Insight

# Congress Offers a Potential Crypto Regulatory Framework

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## Executive Summary


- Regulation of cryptocurrencies ("crypto"), digital assets, and related technologies has been hampered by disagreement over the character of crypto and a turf war between financial regulators.
- The House-passed Financial Innovation and Technology for the 21st Century Act (FIT21) would put the necessary congressional stamp on crypto regulation and resolve regulatory authority disputes by defining a digital asset on the basis of how it is used, not what it is.
- By assigning regulatory roles, FIT21 would provide frameworks within which consumer- and investor-supervised digital assets may be regulated.


## Introduction

Regulation of cryptocurrencies ("crypto"), digital assets, and related technologies has been hampered by disagreement over the character of crypto and a turf war between the Commodity Futures Trading Corporation (CFTC) and the Securities and Exchange Commission (SEC). The House-passed Financial Innovation and Technology for the 21st Century Act (FIT21) would put the necessary congressional stamp on crypto regulation and resolve regulatory authority disputes by defining a digital asset more on the basis of how it is used, and less what it is.

FIT21 contains three important features. First, it is necessary for Congress to establish the regulatory framework for digital assets and to assign regulatory responsibilities to the appropriate agencies. FIT21 would do this and thus end the turf war between the CFTC and SEC. Second, it would put in place the necessary apparatus for consumer protection regulations, including a mechanism to transfer between digital assets and traditional financial assets – a "stablecoin." Finally, it would establish a framework to ensure the safety and soundness of digital institutions and the functioning of digital financial markets.

While there is much to be valued in the bill, there is likely to be daylight – though it is yet unclear how much – between Congress' vision for a crypto framework and how such a framework would likely be adopted by the agencies in practice. As such, lawmakers would need to be especially vigilant over the logistics of FIT21's implementation. Congress should be cautious in ensuring that digital assets are placed on a level playing field with traditional assets, an outcome that is not solely guaranteed by the bill's plain language.

## What Is Crypto and Who Regulates It?

One of the great challenges to the regulation of crypto has been that it is poorly understood. Put another way, it is difficult to answer this question: What?*is*?crypto? And, under current law, the answer really matters. If crypto is a commodity, it is straightforward to assign jurisdiction to the CFTC. The CFTC?defines a commodity ?to include “all goods and articles…and all services, rights, and interests…in which contracts for future delivery are presently or in the future dealt in’ and is not limited to solely tangible assets.”

Alternatively, perhaps crypto is a security. The SEC defines a security as an “investment contract” and relies on the?Howey Test, which was established by a Supreme Court decision nearly a century ago. The test holds that a financial instrument (including, potentially, a digital asset) is considered a security if it is: an investment of money; in a common enterprise; with a reasonable expectation of profits; and derived from the entrepreneurial or managerial efforts of others. On the merits, it is difficult to make these distinctions.

FIT21 would sidestep this conundrum by defining digital assets not on the basis of what they are but on how they are used. This would entail a two-step process. First, the law would hold that digital assets are not securities and, thus, are regulated by the CFTC. It would then create a special class of Restricted Digital Assets (RDAs) that are identified by the fact that they are used to raise capital.

RDAs would be regulated by the SEC for as long as they are significantly controlled by a developer and other insiders. A challenge, of course, is that a standard requiring significant control will necessitate substantial rulemaking and establishing legal precedents to achieve clarity.

The SEC would also be tasked with creating institutions that are parallel to traditional financial assets. Specifically, it would be required to develop the registration of such RDAs, as well as the regulation of brokers, dealers, and exchanges, for the trading of digital assets.

With Congress having weighed in on the assignment of assets and tasks, the existing regulatory turf war would be largely resolved, and those operating in the digital financial world would benefit from greater clarity.

**Consumer Protection**

FIT21 would create a Digital Commodity Exchange framework that is similar to existing exchanges under the CFTC, as well as consumer protections for participants. There would be requirements for monitoring trading activity, prohibiting abusive trading practices, establishing minimum capital requirements, and requiring public reporting of trading information, conflicts of interest, governance standards, and cybersecurity.

Similarly, the digital versions of brokers and dealers will be required to register and meet regulations on minimum capital, fair dealing, risk disclosures, advertising limitations, conflicts of interest, recordkeeping and reporting, daily trading records, and employee fitness standards.

Finally, brokers and dealers would offer payment stablecoins on their platforms and restricted digital assets (if the broker or dealer is also registered with the SEC). Stablecoins avoid the risk of high volatility because their value is “pegged” to another asset, usually the U.S. dollar.

**Safety and Soundness of Digital Investments**

In a fashion similar to the Digital Commodity Exchanges (above), the SEC would develop a Digital Assets Trading System. Trading would be regulated to include order display, fair access, recordkeeping and reporting, and conflicts of interest.

All digital brokers and dealers would have to register and meet minimum capital requirements, protection of customer assets, risk disclosures, recordkeeping and reporting, and conflicts of interest. Customer funds would be segregated and held with a qualified digital asset custodian.

Finally, the trading system could offer a payment stablecoin.

**Challenges**

While FIT21 takes steps in the right direction toward creating a crypto regulatory framework, it is yet unclear how such a framework would be adopted by the agencies in practice. As such, lawmakers would need to be especially vigilant over the legislation's implementation. Congress should also be cautious in ensuring that digital assets are placed on a level playing field with traditional assets.