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# Crypto Regulation: FIT21 and the U.S. Landscape

Authored by Linda Ann Bartosch, Neel Maitra, Dale C. Beggs, Paul Capuano, Sam Scarritt-Selman, Olivia R. Sedita, Cindy Wu, and Lucy Yang

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## Key Takeaways:

The House recently passed the Financial Innovation and Technology for the 21st Century Act (“FIT21”). If FIT21 becomes law, it would:

- More clearly define crypto asset regulatory boundaries for Securities and Exchange Commission (“SEC”) and Commodity Futures Trading Commission (“CFTC”), providing statutory definitions for “restricted digital assets” and “digital commodities.”
- For the first time, give the CFTC plenary jurisdiction over spot trading in digital commodities, instead of the limited jurisdiction the CFTC now has over such spot commodities.
- Provide for a “certification” process, through which a blockchain could be shown to “decentralized,” permitting the assets on such blockchain to be regulated as digital commodities, rather than securities.
- Create new categories of SEC and CFTC registrants, providing a pathway for platforms to offer trading in both digital commodities and securities.
- Provide for provisional registration to transition to the new framework, with a limited safe harbor from SEC enforcement actions.
- Provide exemptions from regulation for certain enumerated types of decentralized finance (“DeFi”) activity.
- Mandate joint rulemaking by the SEC and CFTC in certain areas of shared jurisdiction.

## Introduction

The United States House of Representatives voted 279-136 to pass FIT21 on Wednesday, May 22, 2024. The bipartisan support that FIT21 received has cheered crypto enthusiasts, leading some to anticipate the bill’s successful passage in the Senate.

FIT21 has not yet been introduced in the Senate and is likely to face many hurdles, including, ultimately, a possible Presidential veto. Yet, if FIT21 is ultimately enacted it would significantly change the U.S. regulatory landscape for crypto assets, crypto asset markets and market participants. Below, we summarize what FIT21 seeks to achieve and how, if enacted, it would re-order U.S. crypto markets.

## Background: U.S. Crypto Controversies and Responses

U.S. regulation of crypto assets and crypto markets has been contested terrain over the last five years or more. Crypto asset issuers and market participants have often insisted that crypto assets are not financial instruments and that existing laws, particularly existing securities laws, are unsuitable for crypto assets. Claims relating to “crypto exceptionalism” or the inapplicability of existing Federal securities laws to crypto assets have had a mixed

reception in Federal courts, and the SEC has repeatedly stated that existing securities laws adequately apply to crypto assets without the need for modification.

At the time of this writing, the SEC is involved in enforcement proceedings or litigation against a number of major crypto trading platforms, alleging, among other things, that these platforms are acting as unregistered broker-dealers, exchanges and clearing agencies, in violation of the Federal securities laws.<sup>1</sup> The SEC has also brought claims against crypto asset staking programs and wallet providers,<sup>2</sup> and is understood to have issued a Wells notice to at least one purportedly decentralized trading platform.<sup>3</sup> The counterparties to these actions continue to vigorously contest such claims. Many participants also allege that an absence of regulatory clarity impedes the development of the U.S. crypto industry.<sup>4</sup>

FIT21 is one of several legislative initiatives that attempt to address perceptions of regulatory uncertainty around the crypto industry. Introduced into the House in July 2023 by Chairman Glenn Thompson, Rep. French Hill, Rep. Dusty Johnson, Whip Tom Emmer and Rep. Warren Davidson, FIT21 was co-sponsored by Rep. Patrick McHenry, Chairman of the House Financial Services Committee. FIT21 passed out of the House Agriculture and Financial Services Committees with bipartisan support, before being passed by the House.

Hours before FIT21 came up for a vote on the floor of the House, however, SEC Chair Gary Gensler issued a strongly-worded statement, alleging that FIT21 “would create new regulatory gaps and undermine decades of precedent regarding the oversight of investment contracts, putting investors and capital markets at immeasurable risk.”<sup>5</sup> Chair Gensler listed several ways in which he claimed FIT21 would undermine investor protection and the Federal securities laws, stating in conclusion: “The crypto industry’s record of failures, frauds and bankruptcies is not because we don’t have rules or because the rules are unclear. It’s because many players in the crypto industry don’t play by the rules.”<sup>6</sup>

Before reviewing other comments and criticisms on FIT21, however, it may be helpful to review how the proposed legislation is structured. Accordingly, in this *Dechert OnPoint*, we first provide an overview of the FIT21’s regulatory scheme, and the key concepts around which the proposed legislation is organized. We then discuss some key takeaways from the proposed legislation as well as some of the criticisms and areas in which it has faced, and is likely to continue to face, opposition.

## FIT21: Overview and Summary of Key Concepts

FIT21 seeks to allocate jurisdiction over digital assets and digital asset-related transactions between the SEC and the CFTC. While the SEC would regulate “restricted digital assets” (“RDAs”) and the market participants who

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<sup>1</sup> See, e.g., SEC v. Payward, Inc., No. 3:23-cv-06003 (N.D. Cal., filed Nov. 20, 2023) (alleging that Kraken is an unregistered securities exchange, broker, dealer and clearing agency).

<sup>2</sup> See, e.g., SEC v. Binance Holdings Limited, No. 1:23-cv-01599 (D.D.C. filed June 5, 2023) (alleging, among other things, that Binance’s staking-as-a-service program is an unregistered securities offering).

<sup>3</sup> On April 10, 2024, the CEO of Universal Navigation Inc., doing business as Uniswap Labs, revealed that Uniswap Labs had received a Wells notice. Hayden Adams (@haydenzadams), X.com (Apr. 10, 2024), <https://x.com/haydenzadams/status/1778126466984575166>. Uniswap Labs develops software products for and promotes the Uniswap Protocol.

<sup>4</sup> See, e.g., Defendants BAM Trading Services Inc. and BAM Management US Holdings Inc.’s Memorandum of Law in Support of their Motion to Dismiss, in SEC v. Binance Holdings Limited, (D.D.C., filed Sep. 21, 2023).

<sup>5</sup> Gary Gensler, Chairman, Securities and Exchange Commission, [Statement on the 21st Century Disclosure Act](#) (May 22, 2024).

<sup>6</sup> *Id.*

transact in such assets, the CFTC would regulate “digital commodities” and the market participants who transact in digital commodities.

Under FIT21, entities transacting in RDAs would, depending on their role, be required to register with and be regulated by the SEC as digital asset brokers, digital asset dealers or digital asset trading systems. Entities transacting in digital commodities would, depending on their role, be required to register with and be regulated by the CFTC as digital commodity brokers, digital commodity dealers or digital commodity exchanges.

Perhaps most notably, FIT21 would provide a pathway for an SEC-regulated RDA to transition to become a CFTC-regulated digital commodity if the blockchain system on which such asset is based is both (1) “functional” and certified to be (2) “decentralized.”<sup>7</sup>

### **“Functional,” “Decentralized” Blockchain Systems**

Under FIT21, a blockchain system is **decentralized** if the following five conditions are met:

1. **Control:** During the 12-month period before certification, no person has had the unilateral authority to control the functionality or operation of the blockchain or to unilaterally restrict participation on the blockchain, such as through using, earning or transmitting digital assets, deploying software on the blockchain or operating a node or other infrastructure on the blockchain.
2. **Voting:** During the 12-month period before certification, either:
  - a. no digital asset issuer or its affiliated person has beneficially owned 20 percent or more of the total units of a digital asset or had the unilateral authority to direct the voting of 20 percent or more of the outstanding voting power of such digital asset or related decentralized governance system; or
  - b. the digital asset does not include voting power with respect to the system.
3. **IP:** During the three-month period before certification, no digital asset issuer, affiliated person or related person has implemented or contributed any intellectual property to the source code of the system that materially alters the system’s functionality or operation, other than:
  - a. to address vulnerabilities, errors, regular maintenance, cybersecurity risks or other technical changes to the blockchain system; or
  - b. such alterations as were adopted through the consensus or agreement of a decentralized governance system.
4. **Marketing:** During the three-month period before certification, neither any digital asset issuer nor any affiliated person has marketed to the public the digital assets as an investment.
5. **End User Distributions:** During the 12-month period before certification, all issuances of units of such digital asset through the programmatic functioning of the blockchain system were “end user distributions,” i.e., distributions that:
  - a. do not involve an exchange of more than nominal amounts of cash or other assets; and

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<sup>7</sup> See FIT21 Section 103 (definition of “digital commodity”).

- b. are distributed in a broad, equitable and non-discretionary manner, open to all participants on the blockchain (including as incentive-based rewards).<sup>8</sup>

A blockchain system is **functional** if it allows network participants to use the digital asset for any of the following:

- Transmission and storage of value on the blockchain system.
- Participation in services provided by or an application running on the blockchain system.
- Participation in the decentralized governance system of the blockchain system.<sup>9</sup>

A blockchain system would have to be both functional and certified to be decentralized for the assets on it to be considered digital commodities.<sup>10</sup> Although the certification is only with respect to whether the blockchain system is decentralized, the filing must include a description of the functionality of the digital asset. (Under FIT21, functional systems and decentralized systems are each defined without reference to certification.)

The determination of whether a blockchain is decentralized involves a “certification” process. Any person can file a statement with the SEC certifying, with respect to a RDA, that the blockchain system to which the RDA relates is a decentralized system.<sup>11</sup> The **certification statement** must include, among other things:

- Information regarding the person filing the statement.
- A description of the relevant blockchain and the digital assets, and their development.
- Information regarding the beneficial ownership of, and the distribution of voting power, in any decentralized governance system during the 12 months before certification.
- Information regarding the history of upgrades to the source code for such blockchain system during the three-month period before certification.
- An analysis of why the blockchain network is both functional and decentralized.<sup>12</sup>

The SEC has 60 days to rebut or stay this certification and/or open the certification to public comment.<sup>13</sup> If the SEC does not rebut or stay the certification, the certification will become effective after 60 days of the certification being filed.<sup>14</sup> If the SEC stays a certification, the stay will operate for 120 days from the date of notice of the stay, and the SEC may open the certification for public comment for a period of at least 30 days.<sup>15</sup>

If the SEC rebuts the certification, and disagrees that the blockchain is functional or decentralized, the certification will not become effective once the SEC has published a notification of its rebuttal.<sup>16</sup> This notice of

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<sup>8</sup> FIT21 Section 101 (definition of “decentralized system”).

<sup>9</sup> FIT21 Section 101 (definition of “functional system”).

<sup>10</sup> FIT21 Section 103 (definition of “digital commodity”).

<sup>11</sup> FIT21 Section 304 (certification of certain digital assets).

<sup>12</sup> *Id.* (filing requirements for certification of certain digital assets).

<sup>13</sup> *Id.* (rebuttable presumption).

<sup>14</sup> *Id.* (certification review).

<sup>15</sup> *Id.* (stay of certification).

<sup>16</sup> *Id.* (disposition of certification).

rebuttal must also include a detailed analysis of the factors based on which the SEC concluded that the blockchain was not functional or decentralized.<sup>17</sup> A rebuttal of certification can be appealed to the D.C. Circuit Court of Appeals within 60 days of the notice of rebuttal.<sup>18</sup>

### ***Certification for Digital Commodity Trading***

After the blockchain system on which a RDA is based has been certified as functional and decentralized, the RDA will become a digital commodity for regulatory purposes. However, before that digital commodity can be offered on a trading platform (for example, a digital commodity exchange), the digital asset must also be certified with the CFTC.<sup>19</sup> This trading certification must be filed by a CFTC-registered entity (for example, a digital commodity exchange) and the certification must contain information regarding the digital asset's:

- Purpose and use.
- Unit creation or release process.
- Consensus mechanism.
- Governance structure.
- Participation and distribution.
- Current and proposed functionality.
- Any other information required by the CFTC.<sup>20</sup>

This certification will be effective no later than 20 business days after filing, unless the CFTC objects to the certification or extends the review process for up to 60 business days.<sup>21</sup>

Additionally, a digital commodity exchange may permit trading in a digital commodity only if certain required information is correct, current, and available to the public, including:

- The source code for any blockchain system to which the digital commodity relates.
- A narrative description of the steps necessary to independently access, search, and verify the transaction history of any blockchain system to which the digital commodity relates.
- A narrative description of the purpose of any blockchain system to which the digital asset relates and the operation of any such blockchain system, including certain information related to the digital asset's economics.
- The trading volume and volatility of the digital commodity.<sup>22</sup>

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<sup>17</sup> *Id.*

<sup>18</sup> *Id.* (appeal of rebuttal).

<sup>19</sup> FIT21 Section 503 (trading certification and approval for digital commodities).

<sup>20</sup> *Id.* (certifications for digital commodity trading).

<sup>21</sup> *Id.*

<sup>22</sup> FIT21 Section 504 (public information requirements for digital commodities).

## ***Registration and Regulation of Crypto Market Participants***

FIT21 would create a number of new registration categories for both the SEC and the CFTC. Among others, FIT21 would require “digital asset brokers,” “digital asset dealers”<sup>23</sup> and “digital asset trading systems”<sup>24</sup> to register with the SEC, while requiring “digital commodity brokers,” “digital commodity dealers”<sup>25</sup> and “digital commodity exchanges”<sup>26</sup> to register with the CFTC. Under FIT21, the definitions of these new categories of registrants largely track their equivalent registration categories under the existing Federal securities laws.

A “digital asset broker” refers to a person engaged in the business of effecting transactions in RDAs for the accounts of others, while a digital asset dealer is engaged in such transactions for its own account, through a broker or otherwise.<sup>27</sup>

A “digital asset trading system” refers to any organization or group of persons that provides a market place or provides facilities for bringing together purchasers and sellers of RDAs.<sup>28</sup>

Each of these definitions, however, expressly excludes from its scope “a blockchain protocol or a person or group of persons solely because of their development of a blockchain protocol.” The intent likely is to exclude from registration many so-called DeFi protocols that purport to be decentralized.

On the commodity side, FIT21 defines a “digital commodity broker” as any person who is registered as a digital commodity broker or any person who in a digital commodity cash or spot market is either:

- Engaged in soliciting or accepting orders for the purchase or sale of a unit of a digital commodity from a person that is not an eligible contract participant.
- Engaged in soliciting or accepting orders for the purchase or sale of a unit of a digital commodity from a person on or subject to rules of a CFTC-registered entity.<sup>29</sup>

A “digital commodity dealer” refers to any person who is registered as a digital commodity dealer, has an identifiable business of entering into any agreement, contract or transactions involving retail digital commodity transactions or who in digital commodity cash or spot markets meets any of the following criteria:

- Holds itself out as a dealer in a digital commodity.
- Makes a market in a digital commodity.
- Has an identifiable business of dealing in a digital commodity as principal for its own account.

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<sup>23</sup> FIT21 Section 405 (registration of digital asset brokers and digital asset dealers).

<sup>24</sup> FIT21 Section 404 (registration of digital asset trading systems).

<sup>25</sup> FIT21 Section 506 (registration of digital commodity brokers and digital commodity dealers).

<sup>26</sup> FIT21 Section 504 (registration of digital commodity exchanges).

<sup>27</sup> FIT21 Section 102 (definitions of “digital asset broker” and “digital asset dealer”).

<sup>28</sup> *Id.* (definition of “digital asset trading system”).

<sup>29</sup> FIT21 Section 103 (definition of “digital commodity broker”).

- Engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in a digital commodity.<sup>30</sup>

A “digital commodity exchange” is defined to mean a trading facility that offers or seeks to offer a cash or spot market in at least one digital commodity.<sup>31</sup>

Each of these digital commodity-related definitions is subject to a number of notable exceptions. Perhaps most importantly, FIT21 specifically clarifies that a person will not be subject to regulation under the Commodity Exchange Act solely on the basis of the person directly or indirectly engaging in any of a range of activities (whether singly or in combination) in relation to the operation of a blockchain system or in relation to decentralized finance.<sup>32</sup> These activities include validation or node operation activities, incidental services around digital asset sales, providing user interfaces, developing or publishing a blockchain system and distributing software or systems that create or deploy hardware or software, including wallets. (See our discussion on **Decentralized Finance Activities** below.)

FIT21 contemplates that the same entity may register in multiple capacities with both the SEC and the CFTC.<sup>33</sup> Once registered, however, each category will be subject to extensive regulation by the SEC and/or the CFTC, as applicable. These regulations include:

- Requirements to segregate customers’ money, assets and property and to hold customer assets with a “qualified digital asset custodian (in the case of RDAs)<sup>34</sup> or with a “qualified digital commodity custodian” (in the case of digital commodities).<sup>35</sup>
- Minimum capital requirements.<sup>36</sup>

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<sup>30</sup> *Id.* (definition of “digital commodity dealer”).

<sup>31</sup> *Id.* (definition of “digital commodity exchange”).

<sup>32</sup> A person is not included in the definitions of “digital commodity broker,” “digital commodity dealer,” or “digital commodity exchange” solely on the basis of these activities. FIT21 Section 409 further provides that a person is not subject to the Commodity Exchange Act on the basis of these activities.

<sup>33</sup> FIT21 Section 403 (a registered digital asset trading system may maintain a registration with the CFTC as a digital commodity exchange); Section 405 (a registered digital asset broker or registered digital asset dealer may maintain a registration with the CFTC as a digital commodity broker or a digital commodity dealer); Section 504 (a registered digital commodity exchange may register with the SEC as a digital asset trading system); Section 506 (any person required to be registered as a digital commodity broker or digital commodity dealer may register with the SEC as a digital asset broker or digital asset dealer).

<sup>34</sup> FIT21 Section 404 (holding of customer assets by a digital asset trading system); Section 406 (holding of customer assets by a digital asset broker or a digital asset dealer).

<sup>35</sup> FIT21 Section 504 (holding of customer assets by a digital commodity exchange); Section 506 (holding of customer assets by a digital commodity broker or a digital commodity dealer).

<sup>36</sup> FIT21 Section 406 (capital requirements for a digital asset broker or a digital asset dealer); Section 501 (mandating CFTC to prescribe rules for capital requirements for a digital asset broker or a digital asset dealer); Section 504 (minimum amount of financial resources for a digital commodity exchange); Section 506 (capital requirements for a digital commodity broker or a digital commodity dealer).



- Reporting and recordkeeping requirements.<sup>37</sup>
- Anti-money laundering and related requirements under the Bank Secrecy Act.
- Rules relating to conflicts of interest.

Registered digital commodity exchanges and any person required to be registered as a digital commodity broker or dealer must also become members of the National Futures Association,<sup>38</sup> while SEC-registered digital asset brokers and digital asset dealers must also become members of the Financial Industry Regulatory Authority.<sup>39</sup>

### ***Provisional Registration***

FIT21 permits prospective registrants to **provisionally** register as a digital commodity exchange, digital commodity broker and/or digital commodity dealer with the CFTC and as digital asset trading system, digital asset broker and/or digital asset dealer with the SEC. Such registration is provisional because it would occur before the relevant Commission finalizes the rules relating to registration for the various categories.<sup>40</sup> In theory, a registrant might seek provisional registration at any time after FIT21 comes into effect and until the relevant Commission has adopted final rules relating to registration. (See our **Timeline** in Annex A.).

Provisional registration is, as its name implies, provisional. It is an interim registration measure to be administered while the Commissions are making final rules for the registration of the various registrant categories. A notice of intent to register cannot be filed with the SEC/CFTC, as applicable, after the relevant Commission has finalized its registration rules.

In order to provisionally register, an entity must file a notice of intent to register with the SEC and/or CFTC, as applicable.<sup>41</sup> The notice of intent must include:

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<sup>37</sup> FIT21 Section 404 (mandating SEC to prescribe rules for recordkeeping for a digital asset trading system); Section 406 (reporting and recordkeeping requirements for a digital asset broker or digital asset dealer); Section 501 (mandating CFTC to prescribe rules for reporting and recordkeeping for a digital asset broker or digital asset dealer); Section 504 (recordkeeping and reporting for a digital commodity exchange); Section 506 (reporting and recordkeeping requirements for a digital commodity broker or a digital commodity dealer).

<sup>38</sup> Section 504 (registered digital commodity exchange must be member of a registered futures association); Section 506 (any person required to be registered as a digital commodity broker or digital commodity dealer must be member of a registered futures association).

<sup>39</sup> FIT21 Section 405 (a digital asset broker or digital asset dealer may not register unless a member of a registered national securities association).

<sup>40</sup> See FIT21 Section 106(f)(1) (“A person may not file a notice of intent to register with the [CFTC] after the [CFTC] has finalized its rules for the registration of digital commodity exchanges, digital commodity brokers, or digital commodity dealers, as appropriate.”); Section 107(f)(1) (“A person may not file a notice of intent to register with the [SEC] after the [SEC] has finalized its rules for the registration of digital asset brokers, digital asset dealers, digital asset trading systems, and notice-registered clearing agencies, as appropriate.”).

<sup>41</sup> FIT21 Section 106 (notice of intent to register for digital commodity exchanges, brokers, and dealers); Section 107 (notice of intent to register for digital asset brokers, dealers, and trading systems).

- A statement of the nature of the registration the filer intends to pursue (separate notices of intent may be needed for each registration status being sought).<sup>42</sup>
- Required disclosures, including as to ownership and management, financial condition, affiliated entities, potential conflicts of interest, a rulebook and customer order fulfillment rules, listing standards and the product listing process, anti-money laundering policies and procedures, account approval processes, risk management procedures and certain other information items.<sup>43</sup>

Once an entity has provisionally registered, it is exempt from SEC rules and regulations pertaining to registering as a national securities exchange, broker, dealer or clearing agency, or for activities related to a digital asset.<sup>44</sup> Note, however, that this limited safe harbor is only from SEC rules and regulations pertaining to registration. It does not appear to extend to the corresponding CFTC rules, thus potentially leaving provisional registrants open to CFTC enforcement actions.<sup>45</sup> Nor will the safe harbor bar SEC claims arising from Federal securities laws violations other than a failure to register.

A provisional registrant is required to provide disclosures to customers regarding the assets they list, the transactions they undertake, the manner in which they custody customer assets and their customer data protection policies and procedures, among other things.<sup>46</sup> Provisional registrants are also required to comply with requirements around customer assets, including by custodying such assets so as to minimize any risk of loss, and preventing any commingling of customer funds unless such funds are separately accounted for and commingling is used to margin, guarantee, secure, transfer, adjust or settle a contract of sale of a commodity.<sup>47</sup>

A provisional registrant that fails to apply for registration within 180 days of the effective date of the relevant Commission's final rules for registration will lose its safe harbor from SEC enforcement, and may thereafter be open to an enforcement action based on the SEC rules and regulations relating to registering as a national securities exchange, broker, dealer or clearing agency, or for activities related to a digital asset.<sup>48</sup> Provisional registrants would also lose this safe harbor if the relevant Commission denies their application to provisionally register, or finds that the registrant had not complied with the requirements of provisional registration.<sup>49</sup>

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<sup>42</sup> FIT21 Section 106(a)(2)(A) (a person filing a notice of intent to register as a digital commodity exchange, broker, or dealer must submit to the CFTC and continue to materially update a statement of the nature of the registration); Section 107(a)(2)(A) (a person filing a notice of intent to register as a digital asset broker, dealer, or trading system must submit to the SEC and continue to materially update a statement of the nature of the registration).

<sup>43</sup> FIT21 Section 106(b) (disclosure of general information for a notice of intent to register as a digital commodity exchange, broker, or dealer); FIT21 Section 107(b) (disclosure of general information for a notice of intent to register as a digital asset broker, dealer, or trading system).

<sup>44</sup> FIT21 Section 107(e)(1).

<sup>45</sup> FIT21 Section 106, which sets out the provisional registration terms for digital commodity exchanges, brokers, and dealers, is symmetrical to Section 107, which sets the provisional registration terms for digital asset brokers, dealers, and trading systems. Section 106(e)(1) is nearly identical to Section 107(e)(1) and purports to apply not to CFTC rules and regulations but to SEC rules and regulations: "A person who has filed a notice of intent to register under this section and is in compliance with this section shall be exempt from Securities and Exchange Commission rules and regulations pertaining to registering as a national securities exchange, broker, dealer, or clearing agency, for activities related to a digital asset."

<sup>46</sup> FIT21 Sections 106(d)(3); 107(d)(3).

<sup>47</sup> FIT21 Sections 106(d)(4); 107(d)(4).

<sup>48</sup> FIT21 Sections 106(f)(2)(B); 107(f)(2)(B).

<sup>49</sup> FIT21 Sections 106(f)(2)(A); 107(f)(2)(A).

## ***Removal of “Investment Contract Assets” from the Security Definition***

The definition of a “security” under Section 2(a)(1) of the Securities Act of 1933 and Section 3(a)(10) of the Securities Exchange Act of 1934 each include the term “investment contract.” Federal courts have found that an “investment contract” exists when there is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.<sup>50</sup> The SEC has typically relied on this flexible investment contract definition to claim that many digital assets are securities.<sup>51</sup>

With this as background, Title II of FIT21 seeks to limit the application of the definition of a “security” to digital assets by excluding “investment contract assets” from the security definition. Title II defines an “investment contract asset” as “a fungible digital representation of value”:

- That can be exclusively possessed and transferred, person to person, without necessary reliance on an intermediary, and is recorded on a cryptographically secured public distributed ledger.
- Sold or otherwise transferred, or intended to be sold or otherwise transferred, pursuant to an investment contract.
- That is not otherwise a security.<sup>52</sup>

Title II would amend the security definition to expressly exclude investment contract assets from the definition,<sup>53</sup> which might have the effect of removing many digital assets from the scope of the Federal securities laws.<sup>54</sup> Digital assets that qualify as securities on some basis other than as investment contracts would continue to be securities, however.

Title II has met with significant criticism from SEC Chair Gensler. In his statement on FIT21, Chair Gensler claimed that “by removing this set of investment contracts from the statutory list of securities, [FIT21] implies what courts have repeatedly ruled – but what crypto market participants have attempted to deny – that many crypto assets are being offered and sold as securities under existing law.”<sup>55</sup>

## ***Decentralized Finance Activities***

FIT21 specifically seeks to carve out certain “DeFi” activities from registration and regulation. It provides that a person is not subject to either of the Securities Exchange Act or the Commodity Exchange Act solely on the basis of the person directly or indirectly engaging in any of the following activities (whether singly or in combination) in relation to the operation of a blockchain system:

- Compiling network transactions, operating or participating in a liquidity pool, relaying, searching, sequencing, validating or acting in a similar capacity with respect to a [contract of sale of a digital asset.]

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<sup>50</sup> SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

<sup>51</sup> Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207 (July 25, 2017).

<sup>52</sup> FIT21 Section 202(a)(2).

<sup>53</sup> FIT21 Section 202(a)(1) (excluding “investment contract asset” from the definition of “security” under the Securities Act).

<sup>54</sup> FIT21 Section 202(b) (Investment Advisers Act of 1940); Section 202(c) (Investment Company Act of 1940); Section 202(d) (Exchange Act); Section 202(e) (Securities Investor Protection Act of 1970).

<sup>55</sup> Gary Gensler, Chairman, Securities and Exchange Commission, [Statement on the 21st Century Disclosure Act](#) (May 22, 2024).

- Providing computational work, operating a node or procuring, offering or utilizing network bandwidth or other similar incidental services with respect to a contract of sale of a digital asset.
- Providing a user-interface that enables a user to read and access data using a blockchain system, send messages or otherwise interact with a blockchain system.
- Developing, publishing, constituting, administering, maintaining or otherwise distributing a blockchain system.
- Developing, publishing, constituting, administering, maintaining, or otherwise distributing software or systems that create or deploy hardware or software, including wallets or other systems, facilitating an individual user's own personal ability to keep, safeguard or custody the user's digital commodities or related private keys.<sup>56</sup>

The intent is likely to place beyond regulation what FIT21 considers to be blockchain support or maintenance activities. Could this serve to insulate from regulation activities such as staking or other validation activities? Would this apply even if such staking was being carried out on a delegated basis? It seems unlikely the safe harbor for DeFi activities would extend that far, but further clarification may likely be required.

### ***Permitted Payment Stablecoins***

In addition to RDAs and digital commodities, FIT21 provides a regulatory framework for "permitted payment stablecoins." Under FIT21, permitted payment stablecoins are carved out of the RDA and digital commodity definitions, and out of the Federal securities laws.<sup>57</sup> Instead, a permitted payment stablecoin refers to a digital asset that:

- Is designed to be used as a form of payment or settlement.
- The issuer of which is obligated to convert or redeem it for a fixed amount of monetary value, or represents that it will maintain a stable value relative to a fixed amount of monetary value.
- Is subject to regulation by a Federal or state regulator with authority over entities that issue payment stablecoins.
- Is not a national currency.
- Is not a security issued by a registered investment company.<sup>58</sup>

Notably, the definition of a permitted payment stablecoin does not preclude the possibility that a stablecoin could be algorithmic,<sup>59</sup> or that it could be backed by an asset or assets other than fiat currency. Further, by its definition, primary regulatory authority over a permitted payment stablecoin is likely to rest with a prudential regulator.

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<sup>56</sup> FIT21 Section 409 (Securities Exchange Act); Section 509 (Commodity Exchange Act).

<sup>57</sup> FIT21 Section 101 (definition of "restricted digital asset"); Section 103 (definition of "digital commodity"); Section 401(a) (definition of "security" under the Securities Act); Section 401(b)(7) (definition of "security" under the Securities Exchange Act); Section 401(c)(1) (definition of "security" under the Investment Advisers Act of 1940); Section 401(d)(1) (definition of "security" under the Investment Company Act of 1940).

<sup>58</sup> FIT21 Section 101 (definition of permitted payment stablecoin).

<sup>59</sup> So-called algorithmic stablecoins generally work by offering a floating conversion between the stablecoin and another digital asset, shifting volatility from the stablecoin to the backing asset.

With that said, FIT21 does provide the CFTC and SEC with limited and varying degrees of jurisdiction over permitted payment stablecoins. The CFTC has broad jurisdiction over cash or spot transactions involving a permitted payment stablecoin on or with a CFTC registered entity.<sup>60</sup> The SEC, however, has only anti-fraud and anti-manipulation authority over a permitted payment stablecoin to the extent it is brokered, traded or custodied by or through a broker, dealer, digital asset broker or dealer, an alternative trading system or a digital asset trading system.<sup>61</sup> FIT21 specifically states that the SEC shall have no authority over the design, structure, issuance, redemption, financial resources, collateral or any other aspect of a permitted payment stablecoin's operation.<sup>62</sup>

Stablecoins today serve as the medium of exchange for most digital asset trading platforms. It is therefore easy to contemplate situations where a stablecoin is used in a manipulative scheme on a platform registered with both the SEC and the CFTC. To avoid the regulatory uncertainty that might arise out of such situations, the limited but bifurcated jurisdiction that FIT21 creates over permitted payment stablecoins and transactions in these assets may require clarification through joint rulemaking by the SEC and CFTC.

### **Mixed Digital Asset Transactions**

FIT21 recognizes a category of "mixed digital asset transactions," which it defines as "an agreement, contract, or transaction involving a digital commodity" and either a security or a restricted digital asset.<sup>63</sup> A mixed digital asset transaction that occurs on or with a CFTC-registrant will be subject to the jurisdiction of both the CFTC and the SEC.<sup>64</sup> A mixed digital asset transaction that does not occur on or with a CFTC-registrant will be subject to the jurisdiction of the SEC as a transaction in security or a restricted digital asset.<sup>65</sup> The CFTC and the SEC have joint rulemaking authority under FIT21 with respect to mixed digital asset transactions.<sup>66</sup>

### **Takeaways, Criticisms and Next Steps**

The House's passage of FIT21 marks a brief period of remarkable success for U.S. crypto. Two days after the House passed FIT21, the SEC's Division of Trading and Markets approved a number of proposals from national securities exchanges to list and trade spot Ether-based exchange traded products.<sup>67</sup> Only days before FIT21's passage in the House, Congress issued its joint disapproval of the SEC's Staff Accounting Bulletin 121—a piece of accounting guidance for custodians of crypto assets that had been the subject of sustained industry criticism, although by May 31, 2024, the White House had vetoed this resolution, citing inappropriate constraints on the SEC's ability to set appropriate guardrails and address future issues.<sup>68</sup>

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<sup>60</sup> FIT21 Section 501(b)-(c) (limitation on authority over permitted payment stablecoins and CFTC jurisdiction over digital asset transactions).

<sup>61</sup> FIT21 Section 402(b) (treatment of permitted payment stablecoins).

<sup>62</sup> FIT21 Section 402(a)(3).

<sup>63</sup> FIT21 Section 103 (definition of "mixed digital asset transaction").

<sup>64</sup> FIT21 Section 501(c)(2) (exclusive CFTC jurisdiction does not apply to a mixed digital asset transaction).

<sup>65</sup> Additionally, FIT21 Section 501(c)(3) provides that the CFTC will have certain inspection and examination authority over SEC-registrants that engage in mixed digital asset transactions."

<sup>66</sup> FIT21 Section 105(c).

<sup>67</sup> Self-Regulatory Organizations; NYSE Arca, Inc.; The Nasdaq Stock Market LLC; Cboe BZX Exchange, Inc.; [Order Granting Accelerated Approval of Proposed Rule Changes, as Modified by Amendments Thereto, to List and Trade Shares of Ether-Based Exchange-Traded Products](#), Release No. 34-100224 (May 23, 2024).

<sup>68</sup> [A Message to the House of Representatives on the President's Veto of H.J. Res. 109](#), The White House (May 31, 2024).

## Takeaways

If this run of success continues into the Senate, and if some version of FIT21 were to be ultimately enacted, it could be a major success for the U.S. crypto industry. The enactment of FIT21 would largely deliver on a number of the U.S. crypto industry's most urgent needs. It would, among other things:

- Clearly mark the limits of the SEC's jurisdiction and provide a relatively simple path for assets, asset issuers and market participants to transition to CFTC regulation.
- Permit trading and brokerage platforms to trade both digital commodities and securities and thus operate in a consolidated, unified manner that does not require the fragmentation of existing businesses.
- Provide transitional mechanisms, such as provisional registration, which would avoid market disruption and defer SEC enforcement proceedings.
- Mandate cooperation between the SEC and the CFTC on rulemaking and areas of shared jurisdiction.

If FIT21 were enacted, there could be a rush to provisionally register entities with the SEC and the CFTC, as well as moves to certify many, even most blockchains as being functional and decentralized. The spate of activity that FIT21 would generate would itself be testimony to its huge importance to the U.S. crypto industry, and to crypto market participants.

## Criticisms

Given FIT21's potential to deliver on some of the U.S. crypto's most pressing regulatory needs, it is perhaps surprising that FIT21 has been the target of criticism even from within the crypto industry. Some market participants have taken aim at FIT21's bifurcation of jurisdiction between the SEC and the CFTC, claiming that the bill's division of digital assets into RDAs and digital commodities ignores the fungibility of crypto assets.<sup>69</sup> By creating dual regulatory categories of digital assets, these critics contend, FIT21 leads to confusion and market fragmentation and could impair liquidity, reduce the utility of the crypto tokens and ultimately stifle innovation. At least some of this criticism may emanate from fears that allowing the SEC to intervene in processes such as certification might gradually allow it to expand its regulatory role at the expense of the CFTC.

Criticism has also come from more expected quarters, most notably SEC Chair Gensler. In his statement, Chair Gensler has claimed that FIT21 would severely strain the SEC's limited resources in policing the blockchain certification process, would permit the commingling of customers assets, reduce protections around custody, exacerbate conflicts of interest and undermine investor protections.<sup>70</sup> President Biden has also opposed FIT21, stating that the bill lacks "sufficient protections for consumers and investors who engage in certain digital asset transactions."<sup>71</sup>

It is too soon to tell whether these criticisms and related opposition will have any effect. For the moment, though, the fact that over 70 Democrats (in addition to 208 Republicans) in the House voted for FIT21 may likely be viewed by many in the crypto industry as increasing FIT21's chances of success in the Senate. Given that FIT21

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<sup>69</sup> Joshua Riezman, [The Unintended Consequences of FIT21's Crypto Market Structure Bill](#), CoinDesk (May 24, 2024).

<sup>70</sup> Gary Gensler, Chairman, Securities and Exchange Commission, [Statement on the 21st Century Disclosure Act](#) (May 22, 2024).

<sup>71</sup> [Statement of Administration Policy on H.R. 4763](#), The White House (May 30, 2024).

has not yet been introduced into the Senate—and given the limited amount of time the Senate may have to consider FIT21 even if it is introduced—its passage is far from assured.

Irrespective of how FIT21 fares in the Senate, several issues around crypto assets and markets will likely continue to require legislative attention. These include:

- The regulation of DeFi protocols and platforms, and the circumstances under which DeFi protocol providers will be subject to regulation.
- The extent to which traditional markets and traditional market intermediaries such as registered broker-dealers can transact in crypto assets.
- The tokenization of real world assets and the extent to which these should be governed by emerging crypto asset regulatory regimes.
- Given the global nature of much crypto trading, questions around international harmonization, particularly as the European Union's Markets in Crypto Assets ("MiCA") Regulation comes into force later this year.

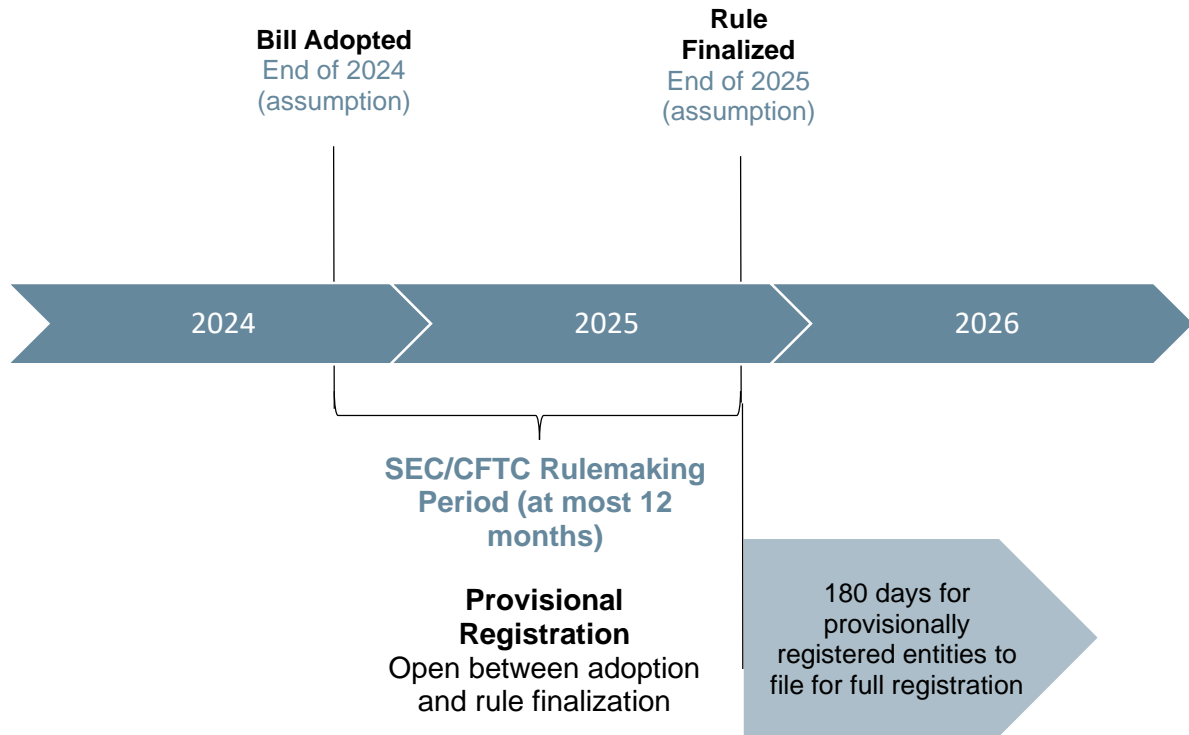
### **Next Steps**

At the time of this writing, FIT21 has yet to be introduced into the Senate. Even if it were to be enacted by Congress without Presidential veto, it would require a significant amount of rulemaking by the SEC and the CFTC to take full effect. FIT21 provides that all such rulemaking must be completed within 360 days of its enactment, which may be an ambitious timeline.

While it would be premature for market participants to begin ordering their businesses as if FIT21 were already law, crypto businesses and particularly crypto market participants who would be directly regulated by FIT21, should consider whether, and to what extent, they should engage in regulatory advocacy and engagement during the bill's continued progress through Congress.

It may also be worth considering whether, if at all, Congress's active consideration of FIT21 has any impact on the SEC's regulatory initiatives on crypto. Many of the matters FIT21 seeks to regulate—such as custody, conflicts of interest, decentralization and participation on decentralized networks—are already being closely considered by leading crypto firms. For these and other crypto firms, FIT21 may provide helpful insights regarding the direction of future legislative action on crypto.

## Annex A – Timeline



**Note:** This Timeline assumes, purely for illustrative purposes, FIT21’s future enactment into law, and related SEC/CFTC rulemaking. These assumptions are made solely to illustrate the way in which FIT21 would likely operate in terms of timing. This Timeline and the assumptions made therein are not intended as a comment on FIT21’s prospects of being enacted, and should not be construed as such.



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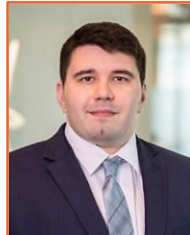
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