

The Fork in the Road for DeFi. Lewis Cohen, DLx Law - E56

Eric: This week, we are fortunate to be able to have Lewis Cohen, founder of DLx law on the podcast. Anyone who follows Lewis on Twitter and his numerous written works, or in his conference appearances, knows that he is very thoughtful in the digital asset space. This episode was going to be originally all about the Reves Test for determining whether a note is not a security and how it relates to crypto lending programs.

But after reading his article on the Path Forward for Defi in the inaugural issue of the International Journal of Blockchain Law, I realized that I would need to do both topics and to endeavor, to type all. Reves is actually covered later in the episode; Lewis contemplates a direction forward for Defi that I agree with.

And I think we'll be saying in retrospect, it was inevitable. Regulators will want regulated intermediaries and Defi has none. So that basically means that it becomes an effective tool for regulated intermediaries in the future. That Lewis envisions as well. Endeavoring to have a place for a permissioned or non-permissioned uses of Defi the peer-to-peer it's compelling question as to whether giving the regulators and policymakers what they want actually achieves the goals of financial inclusion, and egalitarianism, if policy, makers, and regulators in.

That the existing regulated intermediary infrastructure is the only acceptable means for regulating Defi or for devise existence. Then as Lewis notes, it's no longer going to be Defi, but just automated finance and perhaps improved by a short stay in the Defi sandbox. The answer for this of course depends on who you ask.

In this episode, we do explore the new likely emerging. Paradigm for Defi and its regulation. I hope you enjoy it. And if you enjoy it, click on link, and hit share on your mobile phone. I want this podcast to hit the ears of those who will appreciate it. And surely you must know someone and yes, I am talking to you anyway.

Thank you so much for being my audience and what that I bring you this week's episode. With Lewis Cohen. I hope you enjoy it.

Welcome to The Encrypted Economy, a weekly podcast featuring discussions exploring the business laws, regulation, security, and technologies relating to digital assets and data. I am Eric Hess, founder of Hess Legal Counsel. I've spent decades representing regulated exchanges, broker dealers, investment advisors in all matter of FinTech companies for all things, touching electronic trading with a focus on new and developing technologies.

All right, this is Eric Hess with The Encrypted Economy and today I'm really excited to have Lewis Cohen from DLx law firm on the podcast. Lewis, welcome.

Thanks Eric. Great to be here.

Lewis, can you give maybe a little more background about why you think maybe a small boutique law firm might be in some ways better positioned than even some of the larger firms to address the digital asset issues and what's going on?

Lewis: Yeah, it's a great question because I gave a lot of thoughts in that while I was still, I was a partner of two very large law firms who were excellent firms, and they have excellent practices in this area. But what became clear to me was that if you wanted to advise enterprise grade clients in this space, you also had to take on some of the newest startups in the.

Clients that are really difficult to handle and manage in a large firm environment. I like to say you got to get your toes in the mud and really squish around a bit and large law firms just aren't built to handle clients like that matters like that and engagements like that. And I realized that, there was a spot in the market for a very experienced lawyers who had the ability and willingness to deal with startups and new things and stuff that didn't always make complete sense.

And then apply those learnings to our larger, more enterprise type clients. And I feel very fortunate at DLX law that we've established a client base that really ranges from, fortune 100 type companies all the way down to a single person, 20 rolled. Hey, I've got an idea of things and a lot of stuff in between.

And I think that is a real advantage of being a more boutique type law firm.

Eric:

Yeah. Think

when you're particularly in a developing area, like digital assets, if you're trying to shape the space or shape your participation in it, it's easier to do. If it's, you can effectively control it.

Often I asked my guests to share something. Personal, a personal experience that helped define who you are, something a little bit about yourself, maybe a singular event that, that just shaped you as an individually.

Lewis: Sure. I mean, for that, I would say growing up on relatively modest means in New York city in a difficult time for the city New York city is an incredibly eclectic place at all times, when I was a kid in the seventies, it was our really wild place.

And yet a lot of people doing a lot of different things, some of them. Some of them made absolutely no sense whatsoever. And I think early on, I developed a tolerance for the creativity that comes out of look you're in a place where some people are brilliant and crazy, and some people are crazy and crazy.

And I think when you get to crypto, you see some of that too. So I think that was really formative for me.

Eric: Excellent. And, and getting back to the question Effie let's get into your background and pretty much what led you into creating, what I guess I would call it would be a boutique practice focused on digital assets.

Lewis: So I think really the signal point for me professionally. Was being involved in the area of securitization and structured finance. And I was privileged to ride the wave up as securitizations are took over the world. First the credit markets and then pretty much everything in 2004, 5, 6, 7.

And then of course, to watch the utter devastation that the failures in that space caused, throughout the country and throughout the world. And there are a lot of important takeaways that I think folks in the crypto space I can take from that in terms of innovation and its potential negative consequences.

I got involved in the crypto and as we called it back then blockchain and DLT spaces back in 2015, because I felt like this was an area where we could do better, and I continue to feel that way. But at the same time, an absence of learning lessons from what was ultimately behind the financial crisis, can lead to bad results.

They get a price has never looked the same as the last one, but I think it's important to learn from that. So that's really what brought me in here. I couldn't be more excited about this space, but also I bring a certain level of cautiousness. Because of what I did experience, being really very directly involved in the events that occurred in 2000 8, 9, 10.

Eric: Yeah. I can share some of that experience. I was over at Lehman Brothers at the time. So I did, they might have had something to do with it. I left actually a month before they, that happened. Anyway, but I did know. So anyway, I wanted to talk a little bit about you, your recent article you, you published with Alexander Lipton *Defi: A Pathway Forward*.

It was published in the *International Journal of Blockchain Law* their inaugural edition. So congrats on that. In that there was a quote you said regulators should find ways and I'm paraphrasing both formally. Through rulemaking and informal through the regular flow of supervisory, dialogue of incentivizing the development and operation permission, access points UIs to the many protocols developed for use in.

So before there's a lot to unpack here, obviously. That's why he wrote the article. But let's just start off with a retrospective. So if you had to issue a report card, I warned Lewis like two minutes before we started this podcast. So fair and unfair, right? Like I gave him some warning, but really not all that much.

So if you had an issue, a report card on both the informal and informal today, I'll ask you the questions in order, which regulators would you grade.

Lewis: Sure. No, I think it's a good question. And we should all think about that. We live in a world where we are evaluated whether we like it or not.

If we're in private practice, we're evaluated by our clients. If we're in government service, we're evaluated by, our stakeholders. If we're policymakers we're evaluated by the electrolyte. Correct. You know, w we were all evaluated, and I think we shouldn't be shy from expressing opinions and receiving them honestly, and openly, I think at this point, Eric, you've gotta give folks at best incomplete attempts have been made.

And I think we, we have to be sympathetic. And as someone who's been around financial markets for a long time, I really am sympathetic for the difficult job regulators have here. You know, we forget sometimes that regulators are very talented people who often can be making quite a lot more money in the private sector they're there because they care and they want to help sometimes, their positions in the public sector and the regulatory sector may make that difficult.

But you know, it is important to bear in mind. These are folks that are trying to do. You know, particularly when you look at the sec, the work that the fin hub team led by virus, the panic has been super relative and they're really making efforts. I think the question really is how much more can be done.

It's, it's an incomplete so far. I'd love to see a way that you know, staff both at the sec, And at the CFTC and other regulators can not only create sort of an open door policy, but absolutely help drive change. And it's not an easy thing to do. And it's not the job of regulators to deliver solutions.

It's the job of market participants and their counsel. But I would like to see more particularly what we speak about in the article, Eric, is the idea that. I assert fundamentally, Defi as a concept is not something that's going away. People have developed tools that allow Defi to exist, and people have shown that they want to use those tools.

They like it. They like having completely sovereign financial relationships, at a distance without trust among persons. And that is a very enticing thing to many people at the same time. It's a much wider universe. In my view of people who are willing to accept a certain level of trust in their relationships, they're happy to delegate parts of their financial lives, where regulators can do a better job of it's starting to distinguish between those two groups rather than seeking to shut down.

People who are having what in many cases are unequivocally legal and valid economic relationships privately between two peers and rather attempting to stop that behavior. To

get at a relatively smaller percentage that are violating the law what I'd love to see. And my co-author who's amazing.

Alex Leptin, if you don't know Alex in the space, please contact to have some information about him, but he's fantastic. Well, both Alex and I would like to see, as you cited in the quote, Eric is regulators like the sitting down again, formally, and informally and saying, sure. Defi is out there.

And when we find examples of people using it, wrongfully, we're going to prosecute. However, we recognize that folks are going to use that instead. Let's look at the analogy of iTunes, right? File sharing is still a, a thing using. Various tools, but I, the iTunes store and then subsequent other services like Spotify demonstrated that permissioned use of downloading music is something many people are very happy with.

And I think we'll see that with financial arrangements as well. The Defi tools that many of us know in LA. I believe will continue and should continue, regulated financial institutions and other new market entrance can, are, start to say create versions of these tools that are permissioned and allow a greater level of compliance for, regulated entities where people managing money on behalf of others that cannot work in a purely anonymous, Defi environment.

Eric: Lewis, do you think that the regulators. Might be more constrained by and I'm not picking on chairman Gensler, but on a chairman that's probably more politically motivated both publicly. You know, and I, you I guess within the agents then than his predecessors, do you think that constrains the ability of the staff, just you know, they happen now sift through public statements that are generally hostile toward digital assets.

Do you feel that sort of complicates their ability to engage in that constructive?

Lewis: It, it's a really good question. I think when you look at the situation overall, from my perspective, there, there's really one core question at issue here, and that is not whether or not most new.

Issuances of digital assets meet the, how he tasks in our securities, which has been the STCs position pretty much since Clayton and through chair. Ganzler I don't think the, either the, the commissioners or the staff have been wrong sided about that. I think the question really has to do with the digital assets themselves.

I've written a lot about that as Eric, and this is where. I think my views do differ a bit from those of the commission. The commission has maintained without being particularly clear about it that after an investment scheme has been launched through a sale transaction scheme follows the digital asset around like a bad penny.

And so at some point it no longer does with the important caveat that it might come back one day when you're least expecting it. That position was codified as it were in this idea of sufficient decentralization, the idea that a scheme follows an asset around until some point as the whole project is sufficiently decentralized, then it's no longer a scheme.

The asset itself. Is no longer a security. And then later, if for some reason the whole project we centralize, then the asset becomes a security again. And I think that's well-intended, but just an incorrect reading of the law. I'm not aware of case law that supports the idea that an asset independently can be the means by which an investment scheme is transported.

And the reason it's important to understand this. And I know you, you want to talk a little bit about the Reves test? I think the Reece test provides an incredibly important contrast assets, be they digital assets or paintings or any, which other thing earthworms have been used. There've been a myriad of assets that have been part of investment scheme.

Yeah, the problem is when those assets are sold and resold, it is not a parent and frankly it cannot be a parent to the purchaser of the asset, whether that asset is transmitting a scheme, whether it's the embodiment of the scheme or whether it's not the sec themselves, ironically enough, have made this clear in any number of their writings including in some of the.

The briefs that they've filed, where they know that you cannot evaluate whether an investment scheme is or is not present simply by looking at the contractual documents, you have to look at all the facts and circumstances, statements, implied things, all sorts of stuff. And that's fair. And I agree with that, but third parties who are purchasers of.

Cannot do the kind of forensic investigation that the sec can do. So it's simply not possible. And nor is a practicable to apply a doctrine that says an asset carries with it, a scheme. I think there are better ways of getting at that. And I think, hopefully we'll see some introduced into the public discourse before too long.

Because the sec is right to say, and this is, I absolutely concur that more and better disclosure is needed when funds are raised through investment schemes, where assets are sold, that become widely traded. So I think we agree with the sec on a lot. It's the means by which the policies which are right are implemented and they make all the difference in the world.

So I think it's less to me about a political agenda coming back to the beginning of your question and more about how you implement the law, in this case, there's just too little in mind. Humble personal judgment to a little reading of the law here and too much, grandstanding around politics in all directions.

Everybody has responsibility for that. I'd like to your lawyer, let's lawyers, let's be lawyers, let's read cases, let's do analysis and let's get that kind of stuff done.

Eric: And so as it relates to the U S market, does this, does that construct effectively? Forced the adoption of more securitized token offerings.

After you, you pass through the reg D VC angel investors, family offices, where you have an exemption under 500 for that next step. Has often been viewed as, okay. A public ICO doesn't really work in the U S obviously he's the pathway for the U S to now think of that next step as a STO or a securitized token offering.

Lewis: No, this is my short answer. And I'll tell you why our because, there is absolutely no reason why someone seeking to raise money in an investment scheme, be that a whiskey investment scheme or any, which other thing cannot and should not be able to do a full registration. Of that investment scheme or investment contract.

Again, if we swap out digital asset and then whisky and interestingly enough and I'm a fan of whiskey myself especially scotch whiskey. Interestingly enough, there have been a number of whiskey investment schemes that have been proposed recently. If that whiskey investment scheme is a security, there's absolutely no reason why that investment scheme can't be registered with the sec.

It doesn't make the whiskey, the security, even if the whiskey that's being sold is dependent on the efforts of others. So I think first and foremost, we should be able to have registered offerings of investment schemes in which an asset of any type digital or liquid, it comes out the other side.

I think the concern really is a different one. And that is, in very understandable interest in saying how are digital asset markets regulated? And there is unequivocally a concern among a number of our regulatory bodies that right now, the limited regulation that applies to digital asset markets is in.

That gets into some typical questions about what a better approach would be. But I don't believe that characterizing digital assets, which are not securities as securities simply to get jurisdiction or digital asset markets is a good policy outcome, nor is it one. I think that courts will ultimately support.

I think what we need to do is focus on, the laws at stands. Try and squeeze square pegs, proverbially into round holes, but that may require a change in the law, and we'll see how that sort of develops.

Eric: So in, in the model that you envisioned in the paper of moving toward a permissioned, a in a I guess a non-permissioned environment, does it necessitate other precursors to for regulators to start to move towards.

Lewis: Yeah. So Defi is a very unique kind of a beast in that it really allows these automated financial arrangements and the presents two different regulatory challenges.

The first is sort of financial regulatory or you know, money, transmission sanctions orientation, in Sudan. Blockchains, we simply don't know who's participating and there is unequivocally the potential, at least for illicit use.

The financial system has always benefited from a level of due diligence done by financial institutions. This does not mean that financial institutions have done a good job of it. And enforcement action after enforcement action against traditional financial institutions have demonstrated. They haven't always done a great job, but there is at least a choke point.

And I think there's a lot of fear and we saw. And the financial action task force or FATF's final guidance that was released in my two weeks ago. There's a lot of concern that a world without any choke points at all is a much more dangerous place than a world with bad choke points. And I think we can all, if we sit back for a moment, understand at least where they're coming from or why they might be concerned about this.

It doesn't mean that they're presented good answers, but we can understand where the motivation for concern lies to implement, what we thought, and, and kind advocate for in the article. The first step is addressing the permission side of things. And so that is the money transmission related issues, the potential for a money laundering, of course, our anti money laundering prohibitions and sanctions evasion.

So permission to actors that utilize. Automated money excuse me, automated market makers automated lending programs all of that can in theory work just as well with permission front-ends I wouldn't call it Defi because it's not at that point. It is got a centralized choke point.

However many of the tools could still be utilized, albeit, and I know one of the points he flagged Eric was liquidity. You'd really have to rebuild liquidity in that environment. But in theory, you could. But you rightly asked sort impliedly aren't there other precursors or issues that need to be addressed.

And the other issue is definitely the security as well as side, as I said, to the extent that the position is taken, that a given digital asset, other than perhaps Bitcoin and uh, ether. Our securities, then you, how do you get past the idea that all of these transactions need to take place on national securities exchanges?

I think the right answer is not to treat the assets of securities, but rather to recognize that other regulatory schemes are more appropriate. So I think to. Fulfill the vision that the article puts forward. We need to both have a permission front-end that allows AML and anti-sanction avoidance to be implemented and a world where activities in digital assets that are not securities are not regulated as if they were securities.

To achieve a different end. I think those are the two key elements that we do need to achieve, to put forward this. But I think there's a world where, regular folks use DFI and,

asset managers and banks and others use those same tools, but in more permission to environments.

Eric: And so in the permission context, What particular Defi applications do you see being embraced first? What's that pathway look like for traditional finance adoption? Yeah.

Lewis: Yeah.

Right now, financial institutions are there. Ultimately, like we are as lawyers to serve clients, they're not actors in and of themselves.

They don't build or make anything financial institutions serve clients who interact with the real economy and participants in the real economy of. There are things we can start to do in blockchain networks that are interesting and relevant to us, but in order to do them, we need to have access to digital assets in a variety of different ways.

And we need to price them very accurately. So liquidity is a very. Subtle sort of thing it comes and goes. When, kind of people, at least expected markets allow liquidity to be attracted. And so if we're going to have, for example, tools, we are Different kinds of, um, digital assets are used.

I'm trying to think of a good example. The one wasn't immediately coming to mind, but where digital assets are used in the real economy, then you're going to have markets that price, these accurately allow you to hedge exposures and allow you to either dispose of, or acquire those assets whenever you want at a readily identifiable price.

And I think those elements. Of traditional finance fit well in a permission environment, you can acquire the assets, dispose of them, or hedge the risk on them in a variety of different ways, through permission tools, as well as through non permission tools.

Eric: And, and in the context of traditional finance adopting Defi, how do you see that changing the narrative?

From a regulatory embrace perspective, like how, how does that evolve in, in, in does Defi become effectively? Maybe Trojan horses, the wrong word, but way that that the regulators finally start to get the pressure from the real world, like the traditional finance sector that, Hey, this is something that we need to adopt.

fits very well into our infrastructure. We're the, the throat to choke the intermediary. I dunno if that's what you meant by choke point, but we could either mean it can either mean it can either mean like a narrow choke point, which holds things up where it can mean a throat to choke, but.

How do you see traditional finances adoption of that? You know, changing the regulatory, the discussion.

Lewis: And that was a great question, Eric, and I think it will change things, quite possibly dramatically because all of a sudden things like an amenity and a middle. That's hard to say, enhancing cryptocurrencies, as FATF likes to say are perceived, why is privacy needed?

It's probably because there's some illicit activity being, going on there, so that's bad, but if institutions are interested in privacy enhancing um, assets. They're doing so for commercial reasons; they don't want the world to know what they're trading or how they're trading it. And so all of a sudden, privacy enhanced cryptocurrencies and amenity enhanced cryptocurrencies are not a bad thing, but there's something that are essential to commercial activity.

And I think we have to take another look at this. The fact is paper, money evolved somewhat haphazardly into. The solution that we have today, whereby one of the main choke points on paper money is its physicality. Especially as we started to eliminate higher denomination paper bills, and they can just very impracticable to handle large amounts of paper.

And that itself, helped, you limit the illicit use of cash, not eliminate by any means, but a limited we're going to have to find other tools and people are working on other tools. I think you've had some folks on your show that have talked about other tools. So I think, but regulators are going to have to rethink that privacy is not necessarily an indication of illicit activity.

It can be an indication of actual, very legitimate commercial concerns. And hopefully that will get, folks To recognize we just need better tools. We don't need lack of privacy. We want to encourage privacy, but to do it in a way that doesn't, raise other alarms, in terms of money laundering, money, transmission, illegally, or sanctions avoidance.

Right.

Eric: And I think I've even heard interviews like on Z cash, which is often like on the Treasury's Hitlist for these privacy coins. And the point that's been made is that, just because it's a privacy coin, Does it mean that you can't collect information doesn't mean that you can't run adapt next to it?

It doesn't mean that you, you can't otherwise get this information. It just means that the actual transactions themselves are private. It doesn't mean that other relevant information, whether it be on the permission parties or otherwise can't be extracted. So this, this distinction between permission and non-permissioned access, Do you see the regulators saying, yeah, that sounds great.

Partitioning the non-pro permission and embracing the permission.

If

Lewis: you're a regulator and you're listening, give it a thought, I don't know. I think people have to store, if I may say, wake you up and smelling the coffee, that DFI simply not going away that. I, and I often Eric likens this to the experiment experimental the United States with alcohol prohibition, between the twenties and the thirties.

And look we managed to, to have, have a hard fork and our constitution, we call that a constitutional amendment. And we had a hard fork to prohibit the use of a substance. Commercially that a lot of people wanted to use, and it did not work out well at all. It did not work out well at all.

I think trying to outright prohibit private parties from engaging in activity that they're comfortable with will not work out. And you know, I would, I say to regulators is focus on actual bad activity where crimes have been committed and, and hidden through use of Defi, Protocols go after those people, that's bad ransomware, people who hack into, hospital that's horrible and that needs to be stopped.

But, but stop spending time going after Defi, but recognize that the side by side should be encouraged. And how does that get encouraged? As we said, both formally and informally, particularly vis-a-vis bank. Thanks. Supervisors have a lot of sway over what banks do and don't do to quiet conversations that take place, with their supervisors.

And that's a way of starting to suggest that permission to access points is something that the regulators might look favorably on. If a bank has to expend capital to develop a new technique or acquire a business, they don't want it. You know that risk, unless they have some comfort that what they're doing is not going to be, get them in tremendous difficulty with their supervisory entities.

So that is an informal, sort of directional, that regulators can do today is to say, Hey, look into this. This could be worthwhile. And of course, more formally that can be done through rule-making of different types. We don't call that in our article Defi because it's not defined, I don't want my.

Hence, ringing me up and say, Lewis you know, you sold us down the river. We started with automated finance, and I think it is a different thing, but it's still a very valuable thing. And it's something that I think can exist symbiotically with the Phi because as more and more users use the protocols, there's more and more demand and more ability for smart people to come in and.

The Defi primitives that ultimately will be the more centralized, automated finance, widely use tools. And again, a sort of very rough analogy is through Linux and red hat you know, having an open source, an open system. Versus another commercial business that sits on top of it and delivers more sophisticated tools.

It's not a perfect analogy I recognize, but just another kind of angle on this. So I think we, we will see that, but it'll take a little bit of time and some willingness on the part of regulators to stick their necks out a little bit too. And we need to support our regularly or regulator friends and not, constantly denigrate them.

That's not how you get people to, to stick their necks out on your behalf.

Eric: That's true. In that context I just wonder we recently saw doing a deal with maker Dow, which was stunning. And I wonder if, we reach a certain point maybe here in the U S or even internationally.

When you have a couple of signal players, lighthouses, so to speak that adopters, that all of a sudden you've reached the tipping point where everything will start to reaccelerate again. Because now all of a sudden it's oh my God, it's really happening. Like you just need one beacon lighthouse to get pushed out over the goal line.

And then all of a sudden there'll be just like this whole. We were waiting for that signal here it is. We were like reluctant and now all of a sudden we have to embrace it, but that may be the embrace of the, what you call automated finance versus the Defi. And I You know that if, and when it happens.

And I suspect that there will be a tipping point where the, you know, and maybe not everybody will be aware of it, but there'll be meaning it won't necessarily be broadcast, but you might find a lot of institutions simultaneously moving into automated finance and striking these deals in a hurry.

Does the non-permissioned side get trampled in the process?

Lewis: Yeah, no, it's a great question. It's a real question. It is a real risk and look part of what draws so many people to Defi is the fact that it is the, not only is it decentralized finance, but it's the opposite. It's Contra finance. It's all the things that many of us don't like about traditional finance.

The stuffing is conservatism, the sort of idea that the rich get richer. Kind of, has to make, do for their own, right? Yeah, absolutely. And so recreating that is not something I'm necessarily promoting at all. I'm only saying that we need a balance and we're not going to have a world that exists without financial institutions.

I think we can all recognize that financial institutions can and do serve a purpose. We can encourage the ones that do a better job and discourage those. The tone, but I think we've we, we, we've got to have a balance. And in that balance, I think shotgun, to your example, Eric is doing incredible work in, in sticking their neck out.

Doing exactly what we said and say look, let's give it a shot. It's a small project, but let's see what happens when we use maker in this way. So I think there absolutely to be commended. There is some work on the legal side, particularly here in the U S that needs to be addressed. And I think you may have had one or both of Carla Reyes and drew handcuffs on your show before.

I can't recall. Yeah. Yeah. True. Yeah. And they're both terrific. Both of them are very actively involved in an effort through the uniform law commission to amend our state laws regarding commercial transactions to recognize functionally digital assets, which are defined in there, a new draft law.

As a controllable electronic records, I'd love to see that project continuing to move forward. Very swiftly that will help address a lot of foundational legal issues about, a sort of an instrument that is natively digital. Right now. We don't really have a good way of addressing that. And so that is, it will not stop the effort to integrate traditional finance and decentralized finance.

But it, it does slow it down because. There are some really, core legal issues there in terms of documents and the need for paper in some way or another or at least a PDF in the, in a traditional way. So I think we will make progress. I think SOC Chan in Europe is doing great work and we need other banks to get on board and start doing.

Some small-scale experiments and they are they're out there. We know of some, I'm sure there are more than we know of. And it's, it's look, it's a really exciting time to be a lawyer in this space, because we're we just have the incredible opportunity to work on some really cutting edge things.

We need more folks like and doing that. Definitely.

Eric: So, so to change gears a little bit we, we, you mentioned reviews before, and yes, I did want to talk about Reves a little bit on this podcast. This podcast has covered the Howey test before you know, starting back with Gary to wall and covering mark.

a number of others, which I'll throw into the show notes, but we haven't really touched on the Reves Test, I'll turn that over to you to introduce what the Reves test is And when is it used versus how he tests and when are both used and appropriate.

Lewis: Boy it's, this is, if I could do this in sort of five minutes or less pleased.

Yeah, exactly. Thank you. So weaves address a very different issue from Howie in the case of Reves, it was addressing the question of when a note is a security and it's completely different because a note is a type of financial instrument that is well understood. And the term notes that for four letter term appears both in the securities exchange act of 1934 and the securities act of 1933 as an enumerated security.

So right there, we are dealing with a very different type of situation. When you see something that is, as a matter of state law, a note, the question arises is it the type of note that should appropriately be characterized as a security? Both at 33 and 34 acts make clear that the various defined terms are securities unless the context otherwise requires.

And the whole battle that ultimately led to the Reece case was on when the circumstances otherwise. The difference between Howie and Reves is there is nobody labels, anything in investment contract. So you have no way of discerning where investment contract is. Whereas notes are labeled notes are they're readily identifiable as notes.

And so the question that a court. I struggled with really since the 33 act and 30 frack were adopted, I was when should a no, not be a security. And over time there were three different circuit based tests, the primary test by a long measure in most circuits before Reves was known as the commercial versus investment purpose test.

So it was a very straightforward sort of test. Is the note something, that's more of a commercial in nature. Or more investment in nature. And you were supposed to figure that out best as you could. And it was more investment in nature than it was the security of the port commercial in nature.

A couple of states had used a risk capital test, which is it's not really how the note is used is how the proceeds are used. If the proceeds are being used as a certain way to provide risk capital for business. Then that should be considered a security regardless of how widely the note is disseminated or other factors.

And then finally, the second circuit was stood alone with what it referred to as the family resemblance test, yet a third way of answering the question. When should a note not be a security? And the Reves court ultimately adopted the second circuit's approach and said let's look at, I think it was about five or six different types of notes that at least the second circuit and ultimately the Supreme court, we're definitely not security.

And those were private notes and private contacts notes in the connection of a mortgage financing you know, and other sorts of things, let's look at those and then ask, is this, one of those notes and if it is then it's not a security, good to go. If it's not one of those specific things.

Does it bear a family resemblance to one of those specific things, and then it gave you a bonus three-part tests. Thank you, Supreme court for other tests to apply. And so you can guess this didn't really resolve things adequately. The main difference though, between Reves and Howie is that. When working participants see and know they are on notice that they could well be dealing with the security.

And so they have the ability to evaluate at that point and take sort of precautionary steps to deal with the instrument as if it might be a security. Although, when a note is, or is not a

security is a problem. It's nothing like the kind of problem that the investment contract or how we test presents because it's, self-evident from a note, if I may add one subtle detail, the two definitions of security and the 33 and 34 acts are very similar, and courts have repeatedly said they should be running as if they are functionally the same.

Okay. All well and good, but the 33 act has an additional three words, which are not in the 34 act and that's evidence of indebtedness. And so one does have to ask themselves, why did the Supreme court, excuse me, the Congress, forgive me. Why did Congress include evidence of indebtedness in the 33 act alongside the word note?

Clearly evidence of indebtedness had to be something other than note. And so that does raise some issues, which I would. I don't think we need to go into here as to what exactly those words mean. If they mean anything at all. It's important. Also, since we're speaking to a lot of lawyers here, that people will remember that posture of the Reves case, the Reese case was actually a 10 B five case.

A farmer's cooperative had defaulted. On a note, their financial statements have been audited. And the audit potentially had deficiencies. And the question was there a material misstatements or emissions made in the sale or of a security under the 34 act? So the Reves case never even touched upon Devin ends of indebtedness as a defined term.

Also in Reves. It was actually a note. In fact, it just looked like a note, but I think these are some important things. Just when lawyers are. Going back and reading the case to, to think about as you go. So I don't know if that was six minutes, but hopefully that's punchy.

Eric: So let's actually link the Reves tests back to Defi because, Defi, you we talked a little bit about you know, the trading of Digital assets on Defi, but Defi is obviously so much more than just a than just trading.

There are also opportunities to create lending arrangements. We might, people might package it the same way people might say that's an NFT, whatever, but ultimately, there's this notion of trading as almost as a you know, there's something of utility that we're turning, but then there's also leveraging it for.

For lending purposes, how does the Reves test either facilitate the model that you're anticipating in terms of permission, non-permissioned, or something that, when you think of this model, it's not necessarily one of the first areas you think is going to be embraced.

You

Lewis: know, in, in pure Defi, there are no notes. So good starting point, a note as an instrument. And that's why it turned out to be useful that I was talking about the uniform commercial code known as written on a piece of paper. So an instruction given to a network, computer of computers which is all a token is, is simply.

Not a note. So there, there are no notes. There may or may not be evidences of indebtedness. And that's an interesting and challenging question of which there's very little case law, I think, as a principles basis though, I think there are concerns about how do we understand our securities laws in the context of activities that occur in Defi?

And I would say that's, that's an emerging discussion at should have, I think Point has been made frequently by some of the larger lending platforms that, that, we loosely use the word lending, but this is not lending, that happens on these platforms in the traditional sense of I don't have enough money.

Cause I'm here at the bar and I drank too much whiskey and I, at the end of the night, I say, Eric, can you spot me at 50 or something, man? Cause. I don't want to wash the dishes tonight and you lend me the money that's lending. A bank might lend the customer money to buy a house. Auto manufacturer might lend somebody money to buy a car.

The lending occurs generally speaking, when someone who doesn't have enough money and wants to do something. You, you know, gets money today, which they will repay through economic activity in the future. That's not what occurs on these platforms today, as I think people who know Defi understand rather these are more different types of exchanges where you may lock one digital asset in a smart contract and be given access to another digital asset.

I I'd argue that's not necessarily lending. Probably not lending at all. It's another type of activity and the law needs to catch up with how we appropriately characterize that activity, but it is very different from lending. And certainly it's not a note in almost every case query, whether it's an evidence of indebtedness that's its own.

Eric: Okay. So, but in classifying some of what I would call Defi applications that actually seek to leverage I would say, not the model that you referenced of locking one digital asset necessarily to, to, to, to, to, to get another one, to you look at, dApps like a centrifuge or tin lake or even maybe some of the RWA real-world asset initiatives of maker, which may or may not, I wouldn't necessarily fit in this category is a centrifuge and Timberlake.

Do you see those types of models, gaining adoption in the permission and permissions or non-permissioned, space that you're talking about? And maybe, maybe we should define a little bit what centrifuge and tin lake is doing, but basically facilitating lending on for real-world assets, where basically, it.

Your, it could be a house, it could be anything you borrow the money. And then you're basically there's a pool of participants that put money into it. So I'll kick that one over to you to sort through,

Lewis: You know, Eric, it's a fantastic question and it's almost like we planned it, but we didn't you know, from starting off talking about the financial crisis.

So one of the, most central, products in the. Crisis really that many things wound up revolving round was called asset-backed commercial paper and you are probably familiar with this product. And so it became very, very enticing. Yeah. Yeah. I became very, very in placing to effectively.

Borrow short and lend long. So when you borrow for a very short duration, typically the financing rate is very low. When you lend for a long duration, typically the return is relatively higher. And so this maturity transformation. As regulators refer to, it became a very intoxicating kind of tool for financial institutions who replicated this over and over again in particular financing, 30 year mortgages with 30 day commercial paper, I think without commenting specifically, some of the real-world asset plays do need to be really careful and mindful that they're not replicating some of the problems of the past by financing.

Longer-term. Particularly assets that may become illiquid in many of the same ways that subprime mortgages became illiquid with, you are effectively short-term IO use from tools like banker. So I think those are our projects that I would say really need to be very, very, very. Very careful about what they're doing.

Right?

Eric: From that, I take it that is not where you see the first adoption coming that probably needs more, more regulatory oversight and thoughtfulness, as in the context of institutions adopting it. Because arguably if institutions adopted, it would just accelerate those balance sheets.

Lewis: Yeah, I would say so. Think, I in complete fairness that, obviously as you alluded to before what SOC Shan did through their forge sort of business unit was financed through maker. And in some ways it does fall into that category. I think you just, you need to be really careful in doing it.

I think it is exciting. And I think conceivably, it can be done in ways that are appropriate, but it's not an area in which you would just let's Hey, everybody let's pile on the party and via board aid. It's not that kind of thing at all. That's not where you want chat to be going, send Chad somewhere else, please.

That's, that's there's a lot of risk associated with

Eric: that activity. Yeah. And when it gets, when it starts going into institutional adoption, then you get into the fancy financial engineering.

Absolutely.

Lewis: That's right. Those are not things that. That you want a mix for

Eric: sure.

So this has been an exciting discussion. Are there any things that we didn't touch on that maybe in the context of your article or in the context of the discussion that maybe you thought we should explore a little?

Lewis: Yeah, I not quite an out, cause I don't think we touch on NFTs directly in the article, but I do want to give a shout out to the world of NFTs and not just because, sort of it's the hot thing today.

I'd actually tweeted about this. I was very proud of this, I think back in. Like late 7, 20 17 that that NFTs were really the beginning of the blockchain era. And that's because and Eric, you've probably heard me say this before. We are in the kind of crypto blockchain community or get past the regulatory hurdles that we see before us as looming so large, the way.

Kind of put it as a is my particular websites. We have to win the Thanksgiving table. What does that mean? We have to get real folks. We're not in the crypto bubble that we live in to say, wow, digital scarcity makes sense to me. I feel like I can do something that I couldn't have done before because of it.

And as a result, I'm actually either creating new economic activity or engaging, or my life is better in some way or another. Not just because number one, which is not a bad thing, but we need to get, that, that folk, those folks beyond the crypto bubble NFTs really are the way to do that. To introduce people, to the idea of digital scarcity, blockchain, public blockchain technology is absolutely essential to the very concept of NFTs that you can own something through a public record that everyone can see and can be transferred smoothly and easily without trust.

As more people understand what NFTs can do and start to expand the way they engage with NFTs. More people are downloading Metamask, they're getting engaged. They're only ether. Now they're figuring out what Solana is. Oh, that's better. That's worse. They're using side chains now they've owned some crypto and they want to hedge it a little bit and they're coming into.

The world of digital assets in the right way because they're using it for some productive activity. I'm particularly excited by projects as up to us as loot in which people sold NFTs with just words, lists of words that you know, were designed to be creative you know, other things, I'm them, I'm excited about projects with.

Some of the board apes are being used to generate a whole new kind of worlds of stories and different things. The crypto fund guy, whatever they're called are doing incredible things. There are all these projects now that are just driving creativity. And ultimately that will redound to the better.

Of define these financial things because that's why this stuff matters. Otherwise it's just a big sort of internal game that we're all playing with ourselves. When crypto is used outside of the small bubble, that's when we win. That's when regulators will start to say not how do we stop this, but how do we help this grow and develop?

And I think we'll get there. So maybe my parting words, Eric, from my end are like this Thanksgiving, let's have those conversations and hopefully we start to see. Regulators, policymakers, and others, like listening to nieces and nephews, talk about all the reasons they're excited to be in the crypto space and all the way that they can't wait to see what 20, 22 brings.

And I think as those conversations happen, we will be in a really exciting and amazing place you know, next year. Yeah,

Eric: no, I, I completely agree with you on the NFTs. I think. It's often said that innovation is overvalued in the short term and undervalued in the long term.

There might be a hype cycle associated with NFTs, but in the long-term it has tremendous value and we've only scratched the surface. And Lute's a very intriguing example because it is truly generative versus. You are requiring you to access it from a service salute is sort of unique people looking at it.

Like I didn't get loop initially. I was like, what's the, it doesn't, it didn't make any sense to me, but once I got it, I was like, oh my God, it is revolutionary. It's like crypto punks back in the day. And how revolutionary is. I was I'm a little too late to figure that one out.

There'll be,

Lewis: others may be tying us all the way back to the very beginning of our conversation. Yeah. I filed that under good, crazy I, I'm finally getting around to listening to the Barack Obama book and he talks about, kind of good, crazy, and bad, crazy, and we need better, crazy, and loose.

Good, crazy. And I think blockchain and digital assets and crypto is driving. Good, crazy. And we need a lot more of that kind of creativity. In the space and more folks just to get involved and bring your good, crazy, please.

Eric: I don't know how I can top that for a closing remarks. Lewis, thanks so much for coming on the podcast.

It was a pleasure to have you.

Lewis: It's a pleasure. Thank you, Eric. Really appreciate it. .