January 9, 2024

The Honorable Mike Johnson
Speaker
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Hakeem Jeffries
Democratic Leader
U.S. House of Representatives
Washington, D.C. 20515

Re: Concerns About Provisions in the Financial Innovation and Technology (FIT) for the 21st Century Act

Dear Speaker Johnson and Democratic Leader Jeffries:

Better Markets[1] has had a number of serious concerns with the FIT for the 21st Century Act that passed out of the House Financial Services Committee in July 2023. While it has been reported that the bill will change, we again write to readdress a number of concerns that we have with the bill as passed out of Committee. Regardless of whether one supports or opposes the FIT for the 21st Century Act, below are a number of key issues raised that should be carefully considered before any action is taken on the bill or an amended version.

As an initial matter, it must be recognized that the Commodity Futures Trading Commission ("CFTC") is an important financial regulatory agency with mandates and missions that are critical to the functioning of the financial system and economy. For example, every single American depends on the CFTC to ensure that vital commodities are available in cities and towns across America at the right time, in the right amounts, and at prices that reasonably reflect actual supply and demand. That includes cereal for breakfast, bread for school sandwiches, beef for their BBQs, heating oil for their homes, and gas for their cars and trucks to get to work and travel. In addition to those kitchen table concerns, the CFTC's regulation of the derivatives markets is crucial to every farmer in the country who often depend on those markets for hedging their risks.

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[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

The CFTC's entire budget for 2023 was $365 million, and it had just 688 full-time employees. Its enforcement budget is just $67 million with 172 full-time employees, which it needs to police the multi-trillion dollar derivatives and commodities markets in addition to the bitcoin market. As a result, the rampant fraud and manipulation in the bitcoin market is no less threatening to investors in spot bitcoin ETPs than in bitcoin. Adding yet more mandates on the CFTC, especially when it is currently underfunded, will inevitably and significantly compromise the agency's ability to fulfill its vital roles that all Americans depend on and benefit from. Indeed, fully funding the CFTC should be the priority and only then should there be any consideration given to adding more work. With that in mind, the FIT for 21st Century Act raises a number of key issues that all members should carefully consider.

1. The CFTC Lacks the Necessary Investor Protection Mandates to Effectively and Seamlessly Regulate Cryptocurrencies and the Bill Fails to Provide Them.

Investor protection has been at the core of U.S. securities laws and regulations, as well as the ethos and mission of the Securities and Exchange Commission ("SEC")—indeed, its governing statute requires it to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation—for nearly 90 years. While the CFTC does have some ***customer*** protection mandates, the agency's mission—to promote the integrity, resilience, and vibrancy of the U.S. derivatives markets through sound regulation—lacks the investor protection mandate that exists in our securities markets. These differences are largely due to the different types of participants in each market. While retail investors have always been active in, and indeed critical to, the securities markets, specifically the equities markets, they have not traditionally participated in the more complex derivative markets.

The CFTC regulates commodity and derivatives markets, which historically are overwhelmingly dominated by very large institutions with very little retail investor participation–think of them as wholesale markets. As a result, the CFTC's role has mostly been as a referee between very large and very well-funded purchasers and producers seeking price discovery and hedging in their commercial enterprises. The existing CFTC regulatory framework was established, designed, and implemented to facilitate hedging, price discovery, and trading strategies between large, sophisticated entities and financial institutions. The CFTC's regulation of trading in these markets reflects these differences. Specifically, for example, derivatives trading lacks order routing practices and best execution requirements that are critical to protecting retail investors in the securities markets. In addition, the securities law framework includes other standard investor and market protections such as a broker-dealer regulatory regime that governs the interactions and conflicts of interest between broker-dealers and retail investors.

While the FIT for 21st Century Act attempts to recreate an investor protection regime at the CFTC similar to the existing exchange and broker-dealer regulatory regimes that have governed our securities markets for decades, it falls woefully short of protecting investors. For example, broker-dealers registered with the SEC and FINRA are participants in SIPC insurance, which

insures individual investors against losses up to $500,000 in the event of a failure or bankruptcy of their broker-dealer. No such insurance system exists amongst CFTC-regulated participants nor is one established in the bill. Likewise, broker-dealers under securities law are mandated to obtain independent, third-party audits of their financial statements. Again, no such requirement exists in the bill for digital commodity exchanges or digital commodity broker-dealers. The bill also lacks key order routing and best execution requirements for digital commodity exchanges or broker-dealers executing customer orders and does not include any affirmative fiduciary duty or other standard of care owed by any cryptocurrency entity to any customer. The bill also lacks basic investor rights to bring suit against digital commodity exchanges and broker-dealers that are available in the securities regulatory regime.

These are only a few reasons why the attempt to recreate a SEC-like broker-dealer regulatory regime at the CFTC to regulate so-called digital commodities will not only not work, but will result in decades of massive investor harm, protracted legal battles, and extensive agency rulemakings and guidance releases to develop a regulatory regime that will still not be remotely comparative to existing protections in securities law.

2. **The Agency Resources Proposed in This Bill are Insufficient and Main Street Consumers, Commodity Markets, Farmers and Other Commodity Producers Will Pay the Price.**

For years, the CFTC has been chronically underfunded with less than 700 employees (compared to the SEC's approximately 4,500 employees). Frankly, it does not have the funding to fulfill all of its current statutory mandates. Nevertheless, on top of that, the bill would make the CFTC the de facto regulator of crypto exchanges and broker-dealers and charge them with implementing numerous resource intensive and lengthy notice-and-comment rulemakings. During and after that, the CFTC is also somehow supposed to implement, interpret, and enforce those rules. Yet, the bill would only appropriate $120 million over the course of five years for the CFTC to hire staff, draft regulations, acquire technology, and enforce the provisions of the bill. That is grossly insufficient for an agency already underfunded to fulfill its current mission of regulating and overseeing the vast and complex derivatives markets, including the $400 trillion (notational value) swaps markets, futures, and options.

In FY23, Congress set the CFTC's budget at $365 million. In testimony before the Senate Agriculture Committee, CFTC Chair Benham stated that the CFTC would need roughly $120 million over three years to implement provisions of FTX-endorsed crypto legislation under consideration in the U.S. Senate at the time. The CFTC mandates in the bill are far more numerous and onerous on the CFTC than that prior bill and will require even more resources than the CFTC Chair called for in response to the Senate legislation (which we believe was significantly underestimated).

Without significantly more funding appropriated – not just authorized – for the CFTC in connection with this bill, the CFTC's important existing work will be impaired and compromised. That will inevitably include ensuring that vital commodities are available to the American people and policing the derivatives markets, which play a vitally important role for farmers, producers, and in our commodities markets. And because those commodity markets ultimately have a profound impact on the prices that all Americans pay for goods, the public at large will suffer widespread harm from inadequate CFTC oversight when it is forced to divert its finite time, attention, and resources to crypto.

3. Manipulative Wash Trading Will Still Run Rampant in Crypto Markets with Adverse Consequences for Investors.

Due to the global nature of the trading of cryptocurrencies, there is nothing in the bill that will curb the rampant, manipulative wash trading that has become a feature of crypto markets.[2] Long used by unscrupulous traders, wash trading is a form of market manipulation where a trader and/or affiliates create the appearance of high trading interest and trading volume by placing buy and sell orders in the market without actually in effect taking a position.

In securities law, wash trading is strictly prohibited and enforced as securities fraud. However, in crypto markets it has quickly become a frequent mainstream practice. Experts have suggested that a majority of the trading volume in Bitcoin are wash trades and that as much as 95% of that trading could be due to wash trading.[3] Without account-ID information and verification by crypto exchanges, among other things, manipulative wash trading will remain a core predatory feature of crypto markets, preventing accurate price discovery in crypto markets and victimizing retail investors who are lured into the crypto markets through the phony volume and pricing that wash trading creates.

4. The Digital Commodity Exchange Requirements Lack Meaningful Investor Protections.

The bill grants broad authority to digital commodity exchanges to have "reasonable discretion in establishing the manner in which the digital commodity exchange complies with core principles described in [Section 404]." This is no more than the appearance but not the reality of investor and market protection rules. Allowing digital commodity exchanges to use their

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[2] Lin William Cong, Xi Li, Ke Tang, and Yang Yang, *Crypto Wash Trading*, NATIONAL BUREAU OF ECONOMIC RESEARCH (December 2022), https://www.nber.org/papers/w30783 ("[w]e find that the wash trading volume, on average, is as high as 77.5% of the total trading volume on unregulated exchanges…these estimates translate into wash trading of over 4.5 trillion USD in spot markets and over 1.5 Trillion in USD in derivatives markets in the first quarter of 2020 alone").

[3] *See e.g.* Bitwise Asset Management, Presentation to the SEC (Mar. 19, 2019), srnysearca201901-5164833-183434.pdf (sec.gov); *see also* Javier Paz, *More than Half of All Bitcoin Trades Are Fake*, FORBES (Aug. 26, 2022), https://www.forbes.com/sites/javierpaz/2022/08/26/more-than-half-of-all-bitcoin-trades-are-fake/?sh=1a9340576681.

"discretion" when complying with "core principles" is nothing more than the latest version of long-discredited industry self-policing, a euphemism for no policing at all. Relying on what is supposed to be a regulated industry to regulate itself is always perilous, but it is reckless given the crypto industry's demonstrated and widespread lawlessness.

Unlike exchange or broker-dealer regulation in the securities regulatory regime, the bill does not require ***any*** specific policies regarding order routing practices or best execution requirements in executing customer orders. Additionally, despite the well-documented patterns of loss of crypto assets due to hacking and cybercrime, the bill does not require digital commodity exchanges to comply with ***any*** cybersecurity standards. In the securities markets, exchanges and alternative trading systems must comply with Regulation Systems, Compliance, and Integrity (Reg SCI) to monitor the security and technological infrastructure of the exchange.

The bill would also enable digital commodity exchanges to change the rules and policies that govern the conduct of the exchange, the brokers operating on the exchange, and investors investing through the exchange in the middle of the night, without the opportunity for notice and comment. While this behavior has been commonplace amongst unregulated crypto exchanges – unilateral suspension of trading in certain tokens without notice, suspension of investors' rights to withdraw money from the exchange and delisting certain tokens on a whim – all that anti-investor conduct is strictly prohibited by the SEC in the securities markets. As a self-regulatory organization, the securities laws mandate that if an exchange wants to change its rules or policies it must first file that rule change with the SEC and provide an opportunity for the public to comment on the effects of those changes. The SEC also has the ability to approve or disapprove those rule changes if they are not in the public interest, enable fraudulent or manipulative practices, or fails to comply with other requirements applicable to exchange rules.

As crafted, the bill would enable exchanges to largely govern themselves and change their rules or policies at any time and with no input whatsoever from brokers who operate on the exchange or investors who invest through the exchange. The bill also does not provide the CFTC any authority to halt any rule or policy change. These are a vital and irreplaceable customer, market, and financial system protections.

5. The Unprecedented Provisional Safe Harbor Will Be Used as a License to Rip Off Investors for Years.

The so-called safe harbor provisions are shocking and irresponsible. The provisional safe harbors offered to crypto entities in Sections 106 and 107 of the bill would ensure the lawlessness within the crypto industry continues at the very least until the joint rulemakings in Section 105 are complete, which will almost certainly take years. These sections would handcuff the ability of the CFTC and/or SEC from bringing otherwise appropriate, necessary, and lawful enforcement actions or even continue already existing enforcement actions against any entity that submits a provisional registration.

For example, there have been media reports that one of the biggest Ponzi schemes of all-time, FTX, has considered restarting their exchange in an effort to recoup more assets for stakeholders in bankruptcy. Under these provisions, FTX could submit a provisional registration to the CFTC and comply with the limited requirements for registration and thereby halt the existing SEC/CFTC enforcement actions against FTX until all joint rulemakings are completed. According to the terms of the bill, as long as a crypto exchange submits a form to the CFTC and agrees to not commingle customer funds, they have carte blanche to operate; to front-run and trade against their customers; ignore best execution or net capital requirements; and operate generally in a legal immunity-zone, regardless of harm or damage to customers.

These provisional registrations would shield bad actors in the crypto industry for years until the joint rulemakings proposed in the bill are finalized. It is worth observing that there are still a half-dozen rules mandated by Congress from the 2010 Dodd-Frank Act that have yet to be finalized. If the Dodd-Frank Act had a provision such as the one in the bill, it would have enabled the predatory behavior by financial institutions to continue to this day and Americans would still be getting ripped off some 13 years later.

6. The SEC Digital Asset Framework Lacks Requirements for Audited Financial Statements and Ensures No Crypto Tokens Will Be Governed by the SEC.

The limits in Section 201 of the bill related to capital formation for digital asset issuers are similar to the limits in the SEC's Regulation A Tier 2 exempt offerings.[4] However, Regulation A also requires disclosure of two years of audited financial statements, while the limits in Section 201 for digital asset issuers conspicuously do not require any audited financial statements at the time of the offering. Given that audited financials are among the most important investor and market protections associated with a wide range of offerings, the failure to require any independent, third-party audited financial statements in the bill for digital asset issuers, digital commodity exchanges, and digital commodity broker-dealers is a glaring and unacceptable omission.

Further, the digital asset issuer requirements and limitations would likely result in very few registrations with the SEC and drive larger crypto projects overseas. A recent trend in digital token allocation for blockchain projects is to rely more on community incentive structures that give away or airdrop tokens to the public rather than relying on selling tokens to the public (see Figure 1 below). For example, token allocations significantly declined from the Initial Coin Offering days of 2017 when approximately 55% of a blockchain project's tokens were sold to the public. That number has decreased to roughly 3% in 2022, while tokens reserved for community incentives or distributions have risen from 11% in 2017 to 44% in 2022. Following these trends, it is likely that only the very largest blockchain projects would exceed the $75 million offering threshold because

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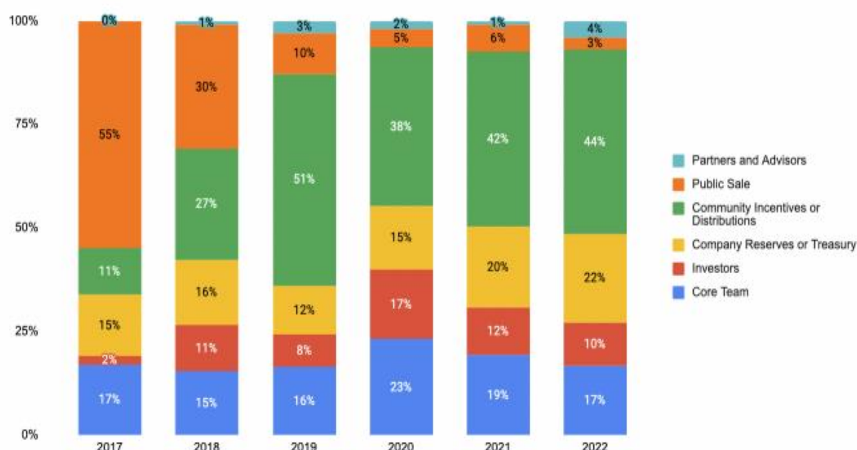
[4] *See* SEC, Overview of Capital-Raising Exemptions, https://www.sec.gov/education/smallbusiness/exemptofferings/exemptofferingschart.

only a small percentage of tokens are sold to the public or investors (for example, the second largest cryptocurrency, Ethereum, only raised roughly $18 million over eight funding rounds).

Figure 1.



Source: Liquifi[5]

Similarly, any large blockchain project that anticipates raising more than $75 million would be best served raising the funds overseas and waiting until the project is sufficiently "decentralized" to list on a digital commodity exchange under the weak CFTC regulatory regime that would be established by the bill. Then, these projects could raise funding without having to register with the SEC and quickly list on a digital commodity exchange under CFTC oversight with few if any investor, market, or financial stability protections.

7. The Exceptions to the Prohibition Against Commingling Customer Assets in the Bill Are Likely to Become Industry Standard.

The prohibition against the commingling of company assets with customer assets is a bedrock of investor protections in securities law. Rules against commingling, combined with regular audits by independent third parties, help to ensure bad actors don't misappropriate customer funds. While the FIT for 21st Century Act prohibits commingling, the exceptions to commingling in the bill for "blockchain services" and the absence of independent, third-party audits will expose investors to very serious and unnecessary risks.

The bill, as amended in Committee, includes an exception to the prohibition against commingling company assets with customer assets for both digital commodity exchanges and digital commodity brokers or dealers. This exception would allow crypto companies to commingle customer funds to provide blockchain services. The bill defines the term blockchain services as

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[5] Robin Ji, *Token Vesting and Allocations Industry Benchmarks*, Liquifi (June 8, 2022), https://www.liquifi.finance/post/token-vesting-and-allocation-benchmarks.

"any activity relating to validating transactions on a blockchain system, providing security for a blockchain system, or other similar activity required for the ongoing operation of a blockchain system." This overly broad definition would open a pandora's box for industry wide commingling of customer assets. And while this exception is only available if the customer waives this right, it is easy to imagine this waiver becoming a fine print pre-condition in a company's terms of service that an investor must accept—if they ever become aware of it—to use the crypto exchange or broker-dealer's services.

8. The Proposed Self-Certification Process Is a Rubber Stamp for the Transition of Cryptocurrency from Security to Commodity That Will Foreclose Meaningful SEC Review.

The self-certification process established in the bill for a cryptocurrency project to submit certification to the SEC that the project is sufficiently decentralized ties the hands of the SEC to adequately challenge any self-certification. Under this provision, after a filing has been made, the SEC would have 60 days to rebut a certification, or it would automatically go into effect. With roughly 20,000 existing crypto tokens and no funding in the bill for the substantial additional SEC staff required to review such certifications so quickly, the SEC will not have the resources necessary to keep up with the number of filings that would bombard the agency, let alone conduct a comprehensive analysis of a cryptocurrency project within 60 days. In effect, this provision means that innumerable cryptocurrency projects will be unleashed on the unsuspecting public with no regulatory review.

Under the bill, the SEC does have the ability to stay the certification for 90 days, in which time they may put the filing out for public comment for 60 days. Ironically, Members of Congress have repeatedly raised concerns about the adequacy of 60- and 90-day comment periods for recently proposed rules by the SEC. If those objections had any merit, then they would have to view this provision as grossly deficient. Additionally, because it can take weeks if not longer for a proposal to be published in the Federal Register, the SEC will likely have as few as 15 days left in the 90-day stay extension to consider all commentor submissions. Requiring the SEC to adequately consider potentially up to thousands of comments on a particular decentralization filing within such a time frame is unreasonable and would almost certainly result in violations of the Administrative Procedure Act ("APA"). That will likely result in endless litigation where courts are forced to reconcile the APA requirements with the unreasonably short time period, all compounded by a lack of funding and staff.

9. Broad CFTC Authority to Exempt Any Digital Commodity Exchange or Broker-dealer From Any Provision of the Bill, Including Commingling Requirements and Other Critical Customer Protections, Is Extremely Problematic.

The bill grants the CFTC nearly limitless authority to exempt any digital commodity exchange or broker-dealer from any provision of the bill, including important prohibitions on

commingling of customer funds and other critical customer, investor, market, and financial stability protections. Despite the apparent intent to recreate spot exchange and broker-dealer regulatory regimes similar to those that exist in our securities markets within the CFTC, Section 404 and 406 of the bill would give the CFTC broad authority to exempt any entity from the provisions of those sections if it is in the public interest ***or*** if the entity "is subject to comparable, comprehensive supervision and regulation by the appropriate government authorities in the home country of the exchange." In general, outsourcing regulation and enforcement in the financial markets to foreign regulators poses huge investor protection and systemic stability risks. And this exemptive authority is particularly problematic because many crypto exchanges are based in countries that have historically lacked strong financial regulatory systems.

Outsourcing the protection of U.S. customers, investors, markets, and stability to foreign regulators has proven woefully inadequate in the past and Americans have paid a very high price for the many failures of those foreign regulators. Authorizing a recurring of that debacle in the crypto space would be wildly inappropriate.

10. State Preemption

The bill would preempt state securities and blue-sky laws, negating a state's ability to protect their own citizens from financial products that meet the state definition of an investment contract or security. As happened with predatory subprime mortgages in the years before the 2008 financial crash, there are states that provide or might want to provide greater consumer, investor and financial stability protections for their citizens. In fact, New York does that now with its BitLicense, which protected the citizens of New York from the FTX collapse. If New York law had been preempted as this bill would have ensured, untold numbers of New Yorkers would have lost their money to the alleged FTX criminal scheme.

It's important to note that states like Alabama and Texas have led the way in bringing enforcement actions against crypto financial intermediaries and issuers in valiant efforts to protect their own citizens from predatory and fraudulent crypto investment schemes. The bill would substantially reduce a state's ability to enforce their securities laws and protect their citizens.

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In conclusion, we hope these comments are helpful as Members continue their work to understand how crypto securities and commodities should fit into our existing financial regulatory system that has helped to foster the broadest, deepest, and most liquid markets in the world. It must be recognized those markets are not preordained to remain the preeminent markets in the world. They have achieved that status because they have the trust and confidence of investors and customers worldwide and that is largely due to their faith in those markets being well-regulated.

Unfortunately, the bill threatens to create new market structures that are not well-regulated if regulated at all. Enacting weak, loophole-ridden regulation (including reintroducing the discredited and failed concept of industry self-regulation that prevailed before the 2008 crash) rather than genuine regulation that prioritizes the public interest virtually guarantees a disaster. That demonstrably failed approach risks killing the golden goose (our markets) that laid the golden egg (a vibrant, growing economy funded by those markets). Nothing less than our economy and financial system are at stake, which is why we hope Members, regardless of what they think about the bill, take these thoughts into account as the process moves forward.

Sincerely,

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