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Regulation of Decentralized Finance in the United States: What to Expect in Crypto

*By Evan Koster and Adam Lapidus**

Over the last decade, digital assets have gone mainstream. Regulators and legislators in the United States have taken note. The authors of this article discuss crypto currency regulation during the rest of this year, which is certain to be a watershed year for digital assets.

Digital assets have over the last decade gone from the fringes to the mainstream. 2021 may have marked a turning point in both their relevance to financial infrastructure and the attention paid to them by regulators and legislators in the United States.

BACKGROUND

By way of background, developments in cryptography and distributed systems have the potential to transform the financial system because existing institutions and the current legal framework in the United States were both developed prior to and without anticipation of digital assets. Many doubt whether a legal and regulatory apparatus developed in an earlier era can support and sustain financial innovation. New legislation is a possibility, but regulators assert that there already exists regulatory authority to guard against potential investor harm, systemic risk, and concentrated economic power.

Many investors complain about how many agencies are tasked with supervising the emerging crypto ecosystem and other aspects of the current regulatory structure.

On November 1, 2021, the President's Working Group on Financial Markets ("PWG"), along with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, published a report on stablecoins (the "PWG Report") that noted among other things the lack of a consistent set of prudential regulatory standards applicable to stablecoin arrangements and urged a congressional remedy. The PWG Report focuses on clarifying the

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authority of banking regulators, while carving out territory of the Securities Exchange Commission (the “SEC”) and the Commodity Futures Trading Commission (the “CFTC”) to oversee trading and markets. The PWG Report suggests that various agencies will regulate the new crypto-based financial system, consistent with the current regulatory framework for traditional assets. But the PWG Report does not provide a blueprint for cross-agency coordination.

2021: THE EMERGENCE OF STABLECOINS AND DEFI

Stablecoins and decentralized finance (“DeFi”) are increasingly popular manifestations of cryptographically secured distributed technology. Both stablecoins and DeFi have analogues in existing financial offerings, namely money and trading exchanges. Stablecoins are designed to maintain their value relative to a specified asset, which could be the U.S. Dollar. DeFi typically refers to “an open, permissionless, and highly interoperable protocol stack built on public smart contract platforms.”¹ Stablecoins and DeFi are of course interesting precisely because they are not identical to their analogues in traditional finance. The absence of a sovereign issuer or centralized authority (such as a bank or an exchange) distinguishes them for their predecessors, as does the technology underlying their creation and validation.

While all stablecoins share the goal of having a stable value, the mechanics can vary and are typically opaque. For example, there are no regulatory requirements regarding:

- The amount of reserve assets that must be held to ensure a stable value;
- The permissible volatility of a stablecoin’s value, or
- Disclosure.

(Ironically, the PWG Report would have stablecoin issuers be required to engage in fractional reserve banking rather than being able to be fully backed by cash and cash equivalents.) Due to their perceived stability, stablecoins can serve:

- As the economic equivalent to a traditional cash account;
- Collateral to fund leveraged trading of digital assets on DeFI trading platforms; or

¹ Fabian Schär, “Decentralized Finance: On Blockchain- and Smart Contract-Based Financial Markets,” Federal Reserve Bank of St. Louis Review, Second Quarter 2021, pp. 153-74. <https://doi.org/10.20955/r.103.153-74>.

- To earn yield on DeFi trading platforms.²

Stablecoins are native to DeFi and thus much of the perceived value—beyond their ability to provide stable value relative to a specified currency—is the relative ease of exchanging stablecoins for crypto assets because there is no need for an interaction with the traditional banking system. The absence of regulatory oversight, however, may be a source of risk.

The overarching question is whether a new legal framework is needed for this financial technology, or whether existing regulators—under existing or new legislation—have authority and capability to regulate. The PWG Report urges congressional action but recognizes several current avenues of authority for banking regulators to regulate stablecoins, and for the SEC and CFTC to regulate trading markets.³ The PWG Report does not explore, however, whether shoehorning stablecoins and DeFi into the existing prudential regulatory framework will sacrifice their novel features or chill financial innovation more generally.

APPLYING TRADITIONAL FINANCIAL REGULATION TO STABLECOINS AND DEFI

Crypto regulation in the United States has proceeded largely on the basis of mapping crypto assets to existing products. For example, certain DAO tokens and initial coin offerings (“ICOs”) have been deemed to have the characteristics of a security and are therefore subject to SEC jurisdiction,⁴ as have crypto asset interest bearing accounts.⁵ Bitcoin has been deemed a commodity and therefore is within the CFTC’s purview.⁶ Crypto derivatives and certain trading platforms could also be subject to CFTC oversight.⁷

² See PWG Report, pages 8–9.

³ See PWG Report, pages 1, 4.

⁴ See SEC.gov, “Framework for “Investment Contract” Analysis of Digital Assets, <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>; see also, SEC.gov, “SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities,” <https://www.sec.gov/news/press-release/2017-131>.

⁵ BlockFi Agrees to Pay \$100 Million in Penalties and Pursue Registration of its Crypto Lending Product, <https://www.sec.gov/news/press-release/2022-26>.

⁶ See, e.g., LabCFTC Releases Digital Assets Primer, <https://www.cftc.gov/PressRoom/PressReleases/8336-20>.

⁷ Keynote Address of Commissioner Dan M. Berkovitz Before FIA and SIFMA-AMG, Asset Management Derivatives Forum 2021, CFTC, <https://www.cftc.gov/PressRoom/SpeechesTestimony/opaberkovitz7>.

If the recommendations of the PWG Report are adopted, stablecoins will be subject to banking regulation,⁸ except to the extent that they relate to digital asset market regulation, supervision, and enforcement. These questions “are under active consideration by the CFTC and SEC but are not the subject of the recommendations in this report.” Even in its push for a comprehensive regulatory program for stablecoins, the PWG report recognizes that consolidated supervision of all crypto assets—including DeFi—will not be left to a single regulator.

2022: THE YEAR OF CRYPTO LEGISLATION?

With regard to stablecoins, the PWG Report calls on “Congress act promptly to enact legislation to ensure that payment stablecoins and payment stablecoin arrangements are subject to a federal prudential framework on a consistent and comprehensive basis.”⁹ That is, stablecoin arrangements should be available only for those entities that are or will be treated as banks. (Interestingly, the Federal Reserve subsequently addressed the threats posed by stablecoins and “other types of nonbank money,” stating that “a Central Bank Digital Currency could spur innovation by banks and other actors and would be a safer deposit substitute than . . . stablecoins. . . .”)⁹ It is noteworthy that the PWG Report’s call for legislation focuses primarily on how (and by whom) stablecoins should be regulated. The PWG report emphasizes jurisdictional authority and sets forth three items that concern the regulators and should be addressed by legislation,¹¹ but the PWG Report does not specify the details. The three items that legislation should require are as follows:

1. Stablecoin issuers must be insured depository institutions;
2. Custodial wallet providers “must be subject to appropriate federal oversight” and provide the appropriate federal regulator to impose risk-management standards on any entity that performs critical activities with respect to the stablecoin arrangement; and
3. Stablecoin issuers should have restrictions on their affiliations with commercial entities, to address potential concentrations of economic power and buildup of systemic risk.

⁸ See PWG Report, page 16.

⁹ See PWG Report, page 2.

⁹ See *Money and Payments: The U.S. Dollar in the Age of Digital Transformation*, at page 17. We note further that the Federal Reserve explicitly cites the PWG’s recommendations regarding legislation.

¹¹ See PWG Report, pages 2–3.

These are reasonable areas of focus, but questions remain. To name a few:

- What, precisely, is a “stablecoin”?
- Where is the dividing line between a “stablecoin” and other crypto assets?
- How stable must a stablecoin be?
- Are there requirements as to how it achieves such stability (and why is fractional reserve banking required of stablecoin issuers)?
- How will stablecoin regulation in DeFi be apportioned among prudential regulators, the CFTC, and the SEC?
- Would there be an “identified stablecoin product” analogous to the Gramm-Leach-Bliley Act preempting CFTC and SEC regulation of “identified banking products”?¹²

The answers to these questions are neither obvious nor addressed by the PWG Report, and are presumably to be left for another day, after Congress has authorized the banking regulators to regulate stablecoins.

Absent new legislation, regulators articulate that existing legislation provides authority to assert oversight. The PWG Report notes that to address economic concentration and risks to financial stability, the Financial Stability Oversight Council could designate (and ultimately regulate) “certain activities conducted within stable coin arrangements” as “systemically important financial institutions” pursuant to The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).¹³ Importantly, though, such designation would not apply where the underlying activity related to the sale of a security and thus SEC oversight.

Certain members of congress have begun to formulate a legislative response. Congressman Tom Emmer (MN-06) reintroduced the bipartisan Blockchain Regulatory Certainty Act (the “BRCA”) with Representative Darren Soto. The BRCA focuses narrowly on the registration requirements applicable to block-

¹² See Section 206A of the Gramm-Leach-Bliley Act defines “swap agreements” as “any individually negotiated contract, agreement, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets, but does not include any other *identified banking product*” (emphasis added). With certain exceptions, Title VII of Dodd-Frank Title VII precludes the CFTC and SEC from regulating “identified banking products” as “swaps” or “security-based swaps,” respectively.

¹³ See 12 U.S.C. § 5323.

chain developers and providers of blockchain services.¹⁴ In particular, it clarifies that no such person or entity shall be treated as a money transmitter under State laws, a financial institution as defined in 31 U.S.C. 5312,¹⁵ which would include registration as a bank, or be subject to any other State or Federal licensing or registration requirement.

The rationale is to exempt service providers that do not hold funds on behalf of customers from the regulations applicable to traditional financial service providers who do hold customer funds. At least with respect to these service providers, the BRCA provides certainty that DeFi innovation can continue apace without having to contemplate the current financial regulatory framework. The BRCA does not, however, address head on the PWG Report's recommendation that custodial wallet providers should be subject to appropriate federal oversight, though perhaps the BRCA leaves open the possibility of such oversight as the BRCA does not apply where the blockchain developer or provider of a blockchain service in the ordinary course of its business has "control over digital currency to which a user is entitled. . . ."

In providing certainty to a particular set of market participants, the BRCA also reveals the multifaceted nature of DeFi and stablecoins and the difficulty of addressing all parts of the digital asset ecosystem in a single bill, as these blockchain developers will almost certainly have to interact with other entities that do perform a custody or money transmitter service. Figuring out how to manage the interaction between regulated and unregulated portions of the system will be key.

In addition, the U.S. House Committee on Financial Services convened a hearing titled "Digital Assets and the Future of Finance: Understanding the Challenges and Benefits of Financial Innovation in the United States."¹⁶ Six financial technology chief executive officers¹⁷ gave testimony, offering alternative visions of the future. The predictable tension, however, centered on whether financial technology (including DeFi and Stablecoins) will be subject to (1) existing financial regulation; (2) an exemption therefrom; or (3) a new

¹⁴ The text of the BRCA is available at https://emmer.house.gov/_cache/files/2/0/20ef89fd-0ee7-49a6-b6b1-85917a6ce7f4/7DCDCE2ADC19C664E67493A2CD38ACDC.brca.pdf.

¹⁵ <https://www.law.cornell.edu/uscode/text/31/5312>.

¹⁶ <https://financialservices.house.gov/events/eventsingle.aspx?EventID=408705&>.

¹⁷ The six CEOs are: Jeremy Allaire (CEO and Chair, Circle); Samuel Bankman-Fried (CEO and Co-Founder, FTX); Brian P. Brooks (CEO, Bitfury Group); Charles Cascarilla (CEO and Co-Founder, Paxos Trust Company); Denelle Dixon (CEO and Executive Director, Stellar Development Foundation); and Alesia Jeanna Haas (CEO and CFO, Coinbase Global, Inc.).

regime of digital asset regulation, whether under a single regulator or a patchwork of regulations.

CONCLUSION

Many in the industry point to a lack of certainty as a threat to the potential of crypto. Certain regulators assert that existing regulation provides sufficient authority. What is clear is that 2022 is certain to be a watershed year for crypto regulation.