Cryptocurrency Regulation – September 2022 Update

Even as cryptocurrency gains broader acceptance and global regulators, financial statement preparers, and investment analysts are begging for consistent guidance, the regulatory process continues to lag. It remains to be seen if the recent crypto crash will cool investor interest. The sell-off puts additional pressure on regulators to impose stricter rules on the industry. Unlike the securities and derivatives markets, no single regulator oversees cryptocurrency or its brokers. Enforcement actions are on the rise as agencies crack down on areas where they have jurisdiction.

How will the recent volatility and market shakeout of early innovators shape future regulation and accounting guidance? This paper summarizes recent key developments.

"The digital asset market would benefit from uniform imposition of requirements focused on ensuring certain core principles, including market integrity, customer protection, and market stability."

Commodity Futures Trading Commission (CFTC) Chair Rostin Behnam – July 25, 2022

International Outlook

Financial Stability Board (FSB)

In July 2022, the FSB issued a statement in response to current volatility in the cryptocurrency market. Highlights include:

- Crypto-assets, including stablecoins, are fast evolving. The recent turmoil in crypto-asset markets highlights their intrinsic volatility, structural vulnerabilities, and the issue of their increasing interconnectedness with the traditional financial system. An effective regulatory framework must ensure that crypto-asset activities posing risks similar to traditional financial activities are subject to the same regulatory outcomes.
- Crypto-assets and markets must be subject to effective regulation and oversight commensurate to the risks they pose, both at the domestic and international level. Crypto-assets are predominantly used for speculative purposes and many currently remain mostly outside the scope of or in noncompliance with financial safeguards, of which participants of these activities should be fully aware.
- Crypto-asset service providers must at all times ensure compliance with existing legal obligations in the jurisdictions in which they operate. FSB members are committed to using the enforcement powers within the legal framework in their jurisdiction to promote compliance and act against violations.

The FSB plans to submit a report on its high-level recommendations for the regulation, supervision, and oversight of stablecoin arrangements to the G20 finance ministers and central bank governors in October.

U.S. Outlook

FASB

Currently, companies provide little information related to digital asset holdings. Helpful details for investors would include the amounts of digital assets held, current fair value, and historical cost. Both analysts and financial statement preparers felt that accounting for digital assets as an intangible under Topic 350, Intangibles—Goodwill and Other, does not appropriately reflect the economics or the nature of how a company is using digital assets. Most stakeholders felt the most important improvement would be to allow companies to account for their digital asset holdings at fair value. In May 2022, FASB added a narrowly focused project to its agenda to address accounting and disclosures for certain digital assets and created a separate research project to address the accounting for exchange-traded commodities.

> Given the FASB standard-setting process and the complexity of the product and outstanding issues, it is unlikely that an exposure draft will be issued in 2022.

U.S. Regulatory Oversight

Federal agencies are divided in how to regulate this asset class. A security subject to SEC oversight is defined in the *Securities Act of 1933* and the benchmark interpretation is based on a 1946 U.S. Supreme Court case that resulted in the Howey test. The Howey test established four criteria to determine if an investment contract exists and is subject to U.S. securities laws. The SEC's ability to regulate digital assets is dependent on the outcome of this test. Legal experts generally believe the first three criteria are easily satisfied for digital currencies. Whether a digital asset qualifies as an investment contract largely depends on whether there is an "expectation of profit to be derived from the efforts of others." This answer is subject to interpretation and—not surprisingly—there is a sharp divide between crypto entrepreneurs and the SEC. The CFTC took an early lead on enforcing cryptocurrencies and has been closely scrutinizing the industry since allowing bitcoin futures to start trading in 2017, but its powers are mostly limited to overseeing derivatives.

SEC

The SEC is adding 20 more officials to its Cyber Unit, which polices crypto markets. The additions will double the size of the existing group. The group's focus includes virtual-currency offerings, decentralized finance, and trading platforms, as well as stablecoin. Recent activity includes:

- Denial of Grayscale's spot bitcoin ETF application
- $5.5 million fine against NVIDIA for inadequate disclosures about the impact of cryptomining on the company's revenues. The SEC's order found that NVIDIA's omissions of material information about the growth of its gaming business were misleading given that NVIDIA did make statements about how other parts of the company's business were driven by demand for crypto, creating the impression that the company's gaming business was not significantly affected by cryptomining. The order also found that NVIDIA failed to maintain adequate disclosure controls and procedures
- Fraud charges announced against MCC International alleging unregistered offerings and fraudulent sales on investment plans called mining packages

On March 31, 2022, the SEC published Staff Accounting Bulletin (SAB) No. 121, which expresses the views of the Division of Corporation Finance and the Office of the Chief Accountant regarding the accounting for obligations to safeguard crypto-assets that an entity holds for platform users. The SAB addresses two key questions:

- How should an entity account for its obligations to safeguard crypto-assets held for platform users?
- What disclosures would the SEC staff expect for safeguarding obligations for crypto-assets held for platform users?

U.S. Treasury

On July 7, 2022, the agency issued a framework outlining an interagency approach to address the risks and potential benefits of digital assets and their underlying technology, including through international engagement to adapt, update, and enhance adoption of global principles and standards for how digital assets are used and transacted. Key international engagements include the G7, G20, FSB, International Monetary Fund, the World Bank, and the Organisation for Economic Co-operation and Development. The framework objectives include:

- Protect U.S. and global consumers, investors, and businesses
- Protect financial stability and mitigate systemic risk
- Mitigate illicit finance and national security risks posed by misuse of digital assets
- Reinforce U.S. leadership in the global financial system and in technological and economic competitiveness
- Promote access to safe and affordable financial services
- Support technological advances that promote responsible development and use of digital assets by advancing research and relationships that increase shared learning

In conjuncture with the framework and to comply with President Biden's March 9, 2022 executive order, the Treasury Department requested comment on digital assets. Feedback sought includes the implications of development and mass adoption of digital assets and changes in financial market and payment infrastructures for U.S. consumers, investors, businesses, and for equitable economic growth. Questions include the current level of adoption of digital assets, and factors to further facilitate mass adoption, as well as opportunities and risks involved.

In a recent speech, Treasury Under Secretary for Domestic Finance Nellie Liang indicated two possible stablecoin regulatory models:

- Bank model: Stablecoins would be backed by bank assets, capital, and liquidity buffers, though safeguards would be needed to prevent significant losses for banks and customers.
- Nonbank model: Stablecoins would be backed with safe assets without a direct tie to the banking system, which could interfere with intermediation if nonbank stablecoins compete with bank deposits.

Federal Reserve

In a July 2022 speech, Federal Reserve Board Vice Chair Lael Brainard highlighted the need for regulation and amplified the FSB's message of "same risk, same regulatory outcome":

Recent volatility has exposed serious vulnerabilities in the crypto financial system. While touted as a fundamental break from traditional finance, the crypto financial system turns out to be susceptible to the same risks that are all too familiar from traditional finance, such as leverage, settlement, opacity, and maturity and liquidity transformation. As we work to future-proof our financial stability agenda, it is important to ensure the regulatory perimeter encompasses crypto finance.

On August 16, 2022, the Fed issued a supervisory letter for banking organizations engaging or seeking to engage in crypto-asset-related activities. The guidance outlines the steps banks should take prior to engaging in crypto-asset-related activities, such as assessing whether such activities are legally permissible and determining whether any regulatory filings are required. Banking organizations should notify the Fed prior to engaging in crypto-asset-related activities. Banks should have adequate systems and controls in place to conduct crypto-asset-related activities in a safe and sound manner prior to commencing such activities. Banks already engaged in crypto activities should contact the Fed promptly if they have not already done so. This closely mirrors interagency guidance issued last year by the Office of the Comptroller of the Currency and FDIC. The letter highlights the following risks:

- Technology and operations – The technology underlying crypto-assets is nascent and evolving and poses novel risks such as those associated with cybersecurity and governance of the underlying network and any related arrangements. These risks are particularly heightened when the underlying technology involves open, permissionless networks.
- Anti-money laundering and countering of financing of terrorism – Crypto-assets can be used to facilitate money laundering and illicit financing. Some crypto-assets have limited transparency, making it difficult to identify and track ownership.
- Consumer protection and legal compliance – Crypto-assets pose significant consumer risks such as those related to price volatility, misinformation, fraud, and theft or loss of assets. In addition, banking organizations engaging in crypto-asset-related activities face potential legal and consumer compliance risks stemming from a range of issues, including, for example, uncertainty regarding the legal status of many crypto-assets; potential legal exposure

arising from consumer losses, operational failures, and relationships with crypto-asset service providers; and limited legal precedent regarding how crypto-assets would be treated in varying contexts, including, for example, in the event of loss or bankruptcy.

- Financial stability: Certain types of crypto-assets such as stablecoins, if adopted at large scale, also could pose risks to financial stability, including potentially through destabilizing runs and disruptions in the payment systems.

Conclusion

FORVIS will continue to follow cryptocurrency regulatory and accounting developments. For more information, visit forvis.com.

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