

There Must Be Some Kinda Way Out of Here<sup>1</sup> Part I -- Security Status<sup>2</sup>

**1. 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?**

To start with, expect that over time, all assets will be represented as digital assets. That goes for a share of stock, a debt instrument, a power output contract, collectible art, fungible “utility” tokens, Web 3 gaming assets, coupons for consumer goods, etc. Moreover, the nature of digital assets is that the same token can be more than one thing at a time. As long as we are trying to categorize things as something (a noun), rather than regulating activities (a verb), we are going to be subject to gamesmanship as clever token issuers try to avoid harder regulatory positions by couching their token as something other than what many agree that it actually is. This is clear in the historical analysis of “utility” tokens, which I put in quotes because notwithstanding their utility, they are often purchased with an eye towards value appreciation. There is also an issue lurking in trying to classify certain tokens as representative of derivative contracts subject to CFTC regulation from securities subject to SEC regulation. There is also a looming giant to deal with in the form of utility tokens that may subsequent to issue start to be a vehicle for sharing of revenue (this can take many different forms, none of which need to be a feature of the token when first distributed).

The SEC is designed well to regulate capital raising activities, regardless of the vehicle for that capital raise. The '33 Act doesn't regulate “securities” in any case, it regulates transactions. Stick with that. Just acknowledge that whatever form the capital raise took, once you get sufficiently down the line, the fact that there was a capital raise should no longer be considered. The '34 Act should be treated separately and need not share the same definition of a “security” that is used in the '33 Act. In other words, the definition of “Security” for the '33 Act should be “Something sold in a Capital Raise”, with some of the current exclusions than also excluded. The definition of “Capital Raise” then becomes your key definition, so we are now regulating an activity (which is going to be much easier). The definition of “Security” for the '34 Act stays largely as it is with a clarification that the Howie test investment contract analysis is not applicable to secondary sale transactions.

The “Capital Raise” definition will take some fine tuning to delineate between sales of tokens for reasons that are not a “Capital Raise”, which happen to involve taking in funds. This will always have some grey area, but it is easy to eliminate whole categories of token sales. For instance, if a token serves as a medium of exchange for a distributed application (a “DApp”), but there is a finite number of those tokens and the tokenomics applicable to that use case should drive token value based on supply and demand mechanics, sales of that token might be regular commerce (sold for its utility), but also might be a Capital Raise (sold primarily as an investment). There are any number of factors that can be used with a fair degree of certainty to determine which is which (is the Dapp already functional or close to it; is the token

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<sup>1</sup> With a tip of the hat to Jimi, Josh Lawler is neither a joker or a thief, but he is a seasoned securities attorney who applies a keen understanding of the technology underpinning distributed ledger use cases to navigate legal grey spaces. Accordingly, he has lots of opinions. Thanks for asking.

<sup>2</sup> As I start this (unpaid) odyssey, staring down Commissioner Peirce's 48 information requests, I can't really know how many I'll get to, but hopefully at least a decent group. Of course, happy to discuss in person (in fact, try to stop me).

immediately used for its purpose; is there a meaningful cap on the number of tokens a purchaser can purchase that is in line with the utility function; etc.)<sup>3</sup> Notably, if the same fungible token is sold both in utility oriented transactions, and Capital Raise transactions concurrently, the law should not treat those sales equivalently just because they are sales of the same token. The utility sales are a consumer good. The Capital Raise tokens, having been sold in a Capital Raise, may be subject to limitations on resale, or potentially may require that the purchaser who resells on a short flip be treated as a legal underwriter (with potential liability for fraud).<sup>4</sup>

A digital asset that is not directly tied to the financial activities of an issuer (equity/debt/revenue share) cannot be subject to many of the types of disclosure specified in Regulations S-K and S-X. It just doesn't work. The idea of GAAP audited financials for a utility token issued by a Cayman non-profit entity should be ridiculous enough to prove the point. It gets even more ridiculous for a token that is subject to decentralized governance.<sup>5</sup> That said, there is plenty of information that an investor in a token that is not a classical financial product would want to have. A very preliminary list might be: (i) if there is a known team, a statement from them as to the specifics of the project as well as their backgrounds; (ii) details on the supply and demand dynamics that will (or will not) generate token value and (iii) a statement as to whether there is any contractual mechanisms in place to align the interests of the token holders with those of the owners of any relevant operating company. Depending on circumstances, there would likely be several others.

These disclosures would develop as informal standards for a private placement (and possible Regulation A) transactions. There is no point in using Form S-1 for a token that does not directly tie to an issuer's financial activities (profits and losses and balance sheet). Projects at different stages will be differentially able to produce definitive information. While that will make for some investments being riskier than others, there should not be a bar on anyone participating just because they have not fully developed robust information. The key is that the disclosure is truthful in the lack of development of the project.

A determination needs to be made as to who should regulate secondary markets in digital assets that are not classical financial products (within the definition of "Security" under the '34 Act). While the courts in the Coinbase and Terraform Labs cases may not have been well founded in determining digital assets to be "securities" for secondary sale purposes, they were correct that a group or team or company with a financial interest in the value of a token that is tied to a project should be held accountable for their public statements. For instance, there has been a good deal of meaningful misrepresentation as to the adoption rate of many token projects. Recognizing that right now, most tokens trade off of sentiment, the pull for some to make false claims seems quite strong. Likewise, there is an unfortunate element of what would be insider trading (were these tokens to be "securities"), that needs to be addressed. Given its historical activities, the SEC would appear to be the correct body to provide that regulation. The fact that a token

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<sup>3</sup> We have been designing tokenomics and platform restrictions for years in light of our belief that an obvious utility function to the exclusion of a reasonable investment paradigm should have avoided the "investment" prong of the Howey test.

<sup>4</sup> More on this later, I expect.

<sup>5</sup> Granted, there are very few of these at the moment and there may be some question as to whether this ideal is even possible.

that trades on a secondary market is not a “security” should not change basic fraud prevention. Perhaps the SEC’s jurisdiction in this case extends beyond “securities” to fungible<sup>6</sup> digital assets.

**2. Should the Commission address when crypto assets fall within any category of financial instruments, other than investment contracts, that are specifically listed in the definition of “security” in the federal securities laws?**

Of course they should. Notably, there are major gains in efficiency to be realized in how the infrastructure of financial markets operate. Do we really need Transfer Agents anymore if the ledger is a Blockchain? How do we feel about decentralized exchanges for stocks and bonds? There are many issues to consider.

**3. Certain crypto assets are used in a variety of functions inherent to the operation of a blockchain network, such as mining or staking as part of a consensus mechanism or securing the network, validating transactions or other related activities on the network, and paying transaction or other fees on the network. These technology functions may be conducted directly or indirectly, such as through third-party service providers. What types of technology functions are inherent to the operation of a blockchain network? Should the Commission address the status of technology functions under the federal securities laws and, if so, what issues should be addressed?**

Taking a page from the Howie test, if the activity that provides a return on investment involves a sovereign recognized actor doing something that requires continuing activity, then you likely have an “investment contract.” The most obvious example is delegated staking. When a token holder provides their tokens to a third-party to stake as part of scheme to generate a return based on provision of compute resources or liquidity, that third-party is for all practical purposes putting forth the efforts required by Howie. This is particularly true for protocol staking where someone has to operate equipment to avoid slashing of the staked tokens. Staking to a smart-contract may be different, but still could use some regulation in terms of assigning responsibility for the functionality of that smart-contract. I could see a system where certain authors of smart-contracts voluntarily subject themselves to regulation in order to get a designation as “licensed.” You won’t be able to stop “unlicensed” smart-contracts, but you can educate people to avoid them. I would not see a circumstance to consider staking directly to an open source protocol smart contract as a securities transaction. It requires significant understanding on the part of the staking party.

There are going to be a multitude of situations and use cases on this topic. I’m not going to try to cover them all here, but as a basic premise, if the point of staking is to achieve ROI through a third-party’s efforts, then the SEC should consider regulating that activity.

**4. Users of liquid staking applications receive a so-called “liquid staking token.” This token represents their staked crypto asset, and the token can be used in other activities, all while continuing to participate in the proof-of-stake protocol. Should the Commission address the status of liquid staking tokens under the federal securities laws, and, if so, what issues should it address?**

Yes, the Commission should address the status. The status is likely that these tokens are not issued in a Capital Raise, and therefore, should not be subject to regulation under the ’33 Act. Note that the act of

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<sup>6</sup> As shown in the EU’s MICA, determinations as to what is fungible have their own difficulties, but that is for another part of this response.

staking (without reference to the liquid staking token) may be an investment contract<sup>7</sup>, and disclosure as to the smart-contract particulars may be an appropriate area for securities regulation. Voluntary registration of staking contracts, allowing for verified smart-contract audit, verified responsible party, and disclosure of historical performance (which is available on chain in any case, but might be made more user friendly) should be considered.

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<sup>7</sup> Particularly true when the staking is either part of a delegated staking protocol or locking of tokens to provide liquidity to a managed liquidity pool.