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Digital assets policy primer: Fall 2022

Over the course of 2022, three parallel paths of (1) federal agency enforcement and interpretive activity, (2) a presidential executive order, and (3) congressional efforts to legislate have made the US federal policy framework for digital assets seem more volatile than ever. In this special issue of our Regulatory Digest, we aim to demystify this environment by presenting major approaches under consideration in the complex and shifting conversation around the national policy treatment of digital assets in the United States. We address the remaining regulatory tension points, latest developments, and general policy outlook for the following topics:

- Classification and reporting of digital assets
- Regulating crypto exchanges
- Stablecoin issuance
- Path to a US central bank digital currency (CBDC)

Classification and reporting of digital assets

The innovative core of the asset class has been mired in regulatory uncertainty since its inception. For years, the industry has sought explicit guidance from regulators as to the applicability of their rules to certain assets. Federal regulators have struggled to provide clarity partly out of an abundance of caution and partly due to the exploding number of novel assets. As a result, the debate over the legal classification of assets and corresponding regulatory framework has festered for years, finally arriving in the courts and before Congress.

While congressional proposals favor a commodities regime, without legislation the legal status of certain assets is increasingly left to the courts.[1] As both the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) continue to step up their enforcement efforts, the pressure on Congress to provide clarity intensifies.[2]

Tension points

At issue are the contrasting regulatory frameworks of the SEC and CFTC. The securities regime dates to the Great Depression with the Securities Act of 1933 and Securities Exchange Act of 1934, which created the SEC. The agency regulates the $118 trillion[3] US equities market, employs a full-time staff of 4,500,[4] and has an annual budget of roughly $2 billion.[5] As written in its authorizing statutes, the SEC's mission is to "protect investors, maintain fair orderly and efficient markets, and facilitate capital formation."[6] In service to this investor protection mandate, the SEC's regulatory framework for securities is disclosure intensive.

Federal commodities legislation originated with the Commodities Exchange Act of 1936. However, the CFTC is a much younger organization having been created by Congress with the Commodity Futures Trading Commission Act of 1974. The agency oversees the $2.5 trillion[7] commodity derivatives markets, has a full-time staff of approximately 740,[8] and an annual budget of approximately $330 million.[9] The statutory mission of the CFTC is "to promote the integrity, resilience, and vibrancy of the US derivatives markets through sound regulation." Although the CFTC is primarily a derivatives regulator, it has additional limited authority over interstate commodity cash markets; it maintains anti-fraud, false reporting, and anti-manipulation enforcement authority over commodity cash markets in interstate commerce.[10]

This limitation of CFTC authority has played a critical role in the SEC's repeated denial of a crypto spot market ETF. On June 29, 2022, the SEC rejected Grayscale's application to list a crypto spot market exchange-traded fund (ETF), the latest application of its kind to meet this end. The SEC's continued reasoning is that the ETF's underlying crypto spot markets are unregulated or underregulated, and therefore an ETF product presents undue risks to retail investors.[11]

As further evidence of the active stance that the SEC has taken, on April 11, 2022, the SEC issued Staff Accounting Bulletin No. 121 (SAB 121). The SAB provided guidance (with the effect of US GAAP), requiring that public filers "safeguarding digital assets", report the assets on their balance sheet.[12] This has had significant implications, including capital impacts, for banks that were considering engaging in an activity (i.e., custody) deemed permissible by the OCC.

Timeline of select recent enforcement actions[13]

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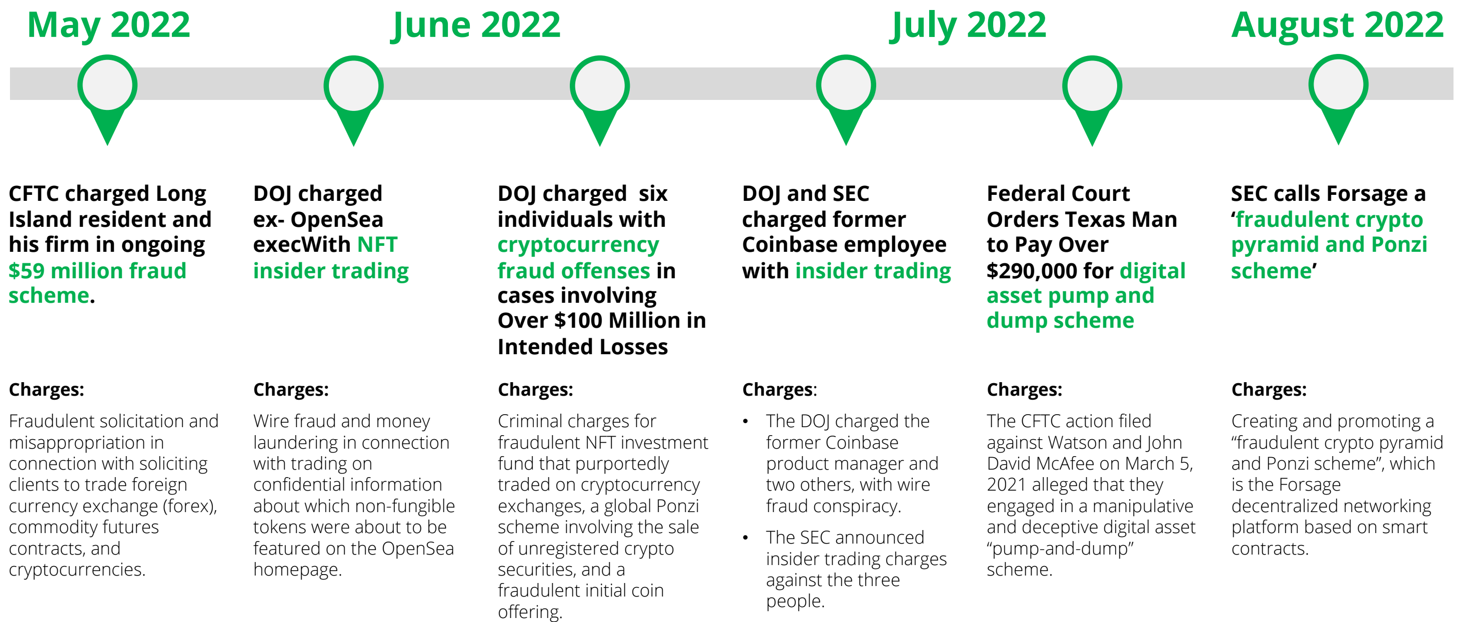

Latest developments

- In August 2022, a bipartisan group of Senators announced the Digital Commodities Consumer Protection Act of 2022.[14] The bill would designate the CFTC as the primary regulator of digital assets, granting it explicit authority to protect consumers and regulate cash markets for digital asset transactions.
- On June 30, 2022, the Basel Committee on Banking Supervision published a second public consultation on the prudential treatment of banks' cryptoasset exposures.[15] The paper classifies cryptoassets into two categories and four subcategories: Group 1a, Tokenized traditional assets; Group 1b, Cryptoassets with effective stabilization mechanisms; Group 2a, cryptoasset exposures that meet hedging recognition criteria; and Group 2b, Other cryptoasset exposures. The paper also provides guidance on capital treatment and risk management for exposure to these cryptoassets. Tokenized traditional assets would command the same risk weights as traditional assets; cryptoassets with a stabilization mechanism would command the same risk weights as equity investment of funds; and all other cryptoassets would be subject to a risk weight of 1250%.[16]
- On June 7, 2022, US Senators Kirsten Gillibrand (D-NY) and Cynthia Lummis (R-WY) introduced the Responsible Financial Innovation Act: Bipartisan legislation that would create a comprehensive regulatory framework for digital assets with the goals of encouraging responsible financial innovation and robust consumer protections and clarifying the treatment of digital assets under existing law. The bill creates a new category of assets, called "ancillary assets," which are "intangible, fungible assets that are offered or sold in tandem with a purchase and sale of a security."[17] Those ancillary assets would be treated like commodities under US law and fall under the jurisdiction of the CFTC. Cryptocurrencies and other digital coins would not be treated like traditional securities under the SEC's scrutiny unless the holder is entitled to the privileges enjoyed by corporate investors, such as dividends, liquidation rights, or a financial interest in the issuer.[18] Crucially, the bill would maintain the Howey Test, which is the current and fraught standard for determining whether an asset is a security under existing law.
- Investor losses have galvanized policymakers' desire to act, and both the SEC and the CFTC have increased their enforcement focus recently. In May 2022, the SEC announced allocation of 20 additional positions to the unit responsible for protecting investors in crypto markets and from cyber-related threats.[19] In August, the SEC brought several new crypto-related enforcement cases, including an insider trading case against a former Coinbase employee.[20] While the CFTC has had a slower start on the enforcement front, CFTC Chair Rostin Behnam has also become increasingly vocal in his calls for enforcement.[21]

- The SEC started legal proceedings against Ripple Labs and two of its officials on December 22, 2020, alleging that the company sold $1.3 billion worth of unregistered securities (XRP). The SEC's rules and regulations require securities to be registered with the SEC, among other things. The eventual outcome of this ongoing court battle will set a crucial legal precedent for determining how the Howey Test can be applied to digital assets.

What's next

Absent legislation: The courts will have final say on the authority of the federal regulatory agencies across the various types of cryptoassets. As court decisions come down and precedents are set, more clarity will be offered for other assets and agencies' jurisdictional authority. However, financial and technological innovation will continue to occur at a breakneck pace—possibly on an iterative basis in response to case law—and could present meaningful factual distinctions that result in new levels of legal and regulatory ambiguity. It will be important to see how US banking regulators respond to the SEC's requirements regarding the reporting of custodied assets, and whether alignment is achieved amongst federal regulators.

With legislation: Legislation is likely to favor a commodities regime for digital assets and could also clarify the distinction between a security and a commodity. To achieve true clarity, Congress might want to consider the practical limitations of legislation that continues to rely on a multi-pronged legal test, like Howey. If legislation were to designate the CFTC as the primary regulator of digital assets, the CFTC also would likely require additional expanded statutory authority to fully implement investor protection regulations because cash market oversight and investor protection are not as explicitly within the bounds of the CFTC's existing mandate. This is especially true in light of the Supreme Court's recent ruling in West Virginia v. Environmental Protection Agency.[22]

Bottom line: While legislative treatment of digital assets is likely to favor CFTC oversight, the SEC continues to assert authority via strategic action, like enforcement and SAB 121. Executives employing digital assets or considering integrating digital asset activities should pay close attention to the development of these cases until Congress draws clear boundaries.

Exchanges

Digital asset exchanges have been thrust to the center of the debate over the legal and regulatory status of their listed products. For months, SEC Chair Gary Gensler has called for crypto platforms to register as exchanges with the SEC, arguing that some of their listed assets are securities.[23] However, the exchanges have largely favored CFTC registration, indicating that they believe their listed assets are exclusively commodities.[24]

Tension points

Alternative policy approaches have mirrored the debate over the legal status of the listed assets. Regardless of oversight authority, digital assets also pose novel questions for regulators due to their cutting-edge technology and the unique structure of crypto markets, which settle in real time and trade 24/7/365. By contrast, US equity securities will not move to a T+1 settlement timetable until 2024.[25] It is crucial that any regulatory regime considers the underlying market structure, and digital assets are no exception.

Latest developments

- The bipartisan Digital Commodities Consumer Protection Act, announced in August, would require platforms to register with the CFTC and permit dual registration with the SEC.[26]
- In May 2022, the SEC rejected another Bitcoin (BTC) spot ETF, disapproving One River's application to list the One River Carbon Neutral Bitcoin Trust on the New York Stock Exchange (NYSE) Arca. The SEC applied similar reasoning to this application as others, asserting insufficient investor protection and fraud prevention guidelines.[27]
- In March 2022, the CFTC opened a public request for comment on a proposal by FTX for amended derivatives clearing registration. There was a formal request from FTX US Derivatives to the CFTC to amend its order of registration as a Derivatives Clearing Organization (DCO) and permit it to directly clear margined products, on a non-intermediated basis (i.e., without use of a registered futures commission merchant). FTX aims to clear derivatives products that are not fully collateralized through a direct access market for both retail and institutional investors. If approved, this proposal would allow investors to post margin directly to the exchange rather than requiring them to go through a broker.[28]

What's next

Absent legislation: Platforms will continue to be thrust into the center of the debate over the legal classification of assets since they are gatekeepers of market activity. Market pressures may increase platforms' incentives to enact measures aimed at consumer protection and market integrity, and regulators—especially the SEC and CFTC—will continue to view these gatekeepers with increasing scrutiny.

With legislation: Since legislation has the potential to clarify the legal classification of assets, it could help remove regulatory gray areas for the exchanges. However, those that list securities and commodities will still need to register with both the SEC and CFTC—barring a major shake-up of the existing financial services regulatory framework—and will be subject to the full spectrum of financial regulation. Legislation also could allow for the creation of a self-regulatory organization, which would provide the industry with a mechanism for collaborating on the development of future rules and regulations.

Bottom line: The SEC and CFTC appear focused on leveraging the tools available to them, including enforcement, and many policymakers share the goal of extending to digital asset markets a similar level of transparency and investor protection that exists for traditional securities and commodities markets. Legislation from either political party is likely to pursue the goals of transparency and resiliency since these features can drive market maturity and product adoption. To help guard against an overly burdensome and prescriptive regulatory regime, exchange platforms should continue to invest in robust, digital assets-tailored monitoring and surveillance capabilities and implement measures that cohesively integrate them into existing practices and systems.

Stablecoins

Stablecoins pose several unique challenges for policymakers. First, their potential as a payments mechanism makes them attractive to retail investors and could lead to broad and rapid adoption.[29] Second, their linkage to the US dollar and Treasury market, especially if coupled with broad-based adoption, could make them systemically important.[30] Third, products under the stablecoin umbrella range from relatively safe, fully reserved assets to riskier algorithm-driven instruments that are not backed by underlying assets. Incidents like the implosion of the algorithmic stablecoin Terra Luna have drawn deep skepticism from regulators.[31] Meanwhile, other jurisdictions have pressed forward with proposals for stablecoin regulation giving the United States an opportunity to mirror effective policy. However, failure to solidify the legal treatment of stablecoins could risk driving economic activity elsewhere.[32]

Tension points

In certain policy circles—including at the Financial Stability Oversight Council (FSOC)—the appropriate federal framework for stablecoins has been intensely debated. The President's Working Group (PWG) Report on Stablecoins, issued last year, proposed bank-like regulation. Specifically, the PWG report recommended that Congress enact legislation requiring that stablecoins be issued only by insured depository institutions. While the PWG report envisioned a legislative solution, it did not clarify the applicability of the existing regulatory framework to stablecoins.

Adding to this confusion, the PWG report also stated that "stablecoin arrangements and activities may implicate the jurisdiction of the SEC and CFTC."[33] SEC Chair Gensler has said that stablecoins "may" be securities, and some have pointed to money market funds as an analogous securities product.[34] However, in some parts of the Biden administration there is a distaste for money market fund products, due to their failure in periods of economic stress.[35] The SEC is currently considering a proposal that would reform its rules for money market funds in hopes of preventing future incidents, but at this time it is unclear whether that proposal will move forward.[36]

Disregarding some of the PWG report's suggestions, a new bipartisan House stablecoin bill proposes that the Federal Reserve (Fed) serve as the primary federal regulator of stablecoins and stablecoin issuers, would allow for non-bank issuers, and would not grant stablecoins deposit insurance. The proposed bill tackles critical issues but faces a series of challenges, including:

- Non-inclusion of key agencies, including the SEC and CFTC, while drafting the bill
- Consumer advocates and progressive policymakers likely will want to see an explicit role for the Consumer Financial Protection Bureau in the final bill
- The prohibition of offering foreign-issued payments stablecoin to US persons could have broader geopolitical ramifications

- Banking entities are likely to argue that non-banks issuing stablecoins could pose significant risks, even with some Fed supervision; powerful entities like big tech platforms are likely to continue to lobby for the ability to issue stablecoins as they seek to expand further into financial services
- Disagreement among key sponsors, including over the treatment of algorithmic stablecoins

Algorithmic stablecoins have become one of the more politicized elements of the legislative debate. Certain models had flawed base economics that can lead to rapid price depreciation, investor harm, and political backlash.[37] However, other products draw parallels to existing financial instruments like complex securities products.[38] Other critical considerations in the continuing debate over stablecoin legislation are:

- How collateralization standards are defined
- Treatment of funds as deposits versus investments
- Use of stablecoins as a mechanism for payments
- Permissibility of rehypothecation of invested assets

The resolution of some of these issues could have existential implications for the business model. In determining a legislative approach, Congress will need to weigh the trade-off between prohibiting excessive risk and stifling financial innovation.

Latest developments

- A bipartisan House Financial Services Committee bill is being negotiated. The bill would define "payment stablecoins," require full backing by high-quality liquid assets, designate the Fed as the primary regulator of stablecoin issuers with regulatory authority over third-party service providers, allow non-banks to apply to the Fed for a special issuer license, create a three-tiered non-bank regulatory structure, prohibit large commercial entities from issuing stablecoins (e.g., retailers), and prohibit US persons from holding foreign-issued payment stablecoins. Importantly, the bill also would not provide deposit insurance for stablecoins.
- On July 13, 2022, the international Committee on Payments and Market Infrastructures (CPMI), part of the Bank of International Settlements (BIS), along with the board of the International Organization of Securities Commissions (IOSCO) published final guidance on the application of the principles for financial market infrastructures to stablecoin arrangements.[39] The guidance confirmed that the Principles for Financial Market Infrastructures apply to systemically important stablecoin arrangements that transfer stablecoins. In cooperation with other standard-setting organizations, CPMI and IOSCO will continue to examine the regulatory, supervisory, and oversight problems related to stablecoin arrangements.[40]
- On June 8, 2022, the New York Department of Financial Services (NYDFS) released "Guidance on the Issuance of US Dollar-Backed Stablecoins" to emphasize certain requirements that will generally apply to stablecoins backed by the US dollar that are issued under NYDFS oversight. Specifically, the guidance establishes requirements relating to (1) the redeemability of such stablecoins; (2) the asset reserves backing stablecoins; and (3) attestations of required reserves.[41]

What's next

Absent legislation: The federal regulatory framework for stablecoins will remain unclear, creating challenges for both market participants and regulators. Ambiguity could stifle economic growth and give rise to excessive speculation, particularly since heavily regulated institutions, like banks, are unlikely to participate if the rules of the road are not clear. If the asset class remains lightly regulated and adoption continues, stablecoins might eventually pose a threat to the broader financial system. At the same time, financial innovation and economic activity will occur in jurisdictions where there is more legal certainty or no regulation, creating a missed opportunity for the US markets.

With legislation: Stablecoin legislation could mark the first step toward establishing a clear policy framework for digital assets and would encourage market participation. The current congressional approach suggests that legislation could appoint the Fed as the primary overseer of stablecoin issuance, and that ultimately all issuers will have to satisfy certain requirements, such as obtaining an issuer's license, fully backing the stablecoin with highly liquid assets, ensuring interoperability, and meeting enhanced disclosure requirements.

Bottom line: As Congress continues to negotiate legislation, the contours of the framework are likely to change. Guidance released by the NYDFS and CPMI-IOSCO emphasize the importance of minimizing credit and liquidity risk by backing stablecoins with highly liquid reserve assets and putting in risk and control frameworks to manage associated risks.[42] Regardless of an issuer's status as a bank or non-bank, we believe that meeting "bank like" standards for safety and soundness (risk management, governance and compliance considerations) will be table stakes for future stablecoin issuers, following adoption of federal legislation.

US CBDC

President Biden's "Executive Order on Ensuring Responsible Innovation of Digital Assets" accelerated the policy discussion around a US CBDC. Two cornerstone requirements of the order are requests for: (1) a determination by the Attorney General of whether legislation is required for the Fed to develop a CBDC, and (2) a legislative proposal for a US CBDC. Prior to the executive order, in January 2022, the Fed released a report indicating that it would not develop a CBDC without a congressional mandate. Not only did the order signal support for a US CBDC from the Biden administration, but also it provided concrete next steps for progressing toward developing one.

Tension points

In designing a CBDC, the Fed will need to weigh competing priorities, which it acknowledges in its January 2022 report.[43] The report asserts that a US CBDC could offer advantages such as improving cross-border payments, serving a critical function in the payments system of the future, and supporting the US dollar's role in the international financial system.[44] As other countries experiment with and develop their own CBDCs, pressure builds on the United States to follow suit, in part to bolster the US dollar's critical role as the world's reserve currency, with related massive implications for geopolitics and the US economy.

However, potential advantages of a CBDC must be balanced against the significant risks they present, including the possibility of disintermediation of the banking system, run risk, and impacts to monetary policy effectiveness. As the Fed's January report detailed, the speed with which consumers could convert their deposits into cash via a CBDC could increase the frequency of bank runs. Additionally, direct consumer access to digital money issued by the Fed could decrease deposits at banks, which in turn would depress lending activities. In pursuing a CBDC, policymakers will consider these risks and opportunities to mitigate them.

A US CBDC presents an opportunity for the United States to respond to a geopolitical environment in which other nations are already issuing their own CBDCs. In achieving the goal of continued international support for the US dollar, policymakers will seek to design a CBDC that minimizes the above-mentioned risks. A wholesale CBDC offered directly and exclusively to banks is one option. Another is a retail CBDC whose distribution is capped, such that it is more suited to payments purposes than saving, thereby limiting disintermediation of the banking system. Regardless of the model chosen, policymakers should consider that a CBDC likely will be subject to its own market forces. Another point of tension remains the role of stablecoins in the presence of a Fed-issued product.

Latest developments

- In September 2022, we are expecting a recommendation from the Attorney General as to whether legislation is required to develop a US CBDC. We also are anticipating a technical evaluation from the Office of Science and Technology Policy (OSTP), which was also mandated by Biden's "Executive Order on Ensuring Responsible Development of Digital Assets" later this month.[45]
- In June 2022, Congressman Jim Himes (D-CT) called for the issuance of a CBDC by the Federal Reserve. Himes posits that the implementation of digital currency by the US government could play a critical role in preserving the US dollar's role as the global reserve currency of choice. Himes further outlined various benefits that a US CBDC can offer, including faster and cheaper cross-border transfers, full-faith backing by the US government, and opportunities to promote financial inclusion.[46]
- In January 2022, the Federal Reserve issued a paper that described potential benefits of a CBDC. The Fed's initial analysis suggests that a US CBDC would best serve the needs of the United States by being privacy-protected, intermediated, widely transferable, and identity-verified. However, the paper also noted that the Fed would not proceed with the issuance of a CBDC without clear support from the executive branch and from Congress.[47]

What's next

Absent legislation: The door remains open for a path to a CBDC absent legislation, pending the Attorney General's recommendation. Should the Attorney General determine that legislation is required, the Fed will not proceed.

With legislation: Legislation authorizing a US CBDC could delegate broad authorities to the Fed to develop a CBDC or may define certain features, for example, by authorizing a wholesale only CBDC. Multiple models could be explored. The intended scope and usage of a CBDC in day-to-day transactions should be clarified in any legislation, as well as the likely impact to various stakeholders (including US banks and depository institutions).

Bottom line: The executive order process will determine the options available to the administration in pursuit of a CBDC. The Fed is also likely to continue to explore architecture constructs for a CBDC if or when one is authorized. In developing a CBDC, lawmakers and the Fed may need to get creative in order to curtail the difficult trade-offs that they face, including threats to the US dollar's international role and disintermediation of the banking system.

Conclusion

Investor protection likely will remain a near-universal focus area for policymakers. It is crucial that the ultimate regulatory framework for digital assets creates incentives and checks that encourage responsible innovation. To strike this balance, it should be holistic, coherent, and nimble. By clarifying the regulatory structure for stablecoins and other digital assets, regulated financial institutions could be empowered to fully participate in the markets, and entities that have operated on the fringes of the regulatory perimeter could face increased scrutiny.

2023 could be the most significant year for US crypto policy yet. To date, Congress has failed to act. Federal agencies continue to scramble for the regulatory football, and important legal battles drag on. Meanwhile, states face a massive challenge in creating a coherent national policy on their own. As the expression goes, it is always darkest before the dawn. Congress has signaled increasing interest in legislation, and recent market developments only compound the sense of urgency. While uncertainty rules today, the United States may be on the doorstep of a coherent national approach to crypto policy.

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