

# COMMODITY INSIGHTS DIGEST

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"DIGITAL ASSETS REGULATION IN 2023"



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## Digital Assets Regulation in 2023: Is a New Regulatory Framework Finally Emerging?

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### Introduction

A redefined regulatory framework is on the horizon for the digital asset marketplace. In this article, we look at the current state of U.S. regulatory authority over digital assets and explore potential changes in the regulation of digital assets.

### Background

On December 1, 2022, in the wake of the downfall of cryptocurrency exchange FTX Trading Ltd., Rostin Behnam, the chairman of the U.S. Commodity Futures Trading Commission (CFTC), urged the U.S. Congress to create a new regulatory framework for digital assets.

Behnam stated that digital assets need to be overseen by a single federal regulator, replacing the current paradigm of overlapping CFTC and U.S. Securities and Exchange Commission (SEC) authority. He noted that the current regulatory situation has undermined the CFTC's investigation into the FTX debacle; for example, the agency is (a) unable to register cash market exchanges, (b) does not have legal authority to examine any of FTX's other entities, and (c) has no visibility into the operations of those FTX subsidiaries.

### CFTC and SEC – Current Statutory Authority

Both the CFTC and the SEC have claimed primary authority to regulate digital assets. The CFTC says that digital assets are commodities, while the SEC says most digital asset offerings are investment contracts subject to its jurisdiction.



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The CFTC has authority over “commodities” as defined in the U.S. Commodities Exchange Act (CEA). This authority includes derivatives, over-the-counter swaps, futures contracts, options contracts, and enforcement fraud and misconduct penalties relating to derivatives and commodities.

The CFTC first defined digital currencies as commodities under the CEA in settlement of the enforcement action *In the Matter of Coinflip, Inc, d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29*. In *Coinflip*, the CFTC stated that the definition of a “commodity” is broad and “bitcoin and other virtual currencies are encompassed in the definition and [are] properly defined as commodities.” Thus, the CFTC concluded it has clear authority to regulate cryptocurrencies. However, even with this expansion of CFTC authority, the CFTC has little to no power to regulate spot markets for commodities - even if the commodities are digital currencies.

The SEC has authority over “securities” as defined in the U.S. Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940, as well as authority over virtually any instrument that might be sold as an investment. The SEC also has more expertise in overseeing the securities markets.

The SEC considers an investment contract as all offerings of an asset in a manner described under the test in *SEC v. W.J. Howey*. The Howey Test states that an investment contract exists where there is a monetary investment into a common enterprise with the reasonable expectation of profits due to the efforts of others. As a result, the SEC considers digital assets that fall under the Howey Test to be “investment contracts” in the form of securities similar to stock in publicly traded companies. The SEC has released guidance providing a framework for whether a digital asset is a security, stating that persons and entities engaged in the marketing, offer, sale, resale, or distribution of any digital asset must determine if the federal securities laws apply to such action using the Howey Test.

### CFTC and SEC – Current Regulatory Authority Arising from Case Law

The two federal agencies are jockeying for pole position in the regulation of digital assets, but courts have affirmed the authority of both agencies over certain digital assets in different contexts.

Courts have affirmed the CFTC’s authority to regulate digital assets in cases involving fraud and Ponzi schemes. These courts have further stated that the CEA’s text supports the CFTC’s assertion of authority due to the CEA defining “commodities” broadly. The courts therefore conclude that the CFTC taking a broad position in its anti-fraud jurisdiction over digital assets is still aligned with congressional intent to strengthen federal regulations of commodity futures trading.

Courts have also supported the SEC’s authority over digital assets, notably in the context of initial coin offerings (ICOs).

In *SEC v. LBRY*, the court examined the economic realities surrounding an offering of a digital asset that would lead investors to have a reasonable expectation of profits to be derived from the entrepreneurial



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or managerial efforts of others along with whether the offeror of the digital assets was aware of the digital assets' potential value as an investment.

Additionally, in cases such as *In the Matter of Steven Seagal and SEC v. Balina*, the SEC has initiated enforcement actions against individuals and entities for promotion of ICOs with a lack of or inadequate disclosure of material relationships.

### Defining a New Regulatory Framework

Several bills have been introduced in Congress to define a new regulatory framework for digital assets. Among the bills introduced in the Senate are the Responsible Financial Innovation Act, introduced in June 2022, and the Digital Commodities Consumer Protection Act of 2022, introduced in August 2022, which would establish a regulatory framework that would set clear standards and define appropriate jurisdictional boundaries while offering greater protections for customers.

Both of these bills aim to give the CFTC more extensive jurisdiction to regulate digital commodity trading. While Congress may grant such jurisdiction to the CFTC, it would not limit the SEC's ability to regulate digital commodities that are offered as securities. Indeed, U.S. Senator Debbie Stabenow (D-MI), the sponsor of the Digital Commodities Consumer Protection Act of 2022, stated that the bill would not take authority away from financial regulators and that the bill recognizes that other financial agencies play some role in the regulation of digital assets that are not commodities, for example, securities. Moreover, the Responsible Financial Innovation Act distinguishes between digital assets that are securities regulated by the SEC and those that are commodities subject to CFTC oversight, in addition to giving the CFTC authority over digital asset spot markets.

In December 2022, the Digital Asset Anti-Money Laundering Act was introduced in the Senate, aiming to bring know-your-customer rules to digital asset participants, including wallet providers and miners. The bill would prohibit financial institutions from transacting with digital assets mixers that obscure the origin of funds of parties. While the bill does not grant specific jurisdiction to one agency over the other, it does direct both the CFTC and the SEC to establish risk-focused examinations and to review the adequacy of anti-money laundering programs and reporting obligations.

Each of these bipartisan bills designate the CFTC as the regulatory agency in the spot crypto space. This is partially because the CFTC has brought enforcement actions against several individuals and entities operating in digital asset spot markets using the current CEA and its rules.

In 2022, the CFTC brought over 80 enforcement actions. More than 20 percent of those were brought against entities engaging in the digital asset marketplace, including some of its major participants.

Moreover, crypto platforms globally have combined the trading of spot digital assets with derivatives of such assets. Because of this amalgamation, and the CFTC's existing authority over derivatives trading involving digital currencies, many of those contemplating a new regulatory framework think that it would be more efficient to allocate authority over spot trading of digital assets to the CFTC.



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### FTX and Regulatory Control

After the fall of FTX, both the CFTC and the SEC charged Sam Bankman-Fried, his companies, several FTX executives and Alameda Research LLC with criminal activity related to the downfall of FTX.

The CFTC alleges fraud and material misrepresentations in connection with the sale of the FTX exchange digital tokens, FTT, as digital commodities in interstate commerce resulting in the loss of over \$8 billion in customer deposits. The CFTC further alleges that FTX did not segregate from FTX's own assets customer funds which were accepted and held by Alameda. Moreover, FTX had features in its code allowing Alameda to essentially maintain an unlimited line of credit on FTX.

The SEC alleges FTX had concealed diversion of customers' funds to Alameda while raising more than \$1.8 billion from investors. In its fraud, FTX and Bankman-Fried attempted to conceal from FTX investors the undisclosed diversion of FTX customer funds to Alameda, the undisclosed special treatment of Alameda on the FTX platform, and undisclosed risk stemming from FTX's exposure to Alameda's significant holdings of overvalued illiquid assets such as FTX-affiliated tokens. The SEC contends that the former executives of Alameda and FTX had engaged in market manipulation of the FTT token at the direction of Bankman-Fried. To underscore that these are security violations, the SEC further contends that FTT is a security because it was "offered and sold as an investment contract."

The results of these cases may succeed in clarifying some ambiguities as to whether digital assets are commodities or securities, or both – possibly before any defining legislation can pass both the U.S. House of Representatives and the Senate. More importantly, these cases, brought simultaneously and cooperatively by the CFTC and SEC, could be a sign of things to come: the CFTC receiving more explicit tools and authority from Congress to regulate the space than any other agency, while the door remains open for the CFTC and the SEC to work together on prosecuting fraud on digital assets, which also are securities under the Howey Test.

### CFTC Recommendations

The CFTC has put forth a set of recommendations for a to-be-implemented regulatory framework. These recommendations are based on the current regulatory framework implemented by the CFTC for designated contract markets, swap execution facilities, and intermediary entities required to register with the CFTC. Its recommendations include:

- Oversight of spot digital assets to be placed in the hands of a single agency, the CFTC, to reduce regulatory fragmentation. This concentration would include creating a fully fleshed out regulatory structure for these assets.
- A registration requirement for digital currency exchanges.





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- Regulatory power to compel participants in the digital assets space to (a) outline their separation and protection of customer funds, (b) prove they are maintaining sufficient capital to operate, and (c) provide public disclosures backed by independent accounting.
- Lastly, Congress should bridge the gap between CFTC and SEC regulation of the space by properly defining the difference in commodities versus securities.

### Conclusion

The CFTC appears poised to retain and perhaps even expand significant regulatory authority over digital assets. Indeed, on October 14, 2022, SEC Chair Gensler recommended that Congress grant the CFTC explicit jurisdiction over at least those digital assets consisting of stablecoins and the stablecoin exchanges.

As the potential regulatory framework begins to take shape, participants in the space should prepare for significant change. To understand what may come next, these market participants can look to rules and regulations put in place by the CFTC for participants in the swaps, options, and futures marketplaces. However, even if the CFTC does gain regulatory jurisdiction over digital assets through legislation, token issuers should be aware that the SEC will retain some authority due to case law and the Howey Test for investment contracts.

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### Endnotes

For additional information on this and related subjects, one may contact DLA Piper's Commodities team at [DLAPiperCommodities@us.dlapiper.com](mailto:DLAPiperCommodities@us.dlapiper.com).

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Deanna Reitman has over 20 years of experience working in commodity markets and more than 18 years of senior management experience. Her background encompasses legal, regulatory and business experience in commodities, with a particular focus on energy. She has extensive global energy commodity legal and regulatory experience. Reitman is a skilled communicator and team manager with a record of success in achieving complicated objectives. Her core competency is in legal and regulatory global commodity marketing and trading, in both physical and financial markets. At DLA Piper, Reitman draws upon her experience as an in-house counsel for energy commodities marketing and trading firms to advise on the structuring of transactions and provide regulatory and commercial advice to energy clients.



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Elizabeth Caires is a technology compliance attorney, with over 15 years' experience advising on the adoption of fully digital transactions and processes, including the practical application of law to technology platforms used for electronic signatures, in person and remote electronic notarization, and creation and vaulting of digital assets. Caires advises both technology platform providers and commercial enterprises across various industries with respect to compliance with laws, regulations and industry standards related to electronic signatures and records. Represented industries include technology companies in the electronic contracting or electronic and remote notarization space, as well as commercial entities purchasing such services, such as entities in financial services, FinTech, equipment leasing, mortgage, and other industry sectors.

### **MICHAEL MAPP** Associate, DLA Piper

Michael Mapp focuses his practice on corporate commodities and representing entities conducting a variety of transactions including mergers and acquisitions and debt finance. He primarily has experience in advising entities operating in the energy sector and entities in the trade of emissions reduction credits in navigating complexities of the Dodd-Frank Act and CFTC regulation. He has further experience representing businesses in the energy sector including renewable energy companies, liquid natural gas companies, and coal companies.

### **ERIC FORNI** Partner, DLA Piper

Eric Forni is an experienced investigator, federal securities laws advisor, civil litigator, and trial attorney who represents clients in connection with Securities and Exchange Commission (SEC), Department of Justice (DOJ), Commodity Futures Trading Commission (CFTC), and Financial Industry Regulatory Authority (FINRA) inquiries or investigations; internal investigations; and a variety of federal securities laws compliance-related matters, including those related to digital assets, insider trading policies and procedures, broker-dealer anti-money laundering (AML) policies and procedures, auditor independence rules, and the marketing rule applicable to investment advisers. Before joining DLA Piper, Forni served as a senior trial and enforcement attorney with the SEC for 15 years, where he developed a deep understanding of the SEC and the laws it enforces, as well as knowledge in such areas as digital asset-related securities registration rules and life science company disclosure obligations.

At the SEC, Forni coordinated parallel investigations with such agencies as the Federal Bureau of Investigation and worked on matters with the assistance of FINRA. Additionally, he was a member of the SEC's Market Abuse Unit, focusing on matters related to complex insider trading, broker-dealer and hedge fund conduct and market manipulation. Forni previously worked as a Special Assistant United States Attorney for the District of Massachusetts, where he conducted federal jury trials in cases concerning conspiracy; securities, mail and wire fraud; witness tampering; false statements; and structuring. He also worked on all aspects of criminal prosecutions, including grand jury investigations and plea negotiations. Forni is a recipient of the Paul R. Carey Award, a national award conferred by the SEC to recognize individuals with exceptional personal commitment and effectiveness, unquestioned integrity, unlimited enthusiasm, and unwavering dedication to the protection of the individual investor.

### **EVAN NORTH** Of Counsel, DLA Piper

Evan North is a litigator with broad experience handling complex government investigations and related civil and criminal litigation. North focuses his practice on handling inquiries by government authorities. He regularly counsels companies in responding to subpoenas issued by grand juries and regulators and has managed real-time responses to unannounced government inspections. North has successfully resolved high-risk regulatory and criminal inquiries brought by federal and state authorities, both in early negotiations and at trial. In his litigation practice, North has successfully resolved white-collar matters for individual and corporate clients and a variety of complicated civil matters. He has experience in an array of industries, including technology, health care, and banking.



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