

Crypto Regulation

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Who am I?



Head of Policy & General Counsel

- At a16z since 2021 working with portfolio companies on regulatory approaches
- Previously, partner in Latham's Emerging Companies & Capital Markets Groups
- Started representing Consensys in 2017
- Co-chaired Latham its global blockchain and cryptocurrency task force of 80 lawyers around the globe.
- Worked with almost every prominent venture firm and was counsel to dozens of startups in the sector.

Basics of Regulation

Who makes and enforces regulations?

- The US has regulations on both the state and federal level
- Legislature makes laws, executive enforces laws, judiciary interprets laws
- Elected vs. appointed officials; policymakers vs. enforcers

Where are they codified?

- United States Code (USC) and Code of Federal Regulations (CFR)
- Other administrative materials: guidance, settlements, no-action letters, etc.
- Unique systems in all fifty states, not to mention other countries

How should you think about them?

- Learn the basics for issue-spotting and use common sense
- Hire a lawyer early

Basics of Regulation

- **Securities & Exchange Commission (SEC)** – Securities, exchanges, investment advisors
- **Commodity Futures Trading Commission (CFTC)** – Derivatives, futures, margin trading, event contracts
- **Department of Justice (DOJ)** – Crimes
- **Financial Industry Regulatory Authority (FINRA)** – Brokers
- **Financial Crimes Enforcement Network (FinCEN)** - Money laundering and illicit finance
- **Office of Foreign Assets Control (OFAC)** - Sanctions
- **Consumer Financial Protection Bureau (CFPB)** - Consumer Protection
- **Office of the Comptroller of the Currency (OCC)** - Banks

Securities Laws

The Securities and Exchange Commission

- The SEC has a three-part mission: to protect investors, facilitate capital formation, and maintain fair, orderly and efficient markets.
- The federal securities laws originated in the 1930s after the Great Depression, which was thought to be caused by financial abuse and information asymmetry
- The SEC regulates “securities” and a broad range of securities market actors, including issuers, exchanges, advisers, brokers, dealers, investment firms, etc.

Securities Laws in Crypto

- Securities are subject to burdensome regulatory requirements that don't work for crypto - They have to be registered with the SEC, traded on SEC regulated venues and held by SEC-approved custodians. All of this precludes the possibility of decentralization.
- Because a securities designation is a death blow for most digital assets, the crypto industry spends a lot of time and money avoiding SEC regulation.

Commodities Laws

The Commodity Futures Trading Commission

- The CFTC's mission is to promote the integrity, resilience and vibrancy of US derivatives markets: futures, options, swaps, etc.
- The CFTC was created in 1974 when most futures trading occurred in agricultural markets and is still overseen by the House and Senate AG Committees
- The CFTC's role and responsibilities greatly expanded after the Global Financial Crisis under the Dodd-Frank Act due to the impact of complex financial derivatives

Emerging CFTC Crypto Focus Areas

- Are digital assets securities (SEC) or commodities (CFTC)?
- Are prediction markets subject to state or federal regulation?
- How can Americans access perpetual futures?

Anti-Money Laundering Laws

The Financial Crimes Enforcement Network

- FinCEN enforces the Bank Secrecy Act (“BSA”), our anti-money laundering / countering the financing of terrorism (“AML/FCT”) laws
- The BSA requires regulated financial institutions to comply with certain AML compliance program requirements, including “know your customer” (“KYC”)
- This includes centralized crypto institutions like exchanges and custodians

AML in Crypto

- The BSA deputizes financial intermediaries to perform the task of surveilling our transactions and reporting on them to the government
- How does the BSA work in a disintermediated financial system like crypto

GENIUS Stablecoin Act

Overview

- Regulatory regime for centralized issuers of fiat-backed stablecoins
- Administered by the U.S. department of the Treasury
- Applies clear regime distinct from SEC and CFTC jurisdiction
- Requires issuers to maintain 1:1 reserves in high-quality liquid assets (e.g., cash, T-bills)
- Applies regular attestation and transparency obligations, including third party audits and public reporting.

Emerging Narratives

- Yield
- Decentralized stablecoins

Building in a maze of regulatory complexity

Building in crypto takes you down a very different regulatory path than what traditional startups experience.

We'll talk about three key parts:

- Protocols vs. Apps
- Token Classification
- Corporate Structuring



Overarching Principle

Same risks → Same rules

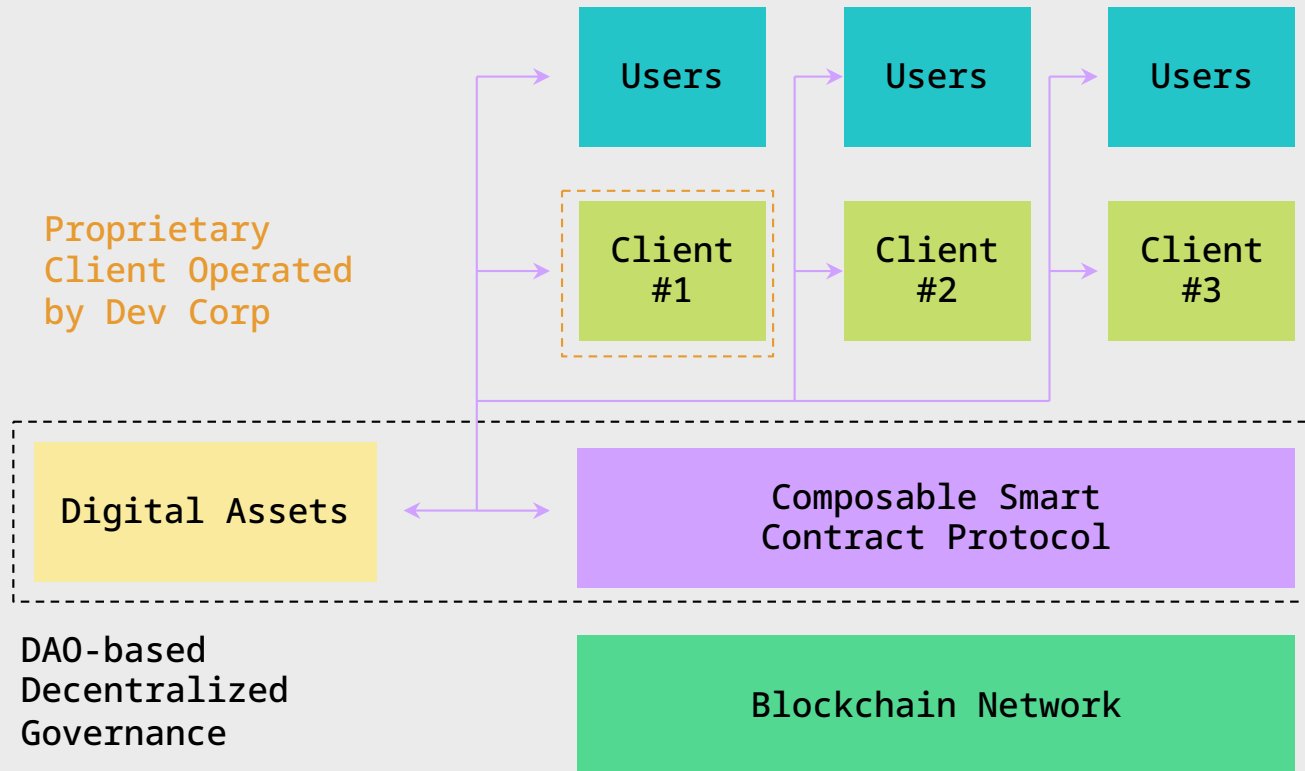
Different risks → Different rules

Blockchains eliminate some risks, but not all risks

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Protocols vs. Apps

How do regulations apply to different layers of the tech stack?



Protocols vs. Apps

Protocols

- A blockchain network or smart contract protocol can be **decentralized** – they can function absent human intervention and control, which eliminates the risk that they function as an intermediary.
- Disintermediated systems cannot technically comply with subjective regulations
- Programmatic systems cannot practically comply with global regulations

Protocols vs. Apps

Apps

- Apps are centralized – they typically are operated by a business and are controlled by humans, which means they could (but do not necessarily) pose risks of an intermediary, even where they do not take custody of assets.
- Apps can technically comply with subjective regulations
- Apps can practically comply with global regulations

Controlled-Based Decentralization Framework for Protocols vs. Apps

Where protocols are NOT **controlled** and DO NOT present **intermediary-risks**, they should not be subject to regulation.

Where apps ARE **controlled** and DO present **intermediary-risks**, they should be subject to regulation.

Token Classification

Category	Definition	Examples	Fungibility	Regulatory Notes
Network tokens	Speculative asset that is intrinsically linked to blockchains and smart contracts that are autonomous.	BTC, ETH, SOL, UNI	Mostly fungible	Likely excluded from securities laws
Security tokens	Digital form of securities	Etherfuse Stablebonds, Aspen Coin	Mostly fungible	Securities laws apply
Company-backed tokens	Speculative asset that is intrinsically linked to offchain applications, products or services that are human-controlled.	FTT (FTX)	Mostly fungible	Likely subject to securities laws
Arcade tokens	Functional assets with little speculative value and often used within closed systems	FLY, PoQ	Varies	Excluded from securities laws
Collectible tokens	Digital analog of tangible and/or intangible goods, often associated to brands or creators, and potentially having utility and/or speculative value	CryptoPunks, Pudgy Penguins, ENS Names	Mostly non-fungible	Varies, mostly excluded from securities laws
Asset-backed tokens	Asset that represents a claim on, or economic exposure to, an underlying asset.	USDC, C-Tokens, Squeeth, stETH	Mostly fungible	Depends on type and structure
Memecoins	Speculative asset that is meme-based, with no intrinsic value or utility	DOGE, PEPE, SHIB, TRUMP	Fungible	Varies, mostly excluded from securities laws

Classifying Tokens: Regulatory Approaches



Efforts-Based Decentralization

Where entrepreneurs **no longer engage in significant ongoing efforts**, secondary transactions of a token may be excluded from securities laws.

Ex: SEC 2019 Framework



Formalistic

Where **no legal relationship** exists between the issuer and purchaser, secondary transactions of a token may be excluded from securities laws.

Ex: "Predicate Contract" theory



Control-Based Decentralization

Where a system **eliminates control**, secondary transactions of a token may be excluded from securities laws.

Ex: CLARITY, Token Safe Harbor 2.0

Case Study: ETH vs. FTX Coin (FTT)

ETH

- Enables holders to transact on the Ethereum Network
- Holders have a financial interest in the **programmatic functioning of the network**
- The network is **decentralized** – it can operate without human intervention or control
- **Eliminates trust dependencies inherent to securities**
- **ETH is a Network Token**

FTX Coin

- Provided holders with discounts while trading on the FTX Exchange
- Holders received economic value from the **manual functioning of the FTX Exchange**
- The exchange was **centralized** – it could only operate with human intervention or control.
- **Fosters trust dependencies inherent to securities**
- **FTT is a Company-Backed Token**

Additional Background: FTX Coin

- Even though FTX Coin didn't provide an **express legal relationship** or a **financial interest** in FTX, **FTX Coin functioned just like a security**:
 - Investors invested in FTX Coin
 - FTX Coin was subject to significant information asymmetries
 - FTX Coin's value was solely dependent on FTX – its price was driven by FTX using its profits to buy back the token (just like stock buybacks).
 - When FTX collapsed, the price of FTX Coin collapsed and investors were wiped out.
- **Conclusion: Transactions of FTX Coin were identical to securities transactions.**

**What does control-based
decentralization require?**

Controlled-Based Decentralization Framework for Tokens

1. **System Value** – Is the network token economically independent?
2. **Functionality** – Is the network functional?
3. **Open** – Is the network open and permissionless?
4. **Programmatic** – Is the network autonomous?
5. **Governance** – Is the network's governance decentralized?
6. **Impartial** - Is the network credibly neutral?

Systems need to be designed to eliminate control, not just disperse it.

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Corporate Structuring

What happens if you can't eliminate control?

Decentralized Unincorporated Nonprofit Association

Where control isn't eliminated, has it been dispersed?

A DUNA can be an effective tool for dispersing control where it hasn't been eliminated.

DUNAs are superior to foundations as they do not necessitate centralized control and structures.

The DUNA's reach is constrained to those activities that are controlled/intermediated by the governance protocol.

Case Study: NFT Marketplace Protocol

Network Token

The network is a series of **immutable** smart contracts facilitating peer-to-peer transactions of NFTs.

Anyone can operate their own **frontend** on top of the protocol to initiate purchases and sales of NFTs.

The protocol collects a **commission** on each transaction and uses those fees to **buy/burn** the native token of the network.

Decentralization

System Value 

Functionality 

Open 

Programmatic 

Governance 

Impartial 

DUNA

Token-based governance:

Control the commission rate, the treasury (50% of the total supply), and the inflationary rate.

No control over the functioning of the protocol or to change the mechanism of fee distribution.

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QUESTIONS

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