

The FSOC On Crypto Assets

The Financial Stability Oversight Council released its *Report on Digital Assets Financial Stability Risks and Regulation* on October 3, 2022¹. The Report was prepared in accord with Section 6 of President Biden's Executive Order 14067 on "Ensuring Responsible Development of Digital Assets." It discusses financial risks posed by the assets, enforcement of regulations, regulatory gaps and future steps.

Risks: A key point in the Report is risk. It notes that crypto asset activity can present risks for the stability of the U.S. financial system. This may result, for example, from rapid growth in the area if it is not tied to appropriate regulation and enforcement.

There has been rapid growth in the area of crypto assets, according to the Report. At the same time there is significant interconnectedness. Participants in the crypto ecosystem have been exploring avenues of connection. In addition, trading platforms offer a significant potential for interconnecting the assets with traditional assets and trading platforms. Consumers have also added to crypto asset activities according to the Report. All of this can aid risk mitigation.

There are, however, crypto asset activities that have amplified instability. Those include:

1. A lack of risk controls to protect against runs and excessive leverage
2. Prices that are driven by speculation and often suffer rapid declines
3. Many crypto-asset firms or activities have sizable interconnections with others that have risky business profiles and opaque positions, and
4. Operational risks may arise from the concentration of key services or other vulnerabilities related to distributed ledger technology

The vulnerabilities are at least in part attributable to the choices made by market participants, issuers and platforms.

Enforcement: While crypto began with an "off the grid focus," many operating in the area are now more interested in regulation. Indeed, enforcement is key. Not infrequently

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crypto-assets are marketed and sold in violation of the securities laws because they are offered and sold without the benefit of registration. In other instances, the marketing may focus on assuring investors of safety through claims such as regulatory backing which in fact does not exist. Consumers may also be confused by what regulation actually governs crypto-assets.

Gaps: Another key point in the Report is regulatory gaps. There is no doubt that while the existing regulation covers large portions of the crypto-asset world, and at times there may be overlapping regulation, there are also gaps. Three examples illustrate the point:

1. Spot markets for crypto-assets that are not securities are subject to little regulation although, in some instances agencies such as the CFTC may have jurisdiction.
2. Frequently crypto-asset businesses do not have a consistent or comprehensive regulatory framework.
3. In some instances, crypto-asset trading platforms have proposed offering retail customers direct market access by vertically integrating services with intermediaries such as broker-dealers or FCMs.

Recommendations

The Report notes that large parts of the crypto-asset ecosystem are currently subject to regulation. The Counsel recommends that members take this into consideration and emphasize the importance of continued enforcement of the existing regulatory scheme.

The gaps must also be considered. These areas can be addressed, for example, by passing legislation that includes rulemaking authority for federal financial regulators over the spot market for assets that are not securities. Steps can also be taken to address regulatory arbitrage including coordination, legislation regarding certain risks and through supervision. The Council, in addition, recommend bolstering members' capacities related to data, analysis, monitoring, supervision and regulation. *See also* Gary Gensler, Statement on Financial Stability Oversight Council's Report on Digital Asset Financial Stability Oversight Council Open Meeting, October 3, 2022².

Discussion

The Report provides a good overview of issues and risks tied to crypto assets. Perhaps the most interesting aspect of the report is its overall approach – it virtually assumes that future legislation will be a supplement to existing regulation. Under this approach the SEC and CFTC will continue to dominate the regulatory sphere. The SEC will likely continue to take the approach that much of the area is governed by the securities laws which would be consistent with the assumption of Chair Gensler that many of the assets are securities.

That regulation will be supplemented by the CFTC since the tokens are commodities and many of the trading platforms used by the tokens are governed by the agency. The tokens have long been viewed as commodities. *CFTC v. McDonnell*, Civil Action No. 18-cv-361 (E.D.N.Y. Opinion March 6, 2018). Trading of the tokens is governed by the agency since those venues self-certify trading, unlike the securities markets. The CFTC

does, however, closely monitor and control the trading. CFTC: Commodity Futures Trading Commission: Digital Primer (December 2020)³. Thus, regulation in the area is likely to continue to be governed largely by a combination of the securities laws and commodity statutes. Those regulations will, of course, be supplemented by other regulators such as FinCEN regarding money laundering and others as appropriate.

¹Available at <https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf>

²See also <https://www.sec.gov/news/speech/gensler-statement-fsoc-meeting-100322>

³Available at <https://www.cftc.gov/PressRoom/PressReleases/8336-20>