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INSIGHT

How the Lummis-Gillibrand Responsible Financial Innovation Act (S. 4356) Would Alter the Crypto Regulatory Landscape

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In June 2022, Senators Cynthia Lummis and Kirsten Gillibrand introduced S. 4356, the Lummis-Gillibrand Responsible Financial Innovation Act (RFIA). The Insight provides an overview of the bill, including its implications for digital assets under securities and commodities laws; oversight of digital-asset exchanges; and regulation of stablecoin issuers. Recent tumult in crypto markets underscores the relevance of the associated policy discussion.

Securities Regulation

The RFIA would seek to clarify the respective jurisdictions of the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) over digital assets. Currently, the SEC exercises jurisdiction over digital assets that qualify as securities. The CFTC exercises anti-fraud and anti-manipulation authority over digital assets that qualify as commodities and more expansive jurisdiction over digital assets that qualify as derivatives.

The RFIA would create a new category of digital assets—"ancillary assets"—that would presumptively qualify as commodities rather than securities under certain conditions. Ancillary assets would include digital assets that are sold pursuant to investment contracts but do not provide their holders with financial interests in a business entity (e.g., a right to dividends or interest payments). If trading in an ancillary asset exceeds a specified threshold and the asset's issuer engages in efforts that "primarily determine" the asset's value, the issuer would be required to make tailored semiannual disclosures regarding its business operations and the ancillary asset itself. While the SEC would administer the disclosure requirements, compliance with them would trigger a presumption that an ancillary asset is a commodity rather than a security. The presumption could thus relieve market participants from other rules governing securities issuers, exchanges, and advisers.

The RFIA would narrow the SEC's jurisdiction over digital assets as the agency currently conceives it. SEC guidance identifies several factors it uses to determine whether a digital asset is a security. While the guidance identifies an entitlement to financial rights in a business entity as an indication that a digital

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asset is a security, it also flags the prospect of capital appreciation derived from the efforts of others as a separate determining factor. The RFIA would thus circumscribe the SEC's asserted jurisdiction insofar as it would allow certain issuers whose managerial efforts "primarily determine" a digital asset's value to avoid the full panoply of securities law requirements.

Commodities Regulation

The CFTC has determined that certain digital assets—including Bitcoin, Ether, Litecoin, and Tether—are commodities under the Commodity Exchange Act. CFTC-registered entities currently allow trading futures and options for Bitcoin and Ether. To date, the CFTC has policed digital-asset markets through enforcement actions, formal guidance, and its oversight of digital-asset derivatives.

The RFIA would grant the CFTC regulatory and enforcement authority over spot markets for fungible digital assets, subject to certain exceptions. The bill would exclude from the CFTC's jurisdiction digital assets that entail financial rights in a business entity. Moreover, off-exchange digital-asset transactions that do not involve CFTC registrants would be exempt from the CFTC's regulatory authority.

The bill would also allow digital-asset exchanges to opt into a federal regulatory framework by registering with the CFTC. Registered exchanges would be subject to requirements regarding their treatment of customer assets, trade reporting and recordkeeping, and conflicts of interest.

CFTC registration would not relieve digital-asset exchanges of their existing duty to register as money services businesses with the Financial Crimes Enforcement Network. Likewise, CFTC-registered spot exchanges would not be permitted to offer derivatives contracts unless they are separately registered with the CFTC as designated contract markets or swap execution facilities.

Implications for Depository Institutions

The RFIA would allow depository institutions to issue payment stablecoins and lays out a framework for them to do so. Any depository that issues stablecoins would be required to maintain high-quality liquid assets valued at 100% of the face value of all outstanding payment stablecoins.

Depositories would be required to provide public disclosures on the assets backing their stablecoins and to redeem them at par in legal tender. The bill would require the federal banking agencies to coordinate with state bank supervisors and adopt rules to implement capital and liquidity standards for stablecoin issuers, as well as rules for third-party service providers, operational risk, and recovery/resolution planning. It would also require depositories to report stablecoin activity on their Call Reports.

The bill would authorize the Office of the Comptroller of the Currency to charter and regulation national banks with the sole purpose of issuing stablecoins. It would also establish tailored holding company supervision for those national banks.

Another provision would ensure that Federal Reserve payment and settlement services are offered to any federal or state-chartered depository institutions, regardless of whether they issue stablecoins, and would require the Federal Reserve to make segregated balance accounts available upon request. The bill also proposes codifying asset-custody standards for depository institutions.

Selected Considerations

The degree to which the proposed legislation would shift the current framework depends in part on how certain provisions are interpreted. One set of ambiguities involves the bill's proposed regime for ancillary

assets. For example, while the bill would adopt a presumption that certain ancillary assets are not securities, it does not identify the legal standards under which that presumption could be overcome.

Another wrinkle involves the requirement that an ancillary asset be issued pursuant to an investment contract—which is itself a type of security—to qualify for the relevant presumption. Although the text appears clear on this point, some commentators have questioned whether the bill's drafters intended to link the presumption to this requirement.

The tailored disclosure regime for ancillary assets applies only if an issuer or major shareholder of an issuer engages in "entrepreneurial or managerial efforts that primarily determine" an asset's value. The precise meaning of that language would likely require further interpretation.

It is also unclear how markets and users will interact with exchanges that do not register with the CFTC. It also remains to be seen whether joining spot and derivatives market exchanges under the CFTC's jurisdiction will allow the creation of futures markets for a broader swath of digital assets than those currently permitted.

Author Information

Andrew P. Scott
Analyst in Financial Economics

Jay B. Sykes
Legislative Attorney

Eva Su
Analyst in Financial Economics

Paul Tierno
Analyst in Financial Economics

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