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The Federal Commission for Crypto Trading

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About the Author

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Introduction

The recent implosion of FTX and its related partner Alameda Holdings, along with over 100 companies in its corporate group, has once again brought the question of cryptocurrency regulation to the forefront of political discussion. This comes hot on the heels of other collapses and seems to have shifted the public mood decisively and negatively against the industry. As the economist Joey Politano noted on Twitter on 11 November 2022, the day FTX filed for Chapter 11 bankruptcy: "The narrative sea change on crypto is that a couple months ago when I wrote 'this is mostly just highly financialized gambling' I would get responses like 'no, there are some good projects!' and now I get responses like 'no, it's institutionalized scamming and crime'."[1]

A strongly negative attitude towards cryptocurrency regulation has gained increasing currency in the media, and is perhaps best summed up using the headline of a recent article in *The Financial Times:* "Let crypto burn."[2] This line of thought argues that creating a regulatory environment for the cryptocurrency industry would grant it an undeserved seal of approval and would lead to a further integration of the industry within mainstream finance and increase the likelihood of publicly-funded bailouts in the event of similar cryptocurrency crashes in the future. Individuals on this wing of the argument make a number of good points, particularly about the dangers of cryptocurrency

becoming deeply enmeshed in mainstream finance. But the implicit assumption of their argument, that cryptocurrency will simply disappear if ignored, seems incorrect and makes the analysis wrong-headed, no matter how cathartic it may feel in the moment.

Given the decentralized nature of the cryptocurrency industry, it seems unlikely that it will simply 'go away' if ignored. People are working on a variety of cryptocurrency applications and will not cease doing so just because policy makers have fallen out of love with it. Cryptocurrency transactions will continue to be attractive for criminal organizations seeking to move large amounts of money outside of the traditional banking system. And members of the public, many of them financially unsophisticated investors, will be attracted to the promises of easy and risk-free returns. This leaves them open to the numerous fraudulent practices and has significant racial-justice implications, with Black Americans disproportionately more likely to own cryptocurrency (a legacy of that community being locked out of other investment opportunities) or be under the false impression that cryptocurrency holdings are regulated by the government.[3]

Given that reality, it is incumbent upon regulators and commentators to consider what are the actual use cases of cryptocurrency and what people working on it are actually working on, which in turn raises concerns both from the perspective of safeguarding the public and ensuring financial stability. Despite the extensive innovation in the area over the past decade and a half, the cryptocurrency industry has struggled to provide a use case for itself outside of financial

[1] https://twitter.com/JosephPolitano/status/1591119237673779247

[2] https://www.ft.com/content/ac058ede-80cb-4aa6-8394-941443eec7e3

[3] https://www.economist.com/graphic-detail/2022/05/20/why-the-crypto-crash-hit-black-americans-hard

engineering. Various attempts to discover more useful functions for the tokens have floundered: for example, initial coin offerings in theory offered the chance to use cryptocurrency tokens to invest in real startups but these often proved to be frauds or 'pump and dump' schemes of various kinds.[4] The collapse of FTX is also a blow to the vision for cryptocurrencies espoused by its founder Sam Bankman-Fried, which would involve revitalizing the industry through the injection of institutional money.[5]

Although cryptocurrency regulation is one of the more discussed topics in finance today, the discussion has focused on whether or how the industry should fit into existing frameworks for financial regulation, primarily that of either securities or commodities. This is unhelpful insofar as it overlooks the fact that cryptocurrencies, as speculative tokens untethered from the real economy, are not a financial asset like a security or commodity. There is no 'business plan' when it comes to owning cryptocurrency tokens, except insofar as groups of cryptocurrency holders pool their holdings, with the holdings of new investors being used to pay interest to earlier ones.[6] Cryptocurrency 'investment' has shown itself to be something close to a closed loop: cryptocurrency funds using cryptocurrencies as leverage for loans to and from other cryptocurrency companies. Furthermore, the pure self-referentiality of the cryptocurrency economy means that illiquidity always results in insolvency. There is not some ultimate asset which could be salvaged by a savvy administrator, unlike, for example, a bankrupt railroad company.

Meanwhile, the layman has been attracted to the industry mainly as a 'get rich quick' scheme, where the prospect of large windfalls makes the risk of losing your investment worth it. Looked at this way, out of the rarefied view of the financial press and instead focusing on the experiential motives of lay users, the obvious analogy for cryptocurrency trading is not financial services but gambling. Cryptocurrency trading is in essence a risky form of entertainment – one which millions of Americans seem to want and enjoy. At present, most gambling is regulated at the state level by gaming boards, which provide licenses to individuals and businesses to run casinos or other gambling operations.

This report outlines how the existing regulatory framework for gambling could be adapted and applied to cryptocurrency. It proposes the creation of the Federal Commission on Crypto Trading, a statutory body made up of three board members, one appointed by the president and the other two appointed by the leaders of other relevant regulatory agencies. It will be supported by a permanent bureaucracy and will have the ability to promulgate regulations for the industry and grant or revoke licenses to issue cryptocurrency. They will also regulate the licensed exchanges on which cryptocurrency will be traded.

This structure will provide advantages for everyone involved in the industry. For issuers, it will provide access to a steady market from which they can extract user fees.[7] For consumers, they will

[4] https://www.coindesk.com/markets/2018/07/12/report-more-than-three-quarters-of-icos-were-scams/

[5] https://news.yahoo.com/crypto-billionaire-bankman-fried-explains-whats-next-for-bitcoin-103739653.html

[6] This is what Sam Bankman-Fried euphemistically called "yield farming" in his now-famous interview on the Bloomberg Odd-Lots podcast, and what guest host Matt Levine more accurately described as a Ponzi scheme.
https://podcasts.apple.com/us/podcast/sam-bankman-fried-and-matt-levine-on-how-the/id1056200096?i=1000531062191

[7] This, of course, is a form of rent seeking and is not encouraged by most economists. This view is addressed in more detail, below, but this report argues that allowing for this kind of rent seeking may be necessary in order to bring the cryptocurrency industry on-side with these reforms.

be able to participate in the market, and potentially make enormous amounts of money (although, it should be noted, most probably will not). For regulators, it will clamp down on a prominent avenue for fraud and generate potentially useful tax revenue.

This report proceeds in two parts. This first part considers the different ways of conceptualizing cryptocurrency tokens in our modern financial system, making the case that understanding them as a type of gambling token better fits the experience of the layman using them. Building on this insight, the second part will outline the structure of the Federal Commission on Cryptocurrency, including its makeup, authority and best practice rules and regulations. This part will also explore the proposal's implications for consumers, issuers and regulators, as well as addressing costs and objections. An appendix will briefly consider the other major aspects of the contemporary digital asset marketplace, explaining what differentiates them from cryptocurrencies and what regulatory structure would be appropriate for them.

Part One: The Nature of Cryptocurrency Tokens

Cryptocurrencies are digital tokens where transactions and ownership data is stored on a digital ledger and whose prices fluctuate relative to fiat currencies. As a speculative phenomenon unmoored from an underlying asset or source of value, they represent a distinct subset of the digital asset market[8] that will require new and innovative thinking if they are to be regulated productively.

When discussing which form of regulation would be most appropriate for cryptocurrencies, it is commonly thought that an analogy should be drawn between these digital tokens and existing asset classes in the form of securities or commodities. Once the correct analogy has been established, regulation can then be properly handed over to the Securities and Exchange Commission ("SEC") of the Commodities and Futures Trading Commission ("CFTC").

However, the practice of creating and trading cryptocurrencies makes analogies with traditional securities or commodities awkward. Rather, the correct analogy is actually with gambling or lotteries, which will have knock on effects for what is the appropriate form of regulation.

Cryptocurrencies as Commodities

The CFTC has asserted its jurisdiction over cryptocurrencies since 2016[9] and this move has largely been welcomed by many in the cryptocurrency industry who favor the CFTC over the SEC.[10] No doubt this is because the CFTC would offer a far lighter regulatory touch, having around 15% of the

[8] For a discussion of the other segments of the digital asset market and what forms of regulation are appropriate to them, see Appendix A.

[9] In *In re BFXNA INC. d/b/a BITFINEX* CFTC Docket No. 16-19 (June 2, 2016), later supported by the Southern District of New York in In Re Ifinex Inc., CFTC Docket No. 22-05 (Oct. 15, 2021) at fn2.

[10] https://www.bloomberg.com/news/articles/2022-07-29/why-crypto-flinches-when-sec-calls-coins-securities-quicktake and https://www.washingtonpost.com/business/2022/04/28/crypto-regulator-cftc/

staff and 16% of the budget of its sister agency.[11] In addition, the CFTC's regulatory approach is based on self-certification and on investigations undertaken by the CFTC itself.[12] As a result, the CFTC's role is mostly limited to policing active fraud and conflicts of interest, leaving issuers subject to relatively few rules on reporting and price transparency. The potential for abuse here is not hard to see.

Historically, the rationale behind this lighter touch regulation is that the market in futures and/or commodities (oil, iron, oats etc.) has largely been the domain of an international group of knowledgeable investors. Regulators have therefore made a broader application of the *caveat emptor* principle.[13] This reasoning is consistent, so far as it goes, but reveals why such regulation is not appropriate for the cryptocurrency market. Far from being the purview of industry experts, much of the hype around cryptocurrency trading surrounds the possibility of laymen 'hitting it big' through speculative trading[14] or as a pathway to wider financial inclusion for underserved individuals and communities.[15] Notwithstanding the existence of a few so-called 'whales,'[16] holding and trading is relatively widely diffused throughout American society[17] and it would be inappropriate to regulate this market as if this were not the case.

Cryptocurrencies as Securities

According to the so-called 'Howey test,'[18] a security is an investment of money in a common enterprise with expected profits derived from the efforts of others. This test has been applied informally to cryptocurrencies by many authorities.[19] In the absence of a clear ruling on this matter by appellate or superior courts, such applications are of course not definitive and have drawn different conclusions.

One scenario where the analogy appears most apt is when cryptocurrency issuers make initial coin offerings ("ICOs"), where private companies issue new cryptocurrency tokens in exchange for other tokens or fiat currency. Coin issuers have purposefully tried to make them, to the point that Investopedia describes ICOs as "the cryptocurrency industry's equivalent of an initial public offering."[20] Not all tokens issued in ICOs grant the holders an ownership interest in the issuer, making the analogy with IPOs inexact, but it does seem to be the closest moment a cryptocurrency comes to passing Howey.

[11] https://rooseveltinstitute.org/2022/09/14/what-current-crypto-proposals-miss-and-why-we-need-to-get-it-right/

[12] https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/bitcoin_factsheet120117.pdf

[13] https://digitalcommons.nyls.edu/cgi/viewcontent.cgi?article=1465&context=journal_of_international_and_comparative_law at 228

[14] For example, https://www.fool.com/the-ascent/cryptocurrency/articles/this-crypto-has-turned-1000-into-almost-100000-in-9-months/ or https://www.gobankingrates.com/investing/crypto/crypto-investing-how-to-get-rich/

[15] https://time.com/6181824/dc-blockchain-summit-2022/

[16] The 100 largest holders of Bitcoin hold over 15 percent of all issued Bitcoins as of May 2022; and 52 percent of Dogecoin tokens were held by 15 wallets.

[17] Over 1 in 10 of US adults own at least one cryptocurrency, with most of the ownership being concentrated amongst those aged between 25 to 34. See https://www.insiderintelligence.com/insights/us-adults-cryptocurrency-ownership-stats/

[18] Derived from the Supreme Court case SEC v. W.J. Howey Co. 328 U.S. 293 (1946).

[19] For example, https://www.sec.gov/news/speech/speech-hinman-061418

[20] https://www.investopedia.com/terms/i/initial-coin-offering-ico.asp

The easiest prong of the Howey test for cryptocurrencies to satisfy is the first one: there must be an investment of money. This is typically satisfied by most cryptocurrency transactions because the token is acquired in return for fiat currency or some other form of consideration.

The second prong of Howey requires the investment of money to be made in a common enterprise. The SEC has asserted that this prong of the test is passed[21] but this view is uncertain and there are many key respects in which holding cryptocurrencies is not similar to how the courts have interpreted this requirement in the past. In particular, courts have in the past required investors to pool their capital for a common enterprise to exist,[22] something which is not necessarily the case amongst cryptocurrency holders.

Like the first prong, the third prong of Howey is more easily satisfied. This prong requires there to be the expectation of profit. Whether sensibly or not, the vast majority of purchasers of cryptocurrency tokens do so because they believe the value of those tokens will increase.

The final prong is the one that has generated the most discussion: for profits to be realized by the efforts of others. In *Balestra v. ATBCOIN LLC,*[23] the Southern District of New York found that the cryptocurrency ATB Coin met this prong because purchasers reasonably believed that the value of the token would increase or decrease in relation to the value of the ATB Blockchain, managed by the issuer. However, this is a lower court ruling and the SEC itself has been dovish on the question of whether this applies to most or all cryptocurrencies. The SEC's guidance on the matter merely notes that some tokens will and others won't.[24]

This discussion has been necessarily brief but it has shown that, at the very least, a positive application of the Howey test to cryptocurrencies rests on significant litigation risk, particularly in the absence of a prior Supreme Court ruling on the matter. Even the SEC, the most bullish of regulators on this question, demurs on the topic of whether all cryptocurrencies should be considered securities under the present system.

Of course, Congress has the power to simply declare cryptocurrency tokens to be securities and explicitly grant the SEC the power to regulate them. In the aftermath of the collapse of FTX-Almeda Holdings, in particular, a narrative seems to have coalesced that Gary Gensler, current chair of the SEC, has been proven right in his hawkish attitude towards the cryptocurrency industry and that regulation of it should now be handed over to his agency.[25] This view, that stricter regulations might be appropriate for the cryptocurrency industry, is now being embraced by some of the more crypto-credulous press as well, presumably as a lifeboat for their disgraced industry.[26]

[21] https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets

[22] Deckebach v. La Vida Charters, Inc., 867 F.2d 278, 283 (6th Cir. 1989)

[23] 380 F. Supp. 3d 340, 354 (S.D.N.Y. 2019)

[24] https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets

[25] https://www.nytimes.com/2022/11/21/technology/gary-gensler-crypto-sec.html

[26] https://www.bloomberg.com/news/videos/2022-11-15/can-washington-get-crypto-regulation-right

Although this is an understandable emotional response to recent scandals, closer examination reveals that there are serious practical problems with simply porting securities regulation into the cryptocurrency world. Simply put, cryptocurrency tokens do not function like stock in a company and their issuers do not have a business plan in the conventional sense of that expression. What kind of securities prospectus, for example, could plausibly be written with regards to the issuance of a cryptocurrency token?

Cryptocurrencies as a Mixture of Both

Cryptocurrency tokens can look like securities at certain points in their life cycles, notably ICOs, but then seem to follow commodity-style price swings at others and fail to meet the prongs of the Howey test. It is possible to imagine a regulatory future where there is an interplay between the CFTC and the SEC, with one agency handing off oversight of a particular token as the cryptocurrency evolves.

Under a bipartisan bill proposed by Senators John Boozman[27] and Debbie Stabenow in August 2022, the CFTC would be given direct oversight of some cryptocurrencies that qualify as "digital commodities" but not others.[28] Unfortunately, the bill is ambiguous about how a cryptocurrency would come to be labeled digital commodities, and about what will happen to cryptocurrencies which do not meet those requirements. The bill suggests that larger cryptocurrencies like Bitcoin or Ether are most likely to be designated digital commodities on the basis that they are the largest competitors in this area. But the idea that less stringent CFTC regulation should be applied to the larger cryptocurrency tokens is barely credible: they are the tokens most likely to be purchased by unsophisticated individuals or institutional investors. A cryptocurrency should become more security-like and less commodity-like as it gets bigger.

The Financial Stability Oversight Council ("FSOC") recently released a paper on digital asset regulation, which argues that regulation should be dispersed across a number of agencies, with a range of informal and formal avenues of coordination between agencies ensuring that there is a coherent regulatory umbrella.[29] However, such regulatory interchange would inevitably be complicated to administer, providing opportunities for private actors to avoid necessary oversight.

[27] This report notes that Senator Boozman was recently the recipient of $1.2 million of support from the cryptocurrency-aligned American Dream PAC. See https://www.bloomberg.com/news/articles/2022-06-21/crypto-donors-poured-money-into-politics-in-may-despite-downturn

[28] https://www.bloomberg.com/news/articles/2022-08-03/push-to-give-cftc-more-sway-over-us-crypto-trading-gains-steam

[29] https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf at 116

Cryptocurrencies as Gambling Tokens

Attempts to fit cryptocurrencies into one of these pre-existing financial categories are, at best, disputable. The fact is that cryptocurrencies are pure speculative assets untethered from anything 'real' and make extremely risky investments. In this context, expecting regulators to come in and ensure that they are made 'safe' or like 'normal' financial products. Because they include the word 'currency' in the title, many are fooled into thinking that the cryptocurrency industry is related to finance but, as shown above, this is often only the case tenuously and occasionally. Instead, the obvious analogy to the task of regulating cryptocurrency is how governments regulate gambling.

In order to understand this analogy, it is important to grasp the experiential difference between cryptocurrency trading and buying and selling securities or commodities.

Person A buys stock in XYZ, Inc. upon the announcement that XYZ is working on a new widget that will revolutionize the market. The widget fails its beta test, the project is abandoned, and XYZ's stock price collapses.

Person B buys stock in 123-coin, after seeing positive things being said about it on social media. One day the value of 123-coin against the dollar falls to below the level when Person B bought in.

In both cases, the investor has lost money. But only Person A can say that their loss derived from the economic fact of a good investment becoming a bad investment due to changing circumstances. The changing circumstances for Person B are entirely unquantifiable and unpredictable, resulting from semi-mythical changes in sentiment known colloquially as "vibe shifts"[30] rather than changes in business performance.

Of course, the performance of a security, business or commodity is influenced by a range of factors outside of that company's control, including political events and the psychology of market participants.[31] However, despite this fact, and the recurrent emergence and bursting of financial bubbles, it seems that long-term economic fundamentals do matter to company performance.[32]

To put it simply, it can be said that the valuation of cryptocurrencies and traditional businesses are influenced by swings in sentiment, but in the case of the former there are also underlying fundamental factors which determine value. In the case of XYZ, Inc., above, that is a company which has a product to sell to consumers, the value of which goes up and down based on a wide range of factors, including managerial competence, practical design considerations and marketing. Furthermore, when it loses value because of the failure of its new application, XYZ, Inc. still has a

[30] https://www.ft.com/content/d95e3d2c-6282-4e3e-ab02-6b9cebb382cd or https://cointelegraph.com/news/love-it-or-hate-it-crypto-s-vibe-shift-is-now-imminent

[31] https://reader.elsevier.com/reader/sd/pii/S0927538X03000489?token=40AEFFE87B321229B74E0586264992AA67140F5A9CF9B7AB17FDA9A21227144F3E22F5D87E9A03FCE7AE67C2C2E533DA&originRegion=us-east-1&originCreation=20221006200954 and https://nicholasbarberis.github.io/ch18_6.pdf, among others.

[32] https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/do-fundamentalsor-emotionsdrive-the-stock-market

range of assets to rely on: from its reputation outside of this project, to its employees, through to the physical and intellectual assets it owns. The real world analogy would be the railroad companies of the nineteenth century or the tech start-ups of the Dotcom Boom, many of which went bankrupt in subsequent years but which nevertheless left a legacy of real achievements – in the form of physical railroads, fiber optic cables and so forth – which were built on by better competitors.

123-coin does not have any of those advantages. It is an entirely speculative digital token which, once people no longer believe in its value, has nothing positive to contribute from a business or financial perspective. To make a profit on her purchase of 123-coin, Person B would have to guess when people's belief in 123-coin's value was at its highest and then sell her holdings. To be sure, Person B may have bought her holding in anticipation of a judicial ruling favorable to 123-coin, leading her to guess that the value people attribute to it would increase. But that is akin to a diehard sports fan being better at making sports bets than someone with no interest, not the signal that 123-coin is succeeding or failing as an investment similar to Person A's holding of stock in XYZ, Inc.

Buying and selling cryptocurrency is more like the purchase of lottery tickets or the placement of sports bets than it is an investment decision. The correct analogy for cryptocurrency trading, therefore, is not securities or commodities trading, but gambling.

Gambling is legal at the federal level (with certain exceptions) but is mostly regulated at the state level. The New York state constitution[33] defines gambling as where a person "stakes or risks something of value upon the outcome of a contest of chance or a future contingent event not under his control or influence, upon an agreement or understanding that he will receive something of value in the event of a certain outcome."

Cryptocurrency trading can very easily be conceptualized along the same lines. A person risks something of value, in the form of their fiat currency which buys the cryptocurrency token(s). The cryptocurrency's price volatility is a future event not under his control or influence. And there is the understanding between buyer and issuer that the buyer will receive something of value – in the form of profit – if they sell their cryptocurrency holdings at the right time.

The analogy is, of course, inexact in many ways and the purpose of this report is not to argue for a precise equivalency. However, digital asset markets are unlikely to disappear or wither entirely and cryptocurrency in particular sits uneasily with traditional categories of financial regulation. Regulators should adopt an approach that recognizes cryptocurrency trading in particular as a form of entertainment with significant risks and regulate it accordingly.

[33] Definitions in other state's constitutions or legislation are somewhat different but not materially so.

Part Two: Structure of the Commission

Following on from the insights in Part One, this section of the report describes a proposed Federal Commission on Crypto Trading (FCCT) which would regulate cryptocurrencies in the manner of contemporary gambling. It proceeds by explaining the commission's make-up, purview, and foundational rules and regulations. The costs and benefits of this scheme are also considered.

Federal Legality

The most obvious way in which the FCCT will differ from already existing gambling regulations in the United States is that it will be a federal agency and preempt any state and local legislation covering cryptocurrency. State-level regulation would be inappropriate and encourage criminality and a race to the bottom between states, which would defeat the purpose of regulation in the first place.[34] A federal-level Commission will enable the institution of a coherent, nation-wide set of rules and regulations.

Congress has the power to create an agency like the FCCT under the constitution's Commerce Clause, which has frequently been used to regulate interstate and international gambling.[35] In addition, there is a long tradition of federal agencies having responsibility for regulating interstate financial industries. This would require Congress to pass specific enabling legislation.

Membership

The FCCT will be made up of three board members with a series of bureaucratic divisions serving underneath them. This structure is drawn from the makeup of the Nevada Gaming Control Board, one of the oldest and most experienced such boards in the United States, making it the obvious precedent from which to draw.

To reflect the different nature of the cryptocurrency market, this report proposes that one board member each will be appointed by the CFTC and the SEC. This reflects the fact that, although they are not themselves financial products, cryptocurrencies do share many similarities with securities and commodities and this regulatory experience would be useful to have on hand. The final member of the FCCT will be appointed by the President. This figure will chair the commission and new regulations (or packages of regulations) may only be approved by the vote of the FCCT chair and one other commissioner. This ensures that the FCCT will remain within the orbit of regular politics.

[34] This raises the question of what this will mean for arrangements on Indian Reservations. The federal government has the plenary power to legislate on behalf of Indian Reservations (see *Lone Wolf v. Hitchcock*, 187 U.S. 553 (1903)) and so could legislate that the FCCT could include the Reservations in its authority.

[35] For example, by prohibiting the unauthorized transportation of lottery tickets across state lines. See https://codes.findlaw.com/us/title-18-crimes-and-criminal-procedure/18-usc-sect-1301.html

Initially, the presidentially-appointed commissioner will be appointed for a five-year term, the SEC-appointed commissioner for a three-year term, and the CFTC-appointed commissioner for a seven-year term. Thereafter, all commissioners will be appointed to five-year terms, with the possibility of one individual holding their position for a maximum of two terms. This ensures that their appointment will not perfectly match presidential and congressional election cycles but, at the same time, the five year period ensures that the vast majority of presidents will be able to appoint a commissioner of their choosing. Partially-overlapping terms will ensure that a single administration could not switch out the entire FCCT in one swoop but that the FCCT's leadership will be regularly refreshed such that the possibility of institutional inertia and groupthink would be regularly challenged. All three commissioners will require Senate approval before being confirmed to their roles.

To prevent regulatory capture, it is proposed that the commissioners will all be subject to revolving door stipulations. Based on best-practice regulations from other state governments, this will impose a lifetime ban on working for or lobbying on behalf of the cryptocurrency industry on someone who has been a commissioner.[36]

The commissioners will appoint a permanent bureaucracy as well as members of sub-committees, task forces or study groups as are deemed necessary from time to time. In particular, the following administrative divisions should be inaugurated from the start: Licensing and Administration – which reviews, approves or declines applications by private companies to issue cryptocurrency tokens or set up a cryptocurrency exchange; Audit – responsible for regular compliance reviews; Investigations – responsible for following up consumer complaints and other ad hoc investigations into issuers; Tax – working with the Internal Revenue Service ("IRS") ensuring that issuers and consumers are all tax compliant.

This is not intended to be an exhaustive list of the various committees, departments and so forth that the FCCT will be expected to found over the course of its lifetime.

Purview

The FCCT will be concerned with the regulation of what have been referred to in this report as 'cryptocurrencies' and the exchanges upon which they are traded. The definition of cryptocurrencies is: Digital tokens which are designed to be transferable through a peer-to-peer network.[37]

To better understand the implications of this, consider the following real-world example. The company Ethereum is an open-source blockchain with a native cryptocurrency (the "Ether"). The FCCT would regulate the issuing and trading of Ether tokens but would not regulate the company's

[36] https://www.citizen.org/article/slowing-the-federal-revolving-door/

[37] The legislation creating the FCCT should also include a method by which this definition could be amended, allowing it to be nimble enough to respond to the next purely speculative financial technology that emerges

other blockchain and software development work.[38] The close links between the FCCT and other regulators (particularly the SEC and the CFTC) will ensure, however, that this does not become an avenue for issuers to engage in regulatory arbitrage.

The FCCT will draft an application process for two types of cryptocurrency-related licenses. The first license will be directly to issuers, giving them the right to issue cryptocurrencies to individuals within the United States.[39] The second will be to the owners of cryptocurrency exchanges,[40] granting them the right for individuals within the United States to trade on those exchanges. Trading cryptocurrency off of licensed exchanges and directly on the blockchain will be banned.

Best Practice Rules and Regulations

This report is not supposed to provide the final answer to the question of cryptocurrency regulation. The FCCT, with its expertise in the industry, will have to be flexible to respond to consumer and market demand in the future. That being said, there are a number of best practice rules and regulations which should be written into the FCCT's constitution from the moment of its foundation. Failure to comply with these regulations on an ongoing basis will result in a delisting of the issuer's tokens or the closing of the relevant exchange. In both cases, investors will have their tokens returned to them in fiat money at the issuer or exchange's expense.[41]

Disclosure Requirements

The FCCT will require issuers and/or exchanges to make a number of public disclosures. Issuers will be required to compile quarterly and annual reports on their performance and the performance of their wider corporate group. As part of an application for a license to issue cryptocurrency, a company will also have to complete a prospectus that contains a legally binding statement of the issuer's financial position.

These requirements closely parallel similar disclosure requirements that have been common in the finance industry for the best part of a century (since the Securities Act of 1933). Furthermore, similar requirements have been made of cryptocurrency exchanges in the United States for a number of years now.

[38] To the extent that this work is bank-like and/or consumer-facing, it is more appropriately regulated by existing agencies. See the Appendix of this report for further details.

[39] And the various territories and minor outlying islands.

[40] The term "exchange" is used in this report because it is the term of art that has been adopted by the industry. In reality, most cryptocurrency 'exchanges' are not traditional exchanges (like the New York Stock Exchange) but more like broker-dealers: matching buyers and sellers, and holding a book of securities. Traders hold the equivalent of brokerage accounts at the exchanges, paying fees on them, and the exchanges act as the custodian.

[41] In the event of an exchange or issuer going bankrupt upon delisting, the consumers will be regarded as secured creditors.

Fiduciary Relationship

The relationship between a cryptocurrency issuer or exchange and their customers is not a fiduciary one. It is therefore not clear, under existing law, that the kind of self-dealing that FTX engaged in would be illegal if it did not contravene their own terms of service.[42] In order to counteract this loophole, the FCCT would mandate that a fiduciary relationship exists between the officers of the issuer and the officers of the exchange, on the one hand, and the consumer on the other.

Proof of Funds

One of the primary concerns the public has about the cryptocurrency market is the potential for individuals to suffer large financial losses. Unfortunately, there does not seem to be a way to eliminate this risk entirely: it is inherent to the nature of the entertainment. However, the FCCT should look seriously at policies which would mitigate risks such that individuals do not supper financial losses beyond their ability to bear.

Issuers and exchanges will therefore require all investors to provide a legally binding proof of funds letter if the investor wishes to buy more than $10,000 worth of cryptocurrency tokens in the aggregate. As with proof of funds letters in the home buying market, these investor proof of funds will show that the investor is not spending over 10% of his or her net worth on the investment. If this proposal is deemed insufficient, the FCCT should consider applying a blanket cap of $10,000 on total cryptocurrency holdings by individuals.[43]

This will not eliminate the risk of investors suffering financial losses but this relatively simple intervention will prevent individuals from losing their family savings, or equivalent, while providing minimal disruption to most users' experience of the market. When combined with active information sharing between issuers, exchanges and the FCCT, regulators will be able to identify problem traders, cut them out of the industry and offer them relevant medical help.[44]

Know Your Customer Checks

It is a widely-held concern that cryptocurrency is used to conduct illegal business online[45] and is used in a number of scams against the public.[46] It is obviously in the public interest for these kinds of uses to be eliminated. The FCCT will require all investors to pass Know Your Customer ("KYC") and Anti-Money Laundering ("AML") checks before buying cryptocurrency tokens.

[42] https://www.law.cornell.edu/wex/self-dealing

[43] This is stricter than existing gambling regulations but is considered appropriate because of the risks caused by cryptocurrency price swings. It may be the case that existing gambling regulators should consider introducing similar rules with respect to casino and online gambling.

[44] A requirement to pay for this treatment could be part of the license granted to issuers and exchanges.

[45] https://www.nytimes.com/2022/08/08/technology/treasury-blacklist-crypto-tornado-cash-laundering.html?searchResultPosition=8

[46] https://consumer.ftc.gov/articles/what-know-about-cryptocurrency-and-scams#scams

These checks will require investors to provide their social security number and some form of ID when they purchase tokens. These kinds of checks are not unduly onerous and are already required before individuals open an account on exchanges such as Coinbase.

Institutional Investors

One of the recent stories in the cryptocurrency world is the potential involvement of institutional investors in the market. However, the quantum of chance required to trade cryptocurrency successfully makes it a poor investment for institutional investors with lots of people's money at stake, and one which should be discouraged. Much as no respectable pension fund or asset manager would regard buying thousands of lottery tickets as a safe investment, the same attitude should be taken with regard to cryptocurrency. The FCCT will ban non-individuals from buying tokens from registered issuers.

Proof of Work

The proof of work technology essential to the functioning of many cryptocurrencies (most notably Bitcoin) requires vast amounts of computing power, which in turn requires a vast amount of electricity, much of which is produced by the burning of fossil fuels. This leads to a wide range of deleterious climatic consequences.[47] Proof of stake technology is being proposed as a way of avoiding these issues, requiring as it does 99.9 percent less energy to operate than similarly-sized proof of work-based tokens.[48]

The FCCT should insert as a requirement of receiving a license to issue cryptocurrency that the issuer manages its blockchain using proof of stake technology, while prohibiting the use of proof of work. Because of the size and importance of the United States in the international cryptocurrency market, this may well have a beneficial chilling effect on proof of work-based tokens worldwide and prompt other international regulators to promulgate similar regulations.

Deceptive Practices and Insider Trading

People would not gamble on sports games if they knew the results were fixed, and people would not invest in the stock market if they knew that the only way to make money was through illicit exchanges of information. The same should be true for cryptocurrency trading, to ensure that it can be enjoyed as an entertainment for all participants equally. Therefore, the FCCT should promulgate

[47] https://www.nytimes.com/interactive/2021/09/03/climate/bitcoin-carbon-footprint-electricity.html

[48] https://www.economist.com/finance-and-economics/2022/09/06/the-future-of-crypto-is-at-stake-in-ethereums-switch?utm_campaign=a.io&utm_medium=audio.podcast.np&utm_source=babbage&utm_content=discovery.content.anonymous.tr_shownotes_na-na_article&utm_term=sa.listeners

anti-insider trading rules which will apply to issuers and holders of cryptocurrency, and cryptocurrency issuers will be bound by rules which prevent them from undertaking unfair or deceptive practices at the expense of consumers. These regulations will be, broadly, based on the precedent set by the Federal Trade Commission ("FTC") and the definitions of its powers set out in subsequent court cases.

This would not prevent a licensed issuer also being a licensed exchange, something which could give rise to certain conflicts of interest. This will be dealt with through various methods. In the first place, corporate officers and their families at licensed issuers or exchanges (or officers of companies in the issuer or exchange's wider corporate group) will be prohibited from buying and selling cryptocurrency tokens. Secondly, where an issuer is also an exchange, and vice versa, notification of this must be displayed prominently on the relevant company website.

Another deceptive practice which is a source of concern is celebrities using their public platforms to attempt to boost the price of a particular cryptocurrency token, before selling their holdings before the price collapses. Events like this have happened before in the cryptocurrency industry and, for obvious reasons, tends to attract a great deal of press attention.[49] The FCCT will tackle this problem incorporating anti-market manipulation language found in the Securities Exchange Act of 1934.

So-called 'pump and dump' schemes are notoriously hard to 'prove' in a court of law. But, nevertheless, the SEC has had a degree of success in prosecuting high-profile individuals such as Kim Kardashian and Floyd Mayweather, Jr.[50] It is anticipated that the FCCT will, with its expertise and sole focus on the issue, enjoy even greater success.

Taxation

Profits made on cryptocurrency investments will be taxable, much like ordinary lottery winnings. All profits over $5,000 will be subject to tax at the rate of 37%. This is in line with the current rate of taxes withheld by state lottery agencies[51] but can be raised or lowered by Congress from time to time. Losses incurred in cryptocurrency investing will not be eligible for tax write-offs.

Cryptocurrency issuers and exchanges will continue to make money through a variety of fees.[52] The fees collected from all US-based investors will be reported to the FCCT's Tax department and the issuers and exchanges will be required to pay federal corporate tax on that in the ordinary way.

[49] https://www.sec.gov/news/press-release/2022-183

[50] https://truthinadvertising.org/industries/celebrities-promoting-nfts/

[51] https://turbotax.intuit.com/tax-tips/fun-facts/tallying-up-the-taxes-of-powerball-winnings/L7Phwt1yr

[52] For example https://help.coinbase.com/en/exchange/trading-and-funding/exchange-fees

Advertising

The FCCT will regulate the cryptocurrency industry's advertising in a number of ways, based on similar steps taken by the gambling industry[53]: minors should not be featured in the advertisement, nor should the advertisement be placed where an audience of minors can see it; advertisements should not describe cryptocurrency tokens as "investments," or as a path to long term wealth-building, or any similar language; all advertisements should include a link or web address describing where the terms and conditions of the tokens can be found; and a hotline for problem users must be included in each advertisements and displayed prominently.

The FCCT will be required to formally approve every advertisement before it is shown to the general public. Notwithstanding the requirements set out above, the FCCT will have absolute discretion to grant or deny approval to show any individual advertisement.

International Issues

The United States is not the country with the most cryptocurrency users, either in raw numbers or on a per capita basis.[54] However, given the United States' importance to the global economy, it is expected that the form of cryptocurrency regulation adopted by the United States will be influential in the rest of the world. The FCCT is expected therefore, while not having an explicit extra-territorial jurisdiction, to have significant informal influence on the international market. It is expected that this informal influence will be wielded to encourage allied jurisdictions, including but not limited to places such as Canada, the European Union and the United Kingdom, to adopt similar regulatory approaches to cryptocurrencies. This could possibly lead to a series of passporting arrangements for licensed issuers and exchanges between jurisdictions.

Oversight of the FCCT

A potential issuer who is refused a license or a current issuer who has theirs rescinded, for example, will be able to follow an appeals procedure. By and large, however, the FCCT will be empowered to take its decisions at its discretion.

Individuals and corporations will be able to appeal their case to the courts, which will be able to strike down an act of the FCCT if the FCCT did not have the power to take such an act in the first place. This is not intended to allow the federal courts to act as another stage of appeals but as a final check that the FCCT is utilizing its discretion as designed.

[53] As with the previous discussion of proof of funds, many of these suggestions go further than existing gambling laws, but are nonetheless considered sensible in view of cryptocurrencies' large price swings.

[54] That dubious distinction belongs to India and Ukraine, respectively. See https://timesofindia.indiatimes.com/business/cryptocurrency/bitcoin/7-indians-own-crypto-7th-highest-globally-un/articleshow/93509467.cms

In addition, the FCCT should be specifically required to follow all orders made by the Consumer Financial Protection Bureau ("CFPB") and the Financial Stability Oversight Council ("FSOC").[55] In both cases, the overlap is anticipated to be minor but could still prove to be necessary.

Given that the FCCT structure is designed to hive cryptocurrency trading off from the rest of the economy, it should be unlikely that cryptocurrency will come under the CFPB's purview to any great extent. However, given the CFPB's broader powers to tackle "unfair, deceptive, or abusive acts or practices,"[56] it may have a vital role to play in protecting investors' interests if the FCCT is asleep at the wheel.

The FSOC should, similarly, have a limited role to play in the FCCT's workings. However, like the CFPB, the FSOC's powers are broad and require it to identify "risks to the financial stability of the United States," promote "market discipline" and respond "to emerging risks to the stability of the United States' financial system."[57] As such, it is possible to imagine a scenario where the business of a digital asset provider is, when taken as a whole, regarded as systemically important. In that scenario, the FSOC will be able to impose prudential standards on the issuer's entire business (including the cryptocurrency issuing part) and direct the FCCT to undertake such activities as would enable those standards to be enforced.

Benefits

There are three major stakeholders in the cryptocurrency space: consumers, regulators and issuers. FCCT regulation would provide benefits for all three in a way that other regulatory models do not.

Consumers

The main risk to consumers is price volatility. The FCCT would not eliminate that risk entirely and this risk is part of the appeal of the market for many of those involved in it. By providing a regulatory structure by which people are limited from putting more than a certain percentage of their net worth into cryptocurrency, however, the possibility of someone suffering a life-ruining loss will be reduced.

By requiring Issuers to register with the Commission, the FCCT will make it a more difficult environment for criminals to operate in. Individual consumers are therefore less likely to be actively defrauded by issuers or exchanges. The FCCT will also set up a process by which individuals can recover their cryptocurrency in the event of accidental transfer or loss of private key details.

[55] Within reason – it is not proposed that the FSOC or CFPB could order that a member of the Commission resign (except perhaps in the case of gross misconduct) or that the Commission abolish itself.

[56] https://www.law.cornell.edu/uscode/text/12/5531

[57] https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc

Regulators

The FCCT would tackle both the macro and micro economic risks posed by cryptocurrencies. A common concern about the cryptocurrency industry is that it getting too far integrated into the real economy could result in contagion and a much wider and deeper financial crisis. The recent collapse of FTX has so far led to little in the way of real world contagion. But proponents of a maximalist negative cryptocurrency approach argue that any form of regulation would give the industry a degree of legitimacy as financial products and create integration with traditional finance where there was none before.[58] However, simply leaving the industry alone is no way to ensure that integration with traditional finance does not occur either. The advantage of FCCT regulation is that cryptocurrency trading will be specifically hived off into one area of public life, with permanent walls erected between it and the finance industry.

Furthermore, requiring issuers and exchanges to obtain KYC information from and perform AML checks on users will mean that cryptocurrency's use by money launderers and other criminals will be immediately undercut.

Aside from economic stabilization of various kinds, a legitimated cryptocurrency trading industry could be a boon to government budgets. This could be an unsavory, or at least problematic, development for some people as, whatever measures are put in place to mitigate some of the predation rampant in the cryptocurrency sector (for example, through advertising restrictions, the cap in individual aggregate holdings, or an industry-wide mental health insurance fund), there is likely to be at least a subset of participants who are being taken advantage of. This is, unfortunately, a persistent dynamic in many areas, including sports betting and state lotteries.[59]

The increased transparency about who is buying and selling how much cryptocurrency would make it easier for the IRS to tax individuals' winnings. In the first five months of sports betting being made legal in New York, the state government earned an estimated $263 million in taxes from the practice.[60] It is impossible to say with certainty what the relevant figure with regard to cryptocurrency trading would be but one can imagine such a figure, collected nationwide, would be several times as large.

On the micro level, it is a bad thing for a government if its citizens are engaged in risky activities which periodically causes them to lose their life's savings. The Commission would not eliminate the risk of losses but would provide a limitation on what could happen.

[58] https://www.ft.com/content/ac058ede-80cb-4aa6-8394-941443eec7e3

[59] This matter is considered in more detail, below.

[60] https://www.governor.ny.gov/news/governor-hochul-announces-new-york-states-record-setting-sports-wagering-tax-revenue#:~:text=According%20to%20New%20York%20State,total%20revenue%20since%20July%202019.

Issuers

The clearest advantage of this shift is that the industry will be purged of its more obviously criminal aspects and those issuers that remain will therefore achieve a degree of respectability. The result of this conferring of legitimacy is likely to be an increase in the number of market participants, much as more people now play the various state lotteries than took part in the criminal-run numbers games which preceded them. In the short term, this is likely to be very profitable to existing holders of cryptocurrency, as new entrants into the market will cause the value of their existing holdings to rise.

As well as this influx of new customers, the proposed FCCT regulation would leave much of the architecture of the contemporary cryptocurrency market intact. Major figures in the cryptocurrency industry, such as Brian Armstrong and Fred Ehrsam, gain much of their net worth not from cryptocurrency trading, as such, but from owning the exchanges. Here they can extract rents in the form of fees from users. This structure, of licensed cryptocurrency tokens being traded on licensed private exchanges, would continue under the FCCT, allowing these important figures in the industry to retain their wealth and revenue sources.

At present the cryptocurrency industry seems to be engaging in a concerted effort to lobby friendly lawmakers to continue to take a light-touch on regulation.[61] This may pay dividends in the short term but risks views on cryptocurrency becoming ever-further sharply divided, with progressives firmly opposing the industry's existence and conservatives similarly sharply in favor. This may result in future lawmakers taking more drastic measures which could effectively shut down the industry in its entirety.[62] FCCT regulation, by contrast, provides an avenue for the industry to remain in existence, continue to be profitable for industry insiders, be safely regulated, and subject to reasonable ongoing political contestation.

[61] https://www.bloomberg.com/news/articles/2022-03-08/crypto-lobbying-skyrocketed-last-year-and-quadrupled-since-2018

[62] This report is relatively sanguine about the possibility of this latter eventuality, but it is one that the cryptocurrency industry would doubtless like to avoid.

Costs and Objections

This section addresses potential objections to and costs of FCCT regulation. The costs do not outweigh the potential benefits described above.

Legitimation of the Industry

Cryptocurrency skeptics will no doubt regard FCCT regulation as unduly favorable to an industry they disapprove of. As Stephen Cecchetti and Kim Schoenholtz say: "Actively intervening [through regulation] would convey undeserved legitimacy upon a system that does little to support real economic activity. It also would provide an official seal of approval to a system that currently poses no threat to financial stability and would lead to calls for public bailouts when crypto inevitably erupts again."[63]

This could not be the case for FCCT regulation. Although issuers and exchanges will gain a degree of legitimacy through regulation, it is a legitimacy as part of the gambling industry separate from financial institutions. By analogy, while most people regard casinos as legitimate business entities, few would regard going in one and gambling thousands of dollars at the roulette tables as a sensible investment strategy for a household. The same will be true for cryptocurrency issuers and exchanges under the FCCT.

Limiting the Investing Pool

It has been a long term aim of many cryptocurrency issuers to attract large institutional investors into their market. This was the ultimate aim of Sam Bankman-Fried's regulatory lobbying attempts before the bankruptcy of his companies. This report has suggested that such investors be actively banned from participating in the cryptocurrency market.

However, while the FCCT will prevent institutions from getting involved in the market, it will not stop individual investors from moving into the space. In fact, this report predicts that the number of individual investors in cryptocurrency will in fact increase. This should draw in enough users to make price swings an entertaining pastime and make up for the loss of potential investment from institutional figures.

[63] https://www.ft.com/content/ac058ede-80cb-4aa6-8394-941443eec7e3

Privacy Concerns

Anonymity has been a core tenet of the cryptocurrency industry since its inception. The founder of Bitcoin, Satoshi Nakamoto, remains anonymous.[64] To a great extent, this anonymity is an important part of the culture of the digital asset industry, a tradition which originates in the anarchist and libertarian beliefs of many early crypto proselytizers.

The prospect of the FCCT places this vision of the industry at obvious risk. Even assuming that the FCCT adopts a largely hands off approach and does not intervene in cryptocurrency trading beyond licensing the tokens and exchanges, the prospect of the cryptocurrency market being limited to such issuers is an affront to many people's conception of this market. The KYC and AML requirements proposed in this report would further erode the prospect of total anonymity.

But these law enforcement powers are necessary because of the extent to which the existing cryptocurrency market is already a haven for criminals of various kinds. The amount of cryptocurrency used on the black market is, for obvious reasons, hard to ascertain but an upper bound estimate suggested that as much as 46 percent of all Bitcoin transactions conducted in 2018 were used to finance illegal activity.[65]

This should override the supposed privacy uses of cryptocurrencies, many of which are largely spurious in any event.[66] The majority of law cryptocurrency users do so through a number of centralized exchanges such as Coinbase. To open a Coinbase account, an individual has to provide a government-issued photo ID, valid email and telephone addresses, and the last four digits of their social security number.[67] Far from ending privacy in cryptocurrency trading, the FCCT may in fact make little practical difference.

Privacy concerns in the modern internet age are legitimate and the FCCT will take measures to ensure that consumers are properly protected.

Effect on Innovation

Senator Pat Toomey has argued that "There are going to be very exciting innovations [in the digital asset industry] which we probably can't imagine yet."[68] Such concerns are currently being levied at the EU's MiCA regulations[69] and would, no doubt, be leveled at the proposed FCCT. The argument

[64] Despite many attempts to find 'him', see for example https://www.lrb.co.uk/the-paper/v38/n13/andrew-o-hagan/the-satoshi-affair

[65] https://freepolicybriefs.org/wp-content/uploads/2019/02/freepolicybrief_jan212019.pdf

[66] While blockchain transactions are stored pseudonymously, they are also done so in perpetuity and, often, on publicly-accessible software. Recent experience has shown cryptocurrency transactions to be, in practice, highly traceable. See https://www.brookings.edu/techstream/shifting-crypto-landscape-threatens-crime-investigations-and-sanctions/

[67] https://help.coinbase.com/en/coinbase/getting-started/getting-started-with-coinbase/create-a-coinbase-account

[68] https://www.bloomberg.com/news/articles/2022-09-15/odd-lots-podcast-sent-pat-toomey-on-crypto

[69] https://cointelegraph.com/news/mica-is-already-stifling-stablecoin-adoption-in-the-eu

is that formally categorizing cryptocurrencies as, effectively, a form of entertainment would limit the entrepreneurs willing to get into the space. In theory, this would halt the development of new and innovative products using blockchain and related technologies.

Such criticisms are misguided. Firstly, the fact is that the cryptocurrency industry has existed in its present form for the best part of a decade and a half, and it has yet to demonstrate a clear use case outside of airy financial engineering and money laundering. Other industries subject to similar speculative manias, such as railroads and e-commerce websites, did not have to wait this length of time before a clear real world use case emerged. Non-cryptocurrency uses of innovations like the blockchain have long been promised but such projects often seem to fizzle out without concrete developments.[70]

On the other hand, to take the claims to innovation of the cryptocurrency industry seriously for a moment, it should be recalled what would and wouldn't be regulated by the FCCT. To return to the example of Etherium, the only part of that company's business which would be regulated by the FCCT is its native cryptocurrency: Ether. The other uses of the company's blockchain, which includes DeFi, smart contracts and the creation of NFTs, would not be regulated by the FCCT. Therefore, the FCCT would not pose a threat to innovation in the digital asset space. In fact, the FCCT acknowledges the wide variation within the digital asset industry and responds proactively and flexibly to that variation.

Encouraging Gambling is Wrong

Legalized gambling has long been a fraught moral question for centuries. Gambling and its attendant negative effects are major social issues. As many as 1% of the American population can be diagnosed as having a gambling disorder,[71] and gambling has also been cited as a major source of a range of societal ills, including crime, suicide, divorce, and personal bankruptcy.[72]

Despite these ills, a majority of American adults (57 percent) describe gambling as neither a good nor bad thing for society.[73] This indicates an acceptance of gambling as a fact of modern life, while also acknowledging that it is far from an unalloyed good. This report would urge the taking of a similar attitude towards cryptocurrency trading. It should also be noted that an appetite for risk has long been part of American culture, witness the popularity of local poker circles, the numbers game

[70] See, for example, https://www.coindesk.com/business/2022/11/17/australian-securities-exchange-cancels-blockchain-based-clearing-system-at-168m-cost/

[71] https://www.yalemedicine.org/conditions/gambling-disorder

[72] See, https://storymaps.arcgis.com/stories/6ee1a03d004445ca97377b1f59e14554, https://pubmed.ncbi.nlm.nih.gov/30427214/, https://www.researchgate.net/publication/6171219_The_Effect_of_Pathological_Gambling_on_Families_Marriages_and_Children, and https://www.researchgate.net/publication/5209377_The_Impact_of_Casino_Gambling_on_Personal_Bankruptcy_Filing_Rates

[73] https://www.pewresearch.org/fact-tank/2022/09/14/as-more-states-legalize-the-practice-19-of-u-s-adults-say-they-have-bet-money-on-sports-in-the-past-year/

and the state lottery. Attempts to stop people from engaging in activities which are potentially harmful to themselves has also had a mixed record in American history, with efforts such as Prohibition and the War on Drugs being regarded as failures by many progressive thinkers. State and federal lawmakers are moving away from prohibition as a solution to many vices: buying and selling cryptocurrencies should be regarded as no different.

Steps can be taken to mitigate the negative effects of gambling and the same approach can be taken with respect to cryptocurrency trading. This report has already urged the implementation of regulations to limit purchases by people who can't afford it, and issuers, exchanges and the FCCT should monitor trades on the exchange to be alert to individuals demonstrating behavior which could indicate an addiction problem. This would not entirely remove the risks of cryptocurrency trading – which are, after all, a major source of the appeal – but would make important steps towards mitigating them.

Conclusion

The emergence and proliferation of cryptocurrency tokens poses a new challenge for financial regulators. Untethered from anything in the real economy, these tokens exist as pure speculative assets whose value fluctuates widely and almost entirely because of sentiment. It therefore offers something which cannot be subject to traditional risk management procedures by investors, nor can lawmakers easily apply existing forms of regulatory oversight to them.

This report has proposed that cryptocurrencies instead be recognised as a form of gambling and not a financial product. The current gambling industry provides plenty of models for how to regulate the cryptocurrency issue and this report has proposed that cryptocurrencies be regulated by a commission which incorporates 'best practice' proposals from a wide range of other regulatory agencies, including those which regulate the gambling industry.

Issuers of cryptocurrency tokens would be licensed, as would the exchanges they trade on, with both exchanges and issuers having to perform AML and KYC checks. Trading would be limited to individuals and regulated such that there would, in practice, be caps on the amount people could invest. These regulations would allow cryptocurrency trading to take place in an environment that both allows people to experience the thrill of perhaps making large financial gains without worrying about the dangers of the losses, and which will be fenced off as much as possible from the rest of the real economy.

Appendix

A major barrier to digital asset regulation is the wide range of business models and products that make up the industry. For the sake of conceptual clarity, the digital asset market should be thought of as containing cryptocurrencies, stablecoins, non-fungible tokens ("NFTs"), blockchains, decentralized finance ("DeFi"), wallets and exchanges. Many large digital asset companies provide all of these services, some provide only one or two.[74] All of these products, however, have very different functions and are better suited to being regulated outside of the FCCT.

Blockchains

Blockchains are the virtual ledgers which record digital asset transactions in order to ensure that double spending and theft do not occur. When a transaction occurs, the information (including the amount, transferee, transferor and time) are recorded on a 'block' and added onto the end of the 'chain.' For wholly public blockchains such as Bitcoin, it would be theoretically possible to view every transaction ever conducted in it.[75] It is therefore best to consider blockchains not as a single product but as a tool which can be deployed in a variety of areas.

This makes them hard to prescribe a single form of regulation for. To the extent that they are being used in innovative and socially useful businesses, continued experimentation in their use is to be applauded. Where there is criminality involved, for example potential fraud in allowing insiders to hoard valuable tokens at the expense of the general public,[76] that should be clamped down upon by the relevant criminal authorities.

Stablecoins

Stablecoins are digital currencies which use digital ledgers to store transaction and ownership information, and are notionally pegged to the value of a specified asset or basket of assets. The paradigmatic case of this is Tether, which is pegged 1-to-1 with the US dollar.[77]

As the value of stablecoins is not meant to fluctuate,[78] they are not generally used as speculative assets but rather have come to fill three niches. Firstly, as a stop off point for traders moving fiat

[74] A relatively common structure is for a blockchain to have a 'native' cryptocurrency. This is the case in, for example, the token Ether issued by Ethereum.

[75] It is important to note that the common belief that blockchain transactions are anonymous is therefore false: they are pseudonymous insofar as transferor and transferee are listed by their 'keys' rather than names.

[76] https://www.forbes.com/sites/sarahemerson/2022/09/23/helium-crypto-tokens-peoples-network/?sh=7c9d88fa7316

[77] This is the most common arrangement, although some stablecoins are pegged to other currencies or to assets, such as gold.

[78] At least not more than the value of the underlying commodity or currency.

currency into cryptocurrency and vice versa.[79] Secondly, they can be a straightforward way for non-Americans to move in and out of dollars. Thirdly, they serve as a useful place to 'park' spare cash much in the same way that money market mutual funds ("MMFs") were used in earlier decades. The stablecoin issuers make investments against their holdings and often pay some amount of interest to investors, like MMFs and traditional banks.[80] Also like MMFs, the implicit promise of stablecoins is that the investor can transition from them into and out of fiat currency at will[81] and suspicion that this is not the case is likely to exacerbate or even trigger runs on stablecoin providers.

However, stablecoin providers have proven to be notoriously secretive about the assets they hold. The largest stablecoin provider, Tether, agreed to pay a fine of $41 million to the CFTC in October 2021 over allegedly misleading statements to the effect that Tether had sufficient dollar reserves to back each of its stablecoins in circulation[82] and other providers are even more opaque.

The relevant form of regulation for stablecoins will be to require issuers to publish transparent accounts showing that they have holdings in cash or certain specified near-cash assets (such as US Treasuries) which are equal to the amount of stablecoins they have in issuance. This means that the implicit guarantee (of $1 for 1 token of stablecoin) will remain strong–indeed, stronger than the requirements for bank reserves–and should eliminate the risk of a run. Bills proposed by Cynthia Lummis and Kristen Gillibrand,[83] and Pat Toomey[84] are good (if imperfect[85]) steps in the right direction, providing solid evidence that industry-supported legislation can include measures such 100% reserve requirements.

NFTs

NFTs are a record on a blockchain which is associated with a particular digital or physical asset, often an image or other piece of media. The ownership of an NFT is recorded on a blockchain, and can be transferred by the owner. In most cases, ownership of an NFT does not grant the holder ownership of the underlying asset. In this sense, it is perhaps most simple to think of buying an NFT as akin to buying a print of a famous painting: it doesn't give you a proprietary claim against the relevant art gallery, but you own a perfectly pleasant image which may or may not be worth something on the open market.

[79] This use is unlikely to be relevant under the FCCT regime.

[80] https://www.cabital.com/blog/stablecoins-and-how-to-use-them-to-generate-passive-income

[81] Although because of trading platform fees and similar rents, the transition is often not exactly 1-to-1.

[82] https://www.ft.com/content/d7db307c-ef43-4af8-8f14-c1d1ba414058

[83] https://www.gillibrand.senate.gov/news/press/release/-lummis-gillibrand-introduce-landmark-legislation-to-create-regulatory-framework-for-digital-assets

[84] https://www.banking.senate.gov/newsroom/minority/toomey-announces-legislation-to-create-responsible-regulatory-framework-for-stablecoins

[85] The parts of these bills relating to other digital assets create concerning regulatory gaps.

The NFT market is best viewed as a fad brought on by a fascination with new technology, and one that appears to already be in the grips of a market correction.[86] The appropriate regulation for this sector is on the consumer protection side, and the CFPB should step in where necessary to prevent consumers being defrauded by unscrupulous sellers.

DeFi

DeFi is shorthand for a wide range of financial services which sidestep banks and other traditional financial intermediaries. At its most simplistic DeFi is also known as a 'smart contract' – a transaction protocol that automatically executes and documents the different stages of a transaction according to the terms of a contract. Such smart contracts are usually automated and made directly between parties. Common uses for them are to provide lending and borrowing facilities, or enter into derivatives contracts.[87]

Despite the portrayal of these DeFi applications by boosters as disintermediated, some intermediaries are still required. DeFi applications are governed by the holders of 'governance tokens', who can vote on proposals or changes to the platform.[88] The analogy between the holders of governance tokens and shareholders with voting rights should be clear. Furthermore, the automated nature of DeFi applications means that there is a strong risk of individuals losing money permanently if there is something wrong with the smart contract or it is otherwise executed improperly.

The relevant regulation for a given DeFi application will vary somewhat depending on the application's purpose and the digital assets it uses. To the extent that some of them facilitate trade in commodity derivatives, it is natural that they would fall under the regulatory purview of the CFTC. They would be able to provide consumer protection in the form of punishing outright fraud, addressing conflicts of interest, and requiring DeFi providers to appoint compliance officers to ensure that regulations are followed, among other things.

Other DeFi applications offer both liquidity pooling services and the ability to trade within those pools.[89] This would indicate that they should be regulated as both brokers and exchanges, and would require the DeFi application to register with the SEC. Some argue that most DeFi applications are too decentralized to allow for this kind of regulation.[90] This is clearly nonsense. If a DeFi application is centralized enough to issue tokens which grant holders decision-making powers, then it is plainly also centralized enough to register with the relevant regulators.

[86] https://www.wsj.com/articles/nft-sales-are-flatlining-11651552616 and https://fortune.com/2022/03/04/nft-bubble-market-crash-price-value/

[87] https://www.bloomberg.com/news/articles/2020-08-26/why-defi-utopia-would-be-finance-without-financiers-quicktake

[88] https://www.bis.org/publ/qtrpdf/r_qt2112b.pdf

[89] See, for example, https://uniswap.org/governance

[90] https://www.cato.org/sites/cato.org/files/2022-07/BP140.pdf

Wallets

A crypto wallet 'stores' an individual's cryptocurrency holdings by signifying a block on the blockchain. Each wallet consists of a 'public key' and a 'private key', both of which are unique strings of letters and numbers. The public key is used to identify a digital asset, while the private key is used to send the asset from one wallet to another. If the private key is forgotten by the owner or otherwise lost then the assets in the wallet cannot be transferred.[91]

The relevant analogy in the traditional financial system are securities brokers and/or clearing houses. Both are required to register with the SEC, which would help safeguard users' assets by allowing the SEC to impose regulations and punish bad actors.

[91] https://www.businessinsider.com/james-howells-threw-away-bitcoin-dump-masterplan-get-back-2022-7

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