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Bipartisan Bill Advances Cryptoasset Regulatory Discussion

A bipartisan bill introduced by Senators Lummis and Gillibrand on June 7 (summarized here) lays a legislative foundation for an important and timely discussion regarding several key gaps that we have written about in the regulation of cryptoassets (see here and here). Certain measures in the bill are likely to raise concerns, including its provision for seemingly guaranteed access to Federal Reserve accounts for banking institutions that are not federally insured. The timing of this provision is particularly acute in light of Custodia Bank's recent lawsuit against the Federal Reserve to try to compel it to grant account access. While it remains to be seen whether the bill will garner broad political support as midterm elections approach, and President Biden's Executive Order on Digital Assets also calls for regulatory measures still to come, the bill attempts to address a host of challenges posed by cryptoassets' rapid proliferation, including:

1. *Stablecoin stability*. As recent events make clear, while stablecoins are designed to maintain a stable, fiat-linked value, this increasingly common cryptoasset implicates important questions of systemic risk and consumer protection. The bill proposes a regulatory framework that provides for the issuance of stablecoins by depository institutions and other supervised entities, subject to the relevant regulatory approval or requirements. It would make stablecoins fully redeemable for fiat currency by customers on demand. Issuers of stablecoins would be required to maintain 100% high-quality liquid reserves, which may include U.S. treasury securities, insured bank deposits, funds held in a Federal Reserve account, or other assets as determined by the appropriate federal or state banking agency. Note that traditional depository institutions issuing stablecoins are subject to even stricter reserve requirements and, in a resolution scenario, stablecoin holders would have priority over uninsured depositors and creditors. While these measures would provide a high degree of certainty that stablecoins maintain their face value during market volatility or even in the case of an issuing bank's failure, they also pose several practical issues. For instance, open questions include why banks would issue stablecoins even though they are subject to strict 100% reserve requirements; whether banks would confront deposit attrition if customers' funds enjoy stronger protections when held in stablecoins as compared to uninsured deposits; and whether traditional lending would be impaired by functionally staunching a deposit source.

2. *Regulatory framework for cryptoassets*. There has been significant uncertainty about who regulates cryptoasset issuers and cryptoassets themselves, as well as the oversight roles of different agencies. The bill aims to clarify the instances in which a cryptoasset is considered a security and to delineate the respective responsibilities of the SEC and the CFTC:

First, under the bill, some cryptoasset issuances would continue to be subject to SEC requirements for securities offerings. The bill does not disturb the principle that the initial sale of a cryptoasset, such as an "initial coin offering," may constitute an investment contract[1] that must either be registered under the Securities Act of 1933 or fit into an exemption.

[1] Whether a cryptoasset is issued pursuant to an "investment contract" is determined based on the so-called *Howey* test, which evaluates whether the sale constitutes an investment of money in a common enterprise with an expectation of profits from the efforts of others.

Second, the bill defines as "ancillary assets" certain cryptoassets that are sold pursuant to an investment contract yet lack traditional indicia of securities (*i.e.*, ancillary assets are cryptoassets without securities hallmarks such as debt, equity, liquidation rights, entitlement to dividends, or profit interests derived from managerial efforts). Under the bill, these ancillary assets would be presumed to be commodities and thereby regulated primarily by the CFTC rather than the SEC. This distinction relies on the notion that many cryptoassets themselves — as opposed to the schemes by which they are sold — do not constitute securities. While this allocation of responsibility would provide needed clarity for spot markets, the breadth of the allocation might spill into the territory of other regulators for matters traditionally within their purview.

3. *Periodic disclosure requirements for cryptoassets.* The bill recognizes that, unlike physical commodities, cryptoassets bear highly variable and technical characteristics, may rely heavily on the efforts of central developers, and pose distinct risks to investors. Accordingly, the bill proposes disclosure requirements for any ancillary asset (above a certain value threshold) for which an issuer or 10% holder is engaged in entrepreneurial or managerial efforts that primarily determine the value of the ancillary asset. As long as the ancillary asset has those criteria, its issuer would be required to file semiannual SEC disclosures appropriately tailored to reflect issuer- and asset-related information that is material in the cryptoasset context. This bears some analogy to the SEC's specialized reporting regime under Regulation AB for asset-backed securities. Potential challenges posed by the bill include the lack of a reporting requirement in respect of current events (analogous to Form 8-K), the difficulty with determining whether there exists an issuer or 10% holder engaged in triggering entrepreneurial or managerial efforts, and the lack of coverage for investable cryptoassets that are not sold pursuant to an investment contract but that may not be truly decentralized.

4. *Supervision of cryptoasset exchanges*. U.S. spot cryptoasset exchanges to date have been subject to neither SEC nor CFTC supervision, which has been an issue noted by the SEC in its review of spot bitcoin ETFs. The bill addresses this gap by having the CFTC regulate markets in "ancillary assets," consistent with the view that ancillary assets are not themselves securities. Issues unaddressed by the bill include in what manner decentralized cryptocurrency exchange protocols may be subject to regulation, and how authority would be allocated between the SEC and CFTC with respect to cryptoasset exchanges that make a market in both ancillary assets and securities.

5. *Consumer protection*. The proposed disclosure obligations and supervision of cryptoasset exchanges discussed above are aimed squarely at enhancing consumer protections in the cryptoasset space. In addition, the bill would require companies that facilitate cryptoasset lending and borrowing to disclose clearly the scope of permissible transactions that may be taken with their customers' assets. Such a service provider would also need to identify clearly whether customer assets are segregated and how the assets would be treated if the provider becomes insolvent. A notable regulatory gap remains in the treatment of customer assets held in custody. While the bill provides an 18-month period for the SEC to modernize its cryptoasset custody rules, this is a real-time issue for institutions and consumers alike. Confronting these complex issues of consumer protection will require engagement not only from legislators, but also from regulatory agencies and industry participants.

6. *Regulatory coordination*. The U.S. cryptoasset market has suffered for years from a lack of coordination among regulators at all levels of government and an associated lack of clarity for market participants, which together have threatened U.S. leadership over this increasingly offshored arena. The bill proposes to enhance coordination and clarity by, among other things, promoting uniform treatment of digital assets under state money transmittal laws and by requiring federal regulators to respond to a substantive written request for guidance within 180 days. In the spirit of supporting coordination and consistency, we believe several fundamental issues merit further study. For instance, if the CFTC has exclusive jurisdiction over any agreement or transaction involving a contract of sale of a digital asset in interstate commerce, it is unclear whether its decisions apply to all activities that fall within the scope of its jurisdiction and uncertain what the impact will be on institutions that are subject to multiple licensing regimes. There are also questions of state reciprocity and harmonization, matters plainly relevant in the wake of the New York State Department of Financial Services' recent enforcement actions and new stablecoin guidance.

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For all its broad coverage (a complete summary of which is beyond the scope of this memorandum), the bill does not address some important regulatory and legal challenges posed by cryptoassets' growth, including when and how decentralized financial applications should be regulated, the relationship between regulatory authorities and decentralized autonomous organizations (DAOs), and the proper accounting for cryptoassets on corporate balance sheets. But despite inevitable gaps, and a long and uncertain legislative road ahead, the bill's introduction is a positive development in finally providing the basis for a substantive and technologically sophisticated debate on critical issues affecting U.S. leadership over a growing industry with millions of consumers.

Kevin S. Schwartz
Rosemary Spaziani
David M. Adlerstein
David E. Kirk
I. Andrew Mun
Amanda M. Lee