

Digital Asset Regulation in the United States: An Opportunity for Progress or a Threat to Innovation?

THE STATE OF THE MARKET – SUCCESS BREEDS REGULATION

The year 2021 will be known as the year when blockchain and digital assets of all types (including “cryptocurrencies”) became mainstream. Digital wallets in the U.S. now number over 150 million and one study predicts that by 2025 the global number of unique digital wallet users could exceed 4.4 billion. In 2013 the market cap for the entire digital asset market was around \$1.5 billion. In 2021 that number had grown to \$2 trillion. The total number of crypto users worldwide in 2013 was 1,000,000. Today, it is over 330 million. Those numbers are particularly astounding given that the use cases for digital assets are still in early stages of development and adoption, and the ability of digital asset platforms to truly scale has only come onto the scene within the last 12 months. Importantly, 2021 also will be known as the year in which solutions emerged to problems with financial products developed and traded on blockchains, such as scalability, speed, practicality, and security. For example, this was the year in which “Layer 2” solutions became ubiquitous which, in turn, drove considerably greater transaction speeds, thus allowing products to be scaled. Accordingly, a “Cambrian explosion” of new financial products have grown in total market value and expanded the numbers and kinds of solutions they offer for users.

This success has bred more attention to the

potential, and the risks, of digital assets. As the market grows, so does the potential for harm to consumers and, perhaps, to market structure and monetary policy. These factors, combined with the complexities of the underlying technology, the speed of funding, and the immediacy and immutability of settlement, have captured the attention of the regulatory community.

THE U.S. REGULATORY STRUCTURE FOR FINANCIAL INSTITUTIONS

The financial regulatory architecture in the U.S. is highly diffused. Sitting above the wide variety of regulatory agencies is the U.S. Congress, which created the statutory scheme on which the current regulations are based. In many cases the relevant statutes were created nearly 90 years ago, drafted by men the youngest of whom was born in 1900, and voted on by Senators 70% of whom were born before Thomas Edison patented the first electric lightbulb. It is not a statutory scheme well designed for the issues presented by instantaneous communications and immutable settlement conducted over globally distributed ledgers and governed by thousands of nodes. The fundamental building blocks forming this statutory foundation are centralized, rules-based, highly bureaucratic, dependent on middlemen, and subject to continuous and sometimes conflicting interpretations.

The regulatory components can be grouped within several large categories. First are the market and anti-fraud regulators such as the Securities and



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Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). Second are the consumer protection regulators, the most active of which is the Consumer Financial Protection Bureau (CFPB), as well as the Federal Trade Commission (FTC). Third are the “prudential” and monetary policy banking regulators – the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). Fourth are the financial policy and anti-crime organizations such as the Department of the Treasury (including the Financial Crimes Enforcement Network [FinCEN] and the Office of Foreign Assets Control [OFAC]) and the Department of Justice (DOJ), including the newly formed National Cryptocurrency Enforcement Team (NCET). Fifth are the organizations that are intended to coordinate the efforts of all of them, such as the Federal Financial Institutions Examination Council (FFIEC), the Financial Stability Oversight Council (FSOC) and the President’s Working Group on Financial Markets (PWG).

Each of these entities has its own jurisdictional perimeter of which it is highly protective and which it often attempts to expand. For example, SEC Chairman Gary Gensler has contended that all digital assets are securities, thus suggesting that the entire market should be regulated by the SEC. On the other hand, the acting Chairman of

the CFTC, Rostin Behnam, noted that the two most popular cryptocurrencies (Bitcoin and Ethereum) account for 60% of the market and have been ruled to be commodities. Both agency heads are seeking additional statutory authority from Congress.

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The lack of clear jurisdictional boundaries contributes to confusion at the regulatory level and industry level. In turn, this makes it more difficult for legislators, regulators, and industry members to find common ground.

THE CURRENT U.S. REGULATORY ENVIRONMENT FOR DIGITAL ASSETS

Digital assets were generally not viewed as mainstream products before 2021. But as the price of Bitcoin rose to over \$60,000 earlier this year, then plummeted, and then returned to its previous highs, and as products such as stablecoins grew to become integral parts of useful innovations (such

as crypto finance), the regulatory view began to tilt more aggressively. At the same time, the new Administration in Washington brought with it new agency heads with a more activist point of view and an enhanced proclivity to regulate.

Today, nearly every U.S. financial regulator has taken an aggressive and mostly negative view toward digital assets in almost all of their manifestations. There has been no lack of heated rhetoric in how digital assets have been described. Phrases like “fool’s gold”, “poker chips”, “toxic” and “snake oil” are in ample supply. But the negative press has not stanching the growth of the digital assets.

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The decentralized nature of digital assets has regulators particularly concerned. Decentralized exchanges, where cryptocurrencies and digital assets are traded, do not maintain a limit order book or other features of a typical securities or commodities exchange. They are direct peer to peer purchases and sales. The absence of a “middle-man” – whom often is the entity which the government regulates – concerns regulators. Obviously, when regulatory action is taken it is important that there be a central governing point with which the regulators can interact. When there are only nodes (as in decentralized finance), which are “pseudonymous”, and which can be distributed across the globe, oversight and enforcement become more challenging. That said, digital asset entities such as crypto exchanges, which interact directly with end-users, are regulated for both consumer protection and systemic risk purposes.

THE NATURE OF NEW REGULATION

The irony of the current regulatory environment is that the agencies are seeking from Congress

additional powers to regulate the blockchain and digital asset industry, while at the same time contending that their existing powers enable them to bring broad enforcement actions. Most of the new agency heads also intend to engage in additional rulemaking related to digital assets. The challenge for regulators is that expanding their jurisdiction through Congressional action is often slow, contentious, and interfered with by other legislative imperatives. Rulemaking, while perhaps not as slow as legislation, involves an extensive notice and comment process that can be just as contentious as law making.

Because of this, regulators often resort to “Regulation by Enforcement,” a kind of de facto rulemaking by issuing guidance (which is not enforceable), undertaking consumer awareness campaigns, and bringing enforcement actions. For example, the CFPB earlier this year withdrew a policy statement issued by the prior Director which had provided clarity to the industry as to what counts as “abusive conduct.” However, the new head of the CFPB, Rohit Chopra, told Congress that the statement did not, in his view, provide clarity and that he would instead likely use a mix of guidance, litigation and rules to help articulate standards for abusiveness. Because “regulation by enforcement” often lacks predictability, it can lead industry members to over-correct for what they guess might be future problems.

WHAT IS ON THE REGULATORY AGENDA?

The CFTC appears content with the current view that most digital assets are commodities and can be regulated as such. However, because it is a small agency, its capacity to truly oversee the market is limited. Nonetheless, it has clear anti-fraud jurisdiction and recently brought two large enforcement actions against BitMEX (\$100MM) and Tether (\$41MM).

The banking agencies, particularly the FRB, appear most concerned about regulation of stablecoins and their potential impact on (i) the Fed’s development of a central bank digital currency and (ii) monetary policy. We anticipate stablecoins will be limited in a particular way, such as by extensive risk disclosures or use cases. We also anticipate extensive requirements for risk assessments and risk monitoring if the Fed

determines that stablecoins pose a “systemic risk,” something that would be more likely if stablecoins emerge as stout competitors of fiat currencies as stores of value.

On October 26, the Chairperson of the FDIC, Jelena McWilliams, indicated her agency was exploring with other regulators “under what circumstances banks can engage in activity involving crypto assets.” She focused particularly on stablecoins and noted that oversight “should rest on the foundation that stablecoins issued from outside the banking sector are truly backed 1:1 by safe, highly liquid assets.”

In an earlier academic paper, Saule Omarova, the current nominee for Comptroller of the Currency and a so-called “crypto critic”, expressed concerns about stablecoins, particularly the launch of Libra/Diem, that could have broad policy implications due to the opening up of “central banks balance sheet to Big Tech and other emerging fintech platform operators.”

Finally, the government has begun to make specific recommendations with respect to its preferences for a future regulatory architecture. On November 1, the PWG (along with the OCC and the FDIC) issued its long-awaited report on stablecoins. It catalogs a series of potential risks and then recommends that Congress enact legislation to ensure that stablecoins and stablecoin arrangements are brought within the federal prudential regulatory framework, by recommending: (i) stablecoin issuers be required to be insured depository institutions, (ii) require custodial wallet providers be subject to federal oversight including requirements for appropriate risk management standards; and (iii) require stablecoin issuers to limit affiliation with commercial entities and that inter-operability standards be implemented. It also recommends that FSOC designate certain stablecoin activities as systematically important. Following that announcement, the Acting Comptroller of the Currency, Michael Hsu, in two different speeches on November 3 and 16, called for an expanded “financial regulatory perimeter,” including “comprehensive consolidated supervision” of certain cryptocurrency firms. He further called for coordination among the regulators and promised that the findings from the inter-agency “crypto sprint” would be available soon.

Further details have been left unsaid for the moment. While apparently conceding they need

additional powers from Congress to achieve all of their desired outcomes, the regulators obviously have firmly placed digital assets at the top of their action list.

WHAT IS THE PATH FORWARD?

Larger digital asset companies and even the most libertarian of digital product advocates are realizing that regulation is inevitable, and that engaging with regulators offers the potential to shape a reasonable regulatory regime. To determine the optimal path forward requires clear definitions of where the industry is headed and why. There is no shortage of thoughtful commentary in this space.

No single U.S. regulator has comprehensive authority to regulate digital assets, and large parts of the sector remain beyond the current jurisdiction of any regulator

In testimony before the U.S. Senate, Jeremy Allaire, the CEO of Circle, called for globally coordinated national policies on digital assets to ensure “there is supervision and compliance around the fundamental protections needed for financial services – enterprise risk, cyber security risk, fraud and financial crime risk, and the risk of theft”, with the goal of enabling rapid technological progress within the context of sound risk management.

Given the decentralized nature of digital assets, another piece of the puzzle is the successor to the internet – what is commonly referred to as “web3”. In an October 21, 2021 White Paper on the subject of “How to Win the Future”, the venture capital firm Andreessen Horowitz stated its belief in three core principles to guide policymakers and “to deliver resilience and efficiency: secure, inclusive digital infrastructure; greater economic prosperity; and participatory, accountable governance.” Web3 systems offer a better vision of how societies should use technology because they are directly accountable to their users and provide an

alternative to the status quo dominated by big tech and centralized regimes.

Decentralization is the organizing principle of our past and future successes with respect to economic growth and dynamism. “Decentralization fosters democratized technology platforms that embody the values of open societies and will provide the infrastructure to power tomorrow’s economy and institutions.”

Policymakers should work with market participants to unlock the potential of web3 technologies

Policymakers should work with market participants to unlock the potential of web3 technologies and design regulatory frameworks that are carefully calibrated to address perceived risks.

Coinbase has issued its own Digital Asset Policy Proposal that embraces the regulation of digital assets. But it also suggests that the regulation take place under a new and separately crafted framework, with one regulator for marketplaces for digital assets (MDAs) and a dedicated self-regulatory organization to strengthen the oversight regime and provide more granular oversight of MDAs. Coinbase’s proposal highlights the risk of continued dependence on the current structure, which could force “the full spectrum of digital assets into supervisory categories codified before the use of computers [thus] stifling the development of this transformational technology [and] pushing offshore the innovative center of gravity that currently sits in the United States.”

For our own part, we suggest four elements of a productive path forward.

First, regulators should prioritize regulatory cooperation. Confusion about jurisdictional boundaries and reach has done little to promote innovation or guide the industry toward safety and security.

Second, regulators and market participants should prioritize digital asset education. Digital assets and decentralized finance can improve access to capital, eliminate or reduce costs, fight

financial crime, and enhance new opportunities to create value. How this can be accomplished prudently must be understood before picking up the regulatory pen.

Third, regulators should clearly articulate the goals of regulation by determining the risks they want to mitigate or avoid. Only then can regulated parties begin to build safe, secure, transparent, and compliant solutions. Where those solutions are not available, appropriate disclosure and reporting regimes can provide consumers and other stakeholders with needed information.

Fourth, regulators should sponsor “regulatory sandboxes” for the broad variety of products and projects being undertaken by the sector. In such venues, the interactions between new products and newly designed regulations can be vetted in a collaborative testing environment. These sandboxes should be developed with full transparency as to the projects tested and the lessons learned.

Thoughtful and collaborative engagement among legislators, regulators and the digital asset industry promises greater benefits than siloed approaches and confrontation. Dialogue builds trust, trust leads to confidence and confidence spurs innovation. That should be the arrival point of the path forward. ■

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