[Securities Regulation Daily Wrap Up, VIRTUAL CURRENCIES—CFTC Chair asks senators for more authority over cash digital assets, (Feb. 9, 2022)]

Securities Regulation Daily Wrap Up

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CFTC Chair Rostin Behnam proposed that Congress use Dodd-Frank-era rules for swaps markets as the model for a regulatory structure for cash digital asset commodities markets.

CFTC Chair Rostin Behnam told members of the Senate Agriculture Committee that the agency he now leads requires additional authorities to adequately police cash digital asset commodity markets and that Dodd-Frank Act-era rules for swaps markets could be a model for a legislative solution that more clearly defines the CFTC's and the SEC's separate authorities over digital assets. Behnam's testimony also expanded upon his written response this week to a January 12, 2022, letter sent to him by the Chairs and Ranking Members of the Senate and House Agriculture Committees. Behnam's testimony led-off a two panel hearing on the risks, regulations, and innovations associated with digital assets.

CFTC leading role? Behnam's opening statement to the committee suggested the limits of the CFTC's existing authorities to police digital asset markets. Behnam said the CFTC is a derivatives regulator, although it also has some insights into cash markets and it does have fraud and manipulation authorities that it can deploy. With respect to digital assets, Behnam said there is no one federal regulator and that most regulation of digital assets occurs through a patchwork of federal and state laws, but primarily through state money transmitter regulations. As a result, Behnam said there is a need for a more proactive federal response.

The hearing was at least in part a legislative response to the letter all four Senate and House agriculture leaders sent to Behnam in January 2022, shortly after the Senate confirmed his nomination to be CFTC chair. The letter sought information about the CFTC's plans for additional guidance on the handling of digital assets. Specifically, the letter asked: "Do you foresee any shortfalls in the Commission's authorities to protect customers and ensure market integrity as the digital asset marketplace grows in volume and scope?"

In reply, Benham wrote that the cryptocurrency market has recently been estimated to have a market capitalization of $2 trillion. He also noted that in the U.S., about 13 to 14 percent of Americans have invested in cryptocurrencies (he offered some perspective though, citing data indicating that only 1 percent of the global population has invested in cryptocurrencies). In response to members' question about the CFTC's authorities, Behnam would presage much of his testimony by outlining what the CFTC could achieve if gaps in the current regulatory framework were filled: "Those safeguards could include pre-trade and post-trade transparency and uniform standards around settlement, data reporting, cyber security, and leverage."

Senate Agriculture Committee Chair Debbie Stabenow (D-Mich) began the questioning of Behnam by asking him to describe the CFTC's market surveillance regarding digital assets. According to Behnam, the agency's visibility into the underlying market is, at best, limited. Behnam suggested that the agency's limited authorities are a contributing factor. He explained that the CFTC currently depends on outside tips about possible enforcement issues because, unlike other markets, there is a lack of regulatory structures that would enable greater market insight. Senator Stabenow also asked Behnam if the CFTC had enough resources to deal with digital asset markets. Behnam said the short answer was "No."

In later questioning by Sen. John Hoeven (R-ND), Behnam would begin to sketch out what legislation to grant the CFTC more authority over digital assets might look like. For one, Behnam declined to say explicitly which federal agency might be the lead agency, but he did say the framework would look similar to the framework for swaps developed by the Dodd-Frank Act in which the CFTC was assigned traditional swaps and the SEC was assigned security-based swaps; in the digital asset space, the CFTC would address digital assets that are commodities and the SEC would address those that are securities. (Behnam noted that the SEC and the CFTC are strictly market regulators but that other federal regulators would be needed to address other issues regarding digital assets.).

Behnam's reply to Sen. Hoeven then turned to the specifics of what such a framework for cash digital assets would include. Behnam said that, like swaps regulations, there would need to be rules for custody and settlement, a set of core principles, a centralized and concentrated order book, and pre- and post-trade transparency.

Before Sen. Hoeven asked about the content of the authorities sought by the CFTC, Ranking Member John Boozman (R-Ark) had asked Behnam why the CFTC should get new authorities. Behnam said that a scenario in which there are fewer regulators (state and federal) would result in less fragmentation and lower risks for investors. Boozman responded by asking Behnam how the CFTC would avoid engaging in mission creep that may result if Congress grants the requested authorities and the agency then uses them beyond the digital asset space.

Behnam said he "unequivocally agreed" with Sen. Boozman and that the CFTC was not looking to go into other markets. However, Behnam explained that digital assets are unique because of their retail-facing element. In his opening statement, Behnam had noted the presence of many retail speculators in the digital asset space and that investors often entrust their assets to unregistered platforms. Behnam suggested that Congress could limit any new CFTC authorities to digital commodity assets.

Senator Roger Marshall (R-Kan) would strike a similar theme to Sen. Boozman by asking Behnam what the CFTC would do with any new authorities. Behnam replied that having greater authority to police digital commodities markets would have the effect of bringing those markets within the regulatory fold.

The notion of pulling digital assets within the ambit of federal regulators is a theme that Behnam's SEC counterpart, Chair Gary Gensler, also has advanced on at least three occasions. In an August 2021 speech to the Aspen Security Forum, Gensler explained that being part of a regulated industry is often critical to the longevity of any financial innovation. Said Gensler: "Right now, large parts of the field of crypto are sitting astride of—not operating within—regulatory frameworks that protect investors and consumers, guard against illicit activity, ensure for financial stability, and yes, protect national security. *** Standing astride isn't a sustainable place to be. For those who want to encourage innovations in crypto, I'd like to note that financial innovations throughout history don't long thrive outside of our public policy frameworks." Gensler then repeated this theme in testimony before the Senate Committee on Banking, Housing, and Urban Affairs and the House Financial Services Committee in September and October 2021, respectively, telling both committees that "technologies don't last long if they stay outside of the regulatory framework."

Additional questions for Behnam from members inquired about the urgency with which the CFTC needs new authorities for digital asset markets and the likelihood that digital asset markets will continue to grow. With respect to the latter question, Behnam told Sen. Hoeven that he is hard pressed to say there will no growth, but that he takes a cautious view in that he assumes technological innovations will take hold and eventually migrate into traditional finance.

With respect to the question of urgency, Sen. Cory Booker (D-NJ) asked why Behnam is hopeful about digital asset markets while also returning to the theme of why the CFTC would be the best agency to provide for a regulatory framework. Behnam answered part one of the question by observing that digital markets can provide quicker and better access to capital, although one must remain cautious about the technology. Behnam answered part two of the question by reiterating that the CFTC as a derivatives regulator understands what makes markets work, namely transparency and customer protection. Behnam added that the CFTC has been uniquely exposed to digital assets markets for the last five or so years and the agency is ready if the committee and Congress were to grant the requested new authorities.

Lastly, Sen. Tommy Tuberville (R-Ala) asked Behnam about the rumored forthcoming executive order on digital assets to be issued by the Biden Administration. Behnam confirmed that the CFTC has been part of the discussions around the proposed executive order. Behnam, however, said he was unsure of the precise timing for issuing the executive order.

Cybersecurity. Federal markets regulators like the SEC and the CFTC have had an increasing number of scrapes with cybersecurity issues, sometimes with their own systems, such as the SEC's EDGAR and the Consolidated Audit Trail, and sometimes in the context of drafting regulations for market participants, like the SEC's Regulation SCI and its latest proposal to extend similar principles to investment advisers and investment companies or the CFTC's now moribund Regulation AT and its 2020 replacement regulation.

Senator Boozman was the first member to raise the issue of cybersecurity with respect to the proposed expansion of the CFTC's authorities over digital asset markets. Behnam answered that dealing with cybersecurity in this context was not a different effort versus the agency's current approach.

But members' cybersecurity questions would get sharper. Senator Kirsten Gillibrand (D-NY), for example, asked Behnam if the CFTC can guard proprietary information. Behnam replied much as he had to Sen. Boozman, which drew a more pointed follow-up question from Sen. Gillibrand: Does the CFTC have the expertise and ability to guard cyber markets if Congress grants the agency new authorities. According to Sen. Gillibrand, the CFTC is critical infrastructure. Behnam replied, "No. We don't have it."

Climate risk. The electricity needed to power cryptocurrency mining operations also arose as an issue in members' questions for Behnam. Currently, many cryptocurrencies use proof of work as the basis for their mining of new cryptocurrency coins. This involves using a lot of electricity to power computers to solve complex mathematical problems that in turn can unlock new cryptocurrency coins for those with such computing power. The alternative mining method, proof of stake, would supposedly reduce the need for large amounts of electricity to power the server farms that enable cryptocurrency mining, but proof of stake has been slower to take hold across the cryptocurrency industry.

Senator Gillibrand noted that one of her constituents that previously operated a power plant designed to meet demand surges had reopened that plant and connected it to a natural gas pipeline for the purpose of supporting its cryptocurrency mining operation. The senator asked Behnam what can be done to reduce the energy needs of the cryptocurrency market.

Behnam replied that the CFTC had taken some steps to begin to address climate change, including the creation of its Climate Risk Unit and LabCFTC, the agency's fintech resource center. Behnam also said that his "gut reaction" is that disclosures have served markets well because they can raise awareness for end users and consumers and, thus, move market participants away from a specific method of cryptocurrency mining and toward renewable power sources or to less carbon-intensive mining methods.

Bad actors. Senator Tuberville asked Behnam about the CFTC's abilities regarding bad actors, such China, Iran, and Russia, whom the senator said may try to harm the U.S. through cryptocurrencies. Behnam pointed to the recent announcement by the DOJ that federal law enforcement officers had arrested two individuals on charges of conspiracy to launder cryptocurrency in connection with the Bitfinex hack. The CFTC previously has brought enforcement actions regarding Bitfinex.

The DOJ announcement, Behnam noted, also said that law enforcement officers had seized $3.6 billion related to the Bitfinex hack. Deputy Attorney General Lisa O. Monaco remarked in a DOJ press release that the federal government can track transactions on the blockchain: "Today's arrests, and the department's largest financial seizure ever, show that cryptocurrency is not a safe haven for criminals. In a futile effort to maintain digital anonymity, the defendants laundered stolen funds through a labyrinth of cryptocurrency transactions. Thanks to the meticulous work of law enforcement, the department once again showed how it can and will follow the money, no matter what form it takes."

Previously, the DOJ had recovered the alleged ransom paid by Colonial Pipeline to DarkSide, following a ransomware attack that disrupted Colonial's ability to distribute oil to locations on the east coast of the U.S.

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