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Digital Assets Defined: SEC, CFTC, and Ancillary (Illusory?) Assets

In "Digital Assets Defined: How Lummis-Gillibrand Will Shape the Coming Fintech Debate," we provided a high-level overview of the Responsible Financial Innovation Act (the "Bill") and examined some of its significant takeaways. We then explored how the Bill would shore up stablecoins.

In this latest installment, we take a closer look at the Bill's contemplated regulatory jurisdiction as between the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") in the digital assets space. In doing so, we will summarize the commissions' respective regulatory roles, and we will highlight the critical importance of the defined term "ancillary asset" in determining where regulatory authority over a particular digital asset would lie.

THE SECURITIES AND EXCHANGE COMMISSION'S EXPANDED JURISDICTION OVER "ANCILLARY ASSETS"

Title III of the Bill is devoted to addressing the SEC's jurisdiction. Its centerpiece is the defined term "ancillary asset," which can, in certain circumstances, trigger a set of conditional disclosure requirements. Importantly, if an issuer of an ancillary asset complies with those disclosure requirements, then the Bill states that the ancillary asset "shall be presumed to be" a commodity, and not a security under various laws.

The Bill describes "ancillary asset" as follows:

> The term 'ancillary asset' means an intangible, fungible asset that is offered, sold, or otherwise provided to a person in connection with the purchase and sale of a security through an arrangement or scheme that constitutes an investment contract, as that term is used in section 2(a)(1) of the Securities Act of 1933 (15 U.S.C. 77b(a)(1)).[1]

Excluded from the definition are assets with the following characteristics:

> [A]n asset that provides the holder of the asset with any of the following rights in a business entity:
> "(i) A debt or equity interest in that entity.
> "(ii) Liquidation rights with respect to that entity.
> "(iii) An entitlement to an interest or dividend payment from that entity.
> "(iv) A profit or revenue share in that entity derived solely from the entrepreneurial or managerial efforts of others.
> "(v) Any other financial interest in that entity."[2]

If an asset is an ancillary asset, the Bill establishes a set of conditional initial and ongoing disclosure requirements for certain issuers that provide or propose to provide the ancillary asset in conjunction with a securities offering:

> [A]n issuer engaged in business in or affecting interstate commerce, or that is organized outside of the United States and is not a foreign private issuer, that offers, sells, or otherwise provides a security through an arrangement or scheme that constitutes an investment contract, as that term is used in section 2(a)(1) of the Securities Act of 1933 (15 U.S.C. 77b(a)(1)), and that provides or proposes to provide any holder of the security with an ancillary asset, shall be subject to the periodic disclosure requirements under subsection (c). . . .[3]

The conditions relate to whether, during prescribed time frames: (i) the average daily trading volume of the ancillary asset in spot markets exceeded $5,000,000; and (ii) "the issuer, or any person owning not less than 10 percent of any class of equity securities of the issuer, engaged in entrepreneurial or managerial efforts that primarily determined the value of the ancillary asset."[4] The initial compliance time frames shift depending on whether the digital asset was either issued prior to the time the provision goes into effect or the digital asset is being issued for the first time after the provision has gone into effect. The ongoing compliance time frames are the same—the issuer's preceding fiscal year—regardless of the timing of the digital asset's issuance.

If the aforementioned conditions are met, then the issuer must furnish, or cause the relevant affiliate to furnish, to the SEC, on a semi-annual basis: (i) corporate information regarding the issuer; and (ii) information concerning the ancillary asset. The former category consists of at least a dozen separately identified topics covering a range of matters such as the issuer's board composition, promotional activities, ancillary asset ownership, purchases and sales, and a going-concern statement signed under penalty of perjury.[5] The latter category also consists of at least a dozen wide-ranging topics relating to the ancillary asset's underlying technology, risk factors, airdrops, source code audits, average daily price, the issuer's plans to continue or discontinue supporting the ancillary asset, and so on.[6] An issuer can terminate its disclosure obligations by providing to the SEC a certification, supported by reasonable evidence, that the relevant conditions are no longer met.[7]

To be sure, these disclosure requirements are substantial, and would require significant investments in time and money to prepare twice per year. However, the proposed disclosures would be less onerous than those associated with publicly traded securities. And, if an issuer complies with them,[8] the ancillary asset "shall be presumed to be a commodity . . . and not to be a security" under various enumerated laws, including the Securities Act and the Exchange Act.[9] Thus, the ancillary asset would not need to be traded through an SEC-registered broker-dealer, or on an SEC-registered exchange. Instead, pursuant to the provisions in the Bill concerning the CFTC, the

ancillary asset would be eligible for trading (assuming the satisfaction of other relevant conditions) on newly defined digital asset exchanges registered with and regulated by the CFTC.

The SEC can, however, challenge the commodity presumption through litigation in a court of competent jurisdiction, and the presumption can be overcome if the court finds that there is not a "substantial basis" for its application to a specific asset.[10] Although it is an open question to what extent the SEC would plan to litigate under this exception to challenge a commodity presumption, its ability to do so cannot be overlooked. In addition, because the definition of "ancillary asset" presumes that the asset has been offered or sold to a person in connection with an investment contract, which would continue to be a "security," there is a nonzero chance the SEC could take a position that the federal securities laws apply to the investment contract as a whole (including the digital assets).

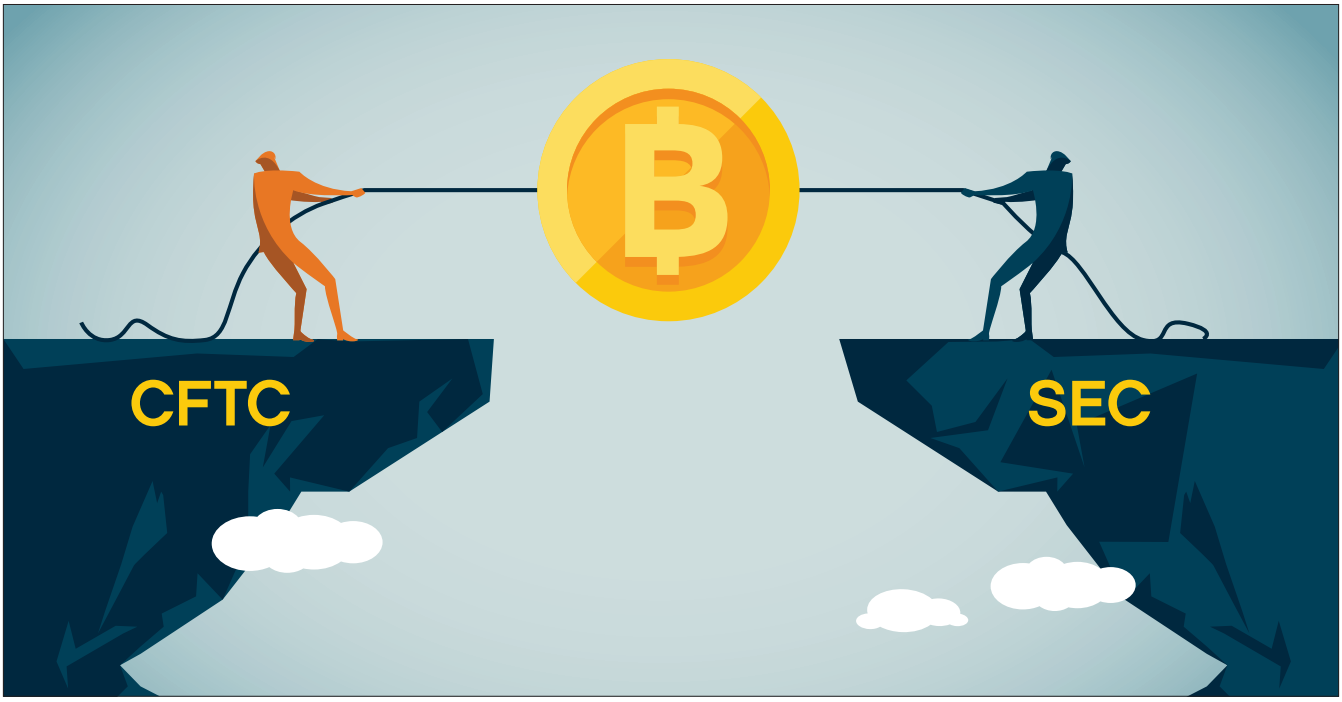
THE COMMODITY FUTURES TRADING COMMISSION

Title IV of the Bill is devoted to addressing the CFTC's jurisdiction. Its centerpiece is a provision providing the CFTC with "exclusive jurisdiction over any agreement, contract, or transaction involving a contract of sale of a digital asset in interstate commerce, including ancillary assets (consistent with section 41(b)(4) of the Securities Exchange Act of 1934)."[11]

The Bill includes a fungibility requirement, however, thereby excluding typical nonfungible tokens, or NFTs.[12]

To facilitate trading in approved digital assets, the Bill articulates a framework for registering and overseeing digital asset exchanges. The definition of a "digital asset exchange" is straightforward: "a trading facility that lists for trading at least 1 digital asset."[13] And the definition of "digital asset" is that used throughout the Bill, with one significant exclusion.[14] The Bill defines a "digital asset" as a natively electronic asset that confers economic, proprietary, or access rights or power, and is recorded using cryptographically secured distributed ledger technology.[15] This definition includes virtual currency, ancillary assets, payment stablecoins, and *other securities and commodities*.[16] But in the title pertaining to the CFTC, the Bill expressly excludes from the definition any digital assets that would not qualify as ancillary assets due to the digital assets being interests in a business entity.[17] As a result, the Bill effectively excludes digital asset securities from trading on CFTC-registered digital asset exchanges. And there is still the risk that the SEC (or a private litigant) could attempt to characterize a digital asset as a security rather than as a commodity/ancillary asset.

Digital asset exchanges would be required to comply with a set of "Core Principles" similar to those for existing CFTC-registered entities.[18] These principles address fundamental



matters such as establishing and complying with exchange rules, treatment of customer assets, monitoring of trading and trade processing, reporting requirements, recordkeeping, financial resources, governance fitness standards, and system safeguards.[19] The Bill includes provisions concerning the segregation of digital assets that are similar to those applicable to registered futures commission merchants.[20]

Of note, digital asset exchanges would be permitted to list and transact in digital assets that are not readily susceptible to manipulation only.[21] Considerations relevant to that topic include the creation or release process, the consensus mechanism, the governance structure, and "any other factors required by the Commission."[22] These provisions appear to be directed to concerns that digital assets purporting to be traded within a decentralized autonomous organization ("DAO") are not truly "decentralized" to a satisfactory degree, such that the organization is not truly autonomous. The Bill would permit digital asset exchanges to leverage the self-certification process in the Commodities Exchange Act to self-certify that a digital asset not previously listed for trading on another registered entity meets this requirement.[23] But, consistent with that process, the Commission could stay the certification while it analyzed the digital asset, and could ultimately deny the certification outright. The Bill would provide the Commission with extended time frames to conduct such inquiries,[24] which would likely focus on the extent to which a digital asset is distributed among unaffiliated persons and entities.

Also of note, the "Core Principles" indicate that digital asset exchanges would be permitted to hold customer money, assets, and property directly, without the involvement of a futures commission merchant or derivatives clearing organization.[25] As a result, a digital asset exchange would be able to independently execute and settle margined, leveraged, and financed digital asset transactions. This disintermediated approach to digital asset trading would further reduce costs and friction in the digital assets market.

ANCILLARY ASSET OR SECURITY?

Within this proposed paradigm, the fundamental question for any digital asset is as follows: Is it an ancillary asset or not?[26] A digital asset that qualifies as an ancillary asset is eligible for comparatively reduced SEC reporting and disclosure requirements, presumed treatment as a commodity, and trading on CFTC-regulated digital asset exchanges. A digital asset that does not qualify as an ancillary asset—and has not been previously classified as a commodity—presumably receives treatment as a security, and remains entirely within the domain of the SEC and the requirements associated with the federal securities laws. As a result, the ramifications associated with a digital asset's ultimate classification are not insubstantial.

To better understand the ancillary-assets issue, it is useful to consider its likely origins. Discussing the application of federal securities law to initial coin offerings ("ICO") at the end of 2018, former SEC Chairman Jay Clayton analogized the sale of crypto "coins" to fund a blockchain protocol to the advanced sale of tickets to fund a Broadway production.[27] Chairman Clayton explained that, in the Broadway context, the advanced sale of tickets was a fundraising scheme and the tickets were securities. And similarly, in the ICO context, the advanced sale of tokens was the fundraising scheme and the tokens were the securities. In articulating this analogy, Chairman Clayton helped highlight the difference between a fundraising scheme and its object—a crucial distinction that the Bill aims to address with its novel legal concept "ancillary asset."

Viewed objectively, the Bill appears to contemplate that even where tokens are offered as part of a fundraising scheme, they would be presumed to be commodities as long as the ancillary-asset disclosure requirements were met. The "ancillary asset" concept, then, reflects a regulatory compromise: The digital assets sold (or promised) in conjunction with the scheme receive reduced disclosure requirements and access to trading on CFTC exchanges; the SEC gets regulatory authority over the former, and the CFTC gets regulatory authority over the latter.

Based on this construct and the Bill's broad definition of "digital asset," most digital assets would *appear* to qualify for treatment as commodities. But appearances can be deceiving. In this case, that is attributable to the Bill's ancillary-asset exclusions, which have the potential to effectively negate the concept in its entirety. As noted above, these relate to whether the digital asset grants the holder certain rights in a business entity. In one sense, the exclusions represent a second application of the *Howey* test. The Bill suggests that this test is first applied to determine whether a token was "offered, sold, or otherwise provided to a person in connection with the purchase and

sale of a security through an arrangement or scheme that constitutes an investment contract." By considering the token holder's rights in a business entity, and the managerial and entrepreneurial efforts of others with respect to that entity, the test is then applied *again* to ascertain—in part—whether the tokens themselves are, nonetheless, securities.[28]

This *Howey* double-dose could pose problems. In the current market, many decentralized finance, or DeFi, companies mint their own crypto-assets called "governance tokens" and award them to users of their smart contract platforms. Doing so incentivizes the use of these platforms by providing a return above and beyond the fees generated from being a liquidity provider.[29] These tokens often include various rights associated with the protocols in which they are intended to operate, such as the right to vote on protocol changes, to receive a portion of the protocol's proceeds, etc. Considering the Bill's ancillary-asset exclusions, the Bill's failure to state whether "[a]ny other financial interest" in a "business entity" includes governance tokens capable of altering equity structure or redemption rights of a protocol through voting rights in on-chain governance is an unfortunate omission. Ancillary assets are presumed to be commodities under the Bill, but there is no express presumption that governance tokens are presumed to be ancillary assets.

Whether governance tokens are ancillary assets would seem to turn on what one considers to be a "business entity," which is a requirement in every ancillary-assets exclusion. Many governance tokens provide holders with a right to interest or dividend payments from the protocol, to profit or revenue payments from the protocol, or to other financial interests in the protocol. Consequently, if a DAO or a smart contract protocol is construed to be a "business entity"—or is registered as a business entity under a state law such as Wyoming's DAO statute—then, despite the Bill's apparent intent, many of these governance tokens would not appear to qualify as ancillary assets presumed to be commodities after all. Given the present realities in the digital assets space, and the features associated with many tokens in the space, the entire ancillary-asset construct would appear to be directed at something that does not exist or, if it does, exists in a very limited sense.

Although it is conceivable that regulators might not consider a DAO or smart contract protocol to be a "business entity," that is unlikely given the SEC's track record.[30] SEC Chairman Gensler has repeatedly insisted that most digital assets are securities. That is abundantly clear in the SEC's insider trading case against individuals at a prominent crypto exchange, which alleges that nine different crypto-assets are, in fact, securities.[31] This risk exists alongside the already extant risk that the SEC would consider a DAO or smart contract protocol to be a "person" under the Investment Company Act.[32]

Furthermore, one must also consider the potential consequences associated with taking the position that a DAO or smart contract protocol is *not* a "business entity," or with deciding not to register a DAO or smart contract as a business entity in the form of a limited-liability company or partnership. A possible outcome is that the DAO or smart contract protocol would be viewed as a general partnership, thereby exposing its participants to unlimited liability.[33]

Given these consequential and unresolved issues, current and prospective token issuers would be right to question whether the Bill's ancillary-assets provisions really provide a workable path to reduced reporting obligations and trading on CFTC-registered exchanges. As a result, the Bill—or future legislation that embraces the ancillary-asset concept—would benefit from greater clarity around the ancillary-asset concept, especially its exclusions. For instance, is a "protocol," a term the Bill utilizes in other provisions, a "business entity" for the purpose of the ancillary-asset exclusions? Similarly, is a DAO, which the Bill expressly designates as a business entity within the context of the Internal Revenue Code, also a business entity in the context of ancillary assets? Also, do voting rights in a protocol or DAO qualify as "any other financial interest" in an entity?

Until these and other bedrock questions are answered, the utility of, and ramifications associated with, the Bill will remain unclear, and the digital assets market will continue its long wait for much-needed guidance and certainty.

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ENDNOTES

1 § 301 (Proposing a new Exchange Act Section 41(a), which would be 15 U.S.C. § 78(a)).
2 *Id.*
3 § 301 (Proposing a new Exchange Act Section 41(b)).
4 *Id.*
5 § 301 (Proposing a new Exchange Act Section 41(c)(1)).
6 § 301 (Proposing a new Exchange Act Section 41(c)(2)).
7 § 302 (Proposing a new Exchange Act Section 41(i)).
8 Although the Bill is somewhat unclear on this point, presumably an ancillary asset would receive the "commodity" presumption even if the issuer was *not required to comply* with the disclosure requirements, because the asset's average daily trading volumes did not exceed the established thresholds for the given time frame, and/or the asset's value was not primarily determined by the entrepreneurial or managerial efforts of the issuer or any person owning not less than 10% of any class of equity securities of the issuer. Such a presumption would seem to be supported by the fact that under the Bill, the CFTC's jurisdiction is not limited to commodity interests but is extended to digital assets—including ancillary assets. § 403 (Creating a new 7 U.S.C. 2(c)(2)(F), CEA § 2(c)(2)(F)).
9 § 301 (Proposing a new Exchange Act Section 41(b)(4)(A)).
10 § 301 (Proposing a new Exchange Act Section 41(b)(4)(C)).
11 § 403 (Proposing a new 7 U.S.C. 2(c)(2)(F), CEA § 2(c)(2)(F)).
12 *Id.*
13 § 401 (Proposing a new 7 U.S.C. 1a(15B), CEA § 1a(15B)).
14 § 401 (Proposing a new 7 U.S.C. 1a(15A), CEA § 1a(15A)).
15 § 101 (Proposing a new 31 U.S.C. 9801(2)).
16 *Id.*
17 § 401 (Proposing a new 7 U.S.C. 1a(15A)(B), CEA § 1a(15B)).
18 Compare § 404 (Proposing a new 7 U.S.C. 7b-4, CEA § 1a(15B))) to 7 U.S.C. 7(d), CEA § 5d, and 7 U.S.C. 7b-3(f), CEA § 5h.
19 *Id.*
20 Compare § 403 (Proposing a new 7 U.S.C. 6d(i), CEA § 4d) to 17 C.F.R. § 1.20.
21 § 404 (Proposing a new 7 U.S.C. 7b-4(c), CEA § 5i).
22 § 404 (Proposing a new 7 U.S.C. 7b-4(d)(3)(C), CEA § 5i).
23 § 403 (Proposing a new 7 U.S.C. 7a-2(c)(5)(D), CEA § 5c).
24 *Id.*
25 § 404 (Proposing a new 7 U.S.C. 7b-4(d)(4), CEA § 5i).
26 § 404 (Proposing a new 7 U.S.C. 7b-4(d)(4), CEA § 5i). Both the SEC and the CFTC have issued statements or enforcement actions classifying Bitcoin and Ether as commodities, but one should be cautious about regarding those actions as representing the final word on the matter.
27 Zack Seward, "SEC Chairman Jay Clayton's Full Consensus: Invest Interview," Coindesk (Nov. 28, 2018, 10:13 p.m.).
28 Notably, because the exclusions are dependent on whether the asset bestows the holder with certain rights in "a" business entity, each of the participants in the associated network ecosystem (e.g., sponsors, protocol creators, platform hosts, technology providers, developers, etc.) would need to be considered. Also, while the exclusions refer to "a business entity," the Bill's periodic disclosure requirements, discussed above, relate to the "issuer" of the ancillary asset.
29 Gemini, "Defi Governance in Action," Cryptopedia (Mar. 10, 2022).

30 *See* Section C of the SEC's DAO report from 2017, pp. 15-16.

The definition of "issuer" is broadly defined to include "every person who issues or proposes to issue any security," and "person" includes "any unincorporated organization." 15 U.S.C. § 77b(a)(4). The term "issuer" is flexibly construed in the Section 5 context "as issuers devise new ways to issue their securities and the definition of a security itself expands." *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 909 (5th Cir. 1977); *accord SEC v. Murphy*, 626 F.2d 633, 644 (9th Cir. 1980) ("[W]hen a person [or entity] organizes or sponsors the organization of limited partnerships and is primarily responsible for the success or failure of the venture for which the partnership is formed, he will be considered an issuer. . . ."). The DAO, an unincorporated organization, was an issuer of securities, and information about the DAO was "crucial" to the DAO Token holders' investment decision. *See Murphy*, 626 F.2d at 643 ("Here there is no company issuing stock, but instead, a group of individuals investing funds in an enterprise for profit, and receiving in return an entitlement to a percentage of the proceeds of the enterprise.") (citation omitted). The DAO was "responsible for the success or failure of the enterprise" and, accordingly, was the entity about which the investors needed information material to their investment decision. *Id.* at 643-44.

31 *Securities and Exchange Commission v. Wahi et al.*, Case No. 2:22-cv-01009 (W.D. Was.), ¶¶ 95-206.

32 15 U.S.C. § 78c(a)(9).

33 *See, e.g., Sarcuni, et al., v. bZx DAO et al.,* No. 22-cv-618, *Complaint* at 3 (S.D. Cal. May 2, 2022) (bringing suit against defendants asserting joint and several liability due to negligence in protocol hack on the theory that DAOs are most analogous to «another phrase in American law. . .[the] general partnership» where two or more individuals carry on as co-owners of a business and agree to share profits or losses.)