State of Play:

Crypto Regulations in the Wake of FTX's Collapse

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The course of regulatory reform in the United States related to digital assets is likely about to change as a result of the allegations against Sam Bankman-Fried and FTX affiliated entities in bankruptcy.

Prior to FTX's bankruptcy, and with Bankman's support, the industry was gaining traction in promoting its own views regarding needed safeguards, including oversight and enforcement by the Commodity Futures Trading Commission (CFTC), rather than the Securities and Exchange Commission (SEC). In the aftermath of FTX, we would expect calls for stricter regulations, which could lean reform in the direction of the SEC and adoption of a framework similar to the European Union's Markets in Crypto-Assets (MiCA) regulation, and at the state-level, New York's BitLicense.

Going forward, as individual and institutional customers and investors seek transparency and trust, we would also expect custodians and platforms that have submitted to the supervision of regulators, such as the Office of the Comptroller of the Currency (OCC), or registered with the CFTC to have a competitive advantage and be in the best position to adopt to any additional regulatory requirements implemented.

As we enter a dynamic stage for regulatory developments, below is a brief review of recent and/or significant actions by the White House, Congress, U.S. financial regulators, states, and regulators abroad to regulate custodians and other service providers engaged in digital asset-related activities.

What Actions Has the White House Taken?

In March 2022, President Joe Biden signed an executive order directing federal agencies to produce nearly two dozen different reports analyzing various issues and assessing potential benefits and risks related to the crypto industry, including the prospect of a U.S. central bank digital currency (CBDC). One such report is the Financial Stability Oversight Council's (FSOC) Report on Digital Asset Financial Stability Risks and Regulation, which includes both a comprehensive overview of crypto regulations as well as ten specific regulatory recommendations. (For example, the report recommends that congress pass legislation that provides for explicit rulemaking authority for federal financial regulators over the spot market for crypto-assets that are not securities.) The executive order itself did not announce any new rules that crypto companies must follow.

What Actions Has Congress Taken?

Two bipartisan bills largely seek to shift regulatory authority over the crypto industry from the SEC to the CFTC. In June 2022, a group of Republican and Democrat Senators introduced the Lummis-Gillibrand Responsible Financial Innovation Act ("Lummis-Gillibrand Bill"). And, in August 2022, another group of Republicans and Democrat Senators introduced the Digital Commodities Consumer Protection Act ("Stabenow-Boozman Bill"). Key takeaways include:

Lummis-Gillibrand Bill

- Grants CFTC "exclusive jurisdiction" over digital asset transactions in interstate commerce, subject to exclusions (*e.g.*, investment contracts)
- Creates new category of digital assets —"ancillary assets"— presumptively qualified as commodities: "intangible, fungible asset[s] that [are] offered, sold, or otherwise provided to a person in connection with the purchase and sale of a security through . . . an investment contract"
- Recognizes decentralized autonomous organizations (DAOs) subject to tax

Stabenow-Boozman Bill

- Grants CFTC "exclusive jurisdiction" to regulate "digital commodity" trading (except for crypto transactions solely for goods/services)
- Mandates that digital commodity platforms register with the CFTC in applicable categories (broker, custodian, dealer, trading facility)
- Defines "digital commodity" as "property commonly known as cryptocurrency or virtual currency, such as Bitcoin and Ether," but excludes any "security"
- Clarifies treatment of crypto in event of platform bankruptcy – by applying Subchapter IV of Bankruptcy Code (Commodity Broker Liquidation)

Given Bankman was a proponent of these bills and the potential for a complete picture of the issues with FTX operations to unfold slowly over time, we would not expect progress on this legislation any time soon.

What Actions Have U.S. Financial Regulators Taken?

The OCC recently granted multiple national bank charters to various fintech/crypto companies, including trust banks that provide custodial and other digital asset services. It also issued several interpretative letters on crypto activities of national banks and federal savings associations:

What Does the OCC Require?	What Does the OCC Permit?
• Notifying the supervisory office of proposed activities and receiving supervisory non-objection • Ensuring the compliance management system is sufficient and appropriate • Maintaining adequate systems to identify, measure, monitor and control crypto-related risks • Demonstrating an understanding of compliance obligations related to specific activities	• Cryptocurrency custody services, including holding unique cryptographic keys • Holding deposits serving as reserves for stablecoins backed on a 1:1 basis by a single fiat currency and held in hosted wallets • Using distributed ledgers and stablecoins to engage in payment activities and independent node verification networks to facilitate payments

Earlier in 2022, the SEC issued Staff Accounting Bulletin No. 121 ("SAB 121") providing new accounting and disclosure requirements on certain SEC reporting companies that hold crypto-assets for platform users.

What Does SAB 121 Require?
• Recording a liability and corresponding asset on balance sheet at a fair value of the crypto-assets held for platform users • Disclosing (i) the nature/amount of crypto-assets the company is responsible for holding with separate disclosure for each significant crypto-asset; (ii) who holds cryptographic key information; (iii) who maintains internal recordkeeping of assets; and (iv) who is obligated to secure assets and protect them from loss or theft • Disclosing (i) types of loss or additional obligations that could occur; (ii) analysis of legal ownership of crypto-assets, including impact of bankruptcy; (iii) potential impact that destruction, loss, theft, or other unavailability of cryptographic key information would have to company; and (iv) if material, information about risk-mitigation steps put in place (*e.g.*, insurance)

In August 2022, the Federal Reserve issued a regulatory letter that applies to Federal Reserve-supervised banks seeking to engage in crypto-related activity.

What Does the Fed Require?	What Does the Fed Permit?
• Notification of lead supervisory contact at Federal Reserve and state regulator	• Crypto-asset safekeeping and traditional custody services

prior to engaging in crypto-related activity • Analysis of permissibility of activities under relevant laws and determination of whether any federal banking filings are required • Having in place adequate systems, risk management, and controls	• Ancillary custody services • Facilitation of customer purchases and sales of crypto-assets • Loans collateralized by crypto-assets • Issuance and distribution of stablecoins

What Actions Have States Taken?

States have led the way in experimenting with crypto laws, though some states have taken a more heavy hand than others.

Burdensome Example: New York's BitLicense (2015)

New York's BitLicense governs any "person (whether an individual or a company) that engages in 'Virtual Currency Business Activity.'" Commentators have noted that BitLicense "is generally regarded as the most onerous regulation of virtual currency businesses in the United States."

What Does a BitLicense Require?	What Does a BitLicense Permit?
• Background reports (with fingerprints/photos of each applicant, principal officer, principal stockholder, principal beneficiary, employee with access to customer funds) • Maintaining/enforcing written compliance policies (anti-fraud, anti-money laundering, cyber security, privacy and information security) • Maintaining capital in the amount and form as superintendent determines • Maintaining surety bond or trust account in U.S. dollars • Holding virtual currency of the same type and amount as that which is owed or obligated to another person	• Transmission or transmitting virtual currency • Storing, holding, or maintaining custody or control of virtual currency on behalf of others • Buying and selling virtual currency as a customer business • Exchange services as a customer business • Controlling, administering, or issuing a virtual currency • A BitLicensee may only offer or use certain coins, including coins on the DFS Greenlist.

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Less Burdensome Example: Wyoming's SPDI Law (2019)

Wyoming-chartered special purpose depository institutions ("SPDIs") are banks that "likely" focus on digital assets, receive deposits and conduct other activity incidental to the business of banking, including custody, asset servicing, fiduciary asset management, and related activities. Note that Wyoming's SPDI law passed into law along with 13 other crypto-friendly laws in 2019, garnering Wyoming the reputation as the nation's most crypto-friendly jurisdiction, or "the Delaware of digital asset law."

What Does the SPDI Law Require?	What Does the SPDI Law Permit?
• Application must include financial report, fingerprint card for each director, executive officer and shareholder with 10% or greater ownership; letters of commitment or similar relating to available capital; and bylaws • Maintaining principal operating headquarters and primary office of the CEO in Wyoming • Maintaining unencumbered liquid assets valued at 100% of depository liabilities and contingency account for unexpected losses/expenses • Meeting certain initial capital and surplus requirements • Complying with anti-money laundering and customer identification requirements	• Conducting "incidental activities" related to depositors, including custody, safekeeping and asset servicing, and custodial services; and investment adviser, investment company and broker-dealer activities • Making contracts as a corporation under Wyoming law • Carrying on a nonlending banking business for depositors • Providing payment services • Applying to become a member bank of the federal reserve system • Conducting business with depositors outside of Wyoming • Opening a branch in another state

What Actions Have Regulators Abroad Taken?

On October 5, 2022, the European Council approved and published the final text of MiCA. MiCA is still subject to a vote by the European Parliament, but is expected to come into effect by 2024. This wide-ranging legislation spanning 380-pages applies to those within the EU that issue, offer and/or trade of "crypto-assets," as well as certain delineated crypto-asset service providers ("CASPs"), such as custodians, trading platforms, and exchanges. MiCA does not fully cover decentralized finance, NFTs or crypto lending.

MiCA defines "crypto-asset" as a "*digital representation of a value or a right which may be transferred and stored electronically, using distributed ledger technology or similar technology.*" In addition, certain defined crypto-asset sub-categories have their own rules and requirements under MiCA.

What are MiCA's Three Sub-Categories of Crypto-Assets?	
Asset-Referenced Tokens (ARTs)	Tokens referring to or backed by one or more assets
Electronic Money Tokens (e-money or EMTs)	Tokens for making payments backed by a State currency
Utility Tokens	Tokens intended to provide access to a good/service supplied by the token issuer

MiCA imposes a robust set of requirements on crypto-asset service providers. For example:

Art. 53 of MiCA Requirements of All CASPs

- Be authorized as a crypto-asset service provider in accordance with Article 55 or a specified entity in accordance with Article 53
- Have a registered office in a Member State of the Union where they carry out at least part of their crypto-assets services

Art. 67 of MiCA Specific Requirements of Crypto-Custodians

- Entering into an agreement with clients (setting forth, inter alia, nature of services provided, description of the security systems used, applicable law, fees, custody policy)
- Keeping a register of positions opened in name of each client
- Establishing a custody policy with internal rules and procedures
- Facilitating the exercise of the rights attached to crypto-assets
- Providing reporting to clients, regularly and upon request, including statement of client positions
- Ensuring necessary procedures in place to return crypto-assets
- Ensure separation of crypto-asset holdings held on behalf of clients from own holdings (and ensure no recourse in event of custodian's insolvency)
- Be liable to clients for loss of crypto-assets from "incident[s]" up to market value

Impact on Crypto Custodial Banks if U.S. Were to Adopt Legal Framework Similar to MiCA

Pros	Cons
• Robust/comprehensive framework in effect would increase customer confidence/stabilize the industry • Thoughtful recognition that different kinds of crypto assets require different rules and considerations • Requirements dovetail with OCC requirements and practices of OCC-regulated entities	• Designed around EU business practices and laws that do not necessarily match U.S. business practices and expectations • Designed without significant input from U.S. market participants • Increased regulatory burden and cost • Potential increased liability in event of lost crypto assets caused by certain events

Conclusion

Given the lack of regulatory crypto guidance in the United States, MiCA's robust and comprehensive requirements may fill the global regulatory void and influence eventual rulemaking in the United States (and elsewhere). If so, trust banks chartered by the OCC will have an advantage given the similarity with OCC requirements and permitted practices. In any event, the inquiry into FTX practices, which will become widely known (given the public nature of bankruptcy proceedings), will likely increase calls for regulatory scrutiny and place a premium on trust in the market, all of which will benefit regulated entities. These benefits should encourage other market participants to submit to jurisdiction of regulators and foster, not impede, the development of digital assets in the United States.

For More Information:
Please contact the attorneys listed below or the Davis+Gilbert attorney with whom you have regular contact.

Joseph Cioffi

Partner/Chair, Insolvency + Finance
212 468 4875
jcioffi@dglaw.com

Adam Levy

Associate, Insolvency + Finance
646 673 8305
alevy@dglaw.com