

## What We Talk About When We Talk About (Tokens)<sup>1</sup>

By Lewis Rinaudo Cohen

The recent statement by Commissioner Hester Peirce of the Securities and Exchange Commission (the “Commission”) requesting information about the crypto asset market, published under the poignant title “*There Must Be Some Way Out of Here,*” (the “Statement”) signals a critical juncture in the ongoing dialogue surrounding the application of federal securities laws to crypto assets (*née* “tokens”) and ably summarizes the sentiment of many in the crypto asset market space.

I believe that many are drawn to the crypto asset space because it is the apotheosis of free and open global markets, with all the benefits and challenges that this brings. Public, permissionless blockchain networks are one of humankind’s most remarkable technological creations—a collective effort that allows information and value to freely flow directly between individuals and businesses without the aid of horse travel, sailing ships, telegraph networks, or financial institutions.

However, as the sector has grown since the first transfer of bitcoin occurred in 2009, the absence of a clear regulatory perimeter for crypto asset activity in the U.S. resulted in an increasingly uneasy relationship among users of crypto assets, policymakers, and prudential and markets regulators. Perhaps this was to be expected to some extent; but a particularly heavy-handed approach by some U.S. regulators over the last three years has resulted in a sub-optimal market structure in the crypto asset sector and has left market participants searching for constructive guidance that will allow them to focus on building useful products. In particular, the absence of a viable and compliant framework to fundraise for the development of new blockchain systems (as defined below) in the public markets has resulted in distortions in the means of price discovery for crypto assets. The time has come for policy makers, regulators, and market participants to work together to change this.

I contribute these thoughts in my personal and individual capacity (and not on behalf of my firm or any clients that we may represent) primarily in response to Question 1 of the Statement:

*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?*

I strongly support the position that, without a clear sense of where the securities law regulatory perimeter lies when it comes to crypto asset activity, it is impossible to postulate potential solutions to the current market structure challenges. I have already written extensively on the application of securities law to crypto asset activity and recently provided written testimony on this topic to the Senate Banking Committee’s Digital Asset Subcommittee, which updated earlier writings. Here, I seek to consolidate those thoughts into an actionable and practical approach that balances multiple interests and, hopefully, will allow the crypto asset sector to refocus on

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<sup>1</sup> With apologies to Raymond Carver.

building, while ensuring that market regulators are able to efficiently perform their critical role of policing marketplaces and market participants that stray from socially acceptable practices.

## **Finding the Regulatory Perimeter**

Although blockchain technology can be remarkably complex, I believe that there is no need to over-complicate the answer to the critical first question in the Statement. Detailed taxonomies of various types of crypto assets, while helpful for scholars, analysts, and users, are independent of the two binary questions we must consider here:

- Is a given crypto asset a security (or not)?
- Is a transaction involving a given crypto asset a securities transaction (or not)?

Accordingly, crypto assets that are intended to be, or to represent, securities (*i.e.*, equity interests in, or debt obligations of, a company) need not be discussed here. These assets are indisputably within the regulatory perimeter and, although they may well raise some very interesting issues of their own, that discussion can be left to another time. Likewise, it is important to bear in mind that our federal securities laws focus on the *activities* of market participants, rather than the ever-developing *technologies* used to effect these activities. There should be a strong preference from a policy point of view for remaining technology neutral when answering these questions.

### *Four Foundational Principles*

Accordingly, I would suggest that the securities law regulatory perimeter can be developed from four basic principles:

1. Crypto assets that do not create a **legal relationship** between the owner of the asset and a person or entity inextricably linked to that asset that would properly be considered the issuer of the asset as the term “issuer” is used in the Securities Act and the Exchange Act (an “issuer”) are not themselves securities. Further, absent an independent investment contract scheme under *Howey* (addressed in point 2 below), sales of these crypto assets by persons other than an entity that conducted a fundraising sale of the crypto asset or that entity’s funders, shareholders, management or directors (collectively, “insiders”) are not securities transactions and should not be treated as if they were securities transactions.
2. **Transactions** in which crypto assets are sold to buyers intending to **provide pooled funding for the asset seller** (or an affiliate) to develop, improve, or promote a blockchain system (rather than those intending primarily to acquire the assets for consumptive use) are securities transactions that must be registered with the Commission or exempt from registration (even where the crypto assets are not themselves securities).
3. Through interpretive and exemptive relief, **viable pathways** should be created by the Commission to allow fundraising transactions involving the sale of crypto assets, as well as sales by that seller’s insiders, to be registered and offered to the general public without the related crypto asset itself being considered a security solely because of the registration of offers and sales thereof.
4. Subsequent sales of crypto assets, a portion of which were previously sold in a *Howey* fundraising sale or otherwise publicly distributed, can raise unique policy issues due to

the potential for information asymmetries when the seller is the fundraising company or insiders of that company. In the absence of new legislation mandating disclosures, the Commission should consider adopting **safe harbor guidance** that, subject to certain conditions being met (as discussed further below), subsequent sales of crypto assets by a project team or its insiders would not be considered securities transactions.

### *Additional Considerations*

So where does the concept of “decentralization” stand in this framework? There can be no doubt that, from the perspective of a *user* of an open and permissionless blockchain-based network (a “network”), a network scaling solution (a “scaling solution”), or a decentralized application built on a network or scaling solution (a “dApp” and, collectively with a network and a scaling solution, a “blockchain system”), the extent to which mechanisms of control over that system, including operational, economic, and voting control, are maintained by identifiable third parties, whether as members of an initial development team or subsequent participants, will be a critical factor to consider when engaging with that system.

At the same time, almost all crypto assets serve a dual role. First, for users of a blockchain system, crypto assets frequently serve as a functional element of the system that empower the user to engage with that system in one or more ways (*i.e.*, as a means of payment, as a reward for validators for processing a proposed transaction, as a reward for securing the system, or for decision-making about aspects of the system, etc.). However, for investors, these same assets can function as “network equity” – a unique relationship unlike equity in a company, in which ownership of a portion of a deterministically finite supply of the asset allows owners to participate economically in the potential growth in demand for use of the related blockchain system.

The extent of the “decentralization” of a blockchain system is of great importance to *users* of the blockchain system but may often be of less relevance to (or even at odds with) the interests of *investors* in that system (including investors in the rapidly growing number of proposed exchange traded products (“ETPs”) comprised of that asset). What matters *from a securities law point of view* is that project teams and others that sell crypto assets in fundraising transactions – *i.e.*, those transactions in which the funds being raised are intended to be used expressly to develop, improve, or promote the blockchain system associated with the assets being sold – provide accurate, complete and non-misleading disclosures about the extent of current (and expected future) decentralization of the related blockchain system. This allows purchasers to make informed decisions about their engagement with the blockchain system and the related crypto assets.

Moreover, legislation similar to the Lummis-Gillibrand Responsible Financial Innovation Act (the “RFIA” – discussed below), if adopted, would provide for an ongoing disclosure regime applicable to project teams that conducted fundraising transactions involving crypto assets (as discussed further below). I believe that such a framework would benefit both users and investors in crypto assets and be fair in its allocation of responsibility for producing this disclosure.

Unlike users, investors in a crypto asset may be more interested in the potential for price appreciation of a crypto asset that often comes with an increase in the demand for the related blockchain system (or sometimes just a belief that this demand may increase), regardless of whether that demand results from, or simply comes with, trust dependencies on third parties. Of course, as with other investable assets, anticipated price appreciation may also be driven by other factors, such as overall market sentiment or the use of the asset either as a store of value or as a “risk-on” investment. As discussed below, this is the case even when the crypto asset itself is properly understood to be a commodity (or the functional equivalent), rather than a security.

However, without decentralization (or at least a *reasonable prospect* of future decentralization), a blockchain system rapidly devolves into nothing more than a centralized ledger that may serve as a useful technological tool, but lacks the key promise and potential that the concept of “blockchain” envisages. However, as discussed below, without the creation of a legal relationship to a third party, such a technological tool is still not itself a “security”.

So should the Commission be charged with endorsing a regulatory perimeter that is designed to create economic incentives for those involved with a blockchain system to reach “decentralization” (however defined)? My concern is that the market will always make these choices more efficiently than a government actor. There are certainly valid reasons to raise concern about the current state of decentralization in many blockchain systems. However, the failure to create a practical framework for parties to engage with the Commission when fundraising – a process that helps to ensure that accurate, complete and non-misleading disclosures, including about the extent of decentralization of the related blockchain system, combined with a fear of unpredictable government litigation wound up only encouraging “decentralization theater” to flourish.

With full disclosures about the extent of, and ostensible roadmap towards, decentralization provided, users and investors alike can make informed economic decisions about the blockchain systems and crypto assets to which they allocate capital. These parties will be more closely involved with the nuances of blockchain systems, when compared with the application of a static, governmentally-mandated standard, and best able to adapt quickly to technological changes that allow systems to become “decentralized” in different ways. Thus, this framework should further promote effective decentralization of blockchain systems by incentivizing project teams to apply a flexible approach driven by market feedback on which elements of decentralization are most important to users of the relevant system.

Finally, in discussing the regulatory perimeter for transactions involving crypto assets under federal securities law, it must be noted that spot markets for non-security crypto assets currently fall outside the oversight of both the Commission and the Commodity Futures Trading Commission. Is this a reason to attempt to expand the Commission’s regulatory perimeter? It is indeed a concern to many that no federal framework currently exists for oversight of, and surveillance of activity taking place on, markets in crypto assets in the U.S. Nevertheless, the allocation of oversight over spot markets in crypto assets in without question the responsibility of Congress and I use this note to call on our legislators to continue their good work to adopt a statutory solution that provides for such oversight.

## Expanding the Discussion

The four principles above provide a *predictable, legally precise, and economically rational* lens through which we can analyze crypto assets in the context of existing federal securities laws. Below, I build upon these principles to offer a more thorough explanation of why these ideas are so critical and how they might be implemented in a manner that balances legitimate market innovation with necessary investor protections.

### *Clarifying When a Crypto Asset Is (and Is Not) a Security*

Since the earliest days of crypto assets, one of the most common questions asked has been: “Is this *thing* a security?” Although the *Howey* test is famously broad and intended to capture many types of investment arrangements, it does not overrule the Securities Act itself which, as drafted by Congress, expects each and every security (including an investment contract) to have an identifiable issuer—that is, an entity for which, if the “issuing” entity were to be dissolved, the security would no longer exist. Said differently, the *Howey* test does not turn a simple commodity, a unit of intangible property, or an investment scheme, into a security absent that asset or scheme creating or involving an accompanying *legal relationship* between an identifiable issuer and an investor. The fact that the market value of an investable asset may depend on the managerial efforts of a third party does not alone make that asset a security; otherwise, diamonds (the market value of which is highly dependent on the De Beers Group) and a variety of other investable assets would be securities.

Likewise, some blockchain systems use smart contract or protocol-level code to allocate value that is internal to that system (such as fees paid by users of a dApp or “rewards” allocated by the protocol code of a network or a scaling solution) to owners of a related crypto asset. Such a feature would not cause the crypto asset to be securities where no legal relationship is formed between owners of the asset and an issuer. This said, as is the case with other non-security crypto assets, fundraising transactions to develop, improve, or promote a blockchain system with these features likely would be a securities transaction and would need to be registered with the Commission or exempt from such registration.

But what of concerns that the need for there being a legal relationship between an issuer and an owner for a given crypto asset itself to be a security could eviscerate the protections of the Securities Act for traditional securities? For example, could a large retail company avoid the need to register a capital raise by selling crypto assets to the public in the U.S. and then, without any *legal relationship* having been created between the retailer and the owners of the crypto asset, periodically (and without any obligation to do so), distribute some portion of the retailer’s revenue to the holders of the crypto asset? First and foremost, as noted above, the fundraising sales of such a crypto asset would be investment contract transactions (and thus offers of securities), requiring registration with the Commission. In addition, even assuming it was possible for a company to construct such a scheme without in some way making any enforceable promises to crypto asset purchasers, without a legal obligation to share its revenue with owners of the crypto asset, the Board of the company would be violating its fiduciary duties to its shareholders by dissipating the company’s assets. Beyond that, the irregularity of such a scenario would raise boundless tax, accounting, and other regulatory and practical questions that

would further ensure that this “loophole” does not become a “get out of jail” card for issuers seeking to avoid appropriate securities law obligations.

Ultimately, while it may be possible with extended effort to imagine a potentially problematic edge case, our judicial system is adept at identifying and punishing those that attempt to circumvent our securities laws in bad faith.

### *Fundraising as Securities Transactions*

Over nearly 80 years, the *Howey* test and the related jurisprudence has served relatively well to assist the Commission and private plaintiffs in redressing fundraising schemes disguised as commercial transactions. (*Howey* case law can also be effective when looking at unusual legal instruments that do not fall neatly in any of the enumerated categories of “security” in the Securities Act or the Exchange Act.) An examination of the full complement of appellate cases applying the *Howey* test (compiled in the appendices to *Ineluctable Modality*) reveal very few that would offend the common sense conclusion of whether (or not) a disguised investment scheme was present.

When applied to fundraising sales of crypto assets, the conclusion in most cases is appropriately that the early funders are primarily interested in profit appreciation in the purchased crypto asset (*i.e.*, the object of the fundraising scheme) based on the efforts of the seller, rather than in consumptive use of the asset. Accordingly, most of these sales would be appropriately be considered investment contract transactions under *Howey* and therefore within the federal securities law perimeter. Yet because a securities transaction may be present, the crypto assets that are the objects of those transactions are not necessarily themselves securities. Maintaining such a position and requiring crypto assets to trade through traditional securities infrastructure (such as broker-dealers and national securities exchanges) means deprecating the related crypto asset’s primary purpose – as a means of engaging with a blockchain system. To avoid this untenable outcome, project teams developing new blockchain systems have as a practical matter been constrained to accessing capital primarily from the limited number of institutional investors active in this area.

### *Crypto Asset Fundraising and Market Structure Shortcomings*

The early days of “initial coin offerings” (roughly 2015-2019) aptly demonstrate the challenges of a global fundraising market for the development of blockchain systems through the sale of crypto assets that was at best perceived to be unbounded by any regulatory perimeter. With virtually no barriers to entry, teams with ideas for new blockchain systems launched fundraising sales of new crypto assets with abandon (and an increasing disassociation with reality or even common sense). As former Commission Chair Jay Clayton correctly noted, virtually all of these fundraising exercises constituted unregistered securities offerings. Aggressive (and appropriate) federal and state enforcement efforts primarily targeting fraud, combined with a market increasingly saturated with dubious, if not outright fraudulent, offerings largely ended this era.

Much of the concern about current market structure for the sale and trading of crypto assets has its roots in practices that developed in response to this early history. With the “ICO era”

effectively ended by about 2019 and no viable path for engaging directly with the public in the U.S. to perform meaningful price discovery, project teams developing new blockchain systems were left with no alternative but to seek funding from providers of institutional risk capital and a relatively small number of individual “angel” investors. Even when investing in the equity of a development company, these early funders inevitably sought an allocation of existing or future crypto assets in exchange for this funding. To ensure scarcity, these crypto assets were created (or “minted”) in a finite supply (subject in some cases to inflationary mechanisms). Although these institutional and sophisticated investors brought a critical level of professionalism and curation to the launch of new blockchain systems, market distortions were also introduced.

Once a project team was satisfied that sufficient work had been done on the blockchain system to release a crypto asset related to that system, to avoid the crypto asset being considered an “investment contract” when traded in secondary markets, a relatively small portion of the crypto assets related to the blockchain system would generally be distributed without charge to potential users of the system in an “airdrop” transaction (the “launch”). Direct and indirect efforts would be made to achieve one or more listings of the crypto asset on popular marketplaces to ensure general availability of the asset, both for potential users as well as for those who wanted to acquire the asset as an investment. Team members and other insiders that received some of the crypto assets at launch were generally restricted in their ability to resell the assets allocated to them, both to incentivize their ongoing efforts to contribute to the project and to avoid the appearance of undisciplined “saturation” of the trading market for the asset (and the possible adverse impact of this supply increase on the asset’s trading price).

As a result, for many projects, given the relatively small percentage of the crypto assets relating to the blockchain system available to third parties for purchase, even a modest level of initial “buzz” was often sufficient to create significant (if temporary) upward price movement. The unit price for the small number of these assets available frequently was imputed to the value of all minted crypto assets, resulting in a pattern of “low public float – high fully diluted value” assets with volatile prices and often very limited end-user input on the value of the overall blockchain system. This pattern has increasingly caused frustration for users, investors, and project participants alike.

Thus, I believe it is exceptionally important that any regulatory perimeter seek to avoid potential market distortions that arose from the combination of imputing security status to non-security assets and closing the door on legitimate means for fundraising for new blockchain systems through access to public markets in a manner aligned with our bedrock federal securities law precepts.

#### *Interpretive and Exemptive Relief, and a Pathway for Registered Offerings of Crypto Assets*

One of the U.S. market’s greatest frustrations over the last three years has been the perception that a project team developing a blockchain system cannot practically register fundraising transactions involving crypto assets relating to the system when the assets are offered to the public without potentially “tainting” the asset as a security, potentially in perpetuity. In fact, previous positions taken by the Commission strongly suggested that most *non-fundraising* transactions (commonly referred to as “airdrops”), if conducted in the U.S., could still taint the

status of the related crypto asset. These considerations, in turn, lead to the sub-optimal market structure currently experienced. The third principle above outlines a potential fix: create a form of interpretative or exemptive relief that allows project teams developing, improving, or promoting blockchain systems to conduct *registered offerings* or, under a possible new safe harbor (such as a framework based on proposed Rule 195), *exempt offerings*, of crypto assets without resulting in the crypto asset itself (or subsequent transactions in the crypto asset) to be treated as a security (or a securities transaction).

### Potential Approaches

1. **Flexible Registration Framework.** In the late 1980s, the Commission provided a variety of guidance to market participants (in the form of no action letters, “telephone interpretations”, and other interpretive relief) to the asset-backed securities (“ABS”) sector. This guidance allowed special purpose entities that were primarily engaged in holding pools of financial assets and issuing various tranches of securities backed by those assets to register offerings of ABS to use the Commission’s standard registration forms (primarily Form S-1) despite the fact that certain elements of the relevant registration form did not apply and were omitted and certain other information not required by the relevant form was included by issuers. Such a *flexible approach to registration* (including for this purpose, an offering conducted pursuant to Regulation A) that focuses on the needs of investors could be applied to sales of non-security crypto assets that are sold in transactions that meet the four prongs of *Howey* and would properly be considered securities transactions capable of registration.
2. **Time-Limited Safe Harbor.** The SEC might by appropriate rulemaking adopt a safe harbor (akin to “Rule 195” proposed by Commissioner Peirce) under which an project team can conduct a public sale of crypto assets *without registration*, subject to robust disclosures for a defined period (say, three years) (the “defined period”). However, as discussed above, there are significant concerns about causing crypto assets that do not create a legal relationship with an identifiable “issuer” to be treated as if they were securities. This is particularly concerning if the safe harbor includes the potential for a “morphing” of the asset’s status from having transactions in the asset initially falling outside of the securities regulatory perimeter to later fall within that perimeter if a given technological baseline (“decentralization”) applicable to the related blockchain system – not the crypto asset itself – is not met within a certain period of time. As an alternative, if after the defined period, the initial fundraising party and its affiliates continue to provide the essential managerial efforts that impact the value of the relevant crypto asset, then sales of crypto by that fundraising entity (or its affiliates) would need to be registered with the Commission (as would have been the case had the safe harbor not been available).
3. **“Ancillary Assets” Framework.** Ultimately, proposals like the “ancillary assets” concept (as set out in the RFIA) would provide a firm legislative basis for the proposition that crypto assets that do not create a legal relationship with an “issuer” are not securities. Under that framework, sales of those ancillary assets conducted by a project team to raise funds to build or support a blockchain system based on reasonable expectations on the efforts of the seller, would be treated as a securities transactions. Under this framework, the relevant crypto asset itself could nevertheless be freely traded by third parties,

creating an opportunity for the related blockchain system to become less dependent on the original project team by disbursing ownership of the relevant crypto asset.

### Advantages

- **Clarity for Project Teams:** A well-defined path for fundraising means that project teams seeking funding for the creation or development of a blockchain system do not have to fear that the related crypto assets they sell for fundraising purposes would be tainted for an indefinite period by the “original sin” of having been initially sold in an investment contract transaction. Instead, the project team can conduct a compliant fundraising sale (whether through registration or an adopted safe harbor rule) and be confident that the related crypto asset can be used and freely traded, permitting the related blockchain system to become less dependent on the original project team over time and function as “public infrastructure”.
- **Protections for both Users and Investors:** During the period in which the project team and its affiliates provide the essential managerial efforts that impact the value of the relevant crypto asset, appropriately tailored securities law disclosures would ensure that both users of the related blockchain system, as well as investors interested in holding the asset for appreciation (or other non-consumptive purposes), are informed of the functioning of the blockchain system, as well as any development plans, operational and other risks, marketing and promotional initiatives, and conflicts of interest of the project team that may be material to the value of the related asset. In fact, in many blockchain systems, “users” and “investors” many overlap significantly, as when the use of a given crypto asset in a given blockchain system is staking to increase the security of the system.
- **Market Efficiency:** Crypto assets associated with the blockchain system would be free to trade on the broader market, and owners of the asset would not need to factor in the risk that a non-security asset they are using or holding would morph at some point into the regulatory perimeter, causing all transactions in the asset to dramatically lose liquidity and likely decline dramatically in price.

### *When Do Sales of Crypto Assets by Fundraising Entities or Their Insiders Become Non-Securities Transactions?*

The fourth principle tackles the most nuanced question: if a project team has previously conducted a fundraising sale using crypto assets related to a blockchain system they developed, or if the team’s insiders hold large allocations of the crypto assets, when do *subsequent* sales of those assets (“resales”) by these persons cease to be securities transactions? And, if the transactions are not securities transactions, what policy-based safeguards can be put in place to avoid potential abuses by insiders selling out quickly without the market being given the opportunity to digest information about the project not otherwise in the public domain?

For the past three years, it appeared that the Commission’s position was that either the relevant crypto assets, having been “tainted” by initial investment contract sales, were somehow themselves securities or that any resales by fundraising entities and their insiders of these assets remained securities transactions indefinitely (regardless of the nature of those transactions). Based on my prior writings and judicial decisions to date, I do not believe that this is an

appropriate application of the *Howey* jurisprudence and do not recommend that the Crypto Task Force adopt this position.

The answer to this question instead comes from applying the basic principles that already exist in the securities law framework. Fundraising sales of any asset, including a crypto asset, that fall within *Howey* will be securities transactions. However, market participants have struggled to understand when resales of those assets by insiders of a fundraising entity may still be considered securities transactions. This is a particular problem when it comes to resales of crypto assets after an initial fundraising sale (and once the related blockchain system has achieved significant and *bona fide* consumptive use) where those persons holding crypto assets allocated to them in an initial transaction may be reluctant to dispose of the assets out of concern that the sale may cause them to violate the federal securities laws, thus unnecessarily constraining the activity of private parties without a clear and concomitant public benefit.

With respect to these resales of crypto assets by fundraising entities and their insiders, the Commission should consider adopting safe harbor guidance that would recognize that, subject to certain conditions being met, resales of crypto assets by a fundraising entity or its insiders that received an allocation of the crypto asset would not be considered securities transactions. These conditions could include:

- A period of, say, six months, passing since the last investment contract sale of the crypto asset by the fundraising entity;
- The proposed sale itself not being used to fundraise for the project; and
- Mitigating the information asymmetries potentially arising from the sales by insiders.

The last of these points would be addressed clearly if Congress adopted legislation containing some variation on the ancillary assets framework as proposed in the RFIA. Under that proposal, if crypto assets related to a blockchain system were offered in a fundraising sale and then later widely available to the general public in the U.S. through centralized or decentralized crypto asset marketplaces, the fundraising entity would be obliged to provide fulsome disclosures to the market about matters relating the relevant blockchain system and the crypto asset, including matters relevant to sales by insiders. If Congress does not move forward with such legislation (or the legislation is delayed), then the Commission could nevertheless address concerns in this area by conditioning any relief on transparency by the selling insider as to relevant matters relating to the sale, as well as penalties focused on sales by insiders in possession of material non-public information about the fundraising entity or its affiliates or about the system or the asset.

What would adopting such guidance mean for retail market participants that acquire these assets from insiders? Disposals by insiders involved with a blockchain system has been a genuine concern in an environment with very limited disclosures about blockchain systems. However, the objective of the federal securities laws is to ensure full and accurate transparency by those who have conducted fundraising securities transactions. So long as market participants have access to all relevant information about a crypto asset and its related blockchain system, these participants (retail or institutional) can evaluate this information to make informed decisions as to which crypto asset they want to purchase, hold or dispose of, and at what price. Most

importantly, with full disclosures concerning the nature of the blockchain system, the extent to which it may be decentralized, and the role of a project team in sustaining or growing that system, the market can provide feedback as to the extent that *commercial provisions* further limiting sales by insiders (known as “lock-ups”) are required when fundraising occurs.

## **Interplay with the Concept of Decentralization**

### *“Decentralization” for Users vs. Investors*

As noted above, there can be no doubt that the concept of decentralization (however it may be defined) is pivotal to *users* of blockchain systems. For instance, if a blockchain system that allows users to exchange different crypto assets or exchange a less liquid crypto asset for a more liquid asset is governed by holders of a given crypto asset, the holdings of which appear to be widely and globally disbursed, users of that system might have enhanced confidence that no single party would be able to freeze their assets or unilaterally change the cost of using the system. Nevertheless, no matter how “decentralization” may be defined, users will understand that one of the challenges of using blockchain systems is that it will always be difficult to determine the extent to which use of the system contains dependencies on one or a small number of related parties.

Likewise, different users may have very different expectations about the degree of dependency minimization a blockchain system should have – this may vary based on a user’s risk tolerance, time horizon for engaging with the system, and the scale of exposure to the system. Moreover, blockchain systems are dynamic and are subject to change over time. Even where the “admin keys” for a given smart contract have been “burned” (or destroyed), new blockchain code can be integrated into the system which reintegrates trust dependencies.

Moreover, blockchain systems are simply software and, as is well understood, software is never “finished”. The blockchain sector is a highly dynamic sector, with one day’s cutting edge technology frequently becoming yesterday’s news as project teams working in similar areas (such as automated market making dApps, scaling solutions, and liquidity aggregation platforms) compete for users, partners and mindshare. As new platforms, protocols and applications are developed, existing systems must be upgraded both to integrate with new systems and dApps and to remain relevant in the face of new completion. It is common for development teams, motivated through grants of crypto assets in the relevant blockchain system, to publish new “versions” of the system or dApp that extend the relevance or utility of the crypto asset they were allocated. These development companies also frequently feature business development and marketing teams whose mission is to keep “their” blockchain system top of mind for potential users, whose activity (or anticipated future activity) implies upward price trends in the related asset. While all of this activity may not impact the decentralization of a system, it can be a very important factor in determining the price of the relevant crypto asset.

The proposed legal relationship framework acknowledges and allows for this healthy competition among development companies, which benefits users by spurring innovation, while providing for appropriate disclosures to the market about the activity taking place by development companies that have raised money through fundraising sales of the related crypto

asset. To the extent a regulatory perimeter were instead to be based on some version of the “decentralization” of a blockchain system, questions about the reliance and dependence of on these development teams to support and update the blockchain system would take on greater importance. A smart contract, the user base of which dwindles to near zero as the result of abandonment by a development team, is not of much use to anyone. Ultimately, the market can discern the types and extent of trust dependencies a blockchain system has on development teams and price that exposure into the related crypto asset.

Finally, and most importantly, trust dependencies applicable to a blockchain system are *extrinsic* to the related crypto asset. In other words, an examination of the crypto asset on its own would not allow a market participant (or a court evaluating the matter) to accurately ascertain the level of decentralization present in a blockchain system. In fact, activity potentially within the securities law perimeter using this model may take place across a period of time during which the related blockchain system had qualities of both “decentralization” (however defined) and non-decentralization. All of this makes decentralization, while a critical metric for users of a blockchain system, a poor element on which to base a regulatory perimeter for purposes of securities law.

In addition, *investors* who simply want to experience an anticipated appreciation in the market price of a crypto asset (even a crypto asset that is not itself a security) may be much less concerned about how decentralized the system is, so long as usage of the system grows and the related asset’s price rises. The mismatch between user priorities (dependency minimization) and investor priorities (profit generation) further confirms that “decentralization”, while highly relevant for user confidence and the overall success of the crypto asset sector, is not necessarily the best bright-line standard for determining when securities law applies to crypto asset transactions.

### *Maintaining a Technology-Neutral Approach*

Another benefit to focusing the securities law perimeter on the presence of a *legal relationship* between an identifiable issuer and the owner of a crypto asset—rather than on technology-based tests, such as control over a threshold number of nodes participating in a blockchain network, the presence of (and control over) “admin keys” for one or more smart contracts, or other “decentralization metrics”—is that it preserves the technology neutrality of our securities laws. The federal securities laws should ideally focus on *activities*, and not the technologies used to undertake these activities. Especially in a sector that mutates as fast as blockchain does, we should avoid incorporating terms or concepts into our securities laws or formally adopted regulations that could potentially become outdated within a few months of inclusion. We should also take care that our securities laws and regulations do not prefer or disfavor a technology approach even if that approach is based on highly laudable principles; rather, it should ensure that *when capital is raised from the public, the information provided by the fundraising party is clear, complete, and correct.*

## The Dual Role of Crypto Assets

### *Functional Utility and Network Investment*

Crypto assets often serve at least two distinct purposes. On one hand, they provide practical functionality—acting as a blockchain system-based means of remunerating transaction validators through “gas” or other fees, enabling governance votes, or permitting use of certain features of a blockchain system. On the other hand, because public blockchains have global reach, crypto assets can (and often do) become a mechanism for network investment – a way to take an economic position in the prospective success of various technology solutions, leading inevitably to a level of speculative trading of the related assets, given the many uncertainties involved. If market participants believe that one blockchain system will gain greater traction when compared to other similar systems, demand for the related crypto assets should rise, producing financial gains for owners of these assets.

Recognizing this dual role is vital. The presence of speculative or “equity-like” demand does *not by itself* turn crypto assets that do not create a legal relationship with an issuer into securities. Where the securities laws are implicated is where fundraising sales of these assets takes place, and purchasers reasonably expect project teams supporting the system to play a significant role in growing the demand for, and hence the price of, those assets.

### **Practical Steps for Implementation**

Translating these principles into actionable policy will require collaboration among regulators, legislators, and industry participants. Below are some suggestions:

1. **Commission Guidance.** The SEC could issue interpretive guidance making clear that a fungible crypto asset does not become a security merely because it is used in a financing transaction. Rather, the financing arrangement can be registered and disclosed as a public offering without altering the asset’s legal status.
2. **Periodic Disclosure Obligations.** A project team that has completed a fundraising transaction involving crypto assets associated with a blockchain system they are developing might remain subject to certain scaled disclosure obligations so long as the team’s ongoing efforts remain material to the growth and development of the blockchain system (and, hence, the value of the associated crypto asset). This could mirror the concept of “ancillary assets” discussed above, requiring fundraising teams to file abbreviated, semiannual disclosures about their business operations, asset distributions, and other material updates. Once the project team can credibly demonstrate that it is no longer essential to the success of the related blockchain system, these disclosure requirements would terminate.
3. **Safe Harbors or Other Exemptive Proposals.** The SEC could adopt a safe harbor from registration for crypto asset sales that incorporate robust initial disclosures and a time-limited reporting framework. If after a defined period, the initial fundraising party and its affiliates continue to provide the essential managerial efforts that impact the value of the relevant crypto asset, then sales of crypto assets by that fundraising entity (or its affiliates) would need to be registered with the Commission.

4. **Clarity on Secondary Market Roles.** The Commission should clarify that third party intermediaries (*e.g.*, exchanges, broker-dealers, or others) who deal in crypto assets in transactions that are not fundraising sales considered securities transactions under *Howey* are not inappropriately deemed to be engaged in securities activities. This would reduce uncertainty for operators of secondary market platforms and participants, preventing them from requiring full-scale broker-dealer registration simply to handle intangible assets that do not involve a legal relationship with an issuer. The corollary is also true – guidance should be provided as to how securities intermediaries could appropriately be involved in transactions involving crypto assets *are* considered securities transactions.

## Conclusion

The four principles set out above provide a predictable, legally precise, and economically rational approach to determining the security status of crypto assets and transactions in such assets. To reiterate:

1. **Crypto assets** that lack a legal relationship to an issuer are not securities—and transactions involving these assets by persons unaffiliated with a project team that conducts a fundraising (or their insiders) using these assets should be considered non-securities transactions unless a separate arrangement triggers *Howey*.
2. **Fundraising** by project teams through sales of crypto assets associated with a blockchain system they are developing are generally securities transactions under *Howey* and should be registered or exempt from registration under U.S. law.
3. A **registered crypto asset offering pathway**, perhaps combined with an **exemptive safe harbor**, can align capital formation with existing frameworks, ensuring robust disclosures without labeling the related asset itself as a security for some indefinite period of time.
4. **Sales by insiders** that are not part of fundraising scheme fall outside of the *Howey* framework and would generally not be considered securities transactions; however, because this standard can be difficult to apply, the Commission should consider adopting safe harbor guidance that would recognize that, subject to certain conditions (including a period of, say, six months, passing since the last investment contract sale of the crypto asset, the sale not being used to fundraise for the project and protections against information asymmetries when insiders resell), subsequent sales by the project team or its insiders that received an allocation of the crypto asset would not be considered securities transactions.

Implementing the principles set out above would do more than resolve confusion in the market about the regulatory perimeter for crypto assets under the federal securities laws; it would also reinforce the U.S. tradition of supporting innovation, competition, and free enterprise, while safeguarding investors. Activity involving crypto assets should not be forced to fit old regulatory frameworks blindly, yet this activity should also not be permitted to disregard the historical values embedded in the federal securities laws—those of transparency, accountability, and protection of the investing public.

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