

1Q 2023 Crypto Update – Regulation & Reporting

This paper is an update on recent developments as global regulators and investigators analyze the collapse of cryptocurrency exchange FTX and begin to unravel the March 2023 bankruptcy filing of the \$11 billion crypto bank, Silvergate, and FDIC takeovers of Silicon Valley Bank and Signature Bank. Capitol Hill outrage produced lively testimony related to FTX and continued finger pointing but little viable regulatory progress, even as some firms in the crypto industry would welcome guardrails and the ability to participate fully in regulated markets. The analysis on the FDIC takeovers is likely to freeze any federal legislative progress on crypto. In the middle of these bank collapses, FASB proposed accounting and reporting guidance for certain crypto assets.

Recent key domestic regulatory and reporting developments are summarized below.

I. FASB Accounting Proposal

When FASB sought feedback on future standard setting in 2021, the board was inundated with responses seeking clarity on crypto accounting and reporting. There is a current lack of information provided by companies related to their digital asset holdings, including the amounts of digital assets held, current fair value, and historical cost. Nonbinding guidance from the American Institute of CPAs says companies should classify crypto as an intangible asset, as outlined in Accounting Standards Codification (ASC) 350, Intangibles—Goodwill and Other. Businesses that do not qualify as investment firms should record cryptocurrency at historical cost and only adjust it if the value declines. Once holdings are written down, companies cannot revise the value back up if the price recovers. This accounting does not appropriately reflect the economics or the nature of how a company is using digital assets, limiting overall transparency and comparability of financial reporting information.

On March 23, 2023, FASB issued a fast-tracked [exposure draft](#) on accounting for certain crypto assets. While the proposal is narrowly scoped, it represents a significant milestone in providing more decision-useful information to financial statement users. Covered items would include crypto assets that:

- Meet the intangible asset definition in the Codification Master Glossary
- Do not provide the asset holder with enforceable rights to, or claims on, underlying goods, services, or other assets
- Are created or reside on a distributed ledger or “blockchain”
- Are secured through cryptography
- Are fungible
- Are not created or issued by the reporting entity or its related parties. FASB clarified during its deliberations that a miner is not the creator of the newly created crypto assets it received as consideration for performing services if that is the only involvement that an entity has in the creation of the crypto asset

The proposal does not cover items such as:

- Non-fungible tokens
- Stablecoins

- Wrapped tokens
- Governance tokens

Under the proposal, crypto assets would be measured at fair value under ASC 820, Fair Value Measurement, with any changes in fair value reported in net income each reporting period. Certain costs incurred to acquire crypto assets, such as commissions, would be recognized as an expense (unless a company follows specialized industry measurement guidance that requires otherwise). The aggregate amount of crypto assets would be presented separately from other intangible assets that are measured using other measurement bases. Gains and losses on crypto assets would be reported in net income separately from the income statement effects of other intangible assets, such as amortization or impairments. Crypto assets received as noncash consideration during the ordinary course of business that are converted nearly immediately into cash would be classified as operating cash flows.

The proposal includes the following new disclosures. For annual and interim reporting periods, an entity would be required to disclose the following information:

- The name, cost basis, fair value, and number of units for each significant crypto asset holding and the aggregate fair values and cost bases of the crypto asset holdings that are not individually significant
- For crypto assets subject to restriction(s), the fair value of those crypto assets, the nature and remaining duration of the restriction(s), and the circumstances that could cause the restriction(s) to lapse

For annual reporting periods, an entity would be required to disclose the following information:

- A rollforward, in the aggregate, of activity in the reporting period for crypto asset holdings, including additions (with a description of the activities that resulted in the additions), dispositions, gains, and losses. If gains and losses are not presented separately, the entity is required to disclose the income statement line item in which those gains and losses are recognized
- For any dispositions of crypto assets in the reporting period, the difference between the sale price and the cost basis and a description of the activities that resulted in the dispositions
- The method for determining the cost basis of crypto assets

II. Regulatory Oversight – Who’s in Charge?

Congress	Banking Regulators	Financial Market Regulators
<ul style="list-style-type: none"> - U.S. House of Representatives - U.S. Senate 	<ul style="list-style-type: none"> - Federal Reserve (Fed) - Federal Deposit Insurance Corporation (FDIC) - Office of the Comptroller of the Currency (OCC) 	<ul style="list-style-type: none"> - U.S. Securities and Exchange Commission (SEC) - Commodity Futures Trading Commission (CFTC)

With the exception of the IRS, federal agencies are divided in how to regulate this evolving asset class. Unlike the securities and derivatives market, no single regulator oversees cryptocurrency or brokers. A security subject to SEC oversight is defined in the *Securities Act of 1933* and the benchmark interpretation is based on a 1946 U.S. Supreme Court case that resulted in the Howey test. The Howey test established four criteria to determine if an investment contract exists and is subject to U.S. securities laws:

- An investment of money
- In a common enterprise
- To be derived from the efforts of others
- With the expectation of profit

The SEC's ability to regulate digital assets is dependent on the outcome of this test.

Legal experts generally believe the first three criteria are easily satisfied for digital currencies. Whether a digital asset qualifies as an investment contract largely depends on whether there is an "expectation of profit to be derived from the efforts of others." This answer is subject to interpretation and—not surprisingly—there is a sharp divide between crypto entrepreneurs and the SEC. The CFTC took an early lead on enforcing cryptocurrencies when it allowed bitcoin futures to start trading in 2017, but its powers are mostly limited to overseeing derivatives.

The current balance of power in Washington will likely delay any meaningful short-term reforms. The House Financial Services and Agriculture Committees split oversight of the financial industry and its regulators. In 2022, there were at least 13 bills introduced in the House and an additional 13 bills introduced in the Senate that touched cryptocurrencies, digital assets, or blockchain.¹ With the beginning of the 118th congressional session in January 2023, any outstanding bills or proposals at the end of 2022 will have to be reintroduced to have a chance at becoming law. As a broad generalization, many Democrats see cryptocurrency as a tool for tax evasion, funding for illicit activities, money laundering, and sanctions evasion, while many Republicans shy away from overregulation and worry about potentially stifling innovation. U.S. Rep. French Hill chairs the House Financial Services digital assets subcommittee and kicked off new hearings on March 9 with the hopes of a more comprehensive digital asset legislation rather than 2022's smaller-scale bills.²

III. Banking Regulators

A few federally regulated banks like Silvergate Bank and Signature Bank offered crypto services, carefully navigating the evolving regulatory landscape, and incurring intense regulatory scrutiny.³ Silvergate's March 9, 2023 voluntary liquidation preempted an FDIC takeover and was not a surprise. In January, the company laid off 40% of its workforce and reported a fourth quarter net loss of \$1 billion as its customer deposits shrank 68% to \$3.8 billion. Silvergate's liquidation plan currently indicates that all deposits will be repaid. While Signature Bank is much larger with more than \$114 billion in assets, it also is facing fallout from the bankruptcy of FTX, which was one of its clients. Signature Bank announced its plans to cut its crypto asset deposits by \$8 billion to \$10 billion to bring its crypto exposure to less than 20% of total assets.⁴ In spite of these efforts, on March 12, 2023, the FDIC intervened under a systemic risk exception.

¹ Legislative Tracker, caphillcrypto.com

² Morning Money, politico.com

³ "Signature Bank Now Servicing Multiple Crypto Companies in the Wake of Silvergate Distress," cryptoslate.com, March 3, 2023

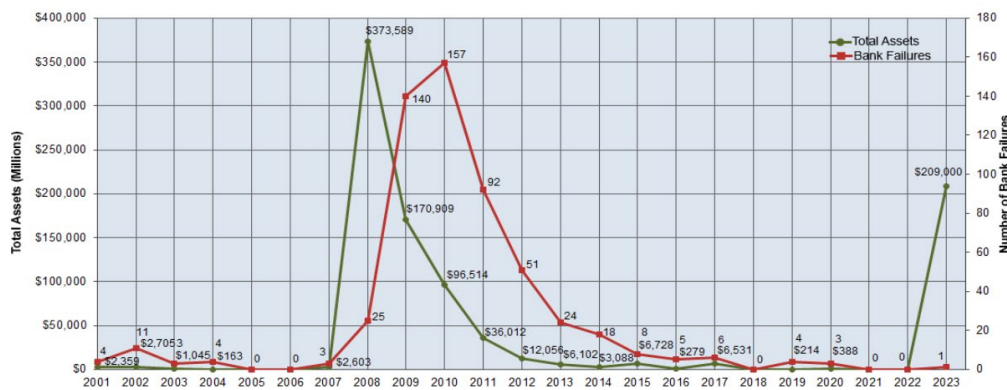
⁴ "Signature Bank to Reduce Crypto-Tied Deposits by as Much as \$10 Billion," coindesk.com, December 6, 2022

A third, record-setting FDIC intervention, while not related to the crypto industry, is likely to freeze any forward momentum on crypto legislation. Silicon Valley Bank with \$209 billion in assets is the second largest bank failure after Washington Mutual's \$306 billion collapse in 2008. This bank catered to the venture capital-backed technology and healthcare startups. A run started when the bank announced it was raising capital to meet capital requirements and manage liquidity risk. Within days, \$42 billion of deposits were withdrawn. On March 10, 2023, the FDIC seized the bank's assets.

As noted below, banking regulators recently issued a joint statement warning about liquidity risks; however, the quickness and scale of these three deposit runs caught many by surprise. In a controversial departure from previous takeovers, the FDIC will make all depositors of Silicon Valley and Signature banks whole. Unlike the 2008 mortgage crisis, investors and bondholders will bear the losses and banks will face an increase in their FDIC insurance premiums.

Bank collapses in 2008 partially gave rise to the Dodd-Frank regulations, and the 2001 \$64 billion Enron bankruptcy gave rise to the Sarbanes-Oxley regulations. It will be interesting to see what extent of regulation will follow these events.

Historical Bank Failures



Source: fdic.gov

Joint Statements

The Fed, FDIC, and OCC have issued several joint statements in the first quarter urging caution on this asset class, focusing on the safety, soundness, and compliance within the banking system.

- [January 3](#) – Key risks for crypto-asset risks and crypto-asset sector participants that banking organizations should be aware of, including significant volatility in crypto-asset markets, fraud risks, legal uncertainties, and heightened risks associated with open, public, and/or decentralized networks
- [February 23](#) – Liquidity risks posed by crypto assets due to the scale and timing of deposit inflow and outflows, generally highlighting previously issued guidance and existing risk management principles

The two statements include the following seemingly contradictory positions:

“Banking organizations are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation.”

“Based on the agencies’ current understanding and experience to date, the agencies believe that issuing or holding as principal crypto-assets that are issued, stored, or transferred on an open, public, and/or decentralized network, or similar system is highly likely to be inconsistent with safe and sound banking practices.”

Federal Reserve

The Fed continues to regulate and enforce those crypto assets under its authorization purview but regularly signals the need for more coordinated oversight at a higher level.

In late January, the Fed quickly rejected Custodia Bank’s application for membership in the Federal Reserve System.⁵ Custodia is a special purpose depository institution, chartered in Wyoming, that wanted to issue crypto assets.

A March 9, 2023, [speech](#) by Fed Vice Chair for Supervision Michael Barr signaled the need for additional oversight help: “But obviously there is a set of activities going on that is mostly not in the banking sector. It is mostly outside the banking sector, and other market regulators and Congress need to think about the appropriate role for regulation of those entities.”

This is consistent with the Fed’s stance when it issued its January 2021 white paper on the benefits and risks of a central bank digital currency⁶ (CBDC).

The Fed made it clear that it does not intend to proceed with a CBDC without clear support from the executive branch and Congress, ideally in the form of a specific authorizing law.

Federal Reserve Member Banks

Fed member banks consist of financial institutions at the state level that meet the operational requirements of the Federal Reserve System and are overseen by the 12 designated regional banks across the United States. On February 7, 2023, the Fed’s Board of Governors issued a [policy statement](#) clarifying permissible activities by member banks:⁷

- “Presumptively prohibit” member banks from holding most crypto assets as a principal. This presumption may be rebutted if there is a clear and compelling rationale for the board to allow the proposed deviation in regulatory treatment among federally supervised banks, and the state member bank has robust plans for managing the risks of the proposed activity in accordance with principles of safe and sound banking. The policy does not prohibit a state member bank from providing safekeeping services for crypto assets in a custodial capacity if those activities are conducted in a safe and sound manner and in compliance with consumer, anti-money laundering, and anti-terrorist financing laws.⁸

⁵ “Statement from Custodia Bank on Federal Reserve Board Action,” [custodiabank.com](#), January 27, 2023

⁶ A CBDC is defined as a digital liability of a central bank that is widely available to the general public, analogous to a digital form of paper money. However, a CBDC would differ from existing digital money available to the general public because a CBDC would be a liability of the Fed and not a commercial bank.

⁷ Federal Reserve member banks consist of financial institutions at the state level that meet the operational requirements of the Federal Reserve System and are overseen by the 12 designated regional banks across the United States.

⁸ OCC Interpretive Letter [1170](#)

- Member banks wishing to issue dollar tokens will need to prove certain security measures and receive formal approval prior to their use in banking transactions.⁹

FDIC & OCC

In November 2021, the President's Working Group on Financial Markets (PWG), along with the FDIC and the OCC, issued a report on stablecoins. The PWG report notes that well-designed and appropriately regulated stablecoins could potentially support faster, more efficient, and more inclusive payment options. The report also notes that the potential for the increased use of stablecoins as a means of payment raises a range of concerns related to the potential for destabilizing runs, payment system disruptions, and concentration of economic power. The PWG report highlights gaps in the authority of regulators to reduce these risks.

To address the risks of payment stablecoins, the PWG report recommends that Congress act promptly to enact legislation that would ensure payment stablecoins and payment stablecoin arrangements are subject to a consistent and comprehensive federal regulatory framework.

IV. Financial Markets Regulators

SEC

Enforcement

The SEC continues to bring [new enforcement actions](#) that leverage its beefed up 50-person Crypto Asset and Cyber Unit. First-quarter activity focused mainly on [FTX](#) and celebrity crypto endorsements, including NBA Hall of Famer [Paul Pierce](#). Other recent charges include:

- The SEC froze the assets of [BKCoin Management LLC](#) and one of its principals, Kevin Kang, in connection with a crypto asset fraud scheme. BKCoin had raised approximately \$100 million to invest in crypto assets, but BKCoin and Kang instead used some of the money to make Ponzi-like payments and for personal use.
- [Genesis Global Capital, LLC](#) and Gemini Trust Company, LLC were charged for the unregistered offer and sale of securities to retail investors through the Gemini Earn crypto asset lending program.

[Avraham Eisenberg](#) was charged with stealing \$116 million by orchestrating an attack on a crypto asset trading platform, Mango Markets, by manipulating the MNGO token, a so-called governance token that was offered and sold as a security.

- Seven parties were charged for their involvement in a fraudulent investment scheme named [CoinDeal](#) that raised more than \$45 million from sales of unregistered securities.
- [Nexo Capital Inc.](#) was charged with failing to register the offer and sale of its retail crypto asset lending product, the Earn Interest Product (EIP). To settle the SEC's charges, Nexo agreed to pay a \$22.5 million penalty and cease its unregistered offer and sale of the EIP to U.S. investors.
- [Kraken](#) was charged with failing to register the offer and sale of its crypto asset staking-as-a-service program, whereby investors transfer crypto assets to Kraken for staking. To settle the SEC's charges, Kraken agreed to

⁹ OCC Interpretive Letter [1174](#) and [1179](#)

immediately cease offering or selling securities through crypto asset staking services or staking programs and pay \$30 million in penalties.

Guidance

On March 31, 2022, the SEC published [Staff Accounting Bulletin \(SAB\) No. 121](#), which expresses the views of the Division of Corporation Finance and the Office of the Chief Accountant regarding the accounting for obligations to safeguard crypto assets that an entity holds for platform users. The SAB addresses two key questions:

- How should an entity account for its obligations to safeguard crypto assets held for platform users?
- What disclosures would the SEC staff expect for safeguarding obligations for crypto assets held for platform users?

SAB 121 requires reporting entities that perform cryptocurrency custody activities to record a liability with a corresponding asset.

On March 2, 2023, a bipartisan group of senators sent a letter to the Fed challenging the basis of SAB 121, stating “SAB 121 upends decades of precedent regarding the accounting treatment of custodial assets for banks, credit unions and other regulated financial institutions.”

Proposed Regulation

Until the Howey test is resolved, the SEC has recently issued several proposals that could impact the crypto industry. The SEC authority to regulate these areas will likely be subject to legal challenges.

1. Asset Safeguarding & Custody Proposal

On February 15, 2023, the SEC approved a [proposal](#) to significantly expand investor protection on advisory client assets. The proposal would expand the custody rule's scope to cover additional client assets, including crypto assets that may not be classified as either funds or securities.

The Custody Rule was first adopted in 1962 and is designed to protect client funds and securities from an adviser insolvency or bankruptcy and prevent client assets from being lost, misused, stolen, or misappropriated. The 2010 Dodd-Frank Act authorized the SEC to prescribe rules requiring advisers to safeguard all client assets, not just funds and securities, over which an adviser has custody. Recent crypto bankruptcies have highlighted the lack of regulation on custody of these assets. Crypto assets generally use a distributed ledger or blockchain technology to record ownership and transfer assets. This technology often makes it difficult or impossible to reverse erroneous or fraudulent transactions and could leave advisory clients without meaningful recourse to reverse erroneous or fraudulent transactions, recover or replace lost crypto assets, or correct errors that result from their adviser having custody of these assets.

The proposal's impact on the crypto assets is unclear. Some crypt exchanges, like Coinbase, may meet the proposed definition of a qualified custodian. Others welcomed the clarity of rule setting versus an enforcement approach (although enforcement actions continue to ramp up).

SEC Commissioner [Mark Uyeda noted](#), “The proposing release takes great pains to paint a ‘no-win’ scenario for crypto assets. In other words, an adviser may custody crypto assets at a bank, but banks are cautioned by their regulators not to custody crypto assets.”

SEC Chair [Gary Gensler noted](#), “Though some crypto trading and lending platforms may claim to custody investors’ crypto, that does not mean they are qualified custodians. ... Make no mistake: Based upon how crypto platforms generally operate, investment advisers cannot rely on them as qualified custodians.”

Resource: [Expansion of Adviser’s Safeguarding & Custody Rules?](#)

2. Alternative Trading Systems (ATSS)

On January 26, 2022, the SEC issued a [proposal](#) to expand and modernize the rules on ATSS. ATSS are trading systems for securities that meet the exchange definition under federal securities laws but are not required to register with the SEC as a national securities exchange (NSE) if the ATS complies with certain exemptions. Communication protocol systems (CPSs) are platforms that bring together security buyers and sellers and provide similar functionality to marketplaces operated by NSEs and ATSS but are not subject to the same regulations. Investors using CPSs do not receive the same investor protection, transparency, and oversight. A CPS that meets the updated “exchange” definition has two choices:

- Register as an exchange and be a self-regulated organization subject to the requirements of Exchange Act Section 6
- Comply with the conditions of the Regulation ATS exemption, which includes registering as a broker-dealer

The new definition could encompass some cryptocurrency platforms to bring them under SEC supervision. Blockchain and decentralized finance groups pushed back on SEC overreach in applying existing concepts to new technology innovations.

Resource: [New Rules & Expanded Scope for Alternate Trading Systems](#)

CFTC

The CFTC also is making some high-profile enforcement actions:

- [Kraken](#) was charged for illegally offering margined retail commodity transactions in digital assets, including bitcoin, and failing to register as a futures commission merchant. Kraken will pay a \$1.25 million penalty.
- [Digitex](#) and its founder were charged with illegally offering futures transactions on a platform other than a designated contract market and with attempting to manipulate the price of the Digitex Futures native token.

Conclusion

Crypto firms and firms supporting the crypto industry should expect enforcement actions to accelerate by all regulators. Piecemeal enforcement and regulation will continue until Congress passes legislation that authorizes and delegates crypto asset oversight to an appropriate agency. The recent bank collapses will chill appetite for any Republican legislative efforts to allow crypto players to participate more fully in financial markets and continue innovations, especially around stablecoin.

FORVIS will continue to follow cryptocurrency tax, regulatory, and accounting developments. For more information, visit forvis.com.

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