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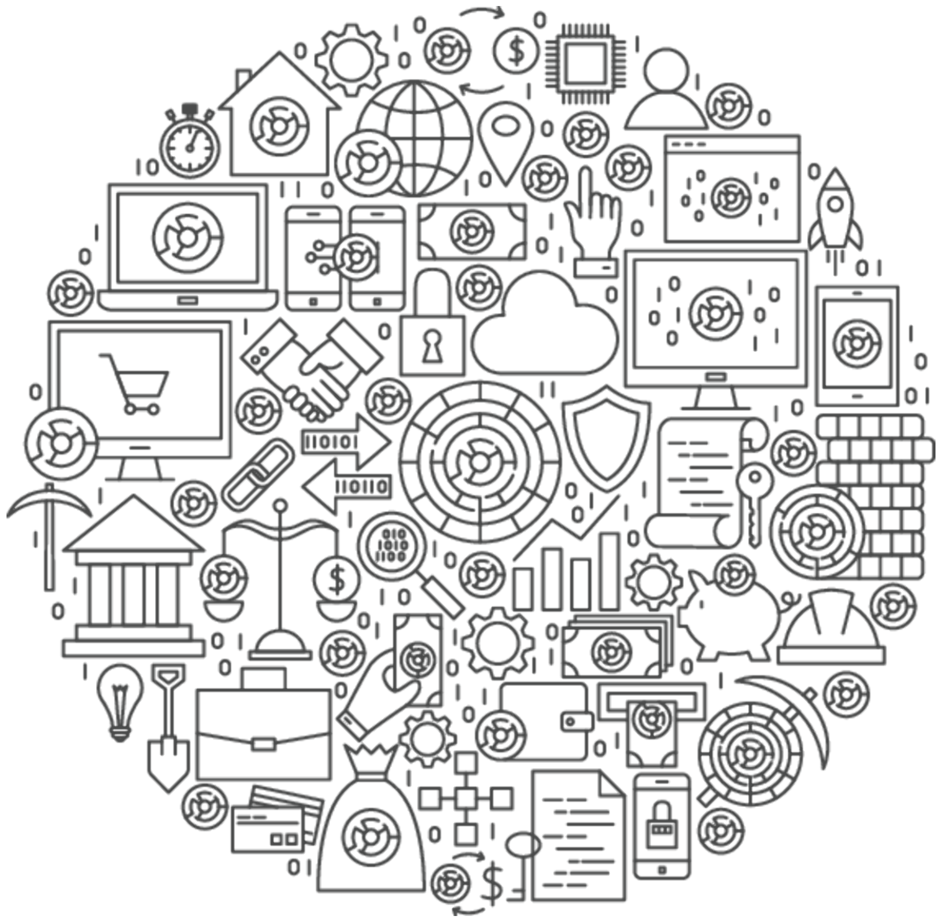


Digital Asset Banking and Capital Markets Regulatory Digest: A Periodic Mark-to-Market on US Regulatory Developments

October 2021 Issue

Introduction

The "crypto market" is becoming increasingly mainstream with market capitalization crossing the $2.5 trillion landmark.[1] Deloitte's annual blockchain survey further reinforces this point: 76% of FSI respondents believe that digital currencies will be a strong alternative to or replacement of fiat currency in the next 10 years. One of the barriers to adoption, noted in the survey, is the level of regulatory risk and ambiguity.[2] By establishing the *Digital Asset Banking and Capital Regulatory Digest*, Deloitte aims to help banking and capital markets institutions, FinTechs, and other ecosystem players track and navigate the latest regulatory developments. While the series will emphasize digital (or "virtual") currencies, it will also consider other digital asset classes—such as non-fungible tokens (NFTs)—whose market adoption and regulation could impact the financial services industry. Further, recognizing that the crypto regulatory environment evolves rapidly, each issue of this Digest will serve as a point-in-time summary and cannot be relied on as legal advice.

As digital assets become further entrenched in global financial markets, regulators will likely take a more active role in regulating this asset class. While policymakers pursue legislative reforms, uncertainty remains due to a lack of clarity and consensus among US regulatory agencies on the future treatment of the asset class. We expect significant releases at both the state and federal level in the coming months, including:

- Recommendations regarding stablecoins by the President's Working Group (PWG) on Financial Markets along with the Treasury Department targeted for release by the end of October 2021[3]
- Revised Financial Action Task Force (FATF) Guidance on virtual assets (VAs) and virtual asset service providers (VASPs) to be officially published on October 28, 2021[4]
- Federal Reserve Board's (FRB) whitepaper on exploring the move to central bank digital currency (CBDC) expected to be released by the end of the year 2021[5]
- Congressional recommendations through the US Senate, which released a public draft of the Infrastructure Investment and Jobs Act that included a range of provisions aimed at bringing cryptocurrencies and other digital assets into the scope of tax informational reporting.[6]

As new regulatory actions take shape, this digest aims to:

- Connect various updates across regulators anchored in the mandate and remit of those authorities;
- Identify key highlights;
- Define potential implications of rulemaking and what to expect in the near future.

Evolving US Regulatory Landscape

Since the introduction of Bitcoin in 2009, the crypto economy has crossed boundaries between banking and securities activities as well as state and federal oversight mandates. To date, the fragmented nature of the US regulatory system has prevented regulators from offering a cohesive regulatory framework that covers crypto activities across banking and capital markets. While state-specific rulesets can vary considerably, discrepancies can also be found across federal agencies. Ultimately, we expect greater regulatory convergence in the form of uniform definitions and harmonization of rulesets and oversight in the US. The sections below highlight potential areas of focus:

Clarity on Digital Asset Definition

Uniform definitions of the respective classes of digital assets—most notably virtual currencies (e.g., stablecoins), but also other assets, like NFTs—are at the center of upcoming efforts to create a unified regulatory framework. The future classification and treatment of a digital asset as a security, commodity, or currency will help clarify the applicability of regulatory requirements, including tax obligations, reporting requirements, and overall compliance obligations.

Federal vs. State Oversight

Due to the characteristics of the US dual banking system—meaning the parallel co-existence of state-level and federal banking systems and oversight—various state-level lawmakers have proactively established regulatory guidance in the digital assets space. Ahead of harmonized guidance and requirements from the federal agencies, several states have initiated crypto oversight for instance, by creating special purpose bank-like charters or Money Transmitter Licenses for providers of digital asset services and products.[7] A leading example is the New York Department of Financial Services (NYDFS). The NYDFS has granted numerous virtual currency licenses and charters under its "BitLicense" regulation to ensure that the participants have a well-regulated way to access the virtual currency marketplace.[8] Other states have chosen "wait and see" approaches and have not applied their securities laws or money transmitter licensing requirements to digital currencies. For instance, Colorado has passed legislation that will exempt digital currency transactions from the securities registration requirements under the Colorado Securities Act (CSA).[9] At the same time, federal banking regulators are also revisiting rulemaking and guidance.

Boundaries and Focus Areas of Different US Regulatory Bodies

Below we have mapped the roles and mandates of selected key regulatory bodies to illustrate our view of the current US regulatory perimeter. However, as the landscape evolves (e.g., legislation or future rulemaking), some of these mandates and focus areas may change.

1: Scope of US Regulatory Agencies and Their Primary Regulated Entities

Regulator Overview	SEC	CFTC	FINRA	FRB	FDIC	OCC	State Regulators	CFPB	FinCEN & OFAC	IRS / US Treasury
	Securities and Exchange Commission	**Commodity Futures Trading Commission**	**Financial Industry Regulatory Authority**	**Federal Reserve Board**	**Federal Deposit Insurance Corporation**	**Office of the Comptroller of the Currency**	**Various state banking authorities, securities regulators, and attorney generals**	**Consumer Financial Protection Bureau**	**Financial Crimes Enforcement Network & Office of Foreign Assets Control**	**Internal Revenue Service and US Treasury**
	Protects investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.	Promotes the integrity, resilience, and vibrancy of the US derivatives markets through sound regulation.	Authorized by the Congress to protect investors by making sure the broker-dealer industry operates fairly and honestly.	Fosters the stability, integrity, and efficiency of the monetary, financial, and payment systems to promote optimal macroeconomic performance.	An independent agency created by the Congress to maintain stability and public confidence in the US financial system.	Works to ensure that national banks and federal savings associations operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations.	At the state level, each state has one or more agencies which are charged with supervising and regulating state-chartered banks and thrifts, as well as non-bank consumer lenders, money transmitters, and other non-bank financial services providers.	Protects consumers from unfair, deceptive, or abusive practices and takes action against firms which violate its requirements.	Safeguard the financial system from illicit use, combat money laundering and promote national security. The OFAC administers and enforces economic and trade sanctions.	Works to enforce taxpayers' tax responsibilities and against the current rules and regulations. They also provide clarification of the rules.
Primary Regulated Entities	Participants in securities market including • Securities exchanges • Broker-dealers • Clearing and settlement agencies • Mutual funds • Hedge funds • Swap dealers • Investment firms	• Futures exchanges • Futures commission merchants, commodity operators • Derivatives clearing organizations • Designated contract markets • Swap dealers and other major swap participants	Registered broker-dealer firms and registered brokers in the US	• Bank holding companies • Financial holding companies • Securities holding companies • Savings and loan holding companies • State member banks • Foreign banking organizations in the US	• Federally insured depository institutions • State banks that are not members of the Federal Reserve System • State-chartered thrift institutions	• National Banks • US federal branches of foreign banks • Federally chartered thrift institutions • National trusts	• State-chartered banking entities (both member or non-member banks) and trust companies • Money transmitters and other non-banks	Consumer protection regulator focused on: • Rulemaking authority for consumer protection for all banks • Consumer financial entities (including non-bank)	N/A	N/A

2. Identifying the Regulatory Agencies' Focus Areas Regarding Digital Assets

Digital Assets – Agencies' Focus Area & Mandates	SEC	CFTC	FINRA	FRB	FDIC	OCC	State Regulators	CFPB	FinCEN & OFAC	IRS / US Treasury
	• Regulating digital assets that meet the definition of a security • Oversight of crypto exchanges • Listing standards for security exchanges • ETF registration • Market manipulation • Investor protection disclosure	• Futures contracts and other digital asset derivatives (that are not securities) • Registration and licensing of Future Commission Merchants • Responsible innovation in derivatives market • Manipulation of commodity pricing • Market transparency	• No explicit mandate regarding cryptocurrency regulation, but generally concerned with broker sales practices, disclosure, and investor protection • Surveillance and enforcement of security rules for broker-dealers	• Analyzing potential risks and benefits of issuing a Central Bank Digital Currency (CBDC) in the US • Ensuring safety and soundness for new product launches related to digital asset initiatives • Ongoing supervision of regulated banks, including application of third-party risk, new product approval, and risk management framework • Protecting the Deposit Insurance Fund • Managing systemic risk and implementing bank-like regulatory framework for stablecoins • Overall assessment of the stability of the financial system due to underlying risks posed by the rise in digital asset transactions • Definition of permissible digital asset services (e.g., custody) by banking entities • Chartering and licensing including access to master payment accounts • Establishing a consistent framework for the supervision and regulation of digital assets • Evolving capital and liquidity frameworks to reflect digital asset risks			Money transmitters & non-banks • Consumer Protection • Enforcement of state digital asset laws and license requirements • Multistate Money Services Business Licensing Agreement Program (where applicable) • Supervision of state bank and trust company digital asset custody and other services	• Consumer protection (heavy focus on consumer complaints), data privacy, fair lending, disclosures, access to financial services • Potential future enforcement actions against crypto and fintech companies for "unfair, deceptive, or abusive acts or practices"	• Enforcement of Banking Secrecy Act/Anti-Money Laundering (BSA/AML) compliance programs • OFAC Travel rule • SAR and CTR reporting • MSB registration	• Enforces the taxation of Digital Asset transactions • Clarifies the tax rules associated with digital asset transactions through Treasury Regulations and other authoritative guidance.

Note: Additionally, The Financial Stability Oversight Council (FSOC), which was established with members from these federal and state regulatory agencies, could also play a significant cross-functional role in bringing uniformity in digital asset regulatory guidance and oversight.

3: Identifying the Proposed Bills, Guidance and Latest Regulatory Developments on Digital Assets

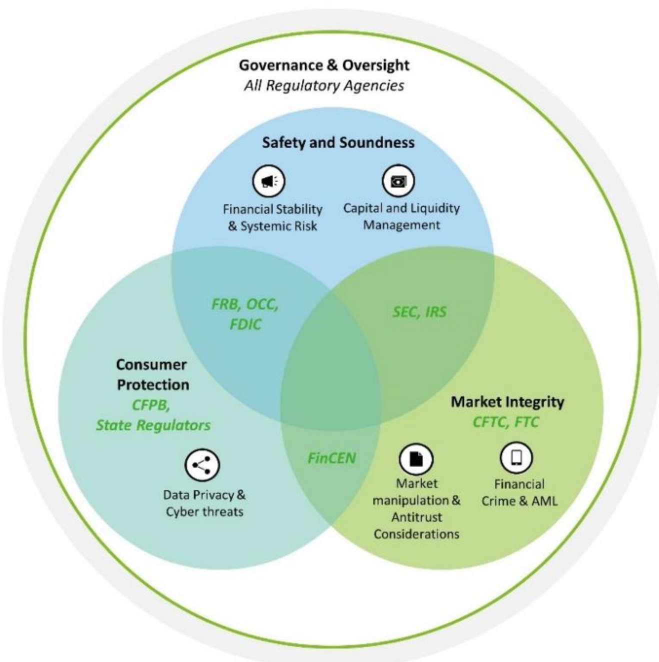
Digital Assets – Bill/Act/ Regulation/ Guidance Issued	SEC	CFTC	FINRA	FRB	FDIC	OCC	State Regulators	CFPB	FinCEN & OFAC	IRS & US Treasury
	• Digital Asset Market Structure and Investor Protection Act[10] • Crypto-Currency Act, 2020[11] • Eliminate Barriers to Innovation Act[12] • SEC Statement—Custody of Digital Asset securities by special purpose Broker-Dealers[13] • Token Safe Harbor Proposal 2.0[14]	• Digital Commodity Exchange Act (DCEA)[15] • Digital Asset Market Structure and Investor Protection Act • Crypto-Currency Act, 2020 • Eliminate Barriers to Innovation Act	N/A	N/A	Digital Asset Market Structure and Investor Protection Act	• OCC Letter #1170 – Cryptocurrency Custody Services[16] • OCC Letter #1174 – Stablecoin for Payment Activities[17]	State regulators are issuing various regulations/guidance: • Wyoming: Select Committee on Blockchain, Technology and Innovation[18] and legislation for special purpose depository institution[19] • South Dakota Legislature—House Bill 1091[20] • NYDFS BitLicense[21] • Nebraska Financial Innovation Act for digital assets repository[22]	N/A	• Crypto-Currency Act, 2020 • Cryptocurrency Enforcement Framework[23]	• Notice 2004-21[24] • Revenue Ruling 2019-24[25] • Q&As on IRS website[26]
Digital Assets – Key Regulatory Developments	• The SEC plans to provide clarity on the treatment of digital assets and to ensure investor protection • The SEC has recently approved Bitcoin futures ETFs and thus made it more accessible to a wider investor base[27] • The SEC has also brought forward several enforcement actions against securities token issuers, digital asset traders, and asset managers[28]	• Commissioner Dawn D. Stump clarified the role of CFTC's regulatory and enforcement authority with respect to digital assets[29] • CFTC charged a Texas resident and his firm for cryptocurrency fraud[30]	• To supervise the broker-dealer activities in digital assets, the FINRA has issued Notice 20-23 (and the respective preceding Notices 18-20 and 19-24), which encourages FINRA members to provide updates on firms' activities relating to digital assets which have not been previously disclosed[31] • FINRA's 2021 Examination and Risk Monitoring Program references digital assets considerations within the context of consumer protection, disclosure/public communications, etc.[32]	• FRB Chairman Jerome Powell stated that a CBDC would only be issued if there were "clear and tangible benefits that outweigh any costs and risks"[33]; the FRB will also release a report exploring the move to issue CBDC[34] • FRB officials have explicitly raised concern discussing the potential threat stablecoin can have on financial stability of the entire ecosystem and the need to develop a comprehensive regulatory framework to govern and address any risk associated with such products[35] • The PWG will also issue recommendations discussing potential benefits and risks related to stablecoins[36] • In the recently released bank supervision operating plan for FY 2022, the OCC has added requirements related to governance and risk management processes around cryptocurrencies[37] • OCC conditionally approved chartering of Paxos National Trust on April 23, 2021;[38] also conditionally approved the conversion of Protego Trust Bank[39] and Anchorage Digital Bank to federal charters[40]			State Regulators are increasingly asserting authority over virtual currency businesses, for instance: • The NYDFS BitLicense has revised the existing framework to ease the process of approval to get a license • Wyoming, Nebraska, and South Dakota have adopted laws addressing virtual currency, including a special purpose banking charter in Wyoming • Illinois has proposed legislation for crypto bank charters[41]	N/A	• On December 18, 2020, FinCEN issued a notice of a proposed rule in relation to transactions involving convertible virtual currencies (CVCs) or legal tender digital assets (LTDAs) offered by banks and Money Service Businesses (MSBs)[42] • Treasury's OFAC has issued "Sanctions Compliance Guidance for the Virtual Currency Industry," to help the firms comply with OFAC sanctions[43]	• Infrastructure Investment and Jobs Act (Proposed)[44] • House Ways and Means Committee approves reconciliation tax bill[45]

Regulatory Concerns Related to Digital Assets

While the US legal and regulatory framework for virtual currencies continues to evolve and the points of friction among regulators persist, key bodies have expressed concern that digital assets could pose a systemic risk to the overall economy.

We expect regulators to address this concern within the context of their respective oversight mandates as represented in Figure 01 (e.g., by promoting safety and soundness, consumer protection, and market integrity).

Figure 01: Evolving risk issues among key regulatory bodies



Safety and Soundness:

Regulators will focus on safe and sound operations, compliance with laws and regulations, and business continuity (e.g., by evaluating resolution plans of large financial institutions):

- *Financial Stability and Systemic Risk*: Regulators have indicated that financial stability risks posed by digital assets may not be material yet due to modest market exposures, limited correlations with other markets and limited interlinkages with the financial system. However, digital assets may pose a threat to financial stability as adoption picks up.[46,47] Analyzing lessons from the financial crisis, Acting Comptroller of the OCC, Michael J. Hsu argues that "a run on a large stablecoin could be highly destabilizing. Stablecoins are not the only potential trigger, however. Forks, hacks, rug pulls, vampire attacks, and flash loans all have the potential to surprise, erode trust, and spark fear."[48]
- *Capital and Liquidity Management*: The novel and complex nature of the products requires that regulators revisit capital and liquidity frameworks to ensure that they evolve with the unique risks posed by digital assets. Regulators are concerned about ecosystem participants' ability to convert high-risk digital assets (that they hold or issue) into fiat currency at minimal or no loss of value; thereby exposing the ecosystem to significant liquidity risks, especially during periods of stress.[49]

Consumer Protection:

An increasing number of consumers have been subject to digital asset investment scams, with nearly 7,000 people reporting losses of more than $80 million since October 2020. Compared to the same period a year earlier, that's roughly twelve times the number of reports and an almost 1,000% increase in reported losses.[50] In response, regulators will likely expect market participants to focus on:

- Increased transparency and adequate measures to protect consumers, including appropriate disclosures of digital assets traded or issued, protections to compensate investors, and safeguarding of ownership rights;
- Resilience, reliability, and integrity (including security) of critical systems;
- Managing data protection and cyber threats by implementing a layered, robust data privacy policy and cybersecurity frameworks. The focus is expected to be on developing detective, preventative, and corrective controls with regard to multi-factor authentications, access monitoring, and reporting activities.

Market Integrity:

The unique operational characteristics of each digital asset class, the volatility of these products, evolving technology, and a prominent retail presence make the space highly susceptible to financial crimes and criminal activities, market manipulation, and antitrust issues. A few key concerns with each are stated below:

- *Market Manipulation:* Concerns about certain manipulative practices—such as cross product manipulation, spoofing, and layering—are magnified given the large number of exchanges at play. Regulators expect market participants to implement systems, procedures, and arrangements to monitor and detect market abuse, ensure orderly trading and periodic reporting.[51]

- *Financial Crime & AML:* Anonymity of the asset owners, limited verification processes in place for participants, and the decentralized nature of the market—exacerbated by the lack of central oversight—are all key drivers of financial crime. SEC Chair Gary Gensler mentioned that he remained "technology neutral," however, "as new technologies come along, we need to be sure we're achieving our core public policy goals. In finance, that's about protecting investors and consumers, guarding against illicit activity, and ensuring financial stability. "[52] In the near future, regulators will likely focus on compliance with AML/KYC requirements, such as appropriate internal controls for onboarding, screening, recordkeeping, and reporting. To this end, OFAC recently published guidance on OFAC sanctions requirements and procedures as well as compliance leading practices, specifically for virtual currency market participants. In its introductory note, OFAC acknowledges that "the virtual currency industry, including technology companies, exchangers, administrators, miners, wallet providers, and users, plays an increasingly critical role in preventing sanctioned persons from exploiting virtual currencies to evade sanctions and undermine U.S. foreign policy and national security interests."[53] Also, the FATF soon will publish its revised guidance for virtual assets and VASPs, covering definitions of virtual asset and VASP, applicability of the FATF Standards to stablecoins, VASP registration/licensing, the "Travel Rule," etc.[54] It is expected to be based on the latest consultation paper published in March 2021.[55]

Regulatory Implications and What to Expect Going Forward

Recent regulatory issuances have converged across three key objectives: ensuring a safe and sound financial ecosystem, maintaining market integrity, and consumer protection. In addition, several proposed bills and guidance focus on (1) enhancing transparency through robust reporting and disclosure, (2) implementing internal controls to support these, and (3) clarifying how digital assets and related transactions should be treated. As regulators look to maintain market trust, fairness, and transparency to support the rapid growth that the digital assets industry is experiencing, more coordination among the regulatory bodies is expected.

Against this backdrop, the OCC recently released its bank supervision operating plan for FY 2022 and has considered fintech partnerships for potential cryptocurrency-related activities, and banks' significant change in operating models, driving technological innovation to be one of the core strategic priorities.[56] In September 2021, Acting Comptroller of the OCC Michael J. Hsu discussed blockchain, cryptocurrencies, decentralized finance, and key lessons from the financial crisis that should guide the future of digital innovation during remarks before the Blockchain Association. He said "the reputable members of the U.S. blockchain and cryptocurrency industry have an opportunity to do things differently. If you apply the lessons from the 2008 crisis—anchor innovation in clear purpose, foster an environment for skeptics to speak up, and follow the money—the risks of fool's gold can be mitigated and the real promise of blockchain innovation can be achieved."[57]

Going forward, we expect a number of issuances from regulatory agencies that focus on:

- **Clarification** of the **legal classification** of digital asset instruments (for tax and other purposes) through proposed bills or guidance;
- **Establishment of the jurisdictional boundaries** and formalization of regulators' roles in governing the digital assets. Commissioner of CFTC Dawn D. Stump recently issued a statement emphasizing the importance of understanding the roles of existing regulatory oversight and enforcement authorities, before considering redesigning the regulatory structure in the crypto context. She clarified the CFTC's role as a regulator, saying "The CFTC does not regulate commodities (regardless of whether or not they are securities); rather, it regulates derivatives—and this is true for digital assets just as for any other asset class."[58]
- **Development of a standard federal regulatory regime through laws and guidance that:**
  - Bring digital assets into the regulatory perimeter and enable ecosystem participants to interpret rulesets and ring-fence themselves against emerging risks;
  - Promote safety and soundness by introducing either a bank-like regulatory framework for market participants, or a framework for operating under the umbrella of a banking charter license; and
  - Include enforcement actions against the violation of federal law for both banks and non-banking entities.

It is imperative for market participants to understand currently applicable laws and finalize the product type that aligns with their business model and strategy before entering the digital asset market.[59] It is also critical to review policies and procedures, recordkeeping requirements, and marketing materials as applicable, and to enhance compliance practices to align with the latest regulatory requirements.[60] Market participants should hedge their regulatory risk by carefully evaluating jurisdiction-specific guidance and establishing their digital assets business strategy accordingly.

The digital assets market and its investment opportunities are here to stay, and so is regulatory focus and attention. Organizations should carefully conduct detailed capability assessments with their legal counsel around people, processes, and technology to identify areas requiring enhancement. They must also implement measures to integrate digital asset controls within their current practices and systems. Investment in the right talent, regulatory and compliance change management, and technology infrastructure are critical milestones to establishing a sustainable digital asset agenda under constantly evolving regulatory and market conditions.

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About Deloitte's Blockchain and Digital Assets Practice

At Deloitte, our people work globally with clients, regulators, and policy makers to understand how blockchain and digital assets are changing the face of business and government today. New ecosystems are developing blockchain-based infrastructure and solutions to create innovative business models and disrupt traditional ones. This is occurring in every industry and in most jurisdictions globally. Our deep business acumen and global industry-leading audit, consulting, tax, risk and financial advisory services help organizations across industries achieve their various blockchain aspirations. Reach out to our leaders to discuss harnessing the momentum of blockchain and digital assets, prioritizing initiatives, and managing the opportunities and pain points associated with blockchain adoption efforts.

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