Miller Strategic Partners LLP

Is This Crypto's *Regulatory* Spring?
&
A Brief Survey of the CFTC's Market Structure Reforms

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Please feel free to reach out with any questions or if we may otherwise support you in any way.

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Is This Crypto's *Regulatory* Spring?

Below we select and highlight a series of notable recent digital asset regulatory developments in the U.S. It is generally fair to observe that none of these items, on their own, are necessarily significant (except maybe the Bitcoin ETF approvals - although those have been long expected). However, when viewed as a whole and as a potential trend, we find ourselves asking for the *first-time-in-a-long-time* whether the U.S. regulatory pendulum on crypto and digital assets is starting to swing back from the extremes of a primarily enforcement focused approach.

- ***Eight U.S. state attorneys general file amicus brief in SEC v. Kraken case, opposing SEC overreach***. In November 2023, the SEC sued Kraken (LINK) for operating as an unregistered securities exchange, broker dealer, and securities clearing agency. That litigation continues in the Northern District of California, where Kraken has filed a motion to dismiss. This past week, attorneys general from eight states (Montana, Arkansas, Iowa, Mississippi, Nebraska, Ohio, South Dakota, and Texas) filed an amicus

brief that does not take any position with respect to Kraken's business but that opens by asserting that the group of attorneys general "*opposes the [SEC's] regulation of crypto assets absent an investment contract because Congress has not delegated this authority to the SEC.*" A few other notable headlines from the attorneys general brief - "*The SEC's Enforcement Action Exceeds its Delegated Powers.*" "*The SEC wrongly expands the definition of 'investment contract' in this enforcement action to any asset that could increase in value.*" And "*The SEC's overly broad interpretation of 'investment contract' and claimed authority over crypto assets squarely implicates the major questions doctrine.*"

- ***The U.S. Department of Energy pulls back mandatory survey on crypto mining electricity use following lawsuit from Texas Blockchain Council***. In January 2024 and acting under a purported emergency authorization, the Energy Information Administration (which is part of the Department of Energy) initiated "a provisional survey of electricity consumption information from identified cryptocurrency mining companies operating in the United States." (LINK). In February, a Bitcoin mining industry association (the Texas Blockchain Council) sued to block the mandatory data collection survey, and a Federal Court, on February 23, 2024, issued a temporary restraining order to pause the survey (LINK). Through an agreement filed in the case on March 1, 2024, between the plaintiffs and the EIA, the EIA has agreed to destroy any data that it has received on the earlier survey and to withdraw the mandatory survey. Instead, it will propose a new data collection subject to public review and comment prior to being finalized (LINK TO AGREEMENT).

- ***House Financial Services Committee votes 31-20 to disapprove of SEC Staff Accounting Bulletin 121***. SAB 121 requires certain SEC registered or reporting companies, and various others, that are keeping a client's cryptocurrencies to reflect those assets on the company balance sheet. The most draconian outcome of this approach is for banks and other similarly regulated financial institutions - which would then have to maintain a highly costly amount of capital against those assets, even though they are customer assets, and not company assets. HSFC met on February 29, 2024 and, amongst other actions, voted 31-20 to support a resolution that if ultimately jointly adopted by both the full House and Senate could overturn SAB 121. As a reminder, the March 2022 staff accounting bulletin has previously been criticized by the Government Accountability Office, in October 2023, because of GAO's conclusion that the release met the Administrative Procedures Act definition of a rule but had not been sent to Congress for review (which is required of rules).

- ***CFTC Technology Advisory Committee releases forward looking Report on DeFi***. On January 8, 2024 the CFTC's Digital Assets and Blockchain Technology Subcommittee of the Technology Advisory Committee (TAC) released a 79-page report entitled *Decentralized Finance* (see the REPORT). While the report covers many benefits and shortcomings of decentralized financial systems, it proceeds with a primary theme of encouraging collaboration between government and industry for advancing the "responsible and compliant" development of DeFi. The recommendations were structured around resourcing and data gathering, mapping existing regulations to DeFi systems, identifying and prioritizing risks, identifying and evaluating policy approaches, collaborating with domestic and global regulators and industry, and focusing on near term progress on policies for for identify, KYC, AML, and privacy in the DeFi context.

- ***SEC approves spot Bitcoin ETFs***. As has been widely reported, on January 10, 2024 (LINK), the SEC approved the listing and trading of ETFs holding spot Bitcoin. Since that time, spot Bitcoin ETFs have seen enormous inflows and have become one of the fastest growing ETF categories (in terms of assets under management) in history.

- ***Digital asset token projects consider payments or revenue share to token holders***. While not "regulatory actions," two very interesting developments emerged from the digital assets industry in February in connection with the ability of a token holder to earn or receive payments in connection with a governance token A proposal was made to the Uniswap Foundation in connection with UNI (the governance token for Uniswap) that, if adopted, would cause payments to be made to UNI token holders based on fees earned by the Uniswap protocol. Separately, Telegram's founder is reported to have said that Telegram will share advertising revenue with owners of certain Telegram channels, with revenue share to be distributed via the TON blockchain network.

Going the other direction, the U.S. District Court for the Western District of Wasington in Seattle, in a SEC case targeting a former Coinbase employee for insider trading, held that certain secondary transactions in digital assets were investment contracts and thus securities transactions. However, the judgment was a default judgment and did not benefit from any response, argument, or advocacy from the defendant, and it should not be viewed as meaningful precedent by other courts. The Order is available here.

A Brief Survey of the CFTC's Market Structure Reforms

Over the past couple years, the CFTC has been pursuing a range of public discussions, consultations, and (more recently) rule proposals centering around the topic of futures market structure. In this context, the staff and industry, along with the Chairman and Commissioners,

are exploring key questions related to whether the traditional core market structure components seen in the majority of today's CFTC governed listed, traded, and cleared derivatives markets are evolving, have evolved, or should evolve. Specifically - regulators and the industry are evaluating the purpose, function, and roles of - and the importance of the relationships between - trading firms, intermediaries, exchanges and their matching engines, clearing houses, and their various key vendors.

Below, we collect and summarize a selection of these initiatives in order to (1) simplify the tracking of the various workstreams, and (2) create a holistic survey of the various themes that are under review.

- ***The 2022 FTX Proposal for Non-Intermediated Clearing of Margined Products***. As one potential starting place or framing reference (certainly not the only one), recall that on March 10, 2022, the CFTC requested public comment on a formal request from LedgerX, LLC (which was at that time doing business as FTX US Derivatives) to amend its order of registration as a DCO to allow it to modify its existing non-intermediated model. LedgerX then operated and continues to operate a non-intermediated model (with no FCMs), clearing futures and options on futures contracts on a fully collateralized basis. In the request for an amended order of registration, LedgerX had proposed to clear margined products for retail participants while continuing with a non-intermediated model. The CFTC extended the public comment period on March 24, 2022.
- ***May 2022 Roundtable on Non-Intermediation***. On May 25, 2022, the CFTC held a public roundtable to "gather information and receive expert input from a wide variety of stakeholder groups regarding the impact non-intermediation could have in the context of CFTC-registered derivatives clearing organizations (DCOs) and what it means for derivatives trading and clearing more generally." (LINK). The roundtable considered a stylized set of facts that resembled many aspects of the FTX proposal. (PDF LINK).
- ***December 15, 2023 - Bitnomial DCO approved***. Bitnomial, which operates a CFTC registered futures exchange (i.e., a DCM), had its application for a CFTC licensed clearinghouse (i.e., a DCO) approved (LINK to Order). As both a DCM and DCO Bitnomial has the ability, like CME and ICE, to list, trade, and clear futures and options with margin. The Bitnomial group also owns a clearing futures commission merchant (*i.e.*, FCM or futures broker), however it does not currently appear on the list of clearing firm FCMs on Bitnomial's website.
- ***December 15, 2023 - CFTC staff advisory on affiliated DCOs and FCMs***. On the same day as the Bitnomial DCO approval, CFTC staff issued an advisory (LINK) addressed to organizations with an affiliated CFTC registered exchange, clearinghouse, and intermediary such as a futures commission merchant (*i.e.*, a FCM or futures broker). The advisory reminded these organizations to "ensure compliance with existing statutory and

regulatory requirements with this affiliate relationship in mind" and that "staff closely scrutinizes how these types of affiliate relationships are addressed when reviewing applications for registration or designation, conducting examinations and rule reviews, and through other supervisory means." The advisory also foreshadowed a forthcoming rulemaking on this topic.

- ***Commissioner statements; calls for further rulemaking***. Following the Bitnomial DCO approval, Commissioner Johnson released a statement (LINK) calling for a rulemaking on the topic of clearinghouses affiliated with intermediaries, focusing on conflicts of interest, amongst other issues. Commissioner Goldsmith Romero (LINK) released a statement also calling for a rulemaking, focusing on direct-to-retail exchange and clearing models and pushing for rules around AML/KYC requirements, customer protection, and bankruptcy treatment, amongst other issues.
- ***CFTC proposed rule (December 18, 2023) on DCO handling of clearing member funds***. The CFTC also proposed a rule (LINK) - a potential first-in-a-series of rulemakings addressed to these vertically integrated market structure issues - addressing requirements related to clearing member funds held by a derivatives clearing organization. The rule addresses segregation of clearing member funds from DCO funds, the ability to hold funds at certain foreign banks, and requirements for daily calculations and reconciliations of customer and clearing member funds. The comment period is extended to March 18, 2024 (LINK).
- ***CFTC proposed rule (December 18, 2023) on operational resilience for intermediaries***. Lastly, the CFTC voted unanimously to propose for comment a rulemaking that would require an Operational Resilience Framework for FCMs, swap dealers, and major swap participants (LINK). This will be an important set of requirements that compel CFTC registered intermediaries to adopt and implement formal programs of monitoring, governance, and supervision related to information and technology security, third-party relationships, and emergencies or other significant disruptions to normal business operations. The comment period has been extended to April 1, 2024 (LINK).
- ***Proposed rule amendments (February 20, 2024) to allow IB's to submit customer orders to FBOTs***. The CFTC proposed rules (LINK) that would, in principal part, permit a foreign board of trade (FBOT) registered with the CFTC to provide direct access to its electronic trading and order matching system to an identified member or other participant located in the United States and registered with the CFTC as an introducing broker for submission of customer orders to the FBOT's trading system for execution. Currently, IB's do not have this permission.
- ***Long awaited proposed rules (February 20, 2024) related to margin adequacy and the treatment by FCMs of separate accounts of a single customer***. The current proposal would add new CFTC Regulation 1.44, which would apply directly to all FCMs, with respect to their customers, a margin adequacy requirement, similar to the one applicable

to DCOs in Regulation 39.13(g)(8)(iii), which is designed to ensure that an FCM does not permit a customer to withdraw funds from its account if the balance after the withdrawal would be insufficient to meet the customer's initial margin requirements. Proposed Regulation 1.44 would also permit FCMs, whether clearing or non-clearing, to treat the separate accounts of a single customer as accounts of separate entities for purposes of the new margin adequacy requirement, and set forth risk-mitigating requirements, based on the no-action conditions (from CFTC Letter 19-17) and similar requirements from an April 2023 proposal.

- ***Proposed (February 20, 2024) conflicts of interest rules for DCMs and SEFs***. The CFTC proposed (LINK) conflicts of interest and governance related requirements, including with respect to market regulation functions, for DCMs and SEFs. The rules should be considered outright and also in the context of the CFTC's ongoing thinking around integrated exchange and clearinghouse models and the role of intermediaries in CFTC regulated markets.
- ***Key Excerpts from the Introduction of Commissioner Kristin Johnson's February 20, 2024 Dissenting Statement on Incomplete Conflicts of Interest Rules, Lack of Vertical Integration Rules, and Equity Transfer Rules***. LINK. "*At best, today's Proposed Rule is window dressing, supplementing long-established and well-developed conflicts requirements in heavily regulated markets. At worst, it creates confusion. While the Commission could have used this rulemaking to address endemic conflicts of interest in emerging markets such as cryptocurrency or digital asset markets, this Proposed Rule does not address these deeply concerning, pernicious conflicts of interest.*" "*I have repeatedly called on the Commission to initiate a rule-making that addresses the conflicts of interest that may arise from adopting vertically integrated market structures.*" "*It is important for the Commission to carefully consider regulations governing equity interest transfers and ensure that anyone acquiring a registered market participant is prepared to comply with the entire regulatory regime applicable to CFTC-registered firms.*"
- ***Key Excerpts from February 20, 2024 Statement of Commissioner Christy Goldsmith Romero on the Importance of Strong Rules for Conflicts of Interest at Exchanges and Swap Execution Facilities***. LINK. "*This proposed rule would not create an adequate conflicts of interest regulatory regime to cover conflicts that come from affiliated entities serving multiple functions (i.e. broker, exchange, clearinghouse, etc.)—so called "vertical integration," which the proposal acknowledges.[footnote omitted] Therefore, this rule does not serve as a basis for future approval of additional vertically integrated structures that break from the traditional structure on which the Commodity Exchange Act and CFTC rules are based.*" "*The proposal purposely attempts to carve out vertical integration from this rulemaking and commits to addressing it in the future in light of the recently completed request for comment on affiliated entities.*"

As is clear, the CFTC and its staff are spending a material amount of time considering market structure and market structure evolution, including the trends toward vertical integration and the growing user demand for non-intermediated access to markets. Still, there is not a direct rulemaking proposal that explicitly addresses either of these two issues, and in many respects one could argue that there is not necessarily a statutorily mandated rulemaking required in either instance. Nonetheless, we expect the topics to continue to be at the forefront of policy discussions - potentially along with discussions surrounding the evolution of clearinghouse risk management models as well. For example, the prevailing global clearinghouse risk management model for digital asset derivatives exchanges is a non-recourse and auto-liquidation model, which is materially different from the user-margin call and grace period model employed by the U.S. listed and cleared derivatives industry.

About us:

Miller Strategic Partners LLP is a law firm headquartered in New York City. We advise clients on trading and markets regulatory and commercial matters, investigations, and crisis management. MSP is a law firm member of the Futures Industry Association.

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