July 15, 2019

Sen. Mike Crapo, Chairman
Sen. Sherrod Brown, Ranking Member
United States Senate
Committee on Banking, Housing, and Urban Affairs
Washington, D.C. 20510

Re: "Examining Facebook's Proposed Digital Currency and Data Privacy Considerations"—
July 16, 2019 Hearing

Dear Chairman Crapo and Ranking Member Brown:

I appreciate the opportunity to submit the following statement for your consideration, and would like to thank you and the members of the Senate Committee on Banking, Housing, and Urban Affairs. My background spans both the traditional financial system and digital assets, as I spent 22 years on Wall Street (most recently as managing director and head of Morgan Stanley's pension solutions business in New York until 2016) and have been involved with digital assets for nearly 7 years. Presently, I serve on the Wyoming Blockchain Task Force as a gubernatorial appointee and am co-founder of the Wyoming Blockchain Coalition, which is continuing to build a welcoming framework for the digital asset industry's regulatory compliance. I am purely a volunteer in both roles. This testimony is my own and should not be construed to represent the views of either organization.

The Libra project is shining light on outdated U.S. financial regulations that are (a) holding back the U.S. economy and (b) giving rise to the concept of digital currency "stablecoins" in the first place.

Digital currencies are the first major innovation in payment systems in nearly five decades. It is imperative that the U.S. tread carefully on this matter, since the genie is out of the bottle—digital currencies cannot be uninvented, and they offer significantly more efficient payment systems relative to those of the status quo. If we fight this technological trend, the innovation will simply move offshore rather than die.

Digital currencies, such as that of Libra, can fit within a regulatory compliant framework in the U.S. today. The State of Wyoming has created a comprehensive, regulatory compliant framework for digital assets by enacting 13 trailblazing laws,[1] one of which may be particularly relevant for the Facebook discussion because it creates a special-purpose bank charter. This new type of bank is authorized to custody digital assets and is required to

[1] A summary is contained here: Caitlin Long, *What Do Wyoming's 13 New Blockchain Laws Mean?*, Forbes.com, Mar. 4, 2019, https://www.forbes.com/sites/caitlinlong/2019/03/04/what-do-wyomings-new-blockchain-laws-mean/.

comply with all federal anti-money laundering and related laws, as discussed further below. Wyoming's suite of laws clearly demonstrate to Congress that it is possible to create a common-sense regulatory framework that can keep blockchain innovation in the U.S., while also strengthening both legal certainty and consumer protection in this space.

However, the Libra project also poses two major policy issues for Congress to consider: privacy and Federal Reserve interest payments. Congress should be concerned about potential abuse of consumer financial privacy by both businesses and governments. Additionally, the project raises the question whether the Federal Reserve's interest on excess reserves (IOER)[2] program should be available to Facebook's project, whether directly or indirectly, especially since the Bank of England recently announced it will open its interest-bearing deposit program to technology companies (including the Libra project).[3]

Below I expand on these four main points: (1) how outdated financial regulations caused the creation of stablecoins, which brought us to this juncture; (2) that digital currencies are the first major innovation in the payment system in decades; (3) that a model for how to fix U.S. federal regulations exists, and it can be found in Wyoming's new blockchain laws; and (4) that Congress should be concerned about two particular issues pertaining to Facebook's project: privacy and Federal Reserve interest payments.

1. **Facebook's Libra project is shining light on outdated U.S. financial regulations that are holding back the U.S. economy, and which gave rise to "stablecoins" in the first place.**

Banks have largely shunned the digital currency industry, making it difficult (if not impossible) for investors to trade U.S. dollars and digital currencies back and forth. If they could, investors would use the traditional banking system to do this, just as they do when trading stocks or commodities back and forth with dollars, but the traditional banking system has almost entirely blocked them. So, out of necessity the digital currency industry responded by inventing a "stablecoin"—a digital currency backed by dollars held in trust, whose trades settle on payment rails that are far more efficient than those of the traditional banking system, but which is also inextricably linked to the traditional banking system.

So, if Congress wants to make stablecoins irrelevant (including Libra), it can easily do so—simply by allowing the banking system to consistently bank this new asset class.

Stablecoins are one of many unintended consequences of Congressional policies that turned access to the financial system into a policy tool to solve certain problems—but, as an

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[2] *Interest on Required Reserve Balances and Excess Balances*, Federal Reserve Bd. of Governors, https://www.federalreserve.gov/monetarypolicy/reqresbalances.htm (last visited Jul. 14, 2019).
[3] Chris Giles, *Bank of England Intends to Open Its Vaults to Tech Companies*, Financial Times, Jun. 21, 2019, https://www.ft.com/content/148c3724-9376-11e9-b7ea-60e35ef678d2.

unintended side effect also created major barriers to lawful commerce. When you create barriers to commerce, you get less commerce. These barriers are one of the reasons why economic growth is sluggish in the United States. *Why are we happy with 3% growth when we regularly hit 5% growth not so long ago?*[4]

To address the conditions that gave rise to stablecoins in the first place, Congress should:

(a) **Remove reputation risk as a factor in banks' CAMELS score.** Bank examiners in Washington, D.C. should not have the power to punish banks for serving customers that the examiners deem to be "high reputation risk"—a subjective standard that is too easily abused. Including reputation risk in bank examinations has led to the unintended consequence of "de-risking"—a term referring to banks withdrawing access to the U.S. banking system for "high risk" customers, which has caused entire countries and lawful industries to lose access. In addition, the policy of requiring reputation risk assessments gave rise to Operation Choke Point[5] from 2013-17, where certain government officials abused these regulations to force banks to withdraw banking access for dozens of politically disfavored (but lawful) industries, including the digital currency industry. Many members of this Committee have attempted to reverse Operation Choke Point, but its effects linger on. Frankly, as long as reputation risk is part of bank examinations (specifically, the CAMELS score), it's simply not worthwhile for banks to serve industries that a bank examiner might subjectively deem "high reputation risk." This policy has reduced lawful commerce in the U.S. and Congress should fix it.

(b) **Stop weaponizing the U.S. financial system.** The U.S. dollar is the world's reserve currency. This means financial services are cheaper to Americans, and this is sometimes referred to as an "exorbitant privilege."[6] Yet, history has shown that no reserve currency status has ever lasted forever. A reserve currency must be ***usable*** to keep its status, and policies that restrict access make it less ***usable*** for lawful commerce. When U.S. policymakers threaten to withdraw access to the U.S. banking system, such as the U.S. Treasury Department did on May 7, 2019 when it threatened Europe for creating INSTEX[7] as a payment system alternative to SWIFT, the usefulness of the U.S. dollar as a reserve currency diminishes. Such restrictions and threats increase the incentive for users to seek alternatives as insurance against the

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[4] *Gross Domestic Product*, Bureau of Econ. Analysis, Dep't of Commerce, https://www.bea.gov/data/gdp/gross-domestic-product (last visited Jul. 14, 2019).

[5] Dennis Shaul, *There's No Downplaying the Impact of Operation Choke Point,* American Banker, Nov. 28, 2018, https://www.americanbanker.com/opinion/theres-no-downplaying-the-impact-of-operation-choke-point.

[6] Wolfgang Munchau, *America's 'Exorbitant Privilege' Is Europe's Sin of Omission,* Financial Times, May 26, 2019, https://www.ft.com/content/4a12d712-7e37-11e9-81d2-f785092ab560.

[7] Jonathan Stearns & Helene Fouquet, *US Threatens Europe That Its Iran Workaround Could Face Sanctions,* Bloomberg, May 29, 2019, https://www.bloomberg.com/news/articles/2019-05-29/u-s-warns-europe-that-its-iran-workaround-could-face-sanctions.

catastrophic scenario being blocked from the U.S. banking system—and, like it or not, digital currencies are a viable alternative. Again, the genie is out of the bottle—digital currencies will not be uninvented. The U.S. dollar would be better served by allowing our banking system to embrace digital currencies rather than shunning them, which is merely driving the innovators offshore.

(c) **Roll back, not ratchet up, compliance requirements.** The last GAO study of criminal conviction rates involving the Bank Secrecy Act found that banks filed 16 million Suspicious Activity Reports (SARs) and the IRS achieved 296 convictions, for a paltry conviction rate of 0.002%.[8] That study is admittedly old (from 2006), but it raises the same question I began asking as I observed the huge increase in compliance obligations before leaving Wall Street in 2016—what are these gigantic compliance costs achieving, really? And at what cost? Every compliance requirement is a barrier to both unlawful *and* lawful commerce, and should be weighed not only against its explicit costs but also against its unseen costs (e.g., lawful commerce that didn't happen, but would have happened if the artificial barriers did not exist). There's an easy way to block all money laundering, tax evasion and terrorism financing—simply block all financial transactions (!). But seriously, Congress should consider the appropriate balance. Moreover, while the Bank Secrecy Act was upheld as constitutional in 1976 by the Supreme Court in the *United States v. Miller* case,[9] its massive expansion since then may not survive a more recent constitutional challenge. This is especially true in light of the *Carpenter v. United States* decision[10] of 2018, in which the Supreme Court narrowed the "third-party doctrine" it initially created in the *Miller* case. There's nothing unconstitutional about Congress passing unconstitutional laws, but when such laws also impose gigantic compliance costs, achieve only a paltry 0.002% conviction rate and erect real barriers to economic growth, Congress should seriously reconsider the whole approach.

2. **Digital currencies are the first major innovation in payment systems in nearly 50 years. It is imperative that the U.S. tread carefully. Fighting the trend will send innovation offshore, rather than kill it.**

No one should be surprised that a new, more efficient type of payment system has garnered serious interest, because we can mail packages around the world faster than we can send money around the world (!). The status quo payment system coddles inefficient incumbents while imposing costs on businesses to retain "comfort deposits" in their bank accounts to fund their unsettled payments. Such comfort deposits trap massive amounts of capital and are a drag on economic growth that I estimate amounts to hundreds of billions of dollars of

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[8] *Bank Secrecy Act: FinCEN and IRS Need to Improve and Better Coordinate Compliance and Data Management Efforts*, Gov't Accountability Office, Dec. 15, 2006, https://www.gao.gov/assets/260/254594.html (last visited Jul. 15, 2019).
[9] 425 U.S. 435 (1976).
[10] 138 S. Ct. 2206 (2018).

GDP annually.[11] It makes zero sense that companies with a high cost of capital must trap their expensive capital in bank accounts, simply because cross-border payments take so long to settle. Such businesses have strong economic incentives to use the most efficient payment system and, if necessary, these businesses will go offshore to find it. Congress should stop allowing the Federal Reserve to protect the incumbent payment system and instead open it to healthy competition.

Many banks have tried to fix the slumbering payment system and some are attempting to create their own blockchain-based alternative systems, but regulatory barriers have slowed the progress of these projects to a crawl comparatively. One such example is “Fnality,” formerly known as “Utility Settlement Coin,” which is making progress but is already nearly four years old.

How does Facebook Libra fit into this?

The basic building blocks of Facebook’s project are not new, with only one exception. The project is functionally akin to a money market fund (the Libra Association) plus a payment network (Calibra wallet), except that its transactions settle on a new type of payment system. The money market fund (Libra Association) invests in a basket of global currencies, government bonds and bank deposits. The payment network (Calibra wallet) is akin to a global version of PayPal or Venmo. The only difference, again, is that transactions in Libra settle on a new type of payment system—one that is far more efficient than any status quo payment system.

It should surprise no one that there’s demand for a more efficient payment system. Already, the U.S. has lost the Libra Association to Switzerland, which has a more welcoming regulatory regime for blockchain projects than the U.S. This, too, should surprise no one.

Yet, regarding this payment innovation point, there is one aspect of the Libra project into which Congress should delve deeply. Facebook announced plans to keep Libra 100% backed by financial assets—therefore, it is not a source of hidden leverage in the financial system. This presumes, of course, that Libra retains 100% backing over time and does not succumb to the age-old temptation of most financial institutions, which is to start playing ‘musical chairs’ under the assumption that all customers would never want to withdraw funds at exactly the same time. Taking Facebook at its word that Libra will retain 100% backing, Libra would be “safer” (less leveraged) than traditional banks or money market funds because its risk of a run-on-the-bank is almost certainly very low. By contrast, both traditional banks and money market funds are exposed to such run-on-the-bank risk—for banks due to fractional-reserve banking, and for money market funds due to

[11] For more information on the “comfort deposits” topic, please refer to this June 30, 2016 interview with Dave Morton, then CFO of Seagate Technology, available here:
https://caitlin-long.com/2016/06/30/blockchains-for-corporate-cfos-treasurers-interview-with-cfo-of-seagate-technology/

rehypothecation of securities, which creates multiple owners of the same asset (i.e., selling something you don't already own, or pledging the same asset to different lenders). From a policy perspective, it may interest you to know that Wyoming law expressly prohibits rehypothecation of digital assets in a custodial setting, owing to a Wyoming Supreme Court case[12] that upheld the felony fraud conviction of a person who pledged the same asset to two different lenders. While this practice is rampant in both traditional banking and securities markets today, it is a clear violation of property rights and should not happen. Ever. The practice is the main cause of periodic instability in the traditional financial system. Since Facebook's project is in its infancy and could grow to enormous size, it is particularly important now to hold Facebook to its promise to keep Libra 100% backed, permanently.

3. **Digital currencies, such as Libra, and other digital assets can fit within a modern regulatory compliant framework. Such a framework has already been built in Wyoming, which would almost certainly welcome Facebook's project.**

Regulatory fears regarding the Libra project are overblown, both because existing laws (including FinCEN's May 9, 2019 guidance regarding digital currencies[13]) and recently-enacted laws in Wyoming demonstrate that these projects can fit within a regulatory compliant framework that promotes innovation, provides legal certainty for all parties and protects consumers.

Within the past two years, Wyoming has developed a world-class regulatory framework for digital currencies like Libra and other digital assets, with the help of some of America's top law firms and law professors. Here's what Wyoming has done:

(a) **Legal Framework for Digital Assets.** Classified digital currencies and similar assets under existing property and commercial law, thereby defining the rights and obligations of parties to a transaction, providing legal remedies and enabling secured lending of digital assets. Wyoming law also establishes a road map for judges to follow in legal disputes and bankruptcy.[14]

(b) **Custody.** Resolved many of the legal uncertainties and transactional issues relating to digital assets that arise within custodial services and the SEC's Custody Rule, by providing a legal framework for qualified custody of these assets by Wyoming banks, thereby promoting their financialization and adoption by institutional investors.[15]

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[12] *Smith v. State*, 721 P.2d 1088 (Wyo. 1986).
[13] *Advisory on Illicit Activity Involving Convertible Virtual Currency,* Financial Crimes Enforcement Network, Dep't of the Treasury, *available at* https://www.fincen.gov/sites/default/files/advisory/2019-05-10/FinCEN%20Advisory%20CVC%20FINAL%20508.pdf.
[14] S.F. 125, 65th Wyo. Leg. (2019), *available at* https://www.wyoleg.gov/Legislation/2019/SF0125.
[15] *Id.*

(c) **Utility Tokens.** Created a new kind of digital asset—utility tokens—which have a genuine consumptive purpose (the inspiration for the first Token Taxonomy Act, H.R. 7356 (2018)).[16] It should be noted that the heavily-revised second Token Taxonomy Act, H.R. 2144 (2019), no longer contains a "token taxonomy." Without such taxonomy, the bill doesn't provide regulatory clarity (and, in fact, that the SEC has already stated key digital currencies (bitcoin and ether) are not securities in ordinary use cases.[17]) Moreover, the newly added federal preemption clause preempts meaningful State-level innovations and is likely to mire it in litigation with States for years. The second draft, H.R. 2144 (2019), needs to be revisited.

(d) **Other Laws.** Established a financial technology sandbox and amended Wyoming's business entity formation and taxation statutes to create a welcoming hub for innovation.[18]

There appears to be a push in Washington, D.C. to require Facebook's project to apply for a bank license. Were it not for the fact that Wyoming law authorizes a new type of bank charter,[19] this would be the functional equivalent of killing Facebook's project in the U.S. because the OCC and FDIC have not yet approved any banks to handle digital currencies. However, there is one type of bank charter—Wyoming's new special-purpose depository institution (SPDI)—that would serve Facebook's needs well, while allowing it to comply with any such requirement to have a bank license. By law, an SPDI (as a state-chartered bank) is authorized to custody digital assets pursuant to its trust powers. It would be required to comply with all federal anti-money laundering and related laws. It would also be required to hold 100% reserves and be prohibited from lending. The Federal Reserve will play an important role in ensuring the safety and soundness of Wyoming SPDIs through the Fed's master account application process, and SPDIs are also likely to want to apply to become members of the Federal Reserve System. Wyoming SPDI charter applications open October 1, 2019.

4. **While Congress should take an enabling regulatory approach to these new payment systems, Congress should fear the financial privacy implications of Facebook's project—especially if Facebook ever shares financial data with governments. Congress should also use this as an opportunity to revisit the Fed's IOER program.**

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[16] H.B. 62, 65th Wyo. Leg. (2019), *available at* https://www.wyoleg.gov/Legislation/2019/HB0062.
[17] Bob Pisani, *Bitcoin and Ether Are Not Securities, But Some Initial Coin Offerings May Be, SEC Official Says*, CNBC, Jun. 14, 2018, https://www.cnbc.com/2018/06/14/bitcoin-and-ethereum-are-not-securities-but-some-cryptocurrencies-may-be-sec-official-says.html.
[18] H.B. 57 & 185, 65th Wyo. Leg. (2019), *available at* https://www.wyoleg.gov/Legislation/2019; H.B. 126 and S.F. 111, 64th Wyo. Leg. (2018), *available at* https://www.wyoleg.gov/Legislation/2018/SF0111.
[19] H.B. 74, 65th Wyo. Leg. (2019), *available at* https://www.wyoleg.gov/Legislation/2019/HB0074.

Privacy risks surrounding Facebook's Calibra wallet are well-documented. Of course that is a major concern, but what concerns me even more is that governments around the world will view Calibra as a surveillance tool. **Congress should prevent governmental abuse of Calibra's data by prohibiting its admission as evidence in U.S. criminal cases, unless the government first obtained a valid warrant for the data.** This would bolster the U.S. Supreme Court's narrowing of the "third party doctrine" in last year's *Carpenter*[20] decision, which required the government to obtain a warrant before obtaining data that Americans had voluntarily disclosed to a third party (cell phone site location data, in that instance). Additionally, since Facebook is a U.S.-domiciled corporation, Congress also has the power to block Facebook from similarly sharing data with governments outside the U.S. for purposes of criminal prosecutions.

Separately, Congress should also re-open discussions about the Federal Reserve's interest on excess reserves (IOER) program—not just for Facebook, but also generally. **The Fed is projected to pay $35 billion[21] to banks this year under this program, without banks doing anything to earn that money. Incredibly, that amounts to almost half of the U.S. budget for food stamps!**[22] It is important for Congress to consider whether it is appropriate for Facebook's project to share in such payments, whether directly or indirectly. In a related move, Bank of England Governor Mark Carney announced plans[23] on June 20, 2019 to open the Bank of England's overnight interest-bearing deposit program to payment technology providers (such as Libra, among others), rather than restricting the program only to banks. Since Facebook does not plan to pay interest to the holders of Libra, Facebook and its project partners would pocket these interest payments as profits, risk-free. Should Facebook benefit from central bank largesse in this way, at the cost of diluting every holder of U.S. dollars? Should banks benefit in this way too? **As this practice becomes better understood by voters, calls of both "where's my bailout?" on the one hand, and "end the Fed" on the other, will inevitably become louder.**

The Bank of England's move to expand its interest-bearing deposit program to Facebook (and other tech companies) illustrates that the U.S. must tread carefully, as other countries will be courting Facebook to redomicile if U.S. regulation is too heavy-handed.

To summarize, the Facebook Libra project is aimed at satisfying demand for a much more efficient payment system relative to the status quo. Congress should recognize that the U.S. is already playing catch-up. Our bad regulations caused the invention of stablecoins in the

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[20] 138 S. Ct. 2206 (2018).
[21] Elliott Middleton, *A Partial Equilibrium Analysis of Current US Monetary Policy With a Prediction*, at *3, *available at* https://osf.io/preprints/socarxiv/ve3uw/.
[22] *Federal Spending for Means-Tested Programs*, *2007 to 2027,* Cong. Budget Office, February 2017, *available at* https://www.cbo.gov/sites/default/files/115th-congress-2017-2018/reports/52405-means-tested-programs.pdf.
[23] Chris Giles, *Bank of England Intends to Open Its Vaults to Tech Companies*, Financial Times, Jun. 21, 2019, https://www.ft.com/content/148c3724-9376-11e9-b7ea-60e35ef678d2.

first place, which is what brought us here today. And Facebook already chose a non-U.S. location (Switzerland) for the Libra Association, in what should be recognized as a “shot across the bow” to the U.S. Rather than fight the first real innovation in payment systems in decades, the U.S. should embrace it. Wyoming’s suite of innovative blockchain laws shows that such an embrace can be done largely within the existing regulatory regime, in a manner that provides legal certainty, protects consumers and promotes innovation.

I would be happy to answer questions as the Committee sees fit.

Best regards,

Caitlin Long