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This deck is one of three that we will update from time to time on key areas of policy development that are likely to affect the financial services industry. You should also read our decks on Financial Services Regulatory Reform and Climate Regulatory Reform and the U.S. Financial Services Sector.
Looking ahead

Consensus has emerged among policymakers, regulators and the industry on the need for sound regulation that supports innovation and inclusion. The why is understood. The questions are who, what, where, when and how.

The fragmented U.S. financial regulatory environment and the need for coordination across many federal and state regulators, together with the lack of clear regulatory authority over some types of digital asset activities, has resulted in ambiguity in the regulation of these activities.

- Thoughtful legislation would be welcome but remains unlikely to be taken up in the near term, given Congress’s other priorities and the challenges in developing a path forward.

- Stablecoins are high on the agenda for bank regulators – the Federal Reserve, OCC and FDIC – but their sphere of action will be limited if Congress cannot pass legislation.

- Legislation is also likely needed to clarify regulatory authority over the digital asset markets more broadly. In the meantime, the enforcement powers of market regulators – the SEC and CFTC – are likely to remain front and center.

  - House and Senate committees held hearings at the end of 2021 on digital assets, and Forbes reports that 35 bills focused on crypto policy were introduced in 2021, but Congress has yet to seriously engage in what a statutory framework for digital assets might look like.

- The crypto industry found its political voice in 2021 and we expect that policy conversations through introduced legislation and industry policy papers will continue in 2022.

This deck looks across the digital asset landscape to regulatory developments on the horizon in key areas, including the characterization of digital assets, and regulation of digital asset trading activities, stablecoins, DeFi and CBDC, among others.
Legal classification of digital assets

The classification of digital assets under existing financial regulatory regimes—as securities, types of money, commodities—remains a topic of significant focus with widely varied views among regulators and Congress.

- **Application of securities laws to digital assets:** Much of the early action on digital assets by the SEC under Chair Gensler was focused on enforcement rather than regulation. We expect continued debate over whether certain digital assets are securities, both in the courts and on Capitol Hill.
  - Despite Chair Gensler’s assertion that the “test to determine whether a crypto asset is a security is clear,” there are many—including Senator Toomey, among others—who feel otherwise.
  - The SEC’s ongoing lawsuit against Ripple Labs and two of its executives may establish an important precedent for the Howey test and the application of securities laws to digital assets—though decisions on the merits are not expected for some time.
  - In November 2021, a jury in the District of Connecticut addressed, apparently for the first time, whether cryptocurrency products were securities.
  - In the absence of clear guidelines, we expect there will be increasing interest in regulatory proposals and legislative, such as Commissioner Peirce’s Safe Harbor 2.0 and its related bill, the Clarity for Digital Tokens Act of 2021, that aim to strike a balance between the important goals of supporting innovation and protecting investors.

- **Application of commodities laws to digital assets:** Congressional agriculture committee leaders recently sent CFTC Chairman Behnam a letter asking a series of questions seeking to understand the scope and size of digital asset markets, the benefits and risks presented by these emerging technologies, and the role of the CFTC with respect to these markets.
Industry and Congress have observed that additional federal regulation may be appropriate for digital asset trading activities. Some have advocated for a comprehensive federal regulatory regime to be established.

- **Digital Commodity Exchange Act:** Senator Thompson has released a discussion draft of the *Digital Commodity Exchange Act of 2021*, which would give the CFTC authority to require registration of digital commodity exchanges on a voluntary basis.

- **Global coordination:** By their very nature, the largest crypto exchanges are global platforms, and as different jurisdictions develop regulatory regimes, global regulatory coordination will be essential.
  - For example, the EU has proposed the *Markets in Crypto-Assets Regulation* (MiCA), which would, among other things, regulate crypto trading platforms operating in the EU.

- **Enforcement:** We expect government agencies to continue to bring enforcement actions against crypto exchanges under a variety of existing regimes, which have included SEC actions against crypto exchanges offering trading in digital assets that are securities, OFAC sanctions against a crypto exchange for facilitating transactions for ransomware actors, and a FinCEN action for violations of the Bank Secrecy Act.
  - In a hearing before the Senate Banking Committee in September 2021, Chair Gensler warned that any crypto exchanges offering trading in digital assets that are securities would be required to register with the SEC or qualify for an exemption.
Stablecoins

In the near future, we expect regulatory turf wars, proposed legislation from Congress and enforcement actions from the SEC, CFPB and other law enforcement agencies.

- The President’s Working Group on Financial Markets (PWG), together with the FDIC and OCC, issued a joint report on stablecoins in November 2021, which recommended that Congress promptly enact legislation to regulate stablecoin arrangements, including a requirement for stablecoin issuers to be insured depository institutions (see our client update).

  - Federal Reserve Board General Counsel Mark Van Der Weide was very supportive of the recommendations in the PWG report, characterizing stablecoins as “deposit substitutes issued by weakly regulated shadow banks” that are “growing rapidly.”

- In connection with a Senate Banking Committee hearing in December 2021, Senator Toomey announced guiding principles for his forthcoming stablecoin legislation.

  - Contrary to the PWG Report’s central recommendation, Senator Toomey does not support requiring all stablecoin issuers to be insured depository institutions and has stated that he is open to working with the Biden Administration and Democrats in Congress on stablecoin legislation.

- Senator Lummis and Representative Gottheimer are both reportedly planning to separately introduce legislation requiring regulation of stablecoin issuers.
Stablecoins

In the absence of congressional action on stablecoins, the PWG Report recommends that the FSOC consider designating “certain activities conducted within stablecoin arrangements” as systemically important payment, clearing, and settlement (PCS) activities.

- The FSOC’s 2021 annual report states that the FSOC will “be prepared to consider steps available to it to address risks outlined in the PWG Report on Stablecoins in the event comprehensive legislation is not enacted.” It is unclear how long this wait-and-see approach will last.

- Given that congressional action or FSOC designation will not happen quickly, we believe that in the near term the SEC and CFPB will focus on enforcement against stablecoin issuers and others under existing law.
  - SEC Chair Gensler has stated that the SEC and CFTC will apply the securities and commodities laws to stablecoin products and arrangements, where applicable.
  - CFPB Director Chopra has noted the application of the federal consumer financial protection laws to consumer use cases of stablecoins.
DeFi

DeFi will be a priority in 2022 because of its spectacular growth and the particular regulatory challenges it represents.

- The Total Value Locked (TVL) in DeFi protocols increased to roughly $300 billion at the end of 2021, up from roughly $20 billion at the end of 2020, according to defillama.com.

- The recent Organization for Economic Co-operation and Development (OECD) report on DeFi provides a balanced and thoughtful summary of what the regulators believe are risks raised by – and potential benefits of – DeFi.

- We expect regulation in 2022 to develop predominantly through enforcement, in the absence of DeFi-specific regulatory guidance or legislation.
  - In August 2021, the SEC announced its first enforcement action that it billed as DeFi-related, finding that two individuals had unlawfully offered and sold unregistered securities through the use of smart contracts to sell digital tokens.
  - In January 2022, the CFTC reached a $1.4 million settlement with Polymarket, a marketplace for betting on future events, for “operating an illegal unregistered or non-designated facility for event-based binary options online trading contracts, known as ‘event markets.’” This too, was billed as a DeFi-related action.
  - In each case, it is debatable whether the activities involved are appropriately classified as DeFi.
  - There have been press reports of various SEC inquiries ongoing in the DeFi space.
- Areas of focus will likely include unregistered facilities or marketplaces, despite concerns with the registration process noted by Commissioner Peirce and others that render it unviable for most crypto companies.
The Federal Reserve released a paper to start a public discussion on the pros and cons of a U.S. central bank digital currency (CBDC) in January 2022. The paper contributes to the public debate but makes clear that the Federal Reserve is unlikely to launch a U.S. CBDC in the near- or medium-term future.

- Publication of the paper marks only the beginning of the Federal Reserve’s exploratory process, “the first step in a broad consultation that will also include targeted outreach and public forums.” The paper seeks input from the public on 22 questions, for which responses are due by May 20, 2022.
- The paper does not commit the Federal Reserve to any policy or design choices. Certain choices, such as the balance between protecting users’ data privacy and preventing financial crimes, are acknowledged but not addressed in detail.
- The paper does, however, confirm certain views that senior officials have previously telegraphed:
  - The Federal Reserve “does not intend to proceed with issuance of a CBDC without clear support from the executive branch and from Congress, ideally in the form of a specific authorizing law.”
  - “[A] potential U.S. CBDC, if one were created, would best serve the needs of the United States by being privacy-protected, intermediated, widely transferable, and identity-verified.”
- In the intermediated model, the Federal Reserve would rely on the private sector to provide accounts or digital wallets to users for them to manage their CBDC holdings and payments. Potential intermediaries include not only banks but also regulated nonbank financial service providers, which “would operate in an open market for CBDC services.”

Our client update on Federal Reserve’s CBDC paper is available here.
Banks: powers and authorities

States have taken the lead on creating innovative charters for companies that provide services related to digital assets, and more states are expected to follow.

- The Wyoming special purpose depository institution charter and the Nebraska digital asset depository institution charter are two of the most recent examples of states that have implemented frameworks for providing bank charters to crypto companies.
- In Illinois, a bill that would create a special purpose trust company passed the state House of Representatives but was defeated in the Senate.
- Federal Reserve Board General Counsel Mark Van Der Weide stated in January 2022 that the Federal Reserve is watching the emergence of special purpose charters “with some concern” and that, together with the OCC and FDIC, the agencies are engaged in a crypto sprint to assess legal permissibility and risk issues relating to digital assets.
- Although the Federal Reserve has issued proposed guidelines for determining which institutions can open a Federal Reserve master account and gain direct access to its payment systems (see our client update), it has yet to establish a consistent and transparent framework for evaluating institutions’ requests for master accounts.
  - In January 2022, when pressed by Senator Lummis on the Federal Reserve’s inaction, Chair Powell acknowledged that “there are good arguments” for expanding access to master accounts but expressed concern over the “hugely precedential” consequences: “we start granting these – there’ll be a couple of hundred of them pretty quickly, and we have to think about the broader safety and soundness, employment implications.”
Banks: powers and authorities

The OCC is adopting a cautious approach towards national banks’ entry into crypto activities.

- In 2021, the OCC conditionally approved three applications to grant national trust charters to companies specializing in digital and cryptocurrency activities – decisions that were criticized by Senator Brown, among others, but welcomed by many crypto proponents.

- The OCC also revisited its prior interpretive letters on crypto activities, leading it to issue Interpretive Letter #1179 in November 2021. The letter confirms the OCC’s previous positions that national banks may engage in certain crypto activities – such as providing crypto custody services, holding reserves for stablecoin issuers and acting as nodes on a blockchain – but imposes new conditions on national banks that wish to engage in these activities in the future.

- These activities remain permissible, “provided the bank can demonstrate, to the satisfaction of its supervisory office, that it has controls in place to conduct the activity in a safe and sound manner.” Before engaging in any of these activities, a national bank must first provide notice and obtain a written non-objection from its OCC supervisory office.

- If a national bank is already engaged in crypto activities, the letter states that it need not obtain a supervisory non-objection to continue doing so, though the OCC expects the bank to have already given notice to its supervisory office.

- The letter thus creates an uneven playing field on two dimensions:
  - state-chartered banks vs. national banks that wish to enter the space, and
  - national banks that have already started engaging in crypto activities vs. those that have not.

- As a result, we think that the current OCC’s desire to slow down crypto activities will be in tension with the traditional view of banking agencies that they ought not to pick winners and losers.
Banks: powers and authorities

- The OCC’s desire to limit national banks’ entry into crypto is evident in a conditional approval issued in January 2022, which states expressly that the bank “shall not engage in any crypto-asset activities or services currently performed by [its parent company]” or otherwise, without a prior written determination of no supervisory objection from the OCC.

  - This restriction would apply to the bank and its operating subsidiaries, but not its parent or sister companies, for which the Federal Reserve is responsible for determining the permissibility of crypto activities.
FATF standards

The Financial Action Task Force (FATF) released updated guidance in October 2021 on the application of its recommendations to virtual assets and virtual asset service providers (VASPs). The guidance reflects international standards and is not legally binding but will almost certainly influence U.S. and state regulators.

- The FATF’s guidance on VASPs clarifies that:
  - When a central governance or developer body maintains control or influence over the administration and function of a stablecoin, that central body likely qualifies as a VASP, particularly if “the governance body carries out other functions in the stablecoin arrangement.”
  - Depending on their specific characteristics, FATF does not generally consider non-fungible tokens to be virtual assets, though the determination must be made on a case-by-case basis.
  - Decentralized or distributed DeFi applications (DApps) do not qualify as VASPs because FATF’s recommendations do not apply to underlying technology or software. Still, creators, owners, and operators who control or maintain influence in the arrangement of DApps may fall under the definition of VASP.
  - The definition of VASP does not typically cover developers or providers of unhosted wallets, particularly when their only function is to develop and/or sell the software or hardware.

- Treasury Secretary Yellen stated that she believes that standing FinCEN guidance is consistent with the updated FATF guidance.

Our client update on FATF’s updated guidance is available here.
The IRS and Treasury have focused on reporting and enforcement. The tax treatment of many common crypto transactions, such as lending and staking, nevertheless remains uncertain, and the difficulties of this situation for crypto market participants are unlikely to be addressed in the near future.

- **Tax reporting:** The Infrastructure Investment and Jobs Act, which became law in November 2021, expands the tax reporting requirements that currently apply to securities brokers to include certain intermediaries in digital assets beginning for digital asset transfers in 2023.
  - Industry players and several senators criticized the broad definition of the term “broker” under the Act, most notably in a letter from six Senate Finance Committee members to Treasury Secretary Yellen, which:
    - requested that Treasury provide guidance limiting the scope of the definition, and
    - expressed concern that the statutory definition could apply to persons who validate distributed ledger transactions through mining, staking and other methods, as well as developers of hardware and software solutions enabling users to maintain custody of their own digital wallets.
  - Treasury officials have stated publicly that guidance regarding the “broker” definition is expected in January 2022 and more comprehensive regulations later in the year. In addition, the Act requires certain persons engaged in business activities to report to the IRS the receipt of digital assets valued at more than $10,000.

- **Tax enforcement:** The IRS continues to engage in enforcement activities aimed at taxpayers who fail to report their digital asset earnings, including through “John Doe” summonses seeking customer information from cryptocurrency exchanges.
Proposed legislation: The Build Back Better Act, which was passed by the House in November 2021 and is struggling in the Senate, would impose additional requirements on digital assets, including application of the “wash sale” rules and “constructive sale” rules. Even if the Build Back Better Act does not pass, we expect that these concepts are likely to make their way into another bill.

- The wash sale rules generally prevent a taxpayer from recognizing a loss on the sale of an asset if the taxpayer acquires a substantially identical asset within a specified period.
- The constructive sale rules cause a taxpayer to have a deemed disposition of an appreciated financial position if the taxpayer enters into certain hedging transactions with respect to the appreciated financial position.