

## Why is Action Needed on Digital Assets Market Structure Legislation?

House Financial Services Committee and House Agriculture Committee Republicans are working to establish a digital asset market structure framework appropriate for the unique characteristics of digital assets. This functional framework will provide clear rules of the road for market participants as well as protect investors and consumers.

In the absence of a framework in the United States, other countries have rushed to build frameworks and become developmental hubs for the digital asset ecosystem. Currently, the largest trading platform and stablecoin issuer are based outside of the United States.<sup>1</sup> Many entrepreneurs are warning against doing business in the United States because of a lack of structure and are advocating for digital asset companies to move offshore.<sup>2</sup> The European Union recently approved its Markets in Crypto-Assets (MiCA) regulation and the United Kingdom will soon finalize its own digital asset regulatory proposal.<sup>3</sup> The ability of other countries to successfully build digital asset frameworks and incorporate distributed ledger technology into their market infrastructure further underscores the need for Congress to act.

While Congress works to negotiate a legislative solution to the many outstanding questions regarding digital assets, the Securities and Exchange Commission (SEC) continues to regulate by enforcement and is actively policing digital asset markets without clear direction from Congress.

Chair Gensler has opined on numerous occasions that the “test to determine whether a crypto asset is a security is clear.”<sup>4</sup> However, Republican SEC Commissioner Hester Peirce and former SEC Commissioner Elad Roisman disagree, citing requests “[the SEC] receives for clarity and the consistent outreach to the Commission staff for no-action and other relief.”<sup>5</sup> Recently,

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<sup>1</sup> Jeff Wilser, *US Crypto Firms Eye Overseas Move Amid Regulatory Uncertainty*, CoinDesk (Mar. 27, 2023), <https://www.coindesk.com/consensus-magazine/2023/03/27/crypto-leaving-us/>.

<sup>2</sup> Brady Dale, *The few crypto firms that have registered with the SEC*, Axios (Mar. 6, 2023), <https://www.axios.com/2023/03/06/crypto-register-sec-securities-exchange-commission>.

<sup>3</sup> Camomile Shumba, *With MiCA Past the Finish Line, UK's Crypto Industry Calls for Rules of Its Own*, CoinDesk, (Apr. 21, 2023), <https://www.coindesk.com/policy/2023/04/21/with-mica-past-the-finish-line-uks-crypto-industry-calls-for-rules-of-its-own/>.

<sup>4</sup> SEC Chairman Gensler Remarks Before the Aspen Security Forum (Aug. 3, 2021), <https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03>.

<sup>5</sup> Commissioner Peirce and former Commissioner Roisman Public Statement: In the Matter of Coinschedule (Jul. 14, 2021), <https://www.sec.gov/news/public-statement/peirce-roisman-coinschedule>.



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Commissioner Hester Peirce emphasized her concerns with the SEC’s enforcement-centric approach and highlighted guiding principles for regulating the digital asset ecosystem.<sup>6</sup>

On July 13, 2023, the Southern District of New York rejected the SEC’s approach on digital assets holding that Ripple’s sale of XRP did not violate securities laws when the tokens were sold to purchasers indirectly through digital asset exchanges. Additionally, the district court also held that XRP sales to institutional buyers *did* amount to a violation for selling unregistered securities. This opinion underscores the urgent need to provide legal clarity for the market. Without legislative action, the regulatory framework created by this ruling could result in greater protections for institutional investors than retail market participants.

## Background

Under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), the SEC has full regulatory authority over the offer, sale, and the trading of securities. This includes investment contracts, and the derivatives trading of securities.<sup>7</sup> Under the federal securities laws, every offer and sale of securities must be either registered with the SEC or conducted under an exemption.

The Commodity Exchange Act (CEA) and Commodity Futures Trading Commission (CFTC) regulations provide a comprehensive regulatory regime to trade commodity derivatives (e.g., buying or selling futures contracts on corn, cattle, or oil). Separately, the CEA provides the CFTC with “after-the-fact” enforcement jurisdiction over fraud and manipulation in the “spot” or cash commodity markets (e.g., buying or selling bushels of corn, heads of cattle, or barrels of oil). The CFTC has no power to impose registration and regulatory requirements on participants in the cash or spot commodity markets. This means **there is no comprehensive federal regulatory regime for the spot trading of commodities.**

Both the term “security” and the term “commodity” are defined in statute in ways that are broader than one might expect:

- The federal securities laws define the term “security” to include not only specific types of financial instruments such as stocks and bonds, but also several undefined terms,

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<sup>6</sup> Commissioner Hester M. Peirce Remarks before the Digital Assets at Duke Conference (Jan. 20, 2023), <https://www.sec.gov/news/speech/peirce-remarks-duke-conference-012023>.

<sup>7</sup> U.S. Securities and Exchange Commission: The Laws That Govern the Securities Industry, <https://www.sec.gov/about/about-securities-laws>.



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notably “investment contract.”<sup>8</sup> The term “investment contract” captures unique or novel instruments and arrangements including many digital asset projects which raised funds.<sup>9</sup>

- The Commodity Exchange Act (CEA) defines “commodity” broadly 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.”<sup>10</sup> In 2015, the CFTC found that the CEA’s commodity definition included bitcoin and other virtual currencies.<sup>11</sup>

These broad definitions blur the line between a security and a commodity. At a very basic level, legally, securities *are* commodities. That is to say “securities” are considered a “good, article, service, right, or interest” in which contracts for future delivery are presently dealt, so they meet the definition of a “commodity.” This would imply that the CFTC would have regulatory authority over security derivatives and enforcement authority over security spot market transactions. **However, the CEA does not grant the CFTC any authority which would supersede or limit the jurisdiction of the SEC or restrict the SEC from carrying out their duties and responsibilities. Since the SEC is provided with jurisdiction over transactions in securities, in the instances in which an asset, transaction, or arrangement is determined to be a security, CFTC jurisdiction does not apply.**

It is difficult to determine whether a digital asset is offered as part of an investment contract or falls under the definition of commodity in the CEA. **Until there is a consistent, clear framework in place, market participants, consumers, and investors will continue to seek regulatory clarity given the requirements that stem from the classification of a particular digital asset.** If a digital asset is offered as part of an investment contract, the offer, sale, trading, and custody of it would fall under the SEC’s authority. This would require the digital asset issuer and intermediaries to register and comply with certain requirements. If a digital asset is considered to be a “commodity,” the CFTC has full regulatory authority over the derivatives trading of that

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<sup>8</sup> The Securities Act Section 2(a) defines a “security” as “any note, stock, treasury stock, . . . bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, . . . investment contract, voting-trust certificate, certificate of deposit for a security, . . . certificate of deposit, . . . or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

<sup>9</sup> *Framework for “Investment Contract” Analysis of Digital Assets*, SEC (Apr. 19, 2019), <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>.

<sup>10</sup> CEA Section 1a(9) defines commodities as any good, article, service, right or interest that could potentially be the subject of a derivatives contract. The statute only excludes onions and motion picture box office receipts from goods and services that may be considered commodities.

<sup>11</sup> *CFTC Orders Bitcoin Options Trading Platform Operator and its CEO to Cease Illegally Offering Bitcoin Options and to Cease Operating a Facility for Trading or Processing of Swaps without Registering*, CFTC (Sep. 17, 2015), <https://www.cftc.gov/PressRoom/PressReleases/7231-15>.



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digital commodity (e.g., a bitcoin futures contract) and limited enforcement authority over the spot trading of that digital commodity (e.g., a bitcoin).

**Currently, neither the CFTC nor SEC has the authority to register and regulate entities engaged in a non-security digital asset, or digital commodity, spot transactions.** The CFTC only has the authority to prosecute those entities if the CFTC believes the entity has committed fraud or manipulation related to a non-security digital asset, or digital commodity, spot transaction. The lack of a regulatory framework for non-security digital asset spot transactions is referred to as the “spot market gap.”

In fact, at the beginning of his term, SEC Chair Gensler shared his view on the regulatory gaps associated with trading platforms. Chair Gensler opined “[we] need a better regime overseeing crypto exchanges to ensure we have in place some investor protection.”<sup>12</sup> Since then, Chair Gensler’s perspective regarding the SEC’s current authority over trading platforms has shifted. Under his direction, the SEC has proposed numerous rules that expand the SEC’s jurisdiction over digital assets. Now, Chair Gensler states, “the probability is quite remote that, with 50 or 100 tokens, any given [trading] platform has zero securities.”<sup>13</sup> While it is unclear how the XRP decision will impact Chair Gensler’s approach moving forward, his previous approach to regulate by enforcement appears less sustainable now. Meanwhile, CFTC Chairman Behnam has frequently and publicly called for additional legislation to close the “spot market gap” and provide the CFTC with the authority to register and regulate non-security digital asset, or digital commodity, trading platforms.

## The House Committee on Financial Services and the House Committee on Agriculture Approach:

In the 118<sup>th</sup> Congress, the House Committee on Financial Services and the House Committee on Agriculture have worked together to address the regulatory gaps by creating a functional framework tailored to the specific risks of different digital asset-related activities.

The FIT for the 21st Century Act provides the CFTC with jurisdiction over digital commodities and clarifies the SEC’s jurisdiction over digital assets offered as part of an investment contract. Additionally, the Act establishes a process to permit the secondary market trading of digital commodities, if they were initially offered as part of an investment contract. Finally, the Act imposes robust customer protections on all entities required to be registered with the SEC and CFTC.

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<sup>12</sup> SEC Chairman Gary Gensler: There Needs to Be Greater Investor Protection of Crypto Markets, CNBC (May 7, 2021), [www.cnbc.com/video/2021/05/07/sec-chairman-gary-gensler-there-needs-to-be-greater-investor-protection-of-crypto-markets.html](http://www.cnbc.com/video/2021/05/07/sec-chairman-gary-gensler-there-needs-to-be-greater-investor-protection-of-crypto-markets.html).

<sup>13</sup> Aislinn Keely, *Gensler Says He Wants to Work with Congress to Regulate Crypto Exchanges*, *The Block*, (May 26, 2021), [www.theblockcrypto.com/linked/106215/gensler-congress-regulate-crypto-exchanges](http://www.theblockcrypto.com/linked/106215/gensler-congress-regulate-crypto-exchanges).



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### ***Classification as a Security vs. a Commodity***

The Act builds on the current exemption regime for the offer and sale of digital assets pursuant to an investment contract. This includes requiring a disclosure regime to address the potential risks associated with digital assets. Under this exemption, digital asset issuers will need to demonstrate that their digital assets operate on a decentralized network and fulfil certain fit-for-purpose disclosure requirements. The Act specifies that a digital asset is considered a digital commodity if certain conditions are met. This would be determined by the network being functional and considered decentralized.

The Act defines a decentralized network and a functional network and provides a certification process under which a digital asset issuer or other individual may certify to the SEC that the network on which the digital asset relates is decentralized. The SEC may object to the certification if the SEC determines the certification is inconsistent with the Act. However, it must provide a detailed analysis of its reasons for doing so.

### ***Regulation of SEC Intermediaries***

The Act would enable digital asset trading platforms to be registered as a Digital Asset Trading System. It would also allow a Digital Asset Trading System to offer digital commodities and payment stablecoins on their platforms. Digital Asset Trading Systems would be required to comply with rules for segregation of customer assets, order display, and fair access, among others. The Act also establishes registration categories for Digital Asset Brokers and Digital Asset Dealers, which would be subject to similar rules.

### ***Regulation of CFTC Intermediaries***

The Act creates a Digital Commodity Exchange (DCE) framework that is similar to existing exchange frameworks in the Commodity Exchange Act (CEA) for Designated Contract Markets and Swap Execution Facilities. A registered DCE would be required to comply with longstanding CEA core principles codified within the Act, and through CFTC regulations. These include 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.

Before offering a digital commodity on its exchange, DCEs would need to certify with the CFTC that the digital commodity is not readily susceptible to manipulation, including considering its availability, structure, functionality, and public information.



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Further, the Act creates a Digital Commodity Broker (DCB) and a Digital Commodity Dealer (DCD) framework. Because they directly serve customers, all DCBs and DCDs are required to register with a registered futures association and meet prescriptive business conduct requirements related to minimum capital, fair dealing, risk disclosures, advertising limitations, conflicts of interest, recordkeeping and reporting, daily trading records, and employee fitness standards.

The bill also builds on the existing commodity market requirements imposed on Futures Commission Merchants (FCMs) to protect customer assets. A DCE, DCB, or DCD that accepted customer funds would be required to segregate customer assets and hold them in a separately licensed qualified digital commodity custodian. A qualified digital commodity custodian would be regulated by a federal, state, or foreign banking supervisor, and be subject to comprehensive supervision and regulation necessary to protect customer assets. Additionally, the Act provides similar bankruptcy protections for customer funds as provided for customer funds held by futures commission merchants for derivatives markets participants.

### ***Regulatory Coordination***

The Act would permit and at times require a single CFTC entity to obtain multiple licenses with the CFTC, depending on the nature of the services the entity engaged in. However, no exchange would be permitted to register as a dealer directly. The Act would also permit certain entities to dually register with the CFTC and SEC to be permitted to facilitate transactions in multiple types of digital assets.

### ***Innovation and Coordination***

The Act codifies the establishment of both the Strategic Hub for Innovation and Financial Technology (FinHub) at the SEC and LabCFTC at the CFTC. The offices will serve as information resources for the Commissions on financial technology (FinTech) innovation. The offices will also make the Commissions more accessible to FinTech innovators and serve as a forum for innovators seeking a better understanding of the Commissions' regulatory frameworks.

The Act also establishes a Joint CFTC-SEC Advisory Committee on Digital Assets, which will consist of at least 20 market participants, who will provide advice to the CFTC and SEC related to digital assets.

The Act requires the CFTC and the SEC to conduct a joint study on decentralized finance. The Act also requires GAO to conduct a study on non-fungible digital assets.

### ***Regulatory Transition***



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The Act provides for a transition period for entities to come under temporary oversight of both the SEC and CFTC immediately, while the Commissions are writing final rules to bring comprehensive oversight to these markets. Existing digital assets are eligible for a safe harbor under which they are permitted to trade during this period, until the SEC or CFTC issues a notice to the trading venue that they are not digital commodities.