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REPORT

# BIPARTISAN PROPOSAL ATTEMPTS TO PROVIDE SOLUTIONS FOR COMPREHENSIVE REGULATION OF DIGITAL ASSETS

June 2022

## THE RESPONSIBLE FINANCIAL INNOVATION ACT

On June 7, 2022, Senators Cynthia Lummis (R-WY) and Kirsten Gillibrand (D-NY) introduced the Responsible Financial Innovation Act (RFIA), a bipartisan effort to develop and provide greater regulatory clarity to the eclectic digital asset industry. Since releasing the text of the bill, Senators Lummis and Gillibrand launched a strong public lobbying campaign, discussing the bill at fundraisers, joint conference panel appearances, and other events as an opportunity for bipartisan cooperation and reassertion of US leadership in the distributed ledger technology fintech and investment space. The RFIA would create a more coherent and consistent regulatory framework for the digital asset industry, and encourage responsible financial innovation, flexibility, transparency, and robust consumer protection.

In particular, the bill addresses a number of significant issues involving the digital asset industry, including the following:

- **Definitions**: The RFIA would provide much needed clarity in the digital asset industry by defining key industry terms, such as digital asset, ancillary asset, virtual currency, distributed ledger technology, and smart contract.[1]
- **Jurisdiction**: The RFIA would expand the jurisdiction of the Commodity Futures Trading Commission (CFTC), assigning regulatory authority over digital asset spot markets to the CFTC, while maintaining the Securities and Exchange Commission's (SEC) jurisdiction over digital assets that are deemed securities. The bill attempts to address the overlapping regulatory jurisdictions between the SEC and CFTC by distinguishing between digital asset commodities and digital asset securities through the designation of "ancillary assets," which are presumed to be commodities.
- **Ancillary Assets**: The bill would define ancillary assets as assets that are not fully decentralized and have some sort of management in place, but are not securities because they do not offer debt or equity, create rights to profits or other financial benefits. While the bill would require issuers of ancillary assets to make disclosures to the SEC semi-annually, it allows such ancillary assets to be considered commodities and not securities. If an ancillary asset were to become fully decentralized, the SEC disclosure obligation would end.
- **Spot Markets**: The RFIA would give the CFTC exclusive jurisdiction over spot markets in all digital assets that are not considered securities, including ancillary assets. The bill would allow digital asset exchanges to conduct trading activities through registration with the CFTC. The bill also allows the CFTC to charge a user fee on digital asset exchanges to fund the agency.
- **Stablecoins**: The bill would require payment stablecoin issuers to hold reserves that are comprised of 100% eligible high-quality liquid assets and subject to periodic audit, and permit customers to redeem all stablecoins at any time. It also would set a framework for the Office of the Comptroller of the Currency (OCC) to issue national bank charters for payment stablecoin issuers.
- **Self-Regulatory Organizations**: The RFIA would instruct the CFTC and SEC to investigate potential ways to create a self-regulatory organization (SRO) for the digital

[1] *See* Annex A.

asset markets and to develop a proposal for the establishment of registered digital asset associations.

- **Taxes**: The bill would amend the taxation regime for digital assets in several ways. It provides a de minimis exclusion of $200 per virtual currency transaction, clarifies the definition of "broker" set forth in the bipartisan infrastructure package, and requires Congress to investigate whether individuals should be able to invest retirement savings in digital assets. It also would clarify the entity status of decentralized autonomous organizations (DAOs).
- **Disclosures**: The RIFA would impose disclosure requirements on digital asset service providers to help reduce the information disparity between digital asset issuers and purchasers. The bill requires digital asset service providers to disclose consumer protection information to investors, requires digital asset service providers to agree on terms of settlement finality with customers, and codifies individuals' rights to keep and control digital assets that they purchase.
- **Money Transmission**: State bank supervisors would be required to adopt substantially uniform standards relating to the treatment of digital assets under money transmission laws within a two-year period.
- **Interagency Cooperation**: The bill directs various government agencies, including the Treasury Department, CFTC, SEC, Federal Reserve Board, and Federal Energy Regulatory Commission (FERC), to study, report on, and propose guidance, regulations, and industry standards.

A more detailed discussion of these and other major components of the bill is provided below.

# A TALE OF TWO REGULATORS: THE TREATMENT OF DIGITAL ASSETS AS SECURITIES AND COMMODITIES

## THE SEC'S ROLE: PRESUMPTION OF COMMODITY, THE CODIFICATION OF HOWEY, AND A NEW DISCLOSURE REGIME FOR "ANCILLARY ASSETS"

The RFIA creates a presumption that a digital asset is a commodity, even if it is offered and sold in connection with a purchase and sale of a security through an arrangement or scheme that constitutes an investment contract, so long as it is fungible, through the creation and designation of a new legal term: ancillary asset.[2] In this respect, the bill acknowledges that a digital asset may be a security when the asset provides the holder of the asset with any of the following rights in a business entity: a debt[3] or equity interest, liquidation rights, interest or dividend payments, profit or revenue sharing derived solely from the entrepreneurial or managerial efforts of others, or any other financial interest. In establishing the concept of an "ancillary asset," the senators who sponsored the bill emphasized that the framework for whether a digital asset is a security is based on the seminal Supreme Court case, *SEC v. W.J. Howey*

[2] *See* Annex A.

[3] The bill does not explicitly reference *Reeves v. Ernst & Young*, 494 U.S. 56 (1990), which addresses when a note is a security. In this respect, there is a rebuttable presumption that a "note is . . . a 'security' unless it bears a strong resemblance (in terms of the four factors . . . [the court] identified) to one of the enumerated categories of instrument." *Id.* at 67.

*Co.,*[4] and subsequent case law that has found that an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.

Under the RFIA, an issuer that engages in fundraising activities through the sale of an ancillary asset in connection with a transaction appropriately characterized as an "investment contract" will be required to furnish tailored disclosures about the issuer and the ancillary asset to the SEC on a semi-annual basis so long as two conditions are present: (1) the average daily value of ancillary assets offered, sold, or otherwise provided in relation to the offer and sale of the investment contract in all open, public US spot markets must be greater than $5 million for the 180-day period immediately succeeding the date of the first offer, sale, or provision; and (2) during that 180-day period, the issuer, or any entity controlled by the issuer, has engaged in entrepreneurial or managerial efforts that primarily determined the value of the ancillary asset. An issuer must be in compliance with the applicable disclosure requirements in order for the presumption that the asset is a commodity, and not a security, to apply.[5] Once a digital asset becomes fully decentralized, meaning no entrepreneurial or managerial efforts are exerted by the issuer, the bill establishes procedures to cease such disclosure requirements to the SEC, but maintains its status as a commodity.[6] The RFIA also establishes a procedure through which a federal court may rebut the presumption that the ancillary asset is a commodity.

Although the bill would grant discretion to the SEC to adopt rules and guidance to implement the disclosure regime, including the ability for the SEC to exempt an ancillary asset from the disclosure requirements, the specific semi-annual disclosure that the bill proposes is consistent with the sort of disclosure public companies are required to provide, although scaled and tailored to the type of issuer and ancillary asset being provided. For example, the disclosure required would include basic corporate information regarding the issuer, such as its experience with developing similar assets, including prior history of issuing ancillary assets to securities purchasers, its activities with respect to the promotion, use, value, or resale of the ancillary asset and anticipated costs, the background of its board of directors, senior management, and key employees, a description of the issuer's assets and liabilities, to the extent material to the value of the ancillary assets, the identification of material legal proceedings, risk factors, ownership of the ancillary asset, related party transactions involving the ancillary asset, and recent sales and dispositions of the ancillary asset. While there is not a requirement to provide historical audited financial statements, the issuer would be required to provide a going concern statement from the chief financial officer of the issuer or equivalent official, signed under penalty of perjury, stating whether the issuer maintains the financial resources to continue business as a going concern for the one-year period following the submission of the disclosure, absent a material change in circumstances.

In addition to issuer-specific disclosure, information about the ancillary asset will be required, such as a description of the asset, including the standard unit of measure, the intended or known functionality and uses of the asset, its market and competition, and the total supply of the ancillary asset or the manner and rate of the ongoing production or creation of the ancillary asset. Issuers would also be required to disclose the average daily price for a constant unit of value of the ancillary asset during the relevant

[4] 328 U.S. 293 (1946).

[5] The bill is silent on what level of compliance is necessary to retain the presumption as well as the final arbitrator of compliance (e.g., the SEC or the CFTC).

[6] Since the RFIA contemplates that these conditions will be retested on an annual basis, it would allow for the possibility to exit the disclosure regime to the extent the conditions are no longer met subject to filing a certification to that effect with the SEC. The RFIA also contemplates a transition rule for ancillary assets that were issued prior to the bill.

reporting period, as well as the 12-month high and low prices, information relating to any external audit of the code and functionality of the asset, and any material tax, legal and regulatory considerations applicable to owning, storing, using, or trading the ancillary asset.

## CUSTODY AND CUSTOMER PROTECTION OF DIGITAL ASSET SECURITIES

Rule 15c3-3 (or the Customer Protection Rule) under the Securities Exchange Act of 1934 (Exchange Act) requires a broker-dealer to promptly obtain and thereafter maintain physical possession or control of all fully paid and excess margin securities it carries for the account of customers and to segregate customer securities from the firm's proprietary business activities, other than those that facilitate customer transactions. Customers who transact in traditional securities use registered broker-dealers to custody their securities and, as such, benefit from the protections provided by the federal securities laws, including the Customer Protection Rule and the Securities Investors Protection Act of 1970 (SIPA).

Relatedly, Rule 206(4)–2 under the Investment Advisers Act of 1940 (Advisers Act) regulates the custody practices of investment advisers registered or required to be registered under the Advisers Act. In general, Rule 206(4)-2 requires advisers that have custody of client funds or securities to implement controls designed to protect those client assets from being lost, misused, misappropriated, or subject to the advisers' financial reverses, such as insolvency. A registered adviser with custody of client funds or securities is required to take a number of steps designed to safeguard those client assets. The adviser must maintain client funds and securities with "qualified custodians," such as a bank or a broker-dealer, and make due inquiry to ensure that the qualified custodian sends account statements directly to the clients.

The SEC has grappled with the concept of custody under the Exchange Act and the Advisers Act as it relates to digital asset securities for some time given the significant concerns regarding fraud, theft, and loss with respect to the custodianship of digital asset securities. [7]

The RFIA attempts to provide some clarity to this long-standing issue involving the custody requirements of digital asset securities by requiring that the SEC issue guidance related to Rule 15c3-3 to provide that a satisfactory control location for a digital asset security may be fulfilled by protecting the asset with commercially reasonable cybersecurity practices for a private key material to transfer control of the digital asset to another person.

In addition, the RFIA would also require that within 18-months after enactment, the SEC complete its modernization of the rules related to customer protection and the custody of securities, digital assets, and client funds to account for changes in custody practices, digital assets, changes in market structure, technology, broker-dealer practices, and parity of state and national banks. Furthermore, the RFIA would effectively overrule the SEC's limited no-action position that allowed "special purpose broker dealers" to maintain custody of digital asset securities in compliance with certain conditions, including that the firm limit its business to only digital asset securities, by requiring the SEC to adopt guidance that would permit a broker-dealer to engage in the trading and custodial activities of both traditional and digital asset securities.[8]

[7] *See, e.g.,* Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities, Division of Trading and Markets, SEC and Office of General Counsel, FINRA (July 8, 2019); SEC Division of Examinations Risk Alert, "The Division of Examinations' Continued Focus on Digital Asset Securities".

[8] *See* SEC Policy Statement: Custody of Digital Assets by Special Purpose Broker-Dealers (Apr. 27, 2021).

## THE CFTC'S ROLE: INCREASED RESPONSIBILITY AND EXPANDED JURISDICTION

Under the RFIA, the CFTC is designated as the primary regulator of fungible digital assets that are not securities, including ancillary assets. The CFTC is provided exclusive spot market jurisdiction over these assets and clarifies when registration as a futures commission merchant (FCM) is necessary in connection with digital asset activities.

The RFIA establishes core principles, rulemaking, custody, customer protection, prevention of market manipulation, information-sharing, and preemption standards. Registration with and oversight by the CFTC as a digital asset exchange is optional and would be available to trading facilities, including registered designated contract markets (DCMs), and registered swap execution facilities (SEFs). Digital asset exchanges must be registered as a money services business with the Secretary of the Treasury's Financial Industry Crimes Enforcement Network (FinCEN). Notably, the RFIA establishes digital asset exchanges as financial institutions under the Bank Secrecy Act (BSA), subjecting such exchanges to a higher standard of BSA/Anti-Money Laundering compliance with FinCEN. However, the CFTC will have exclusive jurisdiction over the regulation and other activities of digital asset exchanges that opt to register.

Under the proposed legislation, the CFTC would have exclusive jurisdiction over **fungible** digital assets in interstate commerce, including ancillary assets. However, the CFTC would not have jurisdiction over collectibles, other unique digital assets, or digital assets that are securities. The CFTC also would be restricted from issuing rules regarding any agreement, contract, or transaction that is not offered, solicited, traded, facilitated, executed, cleared, reported, or otherwise dealt in on a digital asset exchange or other exchanges, clearinghouses, or swap data repositories (SDRs) or by any other entity registered with the CFTC. Thus, unless digital asset exchanges choose to voluntarily register with the CFTC pursuant to the proposed legislation, the CFTC's rulemaking authority would be significantly limited.

Notably, in what would be a significant first for the CFTC, Congress would authorize the CFTC to collect fees from exchanges and other registered entities engaged in cash or spot digital asset activities and in relation to the regulation of such activities under the Commodity Exchange Act (CEA). Fees may not be imposed on exchanges or other registered entities relating to leveraged, margined, or financed digital asset transactions under the CEA. The proposed legislation places a $30 million cap on fees, unless otherwise provided by law.

## NEW DIGITAL ASSET EXCHANGE AND FCM REGISTRATION REQUIREMENTS

In a change from the CFTC's traditional exchange oversight authority, the proposed legislation gives the CFTC jurisdiction over digital asset exchanges that offer spot digital assets and margined, leveraged, or financed transactions. Currently, the extent of the CFTC's jurisdiction over spot or cash commodities is limited to antifraud and antimanipulation authority. Under the bill, any trading facility[9] that offers a market in digital assets **may** register with the CFTC as a digital asset exchange, but it may only offer digital assets (including cash, spot or margined, leveraged, or financed digital asset transactions). Thus, a digital asset exchange may not offer futures contracts, options on futures, or swaps unless it is also registered as a DCM or SEF. However, registered DCMs and SEFs that satisfy the requirements under the digital asset registration provisions may elect to be considered a registered digital asset exchange under

[9] Subject to specific exclusions, a trading facility means "a person or group of persons that constitutes, maintains, or provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions—(i) by accepting bids or offers made by other participants that are open to multiple participants in the facility or system; or (ii) through the interaction of multiple bids or multiple offers within a system with a pre-determined non-discretionary automated trade matching and execution algorithm." 7 U.S.C. § 1a(51)(A).

a deemed registration concept. As noted in the summary, digital asset exchanges must be registered with FinCEN as money services businesses under the proposed bill. Similar to the CEA's provisions governing the registration of other types of exchanges, clearinghouses, and SDRs, the digital asset exchange registration framework incorporates core principles and gives the exchange reasonable discretion in establishing the manner in which it will comply with the core principles.

## NEW ABILITY FOR CUSTOMERS TO OPT OUT OF SEGREGATION

In another first under the CEA, customers would have the right to waive any segregation requirement by written election. In the context of a digital asset exchange, the term "customer" is defined to mean "any person that maintains an account for the trading of digital assets directly with a digital asset exchange (other than a person that is owned or controlled, directly or indirectly, by the digital asset exchange) on behalf of the person or any other person." Although futures contracts and certain swaps must be cleared by a derivatives clearing organization, the proposed legislation does not impose any such requirement on digital asset exchanges but permits digital asset exchanges to accept funds from customers. Digital asset exchanges must comply with the CFTC's customer protection regime, including treating and dealing with customer funds as belonging to the customer; establishing standards designed to protect and ensure the safety of customer money, assets, and property; holding such customer money, assets, and property in a manner that minimizes the customer's risk of loss of, or unreasonable delay in the access to such money, assets, and property; and segregating customer funds. Customers could opt out of segregation if they choose to do so, but the CFTC may establish rules related to the customer waiver as reasonably necessary to protect customers, including eligible contract participants, non-eligible contract participants, and any other class of customers.

## UNIQUE CONSIDERATIONS IN ASSESSING WHETHER DIGITAL ASSETS ARE READILY SUSCEPTIBLE TO MANIPULATION

The proposed legislation addresses the unique nature of digital assets, requiring a digital asset exchange to permit trading only in digital assets that are not readily susceptible to manipulation and including explicit listing restrictions and considerations, including:

- A prohibition on listing a digital asset if it is reasonably likely that the:
  - transaction history of the digital asset can be fraudulently altered by any person or group of persons acting collectively; or
  - functionality or operation of the digital asset can be materially altered by any person or group of persons under common control.
- When assessing a digital asset to determine whether it is readily susceptible to manipulation, a digital asset exchange must consider the following factors:
  - the purpose and use of the digital asset;
  - the creation or release process of the digital asset;
  - the consensus mechanism of the digital asset;
  - the governance structure of the digital asset;
  - the participation and distribution of the digital asset;
  - the current and proposed functionality of the digital asset;
  - the legal classification of the digital asset; and
  - any other factor required by the CFTC.

### EXPANSION TO FCM REGISTRATION REQUIREMENTS

The proposed legislation would expand the definition of FCM to include any person "acting as a counterparty to any cash or spot agreement, contract or transaction involving a digital asset with a person who is not an eligible contract participant" unless the activity is conducted in compliance with the laws of the state in which the activity occurs, subject to regulation by another federal authority, or separately regulated under the CEA. The proposed legislation prohibits an FCM from acting as counterparty in any agreement, contract, or transaction involving a digital asset that has not been listed for trading on a registered digital asset exchange. Such prohibition may lead to decreased cash or spot or retail commodity digital asset transactions or a desire for digital asset exchanges to become registered and allow for the crypto community to continue operating as it has been for the past several years.

In this context, a customer is defined differently than the definition used for digital asset exchanges, and a "digital asset customer" means "a customer involved in cash or spot, leveraged, margined, or financed digital asset transaction in which the futures commission merchant is acting as the counterparty." FCMs that accept funds from customers must adhere to customer protection and segregation requirements, although customers may elect to waive their right to segregation similar to the customer opt out right under the digital asset exchange provisions.

### EXCLUSIONS FROM RETAIL COMMODITY TRANSACTION RULES

Under the proposed legislation, the CEA would be amended to include new exclusions for retail commodity transactions where the underlying asset is a digital asset. Under these exclusions, the retail commodity transaction provision does not apply to any contract of sale of a digital asset that (1) results in actual delivery within two days or such other period as the CFTC may determine by rule based upon the typical commercial practice in the digital asset's cash or spot markets; or (2) is executed on a registered digital asset exchange or with a registered FCM. The requirement that actual delivery occur within two days is different than the CFTC's guidance on actual delivery for retail digital asset transactions, which allows for actual delivery to occur within 28 days. In addition, the exclusion for transactions executed with a registered FCM is not currently available for retail commodity transactions unless actual delivery is satisfied within the prescribed time period.

### BANKRUPTCY REGIME WOULD CAPTURE DIGITAL ASSETS

The proposed legislation also revises the Bankruptcy Code to include digital asset exchanges under the definition of commodity broker, expands the voidable transfer provision to include transfers of digital assets, and expands the exception from the automatic stay provision to apply to digital asset exchanges in the same way it applies to derivatives clearing organizations, DCMs, and other exchanges. The definitions in Chapter 7, Subchapter IV (governing commodity broker liquidations) would be revised such that a commodity contract would include a contract for the sale of a digital asset by a registered digital asset exchange and customer property would include digital assets. In addition, Section 766 of the Bankruptcy Code, treatment of customer property, would be revised to encompass digital assets.

## RESPONSIBLE CONSUMER AND PAYMENT PROTECTION

### CONSUMER PROTECTION

The RFIA imposes on providers of digital assets certain disclosure requirements and other standards related to customer agreements, including information regarding asset treatment in bankruptcy, risks of loss, applicable fees, redemption, dispute resolution process, as well as information concerning the digital asset's source code and legal treatment under commodities and securities laws. Providers of lending

arrangements relating to digital assets also would be required to provide certain specified disclosures to customers. Certain providers of digital assets also would be required to provide higher standards of disclosure. The bill requires digital asset service providers and customers to agree on terms of settlement finality for all transactions, including the conditions under which a digital asset may be deemed fully transferred. In addition, the bill establishes the right to keep digital assets personally owned.

Based on the broad definition of "person who provides digital asset services," the RFIA would impose disclosure requirements on a variety of market participants, including digital asset exchanges.

### PAYMENT INNOVATION

The RFIA provides that issuers of payment stablecoins are required to (1) maintain high-quality liquid assets valued at 100% of the face value of all outstanding payment stablecoins; (2) provide public disclosures on the assets backing the stablecoin and their value; and (3) have the ability to redeem all outstanding payment stablecoin at par in legal tender. The bill establishes an optional process for depository institutions to conduct all incidental activities relating to payment stablecoins, including issuance, while confirming that such a digital asset will not be considered a commodity or a security. The Office of Foreign Assets Control (OFAC) will be required to adopt final guidance articulating the sanctions compliance responsibilities and liabilities of an issuer of payment stablecoins with respect to downstream transactions. The RFIA permits the OCC to charter a National Bank Association engaged exclusively in the activity of issuing a payment stablecoin. The OCC is required to establish permissible activities, tailored capital requirements, community contribution requirements, and a recovery and resolution plan for depository institutions exclusively engaged in issuing payment stablecoins. The OCC must consider the applications for charter of non-depository trust companies or holders of state digital asset licenses prior to any new applications for a charter to operate as a National Bank Association, in order to preserve adequate competition in payment stablecoins.

Finally, the bill establishes an Innovation Laboratory within FinCEN whose purpose is to increase dialogue with the digital asset and financial technology industry, to make recommendations to Congress, and to enable pilot projects with financial companies to enhance supervision of financial technology.

### BANKING INNOVATION

The Federal Reserve is directed to study how distributed ledger technology (DLT) may be used to reduce risk in depository institutions. Further, the services of the Federal Reserve banks are expanded where the bill requires such banks to make available payment, clearing, and settlement services to any depository institution chartered under state or federal law, as well as where the bill requires such banks to make available a segregated balance account upon request. The Federal Reserve Board of Governors is also directed to assume issuance of routing transit numbers to depository institutions.

The Federal Financial Institutions Examination Council (FFIEC) is required to adopt examination standards relating to the digital asset activities of depository institutions within an 18-month period. Furthermore, examinations ratings will no longer be permitted to consider reputational risk in the examination of a depository institution. The FFIEC examination manuals are used by both federal and state agencies in the examination of depository and non-depository financial institutions.

## TAXATION OF DIGITAL ASSETS

If adopted, the RFIA would help answer multiple difficult questions regarding the taxation of digital assets and further directs the Internal Revenue Service (IRS) to adopt guidance or clarifications on other long-standing issues in the digital asset industry, including airdrops and forks, merchant acceptance of digital

assets, charitable contributions, digital asset mining and staking, and the legal characterization of payment stablecoins as indebtedness. Of the various changes to the taxation of digital assets proposed by the RFIA, one headline proposal is a new $200 de minimis exclusion (adjusted for inflation) per transaction[10] from the recognition of gain or loss from the disposition of a virtual currency[11] when an individual uses virtual currency to pay for good or services. Prior legislative proposals that did not become law included a $600 de minimis exclusion. Under current law, there is no such de minimis exclusion and so any expenditure of digital assets may be a taxable event.

Another notable proposal from the RFIA that answers a question confounding many tax practitioners and industry stakeholders would be the adoption of new sub-section 451(l) of the Internal Revenue Code of 1986, as amended (the Code). This new provision would provide that digital assets acquired from mining or staking activities will not be taxable upon receipt; rather, they will be taxable upon disposition of such assets. This position matches the taxpayer's position in a widely publicized district court case in which a taxpayer argues that block validation token awards using a proof-of-stake protocol are not subject to tax on receipt and instead are subject to tax only on disposition.[12]

Importantly, RFIA also narrows the scope of the information reporting requirements for persons effectuating transactions in "digital assets." Specifically, the RFIA explains that a person is treated as a "broker" within the meaning of Section 6045(c)(1) of the Code, and subject to information reporting, if the person "(for consideration) stands ready in the ordinary course of a trade or business to effect sales of digital assets at the direction of their customers." According to Senators Lummis and Gillibrand, this new definition is expected to substantially reduce the number of persons captured by the current broker information reporting rules that are to take effect on January 1, 2024, because the existing rule broadly captures "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person." While the new RFIA definition is captioned a "clarification" of current law, it requires the person to be in the "ordinary course of a trade or business" of effectuating "sales" transactions for "customers", which is a smaller subset of persons engaging in transactions of digital assets. The new definition is unlikely to include such participants as miners, stakers, and other validators and developers who do not otherwise meet the new definition. It is unclear how or whether the guidance expected to be issued by the Treasury Department and IRS with respect to the recently enacted Infrastructure Investment and Jobs Act broker reporting requirement would interact with this new proposal.

The RFIA would also include other clarifications for tax purposes, including expanding the trading safe harbor in Section 864(b) of the Code to include the trading of digital assets for one's own account (other than for a dealer), for foreign persons looking to avoid being treated as engaged in a US trade or business. Furthermore, the RFIA, if passed would also classify certain DAOs as "business entities" and not as a "disregarded entity" under the default entity classification rules of Section 7701 of the Code. Such a change is expected to bring these entities within the purview of the taxing regime and at a minimum cause such entities to be subject to tax return filing requirements, though it is unclear how existing decentralized autonomous organizations would comply with or avail themselves of this change in law. The RFIA also expands the scope of the security lending rules in Section 1058 of the Code to include "digital assets" such that lending of such assets in conformity with the rules does not subject the lender to current taxation.

[10] Subject to an aggregation rule.
[11] As noted above, "virtual currency" is a newly defined term by the RFIA.
[12] *Jarrett v. United States*, No. 3:21-cv-00419 (M.D. Tenn. 2022).

## INTERAGENCY AND STATE COORDINATION

A barrier to consensus among industry practices is the result of, in part, the lack of federal regulatory guidance. Federal financial regulators would be required to provide interpretative guidance on a matter within the jurisdiction of the regulator within six months of a request. Another barrier is the lack of uniform standards in the application of money transmission laws across states. Under the RFIA, state bank supervisors would be required to adopt substantially uniform standards relating to the treatment of digital assets under money transmission laws within a two-year period.

Finally, the RFIA requires various studies to be performed and reported. The Treasury Department is required to study certain topics relating to decentralized finance, FERC is required to conduct a study analyzing topics around energy consumption in the digital asset industry, the CFTC and SEC are directed to conduct a study on self-regulation in the digital asset markets and to develop a proposal for the establishment of registered digital asset associations, and also must develop comprehensive, principles-based guidance related to cybersecurity for digital asset intermediaries. Finally, the RFIA establishes an Advisory Committee on Financial Innovation that will study and report to regulators on the evolving digital asset market for the purpose of adopting and updating regulations as the industry and regulatory needs change.

## TAKEAWAYS: THE POLITICAL CONSIDERATIONS

Dozens of bills seeking to address various aspects of the expanding digital asset ecosystem have been introduced during the 117th Congress. However, attention is a two-way street in Washington, and while lawmakers have grown increasingly interested in regulating digital assets in recent years, industry lobbying and political giving has exploded to shape, or in some cases prevent, future regulation.[13] For years, the biggest question about digital asset regulation on Capitol Hill was "will they"? The RFIA is a massive step forward because it is one of the first efforts to affirmatively answer that question in a comprehensive and bipartisan way.

While it appears more likely than ever that Congress will attempt to create a new regulatory framework for digital assets, it does not necessarily mean that the RFIA will ultimately be that law. First, it is an election year, and the congressional calendar is extremely tight due to other obligations and priorities. If the legislation is not passed by the end of the calendar year, it will need to be reintroduced when the 118th Congress convenes in January 2023. Second, while certain regulators and industry groups were asked to consult on the RFIA,[14] there are many important members of Congress who have not attached themselves to the RFIA. Coupled with the longer legislative timeline and a potential Republican takeover of the House and Senate, it is expected that more key members of Congress will weigh in. Notably, the bipartisan leadership of the Senate Agriculture Committee, Senator Debbie Stabenow (D-MI) and Senator John Boozman, are expected to release their digital asset legislation soon. In the House, Representative Patrick McHenry (R-NC), the top Republican on the Financial Services Committee and a leader on digital assets in Congress, turned down a potential leadership position to remain in charge of Financial Services,

[13] "Crypto industry executives spend millions on political contributions as Washington weighs industry regulations," Open Secrets, June 6, 2022.

[14] Senators Lummis and Gillibrand indicated that the CFTC had an active role "from the very beginning . . . [and they] incorporated all those ideas and thoughts [from the CFTC chair] in [the bill]." Transcript: The Evolution of Money: Cryptocurrency Regulation, Washington Post Live (June 8, 2022). With respect to the SEC, Senator Lummis indicated that the senators were looking forward to SEC Chair Gary Gensler's feedback on the proposed legislation and while that there had been "verbal" feedback from the SEC staff during drafting, the SEC "declined" to provide written feedback on prior drafts of the proposal. *Id.*

saying "over the last four years as the Ranking Member at FSC, I have focused efforts to drive innovation, technology adoption, and embrace digital assets—tools which enable financial inclusion and better economic results. I plan to redouble those efforts, especially where we can achieve bipartisan consensus."[15]

With respect to the SEC and the CFTC's thoughts on the proposal, CFTC Chair Rostin Behnam publicly expressed support for the proposal,[16] while SEC Chair Gary Gensler suggested disapproval, noting that "[w]e don't want to undermine the protections we have in a $100 trillion capital market . . . [l]ike behaviors should have like treatment."[17] This highlights that regulating digital assets will have profound impacts on the regulators as well. Jurisdiction over future regulation of digital assets will require that certain regulatory agencies receive additional resources, and congressional committees may gain massive new power (and the campaign contributions that come with it). This makes a comprehensive bill more difficult and time-intensive to pass. If this is the case, it is possible that Congress could move to more quickly to address individual industry components, such as stablecoins, first while delaying a more far-reaching regulatory endeavor to a future date.

Morgan Lewis will continue to monitor and analyze developments as negotiations impacting digital asset legislation mature.

[15] "GOP's McHenry says he will seek chairmanship, not whip position," *The Hill*, April 25, 2022.
[16] "CFTC Chairman Signals Support for Lummis-Gillibrand Crypto Plan," BloombergLaw.com (June 8, 2022).
[17] Kiernan, Paul, "Crypto Legislation Could Undermine Market Regulations, Gensler Says," Wall Street Journal (June 14, 2022).

# ANNEX A – DEFINITIONS

**DIGITAL ASSET** (A) means a natively electronic asset that (i) confers economic, proprietary, or access rights or powers; and (ii) is recorded using cryptographically secured distributed ledger technology, or any similar analogue; and (B) includes (i) virtual currency and ancillary assets, consistent with section 2(c)(2)(F) of the Commodity Exchange Act [(the CEA)]; (ii) payment stablecoins [(defined below)], consistent with Section 403 of the Legal Certainty for Bank Products Act of 2000 (7 U.S.C. 27a); and other securities and commodities.

**VIRTUAL CURRENCY** (A) means a digital asset that (i) is used primarily as a medium of exchange, unit of account, store of value, or any combination of such functions; (ii) is not legal tender; and (iii) does not derive value from or is backed by an underlying financial asset (except other digital assets); and (B) includes a digital asset, consistent with subparagraph (A) that is accompanied by a statement from the issuer that a denominated or pegged value will be maintained and be available upon redemption from the issuer or other identified person; based solely on a smart contract.

**ANCILLARY ASSET** (A) means an intangible, fungible asset that is offered, sold, or otherwise provided to a person in connection with the purchase and sale of a security through an arrangement or scheme that constitutes an investment contract, as that term is used in section 2(a)(1) of the Securities Act of 1933 (15 USC 77b(a)(1)). (B) The term . . . does not include an asset that provides the holder of the asset with any of the following rights in a business entity: (1) A debt or equity interest in that entity; (ii) Liquidation rights with respect to that entity; (iii) An entitlement to an interest or dividend payment from that entity; (iv) A profit or revenue share int hat entity derived solely from the entrepreneurial or managerial efforts of others; (v) Any other financial interest in that entity.

**PAYMENT STABLECOIN** means a digital asset that is (A) redeemable, on demand, on a one-to-one basis for instruments denominated in United States dollars and defined as legal tender under Section 5103 or for instruments defined as legal tender under the laws of a foreign country (excluding digital assets defined as legal tender under the laws of a foreign country);(B) issued by a business entity; (C) accompanied by a statement from the issuer that the asset is redeemable as specified in subparagraph (A) from the issuer or another identified person; (d) backed by 1 or more financial assets (excluding other digital assets), consistent with subparagraph (A); and (E) intended to used as a medium of exchange.

**DISTRIBUTED LEDGER TECHNOLOGY** means technology that enables the operation and use of a ledger that (A) is shared across a set of distributed nodes that participate in a network and store a complete or partial replica of the ledger; (B) is synchronized between nodes; (C) has data apprehended to the ledger by following the specified consensus mechanism of the ledger; (D) may be accessible to anyone or restricted to a subject of participants; and (E) may require participants to have authorizations to perform certain actions or require no authorization.

**SMART CONTRACT** (A) means (i) computer code deployed to a distributed ledger technology network that executes an instruction based on the occurrence or non-occurrence of specified conditions; or (ii) any similar analogue; and (B) may include taking possession or control of a digital asset and transferring the asset or issuing executable instructions for these actions.

Morgan Lewis

## CONTACTS

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## ABOUT US

Morgan Lewis is recognized for exceptional client service, legal innovation, and commitment to its communities. Our global depth reaches across North America, Asia, Europe, and the Middle East with the collaboration of more than 2,200 lawyers and specialists who provide elite legal services across industry sectors for multinational corporations to startups around the world. For more information about us, please visit www.morganlewis.com.

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