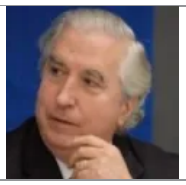
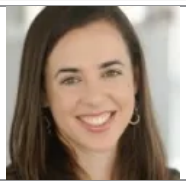


Predicting the Unpredictable: What Will Musk Do Next?

By John C. Coffee, Jr.

Asset Managers as Regulators

1 *By Dorothy S. Lund*



Reforming the Macroprudential Regulatory Architecture in the United States

By Kathryn Judge and Anil Kashya

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THE CLS BLUE SKY BLOG

COLUMBIA LAW SCHOOL'S BLOG ON CORPORATIONS AND THE CAPITAL MARKETS

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Skadden Discusses Senate Bill to Create Regulatory Structure for Crypto and Other Digital Assets

By Alexander C. Drylewski, Nathan W. Giesselman, Stuart D. Levi, Daniel Michael, Bao Nguyen and Andrew R. Beatty June 23, 2022

Comment

In recent years, innovation in the blockchain or "Web3" space has been impacted by uncertainty on the regulatory front. Undoubtedly, the greatest area of uncertainty has involved the Securities Exchange Commission (SEC) and its application of the so-called Howey test when determining whether a cryptocurrency or other digital asset is being offered as an investment contract for purposes of applying U.S. securities law. Despite repeated calls for regulatory clarity from industry members, lawmakers and even SEC commissioners, little progress has been made in achieving that clarity.

Industry members have therefore increasingly come to the conclusion that a long-term solution will need to come from the legislative branch. In an important step in that direction, on June 7, 2022, U.S. Senators Cynthia Lummis (R-WY) and Kirsten Gillibrand (D-NY) proposed the Responsible Financial Innovation Act (RFIA), a bipartisan bill that seeks to create an encompassing regulatory structure for digital assets that promotes responsible innovation in this space. The co-sponsorship by Lummis and Gillibrand is noteworthy not only because the legislators are from different parties, but also because Lummis is a member of the Banking Committee, which oversees the SEC, and Gillibrand is a member of the Senate Agriculture Committee, which oversees the Commodity Futures Trading Commission (CFTC).

The bill offers a comprehensive structure for the regulatory oversight of digital assets, covering wide-ranging areas such as securities, commodities, consumer protection, payments, banking and taxation. The bill also seeks to address a range of activities related to digital assets and exchanges, decentralized autonomous organizations (DAOs) and stablecoins. Some of the highlights of the proposed bill are summarized below.

CFTC Jurisdiction Over Digital Asset Transactions

The RFIA would grant the CFTC authority as the primary regulator of the spot market for cryptoassets by, among other things, formally adding "digital assets" to the definition of "commodity" under the Commodity Exchange Act (CEA). Notably, this definition covers only fungible assets, meaning that "digital collectibles and other unique digital assets" are excluded. Under the CEA framework, merchants of digital assets would be required to segregate customer's funds, unless those funds are held by an entity registered with a federal or state regulator, and investment of such funds may be limited by CFTC rulemaking. Nonetheless, granting CFTC primary regulatory authority over cryptocurrencies will likely be welcomed by the Web3 industry, which has generally viewed digital assets as more akin to commodities than securities.

Registration of Digital Asset Exchanges

The RFIA would require exchanges that deal in digital assets to register with the CFTC, unless otherwise exempted, and be subject to its regulations. Notably, registered digital asset exchanges could not permit trading in any digital asset that is easily subject to manipulation. The insider trading prohibitions of the CEA would apply to contracts for the sale of digital assets. Additionally, beginning October 1, 2023, registered entities engaging in digital asset cash or spot markets would be subject to fee collection to offset the cost of digital asset regulation.

Disclosure Requirements for Digital Asset Issuers

Where an issuer offers and sells a digital asset through what would constitute an investment contract under the Howey test (which the RFIA defines as an "Ancillary Asset"), the bill imposes certain reporting requirements. In doing so, the RFIA aims to codify and clarify the distinction between the initial offer and sale of a digital asset (which may be a "security" under the Howey test) and the Ancillary Asset itself (which may be sold or traded in secondary transactions and may not bear any of the hallmarks that made the initial offer and sale a security, and hence is "ancillary" to that offer). In doing so, the bill

harkens back to the Securities Clarity Act, which was proposed by Rep. Tom Emmer (R-MN). For a discussion of that proposed legislation, see our October 2020 edition of The Distributed Ledger.

To achieve that distinction in this legislation, the RFIA would make issuers of digital assets subject to certain reporting requirements if (i) they have issued more than $5 million of such Ancillary Assets in the previous 180 days and (ii) they (or another person owning not less than 10% of the equity of the issuer) are "engaged in entrepreneurial or managerial efforts that primarily determined the value" of the Ancillary Asset. These issuers would then be required to periodically disclose certain basic corporate information about themselves and specific information about the asset, including: the issuer's experience in the digital asset space; the backgrounds of the board of directors, senior management and key employees of the issuer; and risk factors specific to the digital assets. These disclosure requirements would remain in place until the issuer can demonstrate that the project is decentralized.

Under the RFIA, if the issuer complies with these disclosure requirements, the Ancillary Asset would be considered a commodity and not a security under the federal securities laws. A court order could overturn that categorization by finding there is "not a substantial basis for the presumption that an [A]ncillary [A]sset is a commodity and not a security." Additionally, the presumption does not prevent the SEC from entering into a settlement agreement relating to alleged violations regarding Ancillary Assets.

Consumer Protection Standards

The bill also proposes adding consumer protection standards for digital assets. A person or protocol that provides digital asset services must:

(i) disclose to each customer the scope of permissible transactions that may be undertaken with customer digital assets; and

(ii) give notice to each customer requiring acknowledgement:

- prior to any updates or material source code version changes;
- whether and how customer digital assets are segregated;
- how assets would be treated in bankruptcy or insolvency;
- the risks of loss;
- the time period and manner by which the digital assets will be returned to a customer on request;
- applicable fees; and
- the dispute resolution process.

Furthermore, under the proposed legislation customers using digital assets could not be forced to use an intermediary to store and safeguard those assets.

Taxation of Digital Assets

The RFIA would provide numerous changes or clarifications regarding the taxation of digital assets that would be favorable to taxpayers. First, the bill calls for a narrow pathway to exempt from taxation gains or losses under $200 in a taxpayer's virtual currency when such virtual currency is used to pay for goods or services (which would otherwise generally trigger any built-in gain or loss). This exemption would only apply to transactions where the digital assets are directly exchanged for goods or services; any conversion into another digital asset or into fiat currency would fall outside the scope of the exemption. Taxpayers would thus be incentivized to carefully monitor exactly how an exchange is structured, as economically identical transactions could have significantly different tax results.

The RFIA would clarify that digital assets received in exchange for mining or staking activities would not be taxed upon receipt (as traditionally proposed by the IRS), but would instead be taxable only upon a disposition.

For foreign investors, the RFIA would clarify that income derived from trading in digital assets (including through a broker) would generally not be treated as taxable within the United States, mirroring the current rules for trading in securities and commodities. Similarly, digital assets would be treated in the same manner as traditional securities for purposes of the "securities lending" rules under Section 1058 of the Internal Revenue Code.

The RFIA would also treat DAOs as business entities with a default classification that is not a disregarded entity (practically, this means that such entities would generally be taxed as corporations or as partnerships despite the differences between DAOs and traditional corporations/partnerships). However, DAOs involved solely in treasury management or raising funds for charitable purposes could qualify as tax exempt "social clubs" under Section 501(c)(7).

The RFIA would further impose or clarify certain reporting requirements for brokers with respect to transactions in digital assets, with such rules first applying to the 2025 taxable year.

Additionally, the RFIA would call for the IRS to promulgate guidance on a variety of topics, including mining and staking rewards, charitable contributions, information reporting and stablecoins, with such guidance to apply to taxable years beginning after December 31, 2023.

Depository Institutions' Issuance of Payment Stablecoins

The RFIA would permit depository institutions (i.e., insured banks, thrifts and credit unions) to hold and issue digital assets. However, it would place several restrictions on this practice, particularly with regard to stablecoins — i.e., digital tokens designed to maintain a price ratio consistent with another asset or currency (typically the U.S. dollar). Under the bill, a depository institution that issues "payment stablecoins" would need to maintain "high-quality liquid assets" equal to 100% of the face value of the outstanding stablecoins. Eligible high-quality liquid assets would include: U.S. coins and currency and other legal tender, demand deposits at a depository institution, balances held at a Federal Reserve bank, foreign withdrawable reserves, securities issued by or guaranteed by the Treasury Department with an original maturity of one-year or less, a reserve repurchase agreement relating to an aforementioned security or any other high-quality liquid asset consistent with safe and sound banking practice. The issuing depository institution must also provide public disclosures regarding the assets backing the stablecoin, including their value and the ability to redeem all outstanding payment stablecoins at par in legal tender. Importantly, under the RFIA, payment stablecoins issued by a depository institution would not be a commodity or a security.

The RFIA would establish a detailed process that depository institutions may elect to use to issue payment stablecoins. Moreover, the Office of the Comptroller of the Currency is permitted to charter national banks for the exclusive purpose of issuing payment stablecoins. In addition to facilitating state and national trust charters, this new chartering power would provide another avenue for digital asset companies to subject their activities to prudential oversight and to provide greater public assurances of the safety and soundness of their operations: The RFIA also creates a tailored supervisory framework under the jurisdiction of the Federal Reserve for the holding companies of depository institution issuers of payment stablecoins.

Additional Federal Agency Actions

The RFIA would also require multiple government agencies, often in cooperation with one another, to issue guidance or perform studies regarding digital assets. For instance, the bill requires all states to adopt similar money transmission laws for digital assets within two years of the bill's enactment. These laws would cover, among others, the following topics: whether digital assets are subject to money transmission licensing requirements, the treatment of payment stablecoins under money transmission laws and common examination and examiner training standards.

Additionally, the RFIA would require the Federal Energy Regulatory Commission (FERC), in consultation with the CFTC and the SEC, to conduct an analysis and generate a report regarding the energy consumption associated with digital asset markets. Under the bill, the FERC would be required to submit the report to certain congressional committees that oversee energy and the environment on an annual basis.

Finally, the RFIA would create the Advisory Committee on Financial Innovation — a bipartisan organization composed of members from the public and private sectors tasked with studying multiple aspects of the digital asset and financial sectors. This committee could potentially serve as an efficient channel through which to increase the dialogue between the government and the private sector working in the digital asset space.

Key Takeaways

Although the RFIA likely faces a long legislative path, especially given the number of areas it seeks to address, the bill marks a significant step toward more coordinated and comprehensive regulation of digital assets in the U.S. Notably, the bill seeks to realize a compromise between regulation and innovation through a balanced approach to oversight. It also aims to provide regulatory oversight on a wide range of issues in order to encourage responsible innovation and to ensure that the United States retains its position as a global leader in finance and technological advancement. In this regard, the bill aligns with President Joe Biden's recent executive order on ensuring responsible development of digital assets, issued on March 9, 2022, which recognized that the United States "has a strong interest in promoting responsible innovation that expands equitable access to financial services, particularly for those Americans underserved by the traditional banking system." The RFIA signifies the most comprehensive legislative effort in the digital asset space to date, and practitioners in the fintech sector should follow its development over the months ahead.

This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the firm's memorandum, "Senate Bill Would Create Comprehensive Regulatory Structure for Cryptocurrencies and Other Digital Assets," dated June 9, 2022, and available here.