The Computer & Internet Lawyer

Volume 41 ▲ Number 4 ▲ April 2024

Ronald L. Johnston, Arnold & Porter, Editor-in-Chief

Without a TARDIS or a DeLorean, We Did the Best We Could: Five Blockchain Predictions

By Joseph A. Castelluccio and Justin Herring

While the blockchain universe continues to expand, the direction and pace of its development will continue to be influenced by a number of variables – including financial markets, regulatory environments and politics. While we cannot predict how each of these variables will play out this year, this article describes how we think some of them will influence blockchain developments and what we may expect to see this universe look like by the end of 2024.

1. BLOCKCHAIN INNOVATION AND DEVELOPMENT WILL CONTINUE IN THE UNITED STATES, EVEN WITHOUT ADDITIONAL "REGULATORY CLARITY."

The calls for digital asset "regulatory clarity" in the United States have been frequent – and loud – for a long time, and there is no guarantee that the full clarity most are hoping for will ever arrive. There is ample precedent in the United States for legal regimes to remain a web of overlapping state and federal requirements indefinitely. We expect that progress on digital asset regulatory clarity will be, at best, incremental and comprised of baby steps. (More on the U.S. regulatory outlook below.)

With that said, we also believe blockchain innovation and development in the United States will accelerate, even without significant new or revised regulations.

What will those innovations look like? Blockchain-based assets and transactions will increasingly incorporate features of traditional assets, like anti-fraud protection, transaction reversibility, and improved ability to debug and update blockchain products after launch. While these features may not represent a purist's view of decentralized finance, they will be critical to widespread acceptance of these products by the market . . . and regulators.

In addition, in some cases financial products and services will be little more than "blockchain-enabled" versions of their traditional forms. But the momentum created by these incremental innovations will be important proofs of concept for markets and regulators in the years to come.

The authors, partners with Mayer Brown, may be contacted at jcastelluccio@mayerbrown.com and jherring@mayerbrown.com, respectively.

2. DON'T EXPECT THE "CRYPTO SKEPTICS" IN WASHINGTON TO SUDDENLY CHANGE THEIR VIEWS. HOWEVER, THE WEIGHT OF MARKET DEVELOPMENTS MAY INCH THE NEEDLE FORWARD ON DIGITAL ASSETS REGULATION.

It is unlikely that there will be a radical shift in policy or regulatory approach to digital assets regulation this year. There will be little incentive for lawmakers to abandon their skeptical and restrictive approaches to digital assets unless they have reasons to do so. Historically, election-year political dynamics have cut against major shifts in policy. We are, however, optimistic about three related factors that could align to result in meaningful movement.

- *Traditional Finance Has Joined the Chat.* While regulators will remain skeptical, the increasing involvement of traditional, highly-regulated financial institutions may provide some comfort to regulators that digital assets innovation can be accomplished responsibly. These traditional financial institutions have deep experience navigating the regulatory environment and we will continue to see them bring the weight of their experience to push digital assets products forward. As the market volume of blockchain-based products and services increases, there may also be increasing pressure on regulators to fine-tune their approaches to digital assets. For example, the combination of numerous bitcoin spot Exchange-Traded Fund (ETF) applications by some of the world's largest asset managers and the loss in court by the Securities and Exchange Commission (SEC) regarding its handling of those ETF applications increased the likelihood that these ETFs would be allowed in the U.S. market in 2024. (Post-script: On January 11, 2024, the SEC approved 11 ETF and exchange-traded product applications for the U.S. market and these products have seen significant asset inflows in their first weeks).

- *Take the Easy "W" If You Can Get It.* In addition, legislators may decide that regulation on discrete "low hanging fruit," such as stablecoins, may be an easier accomplishment than a comprehensive set of laws on all things digital assets. They may be more likely to do so if additional stablecoin products are brought to market by existing, well-established (and well-regulated) companies.

- *Regulatory Authority Is Broad, But Not Limitless.* While the SEC has exercised broad jurisdiction over digital assets, the Government Accountability Office recently said that the SEC had overstepped its authority by issuing Staff Accounting Bulletin (SAB) 121[1] without Congressional review. SAB 121 has had the effect of preventing most financial institutions from custodying digital assets for customers and limiting the types of digital asset products they offer to customers. The practical effect of this action is unclear, and SAB 121 may ultimately be validated. But actions like this and the ETF court case, among others, demonstrates that for now, there appear to be limits on regulators' authority in this space. As a result, there could be new examples of these limits this year.

3. SPEAKING OF PLACES OTHER THAN THE UNITED STATES: REGULATORY UPDATES OUTSIDE THE U.S. WILL ENCOURAGE SOME BLOCKCHAIN DEVELOPERS TO ESCHEW THE UNITED STATES MARKET (FOR NOW).

Outside the United States, there has been significant movement toward updating regulatory frameworks for blockchain and digital assets considerations. Different countries have taken different approaches – for example, Switzerland, the European Union, Singapore and United Arab Emirates – and it remains to be seen which will be successful in the long run. But for now, these countries have established more blockchain-friendly legal regimes and that will attract resources – capital and human – away from markets where digital assets development is more challenging or costly.

Some of that development outside the United States has already started; this development includes traditional financial players issuing blockchain-native instruments in France and start-up ecosystems developing in Singapore. To be clear, blockchain projects and digital asset innovation in the United States is not going to grind to a halt in 2024. Institutional interest, confidence in US regulatory regimes and the sheer size of the U.S. market, among other reasons, will continue to make the United States a relevant market for digital assets in the near term. But that relevance will not be uniform across all types of blockchain projects.

4. SEPARATE FROM U.S. FINANCIAL REGULATIONS, LEGAL UNCERTAINTIES IN BLOCKCHAIN APPLICATIONS WILL START TO BE RESOLVED WITH AN INCREASED FOCUS ON UNIFORM RULES AND STANDARDS.

As blockchain technology changes the way we transfer value and record interactions, it has raised (and will continue to raise) a host of new legal questions. Lawyers, legislators and judges will need to figure out what these innovations mean for rights, liabilities, and obligations in contracts, disputes and other contexts.

In general, legal uncertainty has a chilling effect on markets and commerce. In some cases, rights and obligations in blockchain transactions have been sorted out by courts after the fact, but these decisions are often fact specific and are not broadly applicable to the market. As a result, we will continue to see movement toward the creation of frameworks and standards designed to clarify these uncertainties and pave the way for trust in the technology and confidence in the products and services built upon it. In the next twelve months, we expect to see significant movement in three key areas:

- *Development of Uniform Laws*. One of the most prominent U.S. examples of this is the proposed UCC Article 12, which provides a framework for using blockchain records for secured finance transactions. Article 12 addresses market concerns in secured finance that existing commercial law rules may be insufficient to support widespread electronically recorded instruments and records. Broad adoption by U.S. states of these laws – which is already underway – would remove a significant hurdle to broader usage of blockchain technology in sophisticated (and massive) financial markets.

- *Industry Group Coordination and Development of Proposals*. Industry groups, such as the Global Blockchain Business Council, will also continue to develop legal and market standards to address some of this uncertainty as well. With the support of legal and industry leaders, these standards will continue to gain traction and fill voids in the blockchain legal landscape.

- *Technology-Enabled and Regulatorily Compliant Contractual Rights*. Lastly, developers and technologists are developing new technical standards that address practical and legal considerations in the use of smart contracts. Building on the success of the Ethereum Request for Comment 20 (ERC20) standard, newer and more complex standards will expand on previous frameworks and – most importantly – address some of the legal uncertainties inherent in earlier technologies.

Combined, we expect these three avenues of development to resolve some significant areas of legal uncertainty in the use of blockchain applications.

5. THERE WILL CONTINUE TO BE NEGATIVE HEADLINES ABOUT BLOCKCHAIN AND DIGITAL ASSETS, BUT THESE WILL BE FEWER AND GENERALLY LESS EGREGIOUS THAN IN THE PAST SEVERAL YEARS. THE BALANCE OF BLOCKCHAIN HEADLINES WILL BE POSITIVE.

Especially in the United States, legislators, regulators and law-enforcement have made no secret of their skepticism of all things digital assets. In some cases, that skepticism is justified. When wrongdoing involving digital assets is discovered, it will be investigated and prosecuted – just as it is in all other areas of financial markets. And we will continue to see digital assets skeptics blame the technology for human crimes and mistakes.

It is a hallmark of a maturing market and ecosystem that bad actors are flushed out and held accountable, which allows good actors to flourish and build legitimacy for their products. We expect that maturation to continue this year, so we will close this article on an optimistic note: We believe that by the end this year, there will be far more positive news in the ways blockchain applications and digital assets can improve financial markets and transactions than there will be news of crypto fraud.

Note

1. https://www.sec.gov/oca/staff-accounting-bulletin-121.