Lummis-Gillibrand Responsible Financial Innovation Act proposes comprehensive regulatory framework for digital assets in the United States

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On June 7, 2022, Senator Kirsten Gillibrand (D-NY) and Senator Cynthia Lummis (R-WY) introduced the Responsible Financial Innovation Act (RFIA), a highly anticipated legislative proposal that, if enacted by Congress and signed into law, would establish a comprehensive regulatory framework for digital assets in the United States.

Senator Gillibrand is a member of the Senate Committee on Agriculture, Nutrition, and Forestry, which oversees the Commodity Futures Trading Commission (CFTC), and Senator Lummis is a member of the Senate Committee on Banking, Housing, and Urban Development, which oversees the Securities and Exchange Commission (SEC).

Although it is highly unlikely to become law before this congressional session adjourns on January 3, 2023, the RFIA[1] represents a milestone for the crypto industry, and will likely serve as a significant benchmark for future legislation. Recognizing that reviewing a 69-page bill may not be an immediate priority for all market participants, we have prepared this client alert to highlight the most significant aspects of the proposed legislation which, if enacted, would, among other things:

- introduce several digital-asset-related definitions;
- provide numerous changes and clarifications regarding the taxation of digital assets;
- introduce the concept of “ancillary asset,” an asset presumed not to be a security if specified periodic disclosure requirements are satisfied;
- designate the CFTC as the primary regulator of the digital asset spot market and create a new registration category for digital asset exchanges;
- establish various customer disclosure requirements for digital asset service providers;

- authorize depository institutions (both insured and uninsured), subject to obtaining prior regulatory approval, to issue, redeem and conduct all incidental activities relating to “payment stablecoins”; and
- codify certain principles related to the custody of financial assets.

Titles I, II, III and IV – Key definitions

The RFIA would address the confusion caused by the lack of standardized digital-asset-related definitions, and would introduce several key definitions and other concepts including:

Ancillary Asset: an intangible, fungible asset that is sold in connection with the purchase and sale of a security through a scheme that constitutes an investment contract and that does not provide rights in a business entity similar to debt or equity issued by that entity, a share of the revenue or profits of that entity, or a right to any liquidation proceeds from the entity.

Decentralized Autonomous Organizations (DAO): an organization (i) which utilizes smart contracts to effectuate collective action for a business, commercial, charitable, or similar entity, (ii) the governance of which is achieved primarily on a distributed basis, and (iii) which is properly incorporated or organized under the laws of a State or foreign jurisdiction as a decentralized autonomous organization, cooperative, foundation, or any similar entity.

Digital Asset: a natively electronic asset that (i) confers economic, proprietary, or access rights or powers, and (ii) is recorded using cryptographically secured distributed ledger technology or any similar analogue, and includes virtual currencies, ancillary assets, payment stablecoins, and other securities and commodities.

Digital Asset Intermediary: a person who holds a license, registration, or other similar authorization who may conduct market activities relating to digital assets; this includes a licensed, registered, or otherwise authorized person who issues a payment stablecoin, but does not include a depository institution.

Distributed Ledger Technology: technology that enables the operation and use of a ledger that (i) is shared across a set of distributed nodes that participate in a network and store a complete or partial replica of the ledger, (ii) is synchronized between the nodes, (iii) has data appended to the ledger by following the specific consensus mechanism of the ledger, (iv) may be accessible to anyone or restricted to a subset of participants, and (v) may require participants to have authorization to perform certain actions – or requires no authorization.

Payment Stablecoin: a digital asset that is (i) redeemable, on demand, on a one-to-one basis for instruments denominated in legal tender of any jurisdiction, (ii) issued by a business entity, (iii) accompanied by a statement from the issuer that the asset is redeemable as specified in (i), (iv) backed by one or more financial assets, and (v) intended to be used as a medium of exchange.

Smart Contract: (i) computer code deployed to a distributed ledger technology network that executes an instruction based on the occurrence or nonoccurrence of specified conditions, or (ii) any similar analogue. This may include taking possession or control of a digital asset and transferring the asset or issuing executable instructions for these actions.

Virtual Currency: (i) a digital asset that (a) is used primarily as a medium of exchange, unit of account, store of value, or any combination of such functions, (b) is not legal tender, and (c) does not derive value from or is backed by an underlying financial asset (except other digital assets), and (ii) includes a digital asset that is accompanied by a statement from the issuer that a denominated value will be maintained and be available upon redemption, based solely on a smart contract.

Title II – Responsible taxation of digital assets

The RFIA makes a number of important changes and clarifications regarding the U.S. federal tax treatment of digital assets.

USD200 de minimis exclusion

Under current U.S. tax law, using a digital asset (such as bitcoin) to purchase goods or services constitutes a disposition of that digital asset, and thus potentially gives rise to a taxable gain if the digital asset has appreciated in value. The RFIA provides a de minimis exception whereby up to USD200 of such gain or loss is excluded when using virtual currency for the purchase of goods or services in personal transactions. This generally matches an already existing de minimis exception for transactions in foreign currencies.

Broker information reporting

The RFIA clarifies and narrows the definition of broker in the digital asset context to establish that it refers to persons that perform the traditionally understood broker activity of standing ready to effect sales in digital assets on behalf of customers. It replaces an existing definition (which has not yet become effective) that could be read to include a broader set of service providers that play an administrative or operational role in effecting transactions.

Digital assets trading safe harbor

Under current U.S. tax law, non-U.S. persons trading stocks and securities, and commodities for their own account, even through a domestic agent, are not considered to be engaged in a U.S. trade or business. These are critical to non-U.S. investors in many U.S. funds, to establish that the non-U.S. investors are not subject to U.S. tax domestic filing obligations. The RFIA provides a comparable exception for digital assets.

Decentralized autonomous organizations definition

Under current U.S. tax law, certain DAOs may be treated as business entities for tax purposes. The RFIA provides specific rules establishing that a DAO would be a business entity under certain circumstances, including that it is incorporated or organized under the laws of a U.S. state or a foreign jurisdiction.

Digital asset lending agreements

Under current U.S. tax law, securities lending transactions that meet certain requirements are deemed not to be taxable events. The RFIA extends this exception to digital assets, thereby giving them the same treatment as traditional securities.

Future IRS guidance

The RFIA would require the IRS to adopt guidance on certain long-standing issues in the digital asset industry.

Retirement investing

The RFIA would require the Government Accountability Office to study various aspects of retirement investment into digital assets.

Digital asset mining and staking

The RFIA provides that taxpayers would not have to recognize income on digital mining or staking activities until they dispose of the assets produced or received through those activities.

Title III – Responsible securities innovation

Ancillary assets

The RFIA would introduce the category of “ancillary assets,” a subset of digital assets defined by the absence of debt- or equity-like features, provided their value primarily is determined by the efforts of others. While such features are conventional hallmarks of securities status under the Howey test, the RFIA’s text is suggestive of the sponsors’ view that the SEC has applied Howey too indiscriminately to digital assets that lack the bright-line characteristics of a security. This new regulatory category is meant to clarify a currently ambiguous jurisdictional line between two competing regulators: the SEC, which regulates “securities,” and the CFTC, which has jurisdiction over “commodities” and related derivative products. Under the RFIA, the line would be clarified, though likely not in every case.[2] Many ancillary assets would be regulated by the CFTC and be subject to significantly reduced SEC regulation and oversight.

As noted above, “ancillary assets” would include any “intangible, fungible asset that is offered, sold, or otherwise provided to a person in connection with the purchase and sale of a security through an arrangement or scheme that constitutes an investment contract,” but would specifically exclude assets that provide holders with rights in a “business entity” generally associated with traditional debt or equity securities, including liquidation rights, interest or dividend entitlements, profit or revenue share or any other financial interest in the business entity. Under the RFIA, ancillary assets generally would be presumed to be "commodities" under the Commodities Exchange Act, and be subject to the CFTC's exclusive jurisdiction, and not "securities" regulated by the SEC under federal securities laws.

Required disclosure

Issuers of ancillary assets that satisfy specified U.S. jurisdictional tests would be required to make limited semi-annual disclosures beginning 180 days after the initial offering of ancillary assets if (i) the average daily aggregate value of all ancillary assets provided by the company in relation to the underlying investment contract in all spot markets open to the public in the United States exceeds $5 million during the 180 days following that first offer and (ii) during that same period, the company's "entrepreneurial or managerial efforts" primarily determined the value of the ancillary asset. Issuers would reassess these criteria each year, with the possibility that they would cease to be subject to the reporting obligations if trading volume falls below the threshold or, critically, the project becomes sufficiently decentralized that the second prong no longer applies. The required disclosures fall far short of those required of SEC registrants, and could be analogized conceptually to highly abbreviated Regulation S-K business, management and risk factor disclosures regarding the issuer and the ancillary asset. Financial statements would not be required, but a "going concern" statement from a chief financial officer or equivalent officer would be.

Should the RFIA proceed, market participants should expect these elements to be scrutinized carefully by legislators, industry bodies, public interests groups, and regulators (especially SEC officials) and to be revised significantly based on their input.

Broker-dealer custody of digital assets; guidance for satisfactory control location

Among other undertakings, the RFIA would require the SEC to adopt amendments to Rule 15c3-3, the custody rule under the Securities Exchange Act of 1934, permitting broker-dealers to custody digital assets for customers. If ultimately enacted, Section 304 of the RFIA would provide a meaningful and long-awaited path for broker-dealers to maintain custody of digital asset securities.[3]

The RFIA also would require the SEC to issue guidance for digital asset securities providing that the requirement in Rule 15c3-3 that a broker-dealer maintain a satisfactory control location may be satisfied by protecting the digital asset through commercially reasonable cybersecurity practices for a private key.

Title IV – Responsible commodities innovation

The RFIA would make a number of changes to the Commodity Exchange Act to accommodate the trading of digital assets, but three are particularly important: (i) it would expand and clarify the CFTC's "exclusive" jurisdiction over digital assets that are deemed to be commodities; (ii) it would help to modernize the requirements applicable to how futures commission merchants handle digital assets and related business; and (iii) it would create a new voluntary registration category for digital asset exchanges.

CFTC jurisdiction

The RFIA would significantly expand the CFTC's jurisdiction to include all fungible digital assets that are not securities, including ancillary assets (discussed above). The CFTC's jurisdiction over these products would be "exclusive," but there would be important carveouts that allow other regulators to retain some degree of oversight and control – e.g., SEC disclosure obligations for certain non-security ancillary assets. Notably, stablecoins issued by a depository institution would not be regulated as a commodity or a security.

FCM requirements

The RFIA would expand the ability of CFTC-registered futures commission merchants to provide services to digital asset customers. Standard requirements regarding the custody and segregation of customer funds would apply, but customers would have the ability to opt out of these protections under certain circumstances.

Digital asset exchanges

The RFIA would create a new category of registered entity: the digital asset exchange. Digital asset exchanges would be CFTC-regulated trading platforms for spot and physical transactions involving digital assets. Digital asset exchanges seeking to facilitate the trading of derivatives would need to register as a traditional futures exchange (designated contract market) or a swap execution facility. Unlike other regulatory categories for trading platforms, registration as a digital asset exchange would be voluntary – registration would come with certain regulatory benefits, but would not be required. For example, futures commission merchants would be prohibited from trading digital assets that have not been listed on a digital asset exchange. The requirements applicable to digital asset exchanges resemble a hybrid of the core principles applicable to swap execution facilities and futures commission merchants (because digital asset exchanges would handle customer funds). This provision closely tracks the Digital Commodity Exchange Act, an analogous bill under consideration in the House of Representatives. Digital asset exchanges would be "financial institutions" under the Bank Secrecy Act and, therefore, subject to AML requirements.

Title V – Responsible consumer protection

The RFIA would establish various customer disclosure requirements for digital asset service providers (including digital asset intermediaries, financial institutions within the meaning of section 1a of the Commodity Exchange

Act (7 U.S.C. § 1a), and any other person conducting digital asset activities pursuant to a Federal or State charter, license, registration, or other similar authorization). Required disclosures would include a description of the scope of permissible transactions that may be undertaken with customer digital assets; in advance of any updates, material source code version changes relating to digital assets, except in emergencies, which may include security vulnerabilities; whether customer digital assets are segregated from other customer assets and the manner of segregation; how customer assets would be treated in a bankruptcy or insolvency scenario and the risks of loss; the time period and manner in which the provider is obligated to return the customer's digital asset upon request; applicable fees; the provider's dispute resolution process; any lending arrangements (including related collateral requirements and mark-to-market and monitoring arrangements) related to digital assets; and policies on rehypothecation of digital assets, including a clear definition of rehypothecation that is accessible to consumers.

The RFIA also makes clear that no person will be required to use an intermediary for the safekeeping of digital assets legally owned and possessed or controlled by such person.

Title VI – Responsible payments innovation

There is broad international consensus, including among the President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) (Report on Stablecoins, Nov. 2021), the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions (Application of the Principles for Financial Market Infrastructures to Stablecoin Arrangements, Oct. 2021) and the Financial Stability Board (Regulation, Supervision and Oversight of "Global Stablecoin" Arrangements: Final Report and High-Level Recommendations, Oct. 2020), that stablecoins present potentially significant systemic risks warranting intensive regulatory and prudential oversight. There has also been substantial discussion around the issuance of central bank digital currencies as an alternative to stablecoins, which might afford both a safe and easy alternative to more traditional payments products. There is good reason to believe other constituencies are working on proposals for legislative actions to implement solutions to some of these challenges.

The RFIA would authorize depository institutions (both insured by the FDIC and uninsured), subject to obtaining prior regulatory approval from the appropriate federal or state banking regulator, to issue, redeem and conduct all incidental activities relating to "payment stablecoins."

Depository institution issuers of payment stablecoins would be required to maintain high-quality liquid assets equal to at least 100 percent of the face amount of their issued payment stablecoins. In the case of insured depository institutions that engage in on-balance sheet lending activities, such assets would be required to be held at a Federal Reserve bank or a foreign central bank. Depository institution issuers would be required to provide monthly public disclosures, which would also be filed with the appropriate banking regulators, of the number of payment stablecoins outstanding and the details regarding the assets backing the payment stablecoins and their value. In the event of a receivership of the depository institution issuer, the RFIA provides that the claims of payment stablecoin holders would have priority over claims of all other creditors, including depositors, ranking behind only the receiver's claims for administrative expenses.

The RFIA also provides that regulated entities that are not depository institutions would not be prohibited from issuing and redeeming payment stablecoins and engaging in related incidental activities, although such institutions would be required to comply with the asset maintenance, disclosure, and redemption requirements applicable to depository institution payment stablecoin issuers.

The RFIA would also expand the authority of the OCC to charter uninsured special-purpose national banks whose business would be limited solely to issuing payment stablecoins. The RFIA would require the OCC to develop tailored capital, community contribution plan (presumably similar to the Community Reinvestment Act, which would provide for consumer education, financial literacy, charitable donations, volunteer service, job training and internships or similar involvement) and recovery and resolution planning requirements for such institutions, which would also become (along with similar state-chartered institutions) subject to tailored holding company supervision by the Board of Governors of the Federal Reserve System (Federal Reserve) under a proposed new section of the Bank Holding Company Act of 1956.

Title VII – Responsible banking innovation

The RFIA would codify certain principles related to the custody of financial assets by depository institutions and national trust banks. The RFIA would define "custody" to mean "the safekeeping, servicing and management of customer financial assets, including currency, securities and commodities, on an off-balance sheet basis," and would provide that custody would not be deemed a fiduciary or trust activity unless the custodian is providing substantial discretionary services with respect to an account, including through investment advice or investment discretion, and the custodian owes a customer a higher standard of care or duty.

In a provision that is apparently intended to repeal Staff Account Bulletin No. 121, recently issued by the accounting staff of the SEC, the RFIA would provide that assets properly held in a custodial account are not assets or liabilities of the custodian and shall be maintained on an off-balance sheet basis, including for the purpose of accounting treatment for the custodian and the customers of the custodian, notwithstanding the form in which the assets are maintained.

Moreover, the RFIA would require the Federal Financial Institutions Examination Council (FFIEC) (an interagency body that includes the Federal Reserve, the FDIC, the National Credit Union Administration, the OCC, the Consumer Financial Protection Bureau, and representatives from state regulatory agencies), the SEC and the CFTC, in consultation with the Financial Crimes Enforcement Network (the Bureau of the U.S. Treasury responsible for the administration of the Bank Secrecy Act), to publish final guidance and examiner handbooks on digital assets activities, including anti-money laundering, customer identification, beneficial ownership, and sanctions compliance; custody; fiduciary and capital markets activities; and information technology standards. The FFIEC's guidance and examiner handbooks would also be required to cover payment system risk and consumer protection.

Title VIII – Responsible interagency coordination

The RFIA would call for a variety of follow-up actions and reports by the covered regulatory agencies, largely from the perspective of promoting inter-agency and interstate cooperation (and consequently reducing fragmentation) in the regulation of digital assets.

Footnotes

[1]See The Responsible Financial Innovation Act, S. 4356, 117th Congress (2022), available at https://www.gillibrand.senate.gov/imo/media/doc/Lummis-Gillibrand%20Responsible%20Financial%20Innovation%20Act%20%5bFinal%5d.pdf

[2]The RFIA and accompanying materials do not clarify why the drafters have limited "ancillary assets" to those delivered in connection with investment contracts (thereby effectively relying on SEC v W.J. Howey Co. as a predicate to identifying ancillary assets). This approach could potentially limit the utility of the definition for market participants who initially seek to finance DLT platform development only through traditional securities offerings and issue certain token rights in connection with that offering. However, it is notable that the RFIA would not seek to legislatively alter the Howey framework or its application generally, which would have much more wide-ranging implications for financial markets.

[3]The SEC currently has only provided a very narrow and arguably unworkable category of "Special Purpose Broker-Dealers" that may solely custody digital assets that are securities. See SEC, Custody of Digital Asset Securities by Special Purpose Broker-Dealers (Dec. 23, 2020).

Authors by practice

Corporate

Dario de Martino

CFTC/Commodities

David Lucking

Deborah North

Jon Flynn

Vinod Aravind

SEC/Securities and Broker-Dealers

Barbara Stettner

Justin Cooke

Hilary Seo

Tax

Dave Lewis

Dustin Plotnick

Bank Regulatory

Bill Satchell

Lena Kiely