June 17, 2022

Lummis-Gillibrand Digital Asset Bill – Key Takeaways

On June 7, 2022, Senators Cynthia Lummis (R-WY) and Kirsten Gillibrand (D-NY) introduced a bill, the Lummis-Gillibrand Responsible Financial Innovation Act (the "Bill"), proposing a comprehensive framework for the regulation of digital assets in the United States and addressing long-standing topics of concern for those operating in the digital asset space, including asset managers. While the likelihood of the Bill progressing to enactment seems remote given the controversial nature of many digital assets and the fact that it is an election year, it represents a welcome first step in the development of bipartisan digital asset legislation.

SEC and CFTC Jurisdiction over Digital Assets

The Bill proposes to overhaul the division of authority between the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") with respect to digital assets. Currently, the SEC has regulatory authority with respect to digital assets that are securities, and the CFTC has anti-fraud and anti-manipulation authority over digital assets classified as commodities. The Bill largely preserves the SEC's jurisdiction while expanding the scope of the CFTC's authority.

The Bill grants the CFTC exclusive jurisdiction over digital assets, subject to certain exclusions. "Digital assets" are defined as natively electronic assets conferring economic, proprietary, or access rights or powers and recorded using cryptographically secured distributed ledger technology or similar means. Excluded from the CFTC's jurisdiction are digital assets that provide the holder with any of the following rights with respect to a business entity: (1) a debt or equity interest, (2) liquidation rights, (3) an entitlement to an interest or dividend payment, (4) a profit or revenue share derived solely from the entrepreneurial or managerial efforts of others, or (5) any other financial interest. Such assets are subject to the SEC's jurisdiction.

In addition, the CFTC does not have jurisdiction over non-fungible digital assets (e.g., NFTs). Most stablecoins issued by banks and other depository institutions are also excluded from the CFTC's jurisdiction. Furthermore, the CFTC does not have regulatory authority over off-exchange digital asset transactions in which no CFTC registrant is involved, other than limited authority over certain leveraged or margined retail digital asset transactions. Finally, the Bill does not grant the CFTC jurisdiction over digital asset custodial activities of entities regulated by a state or by another federal regulator.

Additionally, the Bill divides authority between the SEC and the CFTC with respect to "ancillary assets," which are generally defined as intangible, fungible assets offered, sold or provided in connection with the purchase and sale of securities through an arrangement constituting an investment contract. Ancillary assets may include digital assets that "are not fully decentralized**,** and which benefit from entrepreneurial and managerial efforts that determine the value of the assets," but do not confer any of the five enumerated rights identified above. The CFTC generally has jurisdiction over ancillary assets that fall within the definition of digital asset. However, disclosure requirements that the Bill imposes on issuers of such ancillary assets will remain subject to the SEC's jurisdiction.

The Bill does not eliminate uncertainty with respect to the boundaries of the SEC and CFTC's respective jurisdiction over digital assets, leaving phrases such as "entrepreneurial and managerial efforts" undefined and open to interpretation. However, the Bill does contemplate that a digital asset self-regulatory organization ("SRO") could make initial determinations, subject to SEC and CFTC oversight, as to the legal classification of particular digital assets. In making such a determination, a digital asset SRO would likely consider whether the digital asset constitutes a security subject to SEC jurisdiction, or a commodity and/or ancillary asset.

To the extent that the CFTC has jurisdiction with respect to a particular digital asset, that digital asset is included within the definition of "commodity," clarifying the regulatory classification of related derivatives and the obligations associated with their use.

In recognition of the additional operational burdens associated with expanding the CFTC's jurisdiction, the Bill permits the CFTC to collect up to $30 million in fees from certain CFTC registrants that engage in spot digital asset activities, such as digital asset exchanges (a proposed new category of registrant), to offset the associated regulatory costs. Fees will not be imposed on asset managers.

Overview of Legislative Scope: Additional Topics Related to Tax, Stablecoins, Custody and Financial Innovation

Additional topics related to digital assets that the Bill addresses include tax, bankruptcy and consumer protection issues, the regulation of digital asset brokers and exchanges, the issuance of stablecoins and the development of a uniform set of state money transmitter laws.

Tax Considerations

From a tax perspective, the Bill includes a *de minimis* exception that excludes from income capital gains from the disposition of "virtual currency," a subset of digital assets, in personal transactions that do not exceed $200, which parallels the existing $200 exclusion for dispositions of foreign currency in personal transactions. This exception only applies to capital gains incurred from transactions involving the purchase of goods or services. It does not include capital gains from dispositions in which virtual currency is sold for cash, cash equivalents, digital assets, or other securities or commodities.

The Bill also calls for final guidance on the taxation of forks and airdrops, as well as how to report such transactions. Such guidance would treat forks and airdrops as non-taxable until affirmatively claimed and disposed of. Additionally, the Bill clarifies the treatment of mining and staking as production of property, such that digital assets obtained from such activities are not taxed until disposed of. The Bill further establishes that digital asset lending agreements are generally not taxable events, which parallels the existing treatment of securities lending transactions.

The Bill expands the trading safe harbor for non-U.S. persons to include generally their trading in digital assets, provided that the digital assets are of a kind customarily dealt in on a digital asset exchange and the transaction is of a kind customarily consummated on such an exchange. The Bill also broadens the definition of "broker" under the Internal Revenue Code to include "any person who (for consideration) stands ready in the ordinary course of a trade or business to effect sales at the direction of their customers." Additionally, it imposes reporting obligations on brokers relating to transfers of digital assets made to those who they have reason to know are non-brokers. The form of the reporting will be determined at a later date and compliance will not be required until 2026.

Stablecoins

The Bill defines "payment stablecoins" as digital assets that are (1) redeemable, on demand, on a one-to-one basis for instruments denominated in U.S. dollars, (2) issued by a business entity, (3) accompanied by a statement from the issuer that the asset is redeemable for the legal tender it is tied to, and (4) intended to be used as a medium of exchange. Additionally, the Bill permits only 100% asset-backed tokens and specifies that the assets backing such tokens must be "high-quality liquid assets." In light of recent events, it is unsurprising that the Bill does not leave room for algorithmic stablecoins. Furthermore, the Bill indicates that entities that do not fall within the definition of "depository institution" under the Federal Reserve Act but are still operating under a state or federal charter or license are permitted to issue and redeem payment stablecoins, so long as they comply with certain requirements.

Custody

The Bill proposes to resolve a long-standing question related to the custody requirements associated with maintaining a "satisfactory control location" and clarifies that this obligation could be met by implementing commercially reasonable cybersecurity practices for a private key. In addition, the Bill requires the SEC to complete modernization of certain custody rules to address digital assets and other matters within 18 months of the Bill's enactment. The Bill also requires the SEC to adopt rules within 270 days permitting a broker or a dealer to perform, within the same legal entity, both trading and custodial activities relating to fully paid and excess margin digital assets, including virtual currency and digital assets that are securities or may represent ownership of securities, in addition to traditional securities, client funds, and other assets.

Facilitation of Future Innovation

Several provisions of the Bill are designed to facilitate further financial innovation and the development of effective regulation, including in contexts other than digital assets. For example, the Bill describes conditions that, if met, would allow the cross-state operation of financial companies offering innovative products or services that emerge from state sandbox programs. The Bill also establishes the "Advisory Committee on Financial Innovation," with members including regulators, industry representatives and policy experts, to study topics such as digital assets and the structure of securities and commodities markets and to make recommendations regarding legislative and regulatory oversight. Similarly, the Bill establishes the "Innovation Laboratory" within the Financial Crimes Enforcement Network to study changes in financial technologies such as digital assets, distributed ledger technology and decentralized finance, and to make recommendations regarding more effective supervision. Notably, the Bill commissions a report on decentralized finance, potentially laying the groundwork for further legislation.

Future of the Bill

Should the Senate pass the Bill, it will almost certainly not be in its current form as it must go through multiple committee markups before a full vote. In addition, it is unlikely that Congress will be willing to consider landmark legislation such as this ahead of the November election.

Please contact the Ropes & Gray attorney who usually advises you for further information or with any questions you may have.