

A Taxonomy of Digital Assets: Is It a Security, Commodity, Banking Product, or Something Else?

by Marjorie J. Peerce, Scott L. Diamond and Tyler M. Cobb

October 19, 2022

Summary

The jurisdictional lines between the different types of digital assets remain unclear. As Congress weighs separate bills seeking to establish a clear and workable regulatory framework, market participants are subject to regulation by enforcement, with multiple executive branch independent agencies and other functional regulators each independently asserting jurisdiction.

Below, we provide an overview of the factors that government agencies will consider in determining which assets are “securities,” which are “commodities,” which are “banking products” and which are likely outside of the regulatory regime.

The Upshot

- Securities would be subject to initial and ongoing disclosures, be traded on regulated exchanges, and be traded through broker-dealers. They would be subject to rules established by the SEC, FINRA, and state laws.
- Currently, the regulatory authority of the Commodity Futures Trading Commission extends to virtual currencies traded on a deliverable forward basis (leveraged retail), as well as virtual currencies traded on a non-deliverable basis (swap), or on an exchange (futures). The CFTC does not require the same level of disclosure required by the SEC.
- Jurisdictional issues have led Congress to exclude certain “identified banking products” from the jurisdiction of the SEC and the CFTC. The exclusion does not apply to digital asset swaps.
- Non-fungible tokens (NFTs) are digital assets that do not fit neatly within the definition of a security, a commodity, an identified banking product or a virtual currency. Certain governance tokens that represent rights associated with a decentralized autonomous organization (DAO) could also fall outside of the definitions. Although the regulatory authority for NFTs is to be determined, the SEC is reportedly investigating the creators of Bored Ape Yacht Club NFTs for possibly making an unregistered securities offering.

The Bottom Line

Two competing bills, both introduced earlier this year, are pending in Congress and aim to settle the regulatory jurisdiction of digital assets between the SEC and the CFTC. How a digital asset is defined will determine which governmental agency will hold regulatory authority over it. It is unlikely that either bill will be adopted before the end of the year. Please contact us if you have questions.

The jurisdictional lines between the different types of digital assets remain unclear. As Congress weighs separate bills seeking to establish a clear and workable regulatory framework, market participants are subject to regulation by enforcement, with multiple executive branch independent agencies and other functional regulators each independently asserting jurisdiction.

Below, we provide an overview of the factors that government agencies will consider in determining which assets are

“securities,” which are “commodities,” which are “banking products” and which are likely outside of the regulatory regime.

Securities: Following the stock market crash of 1929, Congress enacted two sets of securities laws, the Securities Act of 1933, as amended, which addressed disclosure obligations for offerings of securities, and the Securities Exchange Act of 1934, as amended, which addressed the mechanics of the securities markets and business. To the extent that digital assets are deemed securities, they would be subject to those Acts as well as the Securities and Exchange Commission’s rules implementing the Acts, and the rules of the Financial Industry Regulatory Authority (FINRA), a registered securities association, which is the designated regulatory organization for the securities business. In short, this means that unless exempted, digital assets which are securities would be subject to initial and ongoing disclosures, be traded on regulated exchanges, and would be traded through broker-dealers. They also would be subject to regulations concerning maximum leverage and states that also have regulatory authority over securities.

The 1933 Act very broadly defines a security to include almost any financial instrument. However, for purposes of digital assets, the market has focused on a specific sub-category called “investment contracts.” Those are characterized by the four part “Howey” test set forth by the U.S. Supreme Court in 1946 (well before the advent of digital assets): (i) an investment of money; (ii) in a common enterprise; (iii) with a reasonable expectation of profit; (iv) derived from the efforts of others. The SEC determined that Bitcoin is not a security under the Howey test because it did not believe that its “current purchasers . . . are relying on the essential managerial and entrepreneurial efforts of others to produce a profit,” thereby failing parts (ii) and (iv) of the Howey test. Most digital asset cases today focus on the elements of the Howey test that distinguished Bitcoin from a security. (See *SEC v. Ripple Labs*). In that ongoing case, the SEC argued that these elements are satisfied because investors in XRP (the token sold by Ripple Labs) believed the price of their investment would increase based on the marketing efforts and supply restrictions of Ripple. If Ripple prevails and XRP is deemed not to be a security, XRP could be deemed a commodity by the Commodity Futures Trading Commission. Another alternative is for the matter to settle or for the SEC to withdraw, in which case the larger issue of whether virtual currencies are securities would remain open.

Commodities: The Commodity Futures Trading Commission (CFTC) was formed in 1974 as a spin-off from the U.S. Department of Agriculture in order to regulate “enumerated” markets concerning specified agricultural products. Under the current Commodity Exchange Act, a commodity includes enumerated agricultural products and “all other goods and articles . . . and all services, rights and interests . . . in which contracts for future delivery are presently or in the future dealt in.” Courts have noted that “virtual currency is tendered for payment for debts” but is not legal tender which must be accepted and have held that virtual currencies are commodities. Due to the language in the Commodity Exchange Act, the CFTC only has regulatory jurisdiction (similar to the Securities Exchange Act of 1934 mentioned above for products traded in the future (*i.e.* futures, swaps, forwards and options)). However, The CFTC has anti-fraud jurisdiction over any commodity, including virtual currency, in which there is a future market.

Currently, the CFTC’s regulatory authority extends to virtual currencies traded on a deliverable forward basis (leveraged retail), as well as virtual currencies traded on a non-deliverable basis (swap), or on an exchange (futures). The CFTC requires that retail forward virtual currency transactions must be conducted on an exchange, through a futures commission merchant, subject to clearinghouse rules and subject to anti-money laundering protocols. Commercial future virtual currency trading would be regulated as a swap or forward. Several legislative efforts are underway which, if adopted, would authorize the CFTC to regulate spot digital currencies themselves. The CFTC’s current and potential regulatory regimes do not require the same level of disclosure required by the SEC’s regime and the Securities Act of 1933. In addition, unlike the securities laws, federal commodity law preempts state law so virtual currencies classified as commodities would be excluded from state securities regulation.

Banking Products: The regulatory landscape is anything but straightforward. In addition to the CFTC, SEC, and state securities agencies, banks and banking products are separately regulated by either the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the FDIC, and/or the respective states. The jurisdictional discussion between the banking regulators, the CFTC and the SEC has been ongoing for the past 100-plus years and is not likely to be resolved now.

As a result of the ongoing jurisdictional discussion, in the Sarbanes Oxley Act and the Commodity Futures Modernization Act, Congress excluded certain “identified banking products” from the jurisdiction of the SEC and the CFTC. “Identified banking products” include any deposit account, savings account, certificate of deposit or other deposit instrument issued by a bank. To the extent a digital asset, including a virtual currency, is housed in a bank account, it may not be subject to the CFTC’s or the SEC’s regulatory jurisdiction. The identified banking product exclusion does not however apply to digital asset swaps.

In addition, the New York State Department of Financial Services (NYDFS), which co-regulates along with the Federal Reserve in the State of New York, now requires registration as a “virtual currency business” for anyone who, among other things, custodies virtual currencies on behalf of others, exchanges virtual currencies, or administers or issues virtual currencies. The term, virtual currency means “any type of digital unit that is used as a medium of exchange or a form of digitally stored value” and is intended to be read broadly. NYDFS lists those entities registered as virtual currency businesses.

None of the Above: Which digital assets do not fit neatly within the definition of either a security, a commodity, an identified banking product or a virtual currency? Non-fungible tokens (NFTs) are digital assets that possess some property that distinguishes themselves from other digital assets of the same class. NFTs can take the form of tokenized art or collectibles, or “access tokens” that represent a right to access a specific event, property, or person. It is possible that certain types of NFTs would not meet the criteria for a security, a commodity, or an identified banking product. Furthermore, certain governance tokens that represent rights associated with network governance of a particular decentralized autonomous organization (DAO) could also fall outside of the definitions of a security, a commodity, or an identified banking product. However, according to published reports, the SEC is currently investigating Yuga Labs as possibly making an unregistered securities offering in connection with the creation and sale of its Bored Ape Yacht Club NFTs.

Ballard Spahr’s Blockchain Technology and Cryptocurrency team helps clients develop and implement new products and helps clients navigate the labyrinth of government regulation and enforcement. We also advise on issues related to blockchain technology and cryptocurrencies and help clients safeguard their data and the consumers who use it. In addition, we represent clients in matters related to cryptocurrency scams or thefts involving crypto wallets. Ballard Spahr provides comprehensive support at all stages of development, from formation and early-stage startups to large, commercial operations. Please call us for more information.

Copyright © 2022 by Ballard Spahr LLP.
www.ballardspahr.com
(No claim to original U.S. government material.)

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, including electronic, mechanical, photocopying, recording, or otherwise, without prior written permission of the author and publisher.

This alert is a periodic publication of Ballard Spahr LLP and is intended to notify recipients of new developments in the law. It should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult your own attorney concerning your situation and specific legal questions you have.

Marjorie J. Pearce

PARTNER

peercem@ballardspahr.com

646.346.8039

Scott L. Diamond

OF COUNSEL

diamonds@ballardspahr.com

646.346.8065

Tyler M. Cobb

OF COUNSEL

cobbt@ballardspahr.com

602.798.5420