Speech

Digital Assets: Putting Investors First

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Brooklyn Law School Keynote Address

Nov. 16, 2022

Thank you for that warm introduction. It is a pleasure to be here today, and I thank Brooklyn Law School for the kind invitation to deliver today's keynote. I must note at the outset that the views expressed here today are my own and do not necessarily reflect the views of the Commission or its staff, or those of my fellow Commissioners.

Speaking of SEC Commissioners, it is wonderful to know that Roberta Karmel, nominated by President Jimmy Carter as the first woman to serve as SEC Commissioner, is now a Distinguished Research Professor of Law here at Brooklyn Law. I'm grateful to my fellow Commissioner Hester Peirce for first making me aware of Commissioner Karmel's amazing story.

It is also a particular honor to speak at an institution with such a deep commitment to diversity, equity and inclusion (DEI). When founded in 1901, Brooklyn Law embraced inclusion when exclusion was the norm.

Ahead of its time, Brooklyn Law offered legal education opportunities to women and persons of color when those options were limited or not available to them. This founding commitment to DEI that breaks down barriers and expands educational opportunities for all benefits the legal profession, our economy and our country.

I approach issues in the digital asset market from the perspective of a working family or working person who is considering purchasing or investing in digital assets. To better understand that perspective, it's helpful to go back to the emergence of the digital asset market in the first place.

In the fall of 2008, U.S. financial markets were on the verge of collapse. As our nation grappled with the consequences of the most severe financial crisis since the Great Depression, many, understandably, questioned whether the traditional financial system best served their needs. Under those circumstances, an innovative and potentially more accessible alternative to traditional finance could seem very compelling.

The seeds of the digital asset market were initially planted around October 2008, when a person, or persons, using the pseudonym “Satoshi Nakamoto” published the Bitcoin whitepaper. This paper introduced the idea of a “peer-to-peer” electronic cash payment system without trusted third parties. It described weaknesses in our traditional financial system, including the need to trust intermediaries, unavoidable levels of fraud and high transaction costs.

Since that whitepaper, and in the extraordinary aftermath of the 2008 financial crisis, the digital asset market did indeed grow and proliferate. And its growth skyrocketed during the pandemic.

Today, there are nearly ten-thousand tokens and hundreds of digital asset platforms on which customers can buy and sell these tokens. By some estimates, one in five adult Americans has purchased digital assets.

The market’s rapid growth has often been accompanied by the narrative that it serves as a more effective and equitable wealth-building alternative to traditional finance. One key theme in this narrative is the promise of greater financial access for low-income and other underserved communities that the traditional financial system has left behind.

This theme no doubt alludes to real problems and inequities in traditional finance. There is a wealth gap in our country and banking the unbanked remains a persistent problem.

So recent surveys suggesting that persons in low-income and underserved communities are investing in digital assets in increasing numbers are not surprising. Nor is it surprising that a greater share of unbanked and underbanked individuals may own digital assets than those who are fully banked.

In light of all of this, has the digital asset market truly developed into a viable alternative to traditional finance? Does it offer genuine financial inclusivity and robust protections for digital asset purchasers and investors? In my opinion, as of now, and despite the best intentions of many, the answer is no.

In March of this year, President Biden issued an executive order directing federal agencies and financial regulators to examine a range of issues in digital asset markets. Certain reports in response to this executive order outlined several risks: among them, increasing levels of fraud, concentration of wealth and control, highly centralized intermediaries, a lack of transparency and high volatility.

With regard to fraud, one estimate cited by the U.S. Treasury is $14 billion-worth of digital asset-based crime globally in 2021. This amount is nearly double the estimate for 2020. The number of scams in 2021 rose by over 60% year-over-year, while the value of stolen digital assets rose by over 80% in 2021. The Treasury report noted that digital asset crimes are based on self-reporting, so it is likely these numbers don’t show a full picture.

There is also a concentration of wealth and control in the digital asset market. One study found that, at the end of 2020, the top 1,000 market participants owned roughly one-sixth of Bitcoin in circulation. The same study found that the top 10,000 participants owned roughly one-third of it.

When so-called “whales” that hold large positions relative to the size of their counterparties liquidate a position or experience losses, those counterparties can face extreme financial pressure.

A report by the interagency Financial Stability Oversight Council (FSOC) also notes that many digital asset governance tokens are held by the top 1 percent of holders of a given token, which can lead to governance problems if voting rights holders are anonymous or not subject to robust oversight.

Contrary to the narrative that the digital asset market offers decentralization, there are high levels of centralization in the ecosystem. Many digital asset platforms offer a wide gamut of services, such as trading, custody, maintaining order books, market-making, and borrowing and lending.

Such platforms may have conflicts of interest due to their integrated, centralized structure. In addition, their practice of commingling customers' assets with those of the platform poses risks to customers, such as in the event of the platform's insolvency. Asset commingling exposes the platform's customers to greater potential losses than if their assets are properly segregated.

There is significant lack of transparency in the digital asset market. According to FSOC, disclosures by digital asset promoters and issuers lack uniformity and vary widely in the amount of information provided to the public. For stablecoins in particular, some issuers do not disclose, or fully disclose, their underlying asset holdings. As a result, potential purchasers or investors often lack access to quality information necessary to make informed purchasing or investment decisions.

There is also a lack of transparency about technological vulnerabilities. Digital asset activities have been the subject of many malicious attacks. But the scope of these attacks is difficult to measure given that the industry operates largely outside of the regulated space.

Digital asset values are highly volatile. Events this past week and even today, and the recent 2022 crypto winter, revealed how volatile the digital asset market can be. Historically, digital asset prices have vacillated between steep gains and drops that are outside the norm relative to traditional markets' routine fluctuations. This volatility can have cascading effects in the broader digital asset market.

These risks, in my view, are very concerning and can have an adverse impact on digital asset purchasers and investors, and on low-income and underserved communities in particular. It is important to note that initial entry into this market necessarily involves the use of fiat currency to purchase digital assets for the first time. As a consequence, either the erosion of value or significant losses can have a devastating impact on a working family's or a working person's financial security. My sympathy goes out to the retail investors who are suffering an impact from the troubling digital asset market events of this past week.

The digital asset market today cannot, in my view, be described as free from intermediaries, with lower costs, or with reduced fraud, as Satoshi Nakamoto and proponents of this market envisioned. In fact, many of the same problems its proponents claim it will solve are present in the current digital asset landscape. Frankly, the problems in the digital asset market are worse than those in the traditional finance system, because they occur in a largely unregulated space.

So, where does this leave us? In light of recent events, this is a watershed moment that offers an opportunity for issuers and intermediaries in the digital asset market to reflect on their offerings and operations. A key question for them to consider is whether operating outside of the federal securities laws is in the best interest of investors and a fair and transparent market.

To be clear, not every issued digital token necessarily represents a securities offering, and not every digital asset intermediary is necessarily operating as an unregistered market participant. But I generally agree with SEC Chair Gensler that most of the nearly 10,000 digital asset tokens in the market are likely offered as securities. In addition, and without prejudging any particular entity, I am also concerned that intermediaries that sell, trade or advise on digital assets that are securities may be operating as unregistered market participants.

My view is that there is likely a considerable number of digital asset issuers and intermediaries illegally operating outside of the federal securities laws. This undermines the general principle of transparency as well as our ability to protect vulnerable investors in a market that is susceptible to volatility and fraud.

It bears noting that it is not the SEC's responsibility to provide legal advice or analysis to any market participants under its purview. That applies in equal measure, in my view, to those operating in the digital asset market. In light of this, it falls on the issuer or the intermediary and their legal counsel to determine whether their products, business practices, or assets require compliance with the federal securities laws.

Some have suggested that the SEC has not provided guidance to the industry. The reality is that there's an abundance of guidance, from the DAO Report, to the SEC FinHub Framework for "Investment Contract" Analysis of Digital Assets, and multiple no-action letters issued by the staff of the Division of Corporation Finance.

Decades of legal precedent on what constitutes an "investment contract" or "note" under our securities laws also provides ample guidance to the industry, as well as the sophisticated securities law bar. It's not a matter of a lack of guidance but more that the existing guidance may not be what many market participants want to hear.

There is also a narrative that the SEC is engaged in "regulation by enforcement." But I see something different. The laws are well-established, and the cases brought to date have clear applications, as has been apparent in court rulings on these issues. This is not regulation by enforcement, but enforcement of our securities laws as Congress intended.

I'd also like to address the gatekeepers, specifically, the securities bar advising those in the digital asset industry. There is a well-established, highly specialized securities law bar with nearly a century of experience, whose counsel is readily available to digital asset issuers and intermediaries. Attorney gatekeepers play an important role here. They have an obligation to be clear with their clients about the application of the securities laws to their client's businesses, even if it is not advice their clients want to receive.

Finally, while I believe that the SEC should work with those who come to us with good faith plans and concrete timelines to meet the requirements of the federal securities laws, the SEC has an obligation to protect investors and to enforce our rules and regulations. Those who do violate our federal securities laws and harm investors and markets must face the consequences, pure and simple. Congress gave us the responsibility to enforce our securities laws to protect investors and the public interest. We have a duty to the public to fulfill those important responsibilities.

I want to end where I began, and directly address anyone considering purchasing or investing in digital assets. It is important to obtain as much information as possible on the risks involved. An informed investor is a protected investor. One key resource that aims to serve the public in meeting that goal is the Crypto Assets section of Investor.gov, the SEC's investor protection portal.

Innovative blockchain technology can exist side-by-side and be compatible with the existing federal securities law framework. The current moment offers an opportunity to make a meaningful difference for the success of blockchain technology and, possibly, for the financial future of millions. But it requires a good-faith, honest and conscious choice to comply with the law and to put the interests of investors first.

Thank you again for the opportunity to speak before you today and best wishes for a productive and constructive discussion for the panel that follows.