Regulation of DAOs

Law 1078
Spring 2023
US Regulation Overview I

• Securities regulation
  • Regulator: Securities and Exchange Commission (the “SEC”)
  • Only applies to “securities” as defined by the statutes and regulations
    • Howey test (from a Supreme Court case) governs cryptocurrencies
    • Goal: Disclosures to investors and potential investors about key aspects and managers

• Implications
  • Must register before selling tokens that are “securities” to investors
    • On-going reporting obligations
  • Certain intermediaries must register and are regulated by the SEC
    • Exchanges that trade securities
    • Broker-dealers
  • The SEC has the power to address fraud in securities transactions and markets
US Regulation Overview II

• Commodities regulation
  • Regulator: Commodities Futures Trading Commission (the “CFTC”)
  • Authority over futures and options on futures markets that involve commodities
• Implications
  • Regulates futures and certain derivatives exchanges
  • Registers and regulates Futures Commission Merchants ("FCMs")
    • An FCM accepts orders to buy or sell futures contracts or options on futures for a payment from customers.
    • Power extends to regulating fraud over spot markets in commodities
• Bitcoin is a commodity but not a security
• In some cases, assets can be both securities and commodities
US Regulation Overview III

• Other regulators are important but will not be the focus in this discussion of regulation of DAOs
  • E.g., FINancial Crimes Enforcement Network (“FINCEN”)
    • Part of the US Treasury Department
    • Key US regulator concerned with money laundering and enforcing the Bank Secrecy Act

• Important regulatory elements
  • KYC (Know your customer)
  • AML (Anti-money laundering requirements)
  • Imposed by the SEC, the CFTC, or through FINCEN and the Bank Secrecy Act depending on the regulated party
US Regulation Overview IV

• Broker-dealers are regulated by the SEC
  • Must register
  • Lots of requirements
    • Recordkeeping and preservation (customer accounts and trades)
    • Net capital requirements and reports
    • KYC, AML obligations
    • Rules about custody of customer assets
    • Required testing of system; disaster recovery plan
    • Written compliance policies; a compliance officer
    • Disclosure of risk to customers
    • Examination/audit by FINRA
  • Regulatory audits and supervision back up the requirements
“Exchanges” that involve securities are regulated by the SEC and have only two options:

- Operate as a “registered exchange” (national securities exchange)
  - A self-regulated organization that promulgates rules subject to SEC approval and supervises its members (themselves registered BDs; NYSE has about 8000)
  - More rigorous SEC requirements and supervision
- Operate as an “Alternative Trading System” (“ATS”)
  - An ATS must be a registered broker-dealer
  - Are some in the crypto space; e.g. tZERO
Comparison with the EU approach

• The US is regulating cryptocurrencies by applying the existing regulatory framework
  • Most jurisdictions in the world have taken this approach

• The EU recently created a new and separate regulatory regime for “crypto-asset” activities
  • Markets in Crypto-Assets (MiCA) Regulation
  • Approved by the European Parliament on April 20, 2023
Howey Test

• An “investment contract” is a security under §2(1) of the SA of 1933 and §3(a)(10) of the SEA of 1934 and consists of:
  • “an investment of money”
    • Not limited to cash; any consideration
  • “in a common enterprise”
  • “with a reasonable expectation of profits”
  • “to be derived from the efforts of others”
• Orange groves plus optional service contracts that pay out profits
The DAO
(Decentralized Autonomous Organization)

• Virtual organization on blockchain
  • Automate organizational governance and decision making
  • For profit; create and hold corpus of assets to fund projects
  • Holders share the earnings from the projects → return on investment
  • Can monetize by reselling tokens on various web-based platforms that support secondary trading

• History
  • 4/30/2016 to 5/28/2016 sell 1.15 billion tokens for around 12 million ETH (= $150 million); can make purchase via link on DAO website
    • Likened it to “buying shares in a company and getting ... dividends”
    • Solicit media attention; almost daily updates on status and promotional materials on DAO website
The DAO II

• Structure
  • All ETH raised in offering plus all future profits pooled and held in project account unless holders vote to distribute profits of each project
  • Contractors submit project proposals (publish smart contract and post details)
    • Must own at least one DAO token, and deposit ETH lost if project fails to achieve quorum
  • Projects reviewed by DAO Curators before goes to vote
    • Curators have considerable power; complete discretion; control whitelist; can unlist as well as list; can reduce quorum required by 50% every other week

• Considerable secondary market liquidity created

• 6/17/2016 attack diverts 3.6M ETH
  • Move blocked and then take back via hard fork on 7/20/16
  • All DAO token holders who adopt hard fork can exchange for ETH + avoid loss
The DAO Tokens are Securities
SEC SEA 1934 Release 81207 (7/25/2017)

• Despite no action against parties, SEC sees it in the public interest to release report of investigation
  • Put virtual currency issuers on notice
  • No action because all the funds were returned and no projects undertaken

• Apply Howey test (1)-(4)

• (1) “the investment of money”
  • Investment need not be cash, only some “contribution of value”; ETH here suffices

• (2) + (3) “common enterprise with a reasonable expectation of profits”
  • Clear; dividends from projects expected; for-profit entity; pooling of ETH for project investments
The DAO Tokens are Securities II

• (4) derived from the managerial efforts of others – met
  • DAO creators select Curators, propose first project; design and maintain project as Ethereum experts
  • DAO creators and Curators play critical monitoring role for system
    • Screen projects
    • Addressed the attack and resolved the situation
  • Token holder voting rights limited
    • Only vote on proposals cleared by Curators
    • Information on proposals sparse
    • Pseudonymity and dispersion of token holders make it difficult to join together to exercise meaningful control; like corporate shareholders
  • Efforts of DAO creators and Curators were the “undeniably significant” ones, essential to overall success and profitability
Implications of Being a Security

• Must register offering or operate under an exemption
  • DAO is an issuer and information about DAO was crucial to the investment decision
  • Does not matter that it was not a traditional company but a decentralized autonomous organization

• Unlawful for any broker, dealer, or exchange, directly or indirectly, to effect any transaction in a security unless registered as a national securities exchange or is exempted from such registration (e.g. as ATS)
  • Exchange = constitutes or maintains a marketplace bringing together buyers and sellers of securities
  • Platforms trading the DAO met these criteria and were not exempt
Impact of The DAO SEC Release

• No action against DAO although violated the securities laws
  • Returned funds; engaged in no projects
• But various enforcement actions later
  • Munchee – cease and desist unregistered offering; despite claim of “utility token” that has consumptive purpose
  • See Digital Assets SEC Timeline for more examples
• Clayton: by and large ICOs that I have seen did involve offer and sales of securities (12/11/2017)
• November 2018 civil penalties solely targeting ICO violations
  • Airfox and Paragon (250K penalty each; must register; must file periodic reports)
• Sell coins or tokens + expectation that promoters build system → investors can earn a return on investment by selling tokens in secondary market = a security
  • Like oranges in Howey, assets have value in own right, but promise to cultivate will cause value to increase and a profit
  • Investors are passive; bet on success of enterprise
  • Characterize as coin or token does not change Howey inquiry; fact sensitive
  • Could fund business in traditional way using securities; then distribute tokens to functional users
    • Token itself then not a security

• So it is the way token is sold that matters
  • As part of an investment, to non-users by promoters who develop the enterprise → is a security → remove the information asymmetry
Hinman Speech II

• Information asymmetry cured by required disclosure and liability for material misstatements and omissions
  • Efforts of third parties key → information about them key
    • Background, financing, plans, financial stake, etc.

• But points the way to when digital asset no longer a security
  • Network decentralized enough → purchaser no longer can reasonably expect group to carry out essential managerial or entrepreneurial efforts
    • Not an investment contract; informational asymmetries recede
  • Bitcoin today: no central third party that is key determining factor in the enterprise
    • Little value to apply federal securities law to offer and resale of Bitcoin
  • Same with Ether (not confirmed by Clayton who agreed only with the theory)
A useful model for web3: Indirect accountability

Today, web3-native organizations have scarcely leveraged indirect accountability. They should. There are two general approaches they could try:

(1) Give representatives, whether appointed or popularly elected, formal oversight powers.

(2) Create an executive committee that either (a) involves delegates with the most tokens delegated or (b) full-time employees hired by the delegates. The executive committee would be responsible for overseeing the workforce and articulating a unifying vision for the organization.

But there is a warning:

It is still important to note that in designing any governance system, actors should not create information asymmetries that might necessitate the application of securities laws to the underlying tokens in order to protect holders and users. In particular, communities need to ensure that governance designs don’t result in the value of the underlying token being substantially dependent on the “managerial efforts” of such representatives, as in such cases, the tokens could be deemed to be securities by the SEC.
Hinman Speech III

• But whether is a security does not inhere to the instrument
  • Can be packaged and sold as an investment strategy → is a security
  • “investment contracts can be made out of virtually any asset ... provided the investor is reasonably expecting profits from the promoter’s efforts”

• Simply labelling a digital asset a “utility token” does not mean that is not a security
  • An asset for consumption only is not a security; but that is a factual matter
  • Whiskey warehouse receipts example

• Determining whether a third party drives the expectation of return
  • Read the list which is “illustrative, not exhaustive”

• Cases where is more like a consumer item
  • Read list, again not exhaustive
EU: Market in Crypto Assets Regulation (MiCA) Recital 12a

- This Regulation applies to natural, legal persons and other undertakings and the activities and services performed, provided or controlled, directly or indirectly, by them, including when part of such activity or services is performed in a decentralized way. Where crypto-asset services as defined in this Regulation are provided in a fully decentralized manner without any intermediary they do not fall within the scope of this Regulation. (Emphasis added)
Clayton Statement on Cryptocurrencies and Initial Coin Offerings
SEC Chairman Jay Clayton
December 11, 2017

• Address to main street investors and market professionals (e.g., B/D)

• For main street investors
  • No ICOs registered or ETFs approved to date
  • Ask questions (see list); sounds too good to be true check; pressure; invested funds may shift overseas

• For market professionals: security regulation may come into play
  • See DAO investigative report
  • Utility characteristics or calling it a “currency” do not exempt from being a security
    • Must look at detail
  • Pump and dump and other market manipulations are out there; especially in thin markets
  • Payments in cryptocurrency → must ensure AML and KYC obligations, if any, are met
Clayton Statement II

• ICOs
  • Question of whether is security offering
    • Book-of-the-month club versus interest in publishing house
    • Sell on basis of potential of tokens to increase in value and ability to trade on secondary market based on effort of others = “key hallmarks of a security and a securities offering”
  • “By and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities regulation requirements ... these laws provide that investors deserve to know what they are investing in and the relevant risks involved.”

• SEC committed to promoting capital formation and lots of potential in the technology associated with cryptocurrencies
  • But main street investors need to ask the right questions and market participants need to adhere to the securities laws

• Sample questions for investors (read them)
Clayton Statement III

• On AML obligations: “these market participants [e.g., broker-dealers] should treat payments and other transactions made in cryptocurrency as if cash were being handed from one party to the other”

• “I caution those who operate systems and platforms that effect or facilitate transactions in these products that they may be operating unregistered exchanges or broker-dealers that are in violation of the Securities Act of 1934”
  • Obligations extend “to securities firms and other market participants that allow payments to be made in cryptocurrencies, set up structures to invest in or hold cryptocurrencies, or extend credit to customers to purchase or hold cryptocurrencies.”
Super Bowl ads introduction
- Several crypto firms in February 2022 (including FTX)
- Dot cos in 2000 and AmeriQuest before 2007, many went under
- FTX went under – prescient
- Makes innovation (failure common) and hype point = context of SEC “three-part mission: protecting investors, facilitating capital formation, and maintaining fair, orderly, and efficient markets”; also financial stability

Regulation both protects investors and promotes investor confidence
Most crypto tokens are securities under Howey test
- Cites Clayton view and reiterates it
• Platforms (trading and lending)
  • Crypto trading > $100B
    • highly concentrated; top 5 crypto-only 99%, top 5 crypto to fiat 80%, top 5 DeFi 80%
  • Likely are trading securities
• Three goals
  • Get platforms registered and regulated much like exchanges
    • Sees ATS approach as appropriate for institutional investors versus millions of retail investors for crypto
    • engages staff on regulation scope for crypto
  • Determine how to regulate when mix crypto commodity tokens (not a security) with crypto security tokens (are securities)
  • Possible segregation of functions (currently typically integrated) from platform
    • Crypto custody
    • Market-making and trading for own accounts on other side of customers
• Asserts SEC dominion
  • "Nothing about the crypto markets is incompatible with the securities laws. Investor protection is just as relevant, regardless of underlying technologies."

• Of nearly 10,000 tokens in circulation, GG believes the vast majority are securities
  • Sees this as clear from DAO report and other sources
    • No need for "greater guidance" from the SEC
    • "Promoters are marketing and the investing public is buying most of these tokens, touting or anticipating profits based on the efforts of others."
      • Therefore investors deserve disclosure and to be protected against fraud and manipulation

• Regulation strategy
  • Promote registration of tokens as securities
    • "I’ve asked the SEC staff to work directly with entrepreneurs to get their tokens registered and regulated, where appropriate, as securities."
  • Be flexible with required disclosures – “tailored disclosures”
    • Used elsewhere – asset-backed securities versus equities
• Which tokens are securities
  • Non-security tokens (are “a small number” of them; Bitcoin is an example)
  • Represent token clients → unlikely to be dispersed ecosystems
  • Stablecoins
    • Some may be securities, parallel with money market funds
    • Depends on mechanisms to maintain value, how offered, sold, and used
  • Facts and circumstances of product key, not its label

• Intermediaries
  • Tokens are securities → intermediaries of various kinds must register with SEC
    • Exchanges – match orders of multiple buyers and sellers using non-discretionary methods
    • Brokers (effect transactions for others); Dealers (buy and sell for own account)
    • Lending functions for a return
  • Commingling functions creates conflicts of interests and risks for investors
    • Must register each function and possibly disaggregate
  • Problem of trading both crypto security tokens and non-security tokens with same intermediary
• Coordination with CFTC
  • Sees CFTC overseeing and regulating non-security tokens and related intermediaries
  • Look forward to working with Congress to ensure any greater authority that CFTC requires in that domain “consistent with maintaining the regulation of crypto security tokens and related intermediaries at the SEC”
• Acknowledges dual registration possibilities for intermediaries
  • “Further, to the extent that crypto intermediaries may need to register with both the SEC and the CFTC, I would note we currently have dual registrants in the broker-dealer space and in the fund advisory space”
Overall position

- Maintain SEC regulatory domain that includes crypto
  - “I ... look forward to working with Congress on various legislative initiatives while maintaining the robust authorities we currently have”
- Fine tune SEC approach to be appropriate for crypto
  - “On all of these projects, I’ve asked staff to consider using our regulatory toolkit to possibly fine-tune compliance for crypto security tokens and intermediaries.”
- True cooperation and meaningful engagement benefit everybody
  - With respect to regulatory domains and coordination
- Urges participants to work with SEC from outset
  - “As Joseph Kennedy put it, ‘No honest business need fear the SEC.’”
Critique of Current SEC Approaches and Positions
Commissioner Hester Pierce
June 14, 2022

• Regulatory agency competition
  • Are You My Mother?; which agency regulates
  • Industry support for shift of some functions to CFTC based on “disappointment that the SEC has not used more proactively the authorities it already has to sensibly regulate crypto” (HP view)

• SEC refusal to approve a spot BTC exchange traded product (ETP)
  • Access to commodities through ETP not new
    • Help markets more efficiently incorporate information by allowing more voices to weigh in
  • Approved futures-based BTC ETFs
    • More expensive and only approximate spot exposure
  • Fail to approve spot ETP under any of several criteria
    • Despite a mature, liquid, transparent market
    • Despite clear success of spot ETPs in other countries
    • Less expensive and more direct way to own BTC than futures based
Critique of Current SEC Approaches and Positions II

• Regulation by enforcement action
  • SEC has failed to build a regulatory framework, e.g. through rulemaking
  • Instead promulgate rules and approaches via enforcement actions
    • 2017 SEC establishes Crypto Assets and Cyber Unit within Division of Enforcement
      • More than 80 enforcement actions related to fraudulent and unregistered crypto asset offerings and platforms
      • Monetary relief totaling more than $2B
      • July 19, 2022 testimony to House Committee on Financial Services by Gurbir Grewal, SEC Director of Division of Enforcement
    • E.g. in BlockFi (crypto lender) enforcement action, SEC delineates a specific path pursuant to which BlockFi could register and take steps to operate under an Investment Company Act exemption
      • Rulemaking with public and industry comment would be superior
      • Creates clarity and notice, reduces compliance risks, supports innovation
  • Goals should be: provide regulatory clarity, facilitate iterative experimentation, and pursue bad actors in the crypto space
Commodities Futures Trading Commission
CFTC

• Exclusive jurisdiction over regulation of futures contracts
  • CFTC rules → futures contract must be traded through a “designated contract market” (“DCM”) regulated by the CFTC
  • Standardize the terms of such contracts
  • Can regulate spot markets in underlying commodities, but only with respect to fraud and manipulation
    • Includes “stand alone” fraud with no manipulation (Monex 9CCA 2019)

• The CFTC rules Bitcoin is a commodity (2015)
  • Directly regulates derivative contracts on Bitcoin
  • Regulates fraud and manipulation with respect to Bitcoin itself
  • Futures contracts for Bitcoin must be traded on a CFTC-regulated DCM
Contours of CFTC Regulation of Cryptocurrencies
CFTC View

• Central CFTC authority: approval and oversight of Bitcoin futures markets

• 2018 CFTC annual enforcement report emphasizes goal to “aggressively ... root out fraud and manipulation in [crypto] markets”
  • → assert authority over fraud in spot markets involving virtual currencies even where no futures contract or other derivative is involved
  • Note: “Virtual Currencies” is the term that the CFTC uses for the entire class of cryptocurrencies
Contours of CFTC Regulation of Cryptocurrencies
Case Law I

• CFTC v. McDonnell (EDNY 2018)
  • Straight up fraud: Coin Drop Markets “operated a deceptive and fraudulent virtual currency scheme ... for purported virtual currency trading advice ... or virtual currency purchases and trading ... and simply misappropriated [investor] funds”

• Holdings
  • Virtual currencies are commodities, therefore within CFTC regulatory ambit
  • Virtual currencies may also be a security regulated by the SEC
    • CFTC regulatory authority is not exclusive, may overlap with SEC
  • CFTC has power to address fraud and manipulation in spot markets but not to regulate spot markets themselves
    • Need not be connected to a futures or derivatives market
Contours of CFTC Regulation of Cryptocurrencies
Case Law II

• Current or potential futures market → CFTC can regulate the underlying spot market

• CFTC v. My Big Coin Pay, Inc. (D.Mass 2018)
  • Fraudulent offering of a fully-functioning virtual currency called “My Big Coin”
  • My Big Coin is a commodity under the Commodities Exchange Act because it is a virtual currency, and there is futures trading in virtual currencies (Bitcoin)
  • CFTC can prosecute fraud in the absence of market manipulation
  • Note: CFTC v. McDonnell in accord
Summary of Current Position of CFTC

- CFTC has authority to regulate cryptocurrencies as commodities
  - Cryptocurrencies are commodities
- Dodd-Frank amendments to CEA authorize CFTC to address fraud that does not directly involve the sale of futures or derivative contracts
- The fraud does not have to involve market manipulation
- The CFTC’s jurisdiction over fraud in the spot market is not limited to assets that trade in the futures or derivatives markets
Direct Clearing Issue I

• Traditional clearing model: retail participants can trade and clear futures only through professional intermediaries
  • Futures commission merchants ("FCMs"), registered and regulated by CFTC
  • Direct Clearing Organizations
    • Clear trades in futures or derivatives
    • Where margin used, typically mutualize losses in default waterfall → shared by all clearing members

• FTX proposal (FTX is a DCO = derivatives clearing organization)
  • Currently offered clearing of futures and options on a fully collateralized basis
  • Proposes that can clear margined products on a non-intermediated basis
    • Eliminates intermediaries (FCMs and DCOs) who would absorb increased risks

• FTX proposal withdrawn after its collapse
Direct Clearing Issue II

• FTX proposed mechanism
  • Set initial and maintenance margin levels
  • Participant’s margin position recalculated every 30 seconds as mark positions to market
  • If collateral falls below maintenance margin level, begin to liquidate (automated)
    • Liquidate 10% of portfolio at a time until collateral on deposit exceeds the maintenance margin requirement
    • With 30 second cycles, liquidations can occur any time, 24/7
  • If collateral falls below “full liquidation” threshold, liquidate remainder of portfolio
    • Agreements with backstop liquidity providers who agree to accept set amounts of positions in advance and who will receive the remaining margin once full liquidation threshold is hit
    • $250M of FTX capital = guaranty fund to cover losses beyond those accepted by backstop liquidity providers and to cover backstop liquidity provider losses (margin < value of portfolio were obligated to purchase)
    • No mutualization of losses among its participants in a default waterfall
      • Versus typical DCO which mutualizes losses in default waterfall → shared by all clearing members
Ooki DAO – CFTC

• Background
  • bZeroX an LLC operates through smart contracts on the Ethereum blockchain
    • Allows investors to speculate using leverage (margin collateral) on the relative price of digital asset pairs
    • CFTC: these are commodity derivatives transactions and required registering as an exchange and operating in accord with regulations
  • bZeroX transitions to a DAO (Ooki DAO) after the co-founders (Tom Bean and Kyle Kistner) publicly announced that the transition would insulate the enterprise from any need to comply with US law (Darwin award?)
  • The CFTC initiates an enforcement action against the co-founders and the enterprise
  • The founders reach a regulatory settlement with the co-founders, leaving the action against the enterprise
Ooki DAO – CFTC II

• The enforcement action against the entity
  • CFTC contention was that “Ooki DAO is an unincorporated association comprised of Token Holders that used (“voted”) their tokens to ‘govern’ the Protocol.”
  • The dispersed nature of the token holders raised the questions of
    • whether Ooki DAO can be sued as an unincorporated association
      • The judge decided yes, it could be sued as an unincorporated association under CA law
    • and, if so, how to serve the enterprise with notice of the enforcement action as a first step in the enforcement action
      • The judge found that posting on the Chat Box and online Discussion Forum was adequate, since “service reasonably calculated to notify the Token Holders would reasonably notify the DAO itself”; and there was evidence of actual notice given the reactions in those forums
    • Since the CFTC indicated Bean and Kistner were Token Holders, in order to “achieve the best practical notice,” order the CFTC to serve those individuals
Ooki DAO – CFTC III

• Ooki DAO fails to respond by the January 10, 2023 deadline
  • Why?

• The CFTC moves for a default judgment on April 7, 2023
  • A permanent injunction
  • Civil monetary penalties
    • The CFTC notes that Ooki DAO violated three separate provisions of the Act and Regulations. Thus, according to the regulator, the Court should impose three times the per-violation CMP—i.e., three times $214,514, or a total of $643,542. This fine, the CFTC says, is warranted to punish and deter future similar misconduct by the Ooki DAO and similarly situated entities. (FX News Group 4/11/23)
    • How will the CFTC collect?
  • An order to remove the Ooki DAO website from the public domain.
• Agrees with culpability of Bean, Kistner, and the entities
  • Also agrees with injunctive relief

• Disagrees (strongly) with holding Bean & Kistner personally liable for violations of the CEA and CFTC rules by Ooki DAO based on their status as voting token holders of Ooki DAO
  • Natural to suspect that CFTC defined Ooki DAO unincorporated association as consisting of those who vote their Ooki DAO tokens
  • Inequitable: personally liable if voted on any governance proposal, even if not related, versus if did not
  • Creates poor incentives: discourages voting, hindering good governance
Summer Mersinger Dissent II

• A bigger problem: regulation by enforcement
  • Public policy implications way beyond this case
    • Key question of who is a member of a DAO and who will the CFTC hold personally liable
  • Made a consequential decision with no public notice or input
    • Rulemaking would:
      • address the possible consequences for the DAO ecosystem and unincorporated associations other than DAOs;
      • Provide public notice of the rules; there was none here that voting is key or that personal liability can follow

• Were alternatives in this case
  • Hold Bean and Kistner liable for aiding and abetting (an existing legal ground)
    • Almost certainly met the standard; e.g. the public announcement about avoiding regulatory compliance
  • Would avoid all the downsides of what did to and make clear that decentralized organizations are not immune from CEA and CFTC requirements
Reels

• [https://www.instagram.com/reel/CjYzUM1IZjE/?igshid=MDJmNzVkMjY%3D](https://www.instagram.com/reel/CjYzUM1IZjE/?igshid=MDJmNzVkMjY%3D)

• [https://www.youtube.com/watch?v=OQ_g6NOo7yo](https://www.youtube.com/watch?v=OQ_g6NOo7yo)
Reopening Release
Reopening of Comment Period for Amendments to Exchange Act Rule 3b-16 Regarding the Definition of “Exchange”

• Purpose: to answer questions about potential effects on trading systems for crypto assets and trading systems using DLT, including those characterized as DeFi (7)

• “Added ‘communication protocols’ as an example of an established, non-discretionary method ... to bring together buyers and sellers” (5)

• Sees it as likely that crypto trading systems are trading crypto assets that are securities
  • “Because it is unlikely that systems trading a large number of different crypto assets are not trading any crypto assets that are securities, these systems likely meet the current criteria of Exchange Act Rule 3b-16(a) and are subject to the exchange regulatory framework.” (10)

• Thus, subject to the same “regulatory and supervisory standards that govern traditional market infrastructures and financial firms”
The new rule and New Rule 3b-16(a) Systems

“... the Commission proposed to amend Exchange Act Rule 3b-16(a) to include within the definition of “exchange” an organization, association, or group of persons that constitutes, maintains, or provides a market place or facilities for bringing together buyers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange if it is not subject to an exception under Rule 3b-16(b) and it: (1) brings together buyers and sellers of securities using trading interest; and (2) makes available established, non-discretionary methods (whether by providing a trading facility or communication protocols, or by setting rules) under which buyers and sellers can interact and agree to the terms of a trade. For purposes of this Reopening Release, trading systems that meet the criteria of Exchange Act Rule 3b-16(a), as proposed to be amended (i.e., offer the use of non-firm trading interest and provide non-discretionary protocols), are referred to ... as “New Rule 3b-16(a) Systems. New Rule 3b-16(a) Systems would be subject to the definition of “exchange” and be required to register as a national securities exchange or comply with the conditions to an exemption to such registration, such as Regulation ATS.”
Group of Persons

• Who is responsible for compliance?
  • Commenters bring up: code functions as intermediaries, lack of central operator, could extend to open source developers, people who republish and share that info, persons who connect to peer-to-peer networks where DeFi activities take place: all persons involved in DeFi system (developers, AMMs, miners) could be considered essential components

• SEC answer:
  • “The existence of smart contracts on a blockchain does not materialize in the absence of human activity or a machine (or code) controlled or deployed by humans.”
  • “an exchange can also exist where a market place or facilities are provided by a group of persons, rather than a single organization” (quotes language from statue)
Group of Persons II

• Token holders
  • “Depending on the facts and circumstances, significant holders of governance or other tokens, for example, could also be considered part of the group of persons and thus an exchange if they can control certain aspects of it.”
  • Certain aspects include: securities available for trading, requirements and conditions for participation, determining who can share profits or revenues, or having the ability to enter into legal and financial agreements on behalf of or in the name of the marketplace or facilities
Group of Persons III

• Group is collectively responsible:
  • “A group of persons must consider how they will comply with the Exchange Act registration requirements given their activities, which can include, but are not limited to, designating a member of the group, to register the group or forming an organization to register as an exchange or, to operate as an ATS, registering as a broker-dealer and becoming a member of Financial Industry Regulatory Authority (‘FINRA’) to ensure compliance with the requirements of the Exchange Act, Commission rules, and FINRA rules.”
  • Comply or die!
Group of Persons IV

- Commenters:
  - Developers and users act independently of each other; developers only provide communication tools
  - May implicate: interface providers, code developers, DAOs, validators, miners, issuers and holders of governance tokens

- SEC response:
  - They constitute a group if act in concert or share common control
  - No attempt to make any distinctions
Group of Persons V

- Independent software developers only *less likely* to be acting in concert
  - “A software developer who, acting independently and separate from an organization, publishes or republishes code without any agreement (formal or informal) with any person for that code to be used for a function of a market place or facilities for bringing together buyers and sellers of securities may be less likely to be acting in concert to provide a market place or facilities for bringing together buyers and sellers. This could be the case even if the software developer’s code is subsequently adopted and implemented into a market place or facilities for securities by an unrelated person. Whether the activities of actors amount to a group of persons requires an analysis of the totality of facts and circumstances and the activities of each actor.” (28-29)
Group of Persons V

- Any combination suffices (very important)
  - “If the activities of any combination of actors constitute, maintain, or provide, together, a market place or facilities for bringing together buyers and sellers for securities or perform with respect to securities a function commonly performed by a stock exchange, they could today be considered a group of persons and thus an exchange under section 3(a)(1) of the Exchange Act and Rule 3b-16 thereunder and therefore be required to register as an exchange under section 5 of the Exchange Act.”
Group of Persons VI

• Liability exists for persons or entities that initially created or deployed the system’s code even though “the system, once deployed, typically cannot be significantly altered or controlled by any such persons”

• “If, for example, an organization deploys a smart contract that the organization cannot significantly alter or control but constitutes a market place for securities under existing Exchange Act Rule 3b-16 or Rule 3b-16, as proposed to be amended, then that organization would be an exchange and would be responsible for compliance with federal securities laws for that market place. Given that such a market place could be publicly available to bring together buyers and sellers of securities, requiring the organization to be responsible in this case would advance the Commission’s policy objectives by ensuring the exchange complies with federal securities laws and regulations, including, among other things, the oversight, investor protection, and fair and orderly market principles applicable to registered exchanges and ATSs.”
Group of Persons VII

• Commenters: may be hard to comply with BD requirements
  • SEC: Investor protection is just as relevant and already have a range of systems, “many assorted technologies,” in the ATS and national exchange boxes
Rule Language Points

• The project does have to perform functions commonly performed by a stock exchange; can still be an “exchange”

• “makes available” non-discretionary methods replaces “uses”

• adds communication protocols to the scope

• Group includes parties that perform a function as part of collective → cover all functionalities in effort to assure investor protection and fair and orderly markets
Lower Bound on Implementation and Compliance Costs

“...The Commission preliminarily believes that actual costs may be higher than these estimates and discussions express, due to the type of technology and operations utilized in trading crypto asset securities.” (101) [no kidding!]
Scope Concerns

• list by SEC identified 15-20 new systems that trade crypto securities
  • but commenters listed many other possible parties that may have to comply: only write open-source code, DeFi developers, persons making AMMs or interfaces for AMMs available, developers, miners, validators, social networking websites, peer-to-peer messaging operations, blockchain technology nodes, smart contract developers
  • SEC response:
    • “The Commission believes that the entities these commenters describe would only be an exchange if they constitute, maintain, or provide a market place or facility that meets the applicable criteria, and would only incur compliance costs in connection with their activities that constitute, maintain, or provide that market place or facility. The Commission acknowledges that there may be circumstances in which the miners or validators of a blockchain could incur costs under the Proposed Rules, and the Commission solicits comment on any such costs.” (104)
  • No distinctions: comply or die
Costs

• Commenters: danger that will stifle innovation fearing may meet proposed definition of an exchange, perhaps inadvertently
  • “While the Commission does not believe that innovation will be impossible under the Proposed Rules, we acknowledge that there could be less innovation as a result of the uncertainty and compliance costs associated with the broad formulation of the Proposed Rules.” (120-121)

• that’s all! -- no attempt to mitigate it
Costs II

• Discontinuation of non-security for security pairs trading
  • “Because pairs trading is common in crypto asset markets, this cost may be significant for some New Rule 3b-16(a) Systems.” (122)
  • could mitigate by setting up trading for fiat versus security and separately fiat for non-security
  • Reason for restriction: “because existing national securities exchanges and ATSs currently do not facilitate trading between crypto asset securities and non-security crypto assets”
Costs III

• Costs for platforms using certain technologies
  • “... factors associated with certain technologies that might increase the compliance costs of certain specific requirements. It is possible that operating a system that uses these technologies to perform exchange activities under the Proposed Rules in a manner that complies with applicable regulations could significantly reduce the extent to which the system is “decentralized” or otherwise operates in a manner consistent with the principles that the crypto asset industry commonly refer to as “DeFi.”” (123)
Costs IV

• Lowest cost scenario
  • firm controls smart contracts with the sole right and means to make alterations required to bring the system into compliance, to receive fees, to maintain all off-chain operations
  • would have similar cost of compliance versus New Rule Systems that are not automated

• Higher cost scenario
  • “The Commission preliminarily believes that a New Rule 3b-16(a) System that performs its exchange activities in part using smart contracts, but that is not set up in the manner described above, may have significantly higher costs of compliance than the lower bound. The Commission is unable to provide a quantitative estimate of an upper bound because the Commission lacks information on the costs of the activities which may be necessary for more complex systems using such technology to come into compliance.” (125)
Costs V

• The worst case (highest cost): DAOs
  • “The Commission preliminarily believes that a reasonable case, in which the highest possible compliance costs would result, would be a New Rule 3b-16(a) System that performs exchange activities in part using smart contracts, but in which control over changes to the smart contracts is given to a token-based voting mechanism, which may use governance tokens as discussed above, and where the tokens are dispersed among a large number of investors.”
Costs VI (DAO case continued)

- Token holders would bear responsibility for ensuring compliance
  - they should create and organization or delegate persons to undertake the activities required for ATS compliance
  - would have to pay the costs somehow; out of DAO revenues or put money in
    - [sell tokens to raise funds → may be a securities offering!]
  - Would have to change smart contracts by vote
  - Some token holders will sell out to avoid all of this; but fewer token holders means lower costs to comply
    - “The Commission does not have the data it would need to estimate the extent to which this would happen, but to the extent that this process significantly reduces the number of holders of a smart contract’s governance tokens, the Commission expects that the costs of compliance for such a smart contract would fall between the two extremes already discussed.”
Costs VII

• Automate all the operations via smart contracts that are immutable → would have to use a fork
  • “It is possible that in this case costs may exceed the upper bound described above. The Commission is uncertain as to the exact size of the costs that may be involved ...”
  • Miners and validators may quit
• Additional responses to commenters
  • (read pages 129-133; especially last two paragraphs)
Securities Act Section 5 Obligations as ATS

• “under section 4(a)(4) of the Securities Act, a broker-dealer is required to conduct a reasonable inquiry into the facts surrounding the proposed sale of a security by its customer to determine whether the sale of the security would violate section 5, such as if there is no registration statement in effect with the Commission as to the offer and sale of the security, or there is no applicable exemption from the registration provisions available to the customer. Upon registration as a broker-dealer, an entity could face liability under section 5 of the Securities Act for facilitating sales of securities on behalf of its customers that would violate section 5. To the extent a substantial portion of this entity’s business is in the sales of such securities, the Proposed Rules would result in a significant loss in revenue for the entity.” (109)

• Have to decide which crypto assets are securities without SEC guidance!!
Competition

• If all exchanges were regulated as ATS, that would “promote competition by requiring ... [all exchanges to] operate on a more equal basis” (133)

• but then could have higher barriers to entry and a reduction in the rate of adoption of new technologies, and reduced operational flexibility that could cause make it more difficult to innovate → solutions:
  • Systems that have difficulty complying could exit the market for crypto asset securities; OR
  • “The Commission additionally believes that many systems that would experience these higher costs could be restructured to make less extensive use of these novel technologies, although this could significantly reduce the extent to which these systems operate in accordance with “DeFi” principles.” (138)

• [Note skip additional topics discussed at 139-end; more of the same!}
May Revisit Howey

• SEC may attempt same reasoning in the Howey context
  • With respect the “to be derived from the efforts of others” branch of Howey, argue that the “others” are a group of persons, for example, token holders in a DAO
  • Functions like a security → must create an “organization” element so that can register
    • Circumvent the problem of no one responsible for regulation
  • These moves would undoubtedly result in a court challenge and a possible reexamination of Howey all the way up to the Supreme Court
Rendering Innovation Kaput
Statement on Amending the Definition of Exchange
Hester Pierce, April 14, 2023

• Assessment of Reopening Release:
  • “Stagnation, centralization, expatriation, and extinction are the watchwords of this release. Rather than embracing the promise of new technology as we have done in the past, here we propose to embrace stagnation, force centralization, urge expatriation, and welcome extinction of new technology.”

• Origin of Regulation ATS
  • In 1990s, new forms of bringing together buyers and sellers arose
  • SEC allowed them to operate without being national securities exchanges
    • Delta system: registered BD matches counterparties, using bank for clearing
    • Not controlled by members who also were registered BDs
    • Courts upheld that
  • Evolved into Regulation ATS
Rendering Innovation Kaput II

• Origin of Regulation ATS – Assessment:
  • In other words, faced with a choice between fostering innovation or stifling it with an inflexible and expansive interpretation of the statutory definition of “exchange,” the Commission chose innovation. In permitting the Delta system to continue operation, the Commission grappled honestly with the real-world consequences of its exercise of authority. It recognized that “an expansive interpretation of” the statutory exchange definition would harm “innovation and competition.” Accordingly, the Commission determined that it was “not constrained to apply a particular provision of a statute so expansively as to produce absurd consequences” and instead adopted a sensible narrower interpretation.
  • This narrower interpretation facilitated further innovation. Through a series of no-action letters over the next several years, the staff gave the green light to a number of other alternative trading systems. Then, in 1998, after a number of such systems had emerged, the Commission set about to create a tailored regulatory framework. It created Regulation ATS by combining a more-expansive definition of exchange with a prudent exercise of the exemptive authority that Congress had provided two years earlier.
Rendering Innovation Kaput III

• Contrast with action in Reopening Release
  • (read the three paragraphs that conclude the introduction)
Problems with Reopening Release

• Refusal to define the ambiguous term, “Communication Protocol System”
  • Instead of giving examples of what is outside the definition, asks commentators to do that
  • Asking commentators to resolve ambiguity in a novel term of our own creation
  • Increases regulatory risk, especially given regulation by enforcement

• Does not grapple with possible wide scope of “Communication Protocol System”
  • Potential disruption; do systems have to register as BDs or Exchanges?
Problems II

• Confusing and unworkable standards for decentralized activity, participants in that activity, and providers of the underlying technologies, including validators and miners
  • Acting in concert is only one factor to consider
  • The “any combination” language
    • This group, the release suggests, could designate a member to register the group, “form[] an organization to register as an exchange,” or become an ATS, but each member of the group “would be collectively responsible for ensuring that the designated member of the group fulfills its regulatory responsibilities.”
    • The release hints that the relevant “group” may include anybody who has even a purely ministerial role with respect to defi activity. (read what follow to end of bullet point)
Problems III

• Undermines fundamental First Amendment protections for code
  • (read it)
• Does not seriously consider whether compliance is possible
  • (read it)
• Could have taken a gradual route instead
  • (read it)
• It is not the staff’s fault; they worked on the task assigned