



# CRYPTO LOVE IS A BATTLEFIELD



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The battle over blockchain technology and digital assets bears a striking resemblance to the debate over the potential of the internet in the mid-1990s. Where critics see a passing fad with little actual utility or a lawless industry rife with fraud, many others believe a financial system supported by blockchain technology and digital assets, including virtual currencies such as Bitcoin, has significant potential to democratize and transform the very nature of the financial services industry and change how consumers, businesses and even governments interact with the financial system. Innovation in the financial services sector sparked by blockchain and digital assets, however, have caused U.S. federal and state regulators to devote more resources to better understanding this technology and the potential impact a digitized financial system could have on consumer protection, the “traditional” finance industry, and the overall safety and soundness of the financial system. As a result, regulators are taking steps to develop the tools and regulatory infrastructure to better ensure that innovation is being done responsibly.

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# 01

## INTRODUCTION

“We are young, heartache to heartache we stand, no promises, no demands, love is a battlefield.” (Benatar, P. 1983)

While many academics, lawmakers, regulators, bankers, technologists, and entrepreneurs profess to love blockchain technology, at times the relationship with blockchain looks like a battlefield. The “tug-of-war that is likely to evolve between ... traditional methods of payment and blockchain-driven payment systems.”<sup>2</sup> The battle over blockchain technology and digital assets bears a striking resemblance to the debate over the potential of the internet in the mid-1990s.

If you believe certain critics of digital assets and blockchain technology, you might view this battleground as a bleak dystopian science fiction world of lawlessness, fraud, and get-rich-quick schemes. Supporters of blockchain technology and digital assets believe otherwise. One apparent supporter of blockchain technology is former Chair of the Federal Reserve System and current Treasury Secretary, Janet Yellen, who has noted:

*It makes sense for central banks to be looking at [central bank digital currencies] ... We do have a problem with financial inclusion. Too many Americans really don't have access to easy payment systems and to banking accounts, and I think this is something that a digital dollar – a central bank digital currency – could help with. I think it could result in faster, safer and cheaper payments.<sup>3</sup>*

Supporters of blockchain technology and digital assets agree with Secretary Yellen and believe the technology has the potential to democratize finance and promote financial inclusion. They believe the technology has the potential to transform the very nature of the financial services industry. The ability to represent assets on a digital system and execute transactions using distributed ledger technologies has the potential to fundamentally change how consumers and businesses interact with money, trade on markets, and manage wealth and assets.

The digitization of assets is powered by distributed ledger technology or blockchain technology. Existing assets such as securities, real estate, or commodities can be recorded

on a blockchain to enable the settlement of transactions directly against fiat currencies and other digital assets or to power alternative payment systems. In doing so, digital assets have lowered transaction costs by removing the need for centralized intermediaries, improving transaction transparency, reducing counterparty risk, and speeding up settlement of transactions.

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Proponents of a financial system supported by digital assets, including virtual currencies such as Bitcoin, recognize the significant potential of blockchain technology to promote financial inclusion by creating more liquid markets, enabling larger segments of the population to execute transactions, and offering the means to store value without the need of an intermediary or central authority. To meet the growing interest and use of digital assets, industries have emerged to create alternative electronic payment rails to facilitate the movement of digital assets and the settlement of transactions involving such assets, to establish digital asset exchanges that mirror traditional equity exchanges, and to develop new technologies that rely on digital assets. These innovations have caused U.S. federal and state regulators to devote resources to better understanding this technology and the potential impact a digitized financial system could have on consumer protection and the safety and soundness of the financial system, generally.

The past year has been pivotal with respect to the evolving legal treatment of digital assets and virtual currencies in the United States. This article provides an overview of key U.S. regulatory developments that will have a significant impact on how blockchain technology and digital assets will affect the U.S. financial system.

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2 Goldman Sachs, “*Digital Assets: Beauty Is Not in the Eye of the Beholder*,” (June 2021).

3 .Sorkin, A. “*Reading Between the Lines: A Conversation with Janet Yellen*,” (NY Times Dealbook, Feb. 23, 2021).

# 02

## BACKGROUND

Despite the miscomprehension of critics of blockchain technology, digital assets and blockchain technology are not the same. Blockchain technology refers to a distributed ledger technology that distributes a list of all transactions across an entirely digital, peer-to-peer network. The idea of blockchain was introduced in 2008 as the technology powering Bitcoin — the most widely known open-source, digital asset. Today, various blockchains — for example, the Bitcoin, Ethereum, Corda, Hyperledger, Algorand, and Solana blockchains — are used to support all digital assets and provide an authoritative record of transactions.<sup>4</sup>

### A. Blockchain Technology

A blockchain is a database structure that can only be updated by appending a new set (or “block”) of valid transactions to the log of previous transactions (the “chain”).<sup>5</sup> As noted by Goldman Sachs in a note to clients:

In its most basic form, the blockchain records ownership of Bitcoin and transactions involving the crypto currency across a wide network of computers, as opposed to a centralized ledger. Transactions are signed off by the parties involved using the software, checked by the network or the “crowd,” then added to the blockchain — a long string of code that records all activity. Encryption in the software ensures these “blocks” cannot be tampered with or altered. And the decentralized nature means the “crowd” police the whole system. The software cuts out the need for a “trusted middleman” to sit in between parties in a transaction, such as a bank or clearinghouse. This makes transactions quicker, cheaper, and easier when compared to the current systems banks use.<sup>6</sup>

Many firms in the financial services industry believe blockchain technology can be adapted for use in traditional financial services transactions in a way that “has the potential to redefine transactions and the back office of a multitude of different industries. From banking and payments to ... trade settlement ... a distributed shared ledger has the potential to make interactions quicker, less-expensive and safer.”<sup>7</sup> For example, the adoption of blockchain technology among competing financial institutions would enable these same institutions to share a common digital representation of asset holdings and monitor the execution, clearing, and settlement of transactions outside of legacy, proprietary databases and, more importantly, without the need for a central database management system. Instead, blockchain technology would enable users, including financial institutions, to become peers in a shared database that users can rely on to record transfers of assets and to perform additional related activities involving multiple parties, such as trading, clearance, and settlement.

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### B. Digital Currencies

Digital currencies, or “virtual currencies,” refer to monetary units of exchange stored or represented in a digital or other electronic format that operate like currency but does not have all the attributes of “real” currency, including legal tender status.<sup>8</sup> Digital currencies can be created by an individual, corporation, organization, or can arise from use and acceptance by people as currency.<sup>9</sup> Traditional currencies are generally either backed by the faith and credit of the national governments that recognize the currency (the fiat system) or by real assets or hard commodities, such as

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<sup>4</sup> Levin, R. “*Blockchain & Cryptocurrency Laws and Regulation 2020*,” (Global Legal Insights, 2020).

<sup>5</sup> Pinna, A. & W. Ruttenberg. “*Distributed Ledger Technologies in Securities Post-Trading*,” (European Central Bank, April 2016).

<sup>6</sup> Goldman Sachs. “*What if I Told You...*,” (Dec. 2, 2015).

<sup>7</sup> *Id.*

<sup>8</sup> FinCEN Guidance. FIN-2019-G0001: “*Application of FinCEN’s Regulations to Certain Business Models Involving Convertible Virtual Currencies*,” (U.S. Department of the Treasury, May 9, 2019) (“FinCEN 2019 Guidance”).

<sup>9</sup> Turpin, J., *Bitcoin: the economic case for a global, virtual currency operating in an unexplored legal framework*. Ind. J. Global Legal Stud. 21 (1), 335–368 (2014).

gold, silver, or minerals (the commodity system). Generally, U.S. regulators consider the acceptance and transmission of digital currencies as being subject to Bank Secrecy Act and Anti-Money Laundering regulations, among others, regardless of whether the digital currency is represented by a physical or digital token, whether the ledger is centralized or distributed, or the type of technology is utilized for the transmission of value.<sup>10</sup>

### C. Digital Assets

The U.S. Securities and Exchange Commission (“SEC”) has defined digital assets as “an asset that is issued and transferred using distributed ledger or blockchain technology.”<sup>11</sup> Digital assets include, but are not limited to, digital currencies, coins, tokens, stablecoins, and non-fungible tokens (“NFTs”). A digital asset may in certain instances be deemed a security under the federal securities laws. While not defined in the securities laws, the SEC often refers to digital assets that are securities as “digital asset securities.”<sup>12</sup>

### D. Wallets and Keys

Digital assets are stored by associating them with addresses called “wallets,” which can be stored on web servers’ local hardware such as personal computers, jump drives, and mobile devices, or on paper printouts. A digital asset wallet takes the form of a cryptographic public key, which is a string of numbers and letters. Each public key has a matching “private key,” known only to the user. Control of the private key is what assures one control of the digital assets at any address, so collections of private keys must be protected by passwords or other means of securing them. To the extent entities are hosting digital wallets, specifically “hot” wallets that exist online in the entities’ cloud platform, concerns exist as to whether the entity would be operating as a money transmitter and, therefore, require licensure to support its custodial digital wallet.

# 03

## DIGITAL ASSETS AND THE BANKING SYSTEM

Financial regulators in the United States have long focused on ensuring the safety and soundness of financial institutions holding customer funds and securities. As consumers and investors alike have become increasingly interested in digital assets, U.S. regulators have faced the challenge of attempting to protect customer funds and securities using laws written in the 1930s, 1940s, and 1970s. Meanwhile, traditional financial institutions, such as banks, are scrambling to understand the risks and benefits of developing and implementing a new technology infrastructure that can safely incorporate the custody (and related acceptance, remittance, transfers, and lending) of digital assets onto the institution’s balance sheet while maintaining compliance with existing regulations.

### A. OCC Regulation of Digital Assets

In July 2020, the Office of the Comptroller of the Currency (“OCC”) issued an interpretive letter asserting national banks were permitted to provide cryptocurrency custody services on behalf of customers.<sup>13</sup> The OCC’s letter discussed the custody services provided by banks and concluded banks may provide “cryptocurrency custody services, including holding the unique cryptographic keys that permit the control and transfer of the customer’s cryptocurrency, is a modern form of these traditional bank activities.”<sup>14</sup> The OCC also affirmed the agency’s belief in its own power to “authorize national banks to perform, provide or deliver through electronic means and facilities any activities that they are otherwise authorized to perform.”<sup>15</sup>

In September 2020, the OCC reaffirmed its support of financial technology entities, particularly those entities conducting activities considered “core” activities of banking such as deposit-taking, lending and custody services, by confirming that national banks and federal savings asso-

<sup>10</sup> FinCEN 2019 Guidance.

<sup>11</sup> *Statement on Digital Asset Securities Issuance and Trading*, Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets, SEC (Nov. 16, 2018).

<sup>12</sup> *Id.*

<sup>13</sup> Office of the Comptroller of the Currency. Interpretive Letter #1170: Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers. United States Department of the Treasury, Washington, D.C. (July 22, 2020)..

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

ciations are permitted to take and hold fiat currency deposits to back stablecoins associated with hosted digital wallets.<sup>16</sup> In this letter, the OCC recognized that “some stablecoin issuers may desire to place the cash reserves backing their issued stablecoin with a national bank.”<sup>17</sup> Given the OCC’s prior guidance affirming the ability of national banks to “provide permissible banking services to any lawful business they choose,” the OCC concluded that not only are national banks permitted to receive deposits associated with a stablecoin issuance but also may engage in any activity incidental to receiving deposits from stablecoin issuers.<sup>18</sup>

Although the OCC appeared to support nationally-chartered banks providing core banking services involving digital currencies, the proliferation of digital assets and increasing interest in these assets across regulated financial institutions has caused the OCC to slow its adoption among banks. In November 2021, the OCC issued guidance clarifying banks’ authority to engage in certain digital currencies.<sup>19</sup> In this letter, the OCC imposed stricter guardrails for banks intending to provide the digital currency services described in OCC Interpretive Letters 1170, 1172, and 1174 (e.g. providing custody services, taking stablecoin-backing fiat deposits, and facilitating payment transactions on blockchain). Specifically, the OCC noted that banks needed to demonstrate, to the satisfaction of its supervisory office, that it had the necessary controls, policies and procedures in place to ensure these digital currency-related activities could be conducted in a safe and sound manner. To that end, the OCC requires nationally chartered banks to seek a “non-objection” letter from the OCC prior to providing any such services.<sup>20</sup>

## B. Federal Reserve Board

The OCC’s support of banks providing core banking ser-

vices to businesses issuing or heavily involved in cryptocurrencies has not been mirrored by the other U.S. federal bank regulators — the Federal Reserve Board (the “Fed”) and the Federal Deposit Insurance Corporation (“FDIC”). In May 2021, the Fed issued proposed guidelines for evaluating account and services requests (i.e. guidelines for granting “master account” access).<sup>21</sup> The “master account” is both a record of financial transactions that reflects the financial rights and obligations of an account holder and of the Reserve Bank with respect to each other, and the place where opening and closing balances are determined.<sup>22</sup> For each institution, all credits and debits resulting from the use of Fed services at any Fed office are booked to this single master account at one Reserve Bank.<sup>23</sup> The proposed guidelines intend to standardize criteria across the Fed System for granting access to a master account. Among the proposed changes, the authors believe that potential revisions to the scope of eligible entities that are permitted to apply for and obtain master account access are a direct reaction to the increasing number of “non-traditional” entities seeking master account access.

## C. Basel Committee

At the international level, the Basel Committee on Banking Supervision published a consultative paper inviting comment on the prudential treatment of digital asset exposures.<sup>24</sup> The consultative paper proposed a significantly higher risk weight for such exposures, likely leading many banks to suspect that banking regulators remain highly skeptical of digital assets being brought onto the balance sheet of a bank. As a result, banks have been slow to incorporate the provision of custody services for cryptocurrencies and other digital assets into their business model because of the lack of clarity on the permissibility of custody of digital assets across all of the federal bank regulators.

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<sup>16</sup> OCC (2020). Interpretive Letter #1172: OCC Chief Counsel’s Interpretation on National Bank and Federal Savings Association Authority to Hold Stablecoin Reserves. United States Department of the Treasury, Washington, D.C..

<sup>17</sup> *Id.*

<sup>18</sup> OCC Interpretive Letters #1170 and #1172.

<sup>19</sup> OCC. Interpretive Letter #1179: 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. United States Department of the Treasury, Washington, D.C. (Nov. 18, 2021).

<sup>20</sup> OCC Interpretive Letter #1179, 2021.

<sup>21</sup> Proposed Guidelines for Evaluating Account and Services Requests.

<sup>22</sup> Federal Reserve, Reserve Maintenance Manual.

<sup>23</sup> *Id.*

<sup>24</sup> Basel Committee on Banking Supervision. “*Consultative Document: Prudential Treatment of Cryptoasset Exposures*,” (June 2021).

# 04

## DIGITAL ASSETS AND ANTI-MONEY LAUNDERING

In January 2021, Congress passed the National Defense Authorization Act (“NDAA”) and, as part of the NDAA legislation, the Anti-Money Laundering Act of 2020 (“AMLA”). The AMLA represents the most comprehensive overhaul of anti-money laundering (“AML”) laws in the United States since the passage of the USA PATRIOT Act in 2001. Among its many provisions broadening the scope of the U.S. AML regulatory regime, the AMLA specifically amended the Bank Secrecy Act of 1970 (“BSA”) to expand the scope of businesses considered to be engaged in the transmission of money.

While previously “money services businesses” referred only to those businesses that transferred “funds,” money services businesses now explicitly include all businesses that transfer “currency, funds or value that substitutes for currency.” In addition, the AMLA grants the Treasury Secretary authority to define “value that substitutes for currency” through future regulations. Although the AMLA essentially codified prior guidance from FinCEN regarding the treatment of “convertible virtual currencies,” this expanded definition is particularly important for businesses involved in digital currencies, virtual currencies in internet gaming applications, electronic gift cards and other non-traditional cash substitutes.<sup>25</sup>

In December 2020, FinCEN issued a notice of proposed rulemaking (“NPR”) requesting comments on proposed requirements for certain transactions involving convertible virtual currencies.<sup>26</sup> As set forth in the NPR, banks and money services businesses would be required to submit reports, maintain certain records, and verify the identity of customers to the extent transactions involving convertible virtual currencies exceed prescribed thresholds. The proposed reporting requirements effectively enable the government to better surveil transactions involving convertible virtual currencies as well as impose additional AML requirements on such businesses.

<sup>25</sup> FinCEN Guidance, 2019.

<sup>26</sup> FinCEN. Notice of Proposed Rulemaking. “Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets,” (Dec. 23, 2020).

<sup>27</sup> Kauflin, J. “Where Did the Money Go? Inside the Big Crypto ICOs of 2017,” (Forbes 2018).

<sup>28</sup> Clayton, J. “Statement on Cryptocurrencies and Initial Coin Offerings,” (SEC Public Statement, Dec. 11, 2017).

<sup>29</sup> Pound, J. “SEC Chairman Gary Gensler says More Investor Protections are Needed for Bitcoin and Crypto Markets,” (CNBC, May 7, 2021).

<sup>30</sup> Gensler, G. 2018.

# 05

## DIGITAL ASSETS AND THE SEC

2017 marked the start of a frenzy of digital asset offerings commonly known as initial coin offerings (“ICOs”). The ICO craze has been met with a flurry of enforcement actions by the SEC. Unlike initial public offerings, ICOs were marketed without registrations with the SEC or exemptions from registration. ICOs were viewed as similar to crowdfunding efforts using virtual currencies.<sup>27</sup>

The explosion of ICOs prompted several responses from the SEC, including an investigation conducted by the SEC regarding whether the DAO, a decentralized autonomous organization created by Slock.it UG (“Slock.it”), a German corporation, and Slock.it’s co-founders, violated U.S. securities laws with their ICO. The ensuing investigation and report (the “DAO Report”) found that Slock.it engaged in the sale of an unregistered security. The SEC used the DAO Report as an opportunity to remind the public that “All securities offered and sold in the United States must be registered with the [SEC] or must qualify for an exemption from the registration requirements. In addition, any entity or person engaging in the activities of an exchange must register as a national securities exchange or operate pursuant to an exemption from such registration.” 2017 ended with a statement from then SEC Chairman, Jay Clayton, that cautioned potential investors in these ICOs that none of the ICOs were registered with or approved by the SEC.<sup>28</sup> The impact of the SEC statements served as a chilling effect on ICOs.

New SEC Chairman, Gary Gensler, has stated that he believes “a lot of crypto tokens—I won’t call them cryptocurrencies for this moment—are indeed securities.”<sup>29</sup> Speaking during his confirmation hearing before the Senate Banking Committee, Chairman Gensler noted that “Bitcoin and other cryptocurrencies brought new thinking to payments but raised new issues of investor protection we still need to attend to.” As demonstrated by the blockchain course he taught at the Massachusetts Institute of Technology, Chairman Gensler is very familiar with blockchain technology and digital assets.<sup>30</sup> However, supporters of certain digital

assets should continue to exercise caution because Chairman Gensler has stated that certain digital assets including Ethereum, and Ripple are securities.<sup>31</sup> Chairman, Gensler is expected to promote blockchain technology while ensuring investor protections. While the SEC has not adopted rules specifically tailored to digital assets that are securities, Chairman Gensler has noted that it is important for the SEC to provide that guidance and clarity. Furthermore, in previous statements has suggested he believes there is a strong case that all digital assets and currencies, other than bitcoin, created and issued by companies have likely violated securities laws.

## 06 STABLECOINS

A joint report published by the President's Working Group on Financial Markets, the FDIC, and the OCC (collectively, the "PWG") in November 2021 provided key insight into the potential direction federal regulators intend to head regarding the regulation of stablecoins. Stablecoins are digital assets designed to maintain a stable value relative to a national currency, such as the U.S. dollar, or other reference asset.<sup>32</sup> Stablecoins primarily are used in the United States to facilitate trading, lending, or borrowing of other digital assets, predominantly on or through digital asset trading platforms.<sup>33</sup> Although the PWG recognized the benefits of stablecoins as a means of payment, it nevertheless identified a variety of risks associated with stablecoins, including concerns related to (1) market integrity, (2) investor protection, and (3) illicit financial activities that potentially introduce key gaps in prudential authority over stablecoins and how they are used to facilitate transactions in the United States and globally.<sup>34</sup>

The PWG offered several recommendations to address these risks and concerns: (1) passage of legislation that would require stablecoin issuers to be insured depository institutions; (2) subjecting custodial wallet providers to be subject to appropriate federal supervision and risk-man-

agement standards; and (3) imposing activity restrictions on stablecoin issuers, such as limiting their affiliation with certain commercial entities. The implication behind each of these recommendations is that stablecoin issuers could be treated as a bank and, therefore, be subject to the panoply of prudential regulation, supervision, and examination by the federal banking agencies.

In December 2021, the Senate Banking Committee held a full committee hearing on the potential risks stablecoins pose to the financial system. The authors believe that Congress continues to evaluate the PWG Report and are engaging in internal discussions to determine whether legislation regarding digital assets broadly and/or stablecoins specifically would be appropriate. It is worth noting that the SEC, which did not participate in the PWG Report, issued a statement on the same day the PWG Report was released, stating that the SEC, along with the CFTC, would "deploy the full protections of the federal securities laws and the Commodity Exchange Act to [digital assets], where applicable,"<sup>35</sup> which suggests that, to a certain degree, the SEC already believes that it has the necessary regulatory tools to regulate the digital asset industry.

## 07 NON-FUNGIBLE TOKENS

NFTs are quickly gaining notoriety as a popular means of buying and selling digital collectibles representing tangible and intangible assets across multiple industries, including art, sports, music, fashion, and gaming. NFTs, however, are not like digital currencies such as bitcoin and Ethereum, which function as the native assets of their respective blockchains. Instead, NFTs are created as part of a platform built on an existing blockchain (like the Ethereum blockchain) and are not fungible like other digital currencies, meaning NFTs cannot be traded or exchanged for one another without inherent diminution in value (i.e. one dollar is always worth one dollar and one Bitcoin is always equal to another Bitcoin).<sup>36</sup> Instead, NFTs are individually unique and

31 See Popper, N. "A Former Top Wall Street Regulator Turns to the Blockchain," *New York Times* (Apr. 22, 2018).

32 President's Working Group on Financial Markets. "Report on Stablecoins," (Nov. 2021).

33 *Id.*

34 *Id.*

35 Gensler, G. "SEC Statement on President's Working Group on Stablecoins," (Nov. 1, 2021).

36 Conti R. & J. Schmidt. "What is an NFT? Non-Fungible Tokens Explained," (Forbes, May 2021).

use blockchain technology to establish authenticity, ownership, and transferability of a unique asset. An NFT is created from digital objects that represent both tangible and intangible property, including, but not limited to: (1) artwork, (2) videos, (3) collectibles and antiques, (4) video game avatars; and (5) music. The National Basketball Association created NBA Top Shot, a market for selling highlight videos of basketball in the form of NFT.

The subject of many headlines in 2021 and 2022 references the emergence of “the metaverse.” While there is no formal or concrete definition for this term currently, it is generally understood to be one of many building blocks (along with, and co-dependent on, cryptocurrencies, blockchain technology, NFTs, and the expanded use of automation and artificial intelligence) to be employed in the broader development of communications and the next iteration of the internet many know today. This “new” iteration of the internet is colloquially referred to as “Web 3.0.” Use cases and embodiments of the metaverse are being developed at a rapid pace, but one common idea of the metaverse encompasses the use of virtual reality, augmented reality, and using current or yet-to-be created technologies. The metaverse also encompasses the idea of a digital economy where participants can buy, sell, trade, consume, and display virtual goods (perhaps with connections to tangible and real property) in a virtual world. The definition of metaverse and what all it encompasses is not yet settled, but one central component seems to be its adoption of NFTs and digital assets into its operation. While there are likely some benefits to this new means of communication, as with any new technology, there will likely be some uses which land its developers, promoters, and issuers in hot water with regulators and plaintiff’s attorneys, particularly as it relates to consumer protection laws as its use gains broader traction.

The SEC evaluates digital assets in the same manner as traditional assets to determine whether they are securities. Unlike initial coin offerings, which are a type of digital asset that has drawn a considerable level of attention from the SEC staff, NFTs have not been the subject of interpretative guidance or rulemaking by the SEC. Furthermore, the SEC has not initiated an enforcement action against the creator of an NFT or the operator of a platform that facilitates the offer and sale of NFTs. On May 12, 2021, a plaintiff sued Dapper Labs, Inc., the creator of popular NFT platform NBA Top Shot, alleging that Dapper Labs sold unregistered securities (in the form of NFTs that capture video highlights,

or “Moments”) through its platform. The litigation remains pending in New York state courts.<sup>37</sup>

Even if an NFT is not deemed a security, NFTs could be considered a “commodity” under U.S. laws. The trading of commodities is regulated by the Commodity Futures Trading Commission (“CFTC”). A commodity is defined broadly as all goods and articles, and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in.<sup>38</sup> The CFTC notes that the definition of “commodity” is not limited to tangible commodities and has taken the position in enforcement actions that bitcoin and other virtual currencies encompassed in the [commodity] definition and properly defined as a commodity (i.e. not a security) and, as a result, subject to the anti-fraud and anti-manipulation jurisdiction of the CFTC.<sup>39</sup> Furthermore, the inclusion of futures contracts and other derivatives using Bitcoin and Ether as the reference assets are now traded on CFTC-registered trading venues such as the Chicago Mercantile Exchange, which further reinforces that digital assets like Bitcoin and Ether are commodities under U.S. law.

Whether an NFT could be subject to CFTC oversight as a commodity or derivative, particularly a futures contract, is murkier. Generally, a futures contract is an agreement to purchase or sell a commodity for delivery in the future (a) at a price that is determined at initiation of the contract; (b) that obligates each party to the contract to fulfill the contract at the specified price; (c) that is used to assume or shift price risk; and (d) that may be satisfied by delivery or offset.<sup>40</sup> Notwithstanding the foregoing, the CFTC and SEC issued a joint final rule in August 2012 providing for, among other items, a “forward contract exclusion” that excludes certain forward contracts from the definition of “swap” where the “sale or transaction involves a non-financial commodity or security for deferred shipment or delivery, so long as the transaction is to be physically settled.”<sup>41</sup> Given that NFTs often represent a digitized tangible asset that grants the NFT holder ownership rights over the underlying asset, the issue of “physical delivery” could render the NFT a forward, future, or swap even if the underlying asset is not.

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<sup>37</sup> *Jeeun Friel v. Dapper Labs, Inc.* (N.Y. Sup. Ct. 2021).

<sup>38</sup> 17 C.F.R. §1.3.

<sup>39</sup> *In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29.

<sup>40</sup> CFTC Glossary.

<sup>41</sup> 7 U.S.C. §1a(47)(B)(ii).

# 08

## STATE REGULATION OF VIRTUAL CURRENCIES

To date, several U.S. states have issued guidance or passed legislation related to virtual currencies, however, the legal treatment of virtual currency varies by state. The states of New York and Louisiana now have a statutory requirement that requires companies engaged in virtual currency business activities to obtain a license separate from state money transmitter license. In August 2020, Louisiana adopted similar legislation, the Virtual Currency Business Act, which requires virtual currency businesses to obtain a license for conducting business in Louisiana or otherwise seek an exemption from registration. California has proposed legislation to exempt certain digital assets from being considered securities. The states of Washington and North Carolina have passed legislation that formally clarifies the respective states' jurisdiction over virtual currency under each state's money transmission laws. Other states have taken a different approach. The state of New Hampshire passed a law that explicitly excludes businesses using transactions in virtual currency from the state's money transmitter license. In addition, states such as Kansas, Tennessee, and Illinois have issued guidance that virtual currency transactions that do not implicate fiat currency (e.g. an exchange) are not subject to licensure.

# 09

## CENTRAL BANK DIGITAL CURRENCIES

Central bank digital currencies ("CBDCs") are a digital representation of a central bank-issued money denominated

in the national unit of the respective country and, most important, a CBDC is legal tender representing a liability of a country's central bank. From the end user's perspective, a CBDC is riskless unlike other digital currencies (like Bitcoin) or other digital assets (like a stablecoin or utility token) because a CBDC is a direct claim on the central bank just like fiat currency. As a result, the introduction of CBDCs by a central bank could "ensure that, as economies go digital, the general public would retain access to the safest form of money—a claim on a central bank."<sup>42</sup>

Interest in CBDCs has increased globally in response to changes in payment services, financial activity involving digital assets and technological innovation, as well as the disruption brought on by the covid-19 pandemic. A recent survey of more than 60 central banks conducted by the Bank of International Settlements found that 86 per cent of the respondents, including the United States, were exploring CBDCs.<sup>43</sup> Twenty countries have introduced pilot programs for a national CBDC, with the Bahamian central bank launching the first nationwide CBDC, the digital Sand Dollar, on October 20 2020.<sup>44</sup> China launched trials of a digitized yuan in April 2020 and, in January 2022, released its digital yuan wallet on online stores (e.g. Apple's App Store and Google Android app stores) in China. In addition, the Bank of Japan launched a one-year trial of the digital yen on April 5, 2021.<sup>45</sup>

The United States has taken a measured approach to the issuance of a U.S. CBDC. Federal Reserve Governor Lael Brainard has noted "the Federal Reserve is active in conducting research and experimentation related to distributed ledger technologies and the potential use cases for digital currencies."<sup>46</sup> Governor Brainard further mentioned that the Federal Reserve Bank of Boston was collaborating with MIT to "build and test a hypothetical digital currency oriented to central bank uses."<sup>47</sup> The United States, however, has not indicated that a pilot of a U.S. CBDC is on the horizon despite the push forward by other central banks of developed countries to pilot and "go-live" with a CBDC.

On January 20, 2022, the Fed released a discussion paper examining the pros and cons of a potential U.S. CBDC.<sup>48</sup> In the discussion paper, the Fed acknowledges that any U.S.

<sup>42</sup> Bank of International Settlements, 2021.

<sup>43</sup> Codruta B. & A. Wherli, Bank for International Settlements, "BIS Papers No. 114—Ready, steady, go? – Results of the third BIS survey on central bank digital currency" (January 2021).

<sup>44</sup> Bharathan, V. "Central Bank Digital Currency: The First Nationwide CBDC in the World has been Launched by the Bahamas," (Forbes, Oct. 21, 2020).

<sup>45</sup> Novak, M. "Japan's Central Bank Launches One-Year Test of Digital Currency," (Gizmodo, Apr. 6, 2021).

<sup>46</sup> Brainard, L. "An Update on Digital Currencies," (Aug. 13, 2020).

<sup>47</sup> *Id.*

<sup>48</sup> Federal Reserve. "Money and Payments: The U.S. Dollar in the Age of Digital Transformation," (Jan. 2022).

CBDC should seek to accomplish multiple goals, including (1) ensuring the benefits to households, business and the overall economy outweigh the costs; (2) complementing, rather than replacing, current forms of money and methods for providing financial services; (3) protecting consumer privacy; and (4) protecting against criminal activity.<sup>49</sup> To that end, the Fed is soliciting comments on over 20 questions posed in the paper to further develop the United States' position on a U.S. CBDC. Of greatest concern in the Fed's CBDC paper is the following:

The Federal Reserve is exploring the implications of, and options for, issuing a CBDC. For the purpose of this paper, a *CBDC is defined as a digital liability of the Federal Reserve that is widely available to the general public*. While Americans have long held money predominantly in digital form — for example in bank accounts recorded as computer entries on commercial bank ledgers — *a CBDC would differ from existing digital money available to the general public because a CBDC would be a liability of the Federal Reserve, not of a commercial bank*.<sup>50</sup>

The Fed appears to be exploring a retail central bank digital currency model that would disintermediate traditional commercial banks and potentially transform the Fed into an institution similar to postal banks in other countries. Such an approach was proposed by the failed nominee for Comptroller of the Currency, Saule Omarova, and was the subject of substantial criticism in Congress and the financial services industry. The Fed acknowledged that a narrower-purpose CBDC could be developed, “such as one designed primarily for large-value institutional payments and not widely available to the public.”<sup>51</sup>

supporters of the technology see a path forward. Regulators including Treasury Secretary Yellen, Chairman Gensler, and Comptroller Hsu have recognized there are issues to be resolved before blockchain technology will reach its full potential and before banks get into digital currencies. As noted by Secretary Yellen:

What would be the impact on the banking system? Would it cause a huge movement of deposits out of banks and into the Fed? Would the Fed deal with retail customers or try to do this at a wholesale level? Are there financial stability concerns? How would we manage money laundering and illicit finance issues? *There's a lot to consider here, but it's absolutely worth looking at*.<sup>52</sup>

The authors believe the statements by Secretary Yellen about the possible benefits of CBDCs in promoting financial inclusion, Chairman Gensler's high degree of understanding of blockchain technology and digital assets, and Comptroller Hsu's stated desire to work in concert with other regulators on an approach to the regulation of the technology are extremely promising. As purportedly noted by Winston Churchill, “You can always count on the Americans to do the right thing, after they have exhausted all the other possibilities.” The battle over the regulation of blockchain technology and digital assets is not at the end of the world. ■

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“*While critics of digital assets and blockchain technology believe these innovations represent the end of the world, supporters of the technology see a path forward*”

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# 10

## CONCLUSION

While critics of digital assets and blockchain technology believe these innovations represent the end of the world,

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> Sorkin, A. 2021.

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