PolicyPartner

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Look Ahead Calendar - PolicyPartner

- Takeaways from OCC Symposium on Tokenization
- Crypto legislation is back in focus, but challenges remain
- Treasury: 2024 National Risk Assessment for ML/TF
- SEC adopts the "dealer rule" - risks to digital asset space remain unchanged
- State legislation picks up
- International regulations update

Takeaways from OCC Symposium on Tokenization

Discussions are focused on the updates to state-level commercial code. 11 states have adopted the UCC, which will provide greater legal certainty for tokenized assets in private law. A key problem with tokenization panelists have explored is the difference between the transfer of property rights vs the entering of two parties into a contractual arrangement. Property rights are much stronger legal structure, and contractual claims are easily broken. **Updates to the UCC should enable property rights to be activated in more types of tokenization structures.**

Full notes will be available following the event. If you are in attendance - come say hello!

Crypto legislation is back in focus, but challenges remain

As exhibited in Treasury Secretary Yellen's testimony and Q&A before the FSOC hearing, Treasury and House Republicans are in agreement on the need for congress to fill market structure and stablecoin regulatory gaps. The existence of regulatory gaps is not controversial.

In her remarks, Yellen stated that "Congress should pass legislation to provide for the regulation of stablecoins and of the spot market for crypto-assets that are not securities."

Key points made by Secretary Yellen:

- CFTC's role in regulating digital asset commodities should be formalized.
- Stablecoins could potentially become significant in the future and pose risks to the financial system and need to be regulated.
- FSOC believes that there needs to be a "federal floor" in the framework for stablecoins that would apply to all states.
- The Treasury has some concerns about the SEC's custody rule and how it would impact banks.

In response to Yellen's testimony, members of both the HFSC and Ag committee (Patrick McHenry, Glenn Thompson, French Hill, Dusty Johnson) issued a letter on the FSOC's role in coordination of communication between the SEC and CFTC to advance the crypto market structure effort.

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Meanwhile, on February 7 in an interview to Politico, Maxine Waters said that the lawmakers are "very close to reaching an agreement on a stablecoin bill". If the House Republicans can get Maxine Waters on board with their stablecoin bill, the chances of comprehensive legislation rise significantly.

Both the House Financial Services and the Senate Banking committees have engaged with both Treasury and the CFTC on market structure and consumer protections (see Sherrod Brown's letter to Yellen). We believe committee staff are in the midst of a push both market structure and stablecoins in the short window before the election.

It is worth revisiting the leading bills in market structure and stablecoins:

FIT 21 Act (Summary):

- Formalizes SEC and CFTC jurisdiction over crypto assets. SEC is given authority over digital assets offered through an investment contract, while CFTC would have authority over digital commodity markets.
- Outlines registration pathways for intermediaries to register with federal regulators.
- Introduces a definition of "Digital Commodity": digital assets where the SEC has certified the blockchain system is decentralized.
- Excludes payment stablecoins from definition of security.

Clarity for Payment Stablecoins Act (Summary):

- Creates a non-bank/state pathway to issuance of stablecoins through a licensing regime.
- Formalizes guidelines to liquidity, asset backing, interoperability and other standards for stablecoin issuers.
- Creates mechanisms for banks to engage in stablecoin issuance.
- Outlines the roles of the Fed, and federal regulators in licensing and supervising stablecoin issuers.
- Prohibits issuance of algorithmic stablecoins for a period of two years until the framework is established.

Since Yellen commented on the establishment of the federal floor, it is likely that the roles of the Fed, FinCen, SEC and CFTC in both of the bills will remain the biggest points of contention.

The current House of Representatives has passed 20 financial services related bills. In stark contrast, the 118th Senate has passed a total of 21 bills compared to the House grand total of 360. The Senate simply doesn't do very much and when it does, actions are non-controversial measures or items that absolutely must pass. Even if the Republicans and Democrats can reach an agreement on the legislation, getting through the Senate would be no easy task requiring support from Senate Democrats like Elizabeth Warren and Sherrod Brown.

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PolicyPartner's conversations with non-financial focused staff in Democratic leadership indicate digital assets are not a key focus and nor are outstanding regulatory gaps.

RSVP for our call with House Financial Service Committee senior staff this Friday here.

Treasury: 2024 National Risk Assessment for ML/TF

On February 7, 2024, Treasury published three reports on money laundering, terrorist financing and proliferation financing. Discussions of additional AML legislation and regulation are front and center in Washington, examples of the use of digital assets and wallets from these reports will contribute heavily to the discussion.

While the focus is not new, this report highlights issues with FinCen registered money services businesses that do not have adequate compliance programs and/or violate sanctions. Failure to register is also cited as a prevalent issue. **PolicyPartner expects additional enforcement in the category over the next 12 months.**

The report on money laundering includes several sections on cryptocurrencies, as well as a "special focus" section on DeFi. The section on DeFi cites companies exploiting regulatory gaps in AML/CFT regimes - specifically companies that can be considered financial institutions and should be covered by the BSA fail to comply with their AML/CFT obligations.

Besides DeFi the report also states that many VASPs showed inconsistent compliance with both domestic AML obligations and international obligations, citing activities like mixing and "chain hopping" and disintermediation as key methods of evasion of regulations.

While the reports are largely informative and do not provide recommendation, the Treasury states that the reports will fuel the will inform the coming "2024 National Illicit Finance Strategy" that will provide the roadmap to address the vulnerabilities of the US financial system. The strategy document is likely to come in Q2 2024.

SEC adopts the "dealer rule" - risks to digital asset space remain unchanged

On February 6, 2024 the adopted a long pending rule to expand the definition of a "dealer" to include firms engaging in dealer like trading. While the rule will directly impact hedge funds and high frequency trading firms, digital asset advocates have called foul on the presume impact on Automated Market Makers and Liquidity Pools.

While this could open the potential for enforcement action in the digital asset space, we do not view the rule as a new area of policy for the SEC. Current SEC policy is very clear that businesses or technology that deal in securities, are within the SEC remit. The presence of the security is the primary variable and the subject of much debate.

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The SEC brought action in December the Commission reached a deal with Barnbridge DAO case, which resulted in LPs being categorized as unregistered investment companies. While the private settlement does not carry precedential value, it surely reflects SEC stance that DeFi products (regardless of being offered by a DAO or not) should be regulated entities under securities laws. With the potential of the rule to include in AMMs, we could see increased enforcement of the SEC in the DeFi space.

The rule faced criticism from both the digital assets industry and the Republican commissioners with Hester Pierce stating that the rule interferes with traditional market dynamics and could loop in companies engaged in trading into the regulatory environment of dealers, as well as criticized the breadth of the rule. Bloomberg columnist Matt Levine has a great write up on the grasping reasoning behind the final rule. The rule will come into force 60 days after it is published in the Federal Register.

State legislation picks up

- 11 states have enacted the updates to the Uniform Commercial Code (UCC) to include tokenized assets or similar
- Hawaii banking regulator issues findings from the state's innovation lab stating that
    - "the findings indicate that digital currency companies will no longer require a Hawaiʻi-issued money transmitter license to conduct business within the state. The companies will be able to continue transaction activity as an unregulated business."
- Virginia establishes crypto working group to develop recommendations for the digital assets industry. The working group is set to provide an executive summary and a report of the work group's findings and recommendations by November, 2024.
- In Florida, a bill (SB 914) was introduced to provide clarity for state-chartered banks and trustCos that want to participate in services like custody, stablecoin issuance and exchange of crypto. The proposed legislation closely mimics the federal legislation in the House.
- Tennesee, Nebraska, and Indiana introduce simple blockchain bills related to bitcoin mining and transactions.

Global items:

- EU:
    - ESMA 2024 planned consultation papers primer
    - AMLA and AMLD6 to be adopted early 2024
- UK:
    - BOE moves stablecoin comment deadline to Feb. 6
    - FCA publishes note on MEV and Oracles
- South Korean FSC proposed new rule on Feb 5 to require new executives of crypto companies to get regulator's approval as part of a broader effort to increase consumer protections.

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- Hong Kong Monetary Authority publishes 2024 priorities - include promotion of fintech.
- Financial Stability Board (FSB) published its 2024 Work Programme. Agenda includes:
    - Crypto assets implementation plan
    - Work on stablecoins in Emerging markets
    - Analysis of financial stability implications of tokenization
- BIS Innovation Hub 2024 Work Programme includes several tokenization and CBDC projects