What the Reed–Smith Procedural Ruling Settled About Section 404

The Survival of "Solely" and the Joint Rulemaking Ahead

By Yunjie Fan

Ahead of the May 14 Senate Banking Committee markup, Senators Jack Reed (D-R.I.) and Tina Smith (D-Minn.) had filed a joint amendment that would have replaced Section 404's operative comparator phrase. The negotiated text reads "economically or functionally equivalent to the payment of interest or yield"; Reed–Smith would have substituted "substantially similar to the manner in which banking organizations pay interest or yield." Chairman Tim Scott ruled the amendment out of order on procedural grounds, along with more than a dozen others. The Tillis–Alsobrooks text emerged from markup untouched. The bill cleared committee 15–9; Senator Angela Alsobrooks crossed over but described her vote as "a vote to keep working in good faith," reserving her position on the floor.

The procedural sequence is well-reported. What it did to §404's doctrinal structure is the part this piece addresses. Reed–Smith's failure preserved the negotiated comparator phrase, and with it the work that "solely" does in §404's trigger clause. The joint rulemaking now starts from a fixed comparator and a working "solely."

What got locked in

Section 404 has two operative clauses. The first is a trigger: a covered party may not pay yield "solely in connection with the holding" of a payment stablecoin. The second is a comparator: the prohibition reaches payments "economically or functionally equivalent" to deposit interest. Reed–Smith targeted only the comparator clause, proposing the substitute "substantially similar to the manner in which banking organizations pay interest or yield."

The May 8 banking trades letter pressed broader changes, including removing the "solely" qualifier from (1)(A), stripping the "on a payment stablecoin balance" and "on an interest-bearing bank deposit" limiters from (1)(B), substituting a "substantially similar" test, and removing the duration/balance/tenure clarification in subsection (3)(B). Reed–Smith took only the comparator substitution itself, leaving the trigger clause and the carve-out untouched. Both routes — Reed–Smith's narrower amendment and the trades' broader package — would have moved §404 in the same direction; only Reed–Smith found an amendment vehicle, and it did not advance past the chair's procedural ruling. Even had Reed–Smith passed, the trades' May 8 letter signals that further changes to subsection (3)(B) would have followed.

Two facts from the markup itself make the procedural ruling more than procedural. Scott declined to reinstate Reed–Smith when he reinstated other procedurally defective amendments. The reinstatements he chose, including Lummis 122 on DeFi safe harbors (adopted 18–6), produced the bipartisan votes he needed; Reed–Smith plausibly would not have, since it was filed to force a banks-versus-crypto choice that no Republican on the committee was positioned to take. When Senator Catherine Cortez Masto tried to bring Reed–Smith back during the markup itself, the chair's ruling was not overridden.

Sitting behind the procedural sequence is the Tillis–Alsobrooks "respectfully agree to disagree" joint statement, issued in early May in response to the banking trades' first joint rejection of the compromise. The statement articulated a negotiating position. The committee's 15–9 vote on the unchanged §404 text endorsed it. That sequence is now part of the legislative history the agencies will consult when drafting the joint rule.

Why this matters for "solely"

The clause that survived is anchored on the word "solely." Section 404's prohibition reaches a covered party on either of two grounds: paying interest or yield "solely in connection with the holding" of a payment stablecoin, or paying it in a manner "economically or functionally equivalent" to deposit interest. The "solely" qualifier carries the first ground; the comparator carries the second. The two prongs operate disjunctively.

Reed–Smith would have replaced "economically or functionally equivalent" with "substantially similar to the manner in which banking organizations pay interest or yield." The substitution looks marginal but operates on a different dimension. "Economically or functionally equivalent" is an inquiry into the economic substance of the payment: the role it plays, the function it serves. "Substantially similar to the manner" is an inquiry into the payment's form: does it look like bank interest in how it is calculated, accrued, or paid.

The shift matters because a form-based comparator operates independently of the trigger. A payment that looks like bank interest in form would satisfy it regardless of what produced it. Under the trades' aspiration for "manner" to do broad work, "solely" would have no independent operational ground: the comparator would already reach every holding-triggered payment that mattered, plus more. The trigger clause would survive textually but lose its functional work.

A trades-side reading frames "substantially similar to the manner" as a substance-driven test reaching arrangements that resemble deposit interest in effect. But on its plain meaning, "manner" asks how a payment is structured, not what triggered it. Whatever the trades' aspiration for the phrase, the textual hinge it would have offered the agencies is a form question.

The markup record now contains an attempt to make the form-based reading the operative test and a rejection of that attempt. An agency drafting under the Tillis–Alsobrooks language, once enacted, will need to take that record into account.

The companion analysis on file develops the broader doctrinal point in full:[1] the negotiated language, read structurally, fits within the *Reves* family-resemblance framework as applied to the deposit/security line. The structural reading depends on "solely" doing its triggering work. The May 14 record now provides legislative-history support for that reading. The clause the structural argument depends on was the target of an amendment that did not advance to a vote.

The trigger clause and the activity-based carve-out work in tandem. "Solely" on the trigger side defines what falls into the prohibition; "bona fide" on the carve-out side defines what falls out of it. Reed–Smith would have replaced the trigger-side hinge with a form-similarity test. That replacement would have left the activity-based carve-out with nothing to do, because activity-versus-holding would no longer be the question. The negotiated language preserves the two-sided structure. The rulemaking operates on both sides at once.

For routing transactions into 1940 Act–registered tokenized money market funds, the implication is direct: routing falls outside the prohibition because the operative step is the user's signed authorization, not the holding it follows. The "solely" qualifier excludes it.

What this means for the joint rulemaking

Section 404 directs the SEC, CFTC, and Treasury to issue joint rules within twelve months of enactment defining a non-exhaustive list of permitted activities. The clock starts at enactment, not at markup. The rulemaking record, however, begins to take shape now, with the committee record and the Committee Report that will accompany the bill.

Two operational questions are at the front of the queue. First, what counts as user-initiated activity sufficient to take an arrangement out of the holding-only category that "solely" reaches. Second, what counts as the kind of *bona fide* activity the carve-out preserves rather than the kind of disguised yield the prohibition targets. The committee text leaves these open; the joint rulemaking will close them.

A framework I submitted to the SEC's Crypto Task Force on May 7, 2026, proposes a NAV pass-through threshold drawn from the *Reves* family-resemblance test, supplemented by on-chain auditable metrics on the activity question.[2] The framework's premise is that the user, not the operator, bears principal risk in a routing transaction into a registered fund. That is the same premise the surviving "solely" qualifier protects.

The reading proposed here does not pull routing out of regulation; it places routing under the framework already designed for it. The 1940 Act and the broker-dealer regime supply the consumer-protection structure: prospectus disclosures under Rule 2a-7, NAV-based pricing and gating mechanics, SIPC custody, 1099-DIV tax characterization. The Consumer Federation of America has called §404 "a ban not found," noting that the activity-based carve-out preserves space for crypto-platform rewards on continuing stablecoin balances. That critique is well-aimed at balance-and-tenure rewards on continuing stablecoin holdings; it is not well-aimed at routing into registered funds, where the legal character of the user's holding changes at the moment of routing.

Floor risk

The bill is not yet law: it needs consolidation with the Senate Agriculture Committee text, sixty votes on the floor, and reconciliation with the House-passed H.R. 3633 from July 2025. Senator Alsobrooks's reservation matters. So does Senator Ruben Gallego's observation that his committee vote "does not guarantee a vote on the floor." Senator Kirsten Gillibrand, speaking at Consensus Miami on May 6, said a final vote could come in the first week of August, "if we're lucky"; the Senate's Memorial Day state work period runs May 25–29.

The contested item on the floor will not be Section 404. It will be the ethics provision: Democrats are pushing language addressing the Trump family's crypto business interests, while the Republican-side reciprocal posture, per White House adviser Patrick Witt, is to accept rules that apply "across the board" but resist provisions targeting the President. That is the floor's principal sticking point.

If §404 is reopened on the floor as part of a broader package, the structural reading does not require the section's wholesale stability. What it requires is that "solely" remain in the operative text. Stripping §404 entirely would be a separate political question, and no current coalition is pursuing it. The banking trades want a tighter §404, not its removal. The crypto industry wants the activity-based carve-out preserved, not the section stripped. Both directions of advocacy keep "solely" in place.

Where this leaves the rulemaking

The Committee Report accompanying the bill out of committee is now the principal upstream input into the joint rulemaking. Under any plausible enactment scenario, final joint rules are unlikely before mid-2027. The notice of proposed rulemaking will come earlier; by then, the legislative-history record built at markup will have done its work, defining the operative comparator and the boundary it draws. The clause the structural reading rests on remains in the text the rulemaking will operationalize.

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[1] Yunjie Fan, *When Wallets Become Brokers: Section 404, the Reves Boundary, and the Routing Problem in the CLARITY Act Compromise* (May 2026) (draft on file with author, available upon request). The two prongs are disjunctive bases for the prohibition; their structural relationship is developed in the companion analysis.

[2] Yunjie Fan, *Narrowing the Section 404 Prohibition: A Quantitative Framework for Distinguishing User-Initiated*

Routing from Disguised Yield (May 6, 2026), SSRN; submitted to the SEC's Crypto Task Force on May 7, 2026, ctf-written-input-fan-050726.pdf.

Yunjie Fan is an independent researcher working on digital-asset regulation and the boundary between securities and deposit instruments. Her written input to the SEC's Crypto Task Force on Section 404 was posted by the Commission on May 7, 2026.