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Enhancing Cryptoasset Industry Regulation Using Existing Tools

For all the press lamenting the "crypto winter" and urging long-term legislative overhaul, there has not been sufficient attention to how existing regulatory tools can be employed to address some of the key risks and vulnerabilities in the current crypto landscape. Industry leaders and regulatory authorities should engage with open minds and a willingness to discuss practical actions to mitigate current risks in the system while comprehensive legislation may yet be years away. In particular, we recommend that U.S. financial regulators consider the following measures — most of which would not require new federal legislation — to promote innovation and U.S. industry leadership while ensuring the appropriate protection of consumers:

1. *Clarify the rights of customers relying on an intermediary to hold their cryptoassets.*

Any company that holds cryptoassets for customers should clearly state the capacity in which it holds the assets — whether it is (a) as principal (meaning the customer has transferred ownership and, while having a right to the value of the assets, is an unsecured creditor in the event of the company's bankruptcy); (b) as regulated custodian (meaning the assets are held by a regulated financial institution responsible for safekeeping); or (c) in unregulated intermediary capacity, as governed by contract law. The rights of the customers in the first two scenarios are manifestly established: in the first, the customer is fully exposed to the risk that the holder of assets may default (which raises other consumer protection and disclosure concerns); and in the second, the custodied assets belong to the customer under existing regulations.

The third scenario, however, currently presents an important gap in the law. One solution would be the adoption of proposed amendments to the Uniform Commercial Code ("UCC") to separate retail investor assets from bankruptcy estate assets, thereby preventing the commingling of assets deposited for purely custodial purposes with assets deposited through a yield-bearing product with the understanding that the custodian will use the collateral (i.e., rehypothecation). The proposed amendments would make clear that a customer retains ownership of cryptoassets that are held by a securities intermediary, such as an unregulated custodian (subject to satisfaction of certain requirements). Moreover, by introducing a new category of "commercial electronic records," the proposed amendments would recognize property rights over a variety of digital assets, including the ability to gain/retain control of deposited collateral by way of holding the private keys associated with the assets. These clarifications would foster increased consistency in commercial disputes, such as ownership battles over liquidated assets. Another virtue of such a change would be that it might encourage the SEC to consider whether its 2022 accounting bulletin is still necessary.

2. *Confront the reality of what the classification of cryptoassets as securities means.*

For years, the bulk of the cryptoasset regulatory conversation has stopped at whether cryptoassets — other than those bearing clear indicia of equity or debt — are securities or commodities. The practical reality is that if, as some argue, a large segment of cryptoassets will be deemed to be securities, then under the prevailing rules applicable to U.S. securities the cryptoasset market would lack a navigable path for functional compliance. Many features of the

prevailing securities regulatory regime are simply incompatible with the operation of digital assets markets, making immediate compliance without reforms functionally impossible. In particular, to the extent particular cryptoassets may be found to be securities:

- Required disclosures for cryptoassets should be revisited. SEC-mandated disclosures are geared toward traditional equity and debt securities, focusing on material information regarding the issuer, its management, and its financial results. Disclosure requirements for cryptoassets should be tailored to address context-specific information that is material to an investor's decision-making, such as the asset's distinct characteristics, token-level governance rights, and risk management measures (such as audits on smart contract protocols). Relatedly, the SEC could enhance the transparency of centralized providers of some cryptoasset yield-bearing products, while still allowing them to operate, by requiring SEC registration and tailored, crypto-specific disclosure requirements.

- The role of transfer agents should be reconsidered. Cryptoasset ownership is recorded on a blockchain, rather than in the records of a third-party intermediary. But existing rules do not clearly define whether blockchain-based records could supplant a transfer agent's records, including the official holder registry. The definition and role (if any) of a transfer agent should be revisited to ensure clarity in this context and to enable any technical changes to the way participants transact.

- Custody and execution rules should be modernized. Traditional custody rules for securities do not allow for flexibility on how trades are executed and processed. The SEC should consider modernizing custody rules applicable to cryptoassets to account for unique features such as instantaneous trade execution, which may render traditional clearing models unnecessary for particular cryptoassets. These rules should be clarified to ensure that participants understand what is expected of them.

3. *Recognize the existing authority for stablecoins to be issued by banks as representative of actual deposits or to be issued by registered money market funds.*

Stablecoins offer a conduit for transaction activity that leverages the efficiencies of blockchain technology but with the value stability of fiat money. The simplest paradigm for stablecoins, as noted in the President's Working Group for Financial Market's Report on Stablecoins, is for regulated banks to accept deposits and to issue stablecoins solely as a digital representation of such deposits. Transfers of stablecoins would be effected on a blockchain, with unique client identifiers to enable the banks to reconcile the payments in customer deposit accounts. The banks, in turn, would be responsible for settling any interbank movements of underlying deposits through traditional payment channels. Similarly, the issuance of stablecoins by trust companies subject to prudential regulator oversight remains a viable option for a number of use cases. While the relevant stablecoins may be used for different purposes, both structures chart a path forward for tokenized fiat to be used on the blockchain without sacrificing existing financial system protections.

An alternative regulatory structure could require that stablecoin issuers register as money market funds, and be regulated as investment companies under the Investment Company Act of 1940. While this may be a suitable path for issuers that do not wish to rely on regulated financial

institutions, it would require additional disclosures (as is required for all mutual funds) to ensure consumers understand the risks. We are not suggesting that these are the only options, but they are options that have clear paths for implementation.

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These are but a few examples of practical applications of existing regulatory powers that may help support innovation in the nascent cryptoasset industry while enhancing protection for consumers. Industry leaders and financial regulators should collaborate to identify balanced solutions that make better use of the existing regulatory toolkit rather than await comprehensive federal legislation.

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