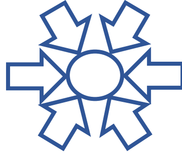

Financial Services Management

U.S. Digital-Asset Framework

Cite

S. 4356, Lummis-Gillibrand Responsible Financial Innovation Act

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Websites:

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Impact Assessment

- While most unlikely to pass, let alone be signed into law, this bill establishes parameters for statutory change, especially if Republicans gain Congressional control. However, recent market events may lead some current supporters to reconsider provisions that strongly favor digital-asset providers at the expense of regulated financial companies.
- The bill would sharply circumscribe the ability of the SEC and CFPB to govern digital-asset transactions which the Commission now believes constitute securities or the CFPB may believe pose consumer risk.
- Consumer/investor protection largely depends on disclosures and agreements between a digital-asset provider and its customers, with this approach to complex issues such as rehypothecation and finality likely to create risks for retail customers and possible providers and even the financial system. Regulatory authority over disclosures/agreement is at best uncertain.
- Federal deposit insurance, custody practices, federal preemption, social-impact finance, interpretive rulings, and the payment system would be revised not only in favor of digital assets, which could also become failure-proof, but also in far broader ways with sweeping competitive and structural implications.

Overview

After protracted negotiations and much public attention, bipartisan senators have introduced a far-reaching bill designed to encourage digital-asset use without undue risk to consumers, investors, or the financial system. The bill decides most, if not all, of the outstanding regulatory barriers to digital-asset use in favor of digital assets and their providers. Provisions in many cases go farther than public discussion has so far noted – for example, the measure not only expands the ability of digital-asset providers to reach retail and wholesale customers, but also gives them access to FDIC resolution without the cost of paying insurance premiums or coming under many of the rules that govern insured depositories. Digital-asset providers could also make loans without the

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disclosures designed to be transparent to less well-informed consumers or the other consumer-protection standards administered by the CFPB.

The payment system would not only be open to digital-asset providers on terms more favorable than those allowed insured depositories but would require the Fed to open the payment system to all eligible financial companies and set a floor on pricing. These provisions combined with the transfer of regulatory jurisdiction to the CFTC, reduced CFPB authority, and limited banking-agency reach are likely to be still more controversial in light of the growing number of runs and sharp asset price reductions across the digital-asset sector shortly after this measure was introduced. Still, digital assets are likely to prove a feature of future finance, making the bill's approach an important element in ongoing U.S. statutory change.

Impact

This is a massive bill addressing an array of digital-asset considerations that are unlikely to be enacted in any form in the near future. However, it is responsive to many goals of the key players in the digital-asset arena and those who believe a hands-off approach to cryptocurrency and other assets is preferable to the far more cautious approach laid out in President Biden's executive order[1] and, for stable coins, the President's Working Group (PWG) report.[2] Although a bipartisan measure, it also includes provisions strongly opposed by progressive Democrats that would, for example, follow the approach supported by Senate Banking Ranking Member Toomey (R-PA) giving the CFTC expanded authority over digital assets, in part by taking it away from the Securities and Exchange Commission.[3]

The bill also includes many provisions opposed by the banking industry and, in some cases, likely also by federal regulators; for example, the measure would force the Fed not only to give payment-stablecoin issuers access to the payment system, but also to provide equal access for "all" payment, settlement, and clearing services, likely opening the payment system to additional nontraditional and even unregulated charters. This differs markedly from the Fed's proposed approach,[4] which allows nonbanks access only under certain conditions. Opponents to these restraints believe the Fed has unduly limited payment-system access to constrain innovation.[5] Many banks argue that payment-system access should be allowed only for fully regulated banks.

The FDIC is unlikely to support authority to rescue digital-asset companies and uninsured depositories without the authority to charge them premiums and otherwise resolve firms at the least cost to the taxpayer. In a resolution, parties with payment-stablecoin claims would have priority over any other claimant – including the FDIC – in a receivership, a move that increases stablecoin security but likely would also contribute to moral hazard given that the bill imposes no ceiling on such a claim akin to the limit on FDIC insurance.

1 See *Client Report* **CRYPTO26**, March 9, 2022.
2 See *Client Report* **CRYPTO16**, December 28, 2020.
3 See **CRYPTO27**, *Financial Services Management*, May 20, 2022.
4 See **PAYMENT24**, *Financial Services Management*, March 9, 2022.
5 See *Client Report* **IOER5**, August 25, 2020.

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The banking agencies have yet even to propose the crypto policy they have long promised but Acting Comptroller Hsu is doubtless joined by the Fed and FDIC in its view that the tough approach proposed by global regulators for bank exposures in this sector should be implemented once certain international differences are resolved (expected shortly).[6] The bill's approach to payment stablecoins gives bank regulators only limited authority to govern activities in this sector even in insured depositories; although prudential standards might apply, the agencies would need to rely on a binding CFO attestation as to reserve-asset adequacy. These assets are more generously defined than in the Toomey draft.

Adopting its "responsible" approach also for consumer protection, the bill eschews direct regulation from the CFPB or other agencies in favor of new disclosure requirements governed largely by those making them. As discussed below, these cover a range of issues across all digital assets, going beyond the limited approach in the Toomey proposal for payment stablecoins. For example, disclosures and broader standards governing rehypothecation create the presumption that a provider has put reserves backing its obligations to use, uses that fall under few restrictions and thus might impair liquidity and redemption rights under stress. Loans associated with digital assets would give providers significant discretion as to lending terms and conditions outside the standardized requirements applicable to other consumer loans enforced by the CFPB.

As detailed below, the bill is in numerous respects contradictory by virtue of specific changes in law or rule mandated with specific regard to digital assets and then also with sweeping structural rewrites of some of these sections (e.g., re custody services, the role of the FDIC, federal preemption). It also contains numerous provisions seemingly unrelated to digital assets such as a prohibition of national banks facilitating third-party lending and on bank regulators providing any formal or informal guidance to banks against doing business with specific customers or groups of customers. This revisits longstanding "Operation Chokepoint" controversies as well as Republican fears that regulators could simply bar banks from servicing the fossil-fuel, firearms, or certain other sectors. The bill also gives any provider of an "innovative" program in one state's "sandbox" the authority to offer the product in other states as long as the product is legal, allowing the OCC to authorize preemption of state law in these and perhaps other cases as long as doing so does not transgress state usury ceilings.

What's Next

This bill was introduced on June 7 by Sens. Lummis (R-WY) and Gillibrand (D-NY) with no cosponsors and has been referred to the Finance Committee. It is likely that, were the bill to advance, other committees – most notably Banking – would claim jurisdiction and slow progress.

There is no companion bill in the House, nor would Chairwoman Waters (D-CA) agree with much in this measure. However, Ranking Member McHenry (R-NC), who has indicated he will assume the HFSC chair if Republicans take over the House, has

[6] See **CRYPTO19**, *Financial Services Management*, June 15, 2021.

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issued principles for digital assets similar in many respects to key provisions in this measure. However, it is likely that Republicans will modulate current proposals, including those in this bill, in light of recent turmoil in the digital-asset sector.

Analysis

I. Framework

A. Definitions

Key definitions include:

- "digital asset," which is defined as an inherently electronic asset that confers economic, proprietary, or access rights or powers that is recorded via DLT or a similar analog, with the bill going on expressly to include instruments such as virtual currency and other assets under different sections of the legislation governing stablecoins and securities/commodity-like digital assets;
- "digital-asset intermediary", which would mean those who hold authorization under an array of current laws and other sections in this bill who conducts digital-asset market activities, including those related to payment stablecoins, that is not a depository institution;
- a "payment stablecoin", as defined in the Toomey legislation for digital assets, is a medium of exchange which may be redeemed via legal tender that is backed by financial assets accompanied by a statement by the issuer to this effect; and
- "digital asset person," who conducts covered activities under a federal or state charter, license, or similar authorization. This term thus appears to cover banks and their parent companies if these are also granted a federal or state charter as well as state-regulated insurance companies. It is unclear how the definition applies to broker-dealers and futures commission merchants which are federally regulated by virtue of their activities but not granted express charters unless these entities have digital-asset licenses or similar authorizations under other provisions of federal and state law. To the extent some firms are exempted from this definition or simply choose to engage in certain digital-asset activities outside the reach of federal and state law, possible loopholes to the bill's requirements might ensue unless or until statutory requirements and/or enforcement actions address these situations.

B. Taxation

This title of the bill clarifies current tax law to encompass digital assets in safe harbors and other privileges applied to certain financial activities, brings certain autonomous digital entities under the Tax Code, exempts digital-lending activities as is currently the case for securities lending, exempts certain crypto mining activities, and presses the IRS to clarify its rules to address digital assets.

C. Bankruptcy

The bill would establish treatment for digital assets under the Bankruptcy Code akin to that governing commodities.

D. Examination Standards

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The FFIEC would need to quickly issue guidance on how member agencies will examine digital-asset activities.

E. Studies

In addition to the provisions below, the bill addresses numerous outstanding controversies by mandated studies. These include:

- a GAO study of the extent to which retirement assets may include digital assets;
- an OMB study in concert with other agencies of the security measures needed for use of the digital Yuan on government devices;
- a Fed study of how DLT could reduce banking system risk taking into account Congressional findings detailed in the bill about how DLT is likely to reduce payment-system risks;
- ongoing Federal Energy Regulatory Agency, CFTC, and SEC analysis of crypto-mining energy use; and
- a rapid SEC and CFTC study of the benefits of self-regulation for digital assets.

II. Securities and Commodities Activities

This section allows digital-asset companies to determine if their activities constitute commodities or securities and states that "ancillary assets" provided in investment contracts are not securities, taking this away from the SEC following Chairman Gensler's assertions about defining activities via court precedent and enforcement action.[7] Companies offering covered ancillary assets that are not fully decentralized would need to file semi-annual disclosures with the SEC and assets covered by these disclosures are deemed commodities. The bill also expands CFTC rulemaking and supervisory powers over these digital-asset commodities and creates a way for digital-asset exchanges to come under the CFTC as well as the Bank Secrecy Act, with all CFTC-regulated digital-asset activities coming under a new framework for investor protection and federal preemption.

The bill also eases custody requirements from those now demanded by the SEC, with the SEC required within eighteen months to overhaul the full body of custody and consumer-protection requirements to modernize them and recognize digital assets. Unless otherwise required by law, no person would be required to use an intermediary to ensure digital-asset safekeeping. In addition, the bill includes an overarching provision declaring that current custody requirements are anachronistic, laying out an entirely new framework for this activity under new law.

The bill expressly states that any payment stablecoin issued by a depository institution is neither a security nor a commodity. It would appear that other digital assets might not enjoy this protection, giving either the CFTC or SEC authority over products banks and bank regulators might view as solely banking.

[7] See *Client Report* **INVESTOR19**, October 5, 2021.

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III. Consumer Protection

The bill does not give the CFPB or any other federal regulator express authority over digital-asset transactions; indeed, by not doing so, it would likely preclude CFPB jurisdiction in matters involving retail customers and cloud the ability of the SEC and CFTC to protect both retail and wholesale investors. However, the disclosure and notice requirements described below fall under the enforcement authority of federal or state chartering authorities and, for depository institutions, the banking agencies or NCUA.

A. Disclosures

The measure would require digital-asset providers to ensure that they offer clear disclosures in their customer agreements of matters such as product and systems updates, whether or not a customer digital assets are segregated, relevant bankruptcy or insolvency treatment, redemption rights, fees, source code, the extent to which securities or commodities law applies, dispute-resolution process, and the extent to which the provider's subsidiaries may benefit from the arrangement and a customer's ability to withdraw from such arrangements.

Additional disclosures are required when subsidiary arrangements permit lending or investment services. Disclosures related to lending fall under the bill's provisions, not those of the Truth-in-Lending Act, meaning that disclosures may be both less extensive related to key terms and broader with regard to matters such as collateral haircuts, rehypothecation, and rights. Consumer consent to rehypothecation would be required and the provider is to undertake numerous risk-management steps for this activity.

B. Finality

Digital-asset providers and customers would agree on the extent to which transaction finality is assured, with the bill specifying that finality could be different for legal than operational purposes based on the distributed and probabilistic nature of the asset and other factors, including the applicability of the UCC.

IV. Payment Stablecoins

A. Framework

As noted, this section of S. 4356 differs from the Toomey draft by detailing how chartered depository institutions engage in payment stablecoins, although these need not necessarily be insured depository institutions. The bill does allow nonbank issuers that are not depositories also to engage in payment-stablecoin activities pursuant to whatever rules a federal or state regulator may deem appropriate and, in some cases, under special rules expressly designed for these issuers – provisions appear to overlap and conflict.

Any depository institution that is principally engaged in payment stablecoins could not be deemed a bank then subject to holding-company regulation; instead, parent companies or controlling persons would need to file certain information with relevant primary regulators, who could also mandate a tax-allocation agreement. Regulators under certain circumstances could also examine these parent entities or even require divestiture. Federal and state bank regulators would need to adopt rules to implement these provisions and to apply additional prudential requirements as desired. These rules

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are optional but could cover usual capital and liquidity issues as well as risks related to third-party providers now being addressed in an inter-agency proposal.[8]

The OCC could also authorize special-purpose charters for digital-asset activities akin to those proposed during the Trump Administration.[9] The bill also includes a provision that would appear to ban all national banks from facilitating third-party lending even though this is a sweeping restriction that IOER has implications well beyond stablecoins.

Reserve assets are broadly defined (e.g., deposits held at the depository), with a binding CFO attestation required to certify which reserve assets are held in what amounts. The banking agencies, SEC, and CFTC are to monitor collateral assets backing payment stablecoins, but it is not clear what they could were they to fear disruptions.

Applications to establish charters in this sector would need to be approved by federal or state regulators within four months and would need to be approved absent evidence of any of the risks detailed in the measure. Resolution-and-recovery planning would be required, but persons with a valid claim on digital assets in the provider's possession would have a superior claim in a receivership on those assets above those of any other party, including the FDIC.

Regulators would also be required to provide favorable capital treatment to institutions principally holding only payment-stablecoin assets.

B. Payment-System Access

Payment stablecoins would need to be redeemed at par in legal tender upon customer request, with depository institutions chartered in this arena also authorized to redeem payment stablecoins by other issuers. The Fed would need to handle clearing and settlement of all such stablecoins and provide equal access to the payment system for "all payment, clearing, and settlement services."

The bill goes farther than this admonition included in the stablecoin section by amending current law to set a maximum price for Fed payment services, transferring routing services from the ABA to the Fed, providing any institution with a segregated payment account upon request, and allowing the Fed to set reserve requirements for payment services beyond the manner now set for insured depositories.

A broader payment system discussion elsewhere in the bill describing the Fed's governance of the payment system as a "ministerial" duty binding it to giving all depository institutions payment system access. The measure bases its discussion in part on noting that Fed independence is premised on faithful adherence to all laws, not judgments that undermine competitive equality and fairness.

8 See **VENDOR9**, *Financial Services Management*, July 21, 2021.

9 See **CRYPTO15**, *Financial Services Management*, September 28, 2020.

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The bill also includes a new, fast decision-making process at the Fed that would, among other things, quickly grant payment-system access to companies chartered by federal or state regulators that have yet to receive payment-access authorization.

V. Additional Provisions

A. AML Enforcement and Sanctions

FinCEN is directed to establish a new process encouraging innovation that would appear to apply to all digital assets, not just stablecoins. OFAC would need to issue guidance laying out how payment stablecoins are to comply with sanctions.

The bill also includes provisions that appear to protect banks from accusations of holding improper customer accounts if the bank has made good faith efforts to avoid doing business with entities known or designated as national-security threats.

B. Applications

All of the banking agencies would have to rule within one year on all applications before them in completed form, reporting to Congress on applications that have not been approved within one year.

C. Reputation Risk

Banking agencies could not formally or informally order a banking institution to terminate a specific or group of customer accounts unless the agency has a "valid reason" unrelated to reputation risk to do so. Unless an account is terminated for national-security or similar reasons, the bank must notify the customer of its decision to do so and the reason for doing so.

D. FDIC Resolution

The bill would allow the FDIC to resolve a depository institution that is not an insured depository even though the institution had paid no premiums to the Deposit Insurance Fund, using the firm's "capital" to pay off its obligations. It describes this by saying that the FDIC "may" be appointed receiver for such a company without stipulating who has the authority to appoint it.

A firm's capital is likely to be insufficient for a cost-free receivership and the bill does not make it clear if the FDIC would use other funds – e.g., the Deposit Insurance Fund – to handle any shortfalls. The measure does not appear to allow the FDIC to resolve such a company via a bridge corporation that might reduce the cost of doing so, although it does say that the Corporation may issue rules ahead of a resolution, saying that rules here are to be comparable to those for an insured depository as long as these rules also account for the limited activities that are presumed to pose less risk in such depository institutions. As noted, these depository institutions are under other provisions in the bill required to have resolution plans in concert with their charter applications, but the bill also subjects them to the requirements for resolution planning applicable to large banking organizations.

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E. Guidance

Financial regulators – here defined to include not only the banking agencies, CFTC, and SEC, but also Treasury, FHFA, and the CFPB – would need to respond within 180 days of receiving a request for "individualized" written guidance regarding the application of law, rule, or policy unless the agency determines that a request lacks "substance." Self-regulatory organizations would be subject to the same requirement and none of these rulings would need to be made public. As a result, firms might gain significant market advantage well before others know of an agency's position.

F. Interstate Activities

Firms engaging in an activity authorized by a state under its "innovative sandbox" program could engage in that activity for a limited period of time under an application process by both federal and state regulators germane to the activity, with federal and state regulators able to condition the new activity outside the primary state. Other conditions also apply to exported activities. This provision does not appear to preempt state law otherwise applicable to an activity in a host state unless this is authorized by a federal regulator (which could not do so with regard to permissible interest rates).

G. State Law

States would need to craft their money-transmitter rules into a uniform framework for digital assets within two years of enactment. The CFPB would enact federal preemptive rules adopting these uniform state standards for hold-out states.

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