

# MOTHERHOOD AND HUMBLE PIE: SOME LESSONS FOR THE SEC

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The views that I will express today are my own and do not necessarily represent those of the Securities and Exchange Commission (SEC) or my fellow commissioners. Indeed, with respect to one particular issue I will be discussing today, my disagreement with my colleagues is sufficiently public and pronounced that it may not even warrant a disclaimer. I speak, of course, of my dissent (Peirce 2018) from the SEC's decision to reject an exchange-traded product that was designed to give investors access to bitcoin (SEC 2018a).

## A Free-Range CryptoMom

In response to my dissent, I was informally dubbed “CryptoMom.” I always have wanted to be a mother, so acquiring this new title was quite an honor. Admittedly, this is not the form of motherhood I envisioned, but one of the wonderful aspects of motherhood is that children are quite different than their mothers anticipated they would be.

If I were a mother, I suspect that I would be a free-range mother rather than a helicopter mom. A helicopter mother hovers over her child in order to ensure the child's success, although this strategy

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often backfires (Bayless 2013). A free-range mother, by contrast, encourages her child to explore with limited supervision, which requires the acceptance of a certain level of risk (Skenazy 2018). Japanese television affords us a real-life example of this type of parenting in a show called “My First Errand,” which portrays children—some under the age of five—going on errands alone (see Hones 2011). Episodes of the show are worth watching, not only for the inevitable laughter and tears they produce, but for the light they shed on the fact that risk taking is not inherently bad. To the contrary, certain achievements are possible only if we take risks.

It is often difficult for parents to realize this—particularly in affluent, Type A areas like D.C.—and understandably so: risks imply the possibility of harm, and most parents instinctively recoil from the possibility of their child getting hurt. But it is not just parents. We regulators have trouble with that concept as well. This discomfort is understandable—and not just because we live in D.C. and bring our helicopter parenting skills to work. No, the downside risk for the regulator is real: When investor risk taking leads to investor losses, regulators inevitably face criticism for allowing investors to take risks that, in hindsight, appear to have offered nothing but downside. We know what inevitably follows—a chorus of critics insisting that “If you, Ms. Regulator, had simply told people they were not allowed to engage in risky behavior, nobody would have gotten hurt!”

## The Regulatory Mindset

We know we will be blamed when something goes wrong, and this fear leads to a default suspicion of risk taking and a regulatory mindset that too often presumes that innovations designed to provide greater access to risk taking are threats, both to our reputations and investor safety. Better, we naturally think, not to allow the investor to leave the house, even for a quick trip down the street, unless properly helmeted, swaddled in regulation protective gear, and strapped into a vaguely European-branded car seat that is secured exactly in the center of the back seat of the largest SUV that an upper-middle class professional’s salary can buy. And thus we convince ourselves that nothing can go wrong, at least not until the little one graduates from the car seat and gets her license—but we tell ourselves that that’s still 30 years away.

The problem with such an approach, of course, is that something *will* go wrong. Something *always* goes wrong. Companies fail. Fraudsters cheat. Nature strikes. Market downturns happen. But the losses of prohibiting risk taking are also real. Even when we cannot readily measure them (or even *because* we often cannot measure them), these losses are potentially very threatening to investor welfare.

As a society, we readily recognize this reality in other areas. Take a commonly cited example in this regard—driving. Steering a speeding machine down the highway is an enormously complex and cognitively challenging task, one that is dangerous for drivers, passengers, and innocent bystanders. Permitting people to drive means people will be injured and, in too many cases, die. Outlawing driving would save lives, but the costs in terms of lost quality of life of doing so would be enormous, albeit difficult to quantify (see Ashenfelter and Greenstone 2002). Instead of banning it entirely, therefore, we place reasonable restrictions on driving. Some of us may decide to avoid risks the law allows us to take. A speed limit, after all, is not a mandate. Some of us may choose not to drive at night, in bad weather, or at all. But, barring bad behavior on our part, the choice is ours, not the government's.

It puzzles me that it is so difficult for those of us who regulate the securities markets to understand this concept; after all, capital markets are all about taking risk, and queasiness around risk taking is particularly inapt. A key purpose of financial markets is to permit investors to take risks, commensurate with their own risk appetites and circumstances, to earn returns on their investments. They commit their capital to projects with uncertain outcomes in the hope that there will be a return on their capital investment. The SEC, as regulator of the capital markets, therefore should appreciate the connection between risk and return and resist the urge to coddle the American investor.

Although helicopter parents convince themselves that they are “helicoptering” for the good of their children, such parenting sometimes seems to serve the needs of the parents more than the interests of their kids. Similarly, actions that we take at the SEC to protect the American investor may reflect a desire to reduce certain types of investor risk taking that may pose reputational damage to the Commission in the event of investor losses. But Congress did not ask us to guarantee that investors would never lose money. Nor did

Congress direct us to substitute our own investment judgment for that of investors. And certainly Congress has never suggested that avoiding or eliminating risk to the Commission should inform our approach to protecting investors.

## The SEC's Mandates and Cryptocurrencies

The SEC's statutory mandates are much more modest. We are directed to protect investors, facilitate capital formation, and maintain fair, orderly, and efficient markets. In my view, this threefold mission requires the Commission to ensure that investors have access to products and services that enable them to construct investment portfolios that meet their needs. Expanding investors' options and ensuring that they have the information necessary to evaluate those options enables them to build better portfolios—portfolios that may both reduce risks and produce better returns.

As the world becomes increasingly integrated, asset classes that were once uncorrelated grow more correlated (see Goetzmann, Li, and Rouwenhorst 2001).<sup>1</sup> This shift creates an appetite for new asset classes that can help to diversify portfolios. Cryptocurrencies may be one such asset class (see Trautman and Dorman 2018). As with all other products, investors need to exercise care and judgment in choosing whether and how to invest in crypto. Kleptocrypto is a new way of stealing from investors, but investors can protect themselves by exercising an old-fashioned dose of skepticism (see SEC 2018b).

Currently, investors access cryptocurrencies primarily through direct purchases of the relevant cryptocurrency. Buying, holding, and selling cryptocurrencies requires some technical know-how, carries with it recordkeeping headaches, and generally has to occur outside one's investment accounts.<sup>2</sup> This complexity means that only a very particular type of investor can pursue the diversification

<sup>1</sup>According to the authors, "Liberalization of global capital flows cuts two ways. It allows investors to diversify across borders, but it also reduces the attractiveness of doing so" (Goetzmann, Li, and Rouwenhorst 2001: 12).

<sup>2</sup>Michael Kaplan (2018) noted losses totaling approximately \$25 billion after bitcoin retrieval codes were lost or could not be accessed following the deaths of the holders.

opportunities such assets can provide. (I will not attempt to characterize this investor type, other than noting that, notwithstanding my CryptoMom title, that investor type does not include me.)

Entrepreneurs are developing new products through which people can access cryptocurrencies indirectly or hedge their cryptocurrency holdings. Bitcoin futures, for example, began to trade recently. Crypto-based securities have *not* yet begun to trade, though not for want of entrepreneurial effort.

It is clear that there is strong interest among some investors for this type of product, and innovators in the industry have made several attempts to respond to this interest. So far, however, the SEC has not shared these investors' enthusiasm.<sup>3</sup> To date, the SEC has stopped all such retail products from getting to market. To shift my metaphor a bit, the SEC helicopters in with good intentions, but often without sufficient concern for the way its regulatory blades roil the markets, frustrate innovation, and potentially expose investors to greater risks.

Consider first the SEC's recent decision to deny an exchange's bid to list shares of the Winklevoss Bitcoin Trust.<sup>4</sup> I dissented from the disapproval because it seemed to turn on the Commission's assessment of bitcoin rather than on the exchange's plans for trading the exchange-traded product. The Commission's order included an assurance that the "disapproval does not rest on an evaluation of whether bitcoin, or blockchain technology more generally, has utility or value as an innovation or an investment."<sup>5</sup> The order, however, seemed to do almost that. It focused on the alleged flaws with bitcoin markets, rather than on whether the exchange proposing to trade shares of the trust had taken steps to ensure the orderly trading of those shares.

The focus on the lack of regulation of cryptocurrencies particularly troubled me. What authority do we have to require that assets

<sup>3</sup>Nonregulators are not uniformly enthusiastic either, but there is plenty of room in our marketplace for diverse opinions (see, e.g., Dowd and Hutchinson 2015).

<sup>4</sup>See "Order Setting Aside Action by Delegated Authority and Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to List and Trade Shares of the Winklevoss Bitcoin Trust" (July 26, 2018), 83 *Fed. Reg.* 37579 (Aug. 1, 2018).

<sup>5</sup>*Id.* at 37580.

underlying securities be regulated as if they were securities? Even if we had this authority, private markets can and do regulate themselves. The crypto community includes lots of people who are very willing to speak up, criticize one another, and bring to light technological, corporate governance, and other perceived weaknesses in cryptocurrencies.<sup>6</sup> Although not formal regulation, this kind of market discipline can be valuable in identifying problems. In addition to this self-policing, there have been discussions about setting up self-regulatory organizations (see, e.g., *Business Wire* 2018). The Commission should not default to a demand that the crypto markets be subject to comprehensive government regulation as a precondition to allowing products linked to those markets to be traded in markets that we regulate.

This leads me to my second disclaimer: I am a lawyer and, now, a regulator; although this may sound redundant, I am not an innovator. I am not a technologist or trader. I certainly do not have the capacity to assess the likelihood of any cryptocurrency's marketplace success, or more generally the prospects of any innovation, financial or otherwise. I worry, however, that the Commission's focus on perceived weaknesses and vulnerabilities of bitcoin implies that we *do* have this capacity.

As I explained in my dissent, our approach creates the very real risk that investors might conclude—reasonably, but incorrectly—that any exchange-traded product approval means that we have done due diligence on the underlying asset and the markets in which it trades and that the exchange-traded product or the underlying asset carries our imprimatur (Peirce 2018). We never do the investor's analysis for her. Implying that we do does nothing to advance investor protection. The investor contemplating putting her money at risk needs to conduct her own due diligence.

These issues will continue to arise as long as investor interest persists—and that interest shows no sign of fading. The Commission has before it more requests from exchanges seeking to trade products

<sup>6</sup>See, e.g., “Unchained Podcasts,” available at <http://unchainedpodcast.co>, and “Appetite for Disruption: The Business and Regulation of FinTech Podcasts,” available at <https://itunes.apple.com/us/podcast/appetite-for-disruption-business-regulation-fintech/id1190934515?mt=2> (shedding light on the diverse views within the crypto community).

tied to bitcoin or bitcoin futures. Last month, the Commission staff, exercising delegated authority and applying similar reasoning to that used in the Winklevoss order, disapproved nine such products, all of them exchange-traded funds that were based on bitcoin futures.<sup>7</sup> The Commission is reconsidering that decision.<sup>8</sup>

Meanwhile, the SEC has suspended U.S. trading in two Swedish products tied to bitcoin<sup>9</sup> that were being quoted in the United States on OTC Link. The SEC suspended trading because there was confusion about exactly what these products are; they were not being described consistently.

<sup>7</sup>Self-Regulatory Organizations; Cboe BZX Exchange, Inc.; Order Disapproving a Proposed Rule Change to List and Trade the Shares of the GraniteShares Bitcoin ETF and the GraniteShares Short Bitcoin ETF, Exchange Act Release No. 83913 (August 22, 2018), 83 *Fed. Reg.* 43923 (August 28, 2018), available at [www.sec.gov/rules/sro/cboebzx/2018/34-83913.pdf](http://www.sec.gov/rules/sro/cboebzx/2018/34-83913.pdf); Self-Regulatory Organizations; NYSE Arca, Inc.; Order Disapproving a Proposed Rule Change to List and Trade the Shares of the ProShares Bitcoin ETF and the ProShares Short Bitcoin ETF, Exchange Act Release No. 83904 (August 22, 2018), 83 *Fed. Reg.* 43934 (August 28, 2018), available at [www.sec.gov/rules/sro/nysearca/2018/34-83904.pdf](http://www.sec.gov/rules/sro/nysearca/2018/34-83904.pdf); Self-Regulatory Organizations; NYSE Arca, Inc.; Order Disapproving a Proposed Rule Change Relating to Listing and Trading of the Direxion Daily Bitcoin Bear 1X Shares, Direxion Daily Bitcoin 1.25X Bull Shares, Direxion Daily Bitcoin 1.5X Bull Shares, Direxion Daily Bitcoin 2X Bull Shares, and Direxion Daily Bitcoin 2X Bear Shares Under NYSE Arca Rule 8.200-E, Exchange Act Release No. 83912 (August 22, 2018), 83 *Fed. Reg.* 43912 (August 28, 2018), available at [www.sec.gov/rules/sro/nysearca/2018/34-83912.pdf](http://www.sec.gov/rules/sro/nysearca/2018/34-83912.pdf).

<sup>8</sup>See Notification of Commission Review of Order Disapproving a Proposed Rule Change to List and Trade the Shares of the GraniteShares Bitcoin ETF and the GraniteShares Short Bitcoin ETF, Exchange Act Release No. 83913 (August 22, 2018), available at [www.sec.gov/rules/sro/cboebzx/2018/34-83913-letter-from-secretary.pdf](http://www.sec.gov/rules/sro/cboebzx/2018/34-83913-letter-from-secretary.pdf); Notification of Commission Review of Order Disapproving a Proposed Rule Change to List and Trade the Shares of the ProShares Bitcoin ETF and the ProShares Short Bitcoin ETF, Exchange Act Release No. 83904 (August 22, 2018), available at [www.sec.gov/rules/sro/nysearca/2018/34-83904-letter-from-secretary.pdf](http://www.sec.gov/rules/sro/nysearca/2018/34-83904-letter-from-secretary.pdf); Notification of Commission Review of Order Disapproving a Proposed Rule Change Relating to Listing and Trading of the Direxion Daily Bitcoin Bear 1X Shares, Direxion Daily Bitcoin 1.25X Bull Shares, Direxion Daily Bitcoin 1.5X Bull Shares, Direxion Daily Bitcoin 2X Bull Shares, and Direxion Daily Bitcoin 2X Bear Shares Under NYSE Arca Rule 8.200-E, Exchange Act Release No. 83912 (August 22, 2018), available at [www.sec.gov/rules/sro/nysearca/2018/34-83912-letter-from-secretary.pdf](http://www.sec.gov/rules/sro/nysearca/2018/34-83912-letter-from-secretary.pdf)

<sup>9</sup>See Trading Suspension, Exchange Act Release No. 84063 (September 9, 2018), available at [www.sec.gov/litigation/suspensions/2018/34-84063.pdf](http://www.sec.gov/litigation/suspensions/2018/34-84063.pdf).

## Five Lessons

In reflecting on these rapidly developing series of events just in the few months since I took office, I see at least five lessons for us at the SEC. Learning these lessons might make us more nimble in dealing with fintech innovations that are intended to create more opportunities for investors to gain exposure to our markets.

First, because most of us regulators are neither entrepreneurs nor technologists, we should respond to attempts to bring innovative solutions into the financial markets with an appropriate degree of humility. We should avoid the temptation to supplant the market's product testing with our own. We will seldom be able to identify viable innovations with any certainty *ex ante*, and it may in fact be impossible to ascertain the benefits and risks of new technologies and products in advance of their release. We should resist the temptation to treat uncertainty as a disqualifier, and we should welcome the opportunity for investors to determine the value of these innovations for themselves in our regulated markets, where they can benefit from the transparency and rules that govern market interactions.

Second, as investor interest in the Swedish cryptocurrency products demonstrates, our efforts to protect investors from the risks of innovative financial technologies are not likely to quell their desire for those technologies. In my dissent, I noted the benefits of institutionalizing the bitcoin market, and I continue to believe that, increasingly, the Commission will be faced with a choice: either create space for innovations to occur in our regulated markets or prepare for investors to seek out such innovations in less-regulated, or unregulated, spaces, such as foreign-registered products that lack the transparency that trading under our rules would provide.

Third, an essential step to encouraging innovations in our markets is to provide innovators with greater clarity and certainty in their interactions with the Commission and its staff. Innovators are often reluctant to ask for regulatory permission for fear of getting an adverse response. Even worse, perhaps, is getting no response at all or an unclear response. Certainty and predictability are important aspects of a pro-innovation environment. In the complex regulatory world we have constructed, clarity does not come easily. Frankly, sometimes our processes can be mystifying even to those who practice before us, much less to entrepreneurs who may realize only late in the game that they are working in a regulated space.



For example, the recent announcement that the Commission would be reviewing the staff's decisions with respect to the nine bitcoin-related products introduced the crypto world to a nuance of the SEC's operations that escapes the notice of many seasoned administrative law scholars—it is the agency's commissioners, not the staff, who have the final say. We have delegated some functions to the staff, but one or more commissioners can decide to reconsider an action the staff has taken by delegated authority.<sup>10</sup> Although this structure makes sense, it may have better served the interests of clarity if the Commission had been able to make the decision in the first instance. Similarly, with respect to the suspended Swedish crypto products, in my view it would have served the market better if we had resolved any investor confusion *before* they started trading here. More generally, we can and must do better by providing clear, reasonable rules for innovators.

Fourth, our investor protection role needs to incorporate a commitment to expanding investor access to our financial markets, including through innovative technologies. Technology offers to financial markets benefits similar to those it offers in other spheres. People with disabilities have reaped the benefits of technologies such as better wheelchairs and 3D printable prosthetics. Many technological advances designed to address the needs of those with disabilities revolutionize access for everyone. Screen readers that enable those with impaired vision to access the internet can be used by others who want to have something read to them while driving or cooking.

Financial technology can open similar doors. The ability of investors to access their accounts from their cellphones has made investing more convenient. Financial firms are looking for ways to improve the mobile experience so that investors *want* to spend time thinking about investing. Online disclosure makes layered disclosures possible, which allows investors to dig deeper when they want information about a particular aspect of an investment product or service. Digital advice is improving access for investors who live in areas served by few financial professionals. New technology is opening investment to people with so little money to invest that they may not be a sought-after group of clients for traditional financial firms. We want these people to invest in our markets, and fintech makes

<sup>10</sup>See 17 C.F.R. § 201.431 (2018).

it possible. Fintech offers important benefits to small companies too by, for example, providing online platforms for raising capital. Technological change in the financial markets space has the potential to be as revolutionary as it is in other aspects of our lives.

Fifth, although we regulators have very different roles from technological innovators, we will play a role in just how revolutionary financial technology becomes in our markets. If we do not become more comfortable with risk, our helicoptering may so burden fintech innovations that they begin to lumber along at a regulatory pace. In addition, because the financial markets are so heavily regulated, a lot of firms' resources—including valuable coding and data analysis resources—go to meeting regulatory demands.

Every rule carries with it an information technology commitment, which means that smart minds are unable to concentrate on customer-serving innovation. In addition to rules, regulatory demands for information also eat up information technology resources. Because innovation is crowded out by such regulatory investments, particularly at the smaller firms that often serve as incubators for this innovation, regulators need to think about these costs as part of the decision to impose new rules or new data demands. Finally, existing rules combined with a strict liability approach to enforcement can scare firms away from innovating. For example, a number of retail financial services firms have exciting ideas about how to communicate with investors more effectively, but the SEC's rules are too inflexible to allow these ideas to be tested on investors, let alone to be introduced into the marketplace.

One partial remedy to this last problem is to allow firms more flexibility to test new approaches. We have processes in place for providing exemptive relief and something called no-action relief, which promises that the staff will not recommend an enforcement action on a certain set of facts. These processes are too formal and too expensive for firms to use every time they want to try out a new disclosure format. Advocates of regulatory sandboxes hope that they are the answer, but I fear these too would be too inflexible and slow to match the speed of innovating minds. We could instead explore ways to allow firms to self-certify that their fintech experiments are consistent with the spirit of regulatory obligations.

Elsewhere I have called for an Office of Innovation at the SEC, not to do the innovation, but to help the innovators navigate the SEC's complicated processes. At a Cato conference, however, I do

not dare spend much time on a suggestion that involves more bureaucracy.

There is an increasing awareness among financial regulators about the importance of making room for fintech to improve the quality of financial services and people's ability to access those services. For example, the Department of Treasury issued a report in the summer of 2018 that focused on financial technology and innovation. The report recognizes that "innovations in financial technology expand access to services for underserved individuals or small businesses and improve the ease of use, speed, and cost of such services" (U.S. Department of the Treasury 2018: 6). Other federal regulators such as the Commodity Futures Trading Commission, the Bureau of Consumer Financial Protection, and the Office of the Comptroller of the Currency are making concerted efforts to accommodate innovation.<sup>11</sup>

### Conclusion

The technological revolution the financial industry is experiencing now is very exciting. New asset classes like cryptocurrencies and new ways for financial companies to communicate with investors are likely to make our world look very different 10 years from now than it did 10 years ago. As a regulator—and one who is not adept with new technology—humility is, as I have noted, important. I do not know which technologies will succeed and fail. It is not my job to assess the relative merits of different products and services. Humility is also important as we think about how our attitudes and

<sup>11</sup>See Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Launches LabCFTC as Major FinTech Initiative (May 17, 2017), available at [www.cftc.gov/PressRoom/PressReleases/pr7558-17](http://www.cftc.gov/PressRoom/PressReleases/pr7558-17) ("LabCFTC is the agency's focal point to promote FinTech innovation and fair competition by making the CFTC more accessible to FinTech innovators and serving as a platform to inform the CFTC's understanding of new technologies."); Press Release, Bureau of Consumer Fin. Prot., BCFP Collaborates with Regulators Around the World to Create Global Financial Innovation Network (August 7, 2018), available at [www.consumerfinance.gov/about-us/newsroom/bcfp-collaborates-regulators-around-world-create-global-financial-innovation-network](http://www.consumerfinance.gov/about-us/newsroom/bcfp-collaborates-regulators-around-world-create-global-financial-innovation-network); Press Release, U.S. Dep't of the Treasury, Office of the Comptroller of the Currency, OCC Issues Responsible Innovation Framework (October 26, 2016), available at [www.occ.treas.gov/news-issuances/news-releases/2016/nr-occ-2016-135.html](http://www.occ.treas.gov/news-issuances/news-releases/2016/nr-occ-2016-135.html) (announcing the creation of the Office of Innovation focused on responsible innovation).

processes need to change to make the United States a comfortable home for the next generation of innovators.

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