

Written Statement of Proposed Testimony

by

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**for the Hearing entitled
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Its Impact on Consumers, Investors, and the American Financial System”**

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Chairwoman Maxine Waters, Ranking Member Patrick McHenry, and other members of the Committee, thank you for the opportunity to participate in this Hearing to examine Facebook’s proposed global cryptocurrency, Libra, and its impacts on consumers, investors, and the American financial system.

I am a professor at Columbia Law School, where I have taught for the past 18 years, mostly in the fields of corporate law; law and finance; comparative law; and law and development. I am also the director of the Law School’s Center on Global Legal Transformation. I have researched the legal underpinnings of global money and finance with comparative and historical perspectives for more than a decade, and have multiple publications that speak directly to this issue. A CV with a full list of publications has been submitted to the Committee.

For the record, I have received a research award as well as grants for my center and that have funded doctoral students and postdoctoral scholars, as well as conferences and workshops related to the above topics from the Humboldt Foundation jointly with the Max Planck Society and the Institute for New Economic Thinking. I have also benefited from Columbia Law School’s customary summer research funding for faculty.

Based on my own research, an analysis of the Libra White Paper and related documents that have been released so far, and a close reading of other comments and analyses of Libra, I have come to the following conclusions:

- Facebook’s Libra is designed to become a “new global currency” that will complement existing fiat currencies. It is designed as a for-profit “currency of currencies.”
- The Libra White Paper promises to create a seamless, global, safe, and inclusive payment system based on modern digital technologies. Libra is labeled a “stable coin”

and as such aims at delivering low volatility and high liquidity to its customers, the holders of Libra coins, who shall be able to exchange their Libras against (local) fiat currency on demand without suffering major haircuts.

- To this end, Libra is backed by a reserve composed of “safe” assets. The safe assets of choice are bank deposits and the liquid debt of reputable sovereigns. These assets owe their safety to *public* backstopping mechanisms in the form of deposit insurance and the “full faith and credit” of the issuing sovereign. In effect, the sponsors of Libra and its profit-earning beneficiaries will be free riding on a public safety net for which they are not paying.
- The main governance architecture of Libra resembles currency boards employed by some countries that use currency baskets to back their currencies, such as Singapore and Kuwait, with the important difference that Libra shall deliver profits for its beneficiaries. All interests and dividends will be allocated to the members of the Libra Association and or investors in Libra Tokens (which are distinct from Libra coins); none to its customers, the holders of Libra coins.
- The central node of what will become an ecology of financial intermediaries is the Libra Association, based in Geneva, Switzerland. It will exercise control over the admission of future members, manage the Libra Reserve, determine asset eligibility for the Reserve, decide whether to amend the protocol on which Libra runs, and determine if, when, and how Libra’s architecture will evolve from a club-like or permissioned system to a permission-less system.
- This concentration of power is unmatched by any meaningful accountability to anyone. The choice of the legal structure means that the members of the Libra Association will be insulated from liability and accountable only to themselves. They will not be accountable to holders of Libra coins or to the citizens of countries that create the safe assets used to backstop Libra.
- Existing legal and regulatory frameworks in the United States and elsewhere are highly incomplete and leave ample room for legal as well as digital arbitrage. They were not designed to govern digital currencies. Regulators are currently using a case-by-case approach to extend their reach, which is no match for the fast-moving technological change.
- Libra’s global reach exacerbates these problems. Many of the activities associated with managing Libra and its Reserve will be beyond the reach of regulators in the United States, or any other country for that matter. The current level of transnational regulatory cooperation does not match the versatility of a private actor, such as Facebook, to pick and choose from legal systems around the globe which laws and regulations best suit its needs.

Cryptocurrencies: A New Opportunity

We live in an age of rapid technological change. Recent advances in digital and crypto technologies have created an opportunity to transform financial systems, both domestically and globally, in ways that would have been unimaginable just a few years ago. They put the dream of an inclusive and efficient financial system within our reach.

Realizing this dream will, however, require great care. “This time is different” is a powerful argument that has been used time and again to advance a new financial technology, as Carmen Reinhart and Kenneth Rogoff have shown in their pathbreaking book (2014). Yet their analysis of 800 years of history of financial crises shows that history tends to repeat itself. This should not stop us from innovating. However, it should caution us before we plunge ourselves into yet another financial experiment, especially one that aspires to be both transformative and global.

In the aftermath of the 2008 crisis, regulators have required banks to make a “living will”: a plan for how they might unwind themselves, should they face insolvency. We should require something similar from the sponsors of Libra and other financial innovations that are likely to exert systemic effects on both domestic and global money and financial systems. Legislatures and regulators should arguably do the same: They should scrutinize whether they have the regulatory and supervisory means in place to respond to a possible crisis scenario either alone or in collaboration with regulators from other countries. And if not, they should quickly put such rules in place to ensure effective crisis prevention.

A Private Currency Backed by Sovereign Assets

According to the White Paper, Libra aspires to become a global currency in the specific *form* of a cryptocurrency. It is not meant to replace existing state issued currencies (at least not yet). Instead, it will use select fiat currencies for determining its value (or unit of account) and will hold assets denominated in these currencies in its Reserve. In short, the Libra is designed as a currency of currencies.

A weakness of this design, as acknowledged in the White Paper, is that the exchange rate of Libra will fluctuate with the value of the underlying assets. This may deter customers who currently enjoy stable state-issued fiat currencies, like the U.S. Dollar or the British Pound (unless they can save on other costs, such as credit card charges), but will likely attract customers from countries with weak(er) or more volatile currencies.

The strength of the design, especially when compared with other cryptocurrencies, is that Libra is backed by “safe assets” that will be held in the Libra Reserve. The two examples for safe assets given in the White Paper are bank deposits and short-term, and thus liquid, debt of reputable sovereigns. The White Paper even refers to these assets as “real” assets having “intrinsic” value. It should, however, be noted that neither fiat currencies nor sovereign debt fit the classic definition of “real” assets, which is typically reserved for commodities, gold, or land.

Nonetheless, choosing government-issued and government-insured assets was a smart move, because only (some) sovereign states can ensure asset safety: States that have their own currency, issue most of their debt in their own currency and under their own laws, and oversee financial intermediaries that also issue most of their debt in the currency of their home regulator.

States ensure asset safety by putting the future productivity of their economies and tax-paying citizens on the line. They insure bank deposits (up to a ceiling) and they stand in for the sovereign debt they have issued. It follows that the safety of Libra depends on the backstopping prowess of select sovereign states, foremost among them the United States and a handful of other countries with a track record as stellar debtors and guarantors of a stable banking system.

The White Paper claims that Libra will be immune from external events because of the safe assets in the Libra Reserve. But it should be noted that safe assets are in high demand globally even today, over a decade after the crisis. In a crisis scenario, there tends to be a rush to safety, as indicated by the dollar scarcity during the 2008 crisis. In such a scenario, investors will pay for the ability to keep their assets safe. A repeat of such a crisis scenario at some point in the future can hardly be ruled out. This means that the global demand and supply of safe assets would affect the Libra Reserve, quite independent of its own operations. As a currency of currencies that reaches billions of households globally, it might well amplify movements in foreign exchange markets.

The White Paper emphasizes the supply of Libra will follow strictly supply and demand — for Libra that is. It does not say how the Libra Association might respond to a (sudden) scarcity of safe assets relative to Libra. While it is possible to change the composition of assets in the Reserve, this will require a two-thirds majority vote by members of the Libra Association, a time-consuming process in an emergency situation.

Furthermore, any substitution of assets would raise safety concerns. The financial sector might fill the void and create assets that meet Libra's demand and (revised) Reserve safety criteria. This should be reason for concern. Recall the massive expansion of "safe" assets that were created by way of legal securitization and *tranching* techniques in the run up to the 2008 crisis. This gave us a garden variety of "safe" assets, including super-senior tranches in asset-backed securities (ABS), collateralized debt obligations (CDOs), and their squared and cubed variants. Money market funds, pension funds, and other intermediaries with a high demand for "safe" assets used them to expand their portfolios. Yet, when house prices deteriorated and default rates increased, assets that seemed safe yesterday became "toxic" virtually overnight.

Financial crises spread through contagion. The transmission mechanisms vary depending on the structure of the financial system. In an era when banks dominated financial system, bank runs were common. They were highly visible and took the form of long lines of depositors trying to withdraw "their" money from the banks. In the 2008 crisis, we witnessed runs on entire

asset markets, including fully collateralized ones. Interdependence of assets and counterparties served as the transmission belt for relatively small price signals. It is not difficult to imagine a “run on cryptos” or a “run on Libras” — whether in response to a truly exogenous shock, to major operational problems, or to heightened safety concerns about assets held in the Reserve. In a hypothetical run on Libra, the transmission mechanism would most likely be a combination of price signals in critical asset markets and social media, which would put billions of Libra holders around the globe on notice.

All of this would matter less if Libra were just one of many other cryptocurrencies that have entered and exited, risen and fallen, over the past decade. Libra’s ambition, however, is of a different kind. It wants to be a global currency and, if allowed to go forward, would be rolled out at breathtaking speed by Facebook, a company that currently has over 2.5 billion users worldwide.

Facebook has teamed up with other companies, some of which are already providing digital payment services through subsidiaries, such as Vodafone; others whose customers may opt for Libra to settle their accounts for car hiring and similar services; and yet others that may have seen the writing on the wall that their services as credit card providers, for example, might soon be substituted by Libra. Their customers might join the Libra ecology. In addition, Libra’s sponsors want to reach out to the unbanked of this world, 1.7 billion people by the White Paper’s account, some of whom but hardly all may already have a Facebook account.

In short, there can be little doubt about the intention of this project: the rapid scaling of a new global currency with billions of customers around the globe. The control over this currency will be vested in a single organization, the Libra Association. Only scale will ensure that Libra will become profitable and generate returns on the minimum investments of \$10 million each, the Founding Members or Token investors are asked to make.

Technical and regulatory obstacles may slow down Libra’s expansion. Perhaps there will not be enough takers, especially in developed markets with stable fiat currencies. Nonetheless, the Libra has the potential to transition in no time from “too small to care” to “too big to fail.”¹

Power Without Accountability

Libra has been advertised as a solution to the challenge of creating an inclusive global payment system that serves as a “public good” so that more people can “have access to financial services and to cheap capital” and realize their “inherent right to control the fruit of their labor.” Little information is available at this point on how the interface between Libra and the cash economy of the unbanked will operate. Experience in Kenya, Mali, and the Fijis suggests that liability rules for the providers of digital services is critical to ensure effective

¹ Zetzsche, Buckley and Arner, “Regulating the Libra: The Transformative Potential of Facebook’s Cryptocurrency and Possible Regulatory Responses,” [2019] UNSWLRS 47.

monitoring of agents who directly interface with customers. It would be helpful to get more information from Facebook about its plans for Libra in this regard.

As currently structured, the governance architecture for Libra is designed to insulate the sponsors of Libra and the founding and possible future members of the Libra Association from liability and accountability.

Libra is sponsored by a consortium of private actors who will become members of an association (a *Verein*) under Swiss law that will shield them against liability. Initial membership is by cooptation. The Libra Reserve will most likely be held in a separate legal entity, such as a trust or corporation (commonly referred to as a special purpose vehicle, or SPV). This will ensure that the Reserve will be immune from any liabilities the Libra Association might incur. Conversely, the Libra Association will have no access to the assets held in the Reserve to meet any liabilities of its own. Since returns will be passed on to the Association's members (and Token holders), the Association may not have significant assets to cover any liabilities of its own.

The Libra Association will have the power, through its organs, to allocate returns on the assets held in the Libra Reserve. They will be used to cover the operational costs of the Libra Association, including the salaries for the Executive Team, returns for the members of the association, as well as dividends for Libra Token holders. In contrast, customers will not receive any returns for depositing fiat currency in exchange for Libras. The Libra White Paper bemoans that the poor are charged fees they cannot afford to access regular banking services, yet they would be denied any compensation for the time value of their money within the Libra framework.

The Libra Association, "an independent, Swiss not-for-profit organization" has been established in Geneva, Switzerland. Under the Swiss civil code (*Zivilgesetzbuch*) an association, or *Verein*, is designed as a legal person with a highly flexible governance structure to accommodate a range of "non-economic interests." Case law, however, has expanded the use of the *Verein* for economic interests.

Nonetheless, as a non-profit entity, the association itself would not be eligible to be licensed to offer financial services under Swiss law, nor be permitted to pay dividends to its members. Some commentators have speculated that a separate entity, "Libra Networks s.a.r.l.," which Facebook established as a limited liability company under Swiss law in April 2019, may serve as a kind of for-profit clone of the Libra Association that will be licensed and will have the power to pay dividends to Libra Token holders.² Founding Members of the Libra Association who receive Libra tokens for their investment might use these tokens to buy shares in this entity.

² The company is officially registered under the file number 08398/2019. See also Zetzsche et al., *supra*.

Given the incomplete disclosure about Libra Tokens and Libra Networks, it is impossible to say whether this conjecture is correct. More information is needed from Facebook about the overall governance architecture, the entities that have already been established and others that are expected to become part of the Libra ecology, their relation to one another, and to the regulatory frameworks in the countries in which they will be established or intend to operate.

The Libra Association shall be a member-based organization. It shall be governed by the Association's Council and the Association's Board. The day-to-day management would be carried out by an Executive Team under the leadership of a Managing Director to be elected by the Council for a three-year term that can be renewed indefinitely.

The membership of the association would be made of the "validator nodes of the Libra network," initially the "Libra founding members." To become a node, an entity "needs to make an investment of at least \$10 million in the network through purchasing Libra Investment Tokens." It would be possible for investors to acquire tokens without assuming a role as validator node. Node validators would obtain one vote in the Libra Council per every \$10 million investment subject to a voting cap of the greater of "one vote or one percent of the total votes in the Council." Investors who are not validators would not be subject to this cap – a possible strategy for resourceful investors to expand their control in the Association.

At the outset, there would be only a limited number — up to 100 — of validator nodes. Within five years, at least 20 percent of the voting power would be allocated by the quantity of Libra coins individuals or entities hold. However, the actual pace of transition would be controlled by the Council. I could not find anything in the documents made public so far that would prevent the Libra Association to slow down or abandon the process to a permission-less system.

Most of the fundamental powers associated with running the Libra Association would vest in the Council, which would elect the Board, appoint the Managing Director, approve the budget, upgrade or change the existing protocol for Libra, and determine by a two-third supermajority vote the eligibility criteria for Founding Members, the Reserve Management Policy, and the Incentive Distribution Policy.

The Council would meet only bi-annually. Except for votes that explicitly require a supermajority, votes would be taken by regular majority, defined as 50 percent of the votes taken provided that at least two-thirds of total votes are represented at the meeting, or 50 percent of *all* Council Members' votes.

The Board would be elected by the Council and would consist of at least five and at most 19 members. Board Members would have to be members of the Council; they would be elected for a one-year term, but they could be re-elected indefinitely. Board Members could be removed by the Council at any time.

The powers of the Council, combined with the fact that at least initially, all Founding Members would be Council Members, suggest a rather flat organizational structure, one that resembles a direct rather than a representative model. Ultimately, however, we should expect the real powers to be exercised not by the Council or the Board, but by the Managing Director and his or her Executive Team.

The Managing Director would be elected by the Council for a term of three years, but could be reelected indefinitely. The Managing Director would also be a member of the Board. Notably, the first Managing Director would be elected as soon as at least *five* members signed up as Founding Members. These first movers, and Facebook is likely to be among them, would therefore put in place the Managing Director and the Executive Team for the critical start-up phase of the Libra.

The Managing Director's major tasks are described as including "*Libra network* management," a wording that hints at powers beyond running the Libra Association. The Managing Director is charged with defining the processes for managing the Libra protocol, for reviewing and accepting changes to its implementation. He or she would also manage (or oversee the management of) the Libra Reserve, including the process of "minting and burning Libra," to "ascertain that the value of assets in the reserve meets the policy criteria," to "invest reserve in low-risk assets," and to "allocate funds (...) generated from interests on the reserve to fund the association activities ... and for distribution to nodes of investors" according to the terms of Libra investment tokens, Incentives distribution policy, and Council decisions. The Managing Director would recruit an Executive Team for all the core functions for a complex business.

Selecting an association as the entity that will be running a global currency as a for-profit business is a peculiar choice. Like trusts and foundations, associations have the capacity to perpetuate themselves without effective accountability. The Founding Members would control key decisions of the Association, including the decisions about its future decentralization, any changes to the guidelines, the protocol, and the composition of assets in the Reserve. The first 28 prospective members of the association have been recruited by Facebook. Given Facebook's control over the start-up phase, it is reasonable to assume that most, if not all, 100 original Founding Members would be hand-picked by Facebook, as would be the first Managing Director and the Executive Team. Facebook, in other words, would be first among equals in the Libra Association for some time to come.

In sum, the Libra Association aspires to create a global payment system on a for-profit basis. To achieve this goal, Facebook has chosen a governance structure that is designed not to have effective accountability mechanisms to anyone except the Association's Founding Members. They would be able to perpetuate their control, if they so wished, and could use their powers to maximize their returns rather than advance the interests of the Libra customers.

If Libra were to achieve its ideal scale, the network effects of this infrastructure would impede competition for alternatives that might better achieve the laudable goals the Libra White Paper has spelled out.

Incomplete Regulatory Governance

Libra would operate as a global currency in a highly fragmented regulatory environment defined largely by national boundaries. Most domestic regulatory regimes already struggle with applying the rules that have co-evolved with financial institutions and markets prior to the rise of crypto technologies to these new forms of financial intermediation. The regulatory framework's incompleteness offers ample opportunity for both digital and legal arbitrage.

Existing experience with attempts to regulate cryptocurrencies suggests that regulating Libra with the tools currently available would not be easy and might even be impossible. Depending on the purpose for which crypto assets are used or designed, a host of different regulatory regimes may be applicable, from securities and banking to anti-money laundering and e-money regulation (in the European Union). With the exception of e-money regulations, none was developed with cryptocurrencies in mind.

In the United States, the Securities and Exchange Commission (SEC) and the Federal Reserve have led the way in trying to interpret existing rules and regulations to these new assets. At the state level, several attempts have been made to issue new rules. For the most part, regulators have been reactive rather than proactive. They have interpreted the rules after the fact; that is, after scandals, such as the premature demise of The DAO, had come to their attention.

In a more proactive mode, the Federal Reserve released a report on "distributed ledger technology" (DLT) in 2016.³ However, the bulk of the report was devoted to the problem of banks moving into new technologies. For tech firms, such as Facebook, that are moving in the opposite direction, taking on traditional financial intermediary roles, the Federal Reserve had the following advice: they will "likely need to acquire some type of charter or license to provide services or conduct activities that involve the holding and transferring of assets and behalf of households and businesses."⁴

Private actors, however, have little incentive to seek out such licenses themselves. Some have paired up with existing regulated financial intermediaries to side step the issue. The only license that Facebook has obtained, through its subsidiary Calibra, is that of a "Money Services Business" under the Financial Crimes Enforcement Network (FinCEN). The plan to create wallets for customers to acquire and hold Libra in exchange for fiat money has not prompted Calibra to seek a banking license or regulation under the Securities Investment Protection Act.

³ "Distributed Ledger Technology in Payments, Clearing, and Settlement", Finance and Economics Discussion Series, 2016-95.

⁴ Ibid, p. 29.

The Federal Reserve clearly sensed the ambiguity of its own advice in the DLT report and sent a strong signal to legislatures and regulators to take charge. “The nature and form of such charters or licenses remains an open question as lawmakers and regulators may consider whether existing financial institution licenses are sufficient, or alternative licenses need to be developed.”⁵ After the publication of the Libra White Paper, Chairman Powell has reiterated the need for taking time and precaution.

The United States’ regulatory reach is, in principle, bounded by its own territory. Facebook and Calibra, Facebook’s subsidiary are U.S. companies. They therefore fall within the reach of U.S. laws and regulations, not however the Libra Association, Libra Networks and many other entities that would be part of the Libra ecology. To ensure effective supervision, the United States will therefore have to cooperate with other nations. Indeed, the forthcoming G-7 meeting will take up the issue of Libra.

By contrast, private parties can freely avail themselves of foreign law as Facebook has already demonstrated in choosing Swiss law for the Libra Association and for Libra Network, the limited liability company. We have not been told which law would govern the entity that will keep the Reserves. While one might suspect that at least one of the custodians who will manage the Reserves will be located in the United States, the White Paper has announced that they will be geographically and, by implication, jurisdictionally dispersed. U.S. law might still apply assets that traded on exchanges or otherwise connected to U.S. jurisdiction, but it will almost certainly not reach the entire Libra ecology.

Towards an Inclusive Global Payment System

The announcement of an imminent launch of a global payments system based on crypto technology indicates that we are on the cusp of a major transformation of money, payment systems, and finance. The new technology offers the potential for a low-cost, highly inclusive transnational, if not global, payment system that may well expand into other financial services.

Several experiments are already underway, including digital, phone-based payment systems in Africa and digital payment systems linked to trading platforms in China. The experience with these networks suggests that they can scale up fast. While the technical demands for scalability may have been met, important governance challenges remain. The preceding analysis of Libra’s governance architecture raises the specter that private agents will put their interests in maximizing profits and insulate themselves from liability and accountability over the public interest in the creation and maintenance of a truly inclusive global payment system. It is therefore time for legislatures in the United States and elsewhere to assess how the goals for such a system might best be accomplished.

⁵ Ibid.

Central bank-backed cryptocurrencies are one widely discussed alternative. So far, the central banks of most Western countries have hesitated to take this step. The reasons are telling and should be kept in mind when assessing Libra and similar ventures. Central bankers in the United States and Germany have voiced concerns about the transition costs associated with the introduction of central bank-based cryptocurrencies, not least the likely fallout for the existing banking system. In addition, they have highlighted the need for effective identity authentication to address money laundering issues and the like.

The introduction of a cryptocurrency may indeed have serious implications for retail banking beyond the payment system. Especially in countries with weak official currencies, a new cryptocurrency may soon become a substitute for retail banking deposits, depriving banks of resources for their credit operations. In short, a “run to digits” will have to be managed, and ultimately it will be the task of domestic regulators and central banks to do so, whether they introduce cryptocurrencies themselves or leave the task to private actors.

Facebook has already recognized the need for identify verification and announced that it would require government-issued identification cards. Indeed, if allowed to go forward, Facebook might become *the* provider of a global digital identity. The question before us is not whether such identities need to be created, but who shall do so: governments that are subject to democratic control, or private actors that can insulate themselves from any accountability.

Keep Big Tech Out of Finance Act Bill

I have also been asked to comment on a draft bill that aims to prohibit large platform utilities “from being a financial institution or being affiliated with a person that is a financial institution” (the Bill). In effect, the bill seeks to prevent Big Tech companies from controlling or being controlled by financial institutions. The list of such financial institutions is comprehensive and would include a branch or agency of a foreign bank.

The separation of deposit taking and payment systems from other financial activities, in particular investment banking, has a long history in the United States. The Bill would extend this separation to “large platform utilities” that operate an online market place or social network with an annual global revenue of \$25 billion or more.

This Bill would require important changes in the current architecture of Libra. It might force Facebook to separate itself from Calibra, its subsidiary, which has been registered as a money services business. Having said this, the same structure could be largely reconfigured contractually. As such, the Bill would be a “game slower,” not a “game stopper.” It would, however, give Congress as well as regulators, possibly under the leadership of the Financial Stability Oversight Council, some breathing space to deliberate about the best governance structure for cryptocurrencies and global payment systems.

Conclusion

The publication of the Libra White Paper has accelerated a debate that has long been coming: a debate about how to harness the opportunities and meet the challenges associated with fast-moving innovations in technology, including crypto technology. These technological changes are advancing simultaneously in many sectors of the economy. Money and finance may be thought of as the nervous system of the economy. Whoever controls this system wields enormous powers. How this power will be exercised, whose interests it will serve, and how it can be held accountable is of fundamental importance not only for the future of money and finance, but also for democratic self-governance.

I appreciate the opportunity to share my thoughts about this today and I look forward to your questions.