



# A PROPOSAL FOR OVERSIGHT OF DIGITAL ASSET SPOT MARKETS IN THE U.S.



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Recent turmoil in the digital asset market has renewed calls for greater oversight of the sector. Unfortunately, the uncertain legal status of digital assets in the U.S. complicates efforts to more vigorously regulate them. The Commodity Futures Trading Commission (“CFTC”) has classified Bitcoin and Ether – and by extension other cryptocurrencies that are similarly structured – as commodities (courts have also upheld this classification). While the CFTC regulates commodity derivatives, they do not regulate commodity spot markets, although they do have enforcement authority for fraud and manipulation in commodity spot markets. The practical effect of this structure is that cryptocurrency exchanges in the U.S. are not regulated at the federal level (they are required to register with the Financial Crimes Enforcement Network and obtain state money transmitter licenses). This article explores potential options for addressing the gap in digital asset spot market regulation and recommends that Congress grant the Securities Exchange Commission exclusive authority over all facets of the digital asset market, from spot to derivatives, by creating a special definition of security under the securities laws that would incorporate digital assets.

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# 01

## INTRODUCTION

Recent turmoil in the digital asset market has renewed calls for greater oversight of the sector.<sup>2</sup> The good news is that the digital asset selloff has not – thus far – spilled into the traditional financial sector. The absence of contagion should only reinforce the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation’s policy of requiring supervised banking institutions to request, and receive, approval before engaging in activities involving or relating to digital assets.<sup>3</sup> The bad news is that digital asset markets are not static, and what is true today will almost certainly not be true a year from now.

Unfortunately, the uncertain legal status of digital assets complicates efforts to more vigorously regulate them. The Commodity Futures Trading Commission (“CFTC”) has classified Bitcoin and Ether – and by extension other cryptocurrencies that are similarly structured – as commodities (courts have also upheld this classification). While the CFTC regulates commodity derivatives, they do not regulate commodity spot markets, although they do have enforcement authority for fraud and manipulation in commodity spot markets. The practical effect of this structure is that cryptocurrency exchanges in the U.S. are not regulated at the federal level (they are required to register with the Financial Crimes Enforcement Network (“FinCEN”) and obtain state money transmitter licenses). This fact recently came into stark relief when the largest cryptocurrency exchange in the U.S., Coinbase, acknowledged in an SEC filing that in the event they file for bankruptcy, crypto assets they hold in custody on behalf of customers “could be subject to bankruptcy proceedings, and such customers could be treated as our general unsecured creditors.”<sup>4</sup> In contrast, the Se-

curities Investors Protection Corporation (“SIPC”) “protects against the loss of cash and securities – such as stocks and bonds – held by a customer at a financially-troubled SIPC-member brokerage firm” up to \$500,000.<sup>5</sup>

This gap in digital asset spot market regulation, and the need to address it, has been acknowledged by Securities and Exchange Commission (“SEC”) Chair Gensler,<sup>6</sup> CFTC Chair Behnam,<sup>7</sup> the digital asset industry, and members of Congress. The threshold question however, is which agency should be given oversight of digital asset spot markets, and what should be the extent of their authority? Here, there are no shortage of proposals, however, a consensus has yet to emerge.

# 02

## KEY PRINCIPLES

It is important to have clearly defined principles when developing and assessing regulatory proposals. In short: What are the policy objectives a comprehensive digital assets regulatory bill should achieve? The Executive Order on digital assets offers six objectives that serve as a natural starting point: protect consumers, investors, and businesses; protect United States and global financial stability and mitigate systemic risk; mitigate the illicit finance and national security risks; reinforce United States leadership in the global financial system and in technological and economic competitiveness; promote access to safe and affordable financial services; and support technological advances that promote responsible development and use of digital assets.<sup>8</sup> I consider each of these objectives in order of priority.

2 See Lily Jamali, *Crypto asset meltdown prompts calls for regulation*, Marketplace, May 13, 2022, <https://www.marketplace.org/2022/05/13/crypto-asset-meltdown-prompts-calls-for-regulation/>.

3 See *Notification of Engaging in Crypto-Related Activities*, Fed. Deposit Ins. Corp., Apr. 7, 2022, <https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html>; *Chief Counsel’s Interpretation Clarifying: (1) Authority of a Bank to Engage in Certain Cryptocurrency Activities; and (2) Authority of the OCC to Charter a National Trust Bank*, Off. of the Comptroller of the Currency, Nov. 18, 2021, <https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf>.

4 Paul Kiernan, *Coinbase Says Users’ Crypto Assets Lack Bankruptcy Protections*, Wall St. Journal, May 12, 2022, <https://www.wsj.com/articles/coinbase-says-users-crypto-assets-lack-bankruptcy-protections-11652294103>.

5 *What SIPC Protects*, SIPC, <https://www.sipc.org/for-investors/what-sipc-protects>, last visited May 17, 2022.

6 See Gary Gensler, *Remarks Before the Aspen Security Forum*, U.S. Sec. & Exch. Comm’n, Aug. 3, 2021, <https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03>.

7 See *Testimony of Chairman Rostin Behnam Regarding “Examining Digital Assets: Risks, Regulation, and Innovation,”* Commodity Futures Trading Comm’n, Feb. 09, 2022, <https://www.cftc.gov/PressRoom/SpeechesTestimony/opabeenam20>.

8 Executive Order on Ensuring Responsible Development of Digital Assets, Exec. Order No. 14067, 87 Fed. Reg. 14143, Mar. 14, 2022, <https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/>.

To accomplish these objectives, any comprehensive regulatory framework for digital assets must have the following features:

### **1. One dedicated regulatory agency with exclusive oversight over digital asset trading markets.**

The fact that some digital assets are commodities while others are securities has led to unnecessary confusion within the private and public sector. It has also prevented meaningful regulatory action to address clear consumer and investor abuse. For example, in a recent speech, SEC Chair Gensler noted that the trading venues the SEC currently oversees solely trade securities, but that some “crypto platforms currently list both crypto commodity tokens and crypto security tokens, including crypto tokens that are investment contracts and/or notes.”<sup>9</sup> Gensler goes on to note that SEC staff is working with the CFTC to address joint regulation of such platforms, but history suggests that this type of interagency collaboration does not yield meaningful results (interagency turf battles are far more common). The bifurcation of digital assets as commodities or securities has also contributed to strange outcomes in trading markets. For example, the CFTC permitted the listing of cryptocurrency futures contracts, and the SEC subsequently authorized an exchange-traded fund (“ETF”) tracking cryptocurrency futures, but the SEC has yet to authorize a spot cryptocurrency ETF. A spot cryptocurrency ETF and cash-settled cryptocurrency futures both provide exposure to cryptocurrency without requiring investors to ever take possession of cryptocurrency. The fact that we have one without the other makes little sense.

### **2. Recognition in federal law of digital assets as a new asset class.**

The confusion around whether a given digital asset is a commodity, security, or something else must be addressed if one agency is to have sole authority over digital asset markets. Gensler recently noted that “Congress painted with a broad brush the definition of a security” and that the Supreme Court’s 1946 *Howey* Test – saying an investment contract exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others – further clarified when an investment contract exists.<sup>10</sup> Were it not for the “efforts of others” prong of the *Howey* Test, the majority of digital assets would qualify as investment contracts.

The Commodity Exchange Act is more prescriptive in defining a commodity but the definition also includes “all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.” In essence, this means that the moment there is a derivative on an underlying asset, that asset is considered a commodity, unless it meets the definition of a security.

While a principles-based approach to securities regulation has served our capital markets – and the investors and issuers within them – well, digital assets do challenge definitional boundaries and contribute to legal gray areas. For example, can a token issued by a decentralized autonomous organization (“DAO”) be considered an investment contract if there truly is no central party, or parties, essential to the DAO’s performance? The only way to address this uncertainty is by statutorily recognizing and defining digital assets in federal law. Of course, most financial assets are digital these days, so the definition of digital assets must be precise enough to exclude existing securities, like stocks and bonds, yet broad enough to incorporate cryptocurrency as well as current and future cryptocurrency offshoots (DAOs, non-fungible tokens (“NFTs”), etc.). One potential definition is found in the Infrastructure Investment and Jobs Act: “‘digital asset’ means any digital representation of value which is recorded on a cryptographically secured distributed ledger...”<sup>11</sup>

### **3. The agency responsible for regulating digital assets must have broad rulemaking authority to address a rapidly evolving market.**

The digital asset market is constantly evolving, which is why Congress must not be overly prescriptive when drafting regulatory proposals. The rise of decentralized finance (“DeFi”), DAOs, stablecoins, and NFTs demonstrates the need for the principal regulatory agency to have the statutory authority to address the risks associated with the latest developments in the digital asset market.

## 03 PROPOSALS

With these objectives and features in mind, I now turn to considering, at a high level, several proposals for

<sup>9</sup> Gary Gensler, *Prepared Remarks of Gary Gensler On Crypto Markets*, Penn Law Capital Markets Association Annual Conference, U.S. Sec. & Exch. Comm’n, Apr. 4, 2022, <https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422>.

<sup>10</sup> *Id.*

<sup>11</sup> Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, 135 Stat. 429, <https://www.congress.gov/bill/117th-congress/house-bill/3684/text>.

regulating the digital asset market that have emerged recently.

### **1. Establish a self-regulatory organization (“SRO”) to establish and enforce standards of conduct.**

This is the preferred solution for many digital asset firms, including Coinbase.<sup>12</sup> While there is precedent in the financial sector for an SRO (FINRA, FICC, etc.), this model suffers from several challenges. As Professor Ryan Clements notes, these challenges include “classic economic problems like organizing ‘the commons’ and dealing with free-riders, as well as practical and legal considerations like ensuring [SRO] accountability, enforcing non-compliance penalties, facilitating government oversight, creating suitable member incentives to participate, and ensuring a high cost of expulsion.”<sup>13</sup> If an SRO is to be pursued, it would be better to assign FINRA the task of regulating digital asset trading rather than to create an entirely new SRO.

### **2. Give the CFTC authority to regulate digital asset spot markets.**

CFTC Chair Behnam recently argued for this during a Senate Agriculture Committee meeting,<sup>14</sup> and it makes intuitive sense, given the CFTC’s role in overseeing digital asset derivatives and the agency’s existing digital asset capacities. This solution has also been advocated by some digital asset firms and CEOs, including Sam Bankman Fried of FTX, because the CFTC has historically acted favorably towards digital assets – going back to the 2017 self-certification of bitcoin futures and the embrace of former CFTC Chair Giancarlo as “Crypto Dad.”<sup>15</sup> However, the CFTC does not have an investor protection mandate, which is one reason for its permissive approach to digital assets, and the agency is chronically underfunded. In addition, the CFTC has used its fraud and manipulation enforcement authority sparingly when it comes to digital assets. In short, the CFTC has been uncritical in its review of digital asset proposals and does not have the resources to sufficiently regulate digital asset spot markets. Furthermore, as noted by Behnam, digital assets are fundamentally different from other commodities in

that more retail investors invest in them and international markets affect them directly, to say nothing of the fact that commodities tend to be tangible.<sup>16</sup> For these reasons, the CFTC should not be given digital asset spot market authority.

### **3. A completely new digital assets regulatory agency.**

Many argue that digital assets are fundamentally new kinds of assets that do not fit neatly into established regulatory categories; therefore, a new regulatory agency is needed to focus exclusively on digital assets. I reject this argument due to the complexities, inefficiencies, and political challenges associated with establishing a new agency. It is also not needed. Markets and the instruments that trade in them have always evolved, and regulatory agencies typically adapt (sometimes with Congress’ help). Furthermore, a new agency could be captured by the digital assets industry in short order.

### **4. Carve out digital assets from the definition of commodity in the Commodity Exchange Act and recognize digital assets as securities under a special definition to the securities laws.**

This would give the SEC exclusive authority to regulate all aspects of the digital assets industry and is the preferred option, given the SEC’s statutory mission to protect investors and its long track record of capable expertise in regulating securities markets. The proposal would impose the same requirements on digital asset issuers and intermediaries as the current securities laws – principally the Securities Act of 1933, the Securities Exchange Act of 1934 (“34 Act”), and the Investment Company Act of 1940 – impose on the securities industry. And it would also unite under a single agency regulation of all aspects of the digital asset market: spot markets, initial coin offerings, derivatives, and investment funds (including ETFs).

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12 Faryar Shirzad, *Digital Asset Policy Proposal: Safeguarding America’s Financial Leadership*, The Coinbase Blog, Oct. 14, 2021, <https://blog.coinbase.com/digital-asset-policy-proposal-safeguarding-americas-financial-leadership-ce569c27d86c>.

13 Ryan Clements, *Can a Cryptocurrency self-regulatory organization work? Assessing its Promise and Likely Challenges*, The FinReg Blog, June 21, 2018, <https://sites.law.duke.edu/thefinregblog/2018/06/21/can-a-cryptocurrency-self-regulatory-organization-work-assessing-its-promise-and-likely-challenges/>.

14 See *Testimony of Chairman Rostin Behnam Regarding “Examining Digital Assets: Risks, Regulation, and Innovation,” supra note 7.*

15 See Robert Schmidt & Allyson Versprille, *Crypto Platforms Ask for Rules But Have a Favorite Watchdog*, Bloomberg, Mar. 31, 2022, <https://www.bloomberg.com/news/articles/2022-03-31/crypto-exchanges-want-say-in-rules-under-biden-administration>.

16 See Rostin Behnam, *Commodity Futures Trading Commission Respond to Letter on Digital Assets*, Senate Comm. on Agric., Nutrition, & Forestry, Feb. 8, 2022, <https://www.agriculture.senate.gov/imo/media/doc/2022%2002%2008%20Ag%20committees%20digital%20asset%20response%20letter.pdf>.

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## EXTENT OF AUTHORITY

The SEC simply has more expertise, more resources (although, to be clear, additional funding would be required), and more appetite for enforcement in the digital assets area than the CFTC does. It is worth noting that even former CFTC Chairman **Timothy Massad** agrees that the SEC should be given oversight over digital asset spot markets: “Despite my personal affection for the CFTC, the SEC may be better suited to the task because it is more focused on retail investors and cash markets.”<sup>17</sup> In authorizing legislation, Congress should make clear that the SEC is expected to implement rules around investor protection, disclosure, pre-trade and post-trade transparency, uniform settlement standards, data reporting, recording keeping, anti-money laundering/know your customer, conflicts of interest, trading practices, client custody, operational risk, governance, and net capital. It will then be up to the SEC to determine if existing rules governing the offering, distribution, and trading of securities are sufficient to cover the risks associated with digital assets or if new rules are needed. Bringing digital assets within the securities laws will also allow investors to avail themselves of Rule 10b-5 of the ‘34 Act, which provides an additional measure of investor protection by making it illegal for any person to defraud or deceive someone, including through the misrepresentation of material information, with respect to the sale or purchase of a security.<sup>18</sup>

# 05

## CONCLUSION

This proposal would address the primary gap in digital asset regulation by having Congress grant the SEC exclusive authority over all facets of the digital asset market, from spot to derivatives. It would do so by creating a special definition of security under the securities laws that would incorporate digital assets. Importantly, this proposal does not preclude Congress from regulating stablecoins, as the Supreme Court’s *Marine Bank v. Weaver* decision held that “deposits” are “securities” for purposes of the federal securities laws unless those deposits are accepted either by Federal Deposit Insurance Corporation (“FDIC”)-insured U.S. banks or by foreign banks that are governed by regulatory regimes providing comparable protections to their depositors.<sup>19</sup> Thus, as professor Arthur Wilmarth has noted, it is possible for stablecoins to be regulated as both “deposits” and “securities” unless Congress decides to bring stablecoins into the banking system and protect them with FDIC insurance.<sup>20</sup>

Should political realities make it untenable for the SEC to be given spot market authority, then the next best option would be to give the CFTC oversight over digital asset spot markets. Indeed, there appears to be growing bipartisan momentum for this approach. At the end of April, four members of the U.S. House of Representatives (two Democrats and two Republicans) introduced the Digital Commodity Exchange Act of 2022 (“DCEA”).<sup>21</sup> The bill introduces a new term, “digital commodity,” to the Commodity Exchange Act, and defines it as: “any form of fungible intangible personal property that can be exclusively possessed and transferred person to person without necessary reliance on an intermediary.”<sup>22</sup> Digital commodity trading venues would then be subject to federal registration and regulation by the CFTC as an alternative to multistate transmitter licenses.

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17 Timothy G. Massad, *It’s Time to Strengthen the Regulation of Crypto-Assets*, The Brookings Institution, Mar. 2019, <https://www.brookings.edu/wp-content/uploads/2019/03/Economis-Studies-Timothy-Massad-Cryptocurrency-Paper.pdf>.

18 17 C.F.R. § 240.10b-5 (1951), <https://www.law.cornell.edu/cfr/text/17/240.10b-5>.

19 *Marine Bank v. Weaver*, 455 U.S. 551, 551-52 (1982).

20 Arthur E. Wilmarth, *It’s Time to Regulate Stablecoins as Deposits and Require Their Issuers to Be FDIC-Insured Banks*, 41 Banking & Financial Services Policy Report No. 2 (Feb. 2022), at 1-20, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4000795](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4000795).

21 Digital Commodity Exchange Act of 2022, H.R. 7614, 117 the Cong. (2022), [https://republicans-agriculture.house.gov/uploadedfiles/digital\\_commodity\\_exchange\\_act\\_of\\_2022.pdf](https://republicans-agriculture.house.gov/uploadedfiles/digital_commodity_exchange_act_of_2022.pdf).

22 *Id.*

In addition to spot market regulation, a comprehensive digital asset regulatory bill would address issues around tax, national security, state jurisdiction, and stablecoins. The latter is particularly salient given the recent collapse in the algorithmic stablecoin, TerraUSD.<sup>23</sup> But time is of the essence, and the digital asset market will continue to evolve with remarkable speed and in unexpected ways. Congress should act quickly to close the regulatory gap in digital asset spot markets and provide the SEC with the tools it needs to protect investors. ■

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“*The DGA-draft is intended to represent a first approach to the creation of an EU single market for data*”

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<sup>23</sup> See Marco Quiroz-Gutierrez & Taylor Locke, *A ‘stable’ coin lost its peg over the weekend and pledged \$1.5 billion in Bitcoin trying to stabilize. Here’s how the algorithmic stablecoin was supposed to work—and didn’t*, Fortune, May 10, 2022, <https://fortune.com/2022/05/10/what-is-algorithmic-stablecoin-terrausd-bitcoin-crash/>.

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