

Client Alert

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House Passes FIT 21 – What does it say, and what does it mean for digital asset providers?

On, May 22, 2024, the U.S. House of Representatives passed H.R. 4763, Financial Innovation for Technology for the 21st Century Act (“FIT21”).¹ The legislation was touted by the House Financial Services Committee’s Chairman, Patrick McHenry (R-NC), as “provid[ing] the regulatory clarity and robust consumer protections necessary for the digital asset ecosystem to thrive in the United States.”² While this is the first time a major piece of crypto legislation has cleared either chamber of Congress, the bill’s future in the Senate is unclear. Nonetheless, the bill’s framework is noteworthy and, were it to become law, would impose new operational and technological requirements for digital asset providers, exchanges, and brokers.

OVERVIEW

FIT21 primarily does two things:

- (i) It seeks to clarify and divide regulatory responsibility by classifying digital assets as either “**Restricted Digital Assets**” regulated by the Securities and Exchange Commission (“SEC”), or “**Digital Commodities**” regulated by the Commodity Futures Trading Commission (“CFTC”); and
- (ii) it obligates certain actors in the digital asset space to comply with registration and disclosure requirements relating to the blockchain system on which a digital asset exists, as well as the underlying source code, transaction history, and economics of the token and platform in question.

RESOLVING THE CFTC-SEC TURF WAR? LINES ARE STILL BLURRY...

FIT21 attempts to divide digital assets into two categories—**Restricted Digital Assets** and **Digital Commodities**—with the former subject to SEC jurisdiction, and the latter under the CFTC.



Under the proposed framework, a digital asset's designation would be driven primarily by three factors: (1) whether the asset's underlying blockchain has been certified as a "decentralized system," (2) how the asset was acquired, and (3) whether the asset holder is an affiliate of, or related to, the issuer.

- **Does the digital asset's blockchain qualify as a "Decentralized System"?:** As a general matter, digital assets associated with a blockchain system that has been certified as "decentralized" would be considered **Digital Commodities**, and therefore subject to CFTC jurisdiction.³ FIT21 allows any person to certify to the SEC that a blockchain system is decentralized by providing information about (i) the operation, functionality, and development of the underlying blockchain, (ii) the issuer and its affiliates, and (iii) the distribution of authority and available safeguards to prevent unilateral control of the system.⁴ The criteria for decentralization require, among other things, that no person has the unilateral authority to materially alter the blockchain system or to exclude others from participating in key features of the blockchain system;⁵ that the asset is not publicly marketed as an investment; that distributions in the prior year have exclusively been "end user distributions"; and that no issuer or affiliated person owned, or had the authority to direct the voting power of, twenty percent or more of the units of the digital asset.⁶ Submission of such a certification would create a presumption that the blockchain system is decentralized, and final certification would follow automatically if the SEC does not notify the certifying person of a stay within sixty days. The SEC would, however, be permitted to challenge certification,⁷ as it does with other filings intended to have automatic effectiveness (e.g., registration statements filed on Form 10).
- **How was the asset acquired?** A digital asset received by a non-affiliate or unrelated party via "**end user distribution**" or through a transaction on a digital commodity exchange would be treated as a Digital Commodity (and thus subjected to the CFTC's jurisdiction). This means the same token can simultaneously be a Digital Commodity and a Restricted Digital Asset depending on how it was obtained. If, for example, a token was obtained by one person via airdrop or through a digital commodity exchange, that token would be deemed a Digital Commodity. But if another person acquired that token through other means—e.g., over the counter—it would be deemed a Restricted Digital Asset. Both tokens would be available for concurrent trading on **different** exchanges—one regulated by the CFTC, the other by the SEC.
- **Is the holder affiliated with the issuer?** Pre-certification, assets held by affiliates and related parties are **Restricted Digital Assets**.⁸ Post-certification, assets held by affiliates and related parties are treated as **Digital Commodities**. Assets held by issuers are treated as **Restricted Digital Assets** before and after certification.

FIT21 provides carveouts for two categories of assets. First, it exempts "permitted payment stablecoins," which are not considered Restricted Digital Assets **or** Digital Commodities.⁹ Second, it exempts digital assets that, prior to the bill's adoption, have been addressed by "a federal court in a Securities and Exchange Commission enforcement action," where the court "determines that a digital asset transaction is not an offer or sale of a security," in which case the asset in question "shall be considered a digital commodity."¹⁰

FIT21 AND *HOWEY*

The proposed regime under FIT21 would effectively replace the so-called *Howey* test. Indeed, FIT21 makes a small but mighty amendment to the federal securities laws by expressly removing "investment contract assets" from the definition of "security" in the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, the



Investment Company Act of 1940, and the Securities Investor Protection Act of 1970.¹¹ An **investment contract asset** is defined as:

- (i) a “fungible digital representation of value” that can be possessed and transferred “without necessary reliance on an intermediary” and is “recorded on a cryptographically secured public distributed ledger”;
- (ii) transferred pursuant to an investment contract; and
- (iii) not otherwise a security under the Securities Act.

These changes would mean that most digital assets that have previously been deemed “investment contracts”—and therefore “securities” subject to the SEC’s jurisdiction—may no longer be deemed securities merely because they were initially issued pursuant to an investment contract.

DISCLOSURE REQUIREMENTS

FIT21’s disclosure framework requires either a digital asset issuer, an affiliated person, a decentralized governance system, or a digital commodity exchange to identify and certify certain information relating to their digital assets and/or the underlying blockchain networks on which those assets exist, as applicable. Disclosures must be made quarterly to the CFTC and SEC and must include the following categories of information:¹²

- (i) the source code for any blockchain system to which the digital asset relates;
- (ii) transaction history, including a “description of the steps necessary to independently access, search, and verify the transaction history of any blockchain system to which the digital asset relates”;
- (iii) the digital asset economics (*i.e.*, information regarding the “launch and supply process,” the applicable consensus mechanism for validating transaction, the process for mining and destroying digital assets on the underlying blockchain, the applicable governance mechanisms, and information regarding how a third party can verify the digital asset’s transaction history);
- (iv) plan of development;
- (v) a list of all affiliates and related persons who have been issued or have rights to units of the digital asset; and
- (vi) a description of the material risks associated with ownership of the digital asset.

As mentioned, extensive disclosures are also required during the decentralization-certification process.¹³ Further, FIT21 would require additional public disclosures prior to an asset’s listing on a digital commodity exchange.¹⁴

INTERNATIONAL COORDINATION

Commentators have noted that market participants could engage in regulatory arbitrage by taking advantage of opaque rules in the U.S. (even after the enactment of FIT21) or, alternatively, pursuing projects in foreign jurisdictions where the rules are more clear.¹⁵ The bill attempts to solve for that risk by calling for “international harmonization.” Specifically, FIT21 contemplates that the CFTC and the SEC will “consult and coordinate with foreign regulatory authorities” to “promote effective and consistent global regulation of digital assets”¹⁶ and provides the SEC and CFTC with 360 days after enactment to promulgate rules and regulations for the implementation of the Act.¹⁷



REACTION FROM OTHER STAKEHOLDERS

FIT21 has received strong support from industry players, with over fifty digital asset organizations signing a joint letter expressing support for the bill.¹⁸ The signatories emphasized their belief that FIT21 would provide “clarity on which digital assets are regulated by each agency” and “accelerate the growth of blockchain technology.” The group also warned that “American innovators will continue to migrate offshore” in the absence of congressional efforts to develop a regulatory framework for digital assets.¹⁹ However, at least one industry commentator has voiced concern with the proposed framework, claiming that FIT21’s concurrent trading regime ignores the fungibility of cryptocurrency, which could lead to “confusion and market fragmentation”; that the bill’s framework would harm consumers by causing “depressed prices and increased volatility,” with “professional arbitrageurs benefiting at the expense of U.S. retail” investors.²⁰

The White House has indicated that it opposes FIT21 in its current form, citing concerns that the current draft lacks sufficient consumer and investor protections.²¹ However, the Administration did not threaten to veto the bill and stated that the White House “is eager to work with Congress to ensure a comprehensive and balanced regulatory framework for digital assets,” signaling its willingness to work with Senate Democrats now that the bill is in the upper chamber.²²

SEC Chair Gary Gensler expressed strong dissatisfaction with FIT21, arguing that the bill would “create new regulatory gaps and undermine decades of precedent regarding the oversight of investment contracts, putting investors and capital markets at immeasurable risk.”²³ Chair Gensler specifically took issue with the removal of “investment contracts” from the statutory definition of securities, the bill’s self-certification process for Digital Commodities, and (in Chair Gensler’s opinion) the bill’s abandonment of the *Howey* test.²⁴ Chair Gensler expressed his concern that the proposed framework would create “a path for those trying to escape robust disclosures” and other applicable SEC rules, thereby allowing bad actors to self-select the regulations that apply to their conduct.²⁵

CONCLUSION

The market structure bill’s prospects remain unclear for substantive and procedural reasons. The House and Senate, and Republicans and Democrats, have largely divergent perspectives on the substance of legislation and regulation of digital assets. And procedurally, time is running out in the current Congress – there are just not that many legislative days remaining in either chamber. The Democrat-controlled Senate, combined with the Administration’s express opposition, likely means that a final version of FIT21 would need to undergo significant revisions before being enacted into law. That said, the surprisingly strong support for the measure by 71 Democratic Members in the U.S. House of Representatives has already changed the tone of the debate, as well as the political calculation. While it is highly unlikely the Senate will adopt the House bill in its current form, we do expect further discussions and debate in an effort find common ground around a bipartisan, bicameral market structure bill. House Majority Whip Tom Emmer (R-MN) recently predicted that his “best bet” is for more progress on FIT21 during the lame duck session after the November election.²⁶ In the meantime, market participants should be aware of the potentially shifting regulatory landscape and its implications for current and future projects.



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¹ Financial Innovation and Technology for the 21st Century Act, H.R. 4763, 118th Cong. (2023) [hereinafter FIT21].

² Press Release, United States House Financial Services Committee, House Passes Financial Innovation and Technology for the 21st Century Act with Overwhelming Bipartisan Support (May 22, 2024), <https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=409277#:~:text=%E2%80%9CFIT21%20provides%20the%20regulatory%20clarity,a%20hub%20for%20technological%20innovation>.

³ See *id.* (describing this framework within the definition of a “digital commodity”).

⁴ The full list of requirements is extensive, requiring that a certification include “(1) information regarding the person making the certification; (2) a description of the blockchain system and the digital asset which relates to such blockchain system, including— (A) the operation of the blockchain system; (B) the functionality of the related digital asset; (C) any decentralized governance system which relates to the blockchain system; and (D) the process to develop consensus or agreement within such decentralized governance system; (3) a description of the development of the blockchain system and the digital asset which relates to the blockchain system, including— (A) a history of the development of the blockchain system and the digital asset which relates to such blockchain system; (B) a description of the issuance process for the digital asset which relates to the blockchain system; (C) information identifying the digital asset issuer of the digital asset which relates to the blockchain system; and (D) a list of any affiliated person related to the digital asset issuer; (4) an analysis of the factors on which such person based the certification that the blockchain system is a decentralized system, including— (A) an explanation of the protections and prohibitions available during the previous 12 months against any one person being able to— (i) control or materially alter the blockchain system; (ii) exclude any other person from using or participating on the blockchain system; and (iii) exclude any other person from participating in a decentralized governance system; (B) information regarding the beneficial ownership of the digital asset which relates to such blockchain system and the distribution of voting power in any decentralized governance system during the previous 12 months; (C) information regarding the history of upgrades to the source code for such blockchain system during the previous 3 months, including— (i) a description of any consensus or agreement process utilized to process or approve changes to the source code; (ii) a list of any material changes to the source code, the purpose and effect of the changes, and the contributor of the changes, if known; and (iii) any changes to the source code made by the digital asset issuer, a related person, or an affiliated person; (D) information regarding any activities conducted to market the digital asset which relates to the blockchain system during the previous 3 months by the digital asset issuer or an affiliated person of the digital asset issuer; and (E) information regarding any issuance of a unit of the digital asset which relates to such blockchain system during the previous 12 months; and (5) with respect to a blockchain system for which a certification has previously been rebutted under this section or withdrawn under section 5i(m) of the Commodity Exchange Act, specific information relating to the analysis provided in subsection (f)(2) in connection with such rebuttal or such section 5i(m)(1)(C) in connection with such withdrawal. (b) Filing Requirements.—A certification described under subsection (a) shall be filed with the Commission, and include— (1) information regarding the person making the certification; (2) a description of the blockchain system and the digital asset which relates to such blockchain system, including— (A) the operation of the blockchain system; (B) the functionality of the related digital asset; (C) any decentralized governance system which relates to the blockchain system; and (D) the process to develop consensus or agreement within such decentralized governance system; (3) a description of the development of the blockchain system and the digital asset which relates to the blockchain system, including— (A) a history of the development of the blockchain system and the digital asset which relates to such blockchain system; (B) a description of the issuance process for the digital asset which relates to the blockchain system; (C) information identifying the digital asset issuer of the digital asset which relates to the blockchain system; and (D) a list of any affiliated person related to the digital asset issuer; (4) an analysis of the factors on which such person based the certification that the blockchain system is a decentralized system, including— (A) an explanation of the protections and prohibitions available during the previous 12 months against any one person being able to— (i) control or materially alter the blockchain system; (ii) exclude any other person from using or participating on the blockchain system; and (iii) exclude any other person from participating in a decentralized governance system; (B) information regarding the beneficial ownership of the digital asset which relates to such blockchain system and the distribution of voting power in any decentralized governance system during the previous 12 months; (C) information regarding the history of upgrades to the source



code for such blockchain system during the previous 3 months, including— (i) a description of any consensus or agreement process utilized to process or approve changes to the source code; (ii) a list of any material changes to the source code, the purpose and effect of the changes, and the contributor of the changes, if known; and (iii) any changes to the source code made by the digital asset issuer, a related person, or an affiliated person; (D) information regarding any activities conducted to market the digital asset which relates to the blockchain system during the previous 3 months by the digital asset issuer or an affiliated person of the digital asset issuer; and (E) information regarding any issuance of a unit of the digital asset which relates to such blockchain system during the previous 12 months; and (5) with respect to a blockchain system for which a certification has previously been rebutted under this section or withdrawn under section 5i(m) of the Commodity Exchange Act, specific information relating to the analysis provided in subsection (f)(2) in connection with such rebuttal or such section 5i(m)(1)(C) in connection with such withdrawal.” *Id.* at § 304 (internal quotation marks omitted).

⁵ See FIT21, *supra* note 1, at § 101 (defining “decentralized system” to include these requirements).

⁶ See *id.* (defining “decentralized system” to also include these requirements).

⁷ See *id.* (describing certification requirements, the review process, and the rebuttable presumption of decentralization).

⁸ Affiliated persons include those that directly or indirectly control or are under common ownership of the digital asset issuer (or fit this definition within the past three months) and those who beneficially own five percent or more of the asset’s outstanding units (or did within the past three months).

Related persons include “a founder, promoter, employee, consultant, advisor, or person serving in a similar capacity [to the issuer]. . . any person that is or was in the previous 6-month period an executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity. . . any equity holder or other security holder” and any other person who received the asset through non-excluded exempt offers and non-end-user distributions.” See *id.* (defining “affiliated person” and “related person” accordingly).

⁹ See *id.* at § 101 (clarifying in the definitions of “Restricted Digital Asset” and “Digital Commodity” that neither encompass payment permitted stablecoin).

¹⁰ *Id.*

¹¹ *Id.* at § 202.

¹² See *id.* at § 303 (amending the Securities Exchange Act to implement these quarterly certification requirements).

¹³ See *id.* at § 304 (amending the Securities Exchange Act of 1934 to create this certification process).

¹⁴ See *id.* at § 504 (amending the Commodities Exchange Act to include these listing requirements).

¹⁵ Joshua Riezman, *The Unintended Consequences of FIT21’s Crypto Market Structure Bill*, COINDESK, May 24, 2024, <https://www.coindesk.com/opinion/2024/05/24/the-unintended-consequences-of-fit21s-crypto-market-structure-bill/>.

¹⁶ See FIT21, *supra* note 1, at § 110.

¹⁷ See *id.* at § 111(a) (describing global rulemaking timeframe for implementation).

¹⁸ Crypto Council for Innovation, *FIT21 Coalition Support Letter* (May 17, 2024), <https://cryptofoinnovation.org/fit21-coalition-support-letter/>.

¹⁹ *Id.*

²⁰ Riezman, *supra* note 6.

²¹ Statement of Administration Policy, Executive Office of the President, H.R. 4769 – Financial Innovation and Technology for the 21st Century Act (May 22, 2024), <https://www.whitehouse.gov/wp-content/uploads/2024/05/SAP-HR4763.pdf>.

²² *Id.*

²³ Statement on the Financial Innovation and Technology for the 21st Century Act (May 22, 2024), <https://www.sec.gov/news/statement/gensler-21st-century-act-05222024>.

²⁴ See *id.*

²⁵ *Id.*

²⁶ Nikhilesh De, *What’s Next for FIT21? (A Consensus 2024 Recap)*, <https://www.coindesk.com/opinion/2024/06/05/whats-next-for-fit21-a-consensus-2024-recap/>.