TEMPLUM
MARKETS

October 11, 2018

The Honorable Mike Crapo
Chairman
U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

Re: Written Testimony before the Committee on Banking, Housing, and Urban Affairs for the hearing on Exploring the Cryptocurrency and Blockchain Ecosystem

Dear Hon. Mike Crapo and Hon. Sherrod Brown,

Templum Markets, LLC, submits the attached written testimony to the Committee on Banking, Housing, and Urban Affairs of the United States Senate for the Committee's October 11 hearing entitled "Cryptocurrency and Blockchain Ecosystem." Templum is very familiar with the regulatory challenges faced by FinTech firms that are issuing and trading digital assets and using blockchain technology. We thank the Chair, the Ranking Member and other members of the Committee for their efforts in addressing these regulatory challenges and for the opportunity to submit this written testimony.

Please do not hesitate to call me at 646-973-3360 or our counsel, Richard B. Levin of Polsinelli PC at 303-583-8261 if you have any questions regarding the testimony or any other matter.

Very truly yours,

Vincent R. Molinari
Chief Executive Officer
Templum Markets, LLC

STATEMENT OF VINCENT MOLINARI

> *There is no area of the securities business which offers more opportunity for reducing costs … than the improvement and modernization of the systems for clearing, settlement, delivery, and transfer of securities.*[1]

Chairman Crapo, Ranking Member Brown, and the distinguished members of the Committee, thank you for the opportunity to submit testimony for the record. I offer my testimony as a representative of Templum Markets, LLC ("Templum Markets"), a financial technology ("FinTech") company and broker-dealer registered with the U.S. Securities Exchange Commission ("SEC") and the Financial Industry Regulatory Authority ("FINRA"). Templum Markets is the operator of an alternative trading system ("ATS") for the secondary trading of digital assets that are securities.[2] Given our experience in the industry, we commend the Chair and the Ranking Member for holding this hearing on this important issue and the role of Congress in helping to ensure that FinTech and the growing field of digital assets are regulated in a manner that both protects consumers and fosters its great potential. We believe that we represent a view that is practically minded with regards to the application of blockchain technology in the financial services industry.

We believe FinTech and blockchain have tremendous potential. However, as this technology develops, regulators must foster innovation without stifling it through unclear regulations. U.S. and foreign regulators have noted the disruptive potential of FinTech and blockchain. They have also recognized the potential of FinTech to revolutionize the financial services industry.[3] We share this belief in the potentially transformative nature of FinTech and support the important role of regulators in ensuring that this revolutionary technology develops in a sustainable manner that promotes fair and orderly markets, protects consumers, and benefits industry participants.

The SEC has been active over the past year, making its position on the regulation of digital assets as securities increasingly clear through speeches, investor alerts, and innovative guidance such as the simulated Howey Coin offering.[4] We believe that the concept of "cyrptocurrency" is limiting and that the industry is in fact made up of digital assets that are securities and digital assets that are not securities, some of which may function as commodities or commodity swaps. The SEC has also provided guidance to the industry through formal enforcement actions and policy statements.[5] We firmly agree with SEC Chairman Jay Clayton that most, if not all, digital assets that have been offered to the public to raise capital through initial coin offerings ("ICOs") and other means are securities, and should have been

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[1] Securities Exchange Act Release No. 13163 (Jan. 13, 1977), 42 Fed. Reg. 3916 (January 21, 1977).

[2] The terminology used by the FinTech industry and regulators to refer to these types of assets has varied between agencies, including property with the Internal Revenue Service, cryptocurrency with the Commodity Futures Trading Commission, and digital assets or property with the SEC. For the purposes of this testimony, we will refer to such assets as digital assets.

[3] *See* Written Testimony of Chairman Jay Clayton before the Senate Banking Committee, Washington, D.C. (February 6, 2018), *available at:* https://www.banking.senate.gov/public/_cache/files/a5e72ac6-4f8a-473f-9c9c-e2894573d57d/BF62433A09A9B95A269A29E1FF13D2BA.clayton-testimony-2-6-18.pdf.

[4] ICO – HoweyCoins, U.S. Securities and Exchange Commission, available at: https://www.investor.gov/howeycoins.

[5] *See* Munchee Inc., Securities Act Release No. 10445 (Dec. 11, 2017) *available at:* https://www.sec.gov/litigation/admin/2017/33-10445.pdf; *SEC v. REcoin Group Foundation, LLC, DRC World Inc. a/k/a Diamond Reserve Club, and Maksim Zaslavskiy,* 17 Civ. [ ] (Sept. 29, 2017) (Complaint); Public Statement, SEC Chairman Jay Clayton Statement on Cryptocurrencies and Initial Coin Offerings, SEC (Dec. 11, 2017), *available at:* https://www.sec.gov/news/public-statement/statementclayton-2017-12-11.

offered pursuant to a registration with the SEC or an exemption from registration. We also appreciate that other digital assets that are not used to raise capital may be commodities or commodities swaps, subject to regulation by the Commodity Futures Trading Commission ("CFTC"). While we believe the existing laws can be applied to the regulation of blockchain technology and digital assets, we believe there is a need to modernize the securities laws, many of which were enacted by Congress in the 1930s and 1940s, to keep pace with these new technologies and to not stifle innovation. We commend the work of the SEC and CFTC to support the industry to date, including in particular the CFTC's establishment of LabCFTC, but we believe that there is more work to be done.

As Congress and the SEC consider how to regulate FinTech, we believe digital assets used to raise capital should be regulated as securities. The focus of this testimony will be with regards to the SEC's regulation of digital assets that are securities, as this is where the expertise of our firm lies. We believe such an approach will promote the development of these innovative financial products and their trading in an efficient manner, as well as market integrity. The regulation of digital assets as securities raises a number of issues including, the clearance, settlement and custody of digital assets, and the future role of transfer agents.

A. The Securities Laws Need to be Amended to Address the Regulation of Digital Assets.

The SEC's duties are to: protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.[6] The trading of digital assets has spread beyond the developers of the digital assets to large financial institutions that see the value of blockchain technology. Developing a tailored regulatory framework for digital assets would not only help to protect investors, but would help to promote market integrity, capital formation, and the protection of the investing public.

There are several specific parts of the securities laws that need to be amended to address the development of blockchain technology and digital assets and to protect investors, maintain fair and orderly markets, and to facilitate capital formation. From 1934 through 1975, trading, clearance and settlement of securities in the United States was governed by the Securities Act of 1933 (the "Securities Act"), and the Securities Exchange Act of 1934 (the "Exchange Act"). The clearance and settlement of trades was governed by state laws. It was not until the late 1960s that the SEC began focusing on how securities transactions were cleared and settled. The SEC has provided important informal guidance regarding the trading of digital assets, and in particular when a digital asset may be deemed to be a security, but the agency has not provided clear guidance on how to treat these assets post-trade. We have been an active voice in encouraging more formal regulation of FinTech, as evidenced by our March 13, 2017 petition for rulemaking to the SEC requesting regulation of digital assets of securities.[7] In addition to formal rulemaking regarding digital assets as securities, we believe that the SEC must address how digital assets are regulated once a trade occurs.

B. The Paperwork Crisis

In the late 1960s and early 1970s, securities markets in the United States experienced a back-office crisis (the "Paperwork Crisis") caused by increasing volumes and back-office inefficiencies in

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[6] Michael S. Piwowar, Acting Chairman, SEC, Remarks at the "SEC Speaks" Conference 2017: Remembenng the Forgotten Investor (Feb. 24, 2017), available at: https://www.sec.gov/news/speech/piwowar-remembering-theforgotten-investor.html.

[7] See Petition for Rulemaking (Mar. 13, 2017), available at: https://www.sec.gov/rules/petitions/2017/petn4-710.pdf. At the time this petition was published, Templum Markets operated as Ouisa Capital, LLC.

processing securities transactions.[8] During the Paperwork Crisis, a brokerage firm used approximately 33 different documents to execute and record a single securities transaction.[9] These paper-based transactions slowed processing to the point where exchanges shortened the trading day to alleviate back-office delays. Clerical personnel at firms were working day and night to process transactions.[10] As the mounds of paper grew, so did the number of errors in handling and recording transactions.[11]

The confusion and delays in the back offices of brokers and dealers were magnified by inadequate clearance and settlement facilities, particularly in the over-the-counter market.[12] Systems designed for the three million share days of 1960 proved incapable of dealing with astonishing volume of thirteen million share days around the end of the decade. Operational deficiencies caused fail rates and customer complaints to soar. Losses in 1967–1968 caused an unprecedented number of broker-dealer firm failures.[13] Approximately 160 New York Stock Exchange ("NYSE") member firms went out of business while others either merged or liquidated.[14]

By the early 1970s, Congress examined the back-office crisis and asked the SEC to: (1) compile a list of unsafe and unsound practices employed by brokers and dealers in conducting their business, (2) report to Congress on steps being taken to eliminate these practices, and (3) recommend additional legislation that might be needed to eliminate these unsafe and unsound practices.

After extensive studies and hearings, Congress agreed that a fundamental weakness in the U.S. clearance and settlement system was the absence of a mechanism to give direction to, and ensure cooperation and coordination among, the entities engaged in securities processing – clearing corporations, securities depositories, transfer agents, and issuers.[15] Industry practice combined with a lack of uniformity had failed to effectively support transaction processing in the U.S., and legislation soon followed.[16]

C. Securities Act Amendments

In 1975, Congress enacted amendments to the Exchange Act finding that: (i) *the prompt and accurate clearance and settlement of securities transactions is necessary for the protection of investors*; (ii) inefficiency imposes unnecessary costs on investors and intermediaries; (iii) new data processing and communication techniques present opportunities for more efficient, effective, and safe clearing procedures; and (iv) linking of clearance and settlement facilities, and the development of uniform standards and procedures, would reduce unnecessary costs and increase investor and intermediary protection.[17]

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[8] Bergmann, L., 2004. Speech: International Securities Settlement Conference – "The U.S. view of the role of regulation in market efficiency" ("Bergmann"). Available at https://www.sec.gov/news/speech/spch021004leb.htm.

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] *Supra* at note 6.

[16] *Supra* at note 13.

[17] 15 U.S.C. § 78q-1(a)(1)(A)-(D).

The Securities Acts Amendments of 1975 (the "Securities Acts Amendments"), made sweeping changes to the federal securities laws, established the national market system and the national clearance and settlement system as they exist today.[18] Congress directed the SEC to, among other things: (i) facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities and (ii) end the physical movement of securities certificates in connection with the settlement among brokers and dealers of transactions in securities.

Two basic themes recur throughout the legislative history of the securities processing provisions of the Securities Acts Amendments: (i) prevent another paperwork crisis in the securities industry and (ii) establish a safe, efficient, and modern national clearing and settlement system. Section 17A of the Exchange Act gave the SEC the authority to facilitate: (i) the establishment of a national system for prompt and accurate clearance and settlement in securities and (ii) linked or coordinated facilities for clearance and settlement of related financial products. Congress directed the SEC in 1975 to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions when it added Section 17A to the Exchange Act as part of the Securities Acts Amendments. At the time of the adoption of the Securities Acts Amendments, the Senate Committee on Banking, Housing and Urban Affairs stated the "banking and security industries must move quickly toward the establishment of a fully integrated national system for the prompt and accurate processing and settlement of securities transactions".

A key component of the SEC's supervision of the securities clearance and settlement system is its authority to regulate clearing agencies. Before performing clearing agency functions, including trade comparison, netting, matching, and settlement activities, intermediaries must either register with the SEC or apply for an exemption from registration. The SEC's ability to achieve these goals and its supervision of securities clearance and settlement systems is based on the regulation of registered clearing agencies.

While blockchain technology was not available in 1975, many technologists believe the technology could help the financial services industry accomplish many of the goals of the Securities Acts Amendments. The question for Congress and the industry will be how such technologies should be regulated by the SEC.

D. Clearing Agencies

Clearing agencies are self-regulatory organizations that are required to register with the SEC. There are two types of clearing agencies: clearing corporations and depositories. Clearing corporations compare member transactions (or report to members the results of exchange comparison operations), clear those trades and prepare instructions for automated settlement of those trades, and often act as intermediaries in making those settlements. Clearing corporations provide several essential services to the market, including comparing and confirming trade data submitted by participants (or reporting to participants the results of trade comparisons submitted by the exchanges), acting as the common counterparty and guaranteeing the completion of the trade if either side defaults or goes out of business, and preparing instructions for their participants regarding their settlement obligations. Clearing corporations generally instruct depositories to make securities deliveries that result from settlement of securities transactions.

[18] 15 U.S.C. §78q-1(a)(2).

A blockchain technology platform could be required to register as a clearing corporation if it compares the trades of users of the platform, clears the trades, and prepares instructions for automated settlement of the trades. The platform could also be required to register as a clearing corporation if the platform acts as the common counterparty and guarantees the completion of trades. We encourage the SEC to clearly define when a blockchain technology platform must register as a clearing corporation and to define how blockchain technology may be used by such firms.

E. Transfer Agents

Blockchain and digital assets represent a fundamental change in the financial services industry and hold the potential to make traditional aspects of the industry obsolete. One area of the securities laws that can be improved through the introduction of blockchain is the role of transfer agents. Traditionally transfer agents perform functions such as: countersigning securities upon issuance, monitoring the issuance of securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a registrar, registering the transfer of securities, exchanging or converting securities, or transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates.[19] Transfer agents record changes of ownership, maintain the issuer's security holder records, cancel and issue certificates, and distribute dividends. Because transfer agents stand between issuing companies and security holders, efficient transfer agent operations are critical to the successful completion of secondary trades. Section 17A(c) of the Exchange Act requires that transfer agents be registered with the SEC, or if the transfer agent is a bank, with a bank regulatory agency.

A blockchain technology platform could be required to register as a transfer agent if it monitors the issuance of securities or registers the transfers of securities. While it is unlikely a blockchain technology platform would countersign securities, platforms operating their own blockchain to track the issuance and trading of digital assets could be deemed to be monitoring the issuance of securities with a view of preventing unauthorized issuance (i.e., a registrar, registering the transferring of such securities). Other blockchain platforms could be deemed to be registering the transfer of securities, exchanging or converting securities, or transferring record ownership of securities by a bookkeeping or ledger entry without physical issuance of securities certifications.

The SEC released a concept release regarding transfer agents in 2015, noting the potential value of blockchain technology in streamlining the industry.[20] We encourage Congress to instruct the SEC to provide clear guidance to the industry as to when a blockchain technology platform must register as a transfer agent and to provide guidance to issuers of digital assets as to when they must use a transfer agent.

F. Clearinghouses

Like transfer agents, clearinghouses perform a valuable function in the financial services industry that is being impacted by the advent of blockchain technology. Generally, clearinghouses such as the Depository Trust and Clearing Corporation ("DTCC") are relied upon in the trading of registered securities to stand between clearing firms in ensuring that a transaction is properly settled. The securities that may be made eligible for DTCC's book-entry delivery, settlement and depository services are those that have been issued in a transaction that: has been registered with the SEC pursuant to the

[19] Securities Exchange Act of 1934 Section 3(a)(25).

[20] Securities Exchange Act Release No. 76743 (Dec. 22, 2015), 80 Fed. Reg. 81948 (Dec. 31, 2015). Available at www.sec.gov/rules/concept/2015/34-76743.pdf.

Securities Act; was exempt from registration pursuant to a Securities Act exemption that does not involve (or, at the time of the request for eligibility, no longer involves) transfer or ownership restrictions; or permits resale of the securities pursuant to Rule 144A or Regulation S, and, in all cases, such securities otherwise meet DTCC's eligibility criteria.

A wide range of security types may be made eligible for DTCC's services in accordance with the DTCC Rules. These include, but are not limited to, equities, warrants, rights, corporate debt and notes, municipal bonds, government securities, asset-backed securities, collateralized mortgage obligations, equity and debt derivatives, variable-rate demand obligations, money market instruments (e.g., commercial paper, bankers' acceptances, institutional certificates of deposit, short-term bank notes, discount notes and certain medium-term notes), American/global depositary receipts, shares of closed end funds, retail certificates of deposits, unit investment trust certificates, shares of exchange traded funds and insured custodial receipts.

Currently, digital assets that are not registered with the SEC are ineligible for book entry delivery through the DTCC. Blockchain technology, however, allows parties to transact directly with each other through a network by leveraging its distributed nature, largely eliminating the need for traditional clearinghouses. We believe Congress should encourage the SEC to evaluate the use of blockchain technology for securities that are not DTCC eligible. Leveraging blockchain will allow parties to streamline transactions and reduce friction, while promoting market efficiency. Clearinghouses are able to process transactions in registered securities that are listed on an exchange; they are not currently able to process transactions in digital assets that are securities that are not DTCC eligible. We encourage the SEC and the DTCC to explore how digital assets that are securities could be DTCC eligible securities.

G. Custody

Section 15(c)(3) of the Exchange Act and Rule 15c3-3 (the "Customer Protection Rule"), are designed to protect customer funds with two main requirements: possession or control of securities, and reserve formula. The requirements have the objectives of establishing guidelines to calculate customer assets to be segregated, methods to segregate and practices to prevent broker-dealers from using segregated customer assets to finance their proprietary activities, satisfying deliveries and covering customer short transactions. Specifically, the rule requires that customer funds involved in an applicable securities transaction be held at a bank as defined in the Exchange Act. The Rule also requires a broker-dealer to maintain physical possession or control over customers' fully paid and excess margin securities. Physical possession or control generally means that the broker-dealer must hold securities in one of several locations specified in the rule and that they be held free of liens or any other interest that could be exercised by a third-party to secure an obligation of the broker-dealer.

The SEC has also addressed the issue of custody in the context of registered investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act"). Under the Advisers Act, the SEC has stated that ***no qualified custodian is required for uncertificated or certificated private shares***. While the SEC has provided guidance to registered investment advisers, it has not provided guidance to broker-dealers. The Customer Protection Rule serves a laudable goals, under both the Exchange Act and Advisers Act. However, the application of the rule is unclear in a world of digital assets that are securities and blockchain technology. It is unclear if digital assets that are unregistered securities must be held in compliance with the Customer Protection Rule and any applicable custody rule.

We believe blockchain technology has the potential to reshape how banks act as custodians, particularly with respect to digital assets that are securities. Blockchain has the ability to hold digital

assets that are securities and record their transfer. We encourage Congress to instruct the SEC to examine the custody rule and the Customer Protection Rule in light of blockchain technology. By allowing issuers or trading platforms to use blockchain technology in lieu of banks as custodians, the SEC could significantly streamline securities trading and reduce transaction costs, producing savings for investors. Such efficiencies created by blockchain have great potential when used on a large scale. To facilitate this, the SEC needs to modernize its traditional rules and regulations to embrace blockchain technology.

H. Recommendations

To support the goals described above, we recommend that Congress support the following initiatives and rulemaking: (1) The SEC and CFTC should publish concept releases regarding the regulation of digital assets. The concept release should be published in compliance with the provisions of the Administrative Procedure Act, in particular providing the public with a period of notice and comment. (2) We encourage Congress to instruct the SEC to provide clear guidance to the industry as to when a blockchain technology platform must register as a transfer agent and to provide guidance to issuers of digital assets as to when they must use a transfer agent. (3) The SEC should consider changes to existing regulations with regard to the clearance and settlement of transactions in order to promote market efficiency, especially in post-trade contexts.

I. Conclusion

Innovation and entrepreneurship is at the heart American economy, and blockchain technology is driving innovation in the financial services industry. We firmly believe that blockchain has the potential to revolutionize financial services. To do so, however, Congress needs to amend the securities laws to give the SEC the tools it needs to regulate blockchain technology and digital assets and how the agency regulates transfer agents, clearinghouses, and custody. Such regulation would provide needed legitimacy to the industry, support market development, and protect investors.