LEGISLATURE *of the* STATE *of* WYOMING

BLOCKCHAIN TASK FORCE

February 27, 2019

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President
Uniform Law Commission
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Dear President Ramasastry,

Thank you for your letters and memoranda dated January 29 and February 6, 2019, which asked the Wyoming Legislature to set aside SF 125 and instead enact the Uniform Law Commission's Uniform Regulation of Virtual-Currency Businesses Act, as well as the accompanying Supplemental Act ("the Model Acts").

Last year, the Wyoming Legislature's Blockchain Task Force studied the Model Acts at length with industry professionals, legal scholars and legislators. The Task Force determined that the Commission's approach was inappropriate because the Model Acts recognize virtual currency under the UCC *only* if the digital assets are owned via a securities intermediary, and therefore neglect to recognize the reality of this asset class, i.e., that individuals (not intermediaries) own a majority of virtual currency. Moreover, as explained below, the indirect ownership regime is particularly risky for virtual currencies because it enables risky practices in intermediary omnibus accounts that can cause insolvency more easily than other asset classes. Unlike the traditional financial industry, which has mechanisms to "paper over" the issues caused by indirect ownership, there is no lender of last resort for virtual currencies and no way to create fault tolerance in their settlement systems. Consequently, ledger inaccuracies that arise due to indirect ownership create acute solvency risks for financial institutions dealing in virtual currencies. Additionally, and perhaps most strikingly, the Model Acts do not address other widely recognized forms of digital assets,[1] including digital consumer assets ("utility tokens") and digital securities, which have

[1] *See, e.g., Guidance on Cryptoassets,* Financial Conduct Authority (United Kingdom), at *8, January 2019, *available at* https://www.fca.org.uk/publication/consultation/cp19-03.pdf; *Guidelines for Enquiries Regarding the Regulatory Framework For Initial Coin Offerings (ICOs),* Swiss Financial Market Regulatory Authority, at *3, Feb. 16, 2018, *available at* https://www.finma.ch/en/authorisation/fintech/; Senate File 125, 65th Wyo. Leg., 1st Sess. (2019), *available at* https://www.wyoleg.gov/Legislation/2019/SF0125.

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marked differences to existing asset classes. Consequently, failing to address these other forms of digital assets at best risks incomplete legislation and, at worst, causes the United States to fall further behind other nations in providing an effective regulatory framework for digital assets.

Additionally, many of the goals stated by the Uniform Law Commission in advancing the Model Acts[2] have previously been criticized by many in the digital asset industry, as this approach is similar to New York's 'BitLicense' regime, which has stifled innovation.

The inherent nature of digital assets largely obviates the need for intermediaries. The Model Acts also have left a gaping hole in this space by neglecting to address the direct ownership and peer-to-peer nature of digital assets. Did the Uniform Law Commission mean to create a structural advantage for the securities industry to the detriment of individual owners? We believe this is the practical impact of the Model Acts, in particular the Supplemental Act.

The Model Acts provide UCC classification *only* for virtual currency that is owned via a securities intermediary—a result that unduly favors the financial services industry and substantially disadvantages individual owners of digital assets by leaving them with inferior UCC protections.

SF 125 allows individuals to opt into Article 8 treatment but, more importantly, it *also* provides UCC protections for those individuals who choose instead to own *all* classes of digital assets directly (i.e., outside of Article 8). SF 125 requires Wyoming-regulated digital asset custodians to provide clear, consumer-friendly disclosures that customers can lose money by opting into the Article 8 indirect ownership regime and will not be bailed out—disclosures that are far superior to those of the securities industry today regarding similar risks of indirect ownership via Article 8. Additionally, SF 125 provides legal certainty for owners of digital assets because, for the first time, a U.S. jurisdiction has addressed the precise nature of the custodial relationship, the reality of "control" as applied to digital assets, as well as the duties of the custodian regarding "forks" and "airdrops." Based on consultation with industry stakeholders, it also serves as an effective bridge to existing custody requirements in federal law, both for commodities and securities.[3]

Clear disclosures that consumers can lose money by choosing indirect ownership under Article 8 are especially important for virtual currency and other digital assets because Article 8 indirect ownership *creates* solvency risks for financial institutions. When we reviewed the archive for the Model Acts, we saw no discussion of this issue. This is crucial: there is no lender of last resort for virtual currency (and most other digital assets), and there is zero fault tolerance in its settlement systems. As a result, financial institutions with uncovered exposures to digital assets are highly susceptible to insolvency in "run on the bank" scenarios.

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[2] *Why Your State Should Adopt the Uniform Regulation of Virtual-Currency* [sic] *Businesses Act*, Uniform Law Comm., *available at* https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=a7446254-cabe-479f-88b4-cb3b12b29be5&forceDialog=0.

[3] *See* Senate File 125, 65th Wyo. Leg., 1st Sess. (2019), *available at* https://www.wyoleg.gov/Legislation/2019/SF0125.

In the securities industry, the Article 8 regime permits the securities industry's ledgers to fall out of synchronization by enabling securities to be pooled in omnibus accounts that do not always 1:1 match the quantity of security entitlements promised to customers throughout. These inaccuracies are "papered over" by allowing fault tolerance mechanisms in the settlement system, such as failures to deliver, operational shorting, two-day trade settlement, and other measures that bridge what is actually the temporary undercapitalization or insolvency of financial institutions. These fault tolerance mechanisms simply do not exist for digital assets, because no central party (such as the Depository Trust Company) can ever control their settlement systems, and consequently, no one can require all industry actors to provide such allowances. By contrast, failure to deliver a digital asset is default.

A prominent example of the securities industry's ledger inaccuracy under Article 8 is *In Re Dole Food Company*,[4] a 2017 Delaware Chancery Court case in which Dole Food had 36.7 million shares issued and outstanding, for which 49.2 million class action claims were filed for the outstanding shares.[5] All 49.2 million claimants had "facially valid" brokerage statements as evidence of ownership.[6] How did Wall Street's ledger systems create 33% more shares of Dole than the quantity validly issued and outstanding?

The answer is easy to understand once you realize the indirect ownership regime of Article 8 permits securities intermediaries to hold security entitlements in pooled, fungible bulk—i.e., omnibus accounts—that rarely at any given moment precisely match the quantity that securities intermediaries have promised to their customers. One of our Task Force members, Caitlin Long, has attested, based on her prior experience as head of Morgan Stanley's Pension Solutions Group, that unauthorized securities lending that occurs via a custodian's omnibus account is not discoverable by reviewing a customer's brokerage account statement. Ms. Long witnessed a situation in which a pension fund's brokerage statements showed certain assets were in its account, but its custodian could not deliver the enumerated assets because it did not hold a sufficient quantity of these assets in its omnibus account. Such situations are only possible under Article 8 indirect ownership, which enables omnibus accounts that permit ledger inaccuracies to develop.

The difficulty with Article 8 traces back to its 1994 amendments, which dramatically limited the direct property rights of owners of publicly-traded securities in the United States. These amendments transformed many individuals from direct owners of property into indirect owners of contractual IOUs (security entitlements, issued by leveraged securities intermediaries). The 1994 amendments also turned what used to be a property relationship into a debtor/creditor relationship because, under U.S. bankruptcy law, customers of securities firms become creditors if the securities firm is unable to deliver the contractually-owed quantity of security entitlements.

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[4] *In re Dole Food Co.*, 2017 Del. Ch. LEXIS 25 (Del. Ch. Ct. Feb. 15, 2017).
[5] *Id.* at *3.
[6] *Id.* at *5.

Delaware Chancery Court Vice Chancellor J. Travis Laster has criticized the indirect ownership regime for securities, and we agree with his critique. In a 2016 speech to the Council of Institutional Investors, he encouraged institutional investors to "take back the voting and stockholding infrastructure of the U.S. securities markets" by replacing indirect ownership with a system in which shareholders own shares directly via a blockchain" and noted that blockchain technology was the "plunger" that had the potential to clean up capital markets.[7]

As Vice Chancellor Laster also noted in his speech, "[t]he current system works poorly and harms stockholders." He gave several examples of the inaccuracy of the proxy voting process for publicly-traded companies, directly caused by the indirect ownership regime, and pointed out that Gil Sparks, a leading Delaware corporate lawyer, "has estimated that, in a [proxy] contest that is closer than 55 to 45%, 'there is no verifiable answer to the question 'who won?'"[8]

Article 8's indirect ownership regime enables such inaccuracies in the securities industry's ledgers, which are patently unfair to investors, but are also permitted by securities regulators due to structural impediments in the current system. Applying this same indirect ownership to digital assets—which have no lender of last resort—demonstrates unfamiliarity with digital assets and a lack of comprehension that creates a significant solvency risk to financial institutions.

For these reasons, the Model Acts would neuter the power of blockchain technology to fix the securities industry's problems when, inevitably, digital securities are issued natively on a blockchain.

There's more. Rehypothecation—a standard practice in the securities industry enabled by Article 8 whereby broker/dealers pledge the very same security for multiple different loans—has been recognized as a felony in Wyoming. A 1986 Wyoming Supreme Court case, *Smith v. State*,[9] upheld a conviction of a person who knowingly rehypothecated the same asset to obtain two different loans. In Wyoming, we consider rehypothecation to be fraud, not as a "worth the risk" tool to promote liquid markets at the expense of meaningful property rights. By enabling digital assets to be pooled in omnibus accounts and then not restricting rehypothecation *from the omnibus account*, the Model Acts leave open the rehypothecation loophole for digital assets. Again, by not addressing this, the Model Acts *enable* a material solvency risk.

Wyoming is actively seeking to be home of solvent financial institutions by recognizing direct, individual property rights in digital assets. We understand why the securities industry does not agree with Wyoming's approach—securities firms today make a great deal of money by taking advantage of the multifarious loopholes in Article 8.[10]

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[7] Hon. J. Travis Laster, *The Block Chain Plunger: Using Technology to Clean Up Proxy Plumbing and Take Back the Vote*, Council of Institutional Investors, Chicago, IL, Sept. 29, 2016, *available at* https://www.cii.org/files/09_29_16_laster_remarks.pdf.
[8] *Id.*
[9] *See Smith v. State*, 721 P.2d 1088 (Wyo. 1986).
[10] *See, e.g.*, UCC § 8-504.

We hope Vice Chancellor Laster's vision comes to fruition—that the securities industry moves away from its current indirect ownership model and embraces a new, blockchain-based system that restores direct property rights in securities and creates a fairer, more accurate, securities industry.

By becoming the first state to recognize property rights in digital assets under Wyoming's widely-used commercial and corporate laws, including blockchain securities in both certificated and uncertificated form, our state has actively decided to lead the charge of ensuring solvent, blockchain-based financial institutions and shaping the course of America's finance industry. We encourage other states to join us.

A brief note about the Uniform Law Commission's strategy regarding SF 125. You may be interested to learn that the Wyoming Senate's reaction to your January 29th letter, in which you "strongly urged" Wyoming to "set aside" SF 125, was poorly received. One prominent member of the Senate remarked, "who do 'these people' think they are telling Wyoming to withdraw a bill?" Moreover, sending this letter to an undisclosed list of persons in Wyoming—not all of whom were legislators—was most surprising and somewhat discourteous because made it difficult for us to respond. We do not know whether this approach is the standard model followed by the Uniform Law Commission in other situations. We would urge you to have a more collaborative, respectful approach in the future, even more so because the Uniform Law Commission has no constitutional authority to enact legislation and operates only on the good will of state legislators.

You are also likely not aware that the Task Force has relied upon the knowledge and experience of professionals including Ms. Long, very prominent Wall Street law firms, law professors, government agencies, technology leaders, consumer advocates and a highly proficient legislative draftsman. Wyoming's policy leadership among the states is known and respected, as our state was the first to adopt the limited liability company form of business entity in 1977 and was also the first to grant women the right to vote. Additionally, several other international, federal and state jurisdictions have also enacted, or are currently considering, digital asset legislation substantially similar to bills first enacted by Wyoming over the last year.[11]

We agree, in principle, with the Uniform Law Commission's goal of uniformity for state commercial laws. However, for the reasons discussed above, existing UCC treatment of securities cannot be applied in a straightforward manner to this new asset class. Your objection that SF 125 would impair the Uniform Law Commission's goal of uniformity is also somewhat misplaced because this objection necessarily assumes that the Model Acts will be widely adopted, even

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[11] *See, e.g.*, H.R. 7356, 115th Cong., 2d Sess. (2018); Senate Bill 19-023, Colo. Gen. Asm., 1st Sess. (2019); House Bill 584, 66th Mont. Leg., 1st Sess. (2019); Senate Bills 838 and 843, 57th Okla. Leg., 1st Sess. (2019); House Bill 1043, 66th N.D. Leg. Asm. (2019); Senate Bills 163 and 164, 80th Nev. Leg. (2019); House Bill 378, Utah Leg., 1st Sess. (2019); Senate Bill 583, W. Va. Leg., 1st Sess. (2019). *See also* Ariz. Sess. Laws, ch. 207 (2018).

though no state has yet adopted the Model Acts. As you know, only a small handful of states have introduced legislation proposing the Model Acts.[12]

SF 125 passed the Wyoming Senate 28-1 and the House of Representatives 54-2, with Governor Gordon signing this bill into law on February 26, 2019. Therefore, Wyoming's newly enacted SF 125 is the most comprehensive regulatory framework regarding digital assets that has been enacted in the United States to date, alongside twelve other bills which have already become law or passed the Legislature and currently await Governor Gordon's signature.[13] In short, Wyoming's Blockchain Task Force has studied these issues in great depth and devoted an enormous amount of time to develop prescient, carefully drafted legislation.

We believe the Model Acts are not yet ready to be considered in any state. We urge the Uniform Law Commission to set aside the Model Acts and develop a proposed uniform law that better accounts for the nature of digital assets and their enormous potential for economic innovation. We will be actively discouraging other states from enacting the Model Acts until your proposals are significantly improved.

Our Task Force members would be happy to assist the Uniform Law Commission in revising the Model Acts. Please do not hesitate to contact us if you would like to accept our invitation.

Sincerely,

Rep. Tyler Lindholm
Majority Whip, Wyoming House of Representatives
Co-Chairman, Blockchain Task Force

Sen. Ogden Driskill
Vice President, Wyoming Senate
Co-Chairman, Blockchain Task Force

[12] *See* Assembly Bill 1489, Calif. Leg. (2019); House Bill 70/Senate Bill 250, 30th Hawaii Leg., 1st Sess. (2019); Senate Bill 195, 80th Nev. Leg. (2019); House Bill 1954, 57th Okla. Leg., 1st Sess. (2019).

[13] *See, e.g.*, House Bills 57 (financial technology sandbox); 62 (utility token amendments); 70 (blockchain commercial filing system); 74 (special purpose depository institutions); 113 (special electric utility agreements); and 185 (corporate stock-certificate tokens), 65th Wyo. Leg., 1st Sess. (2019), *available at* https://www.wyoleg.gov/Legislation/2019.