

## **House Agriculture Committee**

### **Cryptocurrencies: Oversight of New Assets in the Digital Age**

#### **Testimony of Joshua Fairfield, Professor Washington and Lee University School of Law**

Mr. Chairman Conaway, Ranking Member Peterson, and members of the Committee. Thank you for the opportunity to address you today.

#### **Introduction**

My remarks are organized around two questions:

How are people actually using this new technology? And: How should a regulator best proceed in light of how the technology is being used? I will briefly summarize my conclusions before returning to the body of my testimony.

First, blockchain, the technology underlying the current rash of cryptocurrencies, is a relatively new database technology that permits communities to self-organize and build trustworthy decentralized databases. Many communities have formed just to see what the technology can do, and are attempting different experiments, often with each offering its own “coin.” (To be sure, scam artists have also flocked to the development scene.) The potential value in these experiments is considerable: collaborative communities of artists, new corporate forms, distributed autonomous organizations, fast and low-cost check settlement, digitization of securities, open and low-cost electronic mortgage and secured transactions systems, secure international remittances, voting systems, and many more are possible applications of the technology.

The Committee will hear about a range of these applications today. The specific area in which I would like to focus is the potential for blockchain technology to act as a catalyst for expansion of online and electronic personal property rights. This is my primary area of research. My conclusions, as below, are that citizens need and want an expansion of personal property rights online; that cryptocurrencies and cryptocurrency tokens can help solve important problems in building markets for digital property; and that caution may be advisable when regulating overlapping spaces and use cases, such as systems in which most people hold an asset to consume it, and a few hold it to speculate on the price.

On to the second question, how to best proceed? Agencies have already for several years found themselves faced with the potential for overlapping jurisdiction over blockchain-based businesses, products, and services, precisely because the technology can support so many different uses. Because blockchains are just databases, their use must determine the oversight response.

Uses of cryptocurrency tokens can be complex. Not all people who hold a cryptocurrency token do so for the same reasons. Some people hold cryptocurrency tokens to consume, some simply to possess, some to speculate, some to trade, and some change their minds from time to time. Thus, tokens have a fundamentally multi-use nature. There is also a time component. Until the owner takes action (consume or trade), the owner's reason for holding the token may not be knowable. The use and holding of the token as personal property should be generally unproblematic, at least by default. Only the trade and speculation components should trigger regulatory concern, and even then, only if the structure of the transaction looks like an attempt to circumvent some established regulatory mandate.

There are solid paths forward that can protect investors from fraud and permit entrepreneurs and communities to develop new business models. Common sense construction of how groups are using the technology—a “duck test”—will help begin to sort out whether a regulatory structure is needed at all, and if so, which law governs. Rough agency consensus and even active and agile cooperation between regulators can handle these conflicts, and are good for regulators to start working out: more applications of this technology are coming. There is indeed every reason to believe this is how regulation in this space will actually evolve. More concerning is the risk of chilling innovation through incautious overlapping or conflicting regulation. Carefully overlapping jurisdictional claims need not cause contradiction, but it may take time until the contours of how people use the technology become clear. And when those contours do become clear, good rules can draw workably clean lines between shifting uses of a product or service within a community that weaves across a legal boundary.

## **B. Cryptocurrencies and the Future of Property**

In the body of my remarks I would like to discuss how this technology represents a badly needed expansion of personal property rights online. We should care about good property rules for electronic assets. Good property rules contribute to human thriving, or as Nobel Laureate Amartya Sen expressed it, good property rules expand the range of human capabilities. Property matters because it lets people do things. Thus, good property rules are those that expand what people can do. There are three primary ways good property institutions positively impact society.<sup>1</sup> First, good property rules can preserve citizen independence. Property draws an important line between private and state power.<sup>2</sup> Second, property institutions build individual and social welfare by reducing transaction costs, permitting resources to flow to higher-valuing users.<sup>3</sup> And third, property permits humans to express themselves by changing and arranging their environment to reflect

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<sup>1</sup> See JEDEDIAH PURDY, *THE MEANING OF PROPERTY: FREEDOM, COMMUNITY, AND THE LEGAL IMAGINATION* 19 (Yale University Press 2010).

<sup>2</sup> JOSHUA A. T. FAIRFIELD, *OWNED: PROPERTY, PRIVACY, AND THE NEW DIGITAL SERFDOM* 18 (Cambridge University Press 2017) (“His first stream is “libertarianism,” or negative liberty: the idea that property means a kind of liberty from government interference.”) (citing JEDEDIAH PURDY, *supra*, at 19).

<sup>3</sup> *Id.* (“His second stream is efficiency, or what he calls “welfarism”: property is an institution that helps to ensure the free flow of goods for minimum transaction costs, such that it allows people to get what they want at the lowest price.”) (citing JEDEDIAH PURDY, *supra*, at 20).

themselves.<sup>4</sup> Here, examples might be the property interest in a home, wedding band, detailed automobile, and so on.

Despite these advantages, personal property rights have had serious trouble transitioning from offline to the online environment. We don't own much personal property online. Instead, we license everything.<sup>5</sup> If you question whether this is true, consider that people used to own record collections; now they license iTunes, or simply have a subscription to Spotify. People used to have bookshelves; now they have Kindle collections. This modern license framework is in place because, early in the history of the internet, intellectual property holders were worried about illegal copying. It took several decades to develop a technology, blockchain, which operated like a digital object. Slots in a blockchain — cryptographic tokens — can be traded, held, bought, and sold, but not duplicated. Cryptocurrency tokens cannot be double-spent, because they would be rejected by both the protocol and the other “players.”<sup>6</sup>

As a result, cryptocurrency tokens let us own an intangible electronic asset just like we own a hat. Blockchain technology appears poised to un-stick personal property law online by strongly reducing transaction costs for tracking transactions in digital property rights, and by creating rivalrous (that is, non-copyable) digital assets. Already, cryptocurrency tokens are appearing in court decisions on inheritance, wills and trusts, and other routine treatment of personal property under the common law. It may soon become as routine to own digital tokens as it is to own dollars in a bank account.

Property institutions will deeply benefit from this technology-driven drop in transaction costs. Carol Rose notes: “It costs something to define rights, to monitor trespasses, and to expel intruders.”<sup>7</sup> As property rights become more complex and harder to define, property systems cost even more. The difference in expense is why we currently have title registries for big items like houses, cars, boats, and airplanes, but not for smaller pieces of personal property. Cryptocurrency tokens can keep track of minute changes in ownership of property interests at strongly reduced costs. Rose predicted that “when there are changes in the technological or administrative costs of establishing, monitoring and trading property, there may well be changes in property regimes as well.”<sup>8</sup> Her advice: look for drops in those costs. There we will find the future of property. And this is precisely what cryptocurrency tokens represent.

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<sup>4</sup> *Id.* (“Purdy identifies a stream of human personhood, or identity. The identity view of property requires that we have some stability in our environment so that we can build a home, a family, an identity. Property allows us to surround ourselves with reminders of who we are or wish to be.”) (citing JEDEDIAH PURDY, *supra*, at 20); see also Margaret Jane Radin, Property and Personhood, 34 STAN. L. REV. 957, 957 (1982) (“The premise underlying the personhood perspective is that to achieve proper self-development – to be a person – an individual needs some control over resources in the external environment. The necessary assurances of control take the form of property rights.”).

<sup>5</sup> See Aaron Perzanowski & Jason Schultz, THE END OF OWNERSHIP: PERSONAL PROPERTY IN THE DIGITAL ECONOMY (MIT Press 2016).

<sup>6</sup> Joshua A. T. Fairfield, BitProperty, 88 S. CAL. L. REV. 805, 841 (2015).

<sup>7</sup> Carol M. Rose, The Several Futures of Property: Of Cyberspace and Folk Tales, Emission Trades and Ecosystems, 83 MINN. L. REV. 133 (1998).

<sup>8</sup> *Id.* at 139.

These cost drops can fuel further innovation. Just as communications technologies proliferated when the cost of communication went nearly to zero, so a range of property interests will flourish when the costs of transfer go nearly to zero. This is, after all, the model of the broader internet, which, for all of its “free” price points, is extraordinarily expensive to maintain.<sup>9</sup> Internet technologies scale most disruptively at near-zero transaction costs.<sup>10</sup> For each drop in transaction costs, a new range of widely scaled and potentially disruptive uses becomes possible.

So far, property institutions have not yet fully realized the benefits of the last three decades’ advances in information technology because of the cost needed to record transactions and vet trusted intermediaries to maintain and protect records.<sup>11</sup> Token systems can and will reshape property law if they push price points low enough to unleash disruptive and scalable applications.

### **C. A Path to Successful Oversight**

In this section, I turn to the second question, and discuss features of a successful oversight strategy. I derive these principles from experience with several prior analogous regulatory moments: the IRS determination as to when to tax financial gains on virtual objects; the IRS determination as to whether cryptocurrency ought to be taxed as currency or commodity; and the deliberations by FinCEN, CSBC, and other stakeholders in the state and federal banking systems over whether cryptocurrency exchanges ought to be deemed money transmitters under the Bank Secrecy Act.

Responsible regulation must rest on a frank and common-sense determination of how people are using the technology. A primary benefit of close attention to how the technology is actually being used will be to reduce the number of overlapping oversight claims. Almost every regulator will soon be able to claim jurisdiction over some application of blockchain technology, but of course they will not have jurisdiction over all uses.

Working out jurisdiction over actions or business models that cross several different regulatory boundaries will be time-consuming, but no harder for blockchains than they were for network communications technology generally. SEC, CFTC, FinCEN, IRS, and state banking regulators have spent several years sorting out their various roles in regulating the various uses of cryptocurrency, and there has been measurable progress in determining which regimes and what terms govern.

Tokens do present some interesting problems. First, tokens may be used in different ways by different members of a community. Second, even a single owner may buy, hold, consume, sell, trade, or destroy tokens for different reasons at different times. A community may shift to use products or services in illicit ways that the product creator or

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<sup>9</sup> See Joshua A. T. Fairfield, *BitProperty*, *supra*, at 815.

<sup>10</sup> See Kevin Werbach, *The Centripetal Network: How the Internet Holds Itself together, and the Forces Tearing It Apart*, 42 U.C. Davis L. Rev. 343, 347–48 (2008) (“The internet fosters innovation by eliminating transaction costs, enabling new services to emerge.”).

<sup>11</sup> See Joshua A. T. Fairfield, *BitProperty*, *supra*, at 813.

service provider did not predict. Illicit uses may make use of a licit support layer. This is precisely what happened when the SEC warned in July of 2017 that The DAO, an Ethereum-based investment and governance platform had likely violated securities regulations.<sup>12</sup> Contrast this with SEC Division of Corporation Finance Director William Hinman's recent announcement that transactions in Ether are unlikely to be deemed securities transactions.<sup>13</sup> Agencies are already beginning to sketch out the important distinctions that will help preserve beneficial applications of the technology (investors in Ether were justifiably relieved by the announcement) while permitting oversight of bad practices at the application layer (such as another DAO).

The currently hot characterization debate is whether token sales ought to be deemed regulable under the *Howey* test.<sup>14</sup> I find that discussion unhelpful. *Howey* marks in a sense one of the deepest reaches of the SEC into regular ownership behavior. The case is a placeholder, there to preserve SEC's right to make further and more in-depth determinations. As such, it is not a particularly good guide to how things should end up. Instead of the rule of *Howey*, a better approach is to look at how the technology is actually being used. If a community uses cryptocurrency tokens functionally like securities, then they ought to be regulated as such. But if not, they shouldn't. There should be a well-regulated market for blockchain-traded securities. Companies are working now to legally list and trade securities through blockchain databases, and Delaware has been working to make that possible. There is a legal path for companies wishing to list and trade securities on a blockchain, and some companies are moving to do so. This is the duck test as applied to securities: "if it quacks like a security," and everyone knows the rest.

The harder question is how to characterize token sales when the issuer and majority of purchasers can credibly show that their purpose in buying, holding, selling, and consuming cryptocurrency tokens is not to profit from the efforts of others, but in fact to order rights and relationships in some new way. For example, most community members might use a given token system for clearly non-securities related purposes, but some tokens may be bought, held, and traded by speculators. Further, different actors within the community may take on different positions at different times, and the community as a whole may shift its use of the token. In these cases, the trick is to catch the fraudulent ducks without killing a goose who may lay the golden egg—new and powerful communities and business models. Only a deeper dive into how the asset is promoted, used, and traded can begin to provide an answer.

Entities charged with oversight should be cautious not to squash new arrangements of rights merely because there is an arguable conceptual overlap with the broad language of cases such as *Howey*. However, they must not fail to recognize systems that walk, quack, and waddle like ducks merely because of some shiny new cryptocurrency feathers. Many

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<sup>12</sup> See generally SEC, 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (2017).

<sup>13</sup> See Trevor M. Dodge, SEC Director William Hinman: "Current offers and sales of Ether are not securities transactions," THE NATIONAL LAW REVIEW, June 18, 2018, at 1.

<sup>14</sup> SEC v. *Howey* Co., 328 U.S. 293 (1946).

token sales transparently attempt to bilk the public by selling and supporting junk tokens.<sup>15</sup> Some token sales are a transparent attempt to raise money for business ventures that wish to circumvent securities regulation. But just as clearly, many companies and communities are building communities that have nothing to do with securities, although some users may speculate with the tokens. Part of this is unavoidable. Entities tasked with oversight are reasonably reluctant to overcommit to the legality of some cryptocurrency business models, because they are concerned with lending a false sense of credibility to business practices that may turn out in the end to be fraud. But reasonable common-sense guidance is necessary so that innovators can move plans for businesses from the kitchen table to the garage.

During this shakedown period in token technology, regulators will best be able to decide jurisdictional questions, and citizens will best be able to predict how the law will respond to their attempt to create new business models and new communities, by reasoning from past business practices. This new technology permits us to do new things technologically, not legally. This is not a permanent state of affairs, however. The demand for cryptocurrency tokens also demonstrates that there is serious untapped demand for new and cheaper ways to manage and trade certain kinds of rights, and that people want to be able to directly invest by making cryptocurrency purchase decisions—whether this is wise or not. In the end, regulators may determine that certain kinds of transactions simply cost us all too much in terms of defrauded investors, broken promises, emptied bank accounts, and subsequent claims that regulators should have better insulated consumers from harm. But they should not do so lightly, and should take every precaution to avoid stepping on legitimate novel forms of organizing human productivity while they make a determination of how people are using this technology, and what to do about it.

## **Conclusion**

Blockchain technology has enabled new communities and new business forms. It has also provided the technological basis for a badly needed expansion of personal property rights online. An agency exercising oversight must therefore be sure that the use it observes fits in its regulatory wheelhouse—many new uses will not. In determining what law applies to blockchain technology, the legal regulatory regime must rest on an informed and common-sense determination of how the technology is being used. That simple test has some advanced wrinkles, because cryptocurrency tokens are built for overlapping, shifting, and multiple uses. As a result, regulatory agencies have done best with cryptocurrency technologies when they use a common-sense functional analysis, followed by engagement with the industry or community.

In considering regulatory jurisdiction, common-sense sorting into rough buckets will do more good in the near term, as applications begin to come online, and regulators see which applications are likely to impact society the most. In the current characterization debate, a token should be deemed a security when it operates like a security, a

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<sup>15</sup> See, e.g., Nathaniel Popper, In the World of Cryptocurrency, Even Good Projects Can Go Bad, NEW YORK TIMES (May 30, 2018), available at <https://www.nytimes.com/2018/05/31/technology/envion-initial-coin-offering.html> (last visited on July 13, 2018).

commodity when it operates as a commodity, a currency when it operates as a currency, and a simple property interest when it operates as a simple property interest.