By Whom Should Digital Assets Be Regulated? The Solomonic Solution[1]

Are tomatoes a fruit or a vegetable?[2]

Imagine that you may not use tomatoes in cooking, or eat them raw, until the U.S. Department of Fruits and the U.S. Commission of Vegetables reach agreement as to which of them has jurisdiction. Only after an "agreement" is reached (which the regulators cannot do themselves; it must be established by Congress) could the regulators issue requirements as to permissible menus.

That is our current situation as to digital assets, but worse. As to digital assets, we must determine not only whether they are fruits or vegetables (securities or commodities), we must worry whether they are money (stablecoins) or unique objects, potentially of art (NFTs).

But answering the question of fruit or vegetable doesn't tell you whether to put tomatoes in a salad or simmer them for sauce. The question that we should try to answer is not how to categorize digital assets; it is how to regulate them. To stay with the analogy of tomatoes, we should first decide how they are to be cooked (regulated) before deciding what utensils to use for cooking (regulatory agencies).

The memorandum has the following structure:

i. How do we define "digital assets"?
ii. Look at FTX; aren't digital assets just a scam? Were the regulators right all along?
iii. Why the regulation of digital assets is an important policy issue
iv. The SEC's failures in digital asset regulation and smaller failures by the CFTC and the U.S. bank regulators
v. What should digital asset regulation look like?[3]
vi. Which U.S. financial regulator should have authority: The Solomonic Approach
vii. Conclusion

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[1] Some hyperlinks in this memorandum direct to our legal research service **Fried Frank Regulatory Intelligence** ("**FFRI**") and may be password-protected. Free access to FFRI can be obtained by requesting a password through **www.FindKnowDo.com/premium** or by emailing Cheryl Kuntz at **FFRI@friedfrank.com**.

[2] Despite their botanical classification as fruits, tomatoes were held by the U.S. Supreme Court to be vegetables for purposes of U.S. customs regulation. *See* **Nix v. Hedden**, 149 U.S. 304 (1893).

[3] In this memorandum, we refer exclusively to regulation. We recognize that the regulatory structure suggested by this memorandum would require implementing legislation, particularly as to the allocation of regulatory jurisdiction.

I. Defining "Digital Asset"

A potential definition of "digital asset" is any asset that is represented on the blockchain. For regulatory purposes, that definition is overbroad. Plain-vanilla securities, stocks and bonds may be represented on the blockchain. That does not, and should not, for regulatory purposes, make them digital assets. Stocks and bonds represented on the blockchain are ordinary securities and should be regulated as any other stocks or bonds.

To define the term "digital asset," we borrow some concepts from the legislation proposed by U.S. Senators Cynthia Lummis and Kirsten Gillibrand, formally titled the Lummis-Gillibrand Responsible Financial Innovation Act.[4] The RFIA attempts to distinguish between digital assets that may be categorized as securities regulated by the SEC and those that would be categorized by RFIA as commodities regulated by the CFTC. But for purposes of this memorandum, let us suppose that digital assets are a new category of instrument, one that might be regulated by the SEC or one that might be regulated by the CFTC, but not as an asset that must be shoehorned into an existing regulatory category.

For purposes of this memorandum, we will define a digital asset as below:

> Unless the context otherwise requires,[5] a **"digital asset"** is an asset represented on the blockchain that does not represent a debt or equity interest in a business entity, liquidation rights as to the entity, any entitlement to interest or dividend payments from the entity or a profit share in the entity.[6] The term digital asset does not include an ownership interest in securities, currencies or other assets, or in any vehicle that holds such assets. The term digital asset does not include tokens awarded in a "rewards program" where the value of the digital asset is less than 10%[7] of the value of the purchased "primary asset" and the amount of the digital assets awarded is either generally proportionate to the expense of the primary asset or is proportionate to the number of purchases made of the primary asset. The term digital asset does not include a single token representing a unique product, although the fractionalized portions of that token may be a digital asset.

We have defined a digital asset largely by its differences from an ordinary security. Again, that is not to say that the SEC should, or should not, have jurisdiction. Our purpose is to define the asset class, not to categorize it. Treating jurisdiction as the first question means that we are discussing power, who controls the asset and the market participants; rather, we should discuss

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[4] **S. 4356**, 117th Congress (2022) (the "**RFIA**"). For further discussion and analysis of the RFIA, *see* S. Lofchie, J. Schwartz, and C. Almquist, **The Digital Assets Bill: Lummis-Gillibrand Responsible Financial Innovation Act**, FRIED FRANK: CLIENTS AND FRIENDS MEMORANDUM (June 10, 2022). The other significant Congressional attempt to establish a regulatory scheme, and an allocation of jurisdiction, for digital assets is the **Digital Commodities Consumer Protection Act of 2022**, S. 4760, 117th Congress (2022) (the "**DCCPA**"). For further discussion and analysis of the DCCPA, *see* S. Lofchie and S. Souchet, ***The Digital Commodities Consumer Protection Act***, FFRI COMMENTARY (Dec. 15, 2022).

[5] The variety, complexity and novelty of digital assets means that a statutory definition will need to leave room for regulatory interpretation.

[6] *See* Section 401(a)(1)(B) of the RFIA. The language that I have borrowed is not an exact copy of the exclusion in the RFIA, but it is close enough to constitute (legal) theft.

[7] We are not bound to any particular percentage.

purpose, to what ends should power be exercised. In this regard, we point out that the European regulators, who do not have the jurisdictional split that exists in the United States between the SEC and the CFTC, treat digital assets as distinguishable from other financial assets, such as securities.[8]

II. What Went Wrong?

A. Was It All Just a Scam?

In 2022, the market for digital assets crashed. Between November 10, 2021 and June 6, 2022, Bitcoin declined from a high of $69,045 to $31,372. That was bad; and then FTX went under, with default contagion spreading to other digital asset market participants and leading, among other things, to the bankruptcy of BlockFi. As of December 14, 2022, Bitcoin was at about $17,645.[9]

Given so much lost money, it is reasonable to ask whether the whole digital asset class is a scam, and would best just go away. The SEC may point to this crash and say, "See, we were right to do everything that we could to put the kibosh on digital assets. By discouraging investments in these assets, we saved investors." Digital asset skeptics taking a victory lap is an entirely reasonable reaction to the blow-ups. After all, sometimes, bubbles do just pop. While tulips have stayed around, they are no longer viewed as golden tickets, nor are Beanie Babies.

On the other hand, the internet did survive the crash of the late 1990s. Looking to the long term, we should acknowledge that the crash in the value of the digital assets did not result from a failure of the technology. As evidence of the power of the technology, consider that China has established a Central Bank Digital Currency ("**CBDC**"). The Federal Reserve has been experimenting with its own CBDC,[10] as have numerous other nations.[11]

In fact, there is a good argument to be made that the most concerning aspect of blockchain technology is not that it may be used for fraud or theft. The most worrisome aspect is that it may

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8 The European Union is in the process of implementing the Marks in Crypto Assets ("**MICA**") regulation.

9 *See* **Bitcoin Price Tracker**, NEXTADVISOR (last accessed Dec. 14, 2022).

10 *See, e.g.*, **Board of Governors of the Federal Reserve System, Report, Money and Payments: The U.S. Dollar in the Age of Digital Transformation** (Jan. 2022) (Federal Reserve discussion paper examining the costs and benefits of a potential U.S. CBDC). *See also*, Federal Reserve Bank of New York, Press Release, **New York Innovation Center to Explore Feasibility of Theoretical Payments System Designed to Facilitate and Settle Digital Asset Transactions** (Nov. 15, 2022) (announcement by the Federal Reserve Bank of New York that, in cooperation with nine major financial institutions, it initiated a 12-week proof-of-concept project to explore the feasibility of a U.S. CBDC based on distributed ledger technology). Various Federal Reserve Board Governors have made statements discussing their views on the establishment of a U.S. CBDC. *See, e.g.*, Testimony of Federal Reserve Board of Governors Vice Chair Lael Brainard before the House Committee on Financial Services, **Digital Assets and the Future of Finance: Examining the Benefits and Risks of a U.S. Central Bank Digital Currency** (May 26, 2022); *see also* Speech of Federal Reserve Board Governor Christopher J. Waller, **CBDC: A Solution in Search of a Problem?** (Aug. 5, 2021); **FRB Chair Highlights Potential of Central Bank Digital Currencies**, FFRI (May 20, 2021). *See also* Report, White House Office of Science and Technology Policy, **Technical Evaluation for a U.S. Central Bank Digital Currency System** (Sept. 2022).

11 *See, e.g.*, **China's Digital Currency Passes 100 Bln Yuan in Spending - PBOC**, REUTERS (Oct. 13, 2022). *See also* L. Au, **Bank of Japan to Run CBDC Experiments With Country's Megabanks: Report**, COINDESK: POLICY (Nov. 23, 2022); Press Release, Bank for International Settlements, **Central Banks and the BIS Explore What a Retail CBDC Might Look Like** (Sept. 30, 2021).

prove to be a form of currency that can be used by governments to track all spending by their citizens, which could be the ultimate means of governmental control over dissent. In short, however much fraud surrounds it, blockchain technology is intrinsically powerful.

B. How Did the Regulators Get it Wrong?

If one acknowledges the power of digital asset technology, then the next question is how did things go so wrong; *e.g.,* with the failure of FTX. There are two somewhat opposite potential answers to this question: (i) a failure of enforcement, *i.e.*, the regulators failed to enforce existing rules; or (ii) a failure of regulation, *i.e.,* the regulators failed to adopt and implement sensible rules.

1. Failure of Enforcement

This viewpoint begins with the presumption, consistent with the "official" position of the SEC, that virtually all digital assets are securities.[12] If one accepts that presumption, all of the well-known exchanges that were offering trading in digital assets were acting illegally as unregistered brokers and unregistered securities exchanges. These unregistered brokers and exchanges were not hidden; they marketed heavily. FTX purchased the naming rights to the Miami Heat's stadium.[13] The CEO of FTX testified before a Congressional Committee[14] and met with SEC Chair Gensler in March 2022.[15] If the business of FTX was in fact illegal, why was FTX allowed to operate so openly?[16]

The response of the SEC to this criticism would likely be that the SEC did in fact bring numerous enforcement actions in the digital asset space.[17] That is true; there have been a lot of enforcement cases—by number. The problem with these enforcement actions is that they were virtually all for outright frauds and thus they did nothing to establish how a genuine digital asset business should operate without SEC registration and oversight.

By way of an example as to the SEC's enforcement policy, the SEC brought charges against an employee of Coinbase, a digital asset exchange, alleging that the employee had engaged in

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12 *See, e.g.*, Speech of SEC Chair Gary Gensler, Securities and Exchange Commission, **Kennedy and Crypto** (Sept. 8, 2022) (Chair Gensler stating that "[o]f the nearly 10,000 tokens in the crypto market, I believe the vast majority are securities"). *See also* N. De, **SEC's Gensler Holds Firm that Existing Laws Make Sense for Crypto**, CoinDesk: Opinion (Sept. 13, 2022) (interview with Chair Gensler).

13 *See* Z. Strozewski, **Miami Heat Bet on Crypto with $135M Stadium Naming Rights Deal**, SportTechie (April 9, 2021).

14 *See* Testimony of Sam Bankman-Fried, Co-Founder and CEO of FTX, Before the House Financial Services Committee, **Digital Assets and the Future of Finance: Understanding the Challenges and Benefits of Financial Innovation in the United States** (Dec. 8, 2021).

15 *See* C. Gasparino, **SEC Chairman Gary Gensler Met with Head of FTX Months Before Collapse**, Fox Business News (Nov. 15, 2022); ***see also* D. Yaffe-Bellany, Inside a Crypto Nemesis' Campaign to Rein In the Industry, N.Y. Times (Nov. 21, 2022).**

16 FTX operated both a U.S. exchange and a non-U.S. exchange that was supposedly closed to U.S. customers. The U.S. exchange offered trading in a much more restricted list of products than did the non-U.S. exchange, but even that narrower list was much broader than the types of digital assets that the SEC conceded were not securities.

17 *See* Securities and Exchange Commission, **Crypto Assets and Cyber Enforcement Actions** (last accessed December 14, 2022).

insider trading in securities that were listed on the exchange.[18] The general facts establishing the case were developed by the Office the U.S. Attorney for the Southern District of New York, which had charged the employee with wire fraud (but not insider trading in securities) based on evidence that the employee had profited by trading based on information stolen by the employee from the exchange.[19] Assuming the facts alleged by the U.S. Attorney for the Southern District of New York are true, the employee is guilty of a felony, *i.e.*, wire fraud, whether or not the relevant assets are securities. The civil enforcement action brought by the SEC was simply a freebie from the SEC's perspective. If the facts of the case were true, the employee should be convicted of a crime. The employee would have little incentive and probably would not have the resources to argue as to whether he would go to jail only for wire fraud or for insider trading in securities as well. All he will care about is how much jail time he does, and if pleading to the insider trading case shortens his jail time, that is a good trade.

Notably, while the SEC jumped aboard the DOJ's case against the employee, the SEC did not charge Coinbase with being an illegal securities exchange. As a matter of legal logic, this cannot be justified.[20] If the Coinbase employee engaged in insider trading in securities, it follows that the assets being bought and sold on Coinbase were securities and, due to Coinbase acting as a marketplace, Coinbase would be an illegal securities exchange.

The SEC has been accused of engaging in "regulation by enforcement" in its treatment of digital assets, a charge against which the SEC has vigorously defended itself.[21] In fact, the SEC is right that it has not regulated by enforcement, because that term would suggest that its actions have created regulations. They have not. There is no legal logic to going after a Coinbase employee for insider trading in securities, but not pursuing the exchange. Of course there was a practical logic: one case is easy and the other case is hard.

What the SEC did was not regulation by enforcement; it was "regulation by anxiety."[22]

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[18] *See* **SEC Calls Nine Crypto Tokens "Securities" in Insider Trading Case**, FFRI (July 21, 2022).

[19] *See* **United States v. Ishan Wahi et al.**, Docket No. 22 CRIM 392 (unsealed July 21, 2022).

[20] *See* **Letter from U.S. Senator Pat Toomey to SEC Chair Gary Gensler** *(*July 26, 2022).

[21] *Id. See also* Steven Lofchie, Comment, **Senator Toomey Criticizes SEC Chair for Regulating Digital Assets by Enforcement**, FFRI (July 27, 2022). *But see* Speech by SEC Director of Division of Enforcement Gurbir S. Grewal, **2021 SEC Regulation Outside the United States - Scott Friestad Memorial Keynote Address** (Nov. 8, 2021); **SEC Enforcement Director Rejects "Regulation by Enforcement" Criticism**, FFRI (Nov. 9, 2021).

[22] By way of example of what we would view as illustrative of "regulation by enforcement," we point to FINRA's enforcement action against a broker-dealer for failing to perform "locates" of two securities in connection with a riskless principal transaction on the theory that a locate was needed for both the customer's short sale to the broker-dealer and the broker-dealer's sale on to the market. *See*, Steven Lofchie, Comment, **Firm Settles FINRA and NYSE Arca Charges for Short Sale Violations**, FFRI (June 22, 2021). While that legal result is at least questionable, the enforcement action does establish a "regulation"—*i.e.*, firms must do two locates in connection with riskless principal transactions. By contrast, the SEC's differing treatment of exchange employees and exchanges establishes no rule of conduct; it just creates anxiety.

2. Failure of Regulation

There is an alternative take to the view that the regulatory failure was an enforcement failure that should be remedied by a stricter enforcement policy. It is that the regulatory failure was that there were no workable rules.

Rather than adopting regulations that were appropriate for digital assets, the SEC simply fell back on stating that they were no different from other securities; while the bank regulators essentially said that banks should have nothing to do with them.[23] The result was that instead of ending up with "Regulation-Appropriate," which may have been "Regulation-Lite" by the SEC's standards, we ended up with "Regulation-Doesn't-Work," which was effectively "Regulation-Not-At-All," as there is no motive for firms that are legitimately trying to develop a digital asset business to even attempt compliance with a regulatory scheme that is unworkable. By failing to create a workable regulatory scheme, the regulators forced both good guys and bad guys to operate in the gray zone, and made no distinction between the two.[24]

Regulation by prohibition is not necessarily an effective technique. It didn't work for alcohol. When regulation by prohibition fails, it creates other problems. Users turn to illegal providers, or ones who may not be so reliable.

We will further discuss the SEC's treatment of digital assets in Section IV.

III. Policy Issues

In making an analogy between digital assets and tomatoes, I do not diminish either the significance or the difficulty of the policy issues. This Section of the memorandum very briefly outlines the major policy issues.

A. Customer Protection

The SEC and, to a somewhat lesser extent, the CFTC have brought a significant number of enforcement actions against digital asset firms. Unsophisticated investors have lost money purchasing digital asset products in scams, far-fetched schemes, and outright theft. Or, in the case of FTX, by entrusting their assets to unworthy fiduciaries. In any case, while FTX may be the biggest loss case, it is not the only circumstance in which money has disappeared.

In short, as a starting matter, we must concede the necessity or inevitability of fulsome regulation. A market as big as that for digital assets, and which is to a significant extent retail, will be regulated. Our political system is not going to say "caveat emptor" to broad distributions of financial assets to retail purchasers.

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[23] *See, e.g.*, F. Hussein, **Top US Regulators Say Crypto Poses Financial Stability Risks**, Associated Press (Oct. 3, 2022).

[24] Senator Toomey's letter, cited in footnote 20 above, makes a very good case on this point.

B. Anonymity

Governments do not like anonymity, and the U.S. government is not special in this regard. The U.S. government's worries about digital assets include their use for money laundering, sanctions evasion, and the hiding of the proceeds of ransomware.[25] The crime that likely worries the U.S. government most is tax evasion facilitated by anonymity.

C. Systemic Risk

The bank regulators have expressed concern about the potential for failure in the digital assets market to leak into the broader financial system and create a crash. This means that we need rules against, or at least limitations on, financial institutions taking proprietary positions in, or extending credit on the basis of, collateral that consists of digital assets.

In addition, while FTX demonstrates the benefits of custody being in the control of financial institutions subject to regulatory oversight, to the extent that there are worries as to the quality of custodial processes for digital assets, a regulatory system that provides financial institutions with some measure of immunity from liability with respect to custodial failures might be desired.

D. Opportunities and Uses

The above items were largely about the avoidance of negatives. There are also great positives. Blockchain technology is powerful. At a minimum, it could transform systems for payment and other transfers of value. It also allows for the tracking of such transactions. Even the President's Executive Order on Digital Assets recognized the value of blockchain technology. Being a leader in new technologies is good for the economy and good for jobs.[26]

Blockchain technology also has applications that are purely nonfinancial. These include, tracking shipments, recordkeeping and other logistical and social applications. It also has applications that are semi-financial, or financialized, such as customer reward points and transferrable club memberships. A regulatory framework facilitating blockchain technology's financial uses could provide corresponding certainty to its non-financial uses.

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[25] *See* Paul Kiernan, **Crypto Legislation Could Undermine Market Regulations, Gensler Says**, WALL ST. J. (June 14, 2022); *see also*, Steven Lofchie, Comment, **SEC Chair Gensler Reacts to Proposed Regulatory Scheme on Digital Assets**, FFRI (June 17, 2022).

[26] *See* Executive Order, President of the United States, **Executive Order on Ensuring Responsible Development of Digital Assets President Biden Signs Executive Order on Digital Asset** (March 9, 2022); *see also* Steven Lofchie, Comment, **President Biden Signs Executive Order on Digital Assets**, FFRI (March 9, 2022). In particular note Section 2(d) of the Executive Order, stating: "We must reinforce United States leadership in the global financial system and in technological and economic competitiveness, including through the responsible development of payment innovations and digital assets. The United States has an interest in ensuring that it remains at the forefront of responsible development and design of digital assets and the technology that underpins new forms of payments and capital flows in the international financial system."

IV. Failures of the Agencies

A. The Securities and Exchange Commission (the "SEC")

The SEC is the federal regulatory agency that is primarily charged with protecting investors. Given the importance of this mission, it is not surprising that the SEC should be inclined to caution. While one may thus defend the conduct of the SEC, it is nonetheless disappointing that the SEC has failed to engage with the question of how digital assets should be regulated beyond essentially declaring that digital assets are virtually all securities, and thus their initial issuance and distribution was in violation of law and that venues facilitating trading in turn are also in violation of law.[27]

The SEC, or perhaps to be more specific, SEC Chair Gensler, has explained why he does not believe it is necessary to modify the securities regulations in order to apply them to digital assets through a number of mantras.[28] The truth of each of these mantras seems obvious on its face:

- Treat like cases alike[29]
- Regulation should be technology-neutral[30]
- No honest business need fear the SEC[31]

1. Like Must be Treated as Like

If one rephrases the statement "treat like cases alike" to read "similar things must be regulated in an identical manner," then the "obvious truth" of the statement seems a lot less obvious. One has to ask the question "How similar are the things?" and are their differences meaningful such that identical treatment may be neither practical nor desirable.[32]

To turn to the actual world of securities regulation, in fact securities regulation does not regulate all similar securities products identically. Distinctions are made based on the economic characteristics of the product: equity, debt, convertible debt, options, asset-backed. Distinctions are also made based on the types of issuers: private operating companies, investment companies, commodity pools, government-sponsored enterprises, municipal

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27 *See* S. Lofchie, C. Almquist, and S. Souchet, **The Securities Law Treatment of Utility Tokens (Or Why it is Past Time for the SEC to Engage with the Hard Questions)**, FFRI COMMENTARY (Jan. 11, 2022).

28 We focus on the position of Chair Gensler, rather than that of the SEC more generally, because the SEC under Chair Gensler has taken most of its actions by a 3-2 vote, with a Democratic Commissioner majority. Of the three Democratic Commissioners, Chair Gensler's voice is the most significant, both because of his role as Chairman and because he has been by far the most vocal on the treatment of digital assets. To be fair to Chair Gensler, his views on digital assets do not seem to differ materially from those of his predecessor, Chair Clayton, who was a political independent appointed by Republican President Donald Trump.

29 *See* Speech of SEC Chair Gary Gensler, **Remarks Before the Healthy Markets Association Conference** (Dec. 9, 2021) (the "**Aristotle Speech**") (referring to a legal ethic of Aristotle).

30 *See* Speech of SEC Chair Gary Gensler, **Prepared Remarks of Gary Gensler On Crypto Markets Penn Law Capital Markets Association Annual Conference** (April 4, 2022).

31 *See supra* note 10.

32 Oddly enough, in Mr. Gensler's Aristotle Speech he cites in his first footnote to an academic article that makes exactly this point. *See* Aristotle Speech, *supra* note 29 at fn. 1.

issuers, banks, the U.S. government. Moreover, we make distinctions based on the location of organization and the location of the holders: U.S. issuers, foreign private issuers.

In fact, the above distinctions are at a very high level. Just taking the category of funds, it is possible to come up with 20 different types of specific exemptions and specific regulatory requirements. In short, similar products are not treated identically. Rather, the onus is on the regulators to determine what regulation is appropriate in light of the differences between products.

There is a reason why products that are similar are not treated identically: It is because the products are not identical. They have different economic and control characteristics. Therefore, the SEC may create rules that are specific to each type of financial asset. By way of example, here is what the SEC said when adopting rules regarding Asset-Backed Securities ("ABS") in 2004:[33]

> Asset-backed securities and ABS issuers differ from corporate securities and operating companies. In offering ABS, there is generally no business or management to describe. Instead, information about the transaction structure and the characteristics and quality of the asset pool and servicing is often what is most important to investors. Many of the Commission's existing disclosure and reporting requirements, which are designed primarily for corporate issuers and their securities, do not elicit relevant information for most asset-backed securities transactions. Over time, Commission staff, through no-action letters and the filing review process, have developed a framework to address the different nature of asset-backed securities while being cognizant of developments in market practice.

What the SEC said in 2004 about ABS is true as to digital assets: They "differ from corporate securities and operating companies."

SEC Chair Gensler himself has recognized the same truth. In Mr. Gensler's "Kennedy and Crypto" speech, cited above, he said, "I recognize that it may be appropriate to be flexible in applying existing disclosure requirements. Tailored disclosure exists elsewhere—for example, asset-backed securities disclosure differs from that for equities."[34]

Given that SEC Chair Gensler recognized this fact, then the question must be why has the SEC not proposed a modified and tailored disclosure regime. It cannot be the case that there is any lack of resources at the SEC, as demonstrated by the remarkable number of rule proposals that the SEC has put forward under Mr. Gensler's chairmanship. Nor can there be any justification of a lack of awareness given that Commissioner Peirce has put forward a disclosure regime, and that the European regulators have adopted their own disclosure regime.[35] Rather, we have to

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[33] Final Rule, Securities Act Rel. No. 33-8518, **Asset-Backed Securities**, 70 FED. REG. 1506, 1508 (Jan. 7, 2005).

[34] *See supra* note 12.

[35] *See* Statement of SEC Commissioner Hester M. Peirce, **Token Safe Harbor Proposal 2.0** (April 13, 2021); *see also* Steven Lofchie, Comment, **SEC Commissioner Hester Peirce Offers Update to Proposed Safe Harbor for Digital Tokens**, FFRI (April 14, 2021).

say that the decision not to put forward a tailored disclosure regime is an omission consciously made by the SEC.

2. Regulation Should Be Technology-Neutral

If an individual walks on the highway, or rides there on a horse or drives a scooter, an automated lawn mower, a motorcycle, an automobile or a truck, different regulations may apply, even though the purpose of the trip is the same. Regulation is not technology-neutral. The SEC has as a matter of actual conduct conceded this point since it has issued guidance on the custody of digital asset securities that makes it unattractive and likely impossible for any broker-dealer to provide custody of digital assets.[36]

Yet even pointing out an inconsistency in the SEC's position misses a deeper problem because the SEC is fundamentally correct that an equity security in a corporation should be regulated in largely the same manner regardless of whether that equity security is represented by a piece of paper, an electronic blip or on the blockchain.

The real problem is that the "technology-neutral" statement misses the point entirely. No claim is made that equity securities represented through the blockchain should be regulated differently than equity securities represented on paper or through electronic blips. Rather, the argument is that "digital assets" that do not represent ownership in a corporation should be regulated differently from stocks. The difference is not the technology. The difference is the economic characteristics, which are enabled, but not defined, by the technology.

3. No Honest Business Need Fear the SEC

This statement by Chair Gensler is disappointing in that it is contrary to the American ethic. The presumption of Chair Gensler's statement is that freedom from governmental control must be justified and that any resistance to governmental controls is morally suspect, if not proof of dishonesty. That ought not to be our presumption. Freedom should be the starting point, with governmental controls imposed only where and to the extent they are justified.

In *McCulloch v. Maryland*, Chief Justice John Marshall observed that "[t]he power to tax is the power to destroy."[37] That is, the government's authority to tax or impose other requirements is the authority to make an activity impractical. In regard to digital assets, the regulations that would be imposed by the SEC are impractical, and that is why these are resisted, not because all who resist are not honest.

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[36] *See* Commission Statement, Securities Exchange Act Rel. No. 34-90788, **Custody of Digital Asset Securities by Special Purpose Broker-Dealers**, 86 Fed. Reg. 11627 (Feb. 26, 2021); *see also* Steven Lofchie, Comment, **SEC Requests Comment on Broker-Dealer Custody of "Digital Asset Securities"**, FFRI (Dec. 23, 2020). Notably, this custody proposal is now almost two years old and has gone nowhere. Instances where securities regulation makes distinctions between technologies are not limited to those involving digital assets. In fact, different SEC rules distinguish between the transmitting of notices by letter, telex, or email. Likewise, the SEC makes distinction in matters such as the manner in which records are stored; *e.g.*, determining whether "write once, read many" technology is required for recordkeeping.

[37] **McCulloch v. Maryland**, 17 U.S. 316 (1819).

To demonstrate this, let's create a practical problem and ask how the SEC would solve it.

Next to Bitcoin, which is *sui generis* by reason of its history and the breadth of its distribution, ether is the largest digital asset as measured by market value. SEC Chair Gensler has said that he believes ether may be a security. Taking Chair Gensler at his word, this means that, if ether is to be regulated as an ordinary security, it must be possible to create a registration statement providing investor disclosures as required by SEC Regulation S-K and S-X.

Of course, there is an initial problem with this task. There is no "company" and no one who has the authority to create such a registration statement, or who would bear the expenses of it, or who would take responsibility for any inaccuracies.

On the other hand, that void creates the opportunity for the SEC to show the market how a very common digital asset may be regulated as an ordinary security. The SEC is as well positioned as anyone to draft a registration statement for ether. Although the SEC may not have all the relevant facts in house, it has the ability to collect them. If the SEC is able to draft a workable registration statement for ether, it would have a model to demonstrate how ordinary securities disclosure requirements may be applied to digital assets.

Our guess is that the SEC would not be able to create a workable registration statement; there is simply too much in SEC Regulation S-K and Regulation S-X that is wholly irrelevant. If we are wrong, that is all good too; the SEC will have created a model for the market. What I think is a more likely result is that the SEC will find that there are useful disclosures that may be made with respect to digital assets; they are not the disclosures that apply to ordinary equity securities. Instead, the SEC (or the CFTC) will have to create a new disclosure form that is appropriate for the asset, just as it did for asset-backed securities.

B. What About the CFTC?

There is a perception that the CFTC is a looser, kinder, easier regulator than the SEC, and therefore digital assets would be better served by CFTC regulation. The perception that the CFTC is kinder derives principally from the fact that the CFTC's historical mission is more limited than that of the SEC. The SEC is a regulator of product (securities) issuers and product disclosures, and trading in products. On the other hand, the CFTC is largely only a regulator of trading in products. Thus creators of digital assets would prefer to be regulated by the CFTC than by the SEC because that means regulation only of trading and not of the issuer/creator of the product or of the product itself.

Just as digital market participants are keen to be regulated by the CFTC, rather than the SEC, the CFTC is equally keen on being granted authority to regulate digital assets.[38] As with any

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[38] *See, e.g.*, Testimony of CFTC Chair Rostin Behnam Before the U.S. Senate Committee on Agriculture, Nutrition, and Forestry, **Why Congress Needs to Act: Lessons Learned from the FTX Collapse** (Dec. 1, 2022); *see also* **Testimony of CFTC Chair Rostin Behnam Regarding the Legislative Hearing to Review S.4760, the Digital Commodities Consumer Protection Act at the U.S. Senate Committee on Agriculture, Nutrition, and Forestry** (Sept. 15, 2022); Public Statement by CFTC Commissioner Caroline D. Pham, **Regulation of the Future: Building Responsible Digital Asset Markets** (June 28, 2022); Public Statement by CFTC Commissioner Summer K. Mersinger, **An Appropriate Regulatory Regime for Evolving Markets** (Sept. 14, 2022); Public Statement by CFTC Commissioner Kristin Johnson, **Opening Statement of Commissioner Kristin N.**

other regulator, the more it has authority to regulate, the more power it has. The CFTC tells us that it has the manpower to regulate digital assets, the expertise, that it is open to the new and, most importantly, is in all ways much cooler and more "with it" than the SEC.

All of which is probably true. So, if we want the CFTC to regulate digital assets, what is the problem? It is that, like the SEC, the CFTC has failed to engage, though in a different way. This failure to engage can be demonstrated with two examples.

The CFTC has made the case that it has experience regulating trading and custody. This is true—but it is insufficient. There must also be a disclosure regime. The CFTC has not described any type of disclosure regime that might be applicable to digital assets, who would be responsible for the disclosures and what would be the consequences of inadequate disclosure.

Second, the CFTC and policymakers have failed to engage with the fact that the assets that it would be called upon to regulate will present some different challenges than existing commodities. For example, the DCCPA provides that "digital commodity dealers" and "digital commodity brokers" are prohibited from trading, or arranging a trade, in a contract for a digital commodity that is readily susceptible to manipulation or that is determined to be inconsistent with the Commodity Exchange Act.[39] This sounds good in theory, but again it does not resolve the regulatory questions. Think of some commodities that ordinarily trade on CFTC-regulated exchanges: interest rates, currencies, gold, wheat, energy, securities indices. These are all commodities that have aggregate global market value of likely billions of dollars and the ownership of which is very widely distributed. Leaving aside Bitcoin and ether, both of which have meaningful aggregate market value, even if small in comparison to interest rates and other CFTC-regulated commodities, most digital assets have small market values and limited distribution. This means that they will be inherently at greater risk of manipulation than other CFTC-regulated commodities. But if these lesser digital assets are not permitted to be traded on CFTC-regulated markets, then we have not really solved the problem of regulation.

In short, the CFTC and policymakers must work a little harder to think things through a little more than they have done to date. This means that at least two issues must be addressed: (i) what does the disclosure regime look like and (ii) how should we regulate the trading of digital assets that have limited market value and distribution?

C. The Banking Regulators

There is less to be said about the banking regulators than the SEC and the CFTC because they would not generally be the primary regulators. However, the banking regulators have taken, at least since the Biden Administration, a generally hostile approach to the involvement of banks in digital assets. While no one argues that banks should be permitted to take proprietary

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Johnson Before the Market Risk Advisory Committee Meeting (Sept. 28, 2022); Public Statement of CFTC Commissioner Christy Goldsmith Romero, **Financial Stability Risks of Crypto Assets** (Oct. 26, 2022); Public Statement of CFTC Commissioner Christy Goldsmith Romero, **Protecting Against Emerging Global Fintech Threats in Cyberspace and Cryptocurrencies** (Nov. 30, 2022).

39 *See* DCCPA at p. 47.

positions in digital assets, it is disappointing that the banking regulators have discouraged banks from providing digital asset custody.[40] In retrospect, it is very easy to point out the investors in digital assets would have been better off custodying with a regulated bank rather than with FTX.

V. How Should Digital Assets Be Regulated?

The European regulators have adopted a regulatory regime tailored to digital assets, the Markets in Crypto Assets ("**MICA**") regime. If the European regulators can create an appropriate regulatory scheme, then the United States should be able to do it as well.

To create a regulatory scheme, there are three big picture "questions" that must be answered: (i) what should be the disclosure regime to which the issuers/creators of digital assets are subject; (ii) how should the other financial intermediaries (brokers, advisers, custodians, funds) be regulated; and (iii) how should digital asset markets be regulated?

The following section of this memorandum is not intended to lay out the necessary regulatory scheme with any detail; it is only intended to sketch out the bare elements of the regulatory scheme and where the challenges will lie. Once one has defined the elements of the regulatory scheme by which digital assets should be regulated then one can turn to the secondary question of which agency should have authority to flesh out that regulatory scheme and to impose it through supervision and enforcement, a question that we will turn to in Section VI.

A. Disclosure

The most fundamental element of financial regulation is disclosure. Investors/purchasers of a financial asset should have some right to disclosure.

For public companies, the principal non-financial disclosure requirements are defined by the SEC's Regulation S-K and the principal financial disclosure requirements are defined by the SEC's Regulation S-X. For the most part, these disclosure requirements are not relevant to digital assets, as SEC Chair Gensler has him acknowledged. If the SEC's disclosure requirements do not work because digital assets are not the same as "corporate securities and operating companies," then the onus is on the SEC to come up with requirements that do work, just as the SEC did for asset-backed securities.

Fortunately, the SEC is not required to work from scratch in coming up with new disclosure requirements. One of the SEC's Commissioners, Hester Peirce, has published a proposed set of disclosure requirements as to digital assets.[41] Likewise, the European regulators have adopted MICA, a disclosure regime applicable to digital assets. It is not to say that these disclosure requirements should be what the SEC goes with; only that they give the SEC a good starting point. In any case, the regulators must take on the disclosure issue for digital assets, just as the SEC at one point addressed this issue as to asset-backed securities.

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[40] *See, e.g.*, Speech by Acting Comptroller of the Currency Michael J. Hsu, **Skeuomorphism, Commingling and Data Gaps in Crypto** (Oct. 11, 2022).

[41] *See supra* note 35.

The other question that the SEC must take up is "who" is to provide disclosure as to digital assets. In the case of a newly created asset where the creators of the asset are seeking to obtain distribution, the creators will generally be motivated to create a disclosure document, assuming that the disclosure requirements are reasonably tailored to the characteristics of digital assets and that there is a penalty for failing to create a materially accurate and complete document. Where there is no creator to write a disclosure document, CFTC-type regulation does provide an answer to that question: A regulated market can be made responsible for disclosure as to the assets in which it offers trading. If there is neither a creator of the document nor a market willing to develop one (probably because there is limited interest in the product), then regulators could bar the product from trading on a market. Note that does not mean that the product would cease to exist or be unavailable, but interest in it would be limited.

B. Regulation of Intermediaries

The next issue to be considered is the regulations that should be applied to intermediaries of various sorts. The intermediaries that must be considered are (i) advisers, (ii) brokers, (iii) funds and (iv) custodians. As to all of these activities, it should be possible to based digital asset regulation on our existing regulatory schemes. Thus, sketching out a regulatory scheme is a quite straightforward task.

1. **Advisers**. For investment advisers, no modification to the existing regulatory schemes under the Investment Advisers Act should be necessary. As to the Commodity Exchange Act, it is possible that it could be amended to borrow language from the Advisers Act as to conflicts of interest, but such borrowing should not be complicated.

2. **Brokers**. Leaving aside the issues of capital, which we turn to below, and of custody, even further below, the basic brokerage concepts are not inherently very different as to the sale of any asset. The broker must attempt to provide best execution of the transaction, must provide a trade confirmation and periodic statements and is subject to recordkeeping requirements and regulatory reporting. None of these requirements is a show-stopper.

    a. **Capital**. Broker-dealers and FCMs that hold proprietary positions in assets are required to take capital charges on the value of those assets that reflect a write down accounting for their riskiness. For example, on government securities, the capital charges may be as low as 0 - 6% of the value of the assets, depending on maturity; for listed equities, the capital charge is 15%; and for illiquid assets, the capital charge may be 100%. Imposing a capital charge of 100% on digital assets held by firms offering trading services in digital assets would be conservative and would not be a material impediment to firms regulated either by the SEC or by the CFTC acting as brokers.

    Banks may also be prohibited from taking proprietary positions in digital assets just as they are prohibited from doing so in equities.

The same types of restrictions may also be extended to lending. There are many equity securities against which broker-dealers are prohibited from extending credit. Prohibiting broker-dealers from extending credit against digital assets would not prevent the development of a workable regulatory scheme. In contrast to broker-dealers that will generally only make fully-collateralized loans, banks can make uncollateralized loans, so there would seem no reason that they should be absolutely barred from taking digital assets as collateral—it can't be worse than unsecured lending. But banks are required to develop and institute lending procedures that are safe and sound; they should set risk limits on acceptance of digital asset lending at an appropriately low level.

3. **Custody and Custodians**. Custody is actually a more difficult issue than capital because, while we are indifferent or even antagonistic to regulated institutions taking principal positions in digital assets, or even lending against digital assets, the FTX saga makes clear that we want investors to have the option to hold their financial assets with a regulated institution. On the other hand, the U.S. regulators seem concerned that there is not any truly safe way for digital assets to be custodied in a manner that both protects investors and prevents the custodial financial institution from being exposed to undue risk.

   The important questions are whether in the event of a loss of the digital assets (i) the custodian should be held responsible (or whether the customer should bear the risk of custodianship); (ii) if the custodian bears the loss and goes insolvent, should that loss be potentially shared by other customers of the custodian holding traditional assets, *e.g.*, securities and futures; and (iii) should there be insurance, such as that provided by SIPC or by the FDIC, to reimburse digital assets customers in the failure of the broker-dealer.

   To the extent that there is uncertainty as to whether assets may be safely and reliably custodied, it seems reasonable both that other customers should not be required to bear the risks of the digital asset customers and that such customers should not be eligible for insurance. This is essentially the existing CEA scheme, which allows for the division of customers by category of product so that customers that hold different types of products are not required to mutualize their risk. Likewise, the CEA does not offer customers insurance against the failure of a custodian.

   As to whether custodians should bear the losses caused by their failures to hold customers' assets, there is a good argument that they should. If they do not want to be at risk for their inability to hold customers' assets, they likely should not be in the business of acting as custodian. However, if, for example, the bank or other financial regulators do not want to put regulated institutions at risk for being the custodian of digital assets, investors would still be better off by being permitted to custody at a regulated institution than holding their assets at unregulated firm.

4. **Funds**. Each of the SEC and the CFTC has detailed systems of regulation that apply to investment fund/commodity pools and each of these schemes could serve equally well regulating investment vehicles holding digital assets.

C. Markets

The regulatory scheme that should be applicable to digital assets markets will pose more challenges to develop. While each of the SEC and the CFTC has authority over and experience in regulating markets, those markets have been in operation for many decades and so the scheme of regulation has been built up over time, as have the operations necessary to comply with those regulations. The companies that operate fully regulated exchanges are very large, and each controls significant market share. So the problem in establishing a trading market scheme for digital assets will not be one of coming up with new requirements; it will be one of scaling back existing requirements.

As we have said above, it is not realistic to think that the same standards can be applied to the listing of novel digital asset products as apply to corporate issuers; applying unrealistic standards means that no product qualifies for listing, and we have accomplished nothing. We have simply allowed the perfect to be the enemy of the good.

But saying that digital asset markets can not be as heavily regulated as securities markets does not mean that regulation is impossible. Digital asset markets can be required to (i) provide access to disclosure as to the products that they offer; (ii) screen their employees and monitor employees' trading; (iii) protect the trading strategies of investors to prevent frontrunning; (iv) provide trade reporting; and (v) establish custodial connections with regulated custodians that will facilitate immediate settlement of transactions while protecting customers' assets.

VI. Which Regulator Should Have Authority Over Digital Assets?

Having outlined that a regulatory scheme for digital assets should look like, we then turn to the question of which regulator should enforce that scheme.

There are a number of different ways in which one might decide whether the SEC or the CFTC should exercise jurisdiction over digital assets.

- The first way is by deciding whether the relevant asset is a "security"; and if it is not, assume it is a commodity as to which the CFTC is the more likely regulator.
- The second way, which we discuss below, is to determine which of the regulators would be more competent to regulate digital assets.
- The third way is our Solomonic Solution.

A. Are Digital Assets Fruits or Vegetables?

One approach to determining whether the SEC or the CFTC should have authority over the regulation of digital assets is to decide whether such assets are, in their essence, securities or commodities, or whether they may be non-binary, so that they transition back and forth between the two. In this regard, various suggestions have been made as to how to treat the dividing line between digital assets that are securities and those that are commodities.

1. **10% Ownership Test.** A common suggestion has been that the dividing line should be based on the distribution of ownership of the relevant digital asset, most commonly that if no one person owns over 10% of the relevant asset then it is no longer a security. This dividing line is based on the definition of "affiliate" under the securities laws. The basic concept is likely linked to the notion that a person who owns 10% of an asset may have some degree of control over it.

   Beyond that, there is not much to commend it. While affiliates of an issuer are subject to limitations on resale of securities of an issuer, that is very different from saying that the affiliate controls the issuer and should therefore be responsible for providing disclosure. There are lots of persons who own 10% of an issuer and do not control it. In fact, there are lots of issuers where there is no 10% owner; that does not mean that interests in the issuer are not securities. Further, a person may go above and below 10% ownership, and it would not be ideal for an asset to bounce back and forth between being a security and a commodity. In that regard, it is not at all clear to me how anyone would even know whether 10% of a particular asset was held by a person or a group of affiliated persons. Market participants need to know what body of law they are under, and there needs to be some constancy to the body of law.

2. **Investment Contract Test.**[42] The RFIA has a different suggestion: that a digital asset is no longer a security when it is separated from the related "investment contract." This happens when the purchaser of the asset is simply buying the asset for its use, without any expectation that the issuer/developer of the asset will further improve the asset or increase its value. Under this theory, certain holders of a digital asset will hold something that is a security, while other holders of the same asset will not own a security.

   This result seems counterintuitive, but it actually is consistent with the *Howey* test.[43] In that case, the original investors were buying interests in citrus groves with the expectation that the developer would produce more oranges and market them. Therefore, they were buying a security. However, downstream purchasers were just buying oranges; nothing that the developer of the orange grove did would change the quality or nature of their purchase—it was oranges.

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[42] For an extremely comprehensive discussion of whether digital assets are securities under the investment contract test, *see* L. R. Cohen, G. Strong, F. Lewin, and S. Chin, **The Ineluctable Modalities of Securities Law: Why Fungible Crypto Assets are Not Securities**, Discussion Draft Presented by DLx Law (Nov. 10, 2022) (the "**DLx Law Paper**"); *see also* J. Massari, **Why Cryptoassets are Not Securities**, Harvard Law School Forum on Corporate Governance (Dec. 6, 2022). We agree with a good part, even if not all, of the DLx Law Paper. What we do agree on, I think, is that the "fruit" or vegetable" argument is an intellectual and social dead-end. The United States needs a regulatory scheme that has been developed to be appropriate for the product.

[43] **SEC v. W.J. Howey Co.**, 328 U.S. 293 (1946).

Unfortunately, that analysis really does not work for digital assets whose value depends upon both (i) improvements to the underlying technology and (ii) the breadth of the distribution of the underlying technology. The purchaser of a digital asset is not necessarily buying just an orange; the purchaser may buy on the expectation that the nature or the value of the asset will change and be improved over time.[44] If the developer of the technology behind the digital asset invests resources in improvement, the value of the digital asset rises. By contrast, if the developer of the citrus grove improves the grove, the value of the individual oranges would not increase. In short, there is not a perfect analogy between an orange and a digital asset.[45]

3. **The Know It When You See It but Not a Security Test.** The DCCPA has a different approach to the jurisdictional question. Section 3 of the DCCPA establishes that the CFTC generally has "exclusive jurisdiction" over any account, agreement, contract or transaction involving a "digital commodity trade."[46] The DCCPA states that Bitcoin and ether are "digital commodities" as defined in the bill (and thus not securities) over which the CFTC will have jurisdiction. It then goes on to further include in that definition any asset that is "commonly known as a cryptocurrency" (which seems an exceedingly vague standard as one tries to apply it to hundreds of different assets within the class) and any "fungible digital form of personal property that can be possessed and transferred person-to-person without necessary reliance on an intermediary." This last inclusion seems to pick up almost any asset on the blockchain, so it is overbroad.

   But the breadth of the definition of "digital commodity" is not the real problem. The real problem is the exclusions from the definition. The DCCPA carves out from the definition of "digital commodity" any asset that is a "security." However, the SEC takes the view that virtually all digital assets are securities. Thus, the DCCPA would leave us right back where we have started. Bitcoin and ether will be treated as digital commodities under the DCCPA, but we then are told to exclude from the class of digital assets all "securities," which, according to SEC Chair Gensler, is everything else. By attempting to avoid conflict with the

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44 We are not attempting to argue that a digital asset is a security; only that this particular test, which works for oranges, does not work as well for digital assets.

45 Here is another example:

Suppose one buys a house in a small but growing community, which seems to be in the path of urban expansion. The house is not a "security," supposedly on the theory that any increase in its value is not dependent on the efforts of others. But is that really the case? The value of the house will depend on the efforts of the community managers in building schools, in improving roads, in combatting crime. If they are successful in doing these things, the value of the house will likely increase. Under the Howey metaphor, the house would become a security because its value is dependent on the efforts of others. But of course, we all agree that the house is not a security. We might therefore agree that the Howey metaphor is imperfect.

46 DCCPA at p. 16. The DCCPA defines the term "digital commodity trade" to mean a purchase or sale of a digital commodity in exchange for either (i) another digital commodity or (ii) any other consideration. *See* DCCPA at p. 9. The term includes offers to enter into the purchase or sale of a digital commodity, as well as a loan of a digital commodity, an offer to enter into a loan of a digital commodity and other "similar activity, as determined by the [CFTC]." *See* DCCPA at p. 9.

> SEC and SEC Chair Gensler, the authors of the DCCPA have left us with jurisdictional lines that remain unclear.

The above discussion is not meant to prove that digital assets are securities or are not securities. Rather, it is meant to say that the discussion is pointless. Does the cook worry over whether tomatoes are fruits or vegetables?

B. The Competence Test

Another approach to deciding which agency should regulate digital assets would be to consider how digital assets should be regulated and then decide which agency is best positioned to regulate them. Once one has structured a regulatory regime as to digital assets, one may pick a regulator. For purposes of this discussion, we simply treat digital assets as a new legal category, so that we do not let our preconceptions as to "security" or "commodity" category determine which regulator is better suited to the task at hand. While we will confine our discussion to the SEC or the CFTC, it is not out of the question that another regulator might be more appropriate. The banking regulators could be the regulators of those stablecoins that are backed by currency. The Federal Trade Commission and the Consumer Financial Protection Bureau both have some relevant expertise. Having said that, the SEC and the CFTC ought to be given the inside track as they both regulate markets and market intermediaries.

1. Disclosure Regime

The development of a disclosure regime is more within the experience of the SEC. That said, the disclosure requirements that should be applicable to digital assets are even more different from corporate equities than are the disclosure requirements applicable to asset-backed securities. Whatever the SEC's expertise is in disclosure, it seems not to have given consideration to what the disclosure requirements should be as to digital assets.[47] Accordingly, the CFTC would not be at a disadvantage in developing a digital asset disclosure regime.

Further, there are disclosure models that could be reasonably copied by the CFTC, such as MICA or the disclosure regime proposed by SEC Commissioner Peirce. The SEC does have experience in reviewing disclosure statements, but the disclosures for digital assets are likely to be sufficiently *sui generis* that perhaps the CFTC would be better off since they would have to start fresh with staff working on disclosure matters without preconceptions.

So let's call competence as to disclosure a wash, given that each regulator would have models from which it might work, but neither seems to have made any progress in this regard.

2. Brokers and Advisers

For brokers again, perhaps an advantage goes to the SEC, at least in that retail investors are more likely to have a securities account with a broker than they are a futures account with a

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[47] In making this statement, I exclude the efforts of Commissioner Peirce, who has given thought to this, but more of her own individual efforts, as opposed to on the basis of a sponsored agency activity.

futures commission merchant ("**FCM**"). There are also a lot more securities brokers than there are FCMs. Likewise as to investment advisers. But it's not that the relevant rules are so different.

Ultimately, each regulator is capable of overseeing brokers and advisers, so we must call this a wash as well.

3. **Custodians**

All of brokers, FCMs, banks and other vehicles may act as custodians and are heavily regulated in this regard. Thus, there is no reason why the SEC or the CFTC should be the preferred regulator.

4. **Investment Funds**

As with the regulation of investment advisers, it does not seem to make that much difference whether investment funds that purchase digital assets are treated as being subject to the securities laws or the CEA. A reasonable solution would be to allow funds that invest primarily in securities to treat digital assets as securities; and those that invest primarily in commodity derivatives to treat digital assets as commodity derivatives.

Again, neither regulator has any obvious advantage over the other.

5. **Markets**

Both regulators have responsibility for the operation of markets and therefore should be capable of regulating digital asset exchanges. Full scale regulation as a securities exchange or as a commodity futures exchange is heavy handed. Even the SEC's less onerous Regulation ATS, designed for "alternative trading systems," is too much.

For either regulator to be successful in overseeing a digital asset market, it will have to scale back. Again, no advantage to either regulator.

6. **Enforcement**

There is greater scale for enforcement and oversight on the securities law side, which might be an advantage in a retail market. That is a two-edged sword. On one hand, there should be a reasonably scaled enforcement scheme. On the other hand, a good enforcement scheme must impose penalties that are calibrated to the scale of the violation. Perhaps we should acknowledge some advantage to the SEC simply in that it has more size.

7. **Attitude**

Regulators should not be hostile to the industry that they regulate. Regulation is not prohibition. The regulated businesses provide their consumers a valuable service, and part of the task of regulation is to encourage, or at least not impede, the development of that service. In this regard, it is not clear how well the SEC matches up with a start-up industry. Chair Gensler is a proponent of maximalist regulation and that attitude is not specific to the regulation of digital assets.

This attitude is reflected in Chair Gensler's view that "like must be treated as like"; *i.e.*, that the SEC is not focused on making distinctions between different products. Another example of Chair Gensler's regulatory philosophy is demonstrated in the testimony and the dialogue at an SEC Committee meeting on small business. SEC Commissioner Uyeda pointed out that there had been a drastic decline, over a 20-year period, in the number of public companies and wondered if that was, to some extent, because of overregulation by the SEC. Chair Gensler's response was to point to the pandemic and the war in Ukraine ignoring the 20-year timeline to which Commissioner Uyeda referred.[48] That response seems demonstrative of the fact that Chair Gensler is not interested in taking up the question of whether regulation may be excessive or have negative impacts. This approach is not suited to a start-up industry. By contract, the CFTC has stated itself eager to develop a workable regulator scheme.

So on the test of attitude, the advantage must be given to the CFTC.

8. Score

Running through our various tests of competency leaves us with a score of one advantage for the SEC (bigger enforcement staff) and one for the CFTC (greater enthusiasm for the project). In short, we have a tie.

C. The Solomonic Approach

Let us assume that we have two highly competent financial regulators. While each has somewhat different strengths and cultures, each seems competent to develop a disclosure scheme for digital assets, to regulate trading in that asset and to bring enforcement actions.

In light of that joint competence, the simplest Solomonic way forward, to avoid a pointless fight over jurisdiction, is to give both regulators the opportunity for jurisdiction. Allow each creator/developer of a digital asset to elect which regulator the creator favors. If one of the regulators imposes a regulatory scheme that is unworkable, if that regulator elects to kill the digital asset baby, then creators of digital assets will choose the other regulator.

1. Argument Against: Race to the Bottom

As to having two potential regulators, there is an argument that allowing developers to choose their own regulator will create a race to the bottom between the SEC and the CFTC. We do not see any reason to believe that either of the two regulators is quite so hungry for jurisdiction that it would adopt regulations that would be "anything goes." It should be remembered that ultimately each regulator reports to Congress and is effectively controlled by the President. Thus the competition between the two agencies is ultimately constrained by the fact that they both ultimately report to the same bosses.

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[48] *See* Speech by SEC Chair Gary Gensler, **Remarks Before the Small Business Capital Formation Advisory Committee** (Oct 13, 2022).

2. Argument Against: Regulatory Illogic

A logical regulatory scheme would have only one regulator in charge of each type of product. While there is something to be said for regulatory logic and unity of control, that is simply not the world in which we live. Our regulatory structure is a chaotic mess that is the result of historical evolution (or accidents) and is not the product of design oversight. Here are a few examples:

- We have a dual federal/state registration system for banks, in which banks may select a federal or a state charter
- Broker-dealers are dually regulated by federal and state authorities, but FCMs are only regulated by federal authorities and insurance companies only by state authorities, except that variable annuity insurance products may be regulated by both federal and state authorities
- Security futures are regulated by both the SEC and the CFTC;
- Swaps on single securities are regulated by the SEC except that swaps on government securities are regulated by the CFTC
- Forwards on securities that physically settle are regulated by the SEC as securities, but if they cash settle they are regulated as security-based swaps, but if it is not clear whether they will physically settle or cash settle, then you just have to decide for yourself
- Swaps on securities in which there is also an embedded currency swap are regulated by both the SEC and the CFTC
- One could easily go one with the lack of straight lines in our regulatory structure.

VII. Conclusion

Returning to our analogy, ultimately, it does not matter so much whether digital assets are fruits or vegetables within the jurisdiction of the SEC or the CFTC. It is more important that quarrels over jurisdiction do not derail the development and implementation of a reasonable regulatory scheme.

As to the job of developing a workable regulatory scheme, either regulator may accomplish it. If we allow each regulator the freedom to devise a workable regulatory scheme, there is some greater chance that at least one of them will succeed.[49] Best case, both.

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[49] Notably, SEC Chair Gensler has stated that he favors regulation that he believes will increase competition in the securities markets. *See* Speech by SEC Chair Gensler, **Competition and the Two SECs** (Oct. 4, 2022). If competition is good for regulated firms and for athletes, there is no reason why it should not provide benefits to regulators as well.

Author:

Author

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Contact:

New York

Steven Lofchie	+1.212.859.6700	steven.lofchie@friedfrank.com