



Digital Asset Policy: Aspirations, Reality and Regulation

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A Proposal with an Impact.

In October 2021, San Francisco crypto currency exchange Coinbase made waves after releasing a proposed regulatory framework for digital assets entitled *Digital Asset Policy Proposal: Safeguarding America's Financial Leadership* (“dApp”).¹ The proposal generated significant discussion during the House Financial Services Committee meeting with blockchain industry leaders on December 8, 2021.² It resonated with many key players supportive of industry-friendly legislation. The dApp policy proposal highlighted two significant challenges currently facing the digital asset industry and regulators: (1) the lack of a specialized regulator leaves a void that the various regulators attempt to fill despite questionable jurisdictional authority to cover all issues applicable to digital assets; and (2) the need to establish independent dispute resolution mechanisms allowing for disputes to be resolved more quickly meeting the needs of fast moving blockchain technology. Coinbase’s solution? Establish a new regulatory framework and self-regulatory organization. Congress listened and, after much expectation, the first comprehensive crypto regulation bill has seen the light: the Lummis-Gillibrand Responsible Financial Innovation Act (the “Bill”) introduced on June 7, 2022.³ The Bill addresses the aforementioned challenges head on, and myriad other topics critical to the nascent blockchain industry. Yet, while the Bill provides much needed clarity in some respects, it leaves some key questions unanswered—giving ammunition to critics. This comprehensive Bill deserves a fighting chance and here is how it can be strengthened.

¹ Coinbase, *Digital Asset Policy Proposal: Safeguarding America's Financial Leadership* (Oct. 14, 2021) <https://blog.coinbase.com/digital-asset-policy-proposal-safeguarding-americas-financial-leadership-ce569c27d86c> [as of July 15, 2022].

² See Paul Kiernan, Wall Street Journal, *Crypto CEOs Testify Before Lawmakers Mulling Greater Regulation of Market* https://www.wsj.com/articles/crypto-ceos-to-testify-before-lawmakers-weighing-greater-regulation-11638959403?mod=hp_lead_pos7.

³ Lummis-Gillibrand Responsible Financial Innovation Act, S.4356, 117th Cong. § 2 (2022).

The Argument for a Single Specialized Regulator.

Over the past century, American entrepreneurship and innovation in finance has driven a corresponding need for regulatory oversight, driving Congress to establish the U.S. Securities and Exchange Commission (“SEC”), and the Commodity Futures Trading Commission (“CFTC”). To this day, national and international investors draw value from the specialized oversight these regulators provide. Oversight intended not to hinder markets, but instead intended to provide regulatory guidelines to encourage price transparency in markets and fulsome market participation.

Blockchains’ and digital assets’ hyper-growth today demand contemporary regulation. The SEC and CFTC however have been slow to implement clear coordinated policies for the digital asset market. For example, the CFTC has opined that certain digital assets, like Ether and BTC, are commodities, and thus fall under its authority to regulate commodities derivatives markets.⁴ Meanwhile, the SEC has pursued recent aggressive enforcement strategies that have resulted in settlements, but not given industry professionals clarity on how to achieve SEC compliance. (*Discussed below.*) U.S. agencies’ fractal approach to blockchain regulation has been criticized for a lack of clarity and coordination, leading to market confusion.⁵

Coinbase’s proposal for a single specialized digital assets regulator aims to eliminate disparate regulations from the CFTC and SEC. The CFTC and SEC however can hardly be blamed for regulatory confusion as new digital assets have progressed at warp speed outpacing regulator know how.⁶ From currencies, derivatives, securities, non-fungible tokens, digital contracts, information exchange, and online operating systems, technological ability seems to be the only limit to new creative blockchain applications. Gordon Moore’s law is still relevant.⁷ A wholistic approach to digital asset regulation which utilizes a coherent framework will offer improved market transparency, efficiency, and clarity. But creating a new agency may just add one more cook to the regulatory kitchen.⁸

The Lummis-Gillibrand Approach.

Following a similar line of thinking as Coinbase, the Bill would also have a single regulator monopolize oversight in the digital asset space. However, the Bill implicitly disagrees with the idea that a new framework is needed. Instead, it proposes the CFTC as a natural supervisor of digital assets, granting it: “exclusive jurisdiction over any agreement, contract, or transaction involving a contract of sale of a digital asset in interstate commerce, including ancillary assets.”⁹ Of course, certain exceptions apply.

⁴ CFTC, *Bitcoin Basics*, https://www.cftc.gov/sites/default/files/2019-12/oceo_bitcoinbasics0218.pdf [as of July 15, 2022].

⁵ The New Yorker, *The Challenges of Regulating Cryptocurrency* (Oct. 2, 2021) <https://www.newyorker.com/business/currency/the-challenges-of-regulating-cryptocurrency> [as of July 15, 2022].

⁶ Demonstrating this reality, the CFTC recently hired Coinbase’s general counsel as the agency’s director of market oversight, a reversal of the typical trend for private sector entities to hire personnel from the public sector to gain regulatory exposure. CoinDesk, *CFTC Taps Coinbase Lawyer to Head Division Overseeing Bitcoin Futures* (Sep. 17, 2019) <https://www.coindesk.com/markets/2019/09/17/cftc-taps-coinbase-lawyer-to-head-division-overseeing-bitcoin-futures/> [as of Dec. 8, 2021].

⁷ https://en.wikipedia.org/wiki/Moore%27s_Law

⁸ Cheyenne Ligon, CoinDesk (Dec. 30, 2021) <https://www.coindesk.com/policy/2021/12/30/sec-commissioner-hester-peirce-says-washington-doesnt-need-a-new-crypto-regulator/> (quoting SEC Commissioner Hester Peirce: “Typically in Washington, when you build another regulator, all you get is all the existing regulators plus one.”)

⁹ *Lummis-Gillibrand, supra*, § 403(a)(1)(B).

Historically, the CFTC has shown itself to be a dynamic regulator providing guidance to the ever evolving and fast moving commodities and futures industry. Since inception in 1974, the CFTC's guidance in the commodity and futures markets has helped this industry grow to a multi-trillion dollar market. While the CFTC's humble roots stem from its power to regulate agricultural commodities, its reach grew as new derivatives instruments developed. And, as a regulatory agency it has maintained forward thinking leadership that has sought to meet technological changes impacting markets.¹⁰

The CFTC stands in stark contrast with the SEC, which was created when Congress passed the Securities and Exchange Act of 1934 to restore investor confidence following the stock market crash in October, 1929. The SEC's mandate is to ensure sufficient disclosures to promote fairness to investors and prevent fraud in securities transactions. Yet, it is widely commented that the SEC's regulations have created confusion in the crypto markets. The SEC's track record with cryptocurrencies and blockchain technology has drawn critique even from its own commissioners.¹¹ The SEC has yet to provide any clarity for businesses building on blockchain since the ICO craze of 2017.¹² Most recently, the SEC has taken highly publicized enforcement actions resulting in settlements.¹³ Notably, the dispute with Coinbase over its Lend product caused Coinbase to scrap its plans, disappointing hundreds of thousands of users who signed up for Lend's waiting list.¹⁴ In Bill proponent Senator Gillibrand's own words, "[i]t would be inappropriate for the SEC to regulate some of these markets because they don't function like securities."¹⁵ She further points out that "Chair Gensler has already said ... the words that 'Bitcoin is a commodity,' because he understands that it's a form of value in the same way that gold is a form of value, in the same way that oil is a form of value, and that it's more appropriately placed under the CFTC." The CFTC's authority here would be a natural progression, especially because a number of DeFi protocols coming online today feature derivatives markets (such as perpetual options protocols) or swap markets (over which the CFTC has had authority since the Dodd-Frank Act).¹⁶

The Bill seemingly gives the CFTC authority over digital assets. However, the Bill also introduces an exception which critically undermines the CFTC's oversight : investment contracts, which "shall remain within the jurisdiction of the

¹⁰ Commissioner Bart Chilton, CFTC, *Welcome to the Machine* (Oct. 19, 2021) <https://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement101912>.

¹¹ "The idea that there is clarity as to when crypto assets are securities must come as a surprise to the lawyers advising crypto projects that have struggled with this issue for years." Commissioner Hester Peirce, SEC, *Lawless in Austin*, <https://www.sec.gov/news/speech/peirce-2021-10-08>.

¹² See SEC, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

¹³ On July 21, 2022, CFTC Commissioner Caroline Pham released a notable and unusually hostile statement criticizing the SEC's most recent "regulation by enforcement" tactics as a failure to transparently engage the public, and develop policy through expert input using the notice-and-comment procedures under the Administrative Procedures Act. Commissioner Caroline D. Pham, CFTC, *Statement of Commissioner Caroline D. Pham on SEC v. Wahi*, <https://www.cftc.gov/PressRoom/SpeechesTestimony/phamstatement072122>. SEC Commissioner Peirce similarly critiqued her own agency's tactics last year:

"Most of our crypto enforcement actions, however, have not been litigated actions; rather they have ended in settlements, which are not good vehicles for careful legal analysis. . . . Nevertheless, if the SEC cannot easily articulate an unassailable legal theory for why particular assets are securities, is the line as clear as the SEC maintains it is? The ambiguity ultimately serves us well because it effectively forces any actor with any connection to digital assets into our regulatory jurisdiction." Peirce, *supra*, n.11.

¹⁴ Coinbase, *Update as of 5pm ET, Friday, September 17th: we are not launching the USDC APY program announced below*, <https://blog.coinbase.com/sign-up-to-earn-4-apy-on-usd-coin-with-coinbase-cdad79e5f5eb>.

¹⁵ NPR, *There's a new plan to regulate cryptocurrencies. Here's what you need to know* (June 14, 2022) <https://www.npr.org/2022/06/14/1104303982/crypto-bitcoin-stablecoin-regulation-senate> [as of July 17, 2022].

¹⁶ CFTC, *CFTC Orders Event-Based Binary Options Markets Operator to Pay \$1.4 Million Penalty* (Jan. 3, 2022) <https://www.cftc.gov/PressRoom/PressReleases/8478-22>; CFTC, *Dodd-Frank Act*, <https://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm>.

Securities and Exchange Commission.”¹⁷ The debate over what digital assets constitute investment contracts has plagued the crypto industry for years. It is precisely through a broad in-house interpretation of the *Howey* test, used to determine the existence of an investment contract,¹⁸ that certain SEC constituents have laid jurisdictional claims over the field since at least 2019.¹⁹ These efforts are like bolting a carburetor onto Tesla in an effort to match the speed of a Fisker Ocean.

On the one hand, the Bill seeks to foster consensus by establishing (a) an Advisory Committee on Financial Innovation,²⁰ (b) timelines for the resolving certain Bill applications,²¹ and (c) on the surface clear definitions of key terms like “digital asset.”²² On the other, it misses an opportunity to draw a clear jurisdictional line between the SEC and CFTC, ensuring a continued power struggle thus slowing US market innovation in this global market asset class. Instead, the Bill should simply courageously empower the CFTC as sole regulator of digital assets. Compromising over regulatory authority between the SEC and CFTC may provide comfort at meetings on the Hill, but it provides less clarity to US market participants and impairs innovation.

Dispute Resolution and Digital Assets Self-Regulatory Organizations.

Coinbase’s proposal also advocated for a new digital assets self-regulatory organization (“SRO”) subject to a single regulator and enforcement agency. One core function would be dispute resolution for members. Coinbase proposed that a single SRO could be “dedicated to developing the more granular rules for the industry, **rules that would likely go beyond the authority of a federal regulator.**”²³ This proposal mirrored methods that have been effective for legal issues requiring specialized knowledge, which digital assets certainly require. SROs operate throughout our existing financial regulatory space and non-financial areas. Examples include, FINRA, the American Bankers Association, the American Bar Association, and even ICANN. In other situations, specialized courts have been created and are presided over by experts on the subject matter. An industry led SRO would allow for dispute resolution policy that applies to industry participants worldwide similar to ICANN’s domain naming policies and dispute mechanisms. An SRO would allow the US to influence international digital asset policies unlimited from jurisdictional constraints like a traditional enforcement agency.

The Bill intelligently embraces this approach. Section 807(a) specifically calls on the CFTC and SEC, in consultation with digital asset intermediaries and standard-setting associations representing the digital asset industry, to create a report setting principles for self-regulation of digital asset markets. also opens the door to agency and self-regulatory organization cooperation. The report would be due within six months of the enactment of the Bill and be delivered to the Senate Committees on Banking, Housing, and Urban Affairs and Agriculture, Nutrition and Forestry and the House Committees on Financial Services and Agriculture. The diversity of Committees is a testament to the great

¹⁷ *Lummis-Gillibrand, supra*, § 403(a)(1)(B).

¹⁸ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (“*Howey*”).

¹⁹ SEC, *Framework for “Investment Contract” Analysis of Digital Assets* (last modified April 3, 2019) <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets> [as of July 17, 2022].

²⁰ *Lummis-Gillibrand, supra*, § 809. The Advisory Committee on Financial Innovation includes a commissioner from each the SEC and CFTC.

²¹ *See e.g., Id.*, § 304(b).

²² *Id.*, § 101(2).

²³ Coinbase, *Digital Asset Policy Proposal, supra*, n.1.

impact of digital assets on all aspects of the economy. A key area which must be addressed by the report is “dispute resolution and arbitration.”²⁴

A word of caution. Regardless of how fruitful such CFTC, SEC and industry discussions prove to be, Congress and regulators should not grant monopolistic authority to such a SRO. The blockchain industry has already demonstrated that it can develop alternatives for specialized dispute resolution. Blockchain based platforms such as Aragon, Kleros, and OpenBazaar already provide forms of “on-chain” dispute resolution. Existing dispute resolution mechanisms built on blockchains have been critiqued as relying too heavily on the knowledge of the crowd, rather than judges with expertise on smart contract disputes.²⁵ These alternative arbitration methods based on-chain are beginning to establish some levels of legitimacy in the blockchain industry. Ethereum co-founder, Vitalik Buterin, has stated that apps like Kleros have “the potential to completely disrupt and revolutionize resolution processes with untrusted parties.”²⁶ Raise the curtain William Shakespeare.²⁷

Other Bill Highlights.

To the relief of many, the Bill defines key terms more narrowly than previous legislation. For example, the Infrastructure Investment and Jobs Act signed into law in November, 2021, defined a broker as “any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.”²⁸ Such a broad definition created liability concerns for most cryptocurrency market participants overnight. Individual miners, software developers, and a myriad of other types of actors could fall under the definition. The Bill amends this language to limit its scope to what is more traditionally thought of as a broker.²⁹

Another strength of the Bill is its stabilizing effect on the currently not-so-reliable stablecoins. In the wake of the crash of stablecoin TerraUSD,³⁰ the Bill’s mandating of a 100% reserve in high-quality liquid assets to back its stablecoin will come as a relief to many.³¹

Additionally, the Bill foresees national security issues with the advent of use and acceptance of foreign sovereign digital currencies. Specifically, within 60 days of enacting the Bill, several intelligence bodies must develop standards and security measures regarding China’s digital yuan. Digital assets are a product of coding and can create inconspicuous backdoors.

²⁴ *Lummis-Gillibrand, supra*, § 807(a)(ix).

²⁵ See *Crypto Transaction Dispute Resolution*, 73 *Bus. Law.* 109, 146-48.

²⁶ *Cryptonews.net*, <https://cryptonews.net/en/news/ethereum/153781/>.

²⁷ See *Wikipedia*, *Henry VI, Part 2*, https://en.wikipedia.org/wiki/Henry_VI,_Part_2 [as of July 28, 2022]. See also Jacob Gershman, *Wall Street Journal*, *To Kill or Not to Kill All the Lawyers? That Is the Question* (Aug. 18, 2014) <https://www.wsj.com/articles/shakespeare-says-lets-kill-all-the-lawyers-but-some-attorneys-object-1408329001> [as of July 28, 2022].

²⁸ *Infrastructure Investment and Jobs Act*, H.R.3684, 117th Cong. (2021), § 80603.

²⁹ *Lummis-Gillibrand, supra*, § 202(a).

³⁰ *Forbes*, *Stablecoin Market Crash: Hedge Funds Shorting Tether, Regulation Is Coming* (June 30, 2022), <https://www.forbes.com/advisor/investing/cryptocurrency/stablecoin-crypto-crash/>.

³¹ *Lummis-Gillibrand, supra*, § 601.

Conclusion

Congress must seriously consider these issues as the global industry rockets to unprecedented growth, and international competitors continue to erode the dollar in the global economy.³² As new questions arise, Congress will need a dynamic regulator which keeps the spirit of innovation alive in the US, and that regulator should be the CFTC. The Bill meets the challenge head on in various aspects including consumer protection, guidance for industry participants, and national security. However, the Bill falls short on the key topic of agency jurisdiction. Congress has a unique opportunity to consolidate and protect the US' leadership in the digital asset space. Self-absorbed decision making is only accelerating the projected diminished position of US markets in the global economy.³³

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³² *Id.*; see also Peirce, *Lawless in Austin*, *supra*, n.7 ("The Federal Reserve has traditionally supported responsible private-sector innovation. Consistent with this tradition, I believe that we must take strong account of the potential benefits of stablecoins, including the possibility that a U.S. dollar stablecoin might support the role of the dollar in the global economy.")

³³ See generally, Ray Dalio, *The Changing World Order*, Ch. 11.