

Uneven Terrain: Drawing a Regulatory Perimeter Around a Rapidly Evolving Digital Asset Landscape

(Working Paper)

March 2023

Manoj Ramia
General Counsel, Digital Asset

Not all digital assets are the same. Given the emerging complexity of the digital asset ecosystem, the context in which digital assets are created and issued needs to be taken into account by regulators. There is a world of difference between what is commonly understood as “crypto” on the one hand and tokenized “traditional assets” on the other hand, and they should not be subject to the same regulatory treatment.

Not all blockchain technologies are the same. Line drawing exercises are particularly challenging when new technology is involved. Regulators are beginning to recognize that the blockchain technology used to issue digital assets, including tokenized “traditional assets,” impacts the risks posed to regulated financial institutions.

Technology matters. As regulators begin to draw the regulatory perimeter for digital assets, it is important to have a good understanding of the blockchain technologies underlying different digital asset networks. This will allow regulators to protect the financial system while also promoting responsible innovation.

I. Introduction—A Regulatory Perimeter for Digital Assets.

The phrase “regulatory perimeter” evokes a land where there are special boundaries. Within those boundaries, rules and regulations apply. Outside of those boundaries, anything goes.

In reality, however, the phrase “regulatory perimeter” is much more prosaic than the exaggerated description above; it is nothing more than the collective jurisdictional boundaries of various regulatory agencies.¹ If an activity falls within the regulatory perimeter, it will be subject to regulatory regimes, such as disclosure, supervision, or government consent, depending on the nature of the activity and the regulation(s) implicated. If an activity falls outside the regulatory perimeter, standard rules of commerce will govern.

The phrase “digital assets” evokes bitcoin, ether, and other sorts of “crypto” that have over the last few years skyrocketed, and then just as quickly plummeted, in value for no discernable reason other than pure speculative hype. So it would understandably be tempting to dismiss digital assets as, at best, a speculative fad or, at worst—given crypto’s excesses, abuses, and frauds—a danger to the safety and soundness of the financial system that should be banned.² In light of this, when thinking about the regulatory perimeter governing digital assets, the exaggerated description of the regulatory perimeter offered above, for better or for worse, has proven so far to be an apt description—outside the regulatory perimeter, anything goes (or went).

¹ For a good history of the U.S. banking regulatory perimeter, see the Federal Reserve’s “Lessons from the History of the U.S. Regulatory Perimeter” (Oct. 15, 2021), <https://www.federalreserve.gov/econres/notes/feds-notes/lessons-from-the-history-of-the-u-s-regulatory-perimeter-20211015.html>.

² Charlie Munger, *Why America Should Ban Crypto*, WALL ST. J., (Feb. 1, 2023), <https://www.wsj.com/articles/why-america-should-ban-crypto-regulation-economy-finance-china-england-trading-currency-securities-commodity-gamble-11675287477>.

In reality, however, the phrase digital assets encompasses much more than commonly-understood conceptions of crypto. Digital assets also include tokenized “traditional” assets such as stocks and bonds. Indeed, conceptually, virtually any non-tangible asset available today can be a digital asset if the asset is represented in code on a blockchain-based (or distributed) ledger. Just as important, a unique feature of digital assets is that they are inextricably linked to the technology of the platform or network on which they are issued; digital assets do not exist independent of this technology. And there is a lot of interesting—and responsible—innovation happening with this underlying technology.

Efforts to bring digital assets within the regulatory perimeter are rightly gaining momentum. But it is important that the regulatory perimeter around digital assets be drawn to take into account the more expansive conception of digital assets. It would be a mistake to draw a regulatory perimeter around digital assets with only the headline-grabbing crypto debacles in mind (though the regulatory perimeter *does* need to be drawn to prevent similar debacles in the future).

Recent regulatory examples from the Board of Governors of the Federal Reserve (the “**Fed**”), the Basel Committee on Banking Supervision (the “**Basel Committee**”), the Securities and Exchange Commission (the “**SEC**”), and the New York State Department of Financial Services (the “**DFS**”) illustrate this point.

Each regulator attempts to bring what is commonly understood to be crypto within its regulatory perimeter but may in the process be inadvertently subjecting tokenized traditional assets to the same treatment as crypto based on how each regulator defines crypto. While the Fed and the Basel Committee make a concerted effort to draw a distinction between commonly-understood crypto and tokenized traditional assets, neither the SEC nor the DFS even attempt to separate tokenized traditional assets from commonly-understood crypto, subjecting all assets that are issued using distributed ledger technology to the same treatment. The SEC’s and DFS’s blanket approach to defining crypto threaten legitimate and beneficial efforts to tokenize traditional assets.

Moreover, the Fed, the Basel Committee, and the DFS have also introduced the concept of the network on which an asset lives affecting its regulatory treatment, even for tokenized traditional assets, drawing attention to the importance of the technology used when tokenizing traditional assets. But the technology underlying these networks is not uniform—not all blockchains are the same—and the differences among different blockchain technologies can meaningfully impact the risks posed to financial institutions when dealing with even tokenized traditional assets.

As regulators venture into the new frontier of digital assets, they need to be mindful of these differences—both among types of digital assets and types of digital asset network technologies—to ensure that while they rightly seek to protect consumers, investors, and the safety and soundness of the financial system as a whole, they do not inadvertently stifle responsible innovation.

II. The Federal Reserve’s Policy Statement on “Crypto-Asset” Activities—A Recognition That Technology Impacts a Tokenized Asset’s Risk Classification.

On February 7, 2023, the Fed published a policy statement (the “**Policy Statement**”) stating that state member banks would be *presumptively prohibited* from holding “crypto-assets” as principal given certain risks associated with these “crypto-assets.”³ In support of this position, the Fed noted the various risks associated with “crypto-assets:”

- “the absence of a fundamental economic use case;”

³ Federal Reserve Policy Statement on Section 9(13) of the Federal Reserve Act (2023), 88 Fed. Reg. 7848 (Feb. 7, 2023) (to be codified at 12 C.F.R. pt. 208), <https://www.federalregister.gov/documents/2023/02/07/2023-02192/policy-statement-on-section-913-of-the-federal-reserve-act>.

- “the value of most crypto-assets [being] driven largely by sentiment and future expectations, and not by cash flows from providing goods or services outside the crypto-asset ecosystem;”
- “engagement in crypto-asset transactions . . . present[ing] significant illicit finance risks, in part due to the pseudonymity of transactors and validators;” and
- “crypto-assets that are issued or transacted on open, public, and/or decentralized ledgers may involve significant cybersecurity risks—especially in comparison to traditional asset classes.”⁴

Given everything that has happened in crypto markets in the last year, at first blush it is hard to argue with the Fed’s reasoning. But this reasoning hinges on the definition “crypto-asset” used by the Fed, which does a lot of work in the Policy Statement. In footnote 2 of the Policy Statement, the Fed defines “crypto-assets” as:

[D]igital assets issued using distributed ledger technology and cryptographic techniques (for example, bitcoin and ether), but does not include such assets to the extent they are more appropriately categorized within a recognized, traditional asset class (for example, securities with an effective registration statement filed under the Securities Act of 1933 that are issued, stored, or transferred through the system of a regulated clearing agency and in compliance with all applicable federal and state securities laws). To the extent transmission using distributed ledger technology and cryptographic techniques changes the risks of a traditional asset (for example, through issuance, storage, or transmission on an open, public, and/or decentralized network, or similar system), the Board reserves the right to treat it as a “crypto-asset.”⁵

There is a lot to unpack here. This definition weaves together several strands of the digital asset space. To understand whether these strands are appropriately woven together and their overall impact on responsible innovation, we need to separate and examine each one.

A. *The First Strand: A classification based on technological characteristics that is too broad on its own.*

The first strand is the heart of the definition—“digital assets issued using distributed ledger technology and cryptographic techniques (for example, bitcoin and ether).” With the reference to bitcoin and ether in the parenthetical, what immediately jumps to mind when reading this definition is commonly-understood crypto: not just bitcoin and ether but also the many digital tokens that have little to no utility and have served simply as speculative vehicles. For these “crypto-assets,” the Policy Statement makes perfect sense. These tokens fluctuate in value wildly without being anchored to any fundamentals; it would be systemically dangerous for banks to hold these assets as principal and they should rightly be cordoned off from regulated financial institutions. However, the phrase “digital assets issued using distributed ledger technology and cryptographic techniques” covers a lot more ground than just commonly-understood crypto. And none of the components of the definition (digital assets, distributed ledger technology, cryptographic techniques) are themselves defined, leaving their interpretation open. The core idea that is seemingly captured though is that of a “natively” digital asset, an asset that isn’t just recorded on a ledger but that “lives” on that ledger, an asset that is inseparable from its ledger entry because it is inextricably linked to the ledger through code and cryptography. The first strand of the definition of “crypto-asset” thus seems to be a classification based on the technological characteristics of an asset.

But if the first strand of the definition of “crypto-asset” were the entirety of the definition, it would cover not just bitcoin, ether, and other commonly-understood crypto but also traditional assets that are “tokenized,” e.g., assets such as stocks and bonds that are starting to be “coded” natively onto distributed ledgers. These types of assets, however, should not be subject to the same regulatory

⁴ *Id.*

⁵ *Id.*

perimeter as commonly-understood crypto given that they have a very different risk profile than commonly-understood crypto.

B. The Second Strand: A classification based on regulatory characteristics that hems in the first strand.

Accordingly, the Fed included as a second strand in the “crypto-asset” definition a carve out for “assets to the extent they are more appropriately categorized within a recognized, traditional asset class (for example, securities with an effective registration statement filed under the Securities Act of 1933 that are issued, stored, or transferred through the system of a regulated clearing agency and in compliance with all applicable federal and state securities laws).” The parenthetical in the carve out suggests that a relevant question when determining whether the carve out applies is the regulatory classification of the asset. Therefore, while the first strand of the definition of “crypto-asset” focuses on its technological characteristics, the second strand seems to focus on its regulatory characteristics. This makes sense. Any risk introduced by the new technology with which assets are issued can be mitigated by bringing them under the umbrella of existing regulatory frameworks.

C. The Third Strand: Balancing a digital asset’s technological and regulatory characteristics.

The Fed then introduces a third strand that creates an exception to the second strand’s carve out: “To the extent transmission using distributed ledger technology and cryptographic techniques changes the risks of a traditional asset (for example, through issuance, storage, or transmission on an open, public, and/or decentralized network, or similar system), the Board reserves the right to treat it as a ‘crypto-asset.’”

This is where the definition of “crypto-asset” gets interesting. After suggesting with the carve out in the second strand that the regulatory characteristics of an asset outweigh its technological characteristics, at least so long as the asset is a traditional asset, the Fed is now saying “not quite.” Rather, technological characteristics can still matter where they change the asset’s risk profile. But it is not clear what those technological characteristics are. Practically every digital asset (including every tokenized traditional asset) will be “transmi[tted] using distributed ledger technology and cryptographic techniques,” potentially triggering application of the third strand. And the added reference to “an open, public, and/or decentralized network” does not quite clarify the meaning of the third strand because—particularly with the use of the disjunctive “or”—it covers a large portion of networks on which these assets are issued and transmitted. Moreover, the degree and nature of the change in risk that would trigger “crypto-asset” treatment is not specified.

Taken together, the third strand suggests that the Fed will ultimately undertake some sort of balancing exercise to determine whether traditional assets that are transmitted using distributed ledger technology should be considered “crypto-assets” subject to the Policy Statement’s “presumptive prohibition.” Whatever protections are offered by the regulatory characteristics of these assets must be weighed against the risks posed by their technological characteristics. Unfortunately, the Fed does not offer guidance on how it will undertake this balancing exercise.

So even with respect to whether a state member bank can hold a “recognized, traditional” digital asset (e.g., a tokenized stock or bond) as principal, a case-by-case analysis may be required to determine whether the risk profile of that asset has been impacted by the specific characteristics and topology of the network on which the asset lives.

Not all tokenized traditional assets will be the same from the Fed’s perspective because not all networks on which tokenized assets live are the same from the Fed’s perspective.

D. *Seeking definitional clarity through narrow tailoring.*

Ultimately, the discussion above suggests that we need more definitional clarity from the Fed around “crypto-assets.” In attempting to regulate commonly-understood crypto, it inadvertently creates ambiguity and uncertainty around the tokenization of traditional assets, a rapidly growing area that is fundamentally different from commonly-understood crypto. This is a by-product of using one definition to cover both commonly-understood crypto such as bitcoin and ether as well as tokenized versions of traditional assets, with the “presumptive prohibition” effectively applying to both asset classes in at least some circumstances.

The regulatory perimeter may have been drawn a bit too broadly here and may need to be narrowly tailored to better reflect the varied contours of the digital asset space so that those that are innovating responsibly are not penalized.

III. The Basel Committee’s Consultation on Prudential Treatment of Cryptoasset Exposures—More Recognition That Technology Matters.

The Fed’s approach echoes standards issued by the Basel Committee in December 2022 on the prudential treatment of “cryptoasset” exposures (the “**Prudential Standards**”).⁶ While the Basel Committee did not intend for the Prudential Standards to be implemented until January 1, 2025, the European Central Bank released guidance on February 15, 2023 stating that European banks “are expected to comply with the [Prudential Standards] and take it into account in their business and capital planning.”⁷ Moreover, given that the overall Basel III standards have been implemented in the United States, it would be expected that U.S. banks would also be subject to the Prudential Standards.

The Prudential Standards designate capital requirements based on the type of “cryptoasset” held by the bank. Accordingly, we first need to look at how the Basel Committee defines “cryptoassets:” “private digital assets that depend primarily on cryptography and distributed ledger or similar technology.”⁸ This definition relies on the term “digital assets,” which are defined as “a digital representation in value which can be used for payment or investment purposes or to access a good or service. This does not include digital representations of fiat currencies.”⁹ Notably, nothing in these definitions distinguishes between commonly-understood crypto and tokenized traditional assets.

Fortunately, the Prudential Standards address this distinction head on when formulating capital requirements by delineating two groups of “cryptoassets,” Group 1, which includes tokenized traditional assets, and Group 2, which covers commonly-understood crypto.¹⁰ The Basel Committee takes drastically different approaches to Group 1 versus Group 2 “cryptoassets.” While the Prudential Standards can get fairly arcane (as bank capital requirements are wont to do), at a high level, while Group 1 “cryptoassets” are subject to the same capital requirements as the underlying traditional asset, Group 2 “cryptoassets” that do not meet certain hedging criteria are subject to a risk weighting of up to 1,250%.¹¹ As a point of reference, under the current Basel III standards, the highest risk weighting appears to be 400% for “speculative unlisted equity.”¹² In addition, the Prudential Standards also provide an overall exposure limit on Group 2 “cryptoassets” of 1% of Tier 1 Capital. While not the

⁶ Basel Committee on Banking Supervision, *Prudential Treatment of Cryptoasset Exposures* (Dec. 2022), <https://www.bis.org/bcbs/publ/d545.pdf>.

⁷ European Central Bank, *Crypto-Assets: A New Standard for Banks* (Feb. 15, 2023), https://www.bankingsupervision.europa.eu/press/publications/newsletter/2023/html/ssm.nl230215_1.en.html.

⁸ Basel, *supra* note 7.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² Basel Committee on Banking Supervision, *High-Level Summary of Basel III Reforms* (Dec. 2017), https://www.bis.org/bcbs/publ/d424_hlsummary.pdf.

“presumptive prohibition” of the Fed’s approach, it is nonetheless still extremely prohibitive under the Prudential Standards for banks to hold Group 2 “cryptoassets” as principal.

Moreover, the relatively favorable treatment of Group 1 “cryptoassets” (*e.g.*, tokenized traditional assets) is subject to an important qualification: the risk weighting is subject to an “infrastructure risk add-on,” which is “[a]n add-on to risk-weighted assets (RWA) to cover infrastructure risk for all Group 1 cryptoassets that authorities can activate based on any observed weaknesses in the infrastructure on which cryptoassets are based.”¹³ Like the Fed’s consideration of the change in an asset’s risk due to “transmission using distributed ledger technology,” the Basel Committee’s infrastructure risk add-on is a recognition that the technology and network on which a tokenized traditional asset is issued impacts the risk it poses to a financial institution.

IV. Definitional Challenges—SAB 121 and Recent NYS DFS Guidance.

Not all regulators follow the approach of the Fed and the Basel Committee in distinguishing between commonly-understood crypto and tokenized traditional assets. The hazards of too broad of a definition can be seen in two recent regulatory pronouncements.

A. SEC Staff Accounting Bulletin 121.

On April 11, 2022, the SEC issued Staff Accounting Bulletin No. 121.¹⁴ The bulletin provided that “entities that have obligations to safeguard crypto-assets held for their platform users” need to recognize these “crypto-assets” as not just assets on their balance sheets but also as liabilities because “[t]he technological mechanisms supporting how crypto-assets are issued, held, or transferred, as well as legal uncertainties regarding holding crypto-assets for others, create significant increased risks” to these entities.¹⁵

Like with the Fed’s Policy Statement and the Prudential Standards, the term “crypto-asset” does a lot of work in the bulletin. But the SEC takes a much simpler approach to defining “crypto-asset,” stating that it is simply “a digital asset that is issued and/or transferred using distributed ledger or blockchain technology using cryptographic techniques.”¹⁶

As we now know from our discussion in Section II.A, this definition is much too broad. It easily covers tokenized traditional assets. And in contrast to the Fed or the Basel Committee, the SEC makes no attempt to create an exception for tokenized traditional assets. This is especially odd given that one of the risks highlighted by the SEC in the bulletin is due to the “legal uncertainties regarding holding crypto-assets for others,” yet with tokenized traditional assets these legal uncertainties are not a driving concern. Moreover, in the context of custody, the risks highlighted by the SEC make sense for any digital asset that is a bearer instrument (*i.e.*, if the private key to the asset is lost, the asset itself is effectively lost). But depending on the underlying technology used to create and issue a digital asset, the digital asset may not in fact be a bearer instrument, obviating the concern about risk of loss highlighted by the SEC.¹⁷

¹³ Basel, *supra* note 7.

¹⁴ SEC Staff Accounting Bulletin No. 121, 17 C.F.R. pt. 211 (Apr. 11, 2022), <https://www.sec.gov/oca/staff-accounting-bulletin-121>.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Notably, the SEC’s recently proposed “Safeguarding Advisory Client Assets” rule adopts a similarly expansive definition of “crypto,” potentially bringing tokenized traditional assets within the same newly proposed custody rules. See SEC, Safeguarding Advisory Client Assets, SEC Release No. IA-6240 (Feb. 15, 2023), <https://www.sec.gov/rules/proposed/2023/ia-6240.pdf>. However, given that the proposed rule applies to *all* assets,

B. *New York State Department of Financial Services Prior Approval Requirement for “Virtual Currency-Related Activity.”*

On December 15, 2022, the DFS issued an industry letter requiring that all New York banking organizations obtain prior approval from the DFS before engaging in “virtual currency-related activity” (the “**Prior Approval Letter**”).¹⁸ Notably, the letter includes among its examples of virtual currency-related activity, “engaging in traditional banking activities involving virtual currency through the use of new technology that exposes the Covered Institution [e.g., a bank] to different types of risk (e.g., underwriting a loan, debt product, or equity offering effected partially or entirely on a public blockchain).”¹⁹

Again, the underlying definition—here, the term “virtual currency”—does a lot of work. The relevant statute defines “virtual currency” as “any type of digital unit that is used as a medium of exchange or a form of digitally stored value. [V]irtual currency shall be broadly construed to include digital units of exchange that: have a centralized repository or administrator; are decentralized and have no centralized repository or administrator; or may be created or obtained by computing or manufacturing effort.”²⁰

This is an incredibly broad definition. Unlike the other definitions discussed above, the “virtual currency” definition is not limited to assets issued using distributed ledger technology and instead includes digital assets issued on “centralized” ledgers as well. But, most importantly, like the SEC’s “crypto-asset” definition, there is no distinction made between commonly-understood crypto and tokenized traditional assets.

Accordingly, a New York-chartered bank that seeks to engage in traditional banking activities involving tokenized traditional assets that are issued “partially or entirely on a public blockchain” will need to obtain prior approval from the DFS. As part of seeking this prior approval, the bank will need to provide a comprehensive business plan, a thorough account of risk-management practices, a description of its corporate governance practices, an analysis of the impacts on consumers, its financial statements, and a legal and regulatory analysis.²¹

While a thorough prior approval process is warranted for activities involving commonly-understood crypto, it is not clear if it is also warranted for dealing with tokenized traditional assets, even if offered “partially or entirely on a public blockchain.” Banks already deal with these same assets in a different technological context; changing the method by which these assets are offered (on a public blockchain) should not trigger the same scrutiny as when engaging in activities involving commonly-understood crypto. Moreover, the DFS does not define what a “public blockchain” is, and there is no one monolithic understanding of “public blockchain.” The technology in this space is rapidly evolving and the risks posed by some public blockchains today may not be present in those that may be developed in the future. A more nuanced approach may be needed by the DFS to allow for differences between commonly-understood crypto and tokenized traditional assets as well as differences among blockchain technologies.

the impact of this broad definition is limited in this context. We will have to wait and see whether the SEC carries through this definition in any proposed rules for specifically for “crypto.”

¹⁸ New York State Department of Financial Services, *Industry Letter: Prior Approval for Covered Institutions’ Virtual Currency-Related Activity* (Dec. 15, 2022)

https://www.dfs.ny.gov/system/files/documents/2022/12/il20221215_prior_approval.pdf.

¹⁹ *Id.*

²⁰ N.Y. Comp. Codes, R. & Regs. tit. 23, § 200.2(p).

²¹ Industry Letter, *supra* note 19.

V. Are My Orange Groves Inside the Regulatory Perimeter? *Howey* and the SEC’s 2019 Digital Assets Framework.

Finally, no discussion of regulatory perimeters and digital assets would be complete without a note about the much discussed (and often maligned) *Howey* test. If you’ve made it this far in the article, you likely already know that, under U.S. securities laws, digital assets that do not fall into existing securities law categories (*e.g.*, tokenized stocks or bonds) are subject to an “investment contract” analysis to determine whether the issuance of these digital assets is subject to U.S. securities laws. This analysis is enshrined in the 1946 United States Supreme Court decision, *SEC v. W.J. Howey Co.*,²² which provides that an “investment contract” exists when there is (1) an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived from the efforts of others.²³

Faced with an emerging digital asset ecosystem, the SEC in 2019 attempted to draw a regulatory perimeter for digital assets with its *Framework for “Investment Contract” Analysis of Digital Assets* (the “**Framework**”), which sought to provide additional guidance when applying *Howey* to digital assets.²⁴ Included in the Framework was a statement that a digital asset issuance was less likely to be an “investment contract” if “the essential tasks or responsibilities” are to be performed by an “unaffiliated, dispersed community of network users (commonly known as a ‘decentralized’ network)”.²⁵ This followed a 2018 speech by then-SEC Director William Hinman where he stated that, “[i]f the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract.”²⁶ Many commentators and practitioners took these two statements together to mean that “sufficient decentralization” was the boundary of the SEC’s regulatory perimeter for digital assets.²⁷

Unfortunately, this attempt to draw a regulatory perimeter may have been premature. There is no basis in case law for relying on “decentralization” as a relevant consideration in a *Howey* analysis and there is no widely, let alone legally, accepted definition of decentralization. But most importantly, the SEC has made no mention of decentralization in any of its many recent enforcement actions against digital asset issuers, all but orphaning its own Framework, and focusing instead squarely on the *Howey* factors (and the “efforts of others” prong in particular). One reason for this may be that while many crypto projects talked about “decentralization,” it was never clear to what extent the presence of “decentralization” correlated with the absence of the “efforts of others.”

There has already been much written about the impact of the SEC’s recent enforcement actions on the crypto industry. But relevant for our discussion here—drawing regulatory perimeters—is the lesson that in a space where new technology is emerging and rapidly developing, drawing a regulatory perimeter based on the stated ideals of an industry (decentralization) before having had an opportunity to see how those ideals translate to actual implementations—including to see whether “decentralization” actually correlates to whether the “effort of others” is driving the value of a digital asset—can lead to confusion. Crypto projects that may have relied on the SEC’s past statements about

²² *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

²³ *Id.* at 298–99.

²⁴ SEC, FRAMEWORK FOR “INVESTMENT CONTRACT” ANALYSIS OF DIGITAL ASSETS (2019), https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_edn1.

²⁵ *Id.*

²⁶ William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, SEC (June 14, 2018), <https://www.sec.gov/news/speech/speech-hinman-061418>.

²⁷ See, *e.g.*, Stephen Wink & Shaun Musuka, *Insight: Crypto – The Pursuit of Sufficient Decentralization*, BLOOMBERG LAW (Aug. 21, 2019), <https://news.bloomberglaw.com/securities-law/insight-crypto-the-pursuit-of-sufficient-decentralization>; Marc Boiron, *Sufficient Decentralization: A Playbook for Web3 Buildings and Lawyers*, VARIANT FUND (Aug. 2, 2022), <https://variant.fund/articles/sufficient-decentralization/>.

“sufficient decentralization” in forming their legal posture for their token issuances²⁸ may now find themselves legally stranded.

Ironically, while it may seem odd that the legal status of digital assets is controlled by a test from a 1946 Supreme Court decision about orange groves, *Howey* and its line of cases²⁹ may in fact offer the best path forward by allowing courts to make case-by-case determinations (based on the principles set forth by the Court in *Howey*) that take into account the differences in technology and network topology of each digital asset project. Admittedly, the *Howey* approach does not make it easy to draw a clear line as to what is permissible. But what this approach may lack in perceived clarity is potentially outweighed by its robustness against continued innovation in the digital asset space; the technology and ecosystem may not be mature enough for a good line to be drawn so a principles-based approach may be best right now.

And while tokenized traditional assets are typically already subject to U.S. securities laws, the method indicated here of a case-by-case approach that takes into account the technological nuances of each digital asset network can be instructive to regulators wrestling with how to draw regulatory perimeters that encompass a diverse and evolving ecosystem and in fact validates to a certain extent the approach taken in the Fed’s Policy Statement and the Basel Committee’s Prudential Standards. The Framework’s attempt to draw a regulatory perimeter based on decentralization before there was a better understanding of what that means and how it impacts the principles set forth in *Howey* may be a cautionary tale.

VI. Conclusion—Drawing Regulatory Perimeters with Care to Promote Responsible Innovation.

Given the emerging complexity of the digital asset ecosystem, the context in which digital assets are created and issued needs to be taken into account by regulators. There is a world of difference between what is commonly understood as “crypto” on the one hand and tokenized “traditional assets” on the other hand, and they should not be subject to the same regulatory treatment. Not all digital assets are the same.

Line drawing exercises are particularly challenging when new technology is involved. Both the Fed and the Basel Committee (as well as the DFS) appear to recognize that that the network on which digital assets are issued, including for tokenized “traditional assets,” impacts the risks posed to regulated financial institutions. It is important that regulators work to understand the technology underlying different digital asset networks. Not all digital asset networks are the same.

Ultimately, care should be taken in drawing the boundaries of the regulatory perimeter for digital assets so that responsible innovation is not stifled.

²⁸ See, e.g., *Web3 Foundation Announces Polkadot Blockchain’s Native Token (DOT) Has Morphed and is Software, Not a Security*, WEB3 FOUNDATION (Nov. 10, 2022), <https://web3.foundation/press/dot-has-morphed-and-is-software-not-a-security>.

²⁹ See, e.g., *United States v. Leonard*, 529 F.3d 83 (2d Cir. 2008); *Gordon v. Terry*, 684 F.2d 736 (11th Cir. 1982); *SEC v. Glenn W. Turner Enterprises*, 474 F.2d 476 (9th Cir. 1973).