

Who's in charge? an overview of U.S. digital asset regulation

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It is almost impossible to scan the news without seeing multiple headlines relating to cryptocurrency and other digital assets. Perhaps the definitive sign that crypto for the masses has arrived and is here to stay is the fact that Bitcoin and Dogecoin whisperer, Elon Musk, recently hosted Saturday Night Live, which also parodied NFTs. Earlier this year, Tesla announced it was investing \$1.5 billion in Bitcoin, adding momentum to a wave of corporate and institutional investments in cryptocurrencies.

According to Gemini's recently released 2021 State of U.S. Crypto Report, more than 21 million adults own cryptocurrency such as Bitcoin or Ethereum, and the number of crypto investors is projected to double this year. The rapid and widespread adoption of crypto and digital assets at the corporate, institutional and individual level is outpacing the existing legal frameworks that apply to digital assets, causing confusion and frustration for market participants.

There are many legal and regulatory issues related to trading and investing in digital assets, including securities and commodities law concerns, custody issues, trading terms, know-your-customer and anti-money laundering requirements, reporting requirements, and intellectual property as well as tax and accounting issues. Regulations differ based on jurisdiction and, in some cases, the characteristics and use of a particular digital asset.

In the United States, a threshold regulatory question for digital assets is whether the asset is a security or commodity. The rules for each category are different, as are the primary regulators, with securities being regulated by the Securities and Exchange Commission (SEC) and derivatives related to commodities being regulated by the Commodity Futures Trading Commission (CFTC).

SEC regulation of digital assets as securities

The classification of digital assets as securities has wide-ranging implications for the regulatory obligations that flow from the offer, sale, trading and clearing of such assets. Platforms that bring together purchasers and sellers to trade digital assets that are securities in the United States are generally subject to registration as exchanges or alternative trading systems. Individuals or entities facilitating clearing and settlement of securities may be subject to registration with the SEC as a clearing agency, and individuals or entities that effect transactions in digital assets that are securities

in the United States may be subject to registration with the SEC and in certain states as a "broker" or "dealer." After registering, the individuals or entities would be subject to continued regulation by the SEC and applicable states.

It is likely that many initial coin offerings (ICOs) will constitute offerings of securities under the prevailing "Howey Test" used by the SEC to determine whether digital assets constitute securities. In short, if the digital asset can be characterized as an investment of money in a common enterprise with an expectation of profits derived from the efforts of others, it likely qualifies as a security under SEC precedents. Digital assets that constitute securities are subject to the applicable regulatory requirements for all publicly traded securities, including disclosure requirements and rules for public and private offering and selling, as well as investing and trading in, such digital assets.

An important regulator to watch is former CFTC Chairman Gary Gensler who recently took the reins as SEC Chairman. Gensler has extensive expertise in this space and previously served as Co-Director of MIT's FinTech Initiative and Senior Advisor to the MIT Media Lab Digital Currency Initiative.

Market watchers are eagerly awaiting the SEC's decision on whether to allow exchange-traded funds (ETFs) that are linked to Bitcoin and other digital assets. If approved, such a move will exponentially increase both retail and institutional participation in the space. However, approval is far from certain, especially after Gensler testified before Congress in early May about how the crypto market "could benefit from greater investor protection."

CFTC regulation of digital assets as commodities

The CFTC is the federal agency responsible for regulating U.S. commodity futures, option and swap markets. CFTC regulations will apply to digital assets that are not securities, depending on the type of product and the type of transaction conducted.

Some digital assets, such as Bitcoin, were designed for the sole function of value exchange, while other digital assets facilitate transactions such as smart contracts or particular activities on purpose-built networks. For example, Ether via Ethereum allows for the payment of certain computation costs associated with executing smart contracts.

Popular digital assets like Bitcoin and Ether are considered to be commodities from a regulatory perspective, and therefore futures, option, swap or other derivative transactions relating to those assets fall under the CFTC's jurisdiction. The CFTC generally does not regulate spot transactions in commodities, although such transactions are subject to CFTC prohibitions on fraud and manipulation.

The alphabet soup of regulators

While some countries have a centralized agency that regulates (or potentially could regulate) all digital assets — for example, the UK Financial Conduct Authority — in the U.S. we have an “alphabet soup” of rules and regulators, each with a distinct mission. For example, the Bank Secrecy Act (BSA) is a comprehensive federal anti-money laundering and counter-terrorism financing statute requiring that certain financial institutions (e.g., banks, broker-dealers, futures commission merchants, money services businesses and casinos) implement “know your customer” (KYC) and anti-money laundering (AML) programs.

Enforcement of the BSA is led by the Financial Crimes Enforcement Network (FinCEN), which is the bureau of the U.S. Department of the Treasury responsible for combating money laundering. Under the BSA, financial institutions and money service businesses (MSBs) must register with FinCEN, prepare a written AML compliance program, and file BSA reports for suspicious activity and currency transactions. Other BSA requirements relate to record-keeping for certain transactions and obtaining customer ID information.

The Office of the Comptroller of the Currency (OCC), SEC and FINRA as well as state agencies, depending on the type of transaction and institution involved, regulate the custody of digital assets. Custody is a particularly tricky issue as it relates to digital assets with the tension focused on ease of access (e.g., hot wallets and omnibus accounts) versus strength of security (e.g., cold wallets and multi-factor authentication protocols). Examples of custody legal issues include establishing an operation under appropriate legal framework, like a state-licensed trust company, achieving Qualified Custodian status under federal law, access issues and limitations on liability.

About the author



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At the state level, there are 50 attorneys general and various state agencies that enforce digital asset-related laws (or other general laws that may apply to digital assets) passed by state legislatures and applied by the courts. Individual states are taking different approaches, and the laboratory of ideas is actively at work. For example, the New York State Department of Financial Services has enacted the Virtual Currency Business Activity regulatory framework (e.g., the “BitLicense” framework), which covers substantially all virtual currency activity by New York firms and residents.

On the opposite end of the spectrum, Wyoming has passed legislation exempting virtual currency transactions from its money transmitter regulations, utility tokens from certain state securities registration and money transmitter laws and virtual currencies from property taxation laws. And Colorado recently issued guidance exempting certain types of digital asset exchanges from the state's money transmitter licensing requirements. It remains unsettled whether federal regulation will supersede state regulation in respect of digital assets and FinTech more generally, as the courts have not yet ruled on many aspects of crypto regulation.

What's next for crypto regulation?

Increasingly, cryptocurrency and digital assets are looking less and less like a trend that will fall out of fashion and more like an important part of the future of finance. China is aggressively pushing its new Central Bank Digital Currency (CBDC), the digital Yuan, and the UK and US are actively exploring their own CBDC initiatives. In the private sector, PayPal will soon allow customers to pay using cryptocurrency at more than 29 million online stores, and many major banks are rolling out crypto wallets and offering digital asset options to their customers.

Whether as a store of value, medium of exchange, or digital representation of a physical asset, the possibilities presented by digital assets for reimagining the financial system, who has access and how they participate, is wide open.

In the next column, we will look at some use cases for digital assets, what FinTech start-ups have been focused on, and what this means for financial institutions and other incumbents in the space.