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In This Issue

The 2023 Outlook for Crypto Legislation: What's In and What's Missing from Current Proposals

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The 2022 crypto market turmoil has elicited a growing recognition of the need for legislation to remove ambiguity as to who should regulate different types of crypto asset activities and how.

The lack of a clear regulatory framework has reinforced crypto's "permissionless innovation" ethos, reminiscent of the "move fast and break things" mentality often ascribed to Silicon Valley tech upstarts. Permissionless innovation coupled with regulatory uncertainty certainly helped the sector get off the ground—developing an entirely new asset class and technology that reached a peak market value of almost $3 trillion in roughly a decade is no simple feat. But the spectacular collapse of several large and well-known market participants, and the resulting harm to consumers, makes clear that sound regulation is imperative. A clear regulatory framework that accommodates the unique attributes of crypto assets—while still promoting the ultimate goals of traditional financial regulation—would facilitate a new stage of *responsible* innovation. It would also promote a safer integration of crypto assets and their underlying blockchain technology with traditional financial participants like banks and broker-dealers.

A number of legislative proposals have already been introduced in Congress. More are expected to come, and while none are likely to be enacted in their current form, experience tells us that today's proposals will provide the building blocks for what ultimately becomes law.

The proposals released to date would tackle several issues important to financial market participants, but many pressing challenges remain unresolved. A discussion of every consideration that should be included in a future crypto regulatory framework is well beyond the scope of this article. Instead, this article focuses on the practical significance of four of the leading legislative proposals released to date and flags two key topics that are inadequately addressed by the proposals: questions related to crypto assets' classification as a security and their custody.

(Continued on page 2)

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Route to: ❑ Audit ❑ Compliance ❑ Legal ❑ Risk Management ❑ Back Office ❑ Training

2023 Outlook for Crypto Legislation

Continued from Page 1

Consensus on payment stablecoins is emerging

Stablecoins are a type of crypto asset intended to have a stable value relative to a reference asset—say $1. The legislative proposals focus on a subset of stablecoins, typically called "payment stablecoins," that are designed to serve as crypto-native cash equivalents. Despite the name, payment stablecoins so far have served primarily as an on- and off-ramp between the fiat and crypto markets, not for typical payments. Payment stablecoins today represent one of crypto's most direct connections with the traditional financial markets and are accordingly high on the legislative agenda. Payment stablecoins' relatively well-defined nature, potential financial stability considerations related to how they are backed with reserves and Congress's relatively greater understanding of their risks and benefits make payment stablecoin-focused legislation the most likely form of crypto legislation to be enacted in the near term.

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Two of the leading payment stablecoin-focused bills receiving attention are since-retired Sen. Toomey's updated Stablecoin TRUST Act of 2022 and the unnamed and unofficial discussion draft of a Waters-McHenry stablecoin bill. Both bills, like others released before them, are similar in most material respects. While the President's Working Group on Financial Markets recommended that Congress restrict firms that are not insured depository institutions (**IDIs**) from issuing stablecoins, neither bill would do so. Indeed, the Waters-McHenry bill would *prohibit* IDIs themselves from issuing payment stablecoins, instead requiring IDIs interested in issuing payment stablecoins to form a subsidiary from which it issues the coins (the Toomey bill would permit, but not mandate, issuance by an IDI). Both would require issuers to hold a reserve of high-quality, liquid assets at least equal to 100% of the aggregate face value of outstanding coins and disclose the composition of the reserve on an ongoing basis. They would also subject issuers to varying degrees of bank-like supervision (even for non-IDI issuers), grant coin holders structural priority over the claims of the issuer's other creditors and permit state-regulated issuers. They differ, however, in whom they would hand primary federal oversight over nonbank stablecoin issuers: Toomey's bill chooses the OCC while the Waters-McHenry bill selects the Federal Reserve.

Enactment of a bill could facilitate greater mainstream adoption of payment stablecoins. Such adoption would likely include a greater role in day-to-day payments, but could also extend to other economic activities, such as for purchasing traditional securities through a broker-dealer.

Even if payment stablecoin legislation is enacted, there would still be questions around related types of crypto assets. One example concerns the various categories of "decentralized" and "algorithmic" stablecoins, which seek (though in some cases have spectacularly failed) to maintain a stable value through self-executing smart contracts and/or using other crypto assets as collateral, rather than a centralized issuer and fiat-denominated reserves. It is also not entirely clear how the regulation of payment stablecoins might interact with the potential for a future in which tokenized demand deposits issued by IDIs, also known as "deposit coins," become mainstream.

Comprehensive market regulation poses tougher challenges

A comprehensive regulatory framework for the broader crypto asset markets is a more daunting task and reaching a consensus will likely prove more challenging. Two of the most significant legislative proposals are the Lummis-Gillibrand Responsible Financial Innovation Act (the **RFIA**) and the Digital Commodities Consumer Protection Act of 2022 (the **DCCPA**) (the latter of which, however, has the scarlet letter of having been supported by former FTX CEO Sam Bankman-Fried). Each bill would establish a comprehensive regime for the regulation of crypto asset trading activities. Of the two, the RFIA is broader in scope, also covering matters such as payment stablecoins, tax and banking laws.

Each bill would be more effective if it squarely addressed two fundamental issues that are holding back the responsible, broad-based adoption of crypto assets: questions relating to crypto assets' legal classification (i.e., as a security or not?) and custody.

Is it a security? And if so, then what?

As a threshold matter, and as our colleague has argued, there are strong arguments that crypto assets should not be subjected to the existing security/commodity dichotomy. But the leading legislative proposals do not grapple with this fundamental question. Rather, each bill purports to hand primary market oversight authority to the CFTC rather than the SEC, while nonetheless leaving enough room for the SEC to maintain its current position that the vast majority of crypto assets are in fact securities and thus still subject to SEC jurisdiction. Clearly resolving this emerging turf war should be at the top of Congress's list as it considers how to regulate crypto assets.

A leaked markup of the DCCPA reported by the press in October 2022 included a consultation process between the CFTC and SEC to consider a crypto asset's status before a new

(Continued on page 3)

2023 Outlook for Crypto Legislation

Continued from Page 2

"digital commodity" could be listed for trading. Unfortunately, there was no mechanism to require a formal determination or even an agreement between the CFTC and SEC at the conclusion of such consultation. And given that the bill expressly excludes any "security" from the definition of "digital commodity," without making any changes to the definition of "security," the lingering uncertainty for every crypto asset other than Bitcoin and Ether (which are explicitly defined as digital commodities in the bill) would almost certainly continue.

The RFIA would introduce the concept of "ancillary assets" that would permit a crypto asset to be sold pursuant to an investment contract (i.e., a securities offering) without the crypto asset itself being deemed a security. This approach would effectively codify the position that simple agreements for future tokens (**SAFTs**) and similar contracts pursuant to which crypto assets are sold may be investment contracts and thus securities, but that the underlying crypto assets are not necessarily—somewhat similar to how the underlying orange groves in *SEC v. W.J. Howey Co.* were not themselves securities.

But the RFIA would still perpetuate undue reliance on the highly subjective *Howey* test. Excluded from the definition of "ancillary asset" is any asset that gives its holder a "profit or revenue share" in an entity "solely from the entrepreneurial or managerial efforts of others." "Profits," according to the SEC's interpretation of *Howey*, can come in many forms, including capital appreciation. And the SEC staff has stated that "efforts of others" can come from any "active participant," even if not the original promoters. A crypto asset that might appreciate in value from those efforts might therefore be treated as a security, not an ancillary asset, under the RFIA.

If Congress decides that certain crypto assets should be regulated by the SEC, supplanting *Howey* with a clear and replicable test for determining which crypto assets fall within the SEC's jurisdiction would only be the first step. To the extent the SEC regulates crypto-assets, Congress should also direct the SEC to comprehensively update its rules in a way that could accommodate the regulation of crypto assets as securities—a task the SEC has not yet meaningfully taken on. Token registration and disclosure requirements, for instance, should be rethought for an asset class that differs meaningfully from stock and bonds—as just one example, crypto assets typically do not represent a claim on the earnings or assets of a business enterprise. Moreover, the myriad technical rules that undergird the traditional securities market structure would also have to be rethought to address the novel characteristics of public, permissionless blockchains and tokenized assets.

What custody requirements apply to crypto assets? What are the financial consequences for custodians?

Another important question is how customers' crypto assets should or could be custodied by traditional financial market participants such as broker-dealers and banks.

Broker-dealers that hold custody of securities for customers must comply with Rule 15c3-3, which requires that the broker maintain "possession" or "control" over customers' securities in particular ways set out in the rule, such as holding a paper certificate or holding through a clearing agency. The SEC staff has also viewed non-security crypto assets as subject to Rule 15c3-3. Maintaining private keys is (unsurprisingly) not listed in the rule as an acceptable manner of "control", and the SEC staff's general position has been that it does not qualify. As a result, broker-dealers cannot currently comply with Rule 15c3-3 by its terms for crypto assets.

The SEC staff has issued a time-limited no-action position that, in theory, is meant to allow a broker-dealer to comply with Rule 15c3-3 if it limits its activity to crypto asset securities and does not engage in business activities involving either other crypto assets or traditional securities. This condition is especially limiting in light of the fact that the two largest crypto assets by market value, Bitcoin and Ether, are generally accepted as not being securities, and because of the inherent uncertainty today in determining whether any given crypto asset is a security. It is likely for this reason that as of December 2022, the SEC reported that no broker-dealer has yet made use of this no-action position.

The DCCPA, with its focus squarely on a CFTC-regulated crypto asset trading regime, avoids this topic entirely. While the RFIA would direct the SEC to provide guidance stating that maintaining a private key would satisfy Rule 15c3-3 for purposes of crypto asset securities, it would not direct such guidance to extend to non-security crypto assets.

Another roadblock facing market participants seeking to custody crypto assets (security or not) is the SEC's Staff Accounting Bulletin 121. SAB 121 directs public reporting companies that custody customers' crypto assets (including custody by a bank or broker-dealer subsidiary) to account for that obligation as a liability on their balance sheet, in contrast to the usual treatment of customer assets held in custody. While the RFIA intends to effectively overturn SAB 121, DCCPA does not address it.

SAB 121 also directs companies to hold an offsetting asset that is treated essentially as a stub accounting entry. But this stub entry would likely not qualify as an allowable asset for purposes of a broker-dealer's net capital requirements under Rule 15c3-1. Crypto assets custodied by a broker-dealer would therefore increase the broker-dealer's liabilities without a corresponding increase in its assets, thereby reducing its equity levels and making net capital compliance infeasible. And because bank capital and liquidity rules also generally start with a firm's balance sheet for accounting purposes, SAB 121 may adversely affect a bank's decision to engage in crypto asset custody activities as well.■

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