

February 22, 2025

Commissioner Hester M. Peirce
Crypto Task Force
U.S. Securities and Exchange Commission
100 F St. NE,
Washington, DC 20549

RE: A Workable “Efforts of Others” Framework for Digital Assets Sold Pursuant to Investment Contracts

Dear Commissioner Peirce,

On February 21, 2025, you requested “input from anyone in the public with an interest in [crypto] ... that will make [crypto clarity] richer.” Among the 48 listed questions soliciting answers from the public, the very first question was:

What type of regulatory taxonomy would provide a predictable, legally precise, and economically rational approach to determining the security status of crypto assets and transactions in such assets without undermining settled approaches for evaluating the security status of non-crypto assets and transactions?

Under the existing regulatory taxonomy, a financial instrument, such as a digital asset, may share characteristics with any of the classes of securities found under § 2(a)(1) of the Securities Act of 1933 (“Securities Act”). One class is an “investment contract” interpreted by the Supreme Court in *SEC v. W.J. Howey, Co.*, 328 U.S. 293, 298-99 (1946) (“*Howey*”) to mean a “contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” An investment contract is intended to “embod[y] a flexible ... principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.” *Id.* at 299.

The Securities and Exchange Commission (SEC) has applied *Howey* to enjoin issuers of unregistered securities, including digital assets, under § 5 of the Securities Act. Despite the SEC committing to “disentangle” ongoing litigation, most of which involve the application of *Howey* in the absence of fraud, the SEC will still need to grapple with the breadth of *Howey* to combat *securities* fraud as part of the new Cyber and Emerging Technologies Unit.

Although applying *Howey* to some digital assets may yield a straightforward analysis of whether the digital asset was sold pursuant to an investment contract, others may involve a complicated and uncertain analysis. Because digital assets may be sold in non-conventional manners, on autonomous software platforms, and without an identifiable issuer-shareholder relationship, an investment contract may not be present.

Drawing an arbitrary line to determine the existence of an amorphous investment contract is difficult, but the SEC must use its interpretive authority to protect investors, facilitate capital formation, and maintain fair, orderly, and efficient markets in digital asset transactions.

A blockchain-based financial instrument can be distributed in various ways, such as part of the development and maintenance of a blockchain, part of the development and maintenance of an autonomous software program encoded on a blockchain (“protocol”), or independent of an intrinsic blockchain function. The SEC should draw an arbitrary line to determine whether digital assets are sold pursuant to an investment contract based on a flexible three-step test: (1) **control of a blockchain**, (2) **control of a protocol**, and (3) **ownership rights in an enterprise or object**.

This test is intended to delineate the “efforts of others” prong of *Howey*, and offer a workable framework for blockchain projects to decentralize management such that prospective investors are no longer dependent on a *centralized managerial group* to deliver profits, thus the digital asset will not be considered sold pursuant to an investment contract.¹ It is squarely in line with a *decentralization* philosophy that separates blockchain projects from traditional products.

(1) Control of a Blockchain.

First, the degree of control of a blockchain that a financial instrument operates on should not be greater than 10% of either (1) the computing power or (2) all staked digital assets.² In theory, so long as a person or group is able to amass over 50% control of a blockchain, it would have the ability to prevent, reverse, or alter future transactions. This level of control would effectively cripple or shut down a blockchain and is unsuitable for a secure financial system.

A 10% control rule would both act as a cybersecurity safeguard and decentralize control enough to not be dependent on the “efforts of others.” This first step of analysis would only end if the blockchain-based financial instrument is the native digital asset to the blockchain (e.g., Bitcoin is the native digital asset of the Bitcoin blockchain). All other blockchain-based financial instruments must continue to the second step.

(2) Control of a Protocol.

Second, if a blockchain-based financial instrument is designed for a protocol, no more than 20% control of voting rights or unilateral control of the protocol’s source code should be granted. Although a development team may exercise full managerial control over the protocol, once a blockchain-based financial instrument is available, these criteria should be satisfied to not be dependent on the “efforts of others.” Similar to a blockchain, a protocol may designate its own rules that must be satisfied to materially alter the protocol.

¹ The other prongs of *Howey* may be presumed satisfied, and although relevant, are not subject to discussion at this time. As long as a financial instrument is not dependent on the essential efforts of a promoter or third party, it cannot be sold pursuant to an investment contract.

² Control depends on the type of consensus mechanism that the blockchain uses. Proof of work (e.g., Bitcoin) and proof of stake (e.g., Ethereum) are the two most common forms. In proof of work, specialized computers attempt to solve complex mathematical puzzles through “mining” blocks of transactions. In proof of stake, the blockchain selects validators (i.e., users) in proportion to the quantity of the native blockchain digital asset held by the validator (“staking”). If a validator acts maliciously while authenticating transactions, their digital assets will be destroyed. Once a transaction is authenticated, it is added to the distributed ledger. In these consensus models, the blockchain-native digital assets are earned from the blockchain itself, users paying a fee, or both.

20% control of voting rights would better financially incentivize the development of the protocol than a 10% rule. Likewise, the absence of an administrative key that could unilaterally alter the protocol's source code would be a necessary component. However, if the blockchain-based financial instrument is not based on a protocol, but operates on a blockchain meeting the requisite control, a separate set of considerations is necessary under the third step.

(3) Ownership Rights in an Enterprise or Object.

Third, a blockchain-based financial instrument independent of an intrinsic blockchain function (e.g., "memecoins," collectibles, and digital art) should not grant a right of ownership in an *enterprise*. For example, if an artist issued a digital asset that contained the rights to 5% of the artist's sales over the next year, this may satisfy the "efforts of others" prong because purchasers are relying on the managerial efforts of the artist to receive compensation.

However, countervailing property rights, such as ownership in an *object*, may weigh in the other direction. If the artist instead issued a non-fungible token ("NFT") that represented their artwork digitally and transferred the intellectual property rights to the purchaser, the NFT may have enough artistic value to be independent of the artist's promotional efforts. Alienability of the blockchain-based financial instrument, as well as the issuer's independence from any involvement in a secondary market for the instrument would weigh against satisfying the "efforts of others" prong.

This three-step test is intended to provide a workable "efforts of others" framework under *Howey*. It should be flexible enough to spot the countless variations of financial instruments that are offered and sold on a blockchain pursuant to an investment contract, and lenient enough to provide a reasonable guidepost for the development and maintenance of decentralized financial products that are not subject to the federal securities laws.

There may be flaws and unidentified problems in this approach, including the question of how to treat digital assets that have been minted as a "wrapped" token on a blockchain that does not meet the sufficient degree of control in the first step of analysis. Still, this three-step test can go a long way to provide guidance for blockchain projects within the current framework of the law, thus fulfilling the SEC's mission to promote capital formation while protecting investors.

Please feel free reach out to me for further questions on this subject or any other related to the Crypto Task Force. I hope to make additional contributions to the future regulatory framework for digital assets.

My statements are that of my own, and do not represent the views of anyone else. They may not be construed as legal advice as part of an attorney-client relationship.

Sincerely,
Jason Berkun
3L J.D. Candidate at the George Washington University Law School