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Lummis-Gillibrand Responsible Financial Innovation Act

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On June 7, 2022, U.S. Senators Kirsten Gillibrand (D-NY) and Cynthia Lummis (R-WY) introduced the Lummis-Gillibrand Responsible Financial Innovation Act (“**Lummis-Gillibrand**” or the “**Bill**”).¹ This bipartisan legislation integrates digital assets into existing law and sets forth a regulatory framework for such assets. The Bill seeks to balance the promotion and continuation of innovation in the digital asset space, provide clarity to the industry and regulators, and protect consumers. In this article we discuss key components of the legislation and the potential implications of the Bill on both regulators and consumers.

This article discusses several key elements of the Bill including:

- (i) the Bill’s attempt to clarify whether a digital asset is deemed a “security” or a “commodity”—an important distinction because commodities are regulated by the Commodity Futures Trading Commission (the “**CFTC**”) and securities are regulated by the U.S. Securities and Exchange Commission (the “**SEC**”);
- (ii) certain proposed definitions for widely used terms in the digital asset space including “ancillary assets,” “stablecoins” (which also includes a proposal to establish reserve requirements for stablecoins), and “virtual currencies”;
- (iii) the Bill’s attempt to clarify the taxation of purchases made with virtual currency and decentralized autonomous organizations (“**DAOs**”);
- (iv) the classification of brokers and the tax treatment with respect to certain income generated by their digital asset activities; and
- (v) other key provisions the Bill proposes and its potential impact on regulators and consumers in the digital asset space.

Is a Digital Asset a Commodity or Security?

Currently, digital assets lack a common definition or set of standards. Whether a digital asset is a “commodity” or a “security” is primarily decided with reference to non-binding guidance,² administrative orders,³ and judicially

¹ Responsible Financial Innovation Act, S. 4356, 117th Congress (2022) [hereinafter *The Bill*].

² U.S. SEC. & EXCH. COMM’N, *Framework for “Investment Contract” Analysis of Digital Assets*, (Apr. 3, 2019) [hereinafter *SEC Guidance*], <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>.

³ See *In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Docket No. 15-29.

HAYNES BOONE

crafted tests⁴ rather than reference to legislation. Lummis-Gillibrand instead provides clear standards for determining a particular digital asset's place in the federal regulatory regime. If passed, the proposed legislation would decrease the reach of the SEC with respect to crypto regulation and simultaneously give greater authority to the CFTC in the digital asset landscape.

Lummis-Gillibrand follows much of the SEC's guidance surrounding digital assets as securities by codifying prevailing precedents set under the *Howey*⁵ test—the three-prong test set the standard for determining whether a transaction qualifies as an “investment contract,” and thus, a security within the regulatory purview of the SEC. Under *Howey*, an investment contract (and therefore a security) exists if there is: (i) an investment of money; (ii) in a common enterprise; (iii) with a reasonable expectation of profits to be derived from the efforts of others.⁶

Under the Bill, if a digital asset is not a security per the *Howey* test, the asset will generally be considered a commodity, and therefore regulated by the CFTC. Thus, a digital asset will almost always be either a security or a commodity, unless it is within the narrower categories discussed below.⁷

The commodity versus security distinction will depend primarily on the purpose of the asset and the rights or powers it conveys to the consumer. In order to be classified as a “security,” the digital asset must provide the holder with one or more of the following: (i) a debt or equity interest in a business entity, (ii) liquidation rights, (iii) entitlement to interest or dividend payments from the business entity, (iv) a profit or revenue share in a business entity derived from the entrepreneurial or managerial efforts of others, or (v) any other financial interest in the entity.⁸ Digital assets that are deemed “commodities” will be under the authority of the CFTC (with limited exceptions as discussed herein), while the SEC will oversee assets classified as “securities.” Notably and significantly, Bitcoin and Ethereum, which comprise over half of digital asset market capitalization, would be considered “commodities” under this definition.⁹

In contrast to the SEC's prevailing default position that it was the primary regulator, the Bill distinguishes and divides authority between the SEC and the CFTC, provides the CFTC with greater regulatory oversight of the

⁴ See U.S. Sec. & Exch. Comm'n v. W. J. Howey Co., 328 U.S. 293 (1946).

⁵ See Press Release, Cynthia Lummis, *Lummis, Gillibrand Introduce Landmark Legislation to Create Regulatory Framework for Digital Assets* (June 7, 2022), <https://www.lummis.senate.gov/press-releases/lummis-gillibrand-introduce-landmark-legislation-to-create-regulatory-framework-for-digital-assets/>; See W. J. Howey Co., 328 U.S. 293.

⁶ *W. J. Howey Co.*, 328 U.S. at 301.

⁷ See *The Bill*, § 101(a)(2)(B).

⁸ Christian H. Staples, *Breaking Down the New Bitcoin Bill: An Overview of the Lummis-Gillibrand Responsible Financial Innovation Act*, Shumaker (June 8, 2022), <https://www.shumaker.com/latest-thinking/publications/2022/06/breaking-down-the-new-bitcoin-bill-an-overview-of-the-lummis-gillibrand-responsible-financial-innovation-act>.

⁹ Press Release, Cynthia Lummis, *supra* note 5.

HAYNES BOONE

digital asset industry, and gives digital asset companies a better ability to determine their potential regulatory obligations.

Additional Digital Asset Definitions and Their Categorization

The Bill provides clarity with respect to three additional digital asset definitions: (i) ancillary assets¹⁰; (ii) payment stablecoins issued by depository institutions¹¹; and (iii) virtual currencies.¹² As discussed further below, an ancillary asset is presumed to be a “commodity” while stablecoins and virtual currencies are considered neither a commodity nor security.

Ancillary Assets

The Bill creates the legal category of “ancillary assets,” or “intangible, fungible assets offered in connection with the sale of a security.”¹³ Ancillary assets are presumed to be a “commodity” subject to CFTC jurisdiction, provided, however, the issuer of the ancillary asset will also be required to make periodic disclosures with the SEC related to basic corporate information regarding the issuer and information relating to the ancillary asset.

Ancillary assets include digital assets sold alongside an “investment-like” opportunity.¹⁴ To illustrate, a company may raise capital by issuing securities to investors to finance the building of a new cryptocurrency exchange like Coinbase or Kraken. To promote the fundraiser, the company may issue its own cryptocurrency in connection with the investors’ purchase of the securities that gives the investor increased functionality on the company’s exchange. While the contract documenting the investment remains a security, the company’s token would be presumed to be a commodity because it is not fully decentralized and does not create rights to profits or other financial interests in the underlying business entity.¹⁵ However, the company would still be required to provide certain disclosures to the SEC twice a year,¹⁶ and notably, the presumption that the token is a commodity can be challenged in court.¹⁷

¹⁰ *The Bill*, § 301(a)(1).

¹¹ *Id.* § 101(a)(5).

¹² *Id. Bill*, § 101(a)(10).

¹³ Tom Zanki, *Senate Crypto Bill Eyes Bigger Role for CFTC*, LAW360 (June 7, 2022), <https://www.law360.com/articles/1500589/senate-crypto-bill-eyes-bigger-role-for-cftc>.

¹⁴ *See id.* § 301(a)(1).

¹⁵ Jeff John Robert, *Senate Bill Would End SEC’s Oversight of Most Crypto, Create \$200 Tax Exemption*, DECRYPT (June 7, 2022), <https://decrypt.co/102180/lummis-gillibrand-bill>.

¹⁶ *The Bill*, § 301(c).

¹⁷ *Id.* § 301(b)(4)(C).

HAYNES BOONE

Stablecoins

Lummis-Gillibrand creates a tailored regulatory framework with respect to “stablecoins,” or digital assets whose values are pegged to a fiat currency or some other tangible asset.¹⁸ Stablecoins were designed to reduce crypto trading volatility through pegging and can provide stability relative to unpegged cryptocurrencies.¹⁹ Stablecoins help digital asset investors move in and out of the market and serve as a means for immediate payments, including across borders.

The Bill provides a detailed, optional method for banks and credit unions to issue stablecoins and clarifies that a stablecoin issued by a depository institution (*i.e.*, a bank or credit union) is neither a commodity nor a security.²⁰ The Bill authorizes the Office of the Comptroller of the Currency (the “**Comptroller**”) to charter a special depository institution under both state law and the National Bank Act for stablecoin issuance. The Bill tasks the Comptroller with developing a tailored capital framework, community contribution plan, recovery and resolution plan, and tailored holding company supervision. The charter’s tailored capital requirements are based on payment system risk and the greater of (i) all projected costs of receivership or (ii) three years of projected operating expenses. The Bill strives to provide existing and new issuers an adequate opportunity to compete with depository institutions for stablecoin issuance.²¹

To avoid outcomes like the Luna and terraUSD stablecoin collapse,²² the Bill establishes a “100% reserve model,” meaning all stablecoins must be fully backed by reserves so they are consistently redeemable in exchange for the equivalent currency value.²³ This consistent redeemability ensures stablecoins are able to maintain their value and thereby protects consumers from many of the potential risks associated with stablecoins.

Virtual Currency

“Virtual currency” is another new category proposed by the Bill and is considered an umbrella term which refers to a digital asset used as a medium of value that is neither legal tender nor backed by an underlying financial asset (*i.e.*, Bitcoin, Litecoin and XRP).²⁴ Virtual currency is also not blanketly considered a commodity or security.

¹⁸ Aaron Nicodemus, *Lummis Gillibrand bill would regulate crypto for the first time*, COMPLIANCE WEEK (June 8, 2022), <https://www.complianceweek.com/regulatory-policy/lummis-gillibrand-bill-would-regulate-crypto-for-first-time/31759.article>.

¹⁹ *What is a stablecoin?*, COINBASE, <https://www.coinbase.com/learn/crypto-basics/what-is-a-stablecoin>.

²⁰ *The Bill*, § 408.

²¹ *Id.* § 604.

²² Daniel Van Boom, *Luna Crypto Crash: How UST Broke and What’s Next for Terra*, CNET (May 25, 2022), <https://www.cnet.com/personal-finance/crypto/luna-crypto-crash-how-ust-broke-and-whats-next-for-terra/>.

²³ Marco Quiroz-Gutierrez, *The new crypto bill could end algorithmic stablecoins as we know them*, FORTUNE (June 8, 2022), <https://fortune.com/2022/06/08/algorithmic-stablecoins-terra-luna-crypto-regulation-senate-bill-lummis-gillibrand/>.

²⁴ *Id.*

HAYNES BOONE

Rather, the classification of a given virtual currency depends on the facts and circumstances (see “Is a Digital Asset a Commodity or Security?” herein).

Taxation of Digital Assets

Lummis-Gillibrand also seeks to modify existing tax law treatment with respect to digital assets. As discussed below, the Bill seeks to: (i) establish a *de minimis* exemption for purchases with virtual currency, (ii) establish DAOs are business entities for U.S. tax purposes, (iii) establish digital asset miners should not be considered brokers and task the Internal Revenue Service (the “**IRS**”) with adopting digital asset guidance, (iv) establish that digital asset lending transactions should be treated as security lending transactions and should generally not be taxable (iv) provide for an extension of tax trading safe harbors for non-U.S. persons, and (vi) provide for a deferral of income tax on digital assets obtained from mining and staking until the time of the disposition of these assets.

De Minimis Exemption

The Bill allows for a *de minimis* exemption from gross income for gains of up to \$200 on virtual currency used to buy goods or services; therefore, the exemption would soften existing tax reporting mandates. Currently, if an individual uses a debit card funded by a cryptocurrency wallet, the individual is required to report either the gains or the losses on the underlying cryptocurrency when they are converted into U.S. Dollars at the time of sale, which leads to a realization event on the underlying cryptocurrency. Gains or losses that are realized other than through a personal transaction for goods or services must still be reported, even if under the \$200 threshold.²⁵ In addition, separate dispositions that are part of the same transaction will be aggregated for purposes of reaching the \$200 threshold. The Bill’s *de minimis* exemption would allow individuals to make purchases with virtual currency without having to account for and report income under the threshold. This exemption also encourages the use of digital assets for everyday transactions to avoid the income tax that would have been imposed on the gain realized in these transactions.

Decentralized Autonomous Organizations (“DAOs”)

DAOs are organizations (i) that utilize smart contracts to effectuate collective action for a business, commercial, charitable or similar entity; (ii) the governance of which is achieved primarily on a distributed basis, and (iii) which is properly incorporated or organized under the laws of a State or foreign jurisdiction as a decentralized autonomous organization, cooperative, foundation, or any similar entity.²⁶ The Bill provides that DAOs are considered legal entities and thus subject to taxation as business entities in certain circumstances. Additionally, the Bill requires most DAOs to be properly incorporated in a jurisdiction, whether as a DAO, cooperative, foundation, or another similar entity (as established by Wyoming with its “DAO LLC” legislation).²⁷ A DAO-like project under the Bill may be able to avoid certain disclosure requirements if it is sufficiently decentralized, because the disclosure requirements are only triggered if the issuer or a person owning at least 10% of any equity interests in the issuer engaged in entrepreneurial or managerial efforts that primarily determined the value of the ancillary

²⁵ *The Bill*, § 201(a).

²⁶ *Id.* § 204(a)(51)(C).

²⁷ 2022 Wyo. Sess. Laws. Ch. 36, available at <https://www.wyoleg.gov/Legislation/2022/SF0068> (creating a new legal entity for DAOs).

HAYNES BOONE

asset.²⁸ If an issuer does not avoid the disclosure requirements, the issuer can later terminate its obligation to make the disclosures by certifying that (i) the aggregate daily value of all trading of the DAO's token was \$5 million or less or (ii) neither the issuer nor a controlling entity of the issuer engaged in entrepreneurial or managerial efforts.²⁹ The issuer would be required to certify these facts to the SEC, which can deny the certification if it finds the certification is not supported by "substantial evidence" in a majority vote after notice and opportunity for a hearing.³⁰

Brokers

Lummis-Gillibrand seeks to narrow the definition of "broker" in the digital asset context by establishing the term refers to "persons that perform the traditionally understood broker activity of standing ready to effect sales in digital assets on behalf of customers."³¹ The Bill clarifies the definition of broker for the purpose of the digital asset reporting requirement of the Infrastructure Investment and Jobs Act (the "**Infrastructure Bill**").³² Currently, the Infrastructure Bill broadly requires taxpayers engaged in a trade or business to file an information return upon the receipt of \$10,000 or more in digital assets in one transaction or two or more related transactions in the course of trade or business.³³ Lummis-Gillibrand's definition of broker would narrow the applicability of the Infrastructure Bill's digital asset reporting requirement. Further, Lummis-Gillibrand seeks to clarify crypto miners and other crypto validators should not be considered brokers for income tax purposes, and their rewards should not be considered "income" until redeemed for cash. Lummis-Gillibrand requires the IRS to adopt guidance or clarification with respect to this discussion.³⁴

Digital Asset Lending Transactions

Currently, digital assets are not treated as securities for tax purposes and therefore, digital asset lending transactions should be treated as taxable events, unlike other security lending transactions, which are generally exempt under Section 1058 of the Internal Revenue Code of 1986, as amended (the "**Code**"). Under the Bill,

²⁸ *The Bill*, §§ 301(b)(1)(B), 301(b)(2)(B), & 301(b)(3)(B).

²⁹ *Id.* § 302(i)(2)(A).

³⁰ *Id.* § 302(i)(2)(B).

³¹ Dario de Martino et al., *Lummis-Gillibrand Responsible Financial Innovation Act proposes comprehensive regulatory framework or digital assets in the United States*, ALLEN & OVERY (June 14, 2022), <https://www.allenoverly.com/en-gb/global/news-and-insights/publications/lummis-gillibrand-responsible-financial-innovation-act>.

³² *The Bill*, § 202.

³³ Marie Sapirie, *Tax Information Reporting on Digital Assets Steps into the Spotlight*, FORBES (June 27, 2022), <https://www.forbes.com/sites/taxnotes/2022/06/27/tax-information-reporting-on-digital-assets-steps-into-the-spotlight/?sh=59f22fa84ea7>.

³⁴ *The Bill*, § 206.

HAYNES BOONE

digital assets are treated as securities for the purposes of security lending transactions and therefore no gain or loss will be recognized in any such transaction that meets the other requirements of Section 1058 of the Code.³⁵

Tax Trading Safe Harbors

Lummis-Gillibrand expands the trading safe harbor for non-U.S. persons to include their trading in digital assets, provided (i) those digital assets are of a kind customarily dealt on a digital asset exchange and (ii) the transaction is of a kind customarily consummated on such an exchange.³⁶

Non-U.S. investors are generally subject to U.S. income tax on income connected with the conduct of a U.S. trade or business. However, Section 864(b)(2) of the Code provides a safe harbor for a non-U.S. person who trades securities and commodities for its own account as well as a non-U.S. investor who trades in the United States through a resident broker, commission agent, custodian, digital asset exchange, or other independent agent. There has been uncertainty whether trading in digital assets would be included in this safe harbor. The Bill expands the exemption to cover trading in digital assets with respect to sales and exchanges occurring after December 31, 2022.³⁷

Timing of Taxation of Digital Assets Obtained Through Mining and Staking

Under general tax principles, taxpayers are subject to U.S. income tax upon the receipt of cash or assets received in exchange for the rendering of services or goods but are not subject to tax when a taxpayer creates an asset until the time of the disposition of such asset. The Bill provides that the receipt of digital assets from mining and staking should be treated like an asset the taxpayer creates and is therefore not subject to tax until the time of the disposition of such asset.³⁸

Other Key Provisions

Lummis-Gillibrand seeks to provide greater clarity to federal regulators on enforcing existing commodities and securities trading laws, resulting in potentially improved protections for consumers.

While the Bill's key components are discussed in detail in this article, the proposed legislation contains numerous other significant provisions worth noting. In particular, the Bill:

- (i) Seeks to establish an advisory committee comprised of stakeholders who can adequately prepare and adjust to the ongoing evolution of the digital asset space.

³⁵ *The Bill*, § 205.

³⁶ *Lummis-Gillibrand Digital Asset Bill – Key Takeaways*, ROPES & GRAY (June 17, 2022), <https://www.ropesgray.com/en/newsroom/alerts/2022/06/Lummis-Gillibrand-Digital-Asset-Bill-Key-Takeaways>.

³⁷ *The Bill*, § 203.

³⁸ *The Bill*, § 208(a).

HAYNES BOONE

- (ii) Enhances supervision over the digital asset industry by seeking to establish an Innovation Laboratory within the U.S. Treasury Department's Financial Crimes Enforcement Network which should allow an increase in its communication with financial companies.
- (iii) Foresees how a self-regulatory organization working alongside the SEC and the CFTC could be created to provide additional supervision over crypto businesses.
- (iv) Delegates a digital asset energy consumption study to be conducted by the Federal Energy Regulatory Commission.
- (v) Entrusts the CFTC and the SEC to develop cybersecurity standards for digital asset intermediaries.
- (vi) Flags a need to better understand China's central bank digital currency and the digital yuan. This task would be delegated among the Office of Management and Budget, the Cybersecurity and Infrastructure Agency, the Director of National Intelligence, and the Defense Department. As China intends to promote this currency on an international scale, Lummis-Gillibrand emphasizes a need to better understand the currency for national security reasons.

Conclusion

Lummis-Gillibrand represents one of the first major efforts to apply comprehensive regulation to the digital asset space, which currently lacks a strong set of standards or guidance despite the complexity that characterizes the industry. The proposed legislation represents a timely response to the rapidly emerging and uncharted digital asset territory.

For more information, please contact any of the following lawyers: [Kellie Bobo](#), [Robert Bruner](#), [Madelyn Calabrese](#), [Ricardo Davidovich](#), [Daren Domina](#), [Evan Hall](#), [Vicki Odette](#), [Shelley Rosensweig](#), [Taylor Wilson](#), or [Jacqueline Jensen](#).