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Digital Asset Federal Legislation and Regulatory Developments: Wrap Up of First Quarter 2022

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Several recent releases of draft legislation, reports, and speeches highlight the federal government's efforts in the first quarter of 2022 to address the rapidly developing digital asset marketplace and its regulatory landscape.

Congressional Legislative Activity

On February 15, Representative Warren Davidson (R-OH) introduced the "Keep Your Coins Act," which is intended "[t]o prohibit Federal agencies from restricting the use of convertible virtual currency by a person to purchase goods or services for the person's own use, and for other purposes." That same day, Congressman Josh Gottheimer (D-NJ) also announced a discussion draft of the "Stablecoin Innovation and Protection Act," which is intended to define "qualified stablecoins" to differentiate them from "more volatile cryptocurrencies."

On March 17, Senators Elizabeth Warren (D-MA), Jack Reed (D-RI), Mark Warner (D-VA), and Jon Tester (D-MT) introduced the Digital Asset Sanctions Compliance Enhancement Act in an attempt to ensure blacklisted Russian individuals and businesses do not use cryptocurrency to evade economic sanctions. The bill does not come without controversy, however, as it "would place sweeping restrictions on persons who build, operate and use cryptocurrency networks even if they have no knowledge or intent to help anyone evade sanctions," according to policy group Coin Center.

On March 28, Representative Stephen Lynch (D-MA), along with co-sponsors Jesús G. García (D-IL), Rashida Tlaib (D-MI), Ayanna Pressley (D-MA), and Alma Adams (D-NC), introduced H.R. 7231, the Electronic Currency and Secure Hardware Act (ECASH Act), which would direct the secretary of the U.S. Department of the Treasury (not the Federal Reserve) to develop and issue a digital analogue to the U.S. dollar, or "e-cash," which is intended to "replicate and preserve the privacy, anonymity-respecting, and minimal transactional data-generating properties of physical currency instruments such as coins and notes to the greatest extent technically and practically possible," all without requiring a bank account. E-cash would be legal tender, payable to the bearer and functionally identical to physical U.S. coins and notes, "capable of instantaneous, final, direct, peer-to-peer, offline transactions using secured hardware devices that do not involve or require subsequent or final settlement on or via a common or distributed ledger, or any other additional approval or validation by the United States Government or any other third party payments processing intermediary," including fully anonymous transactions, and "interoperable with all existing financial institutions and payment systems and generally accepted payments standards and network protocols, as well as other public payments programs."

On April 6, Senator Pat Toomey (R-PA) released a draft of his Stablecoin Transparency of Reserves and Uniform

Safe Transactions Act, or Stablecoin TRUST Act. The draft bill contemplates a “payment stablecoin,” which is convertible directly to fiat currency by the issuer. Only an insured depositary institution, a money transmitting business (authorized by its respective state authority) or a new “national limited payment stablecoin issuer” would be eligible to issue payment stablecoins. Additionally, payment stablecoins would be exempt from the federal securities requirements, including the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940.

Separately, Senators Kirsten Gillibrand (D-NY) and Cynthia Lummis (R-WY) recently announced they will introduce bipartisan legislation in the near future covering a broad range of digital assets topics to establish the first comprehensive federal digital asset strategy for the U.S., privacy, safety and soundness, consumer protection, and the taxation of digital assets, including cryptocurrencies.

Regulatory Activities and Statements

In late January, the Federal Reserve (Fed) released a report titled, “Money and Payments: the U.S. Dollar in the Age of Digital Transformation,” which focused on the feasibility of a retail Central Bank Digital Currency (CBDC) to be used by the general public, as opposed to a wholesale CBDC that would be used by financial institutions for back-end settlement. The Fed identifies several characteristics of its potential CBDC:

- ***Privacy-protected*****:** Consumer privacy in the digital marketplace is a primary concern, particularly given the global reach of digital assets.
- ***Intermediated*****:** The Fed suggests that a CBDC would be best implemented through the private sector, which could offer digital wallets for transfers, payments, receipt, and holding of CBDCs. This structure is viewed as the most optimal because it would not change the current framework of the Fed, which does not open private accounts, while simultaneously relying on the expertise of the private sector for security and innovation.
- ***Widely transferable*****:** To be effective, the Fed emphasizes that any CBDC must be easily transferrable to maintain the free flow of currency within the market.
- ***Identity-verified*****:** Although consumer privacy is a paramount concern, the Fed notes that a balance must be struck between privacy and “the transparency necessary to deter criminal activity,” including anti-money laundering and countering the financing of terrorism.

The timetable for a Fed-backed CBDC is still uncertain, and the report does not commit the Fed to any particular action. The Fed is now soliciting input on the benefits, risks, policy considerations, and design for a CBDC through May 20. The report also emphasizes that the Fed will not act alone, making clear that it will look for guidance from the President and Congress before moving forward.

Shortly thereafter, on March 9, President Biden signed an executive order (Order) to establish the first comprehensive federal digital asset strategy for the U.S., which would promote digital asset innovation, while balancing benefits and associated risks. The Order directs the Justice Department, U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System, the Consumer Financial Protection Bureau, and many other federal agencies to study the legal and economic implications of creating a U.S. CBDC.

The Order sets forth six main objectives:

1. Consumer and investor protection;

2. Financial stability;

3. Mitigation of illicit finance and national security risks;

4. S. leadership in the global financial system and economic competitiveness;

5. Financial inclusion; and

6. Responsible innovation.

The Order "encourage[s]" the chairman of the Board of Governors of the Federal Reserve System "to continue to research and report on the extent to which CBDCs could improve the efficiency and reduce the costs of existing and future payments systems, to continue to assess the optimal form of a United States CBDC," and to develop a plan for the potential implementation of a CBDC.

Within 120 days of the date of the Order, Secretary Yellen must "establish a framework for interagency international engagement with foreign counterparts … to … enhance adoption of global principles and standards for how digital assets are used and transacted, and to promote development of digital asset and CBDC technologies consistent with our values and legal requirements." The Order also calls for the establishment of a framework for enhancing U.S. economic competitiveness in, and leveraging of, digital asset technologies and a report on strengthening cooperation of international law enforcement for criminal activity related to digital assets.

Speaking at an American University event on April 7, Secretary Yellen delivered her first speech on digital assets in which she claimed that a digital dollar could become a "trusted money comparable to physical cash." Secretary Yellen referenced the Order several times throughout her remarks, stressing that Treasury will work with the White House and other federal agencies to provide reports and recommendations related to the Order's objectives. In discussing the opportunities and challenged posed by nascent digital asset technologies, Secretary Yellen offered five lessons "relate[d] to the nature of responsible innovation, the structure of appropriate guardrails, the fundamentals of the financial system, our role in the global economy, and the value of collaboration," as follows:

1. The U.S. financial system benefits from responsible innovation;

2. Vulnerable people suffer great harm when regulation fails to keep pace with innovation;

3. Regulation should be technology-agnostic and focus on risks and activities;

4. Sovereign money is the core of a well-functioning financial system, and the U.S. benefits from the central role

the dollar and U.S. financial institutions play in global finance; and

5. Digital asset innovation should result from public-private dialogue and development.

Secretary Yellen's speech comes on the heels of SEC Commissioner Gary Gensler's April 4 remarks at the virtual Penn Law Capital Markets Association Annual Conference in which he highlighted three areas related to the SEC's work in overseeing the capital markets, protecting investors, facilitating capital formation, and maintaining fair, orderly, and efficient markets:

1. ***Platforms*****.** Chairman Gensler noted that the SEC plans to register and regulate crypto trading and lending platforms much like traditional regulated exchanges. In recognizing that some crypto platforms combine the trading of securities and non-securities (*e.g.,* crypto commodity tokens), Chairman Gensler asked the SEC staff to work with the Commodity Futures Trading Commission on how to jointly address such platforms. On crypto custody, Chairman Gensler asked staff to work with crypto platforms on registration and regulation. Chairman Gensler also noted that the SEC staff is considering whether rules should be put in place to segregate out market-making functions as it relates to crypto trading platforms.

2. ***Stablecoins*****.** Chairman Gensler stressed his concerns regarding the potential misuse of stablecoins for illegal purposes. Because stablecoins "primarily are used for crypto-to-crypto transactions … the use of stablecoins on platforms may facilitate those seeking to sidestep a host of public policy goals connected to our traditional banking and financial system: anti-money laundering, tax compliance, sanctions, and the like." Chairman Gensler further noted that stablecoins are also often owned by crypto platforms, creating potential "conflicts of interest and market integrity questions that would benefit from more oversight."

3. ***Tokens*****.** Chairman Gensler noted that "most crypto tokens involve a group of entrepreneurs raising money from the public in anticipation of profits — the hallmark of an investment contract or a security under our jurisdiction." Reiterating former Chairman Jay Clayton's comments, Chairman Gensler again emphasized that most crypto token are investment contracts under the *Howey* test, and it is "important" to the SEC that crypto tokens be registered as securities and comply with the SEC's disclosure requirements.

On the banking front, on April 7, the Federal Deposit Insurance Corporation (FDIC) released a letter, requiring all FDIC-supervised institutions that intend to engage in, or that are *currently* engaged in, crypto-related activities to notify its FDIC Regional Director. The FDIC also encouraged institutions to notify their state regulator. The FDIC raised concerns around safety and soundness, financial stability, and consumer protection risks presented by crypto-related activities, all of which echo those laid out in the Order.

The FDIC's letter builds on the increasing attention of U.S. banking regulators to crypto-related activities of their regulated institutions. Prior to this letter, neither the FDIC nor the Federal Reserve had spoken definitively on such activities. However, the Office of the Comptroller of the Currency (OCC) published a letter in November 2021, requiring OCC-regulated institutions to provide written notification of proposed crypto-related activities. At this time, the Federal Reserve continues to remain silent on any similar notification requirements. Although, given the quickly growing interest in this issue, we would not expect the Federal Reserve to maintain its silence for much longer.

Acting Comptroller of the Currency Michael Hsu addressed several crypto-related issues in two recent prepared remarks. Speaking at the ABA Risk 2022 program in late March, Acting Comptroller Hsu warned banks against overlooking the tail risks of trading crypto derivatives. Hsu noted several risks banks should consider, including limited or unreliable price histories of crypto-assets, crypto positions being netted in the risk aggregation process for risk reporting, regulatory capital, and risk management purposes, and the potential for “classic” wrong-way risk (*i.e.,* for counterparties that are structurally long crypto-assets and use derivatives for further leverage, the amount owed by that counterparty to the dealer bank would increase at the same time that the counterparty would be experiencing financial stress).

At a Georgetown University Law Center event on March 8, Hsu turned his attention to stablecoins, broadly cautioning against permitting stablecoin issuers to pick from a range of licensing options, as some lawmakers have suggested (*e.g.,* letting issuers choose between different federal and state regulatory frameworks). Hsu also suggested that banks may need to conduct stablecoin-related activities in a standalone bank-chartered entity, separate from other insured depositary institution affiliates, to properly manage crypto liquidity and blockchain-specific risks.

Our Take

In the wake of the President’s Order, we expect federal regulatory agencies to continue issuing policy releases and prepared remarks outlining differing (and sometimes competing) perspectives on the federal government’s role in digital asset development and regulation. While the executive branch is unlikely to look for guidance and potential legislation from Congress before substantially moving forward, like all things on the Hill, it remains to be seen whether partisan politics will prevent digital asset legislation from progressing this year. Additionally, while the President’s “whole of government” approach includes more than two dozen federal agencies, it conspicuously omits addressing what role, if any, state regulators will play in overseeing digital assets. Nonetheless, state lawmakers and regulators have pressed forward in crafting state-level digital asset legislation and regulation, as more than 150 pieces of legislation relating to cryptocurrencies have been proposed in 40 states. Virginia, as one example, recently enacted new legislation to permit state-chartered banks to provide virtual currency custody services, which is modeled on the Texas Department of Banking notice in June 2021 affirming that state-chartered banks in Texas are permitted to provide virtual currency custody services.

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