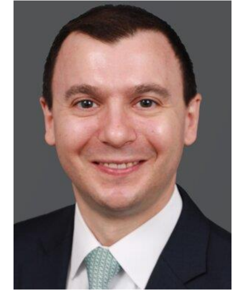
A Call For A More Nuanced Take On Digital Asset Regulation

By **Joe Castelluccio** (October 12, 2022)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The apparent success of bitcoin to date — and the amount of attention, optimism and investment focused on bitcoin — has opened the door to an explosion of development in blockchain technologies, in many cases with far greater utility and scalability than bitcoin itself.

At the same time, this increased attention and potential have given rise to a host of would-be imitators, many of which may be get-rich-quick schemes.

The hyperfocus of regulators, the media and the public on these schemes — and the minute-to-minute fluctuations in the exchange rates between digital assets and traditional, fiat currencies — has led many to assert that traditional financial services regulatory concepts should be applied broadly to blockchains and the digital assets recorded on them, without regard for the differences among digital assets and the ways they are used.

As a result, many of the regulations that are currently applied to digital assets equate all digital assets with shares of stock or futures contracts and focus on investor protection and fluctuations in digital asset prices, which are really just exchange rates with fiat currencies.

These regulations and their enforcement paint with a broad brush and largely ignore the attributes of the technology itself. Even bitcoin — one of the very few crypto assets that have escaped the securities label to date — remains subject to a host of other regulations that were not designed to apply to software, or currencies, for that matter.

To date, most of these regulations and the manner in which they are enforced underscore two messages:

- First, anyone in this sector must comply with the most fulsome set of securities and other regulations that typically apply to investments in financial markets, even though these regulations were written long before these technologies were conceived and are not well-suited to this technology.
- Second, failure to comply will face an increasingly aggressive enforcement agenda from regulators who pursue perceived compliance failures through civil and criminal enforcement actions.

These messages and the application of a one-size-fits-all regulatory approach that is applicable to securities or commodities do not advance the key public policy objectives of protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation. They also do not serve to foster innovation, which is a cornerstone of the U.S. economy.

The good news is, there is a better way.

Focus on the Uses of the Technology, Not the Prices of Digital Assets

From a regulatory standpoint, there is a strong case that blockchain technologies — such as those that enable permanent storage of records across distributed networks of computers, efficient processing of transactions, and self-executing and settling contracts — deserve a regulatory regime that does not assume every action taken with a token is a securities transaction.

Instead, the regime should be tailored for the technology's intended uses.

There are some proposals in the U.S. for updated regulations that begin to take a more flexible approach to regulating digital assets. Some proposals, such as the Digital Commodities Consumer Protection Act currently being reviewed in the U.S. Senate Agriculture Committee, provide helpful direction and a digital assets-specific framework.

However, this and some other recently proposed legislation still paint with a broad brush and create broad categories of in-scope activities and actors. For example, the DCCPA creates a category of digital commodity platforms, which arguably lumps together, among others, centralized intermediaries that transact in digital assets with decentralized protocols that record digital asset transactions.

Regulatory terminology like this should account for the specific nature of the technology and focus on the regulated activities that may be enabled by the technology, rather than putting the use of the technology itself under broad regulatory restrictions.

Other regulatory proposals — such as the safe harbor proposed by Commissioner Hester Peirce of the U.S. Securities and Exchange Commission, which would provide a time-limited exemption from securities law registration for tokens — acknowledge the real-world runway necessary for blockchain projects to get off the ground.

The safe harbor also acknowledges, and does not assume, that every blockchain project should not be regulated as a securities market. This time-limited exemption has precedent in, among other things, the much-delayed implementation of Sarbanes-Oxley Section 404 for smaller public companies.

Section 404 is widely considered one of the most onerous compliance requirements imposed by the Sarbanes-Oxley Act, which itself was passed into law relatively hastily in the aftermath of the Enron and WorldCom scandals and the dot-com bubble.[1]

The deadline for Section 404 compliance by smaller public companies was delayed several times following the Sarbanes-Oxley Act's passage in 2002 in an explicit acknowledgment that smaller companies — even publicly traded ones — need time and resources to bring themselves into compliance.

The Current State of Play and a More Effective Use of Regulatory Resources

While there is room for thoughtful discussion about the nuances of proposed rules, one thing is clear: The current regulation-by-enforcement favored by some regulators is far less effective in protecting investors than a more intentional, tailored approach would be.

Overall, legislators and regulators focused on blockchain would be well served in maintaining a focus on the goals of regulation rather than looking for regulation and expanded jurisdiction as an end in itself.

One way to do this would be to focus more on fraudulent and deceptive practices and less on the lack of registration by blockchains for securities offerings. The perceived success of bitcoin, Ethereum and other digital assets has emboldened would-be imitators with all variety of fraudulent and deceitful schemes. Pursuing and prosecuting these bad actors would benefit everyone, including legitimate blockchain developers.

A Better Road Map for Digital Assets Regulation

Legislators and regulators should focus on the ways in which most blockchains are used and make more nuanced distinctions between different types of digital assets.

The goal of this effort should be to achieve regulatory clarity that advances the missions of protecting investors, promoting capital formation and instilling market integrity. At the same time, this type of regulation would

foster innovations in a broader, more diverse set of widely used blockchains.

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[1] See H.R. 3763 – The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002: Hearings Before the House Comm. on Financial Services, 107th Cong., at 30 (2002) (statement by Rep. Paul E. Kanjorski, Member, House Comm. on Financial Services) ("[W]e run the risk of passing legislation very quickly, and then getting the unintended response. I understand we are hell-bent on getting this legislation passed by Memorial Day, which is shocking to me, because I do not think we know the extent of the problem here."