

## **Alert** | Blockchain & Digital Assets



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### **The Responsible Financial Innovation Act: A Comprehensive Proposal to Regulate Digital Assets**

On June 7, 2022, U.S. Sens. Cynthia Lummis (R-WY) and Kirsten Gillibrand (D-NY) introduced the [Lummis-Gillibrand Responsible Financial Innovation Act](#) (RFIA), a bill that would create the first comprehensive regulatory framework of digital assets in the United States.

The 69-page bipartisan proposal—which consists of eight titles and 54 sections—covers a myriad of issues related to taxes, securities, commodities, consumer protection, payments and stablecoins, banking laws, interagency coordination, and further agency research.

According to Sen. Gillibrand’s [statement](#), the RFIA’s objective is to “generate more flexibility, innovation, consumer protections, and transparency while providing more certainty and clarity to the growing digital assets industry.” In a [statement](#) announcing the proposed RFIA, Sen. Lummis similarly described the bill as “a bipartisan framework” that would create “regulatory clarity for agencies charged with supervising digital asset markets, provide[] a strong, tailored regulatory framework for stablecoins, and integrate[] digital assets into our existing tax and banking laws.”

This GT Alert provides a summary of the RFIA’s key provisions.

**Title I – Definitions.** The absence of universally accepted definitions is a common obstacle in the digital asset sphere. The RFIA would address this issue by creating definitions for key industry terms, including:

- **“digital asset”** – (a) a natively electronic asset that (i) confers economic, proprietary, or access rights or powers and (ii) is recorded using cryptographically secured distributed ledger technology, or any similar analogue; and (b) includes (i) virtual currency and ancillary assets, (ii) payment stablecoins, and (iii) other securities and commodities.
- **“digital asset intermediary”** – (a) a person who holds a license, registration, or other similar authorization that may conduct market activities relating to digital assets, or a person who is required by law to hold such a license, registration or other similar authorization; and (b) includes a person who holds a license, registration, or other similar authorization under state or federal law that issues a payment stablecoin, or a person who is required by law to hold such a license, registration or other similar authorization; and (c) does not include a depository institution.
- **“distributed ledger technology”** – technology that enables the operation and use of a ledger that: (a) is shared across a set of distributed nodes that participate in a network and store a complete or partial replica of the ledger; (b) is synchronized between the nodes; (c) has data appended to the ledger by following the specified consensus mechanism of the ledger; (d) may be accessible to anyone or restricted to a subset of participants; and (e) may require participants to have authorizations to perform certain actions or require no authorization.
- **“payment stablecoin”** – a digital asset that is: (a) redeemable, on demand, on a one-to-one basis for instruments denominated in U.S. dollars and defined as legal tender or for instruments defined as legal tender under the laws of a foreign country (excluding digital assets defined as legal tender under the laws of a foreign country); (b) issued by a business entity; (c) accompanied by a statement from the issuer that the asset is redeemable from the issuer or another person; (d) backed by one or more financial assets (excluding other digital assets); and (e) intended to be used as a medium of exchange.
- **“smart contract”** – (a) (i) computer code deployed to a distributed ledger technology network that executes an instruction based on the occurrence or nonoccurrence of specified conditions; or (ii) any similar analogue; and (b) may include taking possession or control of a digital asset and transferring the asset or issuing executable instructions for these actions.
- **“virtual currency”** – (a) a digital asset that: (i) is used primarily as a medium of exchange, unit of account, store of value, or any combination of such functions; (ii) is not legal tender; and (iii) does not derive value from or is backed by an underlying financial asset (except other digital assets); and (b) includes a digital asset that is accompanied by a statement from the issuer that a denominated or pegged value will be maintained and be available upon redemption from the issuer or other identified person, based solely on a smart contract.

**Title II – Taxation of Digital Assets.** The RFIA would provide crypto holders with small-scale tax benefits and clarify certain aspects of the federal income tax treatment of digital assets. Under the RFIA:

- Trading Safe Harbor for Non-US Persons (Sec. 203) – safe harbors that apply to non-U.S. persons who use a U.S. institution for securities and commodities trading activity would, under certain conditions, extend to digital asset trading.
- Decentralized Autonomous Organizations (Sec. 204) – decentralized autonomous organizations (DAOs)<sup>1</sup> would be considered business entities for purposes of the tax code and would need to be properly incorporated or organized under the laws of a jurisdiction.

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<sup>1</sup> A “DAO” is generally defined as an internet-native, blockchain-based organization or business that is collectively governed by a network of decentralized nodes, typically using native tokens or smart contracts.

- Digital Asset Lending Agreements (Sec. 205) – digital asset lending transactions would not typically be taxable events, much like lending transactions related to securities.
- Digital Asset Mining and Staking (Sec. 208) – digital assets obtained through mining or staking activities would not be counted towards gross income until the “disposition” of those assets.

**Title III – Securities Innovation.** One of the RFIA’s most significant features is that it would consider most digital currencies to be commodities, not securities. Such commodity-like currencies include the well-known bitcoin and ether. These, and similar currencies, would be regulated by the Commodity Futures Trading Commission (CFTC) rather than the Securities and Exchange Commission (SEC). The bill would vest the CFTC with “exclusive jurisdiction” over such assets, although it would preserve certain SEC reporting requirements.

The RFIA proposes a clear standard to determine when digital assets would be considered commodities and when they would be considered securities. An intangible and fungible asset issued under an investment contract (as defined by existing securities law) would qualify as an “ancillary asset” where the asset does **not** give the holder any of the following rights in a specific entity:

- debt or equity interests;
- liquidation rights;
- a right to an interest or dividend payment;
- a profit or revenue share (derived solely from managerial efforts of others); or
- any other financial interests in the business.

According to Lummis and Gillibrand’s [overview of the RFIA](#), an “ancillary asset” would not need to be fully decentralized and could benefit from managerial efforts that determine its value, but would still not be considered a security because it fails to give its holder the requisite financial interests in a particular business entity.

Moreover, under the RFIA, issuers of ancillary assets would also need to comply with certain disclosure requirements set forth by the SEC so that such ancillary assets are presumed to be a commodity. These disclosure requirements would include a lengthy and tailored set of semi-annual disclosures, including basic corporate information regarding the issuer and information relating to the ancillary asset.

However, once an ancillary asset rises to a specified level of decentralization, defined, among other things, by minimal managerial or entrepreneurial efforts, an issuer would likely escape the SEC reporting requirements while retaining its status as a commodity.

The RFIA also would outline how to fulfill the SEC custody requirements to maintain a satisfactory control location with respect to digital assets that are securities, and it would direct the SEC to finish modernizing the Custody Rule and Customer Protection Rule.

**Title IV – Responsible Commodities Innovation.** Because the RFIA would generally designate “ancillary” digital assets as commodities, the CFTC would take on a larger market oversight role. As

indicated above, the CFTC would get exclusive jurisdiction over fungible digital assets that are not securities, including ancillary assets.<sup>2</sup>

However, the RFIA would effectively separate the ancillary asset (a commodity) from the underlying investment contract documenting the arrangement (a security). Thus, the SEC would still have jurisdiction over the arrangement that constitutes an investment contract even though it may be connected to a CFTC-regulated commodity.

Additionally, the bill would:

- outline the restrictions under which futures commission merchants can conduct trading activities and use a customer’s digital assets;
- provide a robust framework for digital asset exchanges to register with the CFTC and conduct trading activities;
- define registered digital asset exchanges as ‘financial institutions’ under the Bank Secrecy Act;
- afford digital assets similar treatment as commodities in bankruptcy and formulates other aspects of the treatment of digital assets in bankruptcy;
- determine that a payment stablecoin issued by a bank or credit union is neither a commodity nor a security; and
- enable the CFTC to impose a small user fee on digital asset exchanges to offset agency costs.

**Title V – Responsible Consumer Protection.** Further, the bill seeks to establish baseline consumer protection standards, which are mainly focused on disclosures. Thus, a provider of digital asset services would be required to provide customers with certain information, including:

- notice of “material source code version changes relating to digital assets,” prior to implementing the updates (with an exception for emergencies);
- whether and how customer digital assets are segregated from other customer assets;
- how the customer’s assets would be treated in bankruptcy or insolvency, and the risks of loss;
- how long and in what manner the provider must return the customer’s digital assets upon request;
- applicable fees; and
- the provider’s dispute resolution process.

Significantly, the provider would be required to “require” a customer to acknowledge receipt of the above disclosures. The RFIA would provide further, stringent disclosure, and some substantive, requirements with respect to “any lending arrangements relating to digital assets,” along with the provider’s policies relative to rehypothecation of digital assets.

Digital asset service providers and customers would also need to agree on terms of settlement finality for all transactions, and certain providers would be subject to higher disclosure standards.

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<sup>2</sup> The CFTC’s jurisdiction, however, would not extend to “digital collectibles and other unique digital assets,” which are non-fungible, blockchain-based digital assets where proof-of-ownership is often served by an underlying non-fungible token (an NFT).

**Title VI – Responsible Payment Innovation.** In the wake of the high-profile crash of several stablecoins<sup>3</sup> – which are cryptocurrencies pegged to the U.S. dollar – the bill seeks to tackle some key issues surrounding the regulation of this particular type of digital asset. Specifically, the RFIA would:

- require issuers to maintain “high-quality liquid assets” worth 100% of all outstanding stablecoins;
- impose monthly disclosure requirements to describe the assets backing the stablecoins and their value;
- require issuers to have the ability to redeem any outstanding stablecoins at par value;
- institute a detailed procedure for banks and credit unions to issue their own stablecoins;
- create tailored holding company supervision for banks and credit unions exclusively engaged in issuing stablecoins; and
- establish an “Innovation Laboratory” within FinCEN to study developments in financial technology, organize pilot projects and engage in dialogue with financial companies, and make legislative recommendations in order to maximize the supervision of financial technology.

The bill would also direct an interagency team led by the Office of Management and Budget to develop standards surrounding the use of China’s official digital currency on U.S. government devices, and it would empower the Office of the Comptroller of Currency to charter a National Bank Association for the purpose of issuing a stablecoin.

**Title VII – Responsible Banking Innovation.** Under the RFIA, the Board of Governors of the Federal Reserve (FRB) would conduct a study discussing how distributed ledger technology can reduce risks for depository institutions, and the FRB would also be responsible for issuing routing transit numbers to depository institutions.

The RFIA includes a provision which would guarantee that any depository institution with a state charter, regardless of whether it is federally insured or supervised, is eligible for an account at a Federal Reserve bank.<sup>4</sup> The bill’s introduction coincides with litigation filed the same day in Sen. Lummis’ home state raising claims related to the Federal Reserve’s (the Fed) processing of master account applications for entities with Wyoming Special Purpose Depository Institution (SPDI) Bank Charters. The suit alleges the Fed has engaged in unlawful delays.

The bill also would clarify that federal banking agencies would need to adhere to the prevailing one-year review period to decide on pending applications submitted under the Riegle Community Development and Regulatory Improvement Act of 1994, prohibiting them from delaying such applications by demanding additional information.

The RFIA would prohibit federal banking agencies from using reputation risk in rating a depository institution or in discouraging a depository institution from entering a particular banking relationship. The federal banking agencies would instead need to provide adequate justifications for terminating a specific customer account. In addition, the bill would be the first federal law to codify principles relating to asset custody of depository institutions.

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<sup>3</sup> Referred to as “payment stablecoins” in the RFIA, “stablecoins” are generally defined as cryptocurrencies with a value that is tied to another currency, commodity, or financial instrument in order to reduce volatility.

<sup>4</sup> The Federal Reserve banks would also need to offer to depository institutions payment, clearing and settlement services, as well as a segregated balance account.

**Title VIII – Responsible Interagency Coordination.** While federal agencies would be called to action throughout the bill, the last title of the RFIA deals directly with federal administrative guidance and coordination among the agencies. The bill would require, among other things:

- federal financial regulators to provide customized interpretive guidance within six months of a request;
- the Federal Energy Regulatory Commission, along with the CFTC and SEC, to analyze the energy consumption in the digital asset market;
- the CFTC and the SEC to study self-regulation in the digital asset markets and advance a proposal for the establishment of registered digital asset associations; and
- the CFTC and the SEC to develop cybersecurity guidance for digital asset intermediaries, on topics such as security operations, risk identification and reduction, and money laundering.

Additionally, if a financial company is already operating in a state financial technology sandbox,<sup>5</sup> they would be allowed to do business across state lines after obtaining approvals from the proper regulators. The RFIA would also draw on the approach of the SAFE Mortgage Licensing Act of 2008, requiring state bank supervisors to adopt standards ensuring the uniform treatment of digital assets under money transmission laws.

The bill would also create an Advisory Committee on Financial Innovation. This new Committee would be made up of members of the financial technology industry, experts in various fields, SEC and CFTC commissioners, an FRB member, and a state regulator, and would be tasked with studying and reporting on the growing digital asset markets in order to meet evolving industry and regulatory needs.

## Conclusion

Whether the bill will ultimately pass the Senate and House and be enacted into law is unclear. Other bipartisan proposals are possible in the near-term, including one being developed by Senate Agriculture, Nutrition and Forestry Committee Chairwoman Debbie Stabenow (D-MI) and Ranking Member John Boozman (R-AR). That committee has jurisdiction over the CFTC. In addition, the Biden administration issued an [Executive Order](#) in March requiring various agencies to produce reports relating to cryptocurrency regulation by September and October. These reports will include legislative recommendations and are expected to have significant impact in Congress. Even if the RFIA is not adopted, however, it may inform the contours of discussion and debate about the contours of appropriate crypto regulation into the future.

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<sup>5</sup> The term “sandbox” refers to a set of rules that creates a limited space where participating businesses can test innovative products or services without being subject to certain regulatory requirements that they would otherwise be subject to.



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