CATO INSTITUTE | CENTER FOR MONETARY AND FINANCIAL ALTERNATIVES

August 8, 2022

Daniel J. Harty
Director, Office of Capital Markets
U.S. Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC, 20220

Re: Ensuring Responsible Development of Digital Assets
Document Number: 2022-14588

To Whom It May Concern:

We appreciate the opportunity to provide input to assist the Department of the Treasury's response to Executive Order 14067, "Ensuring Responsible Development of Digital Assets."[1] The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace, and the Center for Monetary and Financial Alternatives focuses on identifying, studying, and promoting alternatives to centralized, bureaucratic, and discretionary monetary and financial regulatory systems. The opinions we express here are our own.

In our comments below, we will focus our responses on questions 2, 5, and 6.[2]

(2) Factors that would further facilitate mass adoption

a. Describe a set of conditions or pre-conditions that would facilitate mass adoption of digital assets in the future. To the extent possible, please cite any public data related to the responses above.

b. What developments in technology, products, services, or markets account for the current adoption of digital assets? Are there specific statutory, technology, or infrastructural developments that would facilitate further adoption?

[1] Executive Office of the President, "Ensuring Responsible Development of Digital Assets," Federal Register, March 14, 2022, https://www.federalregister.gov/documents/2022/03/14/2022-05471/ensuring-responsible-development-of-digital-assets.

[2] The Department of Commerce issued a request for comment in response to Executive Order 14067 as well. Additional answers to questions not raised here can be found there. Nicholas Anthony, "Developing a Framework on Competitiveness of Digital Asset Technologies," Cato Institute, July 5, 2022, https://www.cato.org/sites/cato.org/files/2022-07/anthony-public-comment-7-5-22.pdf.

To better facilitate, or encourage, the mass adoption of digital assets (commonly known as cryptocurrency), it might be best to reframe the focus and look at how government policies have discouraged the use of cryptocurrency. Policies like capital gains taxes as well as the broker definition and reporting requirements set by the Infrastructure Investment and Jobs Act (Infrastructure Act) have made it much harder for Americans to use cryptocurrency.[3]

Capital gains taxes act as a deterrent to cryptocurrency use in a number of ways. First, capital gains tax rates are structured to incentivize long-term holding, which clearly discourages what is generally considered "currency use." Second, the complexity of administering the tax creates an additional burden on would-be users of cryptocurrencies. Where a sales tax is usually a flat percentage added on to the bill, capital gains taxes require a cryptocurrency user to report the sales price, cost, timeline, and gain or loss for each transaction to the Internal Revenue Service (IRS).[4] Specifically, users must record this information on Schedule D of Form 1040 to calculate the tax owed for each purchase of goods and services.[5] At the very least, capital gains should be removed where cryptocurrencies, and other alternative currencies, are used for purchasing goods and services.

The broker definition (Section 6045(c)(1)) mandated by the Infrastructure Act also discourages the adoption of cryptocurrency. In short, the broker definition in the Internal Revenue Code was amended to include a whole host of new individuals (e.g., miners) and require them to report detailed information on customers involved in transactions despite not having access to said information.[6] By mandating these individuals to report information they don't have, the law effectively set a de facto ban on legal cryptocurrency mining in the United States. Worst of all, this decision came not only in an overnight addition to the Infrastructure Act, but also just as the United States became a global leader in cryptocurrency mining. The amendment to the broker definition should be removed. At the very least, however, the Treasury Department should issue guidance that clarifies the application of the new law such that miners, software developers, and the like are excluded from being required to report financial activity to the IRS.

The reporting requirements (Section 6050I(d)) mandated by the Infrastructure Act have created a similar barrier to adoption.[7] It is indeed objectionable in and of itself to require brokers to report on transactions due to their status as a third party to an exchange. However, it is even more objectionable to require individuals to report on one another in a two-party exchange. Yet the reporting requirements in Section 6050I(d) mandate exactly that. Not only does this put a new burden on every American, but it also may prevent some from ever using cryptocurrency considering the failure to correctly report a transaction can result in a $25,000 fine or five years in

[3] Nicholas Anthony, "The Infrastructure Investment and Jobs Act's Attack on Crypto: Questioning the Rationale for the Cryptocurrency Provisions," Cato Institute, November 15, 2021, https://www.cato.org/briefingpaper/infrastructure-investment-jobs-acts-undue-attack-crypto.
[4] Internal Revenue Service, "Capital Gains and Losses," Schedule D Form 1040, https://www.irs.gov/pub/irs-pdf/f1040sd.pdf.
[5] Ibid.
[6] Anthony, supra note 3.
[7] Abraham Sutherland, "Research Report," Proof of Stake Alliance, September 17, 2021, https://www.proofofstakealliance.org/wp-content/uploads/2021/09/Research-Report-on-Tax-Code-6050I-and-Digital-Assets.pdf.

prison.[8] Not only should the amendment be removed like with the broker definition, but also the entire section should be repealed.

In summary, removing capital gains taxes, the broker definition in Section 6045(c)(1), and the reporting requirements in Section 6050I(d) are far from the only changes that should be made. However, these are steps that could help to encourage the adoption of cryptocurrency use and development in the United States.

(5) Please identify and describe potential risks to consumers, investors, and businesses that may arise through engagement with digital assets. Identify any such responses that directly relate to:

a. Frauds and Scams

e. Potential losses associated with interacting with counterparties directly

i. Ability of consumers, investors, and businesses to understand contracts, coding, protocols

Unlike many centralized financial products like national currencies, stocks, or money market mutual funds, decentralized cryptocurrencies can be freely analyzed by anyone at any time. The code, the transactions, and the history are all openly available. And while that is not to say auditing the code or blockchain is a simple task, cryptocurrencies are not unique in this respect. As Federal Reserve Bank of St. Louis senior vice president David Andolfatto and assistant vice president Fernando Martin noted in a recent paper,

> Understanding how cryptocurrencies work "under the hood" is a challenge for most people because the protocols are written in computer code and the data are managed in an esoteric mathematical structure. To be fair, it's difficult to understand any technical language (e.g., legalese, legislation, and regulation).[9]

And like with legalese, legislation, and regulation, countless educational resources have emerged in recent years to help the public better understand the space. The Wharton School of the University of Pennsylvania, Massachusetts Institute of Technology (MIT), and other universities have already introduced courses and certification programs to their roster.[10] More so, several groups have also introduced more entry level courses.[11]

---

[8] Internal Revenue Service, "Reporting Cash Payments of over $10,000," Publication 1544, revised September 2014, p. 4, https://www.irs.gov/publications/p1544; and 26 U.S.C. § 7203.
[9] David Andolfatto and Fernando Martin, "The Blockchain Revolution: Decoding Digital Currencies," Federal Reserve Bank of St. Louis Review, Third Quarter 2022, https://research.stlouisfed.org/publications/review/2022/07/14/the-blockchain-revolution-decoding-digital-currencies.
[10] Wharton School of the University of Pennsylvania, "Economics of Blockchain and Digital Assets," https://www.web3.wharton.upenn.edu/blockchain; Massachusetts Institute of Technology, "Cryptocurrency," MIT Media Lab, https://mit-online.getsmarter.com/presentations/lp/mit-cryptocurrency-online-short-course/.
[11] Blockchain Council, "Blockchain Certifications," https://www.blockchain-council.org/blockchain-certification/.

Fortunately, with or without formal training, users of cryptocurrencies do not have to carve their paths forward alone. There are many examples of consumers and businesses seeking to regulate and police the cryptocurrency space through private rules. Companies, organizations, and individuals have all worked to publicly identify and remove bad actors from the space. A few examples of these freely available efforts include:

- Blockchain Explorers[12]
    - Etherscan, Blockchain.com, Blockchair, Blockstream, Blockcypher, and countless other websites make the blockchain accessible for anyone. Users can search for transactions, view wallets, explore blocks, and more with little to no prior knowledge of blockchain analytics.
- Uniswap Token Lists[13]
    - In response to the exponential growth in the issuance of ERC20 tokens, Uniswap created "Token Lists"—a community-led initiative that helps users identify legitimate projects.
- ETHPROTECT and Chainabuse[14]
    - Before interacting with the address on the Ethereum blockchain, a user can search it on Etherscan to know if it is associated with scams, hacks, or fraud. Usually, the platform specifies which illegal activities the flagged addresses were involved in. Likewise, Chainabuse provides a platform for cryptocurrency users to file and read reports of potential scams.
- Blockchain Detectives[15]
    - Twitter accounts like @ZachXBT have become known as blockchain detectives, or "on-chain sleuths," seeking to independently research and raise awareness about potential fraud. Likewise, some companies (i.e., Peckshield) have set up Twitter accounts to publish alerts.
- Major Platforms' Efforts in Fighting Scams[16]
    - Coinbase, Binance, Kraken, and others have launched initiatives to educate consumers on how to identify and avoid bad actors.

And while such freely available services have benefited the space, so too have specialized audit firms like Chainalysis, Ciphertrace, Peckshield, and Haechi Labs.[17] So while some are tempted to suggest that the cryptocurrency space is a modern, "Wild West," it would be prudent to remember that even the Wild West had rules.

---

[12] See https://etherscan.io/; https://www.blockchain.com/; https://blockchair.com/; https://blockstream.info/; and https://live.blockcypher.com/.
[13] See https://tokenlists.org/.
[14] Samuel Haig, "Etherscan Launches Fraud Monitoring and Address Blacklisting," Coin Telegraph, April 15, 2020, https://cointelegraph.com/news/etherscan-launches-fraud-monitoring-and-address-blacklisting. Also, see https://www.chainabuse.com/browse.
[15] "ZachXBT," https://twitter.com/zachxbt and "PeckShieldAlert," https://twitter.com/PeckShieldAlert.
[16] Coinbase, "Avoiding Cryptocurrency Scams," Help, https://help.coinbase.com/en/coinbase/privacy-and-security/avoiding-phishing-and-scams/avoiding-cryptocurrency-scams; Binance, "Caution on the Rising Number of Crypto Scams," FAQ, https://www.binance.com/en/support/faq/ba0e3b7e0e19495cbe690544ddaa9010;
[17] See https://www.chainalysis.com/; https://ciphertrace.com/; https://peckshield.com; and https://haechi.io/en/.

(6) According to the FDIC's 2019 "How America Banks" survey, approximately 94.6 percent (124 million) of U.S. households had at least one bank or credit union account in 2019, while 5.4 percent (7.1 million) of households did not. And roughly 25 percent of U.S. households have a checking or savings account while also using alternative financial services. Can digital assets play a role in increasing these and other underserved Americans' access to safe, affordable, and reliable financial services, and if so, how?

> **a. In your responses, please describe specific ways in which digital assets can benefit the underserved and the most vulnerable vis-à-vis traditional financial products and services. Address factors such as identify verification process, costs, speed, ease of use, and access.**
>
> **b. In your responses, please describe specific ways in which digital assets can pose risks to the underserved and the most vulnerable given rapidly developing and highly technical and nature of the industry. Address factors such as financial and technical literacy and accessibility.**

Cryptocurrency can and does play a role in increasing access to financial services for both unbanked and underbanked Americans, as well as Americans across the board. To understand how and why this is happening, it's important to begin with two fundamental insights from the Federal Deposit Insurance Corporation's (FDIC's) 2019 survey: namely, (1) the question of if the unbanked wish to have bank accounts at all and (2) the question of why they do not hold accounts.[18]

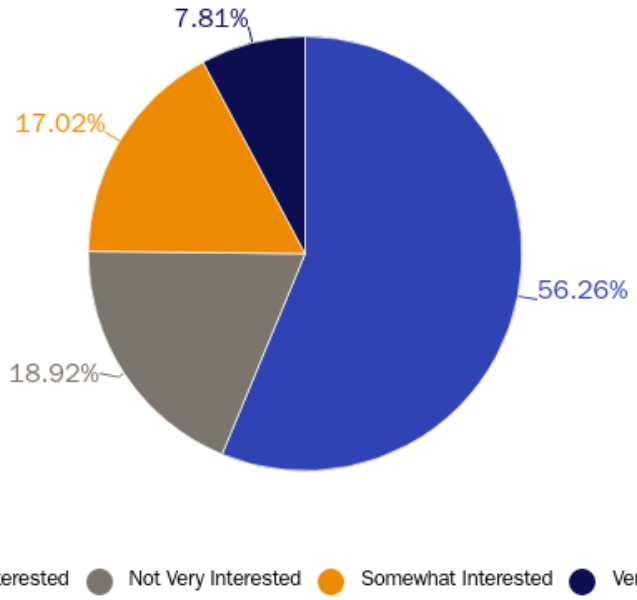
The question of whether or not the unbanked wish to have bank accounts at all is important to address from the beginning because while banking is indeed helpful for securing one's financial future, it should not be something that is forced upon the American people. And as the FDIC's survey shows, over 75 percent of unbanked households reported that they were not interested in having a bank account in the first place (see figure 1 below).[19]

With the unbanked population's disinterest in mind, it is important next ask why they feel this way. The FDIC provided insights toward this question as well. As detailed in figure 2, the FDIC found that high minimum balance requirements, a distrust for banks, and a lack of financial privacy in the banking system were the greatest barriers to becoming banked.[20] Cryptocurrency has a role to play in helping with all three of these reasons.

[18] Federal Deposit Insurance Corporation, "How America Banks: Household Use of Banking and Financial Services," October 2020, https://economicinclusion.gov/downloads/2019_FDIC_Unbanked_HH_Survey_Report.pdf.
[19] Ibid.
[20] Ibid.

Figure 1

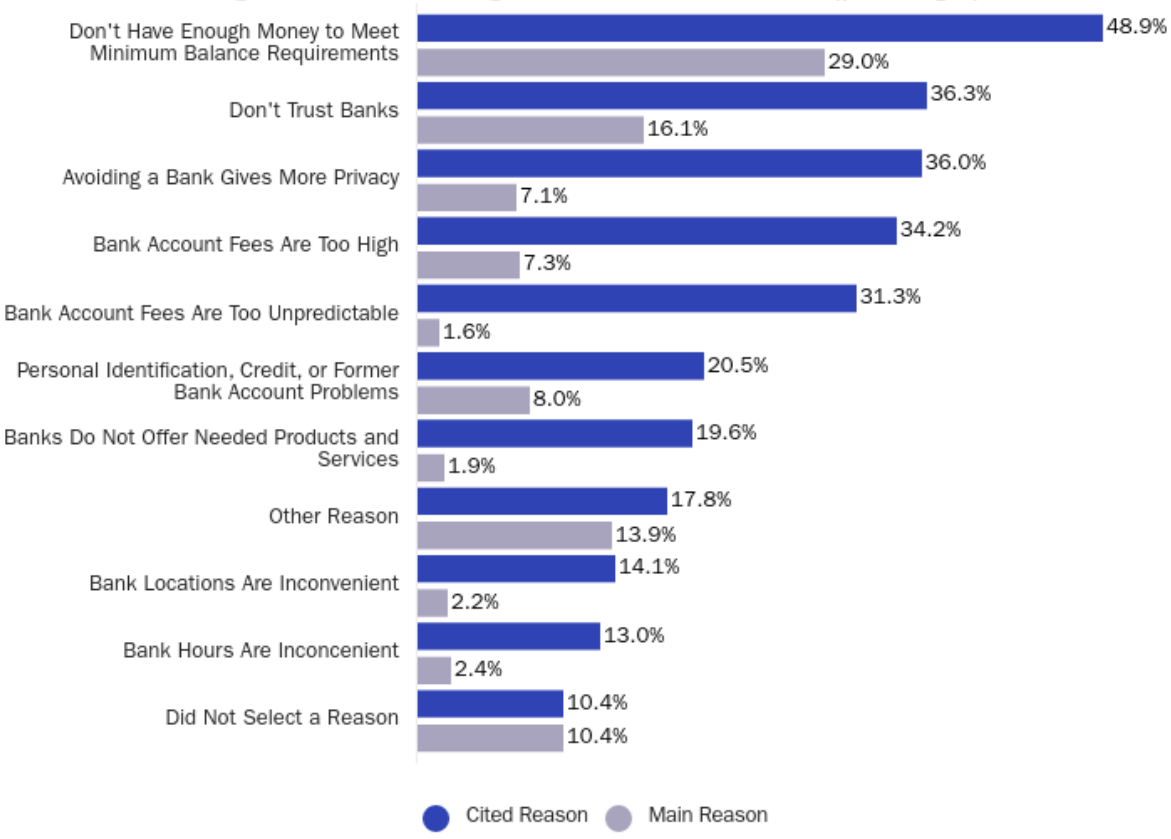
Interest in having a bank account, among unbanked households



Source: FDIC 2019

Figure 2

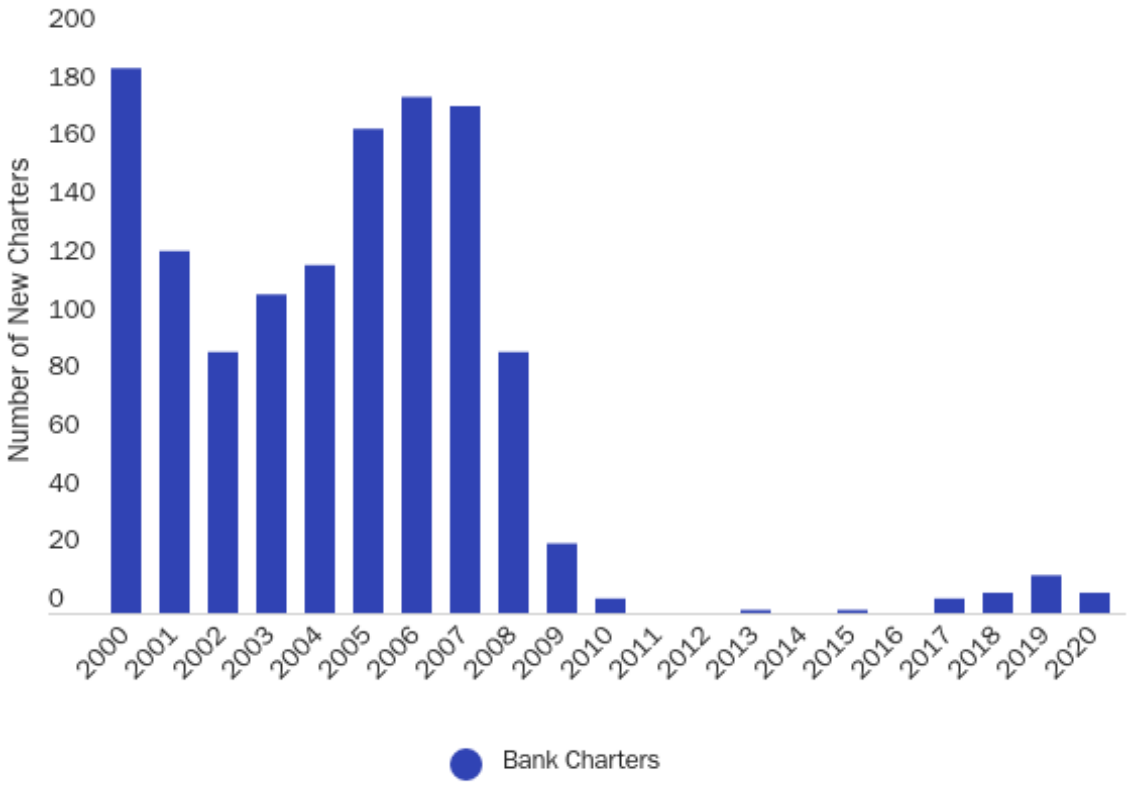
Reasons for not having a bank account, among unbanked households in 2019 (percentages)



Source: FDIC 2019

To truly appreciate the importance of cryptocurrency, however, there is one more figure worth considering: the number of new FDIC-insured commercial bank charters (See figure 3).[21] Although there used to be between 90 and 200 new charters each year, the entire decade following the Great Financial Crisis saw just 37 new bank charters in total.

Figure 3
Number of new FDIC-insured commercial bank charters in the United States



Source: Statista

Now, more than ever, is the time to welcome much-needed competition for the incumbent banks. And cryptocurrencies might be exactly what is needed to introduce that competition. Although someone that is unbanked may not be able to meet the minimum balance requirements of a traditional bank account, they can begin to store money in a self-hosted wallet designed for cryptocurrency without any fees, contract, or expiration date. More so, as cryptocurrency increases in popularity, it is likely that banks will work harder to lower their own fees (as we have seen in projects like the Bank On initiative).

In addition, for some people, cryptocurrencies may be exactly what is needed to better protect their financial privacy. Despite the fact that cryptocurrencies are not completely anonymous, users are still offered a heightened level of financial privacy because decentralized cryptocurrencies (e.g., Bitcoin) offer the opportunity to remove intermediaries from the equation.

[21] Statista, "Number of New FDIC-Insured Commercial Bank Charters in the United States, from 2000 to 2021," Financial Institutions, https://www.statista.com/statistics/193052/change-in-number-of-new-fdic-insured-us-commercial-bank-charters/.

Therefore, there is no third party to pressure for information if the bitcoins in question are held in a self-hosted wallet. If a government wishes to access the information in such a wallet, it must go through the traditional legal system to secure a warrant. That idea, of course, is precisely what underlies the Fourth Amendment to the U.S. Constitution and should be the norm. And it is that idea that might be precisely what is needed to comfort the unbanked population's concerns regarding financial privacy.

****

Thank you for the opportunity to share our perspective regarding the Department of the Treasury's response to Executive Order 14067.

Sincerely,

Nicholas Anthony
Policy Analyst
Center for Monetary and Financial Alternatives
Cato Institute

Ivane Nachkebia
DeFi Fellow
Center for Monetary and Financial Alternatives
Cato Institute