.senate.gov/imo/media/doc/gensler response to warren - cryptocurrency exchanges.p</u> <u>df</u>.

*Howey*¹⁵ and *Reves*¹⁶ tests. However, these tests were developed before the emergence of digital assets and are not tailored to their unique properties and use. As a result, application of these existing tests to digital assets fails to take into account the unique characteristics of digital assets.

The differences between traditional securities and digital assets underscore the challenges with applying these tests to digital assets. While traditional securities typically represent a claim to the assets and profits of a specific corporate issuer, whose management makes choices that influence the success of the company and therefore the return on investment in its securities, digital assets often have decentralized groups of developers whose involvement with a project may ebb and flow over time. The extent to which digital asset holders reasonably rely on the efforts of particular promoters, or the extent to which those efforts are "undeniably significant ones"¹⁷ is much less clear with regard to digital assets.

Further, while many may purchase digital assets with the hope of price appreciation, unlike traditional securities, digital assets typically have functional non-investment uses within a protocol—making them much more akin to real property, which is also often purchased with the hope of price appreciation, but nevertheless is fundamentally a commodity intended for usage.¹⁸ Non-investment use cases include, for example: paying transaction, or "gas" fees; voting on governance proposals related to the operation of the protocol; serving as a medium of exchange for native applications; and helping secure a network.

Coinbase has developed a rigorous process to analyze and review each digital asset, before making any digital asset available on its platforms. These processes ensure that Coinbase is not facilitating transactions in or providing trading infrastructure for digital asset securities. Due to today's substantial regulatory uncertainty, Coinbase is over-inclusive in what it views as a potential security, out of an abundance of caution to ensure that its practices comply with existing applicable law. Coinbase therefore often excludes digital assets based on the mere possibility that they might be securities.

Not all market participants have the resources to apply the same rigorous process. This in turn can result in significant burdens in meeting the Commission's expectation that each market participant conduct and document its own legal analysis for each and every digital asset with which it interacts.¹⁹

Applying the *Howey* and *Reves* tests piecemeal to an entire market sector has proven itself to be an unworkable solution. The SEC needs to provide clarity on the question of what, in the context of digital assets, constitutes a security. This may be achieved by defining a digital asset security through rulemaking, through the creation of a digital asset security offering exemption, or through other regulatory actions. In particular, such a rule should be objective and clear such that it

¹⁵ SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (resulting in the so-called "Howey test").

¹⁶ Reves v. Ernst & Young, 494 U.S. 56 (1990) (resulting in the so-called "Reves test").

¹⁷ SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 (9th Cir.).

¹⁸ Cf. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975).

¹⁹See SEC Strategic Hub for Innovation and Financial Technology Letter to the New York State Department of Financial Services (Jan. 27, 2020),

https://www.sec.gov/files/staff-comments-to%20nysdfs-1-27-20.pdf ("Market participants should not rely on a model framework, whitelist, or state license when evaluating compliance with the federal securities laws – without also undergoing careful legal analysis under the federal securities laws" supported by, for example, "opinion[s] of securities counsel.").

produces predictable, consistent and replicable results, and can be applied by all market participants.

For example, the rule should address, consistent with applicable case law, when an "investment of money" has or has not occurred. If the SEC is of the view that airdrops (i.e., digital assets provided free of payment) constitute an investment of money—a position that is likely irreconcilable with case law²⁰—it should clearly state that position and clarify in which circumstances that would be the case. Similarly, unlike traditional securities whose sole purpose is to represent an investment, digital assets often provide functionality, utility, or a consumptive use, aside from any speculative value. The Supreme Court has noted that "when a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply."²¹ Further, even if the value of an asset, like a dwelling or precious metal, may appreciate, and even if some purchasers may purchase the asset with speculative intent, that does not necessarily convert the consumable asset into a security. The proposed SEC rulemaking therefore should be explicit, in the digital asset context, as to the Commission's view on how the presence or lack of functionality, consumability, and/or utility of the digital asset impacts (and negates) its status as a security.

Given the complexity of the issue, the Commission should seek public input on the classification of digital assets as securities in advance of, or as part of, any proposed rulemaking related to these issues.

Key questions for the Commission to consider and seek public input on:

- 1) Are the *Howey* and *Reves* tests the appropriate tests for determining whether digital assets are securities?
 - a) What risks were these tests designed to identify and are those risks consistently presented in digital asset securities?
 - b) How should the use and utility of a digital asset, apart from any potential investment purpose, impact the analysis?
 - c) Are these tests capable of consistent application to digital assets by issuers, intermediaries, and other market participants? Does this application lead to results that are conducive to advancing the SEC's mission and promoting innovation? Does the application of the *Howey* and *Reves* tests to the specific facts and circumstances of each

²⁰ SEC v. Rubera, 350 F.3d 1084, 1090 (9th Cir. 2003), quoting *Hector v. Wiens*, 533 F.2d 429, 432 (9th Cir. 1976). While in the context of analyzing whether a "sale" of a particular security occurred, there may be arguments that any form of benefit to an issuer could be sufficient consideration to constitute a sale subject to Section 5 of the Securities Act. *See, e.g.*, SEC, SEC Brings First Actions to Halt Unregistered Online Offerings of So-Called "Free Stock" (July 22, 1999), https://www.sec.gov/news/headlines/webstock.htm. The question under *Howey*, however, is whether the asset is a security in the first place, which requires there to be an investment of money, not that the distribution of the asset provided a non-monetary benefit to the issuer. See also Joseph A. Hall, Howey, Ralston Purina and the SEC's Digital Asset Framework, 52 REV. OF SEC. & COMMODITIES REG. 137 (June 19, 2019),

https://www.davispolk.com/files/howey_ralston_purina_sec_digital_asset_framework.pdf (questioning the Digital Asset Framework's "seemingly contradictory" assertion that the "investment of money" prong of *Howey* can be satisfied without an investment of money).

²¹ United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975).

digital asset result in inefficient markets, an inconsistent application of the law, and/or other adverse consequences?

- 2) Should the SEC use its exemptive authority under Section 28 of the Securities Act of 1933 (the "Securities Act") and Section 36 of the Securities Exchange Act of 1934 (the "Exchange Act") to exempt certain transactions (e.g., those for consumptive use) in certain digital assets that may otherwise be securities but for which—for the reasons explained in the remaining sections of this petition—the existing regulatory regime is inappropriate?²² If such transactions are exempted, should an alternative regime be applied and what should that regulation look like?
 - a) Should the Staff reconsider the view in the Digital Asset Framework that receipt of tokens without investing money may nonetheless satisfy the "investment of money" prong under Howey?
 - If not, how does the Staff reconcile this position with existing case law, which requires a recipient to "commit his assets to the enterprise in such a manner as to subject himself to a financial loss"?²³
 - b) How should digital assets that provide significant non-investment use cases (e.g., paying transaction, or "gas" fees; voting on governance proposals related to the operation of the protocol; serving as a medium of exchange for native applications; and helping secure a network) be analyzed under the "reasonable expectation of profits" prong of *Howey*?
 - i) Would a finding that such digital assets satisfy this prong conflict with Supreme Court precedent, which has stated that where a purchaser is not "attracted solely by the prospects of a return' on his investment . . . [but] is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply"? More generally, how should "consumption" factor into the investment contract analysis, giving due regard to the Court's decision in *United Housing v. Forman*?²⁴
 - ii) How should market participants regard digital assets that provide both investment uses and non-investment-based consumptive uses, in light of *Howey* case law that explains the existence of speculative purchasers of an asset and the potential to sell an asset for more than you paid for it does not, on its own, mean that the asset is an investment contract under *Howey*?

²² Section 28 of the Securities Act provides that "[t]he Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." Section 36 of the Exchange Act provides that, subject to certain exceptions inapplicable here, "the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."

²³ See supra note 19.

²⁴ 421 U.S. 837.

- iii) How should the "efforts of others" prong of the Howey test be understood with respect to the "expectation of profits" prong? How relevant is the presence of price fluctuations on secondary trading platforms to the *Howey* analysis, given that the price may fluctuate based on the supply and demand of the digital asset for its consumptive use?
- iv) How should the "expectation of profits" prong be understood to ensure that it does not include digital commodities, where even if bought by a particular buyer with the hope of profit, any such profit is based on supply and demand for the commodity, not the performance of the issuer?
- c) What efforts may be properly classified as "essential managerial efforts" for digital assets that operate on permissionless blockchains or protocols, where independent, unaffiliated nodes are responsible for processing transactions, securing the network, and approving software implementations, or where such separate parties may be involved in proposing or implementing changes to the network or system?
 - i) How can purchasers be reliant upon the efforts of others in the case of digital assets that have no identifiable central party that could be recognized as an "issuer"?
- 3) Recognizing the importance of creating a predictable framework for market participants, how can the SEC provide greater clarity and certainty on which digital assets constitute securities? Should the Staff revisit the Digital Asset Framework and provide bright-line rules that could be applied more consistently and predictably?
- 4) Following a reconsideration of, or an exercise of exemptive authority for, the application of the *Howey* and *Reves* tests to digital assets, should the SEC conduct formal or informal public evaluations, such as through a no-action letter or other consultative process, to decide whether a digital asset is a security? Who should be able to seek, and rely on, such a determination?
- 5) Should other parties, such as the original promoters, be able to make similar determinations that—absent a formal disagreement from the SEC—third-party market participants could rely on? Should those determinations have to follow a particular process? If so, should there be a timeline during which the Commission must respond?
- 6) Should a digital asset be viewed independently from the transaction in which it was initially sold—such that the sale may have been a securities transaction, but the asset is not a security? In a traditional company, the company may produce a product that it sells, and from which it derives its profits. The shareholders share in these profits. A digital asset issuer, however, may sell its tokens to raise capital to develop the network on which those same tokens will be used. The product and the security are represented by the same digital asset, creating a unique coincidence of investment, on the one hand, and use and consumption, on the other.
- 7) Does the current manner in which the *Howey* test is applied result in or promote the maintenance of fair, orderly, and efficient markets consistent with the SEC's tripartite mission?

- 8) Does the current manner in which the *Howey* test is applied result in sufficient certainty and consistency to protect investors in a manner that is consistent with the SEC's jurisdiction and tripartite mission?
- 9) Does the current manner in which the *Howey* test is applied result in sufficient certainty and consistency to facilitate capital formation in a manner that is consistent with the SEC's jurisdiction and tripartite mission?
- 10) In practice, how does a digital asset security transition to be a non-security digital asset? What constitutes "sufficient decentralization" for purposes of transitioning from a security to a non-security?²⁵ How would that determination be made and what would be the mechanism for converting a digital asset from a security to a non-security?
 - a) Is there a difference, or should there be one, depending on whether the digital asset was initially sold in an offering that did not comply with the federal securities laws, or was instead initially sold pursuant to a registration exemption (such as Regulation D or Regulation S)?
 - b) Must the path to sufficient decentralization be predetermined at the time of the digital asset's launch, or may decentralized attributes be introduced over time?
- 11) Even if initially sold in a securities offering, can uses of a digital asset for non-investment purposes (e.g., to use the asset for its actual technological purpose), including transactions on the secondary market to acquire the digital asset for such non-investment purposes, be deemed to be non-securities transactions?

II. Issuance of Digital Asset Securities

A. Registration and Exemptions

The federal securities laws require that the offer or sale of any security be registered with the Commission, unless an exemption is available.

Registration under Section 5 and Section 12 must be sought by the issuer of the security.²⁶ Given the nature of digital securities, however, it may not be either feasible or necessary to identify an "issuer" as required under the securities laws. When an issuer registers an offering, it provides a number of disclosures about the operation of the issuer, its financial statements, its leadership, what risks it may face, and information about various other parts of the business. The purpose behind registration, and therefore requiring these disclosures, is to ensure that investors have the material information they need to make informed decisions. The insiders of the issuer, such as management, have information about the issuer that will affect the value of its securities and therefore the disclosure rules require the insiders to make material information public.

²⁵ William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)* (Jun. 14, 2018) <u>https://www.sec.gov/news/speech/speech-hinman-061418</u> (expressing the view that "current offers and sales of Ether are not securities" because Ether had become "sufficiently decentralized.").

²⁶ See, e.g., Form S-1, Form 10 (each requiring execution by a representative of the prospective registrant).

In many cases, however, the value of a digital asset—unlike the value of stocks and bonds—is not dependent on the operations of the issuer or the issuer's financial condition. Rather, the value of a digital asset routinely depends on the general supply and demand for using the digital asset. In such cases, there is little information possessed by the issuer that is unavailable to the public or that impacts the value of the digital asset, making traditional securities disclosures about the issuer irrelevant to holders of digital assets. In fact, the typical information that the federal securities laws require public companies to disclose presents the risk of misleading investors in digital assets, who may believe this information to be material to their investment decision because the SEC mandated its disclosure.

There are, additionally, digital assets that are created or managed by a diffuse group of individuals, who are not a central "team" at all. Some digital assets are developed by dispersed groups of individuals who may not even know each other's true identities. Current application of existing securities regulations may treat this group as the "issuer" but there is little insider information that this group has, and requiring them to coordinate and assume liability for disclosures would be both impracticable and futile. In such circumstances, the kind of information asymmetries that the federal securities laws are designed to remedy do not exist.²⁷

Mandated disclosures serve a regulatory purpose when there is material information to be pushed out into the market. A diffuse collection of individuals may not have such information to disclose. The SEC's Digital Asset Framework suggests that these dispersed groups may be "Active Participants," or "APs," whose efforts are relevant for determining whether the digital asset is itself a security. But the framework does not itself provide a determinative test for identifying who qualifies as an AP, or specify if these APs are subject to the registration requirements of Section 5 and Section 12.²⁸

If the digital asset is a security, then failure to register would violate Section 5 and subject the "issuer" to penalties. But failure to register does not only impact the issuer—it also makes it effectively impossible for national securities exchanges and other secondary markets to lawfully facilitate trading of the digital asset security. U.S. digital asset securities markets, like on that Coinbase may develop, that seek to comply with the U.S. federal securities laws therefore may not facilitate trading in these assets; instead, trading for these assets occurs on less well-regulated and/or offshore platforms where there is little oversight or investor protections. Exceedingly few issuers have successfully registered a digital asset security under Section 5 and Section 12,²⁹ with many others having failed in attempts to do so.³⁰ As a result, very few digital

²⁸ SEC Staff, Framework for "Investment Contract" Analysis of Digital Assets, https://www.sec.gov/files/dlt-framework.pdf.

https://www.sec.gov/Archives/edgar/data/1725882/000121390020023202/ea125858-424b1_inxlimited.htm.

³⁰ See, e.g., American CryptoFed DAO, Filings, <u>https://www.sec.gov/edgar/browse/?CIK=1881928</u> (SEC staff rejecting S-1 filing for "serious deficiencies" relating to requirements to comply with the form, resulting in withdrawal); Monster Products, Inc., Filings, <u>https://www.sec.gov/edgar/browse/?CIK=1675583</u> (same). *See also* Carrier EQ, LLC (f/k/a Airfox), Form 8-K (noting the issuer would discontinue the development of AirTokens because "[c]urrent laws and regulatory regimes do not provide for the Company to utilize the AirTokens as envisioned by the Company. . . ."); Paragon Coin, Paragon Coin Update (explaining that the issuer was filing for bankruptcy after its "plans were impossible to achieve due to several legal mistakes"); Jamie Chacon, Gladius Network shuts down as ICO investors cry foul (Nov. 25, 2019), <u>https://decrypt.co/12044/gladius-network-shuts-down-ico-investors-cry-foul</u> (issuer shutting down after settling an SEC enforcement action that required the issuer to register).

²⁷ Hinman, supra note 24.

²⁹ See INX Limited, *Prospectus Supplement*,

asset securities are available for trading in the U.S. This is despite the fact that the lack of information that would have been mandated through the registration process would not have provided material information to the market even if the process had been successfully completed. *Key questions for the Commission to consider and seek public input on:*

- 12) Given the potential non-investment uses of digital assets that the Commission today seems to believe may be securities as described in Section II.A, and that digital asset securities typically operate on decentralized and open-source blockchains that are publicly accessible to all, what should be the goal of any registration regime for digital asset securities?
 - a) What risks do digital asset securities present that may not be presented by traditional securities?
 - b) What risks might digital asset securities mitigate, or not present, and how should these changes in risk profile be recognized in the kind of disclosures provided to investors?
 - c) Who, if anyone, should be responsible for registration when there is no identifiable central entity that controls the token or protocol, or when the issuer does not believe registration requirements apply?
 - i) If an entity does serve as an issuer for purposes of a registration of an offering of digital assets, how long should the "issuer" be responsible for the ongoing disclosure requirements that may be required?
 - ii) Are Active Participants responsible for these ongoing disclosure requirements? What if the persons who may be properly treated as APs change over time?
 - iii) Would such a digital asset security have a means to be offered on a regulated digital asset securities trading platform? Should that digital asset still be categorized as a security and should it be subject to SEC regulation?
 - iv) What regulatory goal would such registration accomplish? Is there a way that regulation could be tailored to achieve this goal?
 - v) Should the concept of "active participant" exist at all? How does it promote the goals of the federal securities laws in reducing information asymmetries?
- 13) Taking into consideration that a digital asset team's operations and relationship to the digital asset security may differ meaningfully from the relationship between traditional issuers and the securities they issue, for example, if they are not receiving any proceeds of an offering, should the Commission use its exemptive power under Section 28 of the Securities Act and Section 36 of the Exchange Act to exempt certain developers or promoters of digital asset securities from registration, and/or ongoing disclosure requirements if the SEC were to determine they are subject to its regulatory reach?
- 14) Should platforms be able to facilitate trading in digital asset securities if the initial offer or sale was not registered under Section 5, or the "issuer" of the digital asset security has not complied with the requirements of Section 12?

- a) If there is no central entity that controls the token or protocol, or no one that views themselves as an issuer willing or realistically able to comply with the registration requirements, should trading platforms be permitted to facilitate the trading of the digital asset security if sufficient information about a digital asset security is otherwise available to potential investors without mandatory disclosures?
- b) What responsibility and potential liability, if any, would a platform have for the accuracy and completeness of the disclosures?
- 15) Are digital asset "investment contract" securities "equity" securities under Section 12(g)?
- 16) May a broker-dealer be permitted, under certain circumstances, to facilitate the resale of digital asset securities, even if they were initially sold without registration or an available exemption?

B. Relevant Disclosures

The existing registration process for securities offerings requires a number of disclosures designed to ensure that the market has the same material information about the company as company insiders have. There are also exemptions from registration for offerings by entrepreneurs and small companies, but they too have their own regulatory disclosure requirements. While the required disclosures are fewer and different, they rest on the same assumptions and the belief that insider information is more limited in type or scope, or that the investors participating in these exempt offerings have superior access to the insiders and their information.

Aside from the difficulties with registration, discussed in the section above, there is also a mismatch between the disclosures required for traditional securities offerings and what investors in digital asset securities need. As a result, existing disclosure requirements are not well-designed to meet the regulatory goals of ensuring that the market has the information it needs about the securities being offered or traded.

Disclosure requirements are the hallmark of the federal securities laws. Rather than judge the suitability of investments for public investors, the federal securities laws are designed to protect investors by requiring issuers to provide material information about the securities they issue, and the risks associated with investing in them, that are both accurate and not misleading.

But the Commission's disclosure requirements for the offer and sale of securities and ongoing disclosure requirements are designed for traditional corporate entities that typically issue and register equity and debt securities. The disclosure requirements under the federal securities laws focus on disclosure about companies, their management and their financial results—topics that poorly fit the decentralized and open-source nature of blockchain-based digital asset securities. Digital asset securities that are not tokenized versions of traditional securities raise different investor disclosure considerations than ordinary corporate securities. For example, even if these assets have value primarily based on the promoter's efforts, they generally do not provide holders any rights over the residual value of the issuer, or a claim on the issuer's assets. They are neither equity nor debt.

Digital assets that the SEC may claim are securities often function on decentralized protocols with many contributors, and every holder of a digital asset security can typically examine for

themselves the functionality and governance structure of the asset. As a result, the existing disclosure requirements are both under-inclusive and overinclusive of the information that is relevant to an investor in a digital asset security.³¹ For example, information that may be relevant to digital asset security investors, such as its "tokenomics" (e.g., the supply schedule of the digital asset security),³² or on-chain governance (rather than traditional boards of directors), are not specifically captured by existing disclosure requirements.³³

The result of applying existing disclosure requirements to digital asset securities offerings would be to leave investors exposed. They would be led to believe that information that is irrelevant is actually important to their decision, while missing several pieces of information that could significantly affect the value of the digital assets they hold.

Key questions for the Commission to consider and seek public input on:

- 17) What disclosures should be required for digital asset securities, given their different features as compared to traditional securities?
 - a) What information about the digital asset security, the underlying platform, and those responsible for the development of the digital asset security and the platform should be shared with those who are considering acquiring the digital asset security?
 - b) What existing disclosure requirements are not applicable to digital asset securities? For example, should certain disclosures required under the Williams Act and Section 16 of the Exchange Act be modified or exempted for digital asset securities?
 - c) What new disclosures should be required?
- 18) If it is necessary to provide those that are transacting in a digital asset security certain information about the digital asset security and related matters on an ongoing basis, how should relevant information be disclosed so that it is accessible and useful, taking into account the fact that traditional methods of disclosure may be less effective for digital asset security investors?
- 19) Even if the relevant assets were registered or exempt from registration, how would Rule 15c2-11 apply to broker-dealers facilitating trading in digital asset securities?³⁴ The same

³¹ Chris Brummer, *Disclosure, Dapps and DeFi*, Forthcoming, Stanford Journal of Blockchain Law and Policy (Mar. 24, 2022),

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4065143#:~:text=Disclosure%20in%20decentralized% 20finance%20is.know%20what%20they're%20buying.

³² See Robert Stevens, What Is Tokenomics and Why Is It Important? (Apr. 11, 2022), <u>https://www.coindesk.com/learn/what-is-tokenomics-and-why-is-it-important/#:~:text=A%20portmanteau%20</u> <u>of%20%E2%80%9Ctoken%E2%80%9D%20and.like%20what%20utilitv%20it%20has</u>.

³³ See, e.g., Disclosure, Dapps and DeFi, *supra* note 30 ("[T]he base layer disclosure documents for securities law fail to anticipate the particular technological features of decentralized technologies and infrastructures . . . they assume and inquire only into governance, technology, and other operational features inherent to industrial economies, and which are often different, or altogether absent in digital and blockchain-based economies.").

³⁴ Rule 15c2-11 generally requires, before a broker-dealer may publish a quotation for a security or submit a quotation into a quotation medium, that the broker-dealer must have in its possession specified
challenges noted above with respect to registration—the difficulty in obtaining information about the issuer and the over- and under-inclusive relevancy of the information—apply to the information sought by Rule 15c2-11.

20) Should the SEC preempt state blue sky requirements under Section 18 of the Securities Act, for example, by determining that for certain transactions, investors are "qualified purchasers"? If not, given the limited number of digital asset securities that would be listed on a national securities exchange, could a secondary market develop if state-by-state qualification is required?

III. Trading Digital Asset Securities on National Securities Exchanges

One of the central innovations of digital asset trading technology is the ability of both retail and institutional traders to have direct access to platforms that execute transactions 24 hours a day, seven days a week. Transactions settle in real time. And broker-dealer intermediaries are no longer needed as the digital asset market infrastructure has developed so that exchange and trading services, clearing, settlement, and custody can be provided effectively and more efficiently by the same entity.

However, registering a trading platform for digital asset securities faces a series of significant challenges. Notably, Chair Gensler has suggested that such platforms should register as national securities exchanges ("NSEs"), rather than alternative trading systems ("ATSs").³⁵ But existing NSE regulation does not contemplate the existence of, or need for, disintermediated trading. Exchanges require membership to trade directly, and such membership is available only to broker-dealers.³⁶ Moreover, methods of trading securities outside of a NSE—either on ATSs or over the counter ("OTC")—also require the use of a broker-dealer. ATSs are themselves registered as broker-dealers while OTC trading is facilitated by a network of broker-dealers. None of these models is designed to accommodate direct investor access to a trading venue, which is wholly inconsistent with the current models of digital asset trading and inserts unnecessary layers of intermediation.

Another challenge with Chair Gensler's approach is that it does not contemplate the side-by-side trading, on the same platform, of digital assets securities and digital assets that are not securities. This is problematic because trading in digital assets that are securities would entail trading many that are not. Unlike traditional securities, which are typically purchased using fiat currency, given the 24/7 trading market, digital assets are often traded for digitally native currencies such as stablecoins, or a cryptocurrency like Bitcoin, which is a commodity. For example, a trader might buy U.S. dollar-backed stablecoins and then use these assets as a store of value for purchases of various other digital assets. We anticipate, given existing practices and preferences in the

information about the security and its issuer that it believes are reliable and materially accurate, and much of that information be publicly available.

³⁵ Gary Gensler, Prepared Remarks of Gary Gensler On Crypto Markets Penn Law Capital Markets Association Annual Conference (Apr. 4, 2022),

https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422.

³⁶ Under Section 6(c) of the Exchange Act, only registered broker-dealers may be admitted as members of a national securities exchange. Further, under Section 6(b) and 19(g), national securities exchanges are self-regulatory organizations ("SROs"), and are required to enforce their member broker-dealers' compliance with the securities laws. As they currently operate and under current law, it is not clear that digital asset trading platforms could comply with these requirements, nor is it clear there is a regulatory benefit of requiring that they restructure to do so.

market, that investors in digital asset securities would buy those assets in the same way, using a stablecoin or other digital store of value.

To register as an exchange, a person must first meet the definition of "exchange"—including that it brings together purchasers and sellers of *securities*.³⁷ Its registration must also be approved by the Commission, which must consider, by statute, whether the exchange is "so organized and has the capacity to be able to carry out the purposes of the Exchange Act."³⁸ Facilitating the trading of non-security digital assets, such as Bitcoin, has not yet been recognized as furthering the purposes of the Exchange Act. For a platform to register as a securities exchange, while also listing non-securities digital assets, the Commission may need to clarify that registered exchanges may facilitate trading in both security and non-security digital assets. Finally, securities on NSEs do not currently trade 24/7, but open and close each day through an auction process on their listing venue. They must also comply with a number of other regulations, including most notably Regulation NMS, that may require clarification before they can be easily applied to digital asset securities exchanges. Regulation NMS, for example, assumes the existence of a national market for each listed security, and imposes a number of requirements to harmonize pricing and fees across venues. Digital assets, however, trade on a global scale, with around-the-clock trading. It is not clear how various provisions of these rules would work in a global, 24/7 market.

Key questions for the Commission to consider and seek public input on:

- 21) Recognizing the difficulties in determining which digital assets should be properly classified as securities under existing legal tests,³⁹ should a platform be permitted to register with the SEC as a national securities exchange on the basis that some of the assets on the platform may be securities, without making a definitive determination with regard to any particular asset?
- 22) If an asset-by-asset determination must be made, should a single platform be permitted to register with the SEC for trading both security and non-security digital assets?
 - a) Could such a platform meet the definition of "exchange," and be organized to carry out the purposes of the Exchange Act, even for the non-securities?
 - b) Would its rules relating to non-securities be subject to the same requirements as those relating to securities?
 - c) Would the Commission provide exchanges with legal certainty regarding its security versus non-security determinations?
- 23) Could a national securities exchange facilitating trading in digital asset securities be permitted to follow the typical non-intermediary model used by existing non-security digital asset exchanges?⁴⁰
 - a) If intermediaries are required:

⁴⁰ As discussed in Section IV.A below, this model is critical to the operation of digital asset markets and an improvement from traditional market structures.

³⁷ Exchange Act § 3(a)(1).

³⁸ Exchange Act § 6(b)(1).

³⁹ See supra Section I.

- i) How would this impact the viability of these platforms, particularly given the challenges of operating a broker-dealer for digital asset securities?⁴¹
- ii) Would the introduction of intermediaries potentially result in increased fees for consumers?
- iii) How could the introduction of new digital asset trading technologies provide better investor protections? How should the Commission consider these potential benefits as part of any rulemaking?
- b) If intermediaries are not required:
 - i) How would traditional exchange responsibilities, such as operating as an SRO, apply in the context of non-broker-dealer (including retail) users?
 - ii) Would more limited regulatory requirements, such as engaging in market surveillance as an operator of the market, be more appropriate?
- 24) Would the SEC permit a digital asset security exchange to list digital asset securities that are also traded on unregulated platforms, notwithstanding its Section 6(b)(5) concerns raised in the spot Bitcoin ETF context?
 - a) If not, and given the ease in operating an unregulated trading platform and supporting digital asset securities thereon, would such a prohibition have the practical effect of applying to virtually all digital asset securities, and thereby harm investors by depriving them of any regulated platforms to acquire such assets?
- 25) Would the full scope of NSE requirements apply to an exchange trading digital asset securities? If so:
 - a) What would be the appropriate listing standards for digital asset securities? Existing listing standards typically consider, among other things, quantitative and qualitative standards that are more relevant for corporate securities than digital asset securities.
 - b) Could any national securities exchange grant unlisted trading privileges to a digital asset security listed on another exchange?
 - c) The rules of NSEs generally require that all transactions effected on the exchange be cleared through a registered clearing agency; would this be required for digital asset securities? See also Section IV.D.
 - d) How would the various NMS plans apply?
 - i) Should there be different NMS plans specifically designed and more appropriate for digital asset securities?
 - ii) Would the SROs need to amend their Consolidated Audit Trail rules to contemplate digital asset securities?

⁴¹ See infra Section VI.B.

- e) Would Regulation SCI apply? How would its references to "industry standards" be interpreted—as applying to the traditional securities industry or the digital asset industry?
- 26) Would digital asset securities traded on an exchange be deemed NMS securities, and therefore NMS stock? NMS stock is defined as any NMS security (generally all exchange-listed securities) other than an option. If so:
 - a) How would the various requirements under Regulation NMS, which are designed for traditional corporate stock and shares of stock, apply?
 - b) Would there be a national best bid and offer ("NBBO") for a digital asset security?
 - c) Given 24/7 markets, should non-U.S. trading platforms be included in the NBBO?
 - d) What would constitute a "round lot" under Regulation NMS, where digital asset securities are not measured in "shares?" Would all orders for and transactions in digital assets that are investment contracts be "odd lots" and thus excluded from various aspects of Regulation NMS?
 - e) How would Rule 611—i.e., the Order Protection Rule, which generally prohibits "trade-throughs"—and the relevant exceptions apply?
 - f) What data would be required to be reported to the tape as "core data"?
 - g) How would the various other reporting requirements, such as under Rules 605 and 606, which contemplate shares of stock, apply?
 - h) What pricing increment(s) would be permitted under Rule 612, which prohibits sub-penny quotations for stocks priced at \$1.00 or more per share?

27) How would Regulation SHO apply?

- a) Would exchange-listed digital asset investment contracts be considered equity securities for purposes of Rule 200(g), Rule 203, and Rule 204?
- b) Would exchange-listed digital asset investment contracts be "covered securities," by virtue of being "NMS stocks," for purposes of Rule 201?

IV. Custody of Digital Asset Securities

A. Digital Asset Trading Platforms

One of the most significant innovations of digital assets is the ability to conduct "real-time" or T+0 settlement. Existing regulations regarding the custody of securities, however, make it impossible to realize this considerable benefit. While custody rules for traditional securities are appropriately motivated by a clear regulatory interest—ensuring that customers can rely on their assets being held securely—they allow trades to settle on a T+2 timeframe. This delay permits third-party intermediaries to settle transactions. But if the settlement timeframe is compressed to seconds, reliance on third parties becomes impossible.

Traditional securities are typically held on behalf of investors by a custodial bank or broker-dealer (themselves holding through the Depository Trust Company). This facilitates post-trade settlement through existing channels and permits an investor to centralize their cash and securities with third-party custodians, making trading on multiple venues more capital-efficient. However, it means that real-time settlement (i.e., "t-zero" settlement) is not possible given that the third-party custodians must facilitate post-trade settlement.

The structure of existing digital asset trading platforms is different. Real-time settlement is expected because it is inherent to blockchain technology. Transfers of digital assets do not require intermediaries. But in order to provide real-time settlement off-chain, existing digital asset trading platforms must settle transactions on their own books—as opposed to the books of third-party custodians. Digital asset trading platforms can only settle transactions on their own books if they custody the digital assets themselves, which explains the difference in market structure.

The need to provide custody services to customers means that digital asset trading platforms may wish to register as a broker-dealer, or register an affiliate as a broker-dealer.⁴² For the real-time settlement model to work, all users of the platform would in turn be required to custody their assets with that custodian, through the same broker-dealer. Once again, existing rules present a roadblock.

First, real-time settlement means that clearing is not necessary. Clearing exists because there is a risk that, between the time the trade is made and when it settles, one party may fail to deliver either the money or the assets. That risk diminishes as the time lag disappears. Without the risk created by the time lag between execution and settlement, many of the rules related to clearing may not be necessary. On the other hand, new rules may be required to account for a unique feature of the blockchain—that entries are immutable. Whereas traditional markets can unwind transactions that are completed in error, fraudulently, or without proper authorization, this is not possible with digital asset securities. Reversing a transaction would require a new transaction.

The direct-trading model, and its need for exchange-based custody, also raises questions under Section 6(b)(2) of the Exchange Act, the "fair access" rule. This rule generally requires exchanges to allow any broker-dealer to become a member. This requirement may prohibit a digital asset security exchange from limiting membership to that one broker-dealer (i.e., itself or its affiliate). The alternative, admitting several broker-dealers as members that each separately handle custody of its own customers' securities, again prevents real-time settlement because it would require the introduction of post-trade netting and a clearing agency (to settle all of the trades of the various brokers). If digital asset platforms register as exchanges, they must, under current rules, allow other brokers to access the platform. This requirement has the effect of requiring clearing, and therefore eliminating the ability to effectuate real-time settlement, which was the purpose of the exchange custodying assets in the first place.

⁴² Although "mere custody" of securities, on its own, may not itself require a firm to register as a broker-dealer, the Commission and its Staff have regularly viewed custody combined with transaction execution or other services as potentially requiring registration under Section 15(a). See, e.g., Transfer Online, SEC Denial of No-Action Request (May 3, 2000) (transfer agent may be subject to broker-dealer registration when, in addition to custody services, it brings buyers and sellers of securities together, receiving a fee based on the completion of a transaction); M&A Brokers, SEC No-Action Letter (Jan. 31, 2014); GlobalTec Solutions, LLP, SEC No-Action Letter (Dec. 28, 2005); Swiss American Securities, Inc., Streetline, Inc., SEC No-Action Letter (in each case, granting relief from broker-dealer registration where the proposed services did not also include custodying investors funds or securities).

Additionally the SEC has traditionally been hesitant to allow an exchange, or an affiliate of an exchange, to act as a full-service broker for customers on the exchange because of (i) the potential unfair advantage that one broker-dealer would have, and (ii) conflicts of interest the exchange would face in regulating its affiliated broker-dealer member.⁴³ When there are only a handful of large exchanges, these concerns are valid. In the digital assets markets, however, because trading platforms also serve as custodians and because most trades occur directly, without an intermediary, the competition for customers is between exchanges, not between brokers. This structure, in which customers trade directly on the platform, also significantly mutes any risk that a platform could provide undue advantage to its own broker-dealer; the broker and the platform operate as one service for the customer. It is a fundamentally different business model and therefore presents a different set of risks, necessitating a different regulatory regime.

Key questions for the Commission to consider and seek public input on:

- 28) Can a digital asset securities exchange provide custody of digital asset securities without also being subject to registration as a broker-dealer?
- 29) If broker-dealer registration would be required, would a digital asset securities exchange be permitted to limit membership to one affiliated broker-dealer?
- 30) Would a digital asset securities exchange be permitted to custody both digital asset securities and non-security digital assets?
- 31) Given the differences in business models between traditional securities markets and digital asset markets, what risks might be presented by a digital securities trading platform that do not exist for traditional platforms or exchanges? What risks exist for traditional trading venues that would not exist for digital asset security trading venues?

B. Broker-Dealers

Custody rules present a second major hurdle for digital asset securities markets. As noted above, custody requirements embrace the traditional intermediated model, and provide detailed requirements for how intermediaries may safeguard customer assets, making them difficult to apply to digital asset markets. But these requirements are based on the assumption that assets–or more accurately the proof that a person holds the asset–takes a certain physical form. Proof of ownership of digital assets is represented differently. The Commission has not yet put

⁴³ See, e.g., Order Approving Proposed Rule Change by the Pacific Exchange, Inc., as Amended, and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 4 and 5 Concerning the Establishment of the Archipelago Exchange as the Equities Trading Facility of PCX Equities, Inc., Exchange Act Release No. 44983 (Oct, 25, 2001) ("The Commission recognizes that the potential for unfair discrimination may be heightened if a national securities exchange or its affiliate owns or operates a broker dealer. This is because the financial interests of the national securities exchange may conflict with its responsibilities as an SRO regarding the affiliated broker-dealer. For this reason, the national securities exchange must not serve as the self-regulatory organization that is primarily responsible for examining its affiliated broker-dealer. Moreover, a conflict of interest would arise if the national securities exchange (or an affiliate) provided advantages to its broker-dealer that are not available to other members, or provided a feature to all members that was designed to give its broker-dealer a special advantage"). The Commission has also required national securities exchanges to implement rules prohibiting such exchanges from being affiliated with a broker-dealer member without prior SEC approval. *See, e.g.*, New York Stock Exchange Rule 2B; Nasdag Stock Market, General Rule 2, Section 4(a); Cboe BZX Exchange Rule 2.10.

forward a workable means of achieving the regulatory goal of broker-dealer custody rules: ensuring that customer assets are securely held while facilitating the trading in which customers wish to engage.

Rule 15c3-3, known as the "Customer Protection Rule," is central to this issue. The rule requires that a broker-dealer maintain "physical possession" or "control" over customers' fully paid and excess margin securities in particular ways set out in the rule, such as by holding the paper security certificate (physical possession) or holding through a bank or clearing agency (control). Rule 15c3-3, originally adopted in 1972, does not list holding blockchain private keys as a permitted method of physical possession or control, and the SEC Staff's general position has been that holding blockchain private keys does not qualify as good physical possession or control.⁴⁴

Rather, the staff has suggested that broker-dealers effectively must avoid becoming subject to the rule, by only facilitating transactions in digital asset securities that do not involve the broker-dealer maintaining custody.⁴⁵ Furthermore, even though, by its terms, Rule 15c3-3 applies to cash and securities, the Staff has suggested that broker-dealers would be required to comply with the possession or control obligations even when custodying digital assets that are not securities.

The SEC has attempted to provide a path forward. These attempts, however, are time-limited, not enshrined in final rules, and have ultimately proved not to be workable. In September 2020, the SEC Staff approved a process by which ATSs could facilitate transactions in digital asset securities, where custody is maintained by a third-party custodian (the "Three-Step No-Action Letter"),⁴⁶ and in December 2020, the Commission released a time-limited conditional no-action position related to broker-dealer custody of digital assets (the "Commission No-Action Position").⁴⁷ Both documents required significant limitations on the business activities of broker-dealers who custody digital assets, and do not present a workable solution. We are not aware of any firms that have sought to rely on the Commission no-action position. As a result, even if a digital asset security exchange were to adopt a broker-intermediated model, there appear to be *no* broker-dealers that could act as members because of Rule 15c3-3 and the limitations of the SEC's current "special purpose" digital asset security custody position.⁴⁸

As part of issuing its December 2020 no-action position, the Commission requested comment from the public on its approach.⁴⁹ Despite receiving dozens of comment letters in response to its request, the Commission has not revised its position or used these comments to inform

⁴⁷ Custody of Digital Asset Securities by Special Purpose Broker-Dealers, Exchange Act Release No. 34-90788, 86 Fed. Reg. 11,627 (effective Apr. 27,

2021), https://www.sec.gov/rules/policy/2020/34-90788.pdf.

⁴⁴ SEC, *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities* (July 8, 2019), <u>https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securitie</u> <u>s</u> (the "Joint Staff Statement").

⁴⁵ Id.

⁴⁶ FINRA, SEC No-Action Letter at 2 (Sept. 25,

^{2020), &}lt;u>https://www.sec.gov/divisions/marketreg/mr-noaction/2020/finra-ats-role-in-settlement-of-digital-asset</u> -security-trades-09252020.pdf.

⁴⁸ See, e.g., Hester M. Peirce, Statement, *In the Matter of Poloniex, LLC* (Aug. 9, 2021), <u>https://www.sec.gov/news/public-statement/pierce-statement-poloniex-080921</u> (noting the limited usefulness of the SEC's no-action relief).

⁴⁹ Commission No-Action Position, *supra* note 46 at 16–17.

rulemaking.⁵⁰ We urge the Commission to reengage on this issue to find a workable solution that provides robust customer protection while also enabling investors to access the digital asset securities markets.

Broker-dealers are also subject to Rule 15c3-1, known as the "Net Capital Rule." The Net Capital Rule is designed to ensure that broker-dealers maintain sufficient unencumbered, liquid capital available at all times to satisfy customer claims promptly. A broker-dealer's net capital is calculated by starting with its net worth under generally accepted accounting principles ("GAAP"),⁵¹ and then making various adjustments prescribed by the rule, in particular, deducting non-allowable assets such as those not readily convertible into cash.⁵² While customer assets custodied by a broker-dealer are typically not recorded on a broker-dealer's balance sheet, recent SEC Staff guidance ("SAB 121")⁵³ announced the SEC accounting Staff's view that certain entities that hold custody of customers' digital assets should account for their obligation to safeguard the digital assets by recording (i) a liability on their balance sheet for their obligation to return the digital assets, and (ii) an offsetting asset "similar in nature to an indemnification asset," but "separate and distinct from the crypto-asset itself"—i.e., essentially a "stub" accounting entry.⁵⁴

While by its terms aimed at issuers of securities and SEC reporting companies, it is not clear the extent to which the SEC Staff would view SAB 121 as applicable to broker-dealers that hold custody of digital asset securities for customers, where those broker-dealers are not issuers or reporting companies.⁵⁵ If SAB 121 applies to a broker-dealer's financial accounting, all digital assets and digital asset securities custodied by a broker-dealer for its customers would be added to the broker-dealer's liabilities, thus decreasing the broker-dealer's net worth under GAAP. And on the other side of the balance sheet, although the broker-dealer would be able to add some type of offsetting stub asset entry, such an asset would likely be deemed "not readily convertible into cash" under the Net Capital Rule, as there is no market for this accounting stub. For purposes of computing a broker-dealer's net capital, therefore, its liabilities would increase by the fair value of the digital asset securities held in custody, while its allowable assets would not increase by a corresponding amount. Accordingly, for every dollar worth of digital asset securities custodied, the broker-dealer would have a dollar reduction in its net capital, which the broker-dealer would need to replace with allowable assets. In effect, the parent company of the broker-dealer would need to contribute a dollar of cash as additional equity into the broker-dealer for every dollar worth of digital asset security custodied by the broker-dealer. Such a business model would, of course, be non-economic and unsustainable, and no broker-dealers would be able to offer custody services in digital asset securities.

Key questions for the Commission to consider and seek public input on:

32) Is it practical for digital asset security trading platforms to operate in a non-custodial manner as suggested by the Joint Staff Statement or the Three-Step No-Action Letter?

⁵⁰ SEC, SEC Policy Statement: Custody of Digital Asset Securities by Special Purpose Broker-Dealers (last modified May 3, 2022), <u>https://www.sec.gov/comments/s7-25-20/s72520.htm</u>.

⁵¹ See Exchange Act Rule 15c3-1(c)(2) and Interp. /01.

⁵² See Exchange Act Rule 15c3-1(c)(2)(iv).

⁵³ SEC, Staff Accounting Bulletin No. 121, https://www.sec.gov/oca/staff-accounting-bulletin-121.

⁵⁴ Id. at n.8.

⁵⁵ SAB 121 by its terms applies to "crypto-assets," which would appear to include digital asset securities, as SAB 121 defines the term broadly as "digital asset[s] that [are] issued and/or transferred using

distributed ledger or blockchain technology using cryptographic techniques." *Id.* at n.3.

- 33) How should "possession" and "control" be understood with regard to custody of digital asset securities?
- 34) Should banks or trust companies, to the extent permitted to provide custody services pursuant to their applicable regulatory regime, be eligible to act as "good control locations" through which broker-dealers could maintain custody of their customers' digital asset securities (and non-security digital assets) in compliance with Rule 15c3-3?
 - a) Under the existing Customer Protection Rule, banks can serve as good control locations for securities under Rule 15c3-3;⁵⁶ is there any basis to treat digital asset securities custodied with a bank differently?
- 35) How should Rule 15c3-3 be amended to explicitly consider its application to digital assets?
- 36) What protections or structures would be appropriate to adequately protect customers in the event of the insolvency of a broker-dealer that custodies digital assets for customers (whether securities or not)?
- 37) Should non-security digital assets be subject to Rule 15c3-3 at all, given that they are neither cash nor securities?
- 38) What best practices exist for the custodying of digital assets that should be adopted as requirements through securities regulation?
- 39) What benefits does distributed ledger technology offer with respect to transparency of transaction activity that might address risks addressed through regulation for traditional securities? What new risks does the technology introduce regarding mistaken or unauthorized transactions, and how can these risks be mitigated through regulation?
- 40) How should Rule 15c3-1 be amended to explicitly consider its application to digital assets, including with regards to digital assets held by customers, in inventory, or used as collateral?
- 41) If a broker-dealer holds custody of digital asset securities, would SAB 121 apply to the broker-dealer's capital requirement calculations? If SAB 121 does apply:
 - a) Would the SEC consider adjusting net capital calculations under Rule 15c3-1 so that broker-dealers with material custody business are not effectively prevented from meeting their net capital requirements?
- 42) Would the SEC permit the offsetting stub asset to be allowable for purposes of a broker-dealer's net capital, even though it may not be readily convertible into cash?

C. Requirement for and Role of Transfer Agents

Distributed ledger technology provides an unchangeable record of transactions, visible to all. This could revolutionize how transfer agents can facilitate securities trades. Before the advent of blockchain technology, there was no way to ensure that transactions were recorded accurately and records were properly maintained without the use of third parties. To facilitate the traditional

⁵⁶ Exchange Act Rule 15c3-3(c)(5).

intermediated market structure, transfer agents were established to record changes of ownership, maintain the issuer's security holder records, cancel and issue certificates, and distribute dividends. Some transfer agents are required to be registered with the SEC, or if the transfer agent is a bank, with a bank regulatory agency. Blockchain technology offers to improve this process, performing most if not all of these tasks, with limited labor costs, and without the risks of human error.

It is not clear, however, that existing rules will permit the use of this new technology. We understand that the Commission has only been willing to approve offerings of securities involving a transfer agent where that transfer agent has ultimate control over the official stockholder registry of a security, including the ability to unilaterally make changes to it (e.g., per a court order or to correct errors).⁵⁷ Based on structures that have been approved, it appears that the SEC has not permitted a registered transfer agent to look to a blockchain as its official stockholder registry, and has required that the transfer agent know the identity of each registered owner.⁵⁸ This position prevents the securities markets from realizing the efficiencies offered by the new blockchain technology, harming investors, markets, and issuers alike.

Key questions for the Commission to consider and seek public input on:

- 43) Is a transfer agent necessary for digital asset securities, where records of ownership, at least pseudonymously, are publicly available?
- 44) How may a person properly act as a transfer agent of a digital asset security, given the nature of blockchain-based assets?
- 45) Are there circumstances under which a registered transfer agent should be able to look to the blockchain as its official records?

D. Clearing Agency Status of Blockchains

There is currently uncertainty surrounding whether the blockchain, the nodes, miners, or validators on the blockchain, or others involved in facilitating the blockchain, are acting as a "clearing agency" and subject to registration with the SEC. A person who engages in "clearing" activities must generally register with the SEC as a clearing agency. A person is a "clearing agency" if, among other things, it acts as an "intermediary in making payments or deliveries or both in connection with transactions in securities," it "acts as a custodian of securities in connection with a system for the central handling of" fungible securities, or it "otherwise permits or facilitates the settlement of securities transactions . . . without physical delivery of securities certificates."⁵⁹

⁵⁷ See, e.g., Arca U.S. Treasury Fund, Form N-2,

https://www.sec.gov/Archives/edgar/data/1758583/000121465920005869/s624200n2a2.htm ("Although records of peer-to-peer transactions are viewable on Ethereum, record and beneficial ownership of the Fund's shares is reflected on the records of DTAC, LLC, the Fund's transfer agent (the 'Transfer Agent'). The Transfer Agent is regulated by the Securities and Exchange Commission ('SEC'). The Transfer Agent's records constitute the official shareholder records of the Fund and govern the record ownership of ArCoins in all circumstances.").

⁵⁸ See id.

⁵⁹ Exchange Act § 3(a)(23).

Given the functionality of various components of blockchain technology, it is possible that any or all of these components may be erroneously labeled "clearing agencies." Because a blockchain and each of its components operates without central control, it is not clear how it or any part of it could register as a clearing agency. Nor is the relevance or workability of clearing agency rules evident in the context of digital asset trading occurring on blockchain technology. Many of the rules applicable to clearing agencies are designed to ensure that there is clarity regarding how trades are settled, ensuring it operates fairly and in good faith with respect to all parties, and establishing it as a means of promoting compliance throughout the market. Once again, blockchain technology is specifically designed to mitigate many of the risks that regulation of clearing agencies is intended to address, such as ensuring trades settle, in an open, transparent, and provably final way. Therefore, not only is it unclear how the blockchain or other similar technology could register, it is not clear that the rules applicable to clearing agencies are needed with respect to digital asset securities.

Key questions for the Commission to consider and seek public input on:

- 46) Does the Commission view a blockchain on which digital asset securities may be transferred to be acting as a clearing agency? What risks does a blockchain present that would justify the application of these regulations? What risks does a blockchain mitigate that are presented by traditional clearing agencies? What new risks does blockchain present?
- 47) If so, who would be required to register? Each node, miner, or validator? A group representing them? Would this be practical, considering the often highly distributed nature of nodes, miners, and validators?
 - a) How would nodes, miners and validators satisfy the requirements to assure fair representation of their members and participants in the selection of their directors and the administration of their affairs, particularly where there are no formalized members, participants, or directors?⁶⁰
 - b) Would nodes, miners, and validators be required to become SROs like other clearing agencies?⁶¹ If so, would changes to the network require filings with and approval by the SEC under Rule 19b-4?
 - c) Would nodes, miners, and validators be required to establish, implement, maintain and enforce the detailed written policies and procedures mandated by Exchange Act Rule 17Ad-22(e)?
 - d) Would Regulation SCI apply to nodes, miners, and validators?⁶² How would its references to "industry standards" be interpreted—as applying to the traditional securities industry or the digital asset industry?
 - e) Would nodes, miners, and validators be subject to examination by the Office of Compliance Inspections and Examinations' Office of Clearance and Settlement?

⁶⁰ Exchange Act § 17A(b)(3)(C).

⁶¹ Exchange Act § 3(a)(28).

⁶² 17 CFR 242.1000 (including registered clearing agencies in the definition of "SCI SROs").

- 48) Given the typical permissionless nature of blockchains, how could registration be effected or enforced?
- 49) Could a broker-dealer or exchange facilitate trading of a digital asset security that could, or must, be settled over a blockchain that is not registered as a clearing agency?
- 50) In light of the difficulties described above with any potential registration, would the Commission offer a class exemptive order excluding blockchains from clearing agency registration? What conditions would be appropriate?

V. Necessary Preconditions to Rulemaking

The questions and challenges in this petition highlight the difficult and complex legal, policy, and technical considerations relating to the application of the existing federal securities law regime to digital asset securities. To properly weigh the costs and benefits raised by digital asset security activities, and to understand the market, practices, and needs of investors and market participants, the SEC should engage with all relevant stakeholders to inform the rulemaking we suggest above. We believe the Commission should take the following steps:

First, the SEC needs to seek input from market participants. The SEC has not yet obtained widespread public input, as it frequently does for novel and significant rulemakings. Rather, to date, the SEC has primarily engaged through non-public, bilateral discussions with particular industry members, or through enforcement investigations. It also does not appear that the SEC has engaged with, or solicited input from, retail investors. There is also no representation from the digital asset community on the Investor Advisory Committee or any of the SEC's other advisory committees.

The Commission has frequently used requests for comment, concept releases, advisory committees, and public roundtables to obtain useful public input prior to proposing specific rulemaking items. For example, the SEC first solicited public comment on climate disclosure in March 2021, a full year before proposing climate disclosure rules and, similarly, the SEC issued a concept release on the harmonization of securities offering exemptions in 2019, over a year before adopting rules.⁶³ The SEC has also pursued these forms of public engagement to obtain information about many other areas of potential rulemaking, including with regard to equity market structure, fixed income market structure, transfer agent regulation, "proxy plumbing," and emerging market considerations, among others. Banking regulators have similarly solicited public input on digital assets, for example by issuing requests for information.⁶⁴

⁶³ Acting Chair Allison Herren Lee, *Public Input Welcomed on Climate Change Disclosures* (Mar. 15, 2021), <u>https://www.sec.gov/news/public-statement/lee-climate-change-disclosures</u>; SEC, *The Enhancement and Standardization of Climate-Related Disclosures for Investors* (Mar. 21, 2022), <u>https://www.sec.gov/rules/proposed/2022/33-11042.pdf</u>; SEC, *Concept Release on Harmonization of Securities Offering Exemptions* (June 18, 2019), <u>https://www.sec.gov/rules/concept/2019/33-10649.pdf</u> (Concept Release; Request for Comment); SEC, *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets* (Nov. 2, 2020),

https://www.sec.gov/rules/final/2020/33-10884.pdf (Final Rule).

⁶⁴ FDIC, *FDIC Issues Request for Information on Digital Assets* (May 17, 2021), <u>https://www.fdic.gov/news/press-releases/2021/pr21046.html</u>.

One of the key reasons to conduct public outreach is to ensure that the rules proposed will actually function as intended when put into practice. Given the considerable differences in how digital assets operate, such input would help the Commission to understand the risks and how best to mitigate them. Thoughtful digital asset security rulemaking will require input from professionals with a deep technical expertise in the operation of digital assets and markets.

Second, the SEC's approach to digital asset regulation should be informed by ongoing developments in the executive and legislative branches. The Biden Administration has commissioned a number of reports on digital assets from various agencies in its March 2022 Executive Order,⁶⁵ and this work has only just begun. The Commission itself is requested to contribute to two of these reports, and the knowledge that the Commission gains through this process will be critical to any Commission rulemaking. Congress is also actively working on legislation that could materially affect the regulatory landscape.⁶⁶

Third, coordination between the SEC and other agencies, most notably the CFTC, is critical. CFTC Commissioner Pham and SEC Commissioner Peirce have recently recommended such joint collaboration, noting that "crypto is still early in its development," and such cooperation "would benefit the capital markets, not just the crypto markets."⁶⁷

* * *

The core question is how best to achieve the SEC's mission and promote the innovation and application of digital assets and blockchain technology within the capital markets and our economy more broadly. How best to regulate digital asset securities raises complex and novel issues, and will require thoughtful and rigorous engagement with all stakeholders. We appreciate the opportunity to provide input to the Commission on these important matters and hope the Commission will seek broad public input on how digital asset securities markets can be appropriately regulated in a manner that facilitates investor protection, capital formation, and efficient markets with the integrity investors and other market participants have come to expect. For that reason, we respectfully petition the Commission to solicit broader input from the public to address all relevant questions and challenges related to the regulation of digital asset securities with the goal of informing an important rulemaking on this subject. As noted above, we are

⁶⁵ Biden Administration, *Executive Order on Ensuring Responsible Development of Digital Assets* (March 9, 2022),

https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-resp onsible-development-of-digital-assets/.

⁶⁶ See, e.g., Lummis-Gillibrand Responsible Financial Innovation Act (released June 7, 2022), <u>https://www.lummis.senate.gov/wp-content/uploads/Lummis-Gillibrand-Responsible-Financial-Innovation-Act</u> <u>-Final.pdf</u>.

⁶⁷ Caroline D. Pham and Hester M. Peirce, *Making progress on decentralized regulation* — It's time to talk about crypto together (May 26, 2022),

https://thehill.com/blogs/congress-blog/3503277-making-progress-on-decentralized-regulation-its-time-to-tal k-about-crypto-together/ ("As an initial step, we are calling on our agencies to hold a joint set of public roundtables to evaluate recent market events and risks, and to discuss how to regulate crypto responsibly. These roundtables would be open to the public, and panelists would include crypto users, investor and customer advocates, industry members, and other regulators. The goal would be to assess whether new regulations are necessary to protect the public and the markets, how existing regulations might be modernized to better account for innovation, and how technology is likely to reshape our markets. We could start with topics such as digital asset trading platforms, crypto derivatives, stablecoins, decentralized finance, and the balance between privacy and anti-money laundering measures.").

committed to this endeavor as well, and expect to submit our thoughts on how to address some of these challenges in a series of follow-up responses to this petition.

We would be pleased to answer any questions the Commission or its Staff may have regarding our petition. We appreciate the Commission's continuing attention to this important matter and for allowing us an opportunity to present our views.

Sincerely,

Pres. yord

Paul Grewal

Chief Legal Officer

Coinbase Global, Inc.

CC:

Hon. Gary Gensler, Chair Hon. Hester Peirce, Commissioner Hon. Caroline Crenshaw, Commissioner Hon. Mark Uyeda, Commissioner Hon. Jaime Lizárraga, Commissioner

coinbase

Appendix

A Brief Overview of Howey and Reves

Howey

Whether an instrument constitutes an "investment contract" is determined by reference to a test articulated by the Supreme Court in *SEC v. W.J. Howey Co.*⁶⁸ In 1946, the Supreme Court articulated the *Howey* test in a case involving speculative investments by purely financially motivated parties in a Florida citrus grove profit-generating enterprise—activity plainly within the scope of the federal securities laws. The Court held that the investments amounted to "investment contracts" and thus "securities" because they involved each of the following features:

- (1) an investment of money;
- (2) in a common enterprise;
- (3) made with a reasonable expectation of profits; and

(4) based predominantly upon the entrepreneurial or managerial efforts of the promoter or other third parties.⁶⁹

In analyzing whether a particular instrument is an investment contract, the Supreme Court has emphasized that "form should be disregarded for substance and the emphasis should be on economic reality."⁷⁰ The SEC has adopted a similar position, indicating that "[d]etermining whether a transaction involves a security does not turn on labelling . . . but instead requires an assessment of the economic realities underlying a transaction All of the relevant facts and circumstances are considered in making that determination."⁷¹ An asset must meet each requirement of the *Howey* test to be an investment contract.

Reves

The *Reves* test was articulated by the Supreme Court in 1990 to interpret the term "any note." It is unreasonable to think Congress intended to apply federal securities regulation to every "note"—otherwise a homeowner would have to file a registration statement with the SEC when signing a mortgage note and could only refinance that note through a broker-dealer. Accordingly, the Court laid out a test that considers:

(1) the motivations of the buyer and seller;

^{68 328} U.S. 293, 301 (1946).

⁶⁹ *Id.* ("The test [for an investment contract] is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."); *see also Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel*, 439 U.S. 551, 558–62 (1979); *SEC v. Edwards*, 540 U.S. 389, 393 (2004).

⁷⁰ United Housing Found., Inc. v. Forman, 421 U.S. 837, 848–49 (1975) (internal quotation marks and citations omitted).

⁷¹ In re Munchee, Inc., Securities Act Release No. 10445, at 9 (Dec. 11, 2017).

- (2) the plan of distribution of the instrument;
- (3) the reasonable expectations of the investing public; and
- (4) the presence of an alternative regulatory or other risk-reducing regime.⁷²

Unlike the *Howey* test, which requires satisfaction of each of its requirements for an asset to be deemed a security, the *Reves* test is simply a set of factors that a court should consider in making its decision, with no one factor being dispositive or entitled to a particular weighting.

⁷² Reves v. Ernst & Young, 494 U.S. 56, 66–67 (1990).

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PART 1 Introduction PART 2 Stablecoins and Stablecoin Arrangements PART 3 Stablecoin Use Cases PART 4 Policy Considerations PART 5

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Disclosure: USD Coin (USDC) is a stablecoin issued by Circle. Coinbase and Circle co-founded the Centre Consortium, which supports and administers the governance of USDC. Coinbase has a financial interest in USDC. For more information, please refer to our annual and quarterly SEC filings.

PART 1

¹Wikipedia, Shell money

²BBC, <u>What tally sticks tell us</u> <u>about how money works</u> (10 July 2017)

³Financial Times, <u>Cryptocurrencies untether</u> <u>the goat of sovereign tender</u> (21 Feb 2019)



Introduction

Money takes many forms. It is conventionally defined as a store of value, a medium of exchange and a unit of account. All kinds of objects have been used as money in different times and places, from seashells,¹ tally sticks,² or even goats,³ to coins and paper notes. Whatever form it takes, money has a social dimension: it works because people believe in it and want to use it. Most people today think of money as either hard currency or bank deposits. In the future, we believe stablecoins will be used as money, just as easily as hard currency and bank deposits are today. Like any early stage technology, stablecoins are not yet widely understood, and their development has stretched policy makers' ability to keep up. We offer this whitepaper to help raise awareness of the underlying issues and to ground policy discussions in a solid, factual understanding of what stablecoins are and how stablecoin arrangements work.

Stablecoins are digitally native payment instruments that are designed to maintain a stable value compared to an external reference asset, usually a fiat currency such as the U.S. dollar.

They provide a bridge between the traditional financial system and the cryptoeconomy, allowing fiat currencies to exist in a form that can move more freely and more efficiently on blockchains. Unlike conventional payment methods, stablecoin payments require no centralized intermediary. As blockchain technology continues to improve, stablecoins could make it possible to send money to anyone, anywhere in the world as easily as sending a text message. Stablecoins could therefore be the foundation of a new era of innovation in financial services. But, like all financial instruments, they also present risks that need to be well understood and appropriately addressed by financial regulators.

Policy choices about stablecoins will fundamentally shape the future of the global financial system as it transitions to digitally native environments and distributed ledger technologies. Making good decisions requires understanding the different types of stablecoins and the arrangements underlying them. Our whitepaper explains how different stablecoin arrangements operate, the current and potential uses of stablecoins, and how to consider regulatory approaches that balance their potential benefits against their risks. The overarching goal is to provide insights and perspective to help shape the regulatory path forward. 1.1

Stablecoins and stablecoin arrangements

Two concepts frame the rest of this whitepaper: *stablecoins and stablecoin arrangements*.

Stablecoins are the actual tokens, i.e., digitally native payment instruments on a blockchain. A "stablecoin arrangement" is the ecosystem around a stablecoin, including the processes, people, and entities involved in using it. The processes include issuing and redeeming the stablecoin, transferring it between users and maintaining the stablecoin's peg. The people and entities include not only the stablecoin's holders and its issuer (which could be a legal entity or protocol), but also many others, such as custodians, developers, exchanges, market makers, and arbitrageurs.

Throughout the whitepaper, we use the term "stablecoin" to refer to a digital asset that is supposed to maintain a stable value. We want to use language that is familiar to most crypto market participants, and use technical terms only where their precision is important from a policy perspective. For the same reason, we use the following terms for three main types of stablecoins, based on the different mechanisms they use to maintain their value:

- **Fiat-backed:** Stablecoins backed by reserve assets in the traditional financial system, such as cash, cash equivalents, or securities
- **Crypto-backed:** Stablecoins backed by digital assets that exist and are used independently from the stablecoin arrangement
- Algorithmic: Stablecoins that are not backed by any reserve assets, that instead seek to maintain their value using algorithms to adjust their supply relative to another digital asset within the same stablecoin arrangement

These stablecoins fall into two types of arrangements:

- **Custodial arrangements:** Fiat-backed stablecoins have reserve assets held in custody by the stablecoin's issuer, and the issuer bears primary responsibility for issuance, redemption, and maintaining the stablecoin's peg
- Non-custodial arrangements: Crypto-backed and algorithmic stablecoins do not have reserve assets held in custody, and the core functions of the stablecoin arrangement are performed by automatic operation of smart contracts on a blockchain

These are general categories, and some stablecoins combine features from more than one of them, as the following sections of this whitepaper discuss in more detail.

1.2

⁴The Block, <u>Stablecoins,</u> as of 30 June 2022

⁵Id.

⁶BIS, <u>The journey so far: making</u> cross-border remittances work for financial inclusion (15 June 2022); Coinbase Institute, <u>Crypto</u> <u>& Remittances</u> (30 June 2022)

Background and roadmap

Section 2 of the paper provides an overview of the stablecoin market and types of stablecoins. Approximately \$145 billion in stablecoins are in circulation today.⁴ Fiat-backed stablecoins represent 91.7% of this amount, and nearly all are pegged to the U.S. dollar.⁵ Fiat-backed stablecoins have generally been successful in maintaining their pegs, though as we discuss below they are not without risk. Some crypto-backed stablecoins have also established good track records, even through periods of market dislocation. DAI, for example, makes innovative use of smart contracts and over-collateralization to protect its value against the volatility of prices of other digital assets. In contrast, algorithmic stablecoins like TerraUSD (UST) have attempted to use smart contracts to maintain their pegs without collateral, and almost all of these have failed. We discuss the successes and the failures in Section 2.

Section 3 discusses the expanding range of stablecoins' potential uses. The earliest and heaviest use of stablecoins is for paired-trading with other digital assets on blockchains. Stablecoins provide market participants the simplicity and efficiency of pricing assets in a common currency, near-instantaneous settlement of digital asset transactions, and a way to retain assets on-chain with less exposure to volatility. But stablecoins also have the potential for mainstream commercial uses such as merchant payments and can even reshape parts of traditional finance by which disadvantaged communities have been underserved. For example, the global average cost of sending a \$200 remittance was \$12.08 in 2021, and in many remittance corridors the typical cost is much higher.⁶ Stablecoins, in addition to other cryptocurrencies, make it possible for these payments to be made instantaneously at a much lower cost.

Section 4 covers a wide range of policy considerations that will inform decisions in many jurisdictions on the regulatory frameworks for stablecoin issuance and use. These include:

- Financial stability and run risk
- Operational resilience
- Prevention of financial crimes
- Consumer protection and market integrity
- Monetary policy
- Competitiveness
- Legal rights of stablecoin holders

In Section 5 we conclude with our recommendations regarding the path forward for stablecoin policymaking. Most importantly, we believe regulatory frameworks should not impose a one-size-fits-all approach on stablecoins. Fiat-backed stablecoins should meet rigorous requirements to support consumers' confidence. Regulatory frameworks should also hold space for continued experimentation with crypto-backed and algorithmic stablecoins, within guardrails for consumer protection and financial stability.

1.3

⁷Coinbase, <u>About Coinbase,</u> as of 30 June 2022

⁸The Coinbase Blog, <u>Listing</u> <u>assets on Coinbase is free, and</u> <u>always has been</u> (31 May 2022)

[°]Coinbase, <u>Digital Asset Policy</u> <u>Proposal (#dApp)</u> (14 Oct 2021)

10 Coinbase, Public Policy

¹¹Coinbase, Coinbase Institute

About Coinbase

Coinbase provides a trusted and easy-to-use platform for accessing the broader crypto economy. Today, there are approximately 98 million verified users, 13,000 institutions and 230,000 ecosystem partners in over 100 countries who rely on Coinbase to easily and securely spend, save, earn, and use stablecoins and other cryptocurrencies.⁷ We offer custody services for 212 digital assets and trading services for 172 digital assets, including stablecoins, on our platform.⁸

Coinbase favors a comprehensive approach to the regulation of digital asset activities, tailored to the benefits and risks raised by these activities. We strongly believe that regulation of digital asset activities should not simply seek to pigeonhole new activities into existing categories, which are often ill-suited to the task. Designing an effective regulatory framework calls for careful balancing of risks, benefits, and tradeoffs. We actively contribute to the policy discussion through publications like our Digital Asset Policy Proposal (#dApp),⁹ responses to regulatory proposals and consultations,¹⁰ and research from the Coinbase Institute.¹¹ This whitepaper is a further contribution to that important discussion. ¹²The Block, <u>Stablecoins,</u> as of 30 June 2022

PART 2

¹³Id.

Stablecoins and stablecoin arrangements

Stablecoins have rapidly gained popularity in the past few years in response to users' demand for stable and secure digital assets. As shown below, the total market capitalization of stablecoins globally is currently around \$145 billion, roughly 1.4 times the \$106 billion market capitalization as of the end of May 2021, and 13 times the \$11 billion market capitalization as of May 2020.¹² The four largest stablecoins today are USDT, USDC, BUSD, and DAI, which together comprise roughly 94.8% of the market.¹³

Figure 1: Market capitalization of USDT, USDC, BUSD, DAI¹⁴ (\$BN, 1/1/20 - 6/30/22)



The trading volume of stablecoins has generally increased over time. In the past, stablecoin on-chain trading volume, as shown below, has generally been correlated with overall digital asset prices – stablecoins have traded in greater volume as digital asset prices increased. This changed in Q2 2022, when the volume of stablecoin on-chain trading increased following the collapse of UST and an overall decline in digital asset prices (Figure 2). This arguably shows digital asset market participants' willingness to remain digitally native in a market downturn, and demonstrates the use of stablecoins as a store of value outside of the traditional financial system.

Figure 2: Quarterly stablecoin trading volume and Bitcoin prices, Q1 2018 to Q2 2022 $^{\scriptscriptstyle 15}$

Quarterly on-chain trading volume shown for USDT, USDC, DAI, USDP, HUSD, GUSD, BUSD in \$ billions. BTC quarterly average prices shown in \$ thousands.



¹⁵The Block, <u>Adjusted On-chain</u> <u>Volume of Stablecoins</u>, as of 30 June 2022; Coinmarketcap, <u>Bitcoin Price</u>, as of 30 June 2022



Bitcoin price averaged over a quarter

Quarterly stablecoin on-chain trading volume



Defining characteristics of stablecoins

Stablecoins differ from conventional payment instruments in several ways. Although the designs differ, all stablecoins today possess each of these characteristics to varying degrees.

#1	Digitally native and programmable Stablecoins run on blockchains operating like cash on digital rails. Security is enforced through private keys (complicated passwords) and they can be programmed in smart financial contracts that are self-executing based on predetermined conditions.
#2	Decentralized (peer-to-peer) transactions Stablecoins do not require a centralized third party, like a bank, to facilitate a transfer. They operate on 'permissionless' blockchains that allow any two counterparties to transact according to the rules established by the blockchain protocol.
#3	Operationally transparent Stablecoins transactions are fully observable on blockchains, making it possible for users and regulatory authorities to fully track their use, measure circulation, and assess their functionality and reliability.
#4	Pseudo-anonymous Transactions occur between digital wallets identified by a random arrangement of characters that preserve anonymity. However, once an address is connected to a person or entity, their full history of wallet transactions is revealed, resulting in a loss of anonymity.
#5	Stable value Stablecoins are less volatile than other cryptocurrencies, such as Bitcoin or Ether, because their value is pegged to fiat currencies. While different stablecoin arrangements can lead to different levels of price stability, their pegged values allow them to serve as a reliable medium of exchange.

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2.1

¹⁶ Christian Catalini and Alonso de Gortari, <u>On the Economic Design</u> <u>of Stablecoins (</u>5 Aug 2021).

Types of stablecoins

There are different ways that stablecoins maintain a stable value relative to the reference currency, falling into three general categories: fiat-backed stablecoins, crypto-backed stablecoins, and algorithmic stablecoins. These categories are not mutually exclusive, and a stablecoin may also use a combination of these mechanisms to maintain its value.

The core questions of stablecoin design are embodied in a problem known as the stablecoin trilemma: a theoretically perfect stablecoin would have three key features – price stability, capital efficiency, and decentralization – but, because of the tradeoffs between these features, no stablecoin can possess all three at once.¹⁶

- **Price stability** is the strength of a stablecoin's ability to maintain its peg, even through periods of market stress.
- **Capital efficiency** refers to the total amount of assets (reserves plus a capital buffer) that a stablecoin needs to maintain its price stability; safe, liquid assets do not need as large a buffer and are therefore more capital efficient, as discussed below.
- **Decentralization** is the extent to which control of a stablecoin arrangement is distributed among its participants, and not concentrated in any single person or entity.

Each type of stablecoin represents a different tradeoff within the trilemma. Fiat-backed stablecoins have price stability and capital efficiency, but not decentralization. Crypto-backed stablecoins have price stability and decentralization, but not capital efficiency. Algorithmic stablecoins have decentralization and capital efficiency, but not price stability.

Figure 3: Stablecoin Trilemma



2.1.1

Fiat-backed stablecoins

A fiat-backed stablecoin is generally issued in exchange for a fiat currency that is then used to invest in reserve assets denominated in the same currency. By this process the original fiat currency becomes digitally native and can travel on the blockchain. The issuer of a fiat-backed stablecoin maintains the stablecoin's 1:1 peg with the fiat currency by holding reserve assets of at least equal value to the total amount of stablecoins outstanding. That is, the reserves back an issuer's obligation to redeem a stablecoin at its face value. Holding reserves in excess of the total amount outstanding provides a capital buffer for further stability. All fiat-backed stablecoins operate within custodial arrangements, as discussed in section 2.2 below.

As of June 2022, an estimated 91.7% of the total market capitalization of all stablecoins are fiat-backed stablecoins pegged to the U.S. dollar.¹⁷ Their defining characteristic is that reserve assets are held by custodians in the traditional financial system, apart from any blockchain.

The fundamental factors affecting a stablecoin's ability to maintain its peg to a fiat currency are: (1) the composition of its reserve assets, and (2) the size of its capital buffer. The capital buffer is necessary to protect against an unexpected decrease in the value of the reserve assets, which typically include cash, cash equivalents, and government bonds maturing within 90 days. But a fiat-backed stablecoin might also be backed by other types of assets, e.g. securities or commodities such as precious metals. The riskier and less liquid a stablecoin's reserve assets are, the larger the buffer needs to be to maintain a stable peg. In this respect, the economics of stablecoin reserves can draw on well-established principles from bank regulatory capital frameworks.

Reserve composition and buffer size are not the only determinants of a stablecoin's price stability. Clear, detailed disclosures verified by an independent accountant are necessary to alleviate concerns that might spark a run. Stablecoin arrangements also need to maintain strong risk management practices, encompassing financial as well as operational risks. Effective operational risk management is critical to maintaining a smoothly functioning redemption process, which in turn is necessary for stablecoin holders to have confidence in their ability to exchange the stablecoin for fiat currency on demand. Stablecoin issuers must also exercise care in establishing relationships with other institutions that perform critical functions within the stablecoin arrangement. For example, holding cash reserves at a bank may expose stablecoin holders to significant losses if the bank were to fail, especially where cash reserves are commingled in a single account and subject to a deposit insurance limit of only \$250,000.

The quality and liquidity of stablecoins' reserve assets are particularly relevant during periods of market stress. In May 2022, when the Terra USD (UST) algorithmic stablecoin collapsed, USDC and BUSD, which are backed by cash and short-term U.S. Treasuries, generally maintained their pegs.¹⁸ In contrast, USDT's reserves reportedly include some assets that are riskier and less

¹⁷The Block, <u>Stablecoins,</u> as of 30 June 2022

¹⁸ Circle, <u>How to Be Stable – USDC</u> <u>Transparency and Trust</u> (13 May 2022); Binance, <u>The Importance of</u> <u>Fiat Reserve-Backed Stablecoins</u> (10 May 2022); see also Coingecko, <u>Tether Price Chart</u>; Coingecko, <u>USDC Price Chart</u>; Coingecko, <u>BUSD Price Chart</u>.

¹⁹ For more information on USDT reserve assets, see Tether's Transparency Report. As of 31 March 2022, USDT's self-reported reserves included 4.52% in corporate bonds, funds, and precious metals; 3.82% in secured loans to unaffiliated entities: and 6.02% in other investments including digital tokens. The remaining 85.64% is invested in a general category of assets called "Cash & Cash Equivalents & Other Short-Term Deposits & Commercial Paper.' 28.47% of the assets in this category are commercial paper and certificates of deposit. Some of these assets entail credit risk and may contribute to concerns regarding the reliability of USDT's reserves in maintaining a stable peg.

²⁰Coingecko, <u>Tether Market</u> <u>Capitalization Chart.</u>

²¹Coingecko, <u>USDC Market</u> <u>Capitalization Chart.</u>

²²Coingecko, <u>Tether Price Chart;</u> Coingecko, <u>USDC Price Chart;</u> Coingecko, <u>BUSD Price Chart.</u> liquid. These features may have contributed to USDT's deviation from its one dollar peg during this stress period.¹⁹ Changes in the market capitalization of each of these stablecoins show how the quality and liquidity of a stablecoin's reserve assets can be important to their long-term resilience. USDT's market capitalization fell from \$72.58 billion to \$66.41 billion from May to June 2022,²⁰ whereas USDC's market capitalization increased from \$53.73 billion to \$55.6 billion over that same period.²¹

Over longer time horizons, the market prices of leading fiat-backed stablecoins have generally remained stable, with only a handful of instances where the price at which one of these stablecoins could be purchased or sold on an exchange deviated more than half a basis point (\$0.005) below the stablecoin's face value.²² These deviations generally occurred due to major, short-term increases in volatility in crypto asset markets and were quickly eliminated. In most cases, the stablecoin's price returned to within \$0.005 of its face value within a few hours. As shown in the figure below, there are minimal fluctuations in the price of USDT and USDC stablecoins from their pegs. From January 2021 to the end of May 2022, both USDT and USDC ranged between \$0.995 to \$1.005 a vast majority of the time.

Figure 4: Peg deviations for USDT and USDC January 2021 – June 2022²³



	# of hours	% of hours
Price < \$0.995	18	0.14%
\$0.995 ≤Price ≤ \$1.005	13,078	99.80%
Price ≥ \$1.005	8	0.06%
Total	13,104	100%

Peg stability for USDC January 2021 – June 2022 \$USD, prices observed at the end of every hour



	# of hours	% of hours
Price < \$0.995	9	0.07%
\$0.995 ≤Price ≤ \$1.005	13,086	99.86%
Price ≥ \$1.005	9	0.07%
Total	13,104	100%

12

²⁴ JPMorgan, <u>Onyx Coin Systems,</u> as of 30 June 2022

²⁵USDF Consortium, <u>Introducing</u> <u>the USDF Consortium</u>, as of 30 June 2022 The definition of fiat-backed stablecoins can also include deposit coins, which are digital representations of deposits at a bank. Deposit coins are not yet a widely adopted method of putting fiat currencies on blockchain rails but may emerge over time. Examples of deposit coins include JPM Coin²⁴ and USDF.²⁵

Deposit coins are a promising innovation, but their potential will be hard to realize without significant changes to existing bank regulations. Banks today must satisfy Know-Your-Customer (KYC) requirements with respect to each depositor, which means that deposit coins cannot trade freely outside of a bank's perimeter on public blockchains. Regulatory authorities would also need to determine how deposit coins should be covered by deposit insurance, and how users' deposit coin holdings should be aggregated in relation to deposit insurance limits (e.g., in the United States, \$250,000). The claims of deposit coin holders should also have the same priority (i.e. rank pari passu) as traditional bank deposits in the event that the bank fails. Each of these issues would likely require changes to the bank regulatory framework in most jurisdictions.

Crypto-backed stablecoins

A crypto-backed stablecoin is similar to a fiat-backed stablecoin in that both sustain their pegs based on a pool of reserve assets of at least equal value to the total amount of the stablecoins outstanding. However, a cryptobacked stablecoin relies on digital assets whose primary purpose is not to support the stablecoin. DAI, for example, is a crypto-backed stablecoin that is minted in U.S. dollar denominations by posting another digital asset as collateral. To prevent the value of DAI from dropping below its face value, the amount minted is only a fraction of the value of the collateral posted.²⁶ This overcollateralization serves as a buffer for any volatility in the price of the posted collateral relative to the dollar and pledged digital asset. This is conceptually similar to what happens when borrowers ask for a home equity loan at a bank. Borrowers post their houses as collateral, and the bank issues them newly minted currency in the form of a loan.

Crypto-backed stablecoins have another key difference from fiat-backed stablecoins in that there is no custodial arrangement. As with algorithmic stablecoins discussed in the next section, they rely on smart contracts to maintain their pegs. For example, the MakerDAO smart contract that governs DAI provides for the automatic liquidation of a user's collateral if its value drops below a pre-specified threshold.²⁷ While abrupt deviations in prices might yield unexpected liquidations, this mechanism protects the integrity of the peg.²⁸ DAI's track record demonstrates that this solution has been relatively effective to date in maintaining its peg to \$1.00, as does its resilience during the May 2022 volatility period.²⁹ The following figure shows that the price of DAI, like USDT and USDC, generally remained within a narrow range between \$0.995 and \$1.005 from January 2021 to the end of June 2022.

2.1.2

²⁶MakerDAO, <u>A Guide to Dai Stats.</u>

²⁷Id.

²⁸MakerDAO, <u>Liquidation</u>, as of 30 June 2022.

²⁹ Data sourced from <u>CryptoCompare</u>, as of 30 June 2022

Figure 5: Peg stability and market capitalization for DAI ³⁰



Peg stability for DAI January 2021 - June 2022

	# of hours	% of hours
Price < \$0.995	54	0.41%
\$0.995 ≤Price ≤ \$1.005	12,910	98.52%
Price ≥ \$1.005	140	1.07%
Total	13,104	100%

Peg stability for DAI May 2022 – June 2022

	# of hours	% of hours
Price < \$0.995	1	0.07%
\$0.995 ≤Price ≤ \$1.005	1,461	99.80%
Price ≥ \$1.005	2	0.14%
Total	1,464	100%

³⁰Id.

³¹See, e.g., <u>On the Economic</u> <u>Design of Stablecoins</u>, by Christian Catalini and Alonso de Gortari, (August 5, 2021).

2.1.3

The primary weakness of crypto-backed stablecoins is their capital inefficiency. While over-collateralization can be an effective way to maintain a 1:1 peg, the amount of resources needed to protect against the volatility of collateral assets' prices is substantially larger than the resources required for traditional finance arrangements.³¹

Algorithmic stablecoins

Algorithmic stablecoins are similar to crypto-backed stablecoins in that they both operate in non-custodial arrangements using smart contracts, but there is a key difference. Crypto-backed stablecoins have reserve assets that exist apart from the stablecoin arrangement, whereas algorithmic stablecoins use another digital asset within the same arrangement to maintain their peg. That is, the value of the digital asset backing an algorithmic stablecoin depends on the stability of the stablecoin itself. This is commonly referred to as endogenous backing. An endogenously backed algorithmic stablecoin involves two tokens: a stablecoin with an intended fixed face value, and an investment token with a floating value. The algorithm enables each token to be converted into the other at a ratio determined by the investment token's market price. For example, if the investment token has a market price of \$10, and the stablecoin has a face value of \$1.00, one stablecoin can be converted into one-tenth of an investment token. So long as the investment token has a non-zero market value, and the aggregate value of the investment tokens is greater than the combined face value of all minted stablecoins, the stablecoin should in theory be able to maintain its peg.

The primary weakness of algorithmic stablecoins is that their value could collapse if confidence wanes in the stablecoin arrangement as a whole - a so-called "death spiral." As seen with the Terra USD stablecoin (UST), which was endogenously backed by LUNA tokens, it can be difficult for an algorithmic stablecoin to maintain its peg to a fiat currency. LUNA tokens had a floating value based on their utility in the Terra ecosystem and served as the shock absorber for UST. When UST began to lose its peg on May 9, dropping below \$1, speculators could buy and swap the discounted UST for \$1 of LUNA. In theory this arbitrage should have driven the price of UST back to \$1. In practice, the LUNA token was unable to maintain its value and support the arbitrage. Each UST coin burned required new LUNA tokens to be minted, and the supply of LUNA ballooned, diluting its value. Moreover, the demand for minting new LUNA was so strong that the network became congested, more costly, and unable to keep up. As a result, the price of LUNA dropped on trading platforms. The loss of confidence in UST fueled a loss in confidence in LUNA, which fueled a loss in confidence in UST - accelerating into the death spiral of a stablecoin that as of May 8 had a market cap of more than \$18.6 billion.³²

The UST death spiral was not entirely unexpected. As described by Christian Catalini and Alonso de Gortari in August 2021, "Death spirals are likely to occur whenever the value of a stablecoin's reserve is tied to the future success of the stablecoin itself, for example through the inclusion of an investment token as part of the reserve assets."33 The point of no return in the UST-LUNA death spiral was when the total market value of LUNA dropped below the total market value of UST in circulation – meaning a full conversion could no longer be supported. As this breaking point approached on May 9, the Luna Foundation Guard, a reportedly nonprofit entity established to support UST's peg in the event of a crisis, announced the release of Bitcoin reserves to purchase UST and drive its price back up. But it was too late. The run on UST could not be stopped, and by May 13 even Do Kwon, the CEO of Terraform Labs, acknowledged that UST would never restore its peg.³⁴ The collapse of UST and LUNA provides real-world evidence to support the theoretical prediction that a purely algorithmic stablecoin would struggle to maintain its peg during a market stress event.

³²Coingecko, UST Price, last visited 30 June 2022

33 Catalini, supra at 16

³⁴Do Kwon, <u>Terra Ecosystem</u> <u>Revival Plan</u> ("While a decentralized economy does need decentralized money, UST has lost too much trust with its users to play the role.")

Figure 6: Terra USD (UST) price in May 2022 35



³⁵Data sourced from <u>CryptoCompare</u>, as of 30 June 2022

2.2

Stablecoin arrangements: custodial and non-custodial

A stablecoin arrangement is the ecosystem around a stablecoin, including the processes, people and entities involved in using it. There are two types of stablecoin arrangements: custodial and non-custodial. Unlike the traditional payments system, in which banks can control the creation, redemption, transfer, and storage of money, both types of stablecoin arrangements can have these functions performed by different parties.

In a custodial arrangement, the reserve assets backing the stablecoin are held in custody by the stablecoin's issuer. The issuer bears primary responsibility for maintaining the functioning of the stablecoin arrangement. In many cases, the issuer may rely on third parties to fulfill this responsibility. For example, the issuer of a fiat-backed stablecoin would maintain an account at a bank to hold cash and other reserves, and may work with exchanges and market makers to facilitate issuance and redemption transactions. Non-custodial arrangements seek to operate without the need for a stablecoin's holders to place their trust in an issuer or other intermediary. They do so by structuring the economic relationships among participants in the stablecoin arrangement through blockchain protocols.

All fiat-backed stablecoins must operate within a custodial arrangement; fiatdenominated assets exist in the traditional financial system, and therefore require an intermediary to interface with a blockchain. A crypto-backed stablecoin could potentially operate in a custodial arrangement, though most of them have non-custodial arrangements. All algorithmic stablecoins operate in non-custodial arrangements.

The following table, adapted from the Financial Stability Board's report on "Regulation, Supervision and Oversight of 'Global Stablecoin' Arrangements,"³⁶ describes the functions and activities in stablecoin arrangements, both custodial and non-custodial.

Table 1: Stablecoin arrangements - functions and activities

Functions	Activities	Description
Governance	Establishing rules governing the stablecoin arrangement	Rules covering, among other matters, the types of entities that may be involved in the arrangement, the protocol for validating transactions, the mechanism for maintaining the stablecoin's peg, and arrangements for management and ownership of the reserve assets
	Issuing, creating and destroying stablecoins	The mechanism through which stablecoins may be issued or created (i.e. minted), or subsequently destroyed (i.e. burned) by one or more entities or software protocols
Issuance, redemption, and stabilization of value	Managing reserve assets	The activity of managing the assets that back the value of a stablecoin, where a stablecoin fully or partially maintains its value (or confidence in its value) based on real or financial assets or other crypto-assets
	Providing custody/trust services for reserve assets	The activity of holding the reserve assets backing the value of a stablecoin
Transfer of coins	Operating the infrastructure	A blockchain protocol that determines roles and levels of access to the arrangement. Access may be permissioned or permissionless
	Validating transactions	Mechanism by which a transaction is authorized and validated by validator nodes
Storage and interaction with users	Storage of private keys providing access to stablecoins in a digital wallet	Cryptographic wallets storing private and public keys which are used to digitally sign transaction instructions performed by the stablecoin arrangement. Wallets can be custodial (hosted) or non-custodial (self-hosted), and can be developed by multiple parties
	Exchanging, trading, reselling and market making	The activity of purchasing/exchanging a stablecoin with fiat currencies, or a stablecoin with other stablecoins or digital assets

³⁶Financial Stability Board, <u>Regulation, Supervision and</u> <u>Oversight of "Global Stablecoin"</u> <u>Arrangements (</u>13 Oct 2020) All of the functions and activities performed by a stablecoin arrangement have analogues in traditional payments. One important difference between stablecoin arrangements and traditional payments is that core functions can be disaggregated and performed by different parties in a stablecoin arrangement.

Consider three of a stablecoin arrangement's core functions: (1) the creation and redemption of stablecoins, (2) transfers among users, and (3) storage of the stablecoins. Analogous functions could all be performed by a bank in the context of traditional payments. A bank creates and redeems a payment instrument by accepting a deposit or permitting its withdrawal by a depositor. The bank can make a transfer, either to another depositor at the same bank on its own books and records, or to a depositor at a different bank through a network of intermediaries, such as the Automated Clearing House (ACH). A bank can also store value for a depositor in a deposit account.

In a stablecoin arrangement, by contrast, each of the same three functions can be performed by different parties who may have no pre-existing relationship with one another. Creation and redemption of a stablecoin would be performed by the issuer in a custodial arrangement or by a protocol in a non-custodial arrangement. Transfers are effected on the blockchain in both arrangements. Storage could be provided by a custodial wallet provider or by a user herself with a self-hosted wallet.

Maintaining the smooth functioning of our payments infrastructure is of critical importance to the financial system and the real economy. As stablecoins grow in importance as a means of payment, policymakers must consider how standards to maintain the integrity of traditional payments infrastructure should be adapted for stablecoin arrangements. Global standard-setters have already made significant progress to provide a starting point for policymakers to implement globally coordinated standards in their respective jurisdictions.³⁷

³⁷BIS, CPMI-IOSCO, <u>Application of</u> <u>the Principles for Financial Market</u> <u>Infrastructures to stablecoin</u> <u>arrangements</u> (13 July 2022) PART 3

Stablecoin use cases

Stablecoins were born out of a need to put fiat currencies on digital rails for the purpose of accessing the crypto ecosystem. As the ecosystem grows, and infrastructure further develops, so will stablecoin use cases. Current use cases include domestic and international payments, digital asset trading, and lending and borrowing through decentralized finance (DeFi) protocols. More use cases, such as in additional DeFi solutions and financial inclusion, are likely to develop over time as innovations continue and stablecoins achieve further scale and breadth of acceptance.

It is important for policymakers to understand stablecoins' current and future uses when developing regulatory frameworks.

Digital asset trading – increasing digital asset market liquidity

One of the primary uses of stablecoins is to provide an efficient and safe onramp from a fiat currency into the digital ecosystem. Stablecoins allow digital asset investors to modify their portfolios in the same way investors trade in and out of securities listed on stock exchanges using conventional currencies like the dollar or euro. As such, digital assets are often listed on trading platforms as trading pairs with stablecoins.

Using stablecoins for digital asset trading is advantageous because it allows exchanges and market participants the simplicity and efficiency of a common medium of exchange, with assets priced in the same unit of account. It also allows investors to retain a portion of their portfolio in a low-volatility asset while they decide on the next investment or if they would like to temporarily reduce their exposure to the market. Stablecoins efficiently provide this option for digital asset investors by allowing near-instantaneous digital asset transactions and 24/7 availability via public blockchains. The result is an increase in market liquidity and depth for digital assets. This enables digital asset markets to provide more stability and reliability for participants to buy and sell easily, better protection for investors when trading, and higher barriers to any potential price manipulation. The expected increase in digital asset trading volumes over time will likely fuel continued demand for stablecoins in this use case.³⁸

³⁸IMARC Group, <u>Cryptocurrency</u> <u>Market: Global Industry Trends</u>, <u>Share, Size, Growth, Opportunity</u> <u>and Forecast 2022-2027</u> February 2022.

Figure 7: Share of Centralized Exchange trading volume: USDC, USDT, BUSD, DAI ³⁹





³⁹ Data sourced from <u>CryptoCompare</u>, as of 30 June 2022
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Payments – faster, cheaper money transfer

The stablecoin infrastructure developed for market trading can also serve as a medium of exchange between individuals and entities, including for cross-borders transfers, which today can be prohibitively expensive using conventional methods. The following figure shows trends in the global cost of sending \$200 in remittances since 2011:

Figure 8: Trends in the global cost of sending \$200 in remittances⁴⁰



⁴⁰BIS, <u>The journey so far: making</u> <u>cross-border remittances work</u> <u>for financial inclusion</u> (15 June 2022)

⁴¹Coinbase Blog, <u>There's now</u> <u>a cheaper, easier way for your</u> friends and family in Mexico to <u>cash out the crypto you send</u> <u>them</u> (15 Feb 2022) As one example, Coinbase supports cross-border transfers of digital assets on our platform, including stablecoins such as USDC. Recipients of transfers from the U.S. to Mexico are able to save or cash out the money received in Mexican pesos at more than 37,000 physical retail outlets and convenience stores across Mexico.⁴¹ ⁴²Circle Blog, <u>USDC Market Cap</u> <u>Grows to More than \$50 Billion,</u> (February 2022)

⁴³Coinbase, <u>Commerce,</u> (March 2022)

⁴⁴ Coinbase, <u>Coinbase pricing and</u> <u>fees disclosures</u>, as of June 2022. Note that the above description doesn't refer to Coinbase Wallet, a separate, self-hosted wallet product.

⁴⁵ PYMNTS.com, <u>Average US Firm</u> <u>Waits 33 Days to Receive Cross-</u> <u>Border Payments, Data Show,</u> September 16, 2021.

⁴⁶ Forbes, <u>Credit Card Processing</u> <u>Fees</u> (2022 Guide) (14 July 2022) Stablecoins are also increasingly being used and accepted as means of payment by businesses. For example, since USDC operator Circle's launch of Circle Accounts for business clients to deposit, withdraw, receive, and store digital assets and settle all payments in USDC, the number of active Circle Account customers increased by 213% from 2020 to the end of 2021.⁴² Coinbase Commerce currently has 8,000+ merchants signed up to accept digital assets including USDC and DAI from their customers globally, in addition to accessing a set of business tools to manage such business transactions.⁴³

There is strong appeal to using stablecoins over conventional payments methods. Because stablecoin payments can be conducted on a public blockchain that enables peer-to-peer transfers, users can settle transactions near-instantaneously without an intermediary bank or financial institution to facilitate settlement. Stablecoin transfers can also be sent off-chain through a trusted intermediary. For example, Coinbase offers USD Wallet and Hosted Cryptocurrency Wallet services free of charge, and does not charge for transferring digital assets, including stablecoins, from one Coinbase user's wallet to another.⁴⁴

These options give stablecoin users alternatives to incumbent payment systems that can be slow and more costly, particularly for cross border transfers. For example, current payment and remittance platforms require multiple intermediaries to execute a transaction, often resulting in longer transaction/settlement times and additional fees, such as foreign transaction fees. Stablecoin transfers can be settled in under 30 minutes whereas international transfers can take multiple business days. According to PYMNTS' August 2021 Global B2B Payments Playbook, the average U.S. firm now waits 33 days to receive a cross-border payment, a lag that can significantly stress cash flow and cause downstream effects.⁴⁵ High costs and lengthy delays represent significant disadvantages for conducting payments transfers in traditional markets today.

The flexibility and low cost of stablecoin payment methods could also benefit consumers and businesses by increasing the competitive pressure on incumbent systems. Credit card processing fees, for example, typically range from 1.5% to 3.5% of the value of each transaction, with the vast majority of transactions processed on one of only four large networks.⁴⁶ The availability of stablecoins as an alternative could reduce the costs for merchants to receive payment for goods and services – not only could merchants choose to accept stablecoins directly, credit card companies may reduce their fees to incentivize merchants to remain on their networks. Increasing competition could similarly reduce costs to consumers for wire transfers and other traditional payments.

While stablecoins can reduce the cost and delay in transmitting payments, there remains a criticism that on-chain transactions can still be subject to high gas fees. Gas fees are payments required from users for their transactions to be validated and processed on a blockchain. The cost of gas fees to record transactions on some blockchains can be large on a percentage basis for a small dollar transaction. This can be particularly true for popular and

frequently congested networks like Ethereum. However, as with any emerging technology, the costs are likely to decrease over time as users migrate to using new blockchain solutions. In the long term, given that payments on blockchains allow for an automated transaction verification process, unlike the more costly manual verification process many banks use today, stablecoin payment methods are likely to be a competitive alternative.

Broadening access to financial services - financial inclusion

A remarkably large number of people around the world remain unbanked or underbanked. Globally, 1.7 billion people do not have access to a bank account.⁴⁷ In the United States, 5% of adults are unbanked and 13% are underbanked.⁴⁸ In a survey conducted by the FDIC, commonly cited reasons for not having a bank account included not having enough money to meet minimum balance requirements, distrust of banks, and fees being too high or unpredictable.⁴⁹ Many of these challenges were exacerbated during the COVID-19 pandemic, which highlighted the need for contactless and digital payments systems.

Stablecoins have the potential to overcome some of these barriers by making the global payments system faster and more efficient, and reducing the overall cost of financial services. All that is required is a smart phone or computer access to the internet, which includes many of the currently unbanked population. For example, among this population of 1.7 billion, 1 billion have access to a mobile phone and 480 million have access to the internet.⁵⁰

Next-generation applications – growing diversity of DeFi, tokenization, and web3

The next generation internet, dubbed "web3," seeks to give users more control over their information, data, and digital footprint relative to the current walled-garden approach of web2.

In this decentralized approach to the internet, digital tokens will become the unit of the economic exchange for the services that fuel disintermediation. In web3, the value of a digital platform would be shared with its users, rather than captured entirely by its corporate creator, through tokens that provide both functionality on the platform and benefits from its success. We expect stablecoins to play an important role as the fiat onramp into this digital

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⁴⁷a16z, <u>State of Crypto</u> (17 May 2022)

⁴⁸Board of Governors of the Federal Reserve System, <u>Report</u> on the Economic Well-Being of <u>U.S. Households in 2020</u>, (May 2021)

⁴⁹FDIC, <u>How America Banks:</u> <u>Household Use of Banking and</u> <u>Financial Services</u>, 2019 FDIC Survey (October 2020)

⁵⁰a16z, <u>State of Crypto</u> (17 May 2022)

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ecosystem, even as central bank digital currencies are being contemplated by many jurisdictions.

Today's DeFi protocols provide a glimpse of this future, with new protocols constantly being developed that present innovative ways to address new market needs.⁵¹ These innovations include:

- digital asset trading
- insurance solutions
- automatic payments e.g., rent, salaries, subscriptions, etc.
- prediction markets
- saving, lending, and borrowing

DeFi protocols that allow potential borrowers and lenders, or buyers and sellers, to find each other nearly instantly offer a tremendous opportunity to improve economic efficiency around the world. They have several key advantages over traditional finance. The lending protocols are autonomous and permissionless, enabling lending directly between participants without the need for any third-party involvement or any minimum funds. Eliminating the need for intermediaries can lead to lower barriers to entry, a more streamlined lending process, and better borrowing speeds compared to traditional lending.

⁵¹Statista, <u>TVL across DeFi</u> <u>blockchains from November 2018</u> to June 26, 2022

PART 4 Policy considerations

Although no jurisdiction has yet adopted a comprehensive regulatory framework for stablecoins, many have issued reports and proposals, and further development is progressing quickly. There are a number of key considerations that we believe should inform policy development in the near term.

Financial stability and run risk

There is general concern among policymakers that a failure or distress of a stablecoin or stablecoin arrangement could adversely affect the stability of the financial system. For example, a sudden loss of confidence in a fiat-backed stablecoin could lead its holders to seek redemptions en masse, which in turn could force the stablecoin's issuer to liquidate reserve assets in a fire sale. The fear is that such an event could cause a sharp decrease in the market price of the reserve assets below their intrinsic value, with spillover effects on other market participants.

Different fiat-backed stablecoins present different run risks. The following figure provides a breakdown of the reserve assets backing the three largest fiat-backed stablecoins: USDT, USDC, and BUSD:

Figure 9: USDT, USDC, and BUSD reserve assets⁵²

USDT		
Asset	\$ bn	%
Cash/Deposits	\$4,100,485,805	4.97%
U.S. Treasuries	\$39,199,221,428	47.56%
Commercial paper	\$20,096,579,998	24.38%
Reverse repo	\$105,331,269	0.13%
Money market funds	\$6,798,150,552	8.25%
Other investments (incl. digital tokens)	\$4,959,634,446	6.02%
Corporate bonds, funds, prec. metals	\$3,729,529,946	4.52%
Secured loans	\$3,149,732,368	3.82%
Non-U.S. Treasuries	\$286,155,289	0.35%
Total	\$82,424,821,101	100%

 USDC

 Asset
 \$ bn
 %

 Cash/Deposits
 \$13,581,264,959
 24.38%

 U.S. Treasuries
 \$42,122,235,732
 76.62%

 Total
 \$55,703,500,691
 100%

BUSD		
Asset	\$ bn	%
Cash/Deposits	\$738,064,449	4.19%
U.S. Treasuries	\$10,597,042,200	60.12%
U.S. Treasury repos	\$6,292,771,150	35.70%
Total	\$17,627,877,799	100%

⁵² Tether, <u>Transparency</u>, last viewed 30 June 2022, based on data from Tether's Independent Accountant's Report as of 31 March 2022; Circle, <u>USDC Reserve</u> <u>Assets as of 30 June 2022; Paxos, BUSD Reserve Assets as of 30 June 2022.</u> ⁵³Id.

⁵⁴CFTC, <u>CFTC Orders Tether and</u> <u>Bitfinex to Pay Fines Totaling</u> <u>\$42.5 Million</u> (15 Oct 2021); New York Attorney General, <u>Attorney</u> <u>General James Ends Virtual</u> <u>Currency Trading Platform</u> <u>Bitfinex's Illegal Activities in New</u> <u>York</u> (23 Feb. 2021)

⁵⁵ Tether, <u>Tether Continues to</u> <u>Reduce Commercial Paper</u> <u>Holdings As It Solidifies Its</u> <u>Position As The Most Transparent</u> <u>Stablecoin (</u>1 July 2022)

⁵⁶Centre, <u>USDC Transparency</u>, last viewed 30 June 2022

⁵⁷ Paxos Binance USD (BUSD), <u>Unaudited Holdings for June 30,</u> <u>2022 at 5pm EST</u>

⁵⁸ DeFi Llama, <u>defillama.com,</u> as of 30 June 2022 For example, Tether has not disclosed which companies' commercial paper it owns, making it impossible to assess asset-specific credit risk.⁵³ Consistent with these shortcomings, the CFTC and New York's attorney general both fined Tether for fraudulently misrepresenting its reserves.⁵⁴ Tether has announced its intention to shift a substantial portion of its reserves from commercial paper into U.S. Treasuries, which if done should substantially reduce incentives for a run.⁵⁵

In contrast, the run risk for USDC and BUSD is lower because, among other things, their reserves are more transparent. Independent certified public accountants attest monthly to the amount of USDC's reserves.⁵⁶ BUSD's issuer, Paxos Trust, is a regulated trust company in New York. Paxos recently published an unaudited list of the stablecoin's reserve assets.⁵⁷

As the market capitalization of stablecoin issuances grows, continued mitigation of financial stability concerns will depend not only on the quality of reserve assets, but also on the level of public transparency of reserves and the safeguards established to prevent a run. Regulatory frameworks should establish standards to engender confidence among stablecoin holders that the stablecoin can maintain its value, and thereby remove incentives to redeem, even during periods of financial market stress. Our policy recommendations for these regulatory frameworks are set out in section 5.

Lastly, the growing use of DeFi is sometimes cited as a potential risk to the traditional lending sector or to financial stability. DeFi collateralized lending protocols currently do not provide conventional credit intermediation. In place of assessing a borrower's creditworthiness, they rely on overcollateralization and automatic liquidation mechanisms to make loans, which are limited by the amount of collateral that a borrower posts. Potential risks to financial stability could materialize if a decrease in the value of collateral assets were to trigger mass liquidations, leading to further selling and even sharper decreases in their value.

The total value locked (TVL) in DeFi protocols was \$73 billion as of June 30, 2022, far below the high of over \$229 billion reached in March 2022.⁵⁸ This level of TVL is not in the realm of a financial stability concern. A cascade of selling triggered by automatic liquidations was in fact observed in May 2022, yet the DeFi collateralized lending protocols themselves generally continued operating throughout this period.

More generally, because DeFi protocols are over-collateralized, and not dependent on the creditworthiness of borrowers or the cash flow-generating capacity of the collateral pledged, they do not engender the same concerns as credit intermediation in the traditional system. However, to the extent these protocols are procyclical, they could increase the price volatility of the assets accepted as collateral. These risks should be monitored as DeFi grows, but they can be managed effectively using existing tools, as many DeFi protocols have demonstrated.

Operational resilience

Stablecoins are still in the process of gaining trust from mainstream users, and to do so they need to continue establishing a strong foundation of operational resilience and technological reliability. That means delivering good service consistently over time without disruptions.

Fiat-backed stablecoin arrangements, because they custody reserve assets at a centralized financial institution, face many of the same operational risks as with traditional payments systems. For example, to process issuance and redemption transactions, information from the blockchain must be sent off-chain to a custodian; these communications between the issuer and the custodian should be protected by high standards of information security. The issuer should follow best practices in vetting the custodian and any other entities performing important functions within the stablecoin arrangement. And, as for any process controlled by human beings on a day-to-day basis, certain types of operational risk – physical security risk, the risk of fraud or malfeasance, and basic fat-finger error risk – cannot be eliminated but can be managed effectively.

The blockchains themselves also present novel forms of operational risk. While blockchains have no single point of failure and can be more resilient than centralized payment systems in some respects, they introduce new risks related to programming errors and software bugs. Moreover, blockchains vary widely in terms of their security guarantees, resilience against malicious attacks, and extent of decentralization – on some blockchains, a centralized developer team maintains a high level of control, whereas others rely on agreement among a disparate set of validators.

Other potential risks could arise from the security arrangements associated with any super-users of a stablecoin smart contract – for example, if a small number of core developers are empowered to push through updates to the smart contract code in an emergency, strong safeguards must be in place to prevent malicious use of these special powers. Best practices for development should apply not only to the blockchain itself but at the level of stablecoin smart contracts too.

A stablecoin is only as good as the blockchain on which it runs, or if a stablecoin runs on many blockchains, as good as the weakest one. Operational problems could disrupt stablecoin holders' access or even cause them to lose their money. Before a stablecoin is deployed, a blockchain should reach a sufficient level of maturity in accordance with best practices for development, including testing, detecting bugs, and deploying fixes.⁵⁹

The importance of these technical issues will grow as the total amount of stablecoins increases over time. To reach sound, well-informed decisions on stablecoins, financial regulatory policymakers will need to develop greater fluency in these areas of technical expertise and integrate them into policymaking processes.

⁵⁹See generally Neha Narula, <u>The Technology Underlying</u> <u>Stablecoins</u> (23 Sept 2021)

⁶⁰Elliptic, <u>Financial Crime</u> <u>Typologies in Cryptoassets</u> at 5 (2020) ("illicit activity today still accounts for less than 1% of all transactions"); CipherTrace, <u>Cryptocurrency Crime and</u> <u>Anti-Money Laundering Report</u> at 9 (2021) ("illicit transactions mak[e] up less than 0.5% of Bitcoin's yearly volume in 2020"); Chainalysis, <u>The 2021 Crypto</u> <u>Crime Report</u> at 5 ("In 2020, the illicit share of all cryptocurrency activity fell to just 0.34%[.]").

⁶¹Neal B. Christiansen and Julia E. Jarrett, <u>Forfeiting</u> <u>Cryptocurrency: Decrypting</u> <u>the Challenges of a Modern</u> <u>Asset</u>, 67(3) Department of Justice Journal of Federal Law and Practice 155, 166 (Sept. 2019) ("Cryptocurrency, despite the purported anonymity it grants criminals, provides law enforcement with an exceptional tracing tool: the blockchain.").

⁶²Wired, <u>The DOJ's \$3.6B Bitcoin</u> <u>Seizure Shows How Hard It Is to</u> <u>Launder Crypto</u> (9 Feb 2022)

⁶³Bloomberg, <u>Crypto Experts</u> <u>Say No Evidence of Major Russia</u> <u>Sanctions Dodging</u> (17 March 2022)

⁶⁴Reuters, <u>U.S. Treasury official</u> sees modest uptick in crypto illicit finance, but transactions small (18 March 2022)

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Preventing financial crimes

Stablecoins, like any financial asset, could potentially be used in financial crimes, such as money laundering, financing of terrorism, or sanctions evasion. Although crypto assets have certain features, such as speed and purported anonymity, that may appear to be beneficial to illicit actors, only a small percentage of crypto transactions are related to criminal activity.⁶⁰ Indeed, bad actors incur significant risk when using crypto assets because most transactions are recorded on a public searchable database – providing significant new methods of tackling financial crimes.⁶¹

A key difference between traditional financial transactions and those involving digital assets is that blockchain technology makes it easier to trace how and where digital assets are being moved. Public blockchains offer law enforcement unprecedented visibility into the details of transactions, including the date, time, amount, and addresses involved in a transaction, without having to issue requests for information or subpoenas to market participants. The public, traceable, and permanent nature of blockchains have enabled law enforcement to achieve high-profile successes.⁶²

Questions about the role crypto assets could potentially play in illicit finance have come to the fore with Russia's invasion of Ukraine. Even with intensified scrutiny of digital assets, including stablecoins, from the perspectives of national security and foreign policy, there is little to no evidence that crypto assets have played a role in helping Russians avoid U.S. and global sanctions.⁶³ For example, U.S. Treasury Under Secretary for Domestic Finance Nellie Liang referred to the potential illicit use of cryptocurrency in this context by stating that "People are very aware of it, and paying attention to it . . . While it's growing because the use of crypto is growing, its share as a medium for illicit finance is not anywhere as large as just using cash."⁶⁴

So, while some speculate that stablecoins could spur illicit activity, the evidence suggests this is not the case. As with most illicit finance risks, it appears the best defense against misuse of stablecoins is to ensure that regulated financial institutions handling these assets maintain effective anti-money laundering programs, including implementing Know Your Customer procedures, monitoring transactions, and filing suspicious activity reports. Regulation of stablecoins should avoid pushing their development and operations to jurisdictions where financial institutions are less likely to maintain robust anti-money laundering controls.

Consumer protection and market integrity

An appropriate regulatory framework of consumer protection for the issuance and use of stablecoins is still developing and merits careful attention to provide consumers with reliable protections as well as meaningful access to developing financial products. Key policy considerations include:

- Stablecoin holders should be protected from the risk of losses due to fraud, misconduct, negligence, or the operational failure of a stablecoin arrangement.
- Consumers should have the right to control the storage and use of any personally identifiable information (e.g., information stored off-chain at a service provider that could be used to connect their identities to on-chain wallet addresses).
- Consumers should have access to clear information about the risks and benefits of stablecoins, including their reserve assets, key technological features, and redemption rights.
- In the event that a fiat-backed stablecoin issuer enters into insolvency proceedings, stablecoin holders should have priority over other creditors of the issuer, either through a more senior claim on the issuer itself or a direct interest in the stablecoin's reserve assets.

In addition to robust protections for consumers' rights, stablecoins also need to operate in a fair and orderly market. Stablecoin issuers, market makers, and service providers should have measures in place to detect and prevent manipulative activity, such as trading activity designed to create false or misleading signals as to the supply, demand, or price of a digital asset.

Monetary policy

Central banks around the world are considering the potential impact that stablecoins could have on monetary policy and the provision of credit to the real economy. As with any financial market innovation that reaches a large scale through mass adoption, stablecoins could one day present certain risks to the formulation and operation of central banks' monetary policies. The prevalence of stablecoins might affect the speed of currency circulation, the effectiveness of different monetary policy transmission mechanisms, and foreign exchange price movements due to issuance and redemption of stablecoins. The same has also been true of the big-picture, historical shifts in the United States from bank lending to capital market borrowing, and the similar shift since the global financial crisis from bank to non-bank financial activity. Stablecoins are only one item in a long list of shifts in finance that affect monetary policy.

As explained in a Federal Reserve staff paper,⁶⁵ the potential impact of stablecoins on credit intermediation depends on two things: (1) the sources of inflows into stablecoins – e.g., cash, bank deposits, and cash-equivalent securities like money market funds – and (2) the composition of the stablecoin reserves in which the inflows are invested. For example, if funds are withdrawn from a bank savings account to purchase a fiat-backed stablecoin investing in government securities, the provision of credit is correspondingly shifted from commercial bank lending to government funding. If done on a wide scale, this could tilt the cost of capital in favor of public versus private financing.

⁶⁵ John Carmichael and Gordon Liao, <u>Stablecoins: Growth</u> <u>Potential and Impact on Banking</u> (January 2022) ⁶⁶ <u>New forms of digital money,</u> Bank of England discussion paper (7 June 2021) The reverse would be true if, for example, funds were redeemed from a money market account invested in government securities to purchase a bank-issued deposit coin.⁶⁶

The potential impact on credit intermediation therefore depends on the permitted types of stablecoins within a jurisdiction. The most significant potential impact on the provision of credit by banks relates to whether a narrow banking framework is permitted, in which a bank issues stablecoins backed directly by central bank reserves. The relative safety of such an arrangement could result in a migration away from commercial bank deposits that are classically used to underwrite (riskier) loan portfolios.

Because there is not yet widespread adoption of stablecoins these potential effects are uncertain. But the predictions are not dire. For example, the Bank of England predicted that the overall impact on lending rates and credit provision to the real economy would be modest, as any increase in non-bank lending largely compensates for a reduction in credit provision by banks.⁶⁷ Banks can always increase the interest rate they pay on deposits to incentivize more deposits to remain with them if volumes are decreasing more than they would like.

Stablecoins even have the potential to enhance the transmission of monetary policy. According to the Bank of England, "New forms of digital money would be more likely to enhance the transmission of monetary policy to lending rates if they were interest-bearing and passed through interest rates with greater speed or extent than commercial banks, prompting banks to respond." ⁶⁸

Stablecoins could also increase the velocity of money, i.e., the number of times that a unit of currency is used to purchase goods or services within a given period of time.⁶⁹ Inefficiencies in the existing payment system often leave money trapped – consider, for example, the amount of time between depositing a check and the funds becoming available in the depositor's checking account.

Stablecoins could unlock a significant amount of capital by making the payments system more efficient and reducing the amount of time to settlement finality for many consumer transactions.

67 Id.

⁶⁸Id.

⁶⁹ Caitlin Long, T<u>en Stablecoin</u> <u>Predictions and Their Monetary</u> <u>Policy Implications</u> (Cato Journal, Spring/Summer 2021).



Stablecoins present a more varied and complex set of monetary policy implications in jurisdictions with weaker or less stable fiat currencies. While consumers may find it advantageous to use foreign denominated stablecoins in lieu of a volatile local fiat currency, the local central bank may as a result find it more difficult to implement monetary policy. Global equity should remain an important consideration in the policy discussion of stablecoins going forward. For example, stablecoins today are commonly U.S. dollar backed, and their use in jurisdictions outside the United States could have the effect of dollarizing those economies. In contrast, for countries where a stablecoins is pegged to the local currency, use of those stablecoins by individuals in other jurisdictions could strengthen the currency. For example, increasing circulation of U.S. dollar backed stablecoins outside the United States could strengthen the U.S. dollar.

Concentration of economic power

Regulatory authorities have expressed concern about potential risks of scale associated with stablecoin arrangements. For example, the President's Working Group on Financial Markets cited concern that a stablecoin issuer or wallet provider being tied to a commercial firm could lead to an excessive concentration of economic power.⁷⁰ Additionally, if a particular stablecoin becomes widely adopted as a means of payment, there could be anti-competitive effects if users of that stablecoin face undue frictions or costs in the event they choose to switch to other payment products or services.⁷¹

In the near term, these risks are still highly attenuated, given the total amount of stablecoins currently in circulation is less than \$145 billion.⁷² By comparison, at the end of 2021, the largest bank in the United States had assets of \$3.7 trillion,⁷³ the largest six banks together had assets of \$13.8 trillion,⁷⁴ and the GDP of the United States was \$23 trillion.⁷⁵ Moreover, the interoperability of stablecoins across different blockchains, the ability to quickly and efficiently convert between stablecoins on centralized exchange platforms, and the broad decentralization of digital asset marketplaces are significant mitigants against potential anti-competitive effects.

Longer term, because the use and circulation of stablecoins can be measured with precision on public blockchains, regulators will be in a strong position to monitor for concentrations of economic power and anti-competitive behavior as stablecoins grow in volume and usage. Importantly, regulators will not need to rely on the accuracy and completeness of private entity reporting to collect this information, and neither will any other market participant. Any concerns that may arise regarding the concentration and use of stablecoins would be in full public view, enabling an unfettered analysis and discussion of the public interest.

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⁷⁰ President's Working Group on Financial Markets, <u>Report on</u> <u>Stablecoins</u> (1 Nov 2021)

71 Id.

⁷² The Block, <u>Stablecoins</u>, as of 30 June 2022.

⁷³ FFIEC, <u>Large Holding</u> <u>Companies</u>, as of 31 March 2022.

⁷⁴ Id.

⁷⁵ St. Louis Fed, Gross Domestic Product, as of 30 June 2022.

⁷⁶ Jess Cheng, <u>How to Build a</u> <u>Stablecoin: Certainty, Finality, and</u> <u>Stability Through Commercial</u> <u>Law Principles</u> (24 Sept. 2020)

Commercial law clarity and certainty

Stablecoin users need to have legal clarity and certainty about the risks to which they are exposed for stablecoins to function well as a means of payment. Jess Cheng provides a thorough exposition of the commercial law issues that stablecoins raise in her 2020 paper, "How to Build a Stablecoin: Certainty, Finality, and Stability Through Commercial Law Principles."⁷⁶

Stablecoins do not cleanly fit into existing categories under commercial law, which treats currencies and payment instruments differently from investment securities and commodities. Stablecoin arrangements can be complex, involving not only stablecoin issuers and holders but a range of other parties, including validators, custodians, market makers, exchanges, and others. Stablecoin issuers thus need to overcome significant hurdles to provide legal clarity and certainty to other participants in a stablecoin arrangement using the existing mechanisms of contract, property, and commercial law. Key questions include:

- What is the nature of the commitment made by a stablecoin's issuer to its holders?
- What relationship does the stablecoin have to its underlying assets?
- What are the stablecoin issuer's obligations with respect to the safekeeping and possession of reserve assets?
- What are the stablecoin's terms of redemption?
- What does it mean for a stablecoin transaction to achieve settlement finality?
- At what point is the underlying obligation discharged in a stablecoin transaction?
- What rules should govern adverse claims, e.g., in instances of fraud or theft?

Providing clarity and certainty on these legal issues will require significant work on the part of stablecoin issuers, and potentially changes to existing commercial law. Policymakers should bear these considerations in mind as regulatory frameworks for stablecoins are developed. PART 5

5.1

Policy recommendations

As jurisdictions deliberate over the appropriate regulatory frameworks for stablecoins, we believe there are certain objectives that policymakers have in common: protecting consumers, preventing financial crimes, safeguarding financial stability, and promoting responsible innovation. A well-designed approach to regulating stablecoin arrangements can achieve all of these objectives, providing consumers with fairer and more efficient financial services that are more responsive to their needs. Below we offer views on how to answer common questions faced by policymakers.

Which entities should be permitted to issue fiat-backed stablecoins?

Three models for the issuance of fiat-backed stablecoins are frequently considered in policy discussions:

Model 1: stablecoins limited to deposit coins issued by insured depository institutions. In this model, all fiat-backed stablecoins would be deposit coins, issued by the subset of banks that are insured depository institutions ("IDIs"). Each stablecoin would be a deposit liability on the balance sheet of the issuing IDI. In the United States, this model is consistent with the recommendations in the President's Working Group's report on stablecoins.⁷⁷ Under this approach, IDIs would manage stablecoins in essentially the same manner as deposits, i.e., as liabilities that are redeemable for fiat currency on a 1:1 basis at any time. IDIs would remain subject to existing capital and liquidity requirements, and stablecoin holders' balances would be eligible for deposit insurance coverage.

Model 2: limited to fully reserved stablecoins issued by any bank. Less restrictive than the first model, this model would permit any bank to issue fiat-backed stablecoins, including trust banks and other kinds of depository institutions whose deposits are uninsured. Rather than backing stablecoins with deposit liabilities, issuers could back their stablecoins with corresponding reserve assets in a segregated account or separate fund, apart from the rest of their business. The stablecoins would still be redeemable 1:1 for fiat currency at any time, and in a similar manner as conventional money market funds. Under this approach, assurance of the stablecoins' value would not come from government-backed deposit insurance, but from the quality of the segregated reserve assets.

Model 3: limited to fully reserved stablecoins issued by any supervised and regulated entity. Any entity would be permitted to issue fiat-backed stablecoins, provided that it satisfies rigorous regulatory requirements and remains subject to supervision. The regulatory requirements would address the composition and quality of reserves, disclosures and audits, financial and operational resilience, consumer protection, and other key areas.

⁷⁷ President's Working Group on Financial Markets, <u>Report on</u> <u>Stablecoins</u> (1 Nov 2021)

While proposed frameworks that follow bank models would leverage existing regulatory frameworks and bring comfort to prudential regulators that are familiar with the benefits and drawbacks of bank supervision, these models could severely restrict the adoption and use of stablecoins generally. Model 1 in particular would encumber the issuance of stablecoins with bank capital requirements that are designed for different purposes and to address different risks. Model 2 could enable banks to issue stablecoins without the complexity of these requirements, but it has other drawbacks. Banks may have little economic incentive to undertake this business model if it cannibalizes existing profit centers by competing with traditional bank deposits, particularly if they do not face competitive pressure from other types of stablecoins.

In our view, Model 3 strikes the appropriate balance between economic viability, consumer protection, responsible innovation, and financial stability. While the bank models should be permitted, they should not be the only models permitted. Neither has yet been implemented in significant volume or demonstrated economic viability, and restricting frameworks to only these models presents undue risk to safe and efficient innovation in digital marketplaces. Nonbanks can be subject to appropriate bank-like supervision and regulation to protect consumers and financial stability.

Fiat-backed stablecoins issued by non-banks have already gained traction and would benefit from high standards of regulation and supervision.

What requirements should apply to fiat-backed stablecoin arrangements?

The previous section stated our view that issuance of fiat-backed stablecoin should be permissible by any entity that meets high standards. This section states our views on what those standards should be. In many cases, these standards are more stringent than existing standards.

• Reserve assets. Permissible reserve assets for a fiat-backed stablecoin should be highly liquid and low risk: cash and cash equivalents, including short-duration U.S. Treasuries. Beyond these categories, further classes of reserve assets should be subject to appropriate capital buffers – above the aggregate amount of stablecoins outstanding – to account for potential credit risk losses and assure a stablecoin's redeemability at face value. These capital buffers would be particularly relevant during periods of market stress.

- Transparency and audits. Transparency is necessary for stablecoin holders to have the information necessary to make informed decisions, and independent verification is necessary for their disclosures to be worthy of stablecoin holders' trust. Effective transparency requirements for fiat-backed stablecoin issuers should include both monthly and annual disclosures. Monthly disclosures should include attestations by an independent accountant as to the composition and quality of reserve assets and whether they are at least equal in value to the aggregate face value of the stablecoins outstanding. Annual disclosures based on an independent audit should be more detailed, including information about the stablecoin's key technological characteristics, holders' ability to redeem, and the effectiveness of the issuer's internal controls, risk management and compliance.
- **Operational resilience and compliance.** Fiat-backed stablecoin issuers should be subject to high standards that cover a wide range of areas that could affect stablecoin holders. These would include cybersecurity and privacy safeguards to prevent hacks and protect stablecoins holders' personal information, operational risk and business continuity measures to sustain uptime, and a compliance program to prevent financial crimes. In most cases, these standards can be developed based on the existing standards that apply to banks today, tailored in an appropriate manner to reflect the differences in stablecoin issuers' business model and risk profile.
- **Government oversight.** A federal or a state regulator should periodically examine issuers' compliance with applicable regulatory requirements. Knowledge that the issuer of a stablecoin is subject to this kind of oversight will give the public additional confidence in issuers' financial and operational resilience.

What role should algorithmic stablecoins have in the marketplace?

The recent failure of TerraUSD has led many to call for bans on algorithmic stablecoins. Media reports told stories about investors whose life savings were lost, and many crypto pundits now claim that algorithmic stablecoins are not suitable for retail consumers and other users of crypto products. Indeed, some are even questioning whether TerraUSD was a fraud.⁷⁸

While time and investigation will make more clear why and how TerraUSD failed, it is important to note that its failure did not come as a surprise to many. As discussed earlier, academics explained how its endogenous support arrangements were inherently unstable and might not be able to absorb market shock or selling pressure. The May 2022 death spiral of UST has made this fragility more broadly understood, providing valuable empirical evidence that can inform future innovations.

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⁷⁸Barron's, <u>U.S. Senator Sees</u> <u>Potential for Fraud in Terra.</u> <u>Stablecoin Collapse</u> (23 May 2022); Al Jazeera, <u>South</u> <u>Korean prosecutors raid crypto</u> <u>exchanges amid Luna probe</u> (21 July 2022) It is now broadly understood that algorithmic stablecoins are not really stable, and it is a misnomer to call them as such. Their value is not backed by exogenous reserves, but based on a tautology – that one token can be converted into another, and vice versa, at a ratio determined by code.

But this does not mean algorithmic stablecoins should be banned. Markets are better than governments at picking winners and losers. Innovation requires running experiments, and not all will succeed. Blockchain technology is moving the internet into its next phase, and we should not be surprised if we see shades of the dot.com era of the late 1990s. With hindsight it is always easy to understand and identify failures, and many of the dot.com-era investments look foolish today. But many of the successes were similarly accused of futility in their early stages.

In assessing the future regulatory framework, policymakers should avoid draconian and harmful measures like bans, and instead focus on the key principles that underpin today's successful markets. Crypto-backed stablecoins with exogenous collateral are likely to survive over the long-term. Allowing markets to experiment will help refine optimal designs. In doing so, protecting consumers through clear disclosures of the attendant risks is critical. Regulatory frameworks that focus on transparency as a central tenet, with robust provisions that protect against fraud and misconduct, will best allow stablecoins to continue to develop and prove themselves while letting market forces play out.

What rights should you have as a stablecoin holder?

Anyone who holds a fiat-backed stablecoin should know that their money is safe, without any need for due diligence or worry. That means being able to see quickly that their stablecoins are subject to a rigorous level of regulation and supervision and therefore can be trusted. As discussed above, regulatory requirements should cover the composition and quality of reserve assets, transparency and audits of the issuer's disclosures, and the issuer's ability to maintain strong operational resilience and compliance programs.

Consumers should also be confident in their ability to use fiat-backed stablecoins as money. From a legal perspective, there are two key issues: settlement finality and insolvency treatment. First, the law should treat stablecoins just like any other form of money and provide certainty that when a stablecoin transaction settles on a blockchain a corresponding legal obligation can also be discharged as nearly as possible at the same moment in time.

Second, should an issuer become insolvent, the law should make sure that holders suffer no losses and are able to keep using their money with minimal

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interruption. In an insolvency proceeding, stablecoin holders should be first in line to receive any value from the stablecoin's reserve assets. This can be accomplished by making the stablecoin holders' claims senior to those of other creditors, or by treating stablecoin holders as having a pro rata interest in the reserve assets directly. Either way, stablecoin holders' claims should be satisfied as quickly as practicable, potentially in an administrative proceeding akin to the bank resolution process, if proceedings under the normal bankruptcy regime would not move quickly enough. To the extent that changes to commercial laws or banking laws are needed to facilitate these outcomes, the time for those changes has come.

For crypto-backed and algorithmic stablecoins, there is currently significant skepticism about their long term viability and appropriateness for consumers. The UST-LUNA failure in particular has led many policy makers to advocate for bans. However, a draconian measure like this can lead to suboptimal outcomes by limiting future innovation in an area that is still developing. Moreover, there are significant practical limitations of imposing a ban on activities that take place through DeFi protocols.

For these types of stablecoins, a better path would be to focus on facilitating disclosures that promote consumer protection. These products should be clearly differentiated from fiat-backed stablecoins that are subject to regulation and supervision as described above. The disclosures should be clear and conspicuous, free of misrepresentations, and otherwise subject to antifraud provisions. Under these conditions, there is value in permitting crypto-backed and algorithmic stablecoins to move forward with responsible innovation.

How should stablecoins interact with other forms of money?

Maintaining interoperability across stablecoin networks, and between stablecoins and other forms of money, will be crucial for stablecoins to realize their full potential benefits.

Observing the growing usage of private sector digital currencies, many countries are launching, or exploring the possibility of launching, a retail Central Bank Digital Currency ("CBDC"). Globally, over 100 countries, with over 90% of global GDP, are exploring a CBDC today.⁷⁹ While there are many different possible designs depending on the situational context of each country, a CBDC would represent a digital currency issued and backed by a country's central bank, which would enable the public to safely make digital payments.

While some predict that CBDCs will render stablecoins obsolete, we strongly believe CBDCs will complement and encourage robust, inclusive, and safe innovation for stablecoins and the broader digital asset economy.

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Stablecoins can meaningfully complement a CBDC in providing optimal support for consumers and businesses.

Well-regulated, privately issued stablecoins would complement CBDCs in several ways:

- Programmability and tailored services for different customer segments: CBDCs will necessarily be designed to serve the mass market, while stablecoins can be tailored to serve the specific needs of various user segments. Although CBDCs may be designed to allow some level of programmability, there may be constraints on how far and effectively CBDCs can go in this direction as a by-product of other policy constraints and objectives. The greater flexibility and innovative potential of stablecoins can compensate for any such constraints on a CBDC.
- Potential constraints on CBDCs that stablecoins may not face: Stablecoins may be able to offer economic options that a CBDC does not. For instance, the European Central Bank is exploring a 3,000 euro limitation on the amount of digital euro that can be held by one party, based on various policy considerations. Stablecoins would be able to cater to those needing larger holdings of a digital fiat currency equivalent. Similarly, a stablecoin may choose to pay interest, or to pay a rate higher than a CBDC may offer.
- Current state and expected near-term innovation: Stablecoins may also be in a better position to innovate, offering new features to their customers than would a CBDC. In addition to having a first-mover advantage, stablecoins are expected to continue to rapidly evolve and innovate over the coming years, experimenting in ways CBDCs may not be able to due to differences in size and scope. The private sector will be in a better position to experiment and will have more incentive to do so, as individual stablecoin providers vie for market share.

PART 6

Conclusion

Coinbase supports a broad, balanced, and fact-based dialogue on stablecoins to form the basis for a regulatory framework that will enable responsible innovation.

We look forward to continuing to share our experience and expertise and being a part of future consultations.

Tax Whitepaper

From: Coinbase

Subject: U.S. Taxation of Cryptocurrencies-- A Sensible Proposal For Tax Policy Guidance

Date: July 2022

Tl;Dr The crypto economy has enjoyed rapid growth and wide acceptance within the US and abroad. It also has engendered considerable concern among Congress, Treasury and the IRS regarding tax compliance, resulting in legislation and forthcoming regulations regarding information reporting But, there is a huge tax gap in mainstream tax policy for crypto, which hinders growth, liquidity and U.S leadership in the crypto economy. The lack of guidance on critical U.S. tax matters impedes expansion of these markets within the United States, creates incentives for users to transact on non-U.S. platforms and creates confusion as different market participants report identical items differently. The following Whitepaper provides a summary of open areas that call for active dialogue and collaboration with policy makers to clarify and properly tax participants in the crypto economy.

Overall Request: Creation of Crypto Tax Task Force

Congress should empower the Treasury Department to convene a digital asset task force for tax, consisting of Treasury, IRS, and external industry experts to meet on a regular basis and provide timely recommendations and action steps within 6 months to clarify U.S. tax law applicable to cryptocurrency. Ideally, this would include proposed legislation for Congress to enact to provide a timely set of guiding rules and principles related to crypto taxation.

Specific Tax Guidance Priorities

1. Specific subcategories of "cryptocurrency" or "digital assets" should be identified and defined.

The term "digital asset" is a defined term in the U.S. tax code and refers generally to "any digital representation of value."

Cryptocurrency assets come in multiple "flavors," reflecting the usage for the asset (or platform), the regulatory context and the attributes of the coin/token. In general, U.S. tax principles attempt to characterize assets based on their function and attributes. For this reason, guidance is needed to assign particular crypto assets to a category for tax purposes that most resembles their character. This would contribute to reaching a tax result most appropriate to the function and use of such assets in the crypto economy.

These characterizations would be broken down by digital asset "type" for U.S. tax purposes (for example, commodity, utility, currency, other property (e.g., NFTs), etc.). Further, digital assets may be characterized by the predominant function(s) they provide in the ecosystem (such as providing software as a service, as a medium for payment, collectible, etc). Consideration could be given to whether certain cryptocurrency ought to be treated as a currency (contrary to current IRS guidance) where it has been adopted as legal tender of a sovereign jurisdiction or is pegged to the value of the legal tender of a sovereign state.

 Cryptocurrency lending should be treated similarly to securities lending under Section 1058.

Liquidity is critical to any properly functioning financial market. The ability to "lend", or make available for use, assets held by long-term investors is critical in supporting market liquidity (particularly in less liquid coins and tokens). The lack of clear rules applicable to cryptocurrency lending, and the risk that lending could be treated as a deemed "sale" of the loaned cryptocurrency, place a chilling effect on much needed market liquidity in the cryptocurrency market. Furthermore, the lack of guidance regarding the "source" of fees paid for such loans generally disadvantages U.S. digital asset borrowers who may need to "gross up" foreign lenders and thus incur higher costs of capital than foreign counterparts.

Congress faced a similar challenge in the 1970s, and enacted specific rules for securities lending transactions to provide lenders of securities certainty that properly structured securities loans did not trigger gain on such positions. Although such a position could be reached under a reasoned reading of currently applicable U.S. tax authorities, it is not free from doubt.

Our recommendation is to: (i) apply non-recognition treatment to the lender of cryptocurrency in a manner similar to section 1058; (ii) treat the source of fees as based on the residency of the recipient (or provide a complete exemption to withholding, similar to almost all interest payments); and (iii) extend the protections from the recognition of unrelated business taxable income ("UBTI") for income and gains derived from securities loans to cryptocurrency loans.

Further consideration should also be given to the extent that such non-recognition treatment should extend to certain DeFi transactions that bear similar economics to traditional bilateral lending.

3. Information reporting should be introduced sensibly across Centralized Finance ("CeFI") and Decentralized Finance ("DeFI"), taking into account the balance between government and industry needs.

Historically, the IRS has relied on information reporting provided by third party market participants (brokers, middlemen, payors, etc.) to encourage voluntary tax compliance and to support audit activity in its absence.

Blockchain and similar technology fundamentally changes this paradigm, as most transfers and payments are recorded to a decentralized public ledger, versus to the private ledger of a broker or middleman. Accordingly, much of the information the IRS would seek through traditional information reporting may be or could be made available on the public ledger itself.

For this reason, Congress and the Treasury Department ought to consider technological alternatives (mentioned below) for account documentation beyond properly completed W-series forms (like Forms W-8 series and W-9). Further, given the use cases for cryptocurrency as a medium for payment, a consistent *de minimis* rule for Form 1099 reporting of crypto (for example, \$600 similar to the 1099-MISC and the 1099-K) would reduce the compliance burden for participants and processing burden for the IRS. In DeFi specifically, reporting alternatives to the Form 1099 ought to be considered to address that market participants may not possess (or be able to solicit and receive) full tax documentation for participants and recipients. The continued lack of guidance on DeFi reporting threatens to move all such activity, including its development, completely offshore which could have the effect of eroding Treasury's ability to gain insight into transaction activity.

New technologies in crypto can be used to facilitate tax reporting and collections, including the use of identification tokens and smart contracts to collect information for limited governmental purposes and/or to impose and collect transaction level taxes. These new technologies would complement or replace the current process of tax reporting by identifying the taxpayer through the use of their Taxpayer Identification Number (TIN). Taxpayers prefer simplicity and finality– a new tax reporting and compliance framework that attributes tax residency and provides immediate tax identity to taxing authorities will enhance tax compliance and ease anxiety

among crypto market participants about running afoul of tax laws. Sales and other transactional taxes can be collected and remitted upfront. Income taxes can be collected and withheld pending final determination of tax liabilities similar to the existing but cumbersome withholding tax framework.

4. Stablecoins should be excluded from information reporting

Stablecoins, by definition, are intended to retain their value by being "pegged" to an existing financial asset (like the U.S. dollar). This "peg" is achieved through a variety of means (such as supporting a redemption right through reserve accounts with adequate or surplus collateral). For this reason, information reporting on the gross proceeds of the disposition of such coins is expected to be of limited value, as the gains on such assets are minimal or zero. (Stablecoins not based on adequate or surplus collateral, and supported instead by an algorithm, have proven not to be stablecoins in the truest sense and therefore are not included in this discussion as stablecoins).

For this reason, our recommendation is to exclude stablecoin transactions from U.S. tax information reporting because such reporting is both operationally burdensome and expected to yield minimal (if any) otherwise unreported gains. Such an exception is quite similar to the current exception from gross proceeds reporting for non-transferable bank deposits and, therefore, consistent with existing tax policy in traditional finance.

Furthermore, taxpayers should similarly be exempt from having to track and report dispositions of U.S. Dollar stablecoins (*e.g.*, Form 8949), again because the opportunity for gain is minimal.

5. Source and timing of staking rewards should be defined.

Environmental considerations and practical restraints have supported a consistent move within the cryptocurrency ecosystem from proof of work networks (like Bitcoin) to proof of stake networks (like Solana and Ethereum 2.0).

Having owners of tokens in such ecosystems make their coins/tokens available to stake is critical to drive processing speed and availability (and diversity) of validators. Investors with certain tax attributes (such as tax-exempt and non-U.S. investors) may be wary of staking their tokens with any party that has any U.S. connection out of a concern about U.S. tax imposed on the passive income earned from staking. This is currently driving (and will continue to drive) capital and

business out of the United States and into jurisdictions that do not present such withholding concerns.

Our recommendation is to provide guidance treating any staking reward as sourced based on the residency of the recipient. While sourcing to the residency of the recipient would be the best option for staking rewards, if sourcing is determined differently, then it is also requested that further guidance is provided as to the treatment of cryptocurrencies within the framework of U.S. income tax treaties. For example, if staking rewards paid to a non-U.S. recipient are considered U.S. source then the non-U.S. recipient should be able to claim treaty benefits on such income.

Further, such guidance should clarify that staking rewards are treated similar to other kinds of portfolio income (like interest or dividends), such that the rewards do not represent unrelated business taxable income ("UBTI") or income from the conduct of a U.S. trade or business. Further, the timing for the recognition income for staking rewards should be clarified, taking into account the limitation on receipt for such rewards in certain protocols.

6. Charitable Donations of Cryptocurrency should be encouraged.

Charitable donations of all kinds ought to be encouraged to assist these organizations to further their exempt purposes. A study from Fidelity found that holders of cryptocurrency are disproportionately more charitable as investors, with 45 percent donating \$1,000 or more to charity in 2020, compared to 33 percent of the entire investor population. This aligns with the demographic ownership of cryptocurrency: Millennials and Gen Z investors are more likely to hold cryptocurrency and are more inclined to make charitable donations.

Our recommendation is to (i) treat cryptocurrency like publicly-traded stock where a donation to a private foundation of long-term gain property would permit the contributor to a charitable deduction for the full fair market value at the time of the donation; and (ii) eliminate the requirement on larger donations to seek appraisal for a readily-tradable cryptocurrency. To eliminate barriers to receiving such donations on the exempt organization side, the recommendation is to clarify that income related to cryptocurrency (lending and staking) is neither UBTI nor income that is subject to the prohibited transactions tax for private foundations.

7. U.S. Trade or Business Treatment for Non-U.S. Traders in Cryptocurrency should be symmetrical with securities and commodities.

Current law excludes income from trading in securities and commodities from being treated as a non-U.S. persons' "effectively connected" income, even if a U.S. resident broker or agent conducts the trades. The current law safe harbor covers certain cryptocurrencies today (based on their trading market and regulatory status in the U.S.), but not all cryptocurrencies.

Our recommendation is to apply the section 864(b) safe harbors to non-U.S. persons trading in all cryptocurrencies, regardless of whether they constitute securities or commodities for U.S. tax purposes or other types of property.

8. De Minimis gains should be excluded from tax similar to foreign currency

Current law excludes from tax de minimis gains from foreign currency held for personal use (for example, Euros brought back from a European vacation). The basis for such exclusion is administrative (large tax filing / calculation burdens for minimal tax revenue).

As mainstream adoption of cryptocurrency as a medium for payment (similar to foreign currency), a *de minimis* rule ought to be provided to exclude gains on an annual basis up to a certain minimal threshold (e.g., \$600) or up to \$50-\$100 per transaction. The amount of tax revenue impacted from such a provision is minimal, and the elimination of the need for reporting supports the adoption of various cryptocurrencies in payment use cases.

9. Tax treatment of DAOs should be clarified

Decentralized Autonomous Organizations ("DAOs") form the backbone of many cryptocurrency ecosystems. DAOs are frequently set up to automate the management of a particular blockchain ecosystem, reducing the risk of human error and using consensus to manage the risk posed by large investors controlling a particular market. DAOs often lack a juridical entity, centralized management or other hallmarks of a traditional business entity.

Our recommendation is that it should be clarified when DAOs rise to the level of a business entity. Further, if some or all DAOs were to be considered business entities, clear guidance should be provided on how to determine whether a DAO should be classified as a business entity, how its jurisdiction of residence (as domestic or foreign) is determined, and how it and perhaps its "members" can comply with information reporting and tax paying requirements.

10. Tax treatment of non-fungible tokens ("NFT") should be clarified

The NFT market has exploded over the past 18 months. NFT technology can be leveraged to sell (or "wrap") any kind of property, with a current market focus on the sale of digital art, sports moments, music and similar assets. Expansion of ventures in the "metaverse" increases the relevance of NFTs as a mechanism to purchase digital goods in the "metaverse."

Guidance on the principles on which to characterize specific NFTs are needed as this asset class expands for retail purchasers. Further, safe harbor rules may be particularly welcome to avoid a time consuming facts and circumstances analysis for each NFT. Specific sourcing rules for these digital assets are needed, as the nature of such assets as being geographically anonymous makes determining the "location" of title passage (the standard for sourcing certain property sales) difficult or impossible to determine. Finally, specific guidance is needed on the information reporting required for NFTs, both as a "digital asset" and whether they also represent digital "goods" (in assessing the potential application of section 6050I reporting for payments of cryptocurrency for non-cash goods and services).