Demystifying the Crypto Universe: DeFi, Stablecoins and more!

Forecast ‘23
Federal and Congressional Activity on Digital Assets

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Executive Action

- President Biden’s March 9 Executive Order (EO) on *Ensuring Responsible Development of Digital Assets* outlined the first whole-of-government of digital assets and their underlying technology.
Executive Action

- consumer and investor protection;
- promoting financial stability; countering illicit finance;
- U.S. leadership in the global financial system and economic competitiveness;
- financial inclusion; and responsible innovation.
Executive Action

○ made a number of recommendations for congressional action

○ much of the crypto policy focus in Washington has now turned to a few key bills on the Hill.
Congressional Activity

Top Issues are:

○ Regulatory clarity and additional oversight authorities for the Commodity Futures Trading Commission (CFTC)

○ Stablecoin regulation

○ Tax clarity

○ National security issues
The Lummis-Gillibrand Bill

- distinctions between digital assets that are commodities or securities and grants CFTC exclusive spot market jurisdiction over all fungible digital assets

- clarifies tax definitions and provides an exclusion of up to $200 per transaction from gross income for use of digital assets for payment for goods and services.
The Lummis-Gillibrand Bill

○ provides guidance around digital asset issuer and provider disclosures
○ subjects stablecoin issuers to new prudential regulations
○ categorizes decentralized autonomous organizations (DAOs) as business entities for tax purposes
○ Requires study of blockchain technology use by depository institutions, decentralized finance (DeFi), energy consumption in digital asset markets, and self-regulation
Regulatory clarity and CFTC oversight authority

- H.R. 7614, the Digital Commodity Exchange Act (DCEA)
- S. 4760, the Digital Commodities Consumer Protection Act of 2022 and (DCCPA) companion bill (H.R. 8950)
Regulatory clarity and CFTC oversight authority

- Differences lie in defining which cryptocurrencies are securities and which are commodities
- Determines future registration and oversight requirements for cryptocurrency exchanges.
Stablecoin regulation

November 2021 Report on Stablecoins from the President’s Working Group on Financial Markets
Stablecoin regulation

Draft bill, the Stablecoin Innovation and Protection Act of 2022

○ Require stablecoins be issued by either a bank or a non-bank qualified stablecoin issuer;

○ Define stablecoins as cryptocurrency redeemable on demand on a one-to-one basis for U.S. dollars and issued by qualified issuers; and

○ Provide the OCC with oversight authority over stablecoin issuers and require the FDIC to develop a Qualified Stablecoin Insurance Fund
Stablecoin regulation

S. 3970, the Stablecoin Transparency Act and companion bill (H.R. 7328) in the House.

- applies to fiat-backed stablecoins, and requires that issuers disclose reserves and hold their reserves associated with fiat currency-backed stablecoins
Stablecoin regulation

Still-untitled stablecoin legislation

○ give the Federal Reserve oversight over stablecoin issuers, implement new reserve requirements to ensure that customers would be made whole in the event of insolvency,

○ implement a two-year ban on algorithmic stablecoins while Treasury conducts studies on them.
Tax exemptions for small personal transactions

H.R. 6582, Virtual Currency Tax Fairness Act of 2022,

- simplify the use of digital assets for everyday purchases by creating an exemption from taxation for personal transactions that are $200 or less that use cryptocurrencies for goods and services.
Tax exemptions for small personal transactions

S. 4608, the Virtual Currency Tax Fairness Act

- provides a similar exemption, but would create a de minimis exemption for capital gains of less than $50 on personal transactions and for personal transactions under $50.
National security issues


- requires congressional notification for Department of State rewards paid using cryptocurrencies; and
- modernizes FinCEN’s special measure authorities
National security issues


- Numerous amendments that touch on cryptocurrency, blockchain technology, and related issues have been filed in the Senate
Outlook?

○ Potential for crypto provisions to be included in must-pass legislation before adjournment

○ Momentum in the 118th Congress

○ Many bills are bipartisan

○ Key issues addressed – CFTC authorities and stablecoins in particular
State of State Legislation

Cryptocurrencies, Digital Assets and Blockchain

- What is it?
  - Definitions

- Uses/Development
  - How to encourage innovation

- Impact
  - Energy usage concerns

- Fraud
  - Will states step in?
Money Transmission & Licensing Statutes

Subject States
Enactments from 2015 to 2022 legislative sessions.

Exempt States
New Hampshire and Wyoming enacted exemptions. Montana doesn’t have a money transmission law. Colorado and Montana have enacted exemptions to securities laws.

- Subject to money transmission/licensing statute
- Exempt from money transmission or securities law
Securities Law

Securities specific statutes
Emerging Issues

Taxes, Crypto Mining and Decentralized Autonomous Organizations

1. **DAOs**
   - Tennessee and Wyoming have authorized DAO LLCs.

2. **Crypto Mining**
   - While Kentucky enacted legislation to grant tax exemptions to encourage crypto mining, New York enacted a bill that imposes a two-year moratorium.
Issues for Policymakers

Impact

○ New York enacted legislation that establishes a two-year moratorium on the operation of cryptocurrency mining centers.

Fraud

○ FTC reports that since the start of 2021, more than 46,000 people have reported losing over $1 billion in crypto to scams.

○ The FTX cryptocurrency exchange collapse and bankruptcy raises questions regarding corporate governance and commingling of customer funds.
○ Cryptocurrency 2022 Legislation

○ Cryptocurrency 2021 Legislation

○ Blockchain 2022 Legislation

○ Blockchain 2021 Legislation

NCSL Digital Asset Resources
Earlier legislation lists available on the NCSL website.
Heather Morton
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Reach out anytime!

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WHAT IS THE UNIFORM COMMERCIAL CODE?

- Uniform state law enacted in nearly identical form in all 50 states, District of Columbia, U.S. territories
- Comprehensive set of mostly default rules to govern commercial transactions
- Essential for providing certainty and predictability
- The reason why interstate commercial markets thrive
THE 2022 UCC AMENDMENTS PROJECT - BACKGROUND

- The sponsoring organizations: the American Law Institute & the Uniform Law Commission
- The process
  - Recommendation of the Permanent Editorial Board for the Uniform Commercial Code
  - Study committee (2019)
  - Drafting committee
  - Advisors
  - Observers (approximately 350)
  - Meetings – open, in-person, virtual
  - ULC web site for drafts
  - ALI and ULC approvals obtained
  - State introductions to begin in 2023 legislative sessions
Digital Assets
WHAT IS A DIGITAL ASSET?

- An “electronic” record in contrast to a paper record
  - UCC 1-201(b)(31) defines “record” as “information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form”
- Despite the word “asset,” the electronic record may or not have value
  - An electronic contract to receive goods has the same value as a paper contract to receive goods
    - Merely possessing the paper contract does not entitle the possessing party to the goods
    - Merely receiving and storing the electronic contract does not entitle the receiving party to the goods
  - However, some digital assets do themselves have value
    - Bitcoins and other virtual currencies
    - Non-fungible tokens (“NFTs”)
    - Electronic versions of negotiable instruments
SCOPE OF AMENDMENTS RELATING TO DIGITAL ASSETS

- Focus on **commercial law** in relation to digital assets deals with the rights of private parties. The 2022 UCC amendments, primarily in new Article 12, address such questions as:
  - How can a buyer of a digital asset take the asset free of third-party property claims?
  - Consider virtual (non-fiat) currency
  - How does a lender accept a digital asset as collateral and protect itself in case of default?

- The 2022 UCC amendments **do not address other law**, such as:
  - Whether a digital asset is a security or a commodity for regulatory purposes
  - Taxation of digital assets
  - Money transmission laws
  - Anti-money laundering laws
THEMES AND OBSERVATIONS

- Rapidly changing technology; law trying to catch up
- 2022 Amendments include updates to the entire UCC, not just those areas where there is acute market pressure
- Technological neutrality
  - Experience with Uniform Electronic Transactions Act
  - No express mention in 2022 UCC amendments of blockchain, distributed ledger technology, public key or private key – covered by technology neutral provisions
- No change in policy choices unless justified
- Same rules apply to digital asset being directly or indirectly held; agnostic
NEW UCC ARTICLE 12: CONTROLLABLE ELECTRONIC RECORDS (CERS)

- New term builds on existing UCC definitions of “electronic” and “record”
- A digital asset that can be controlled
- Includes non-fiat cryptocurrency and NFTs
- Control of a CER is analogous to possession of a tangible asset
  - A digital asset that cannot be controlled is outside of the scope of the 2022 UCC amendments
“CONTROL” OF A CER (1)

- Elements:
  - Power to enjoy “substantially all the benefit” of the CER (does not have to be “exclusive”)
    - The electronic record must have some “use” that one person can enjoy to the exclusion of all others, *e.g.*, the power to “spend” a Bitcoin
  - Exclusive power to prevent others from enjoying the benefits of the CER (“rivalrous”)
  - Exclusive power to transfer
    - A person must be able to transfer to another person this exclusive power to use the electronic record. To remain exclusive, the transfer must divest the transferor of the power to use the electronic record
  - Identification
    - The person must be able to identify itself to a third party as the person having these powers (can be done by cryptographic key or account number)
  - Rebuttable presumption of exclusivity
“CONTROL” OF A CER (2)

- Control for another
  - A has control but acknowledges that A has control for B. B also has control.

- Exclusivity requirement is satisfied even if certain sharing/multi-sig arrangements have been agreed to by the parties or are built into the system in which the CER is recorded.

- Examples of multi-sig arrangements
  - CER cannot be transferred, or others prevented, without the consent of A and B. A and B have control.
  - CER cannot be transferred, or others prevented, without the consent of three of A, B, C or D. A, B, C and D have control.
  - A can transfer control, or prevent others, without the consent of B. B can transfer control, or prevent others, without the consent of A. A and B have control.
  - A can transfer control, or prevent others, without the consent of B. B can transfer control, or prevent others, only with the consent of A. Only A has control.
A purchaser acquires all rights in the CER that the transferor had.

A *qualifying* purchaser also takes free of any property claim to the CER.

A “qualifying purchaser” is a purchaser who obtains control of a CER for value, in good faith, and without notice of a property claim to the CER.

- The filing of a financing statement of itself is not notice of a property claim to the CER.
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CHOICE OF LAW

- Look to the law where the CER is located
- The CER is located in the jurisdiction by which the CER is expressly stated to be governed
- If the CER is not expressly stated to be governed by the law of a jurisdiction, the CER is located in the jurisdiction which is stated to govern the system in which the CER is recorded
- Otherwise, the CER is located in the District of Columbia or, if DC has not adopted the UCC amendments, the Official Text applies
Secured Transactions
The problem: Using digital assets as collateral for a loan

Issues:

- How to define?
- How to secure?
- How to collect upon default?
The solution: Amendments to UCC Article 9 that provide:

- For existing loans, CERs are a type of general intangible
- A lender’s security interest in CERs can be perfected either by filing a financing statement or by obtaining control
- A security interest perfected by control has priority over a security interest that is only perfected by filing
TRANSITION RULES

- Designed to protect the expectations of parties to pre-existing transactions and to provide for sufficient time for parties to plan transactions post-amendments effective date.
- Will not contain a uniform effective date for the amendments because some states appear ready to enact the amendments as early as possible.
- However, the transition rules will contain a uniform adjustment date of at least one year from the effective date.
- The adjustment date gives transacting parties a grace period to preserve priorities already established on the effective date if the amendments would otherwise affect those priorities.
Other Issues
“Money” is currently defined in the UCC as a medium of exchange authorized by a domestic or foreign government.

Given the adoption of Bitcoin as fiat currency by El Salvador and the Central African Republic, today Bitcoin is arguably “money” under the UCC definition, leading to unanticipated outcomes.

Definition of “money” revised to exclude a medium of exchange in an electronic record (such as Bitcoin) that existed before it was authorized or adopted as a medium of exchange by a government.

A medium of exchange in an electronic record so excluded might still qualify as a CER.
EARLY ACTION BY SOME STATES

- Wyoming (Wyo. Stat. § 34-29-101 et seq.), followed by Idaho (HB 583)
  - Broad scope for digital assets
  - Treats virtual currency as money
  - Treats control (broad definition) as possession
  - Adverse claim cut-off rule applies after two years
  - Aggressive choice-of-law rules
- New Hampshire (HB 1503) adopted earlier version of entire UCC amendments
- Iowa (H. 2445), Nebraska (LB 649) and Indiana (HB 351): adopted earlier versions of CER proposal
- Arkansas (HB 1926) and Texas (HB 4474): adopted earlier version CER proposal just for virtual currencies
Please contact us for assistance enacting the UCC Amendments in your state:

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Any Questions?