Eric: [00:00:00] When Lewis Cohen and Dlx Law released their paper titled *the Ineluctable Modalities of Securities Law, why Fungible Crypto Assets Are Not Securities?* On November the 10th, one thing became very apparent that both the Encrypted economy and the Law of Code podcasts would both wanna do episodes on it. It is a very important paper and it's not just any paper. The SEC has embraced their investment contract analysis under Howey as the basis for finding virtually any digital asset is a security more important. However, the s SEC's analysis is based on a classification model that wants a security, always a security, or what is known in the paper as the original sin theory of a security. Now this paper meticulously analyzes all the jurisprudence around this investment contract analysis, particularly as it relates to continuing classification of an asset as a security in the secondary market. [00:01:00] So Jacob and I decided to do one podcast and split it, upping the pressure, of course, to make it a solid podcast or podcasts throughout.

In episode one, we discussed the journey of this work and the rigor that went into it. The reactions, misconceptions, relation of disclosure and information asymmetries to the analysis. The SEC's current interpretation versus jurisprudence. The constants that emerge in their investment contract and analysis across the three 50 cases, they reviewed what it means for Ripple and this notion that an investment contract is meant to capture broader investment schemes.

Now in this episode, we delve deeper into the characteristics of judicially recognized security instruments. Why case law points to a different treatment for secondary markets versus primary. How this relates back to early cases like telegram and recent cases, recent summary judgments, I should say, in the SEC's case against LBRY of New Hampshire. Consumptive use cases [00:02:00] and how they factor into it, how Hinman mis framed sufficient decentralization.

Of course, Lewis is a little kinder, maybe calling it more an outcome focused interpretation, but at any rate, there's a lot of substance here, and if you're really interested in whether digital assets are securities or not, and the different interpretations and whether it's actually even judicially supported, this is a podcast for you.

So, I hope you enjoy it. But if you like it, share it, save it. And with that, I bring you the second part of the podcast episode with DLX Law regarding their unelectable modalities master work paper.

Welcome to The Encrypted Economy, a weekly podcast featuring discussions exploring the business laws, regulations, 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, and all matter of FinTech companies for all [00:03:00] things touching electronic trading with a focus on new and developing technologies.

Jacob: Do you think that given your analysis of the how we test and I'm sure everything's surrounding it, and since then, was it intended to capture any secondary transactions? And if so, under what circumstances?

Lewis: Yeah, I would say it was intended. This is gonna be tic in, in those instruments that are security. So, in my example of there are actual legal instruments that represent a relationship with an issuer like the shares. And she. And the variable annuities in Vedic. And I think secondary transactions in those probably should be considered securities transactions because those are instruments that can be identified.

So that's a very small subset of the total Howey cases, but I think That's different. Greg, do you wanna talk maybe a little bit about we have a small part, but it's quite important I [00:04:00] think, about the Reves test, which is really separate and notes and how that sort of, I think, presents a very helpful contrast.

Again, this is very technical, I know but hopefully some of your listeners are up for hearing about this level of technicality, but it's a very important point.

Greg: Yeah, sure. Thanks Lewis. So, I think Lewis was just talking about the instruments in in those two cases. And the instrument's purpose is really to put anyone who comes into contact with the instrument on notice as to what the rights and obligations of the parties to the instrument are.

And when you have an instrument of that, I could give it to Lewis and he could read it and he could understand that okay, if I'm gonna accept a transfer of this instrument from Greg I'm gonna step into his shoes and I'm gonna have these rights and obligations under this agreement with [00:05:00] whoever the counterparty to the instrument is.

And he would probably be on notice that that those rights and obligations might be treated as a security under the law. And so that's really how it works with notes. A note is a written instrument that contains a promise to pay generally speaking. And notes are one of the enumerated items within the definition of a security and the 33 and 34 act.

And the Reves test is the test to determine whether or not a particular. Should be treated as a security or not. And there's a presumption that notes are securities but that presumption is rebuttable. And so certain notes are not treated as securities when they don't really have an investment character.

And so, a note associated with, a commercial [00:06:00] financing or a consumer financing would not likely be treated as a security because the purpose of that is not to make an investment, it's to buy a house or a car or something like that. And so, the Reves Court looked at a list of notes that sort of should not be treated as securities and set out that list. And then they also devised a test to determine when notes that are not specifically on that list should also. Not be treated as securities called the Family Resemblance test. And there's a presumption that notes are securities because anyone can pick up a note and they can see what the obligations look like, what the rights are, and it's pretty straightforward.

And I think the problem that we wanted to address in secondary transactions and digital [00:07:00] assets is that there is no such written instrument that would put the participants in a secondary transaction on notice of the investment contract scheme that may have been present when the digital asset was initially sold.

And so, this idea that the asset. Embody all of the facts and circumstances relevant to the original transaction without actually having any means of putting an acquirer of the asset on notice of those things we think is pretty problematic from a securities law perspective. So, I'm, maybe Lewis, I'll turn it back over to you at this point.

Lewis: No, I think that's exactly right and I know we're widening down our time, so probably have the last couple of questions. I just wanna flag one small point, but it's, [00:08:00] while we're being technical, we talk about secondary transactions.

There are, it's really all cases other than, where there's a fundraising transaction. And another example is in a custodial relationship. You need to know sometimes are you dealing with the security? There may not be a transaction as such, but again, you may still need to know. So, it's really in, in those circumstances where law abiding, good faith actors just need to know and one thing we may a point we make in the paper, but I don't think we've made here:

most of our securities laws are strict liability. They don't, there, there's no, "I wasn't sure. I didn't know." If you make a mistake, you will have liability regardless of how hard you tried to figure it out. And so, I think, it is very reasonable to say that the law was really not designed to create gotchas for people who are good faith actors.

Again, these are not, to take away from any liability that the original schemer had, but just to simply put an unknowable and unsatisfiable burden on third party market [00:09:00] participants is just simply not something that the law, in any other circumstance does. I think when you step back a bit from this and look at it, common sense as well, hang on a second,

how can it be the case that someone who. If you were a dealer in lawnmowers, you wouldn't really be expected to undertake a 32- or 65-part test to figure out at any given time. Whether that, lawnmower was really a security and it's really the same with digital assets.

Eric: Do you want to talk a little bit about cuz I, we were talking about secondary transactions and I know that Hawking has come up, has come up a number of times with regards to assessing the application of Howey to the secondary market.

Lewis: Greg, do you wanna take that one? Maybe?

Greg: Sure. And actually, when Jacob asked earlier, what was what were your key takeaways having, gone through all the analysis and written the paper? I think this is what I [00:10:00] was gonna talk about, which is, there really is a lack of Howey cases that apply to secondary transactions.

And I think that's probably for good reason because most of the assets associated with investment contracts over the years really have not been the types of things that you would expect to be to be transacted secondarily. But I think we do have the Hocking case, which deals with a transaction that was not actually initiated by the original sponsor of what one might call a scheme.

It was initiated by a real estate broker. Who was assisting a purchaser in buying a condo unit in Hawaii to rent out and to make some money. And the real estate broker, [00:11:00] indicated to the purchaser that there was an opportunity to obtain a rental pool agreement in connection with the purchase of the condo.

And so here we have a real estate agent that was found to have sold an unregistered investment contract in connection with the sale of the condo. The initial developer of the condo was offering the same thing, buy a condo, enter into a rental pool, a. And we'll manage everything for you and you can make some money.

So, I think the court says in Hawking that, that looks a lot like an investment contract scheme and then goes through the analysis anew with respect to the specific transaction at issue, which did not involve the developer but did involve a [00:12:00] separate person who was, selling the condo.

and assisting in getting the purchaser into one of these rental pool agreements. And so, the key takeaway away for us there is that the court didn't say, because we think the initial sale of condos packaged with the rental pool agreement by a developer makes that arrangement a securities transaction every single time thereafter.

They said, that's not what we're doing. We're gonna reapply Howey to the specific facts and circumstances surrounding this transaction, and we're gonna make a determination as to whether or not we think the four elements of Howey were met. And that I think is the way that Howey should be applied because we don't believe that security attaches to the object of an investment [00:13:00] contract because it's initially sold in a transaction or scheme that meets the elements of Howey. And so, every time there's a transaction you know Howey should be applied.

Jacob: Regarding the limited nature of investment contract analysis, particularly how judge Castell approached this in the Telegram case. Do you think that was the correct approach? Do you think he recognized the limited nature of this analysis in his approach, Lewis?

Lewis: Yeah. I wouldn't say, I wouldn't call it limited is the only thing, but I think he had a great as someone who one presumes had little or no exposure to, to crypto assets prior to his taking on that case.

I think he had a lot of insights into what transpired. Basically, what he said was twice the. The investment contract and the [00:14:00] security in the Telegram case where grams were initially privately placed with sophisticated investors, the investment contract was not the gram itself, but the entirety of the scheme.

And he makes that very clear to people. And I think he just really understood how the law works and how it's applied. And I think in many ways it, it is pretty common sensical. When you look at all the case law, it's not really that difficult a case. I think it only were. There's a separate agenda to create a regulatory framework over secondary markets that you start getting tangled up in these other principles.

Yeah, and if you want a short answer, cuz I know you gotta run, I will say Costello's decision is a, is a strong one, thoughtful and probably the best reasoned district court argument to date. No. That was just the, he is a southern district. It was only. Yeah. Of New York for everybody's benefit.

Yes. As if there were other southern districts out there that [00:15:00] mattered from now. Very bad. Southern District of New York.

Eric: So, I'm gonna shift gears to the LBRY decision. And as part of that also gonna start talking about districts and whether. Maybe, analyzing LBRY from the context of a of that jurisdiction, that district and how that actually potentially matches up with other case law within that same jurisdiction.

Again, one of the questions that I wonder is whether this case against LBRY was chosen for, it's for where they thought it would be for where it would be litigated and whether they thought that they would do better in New Hampshire than they would in let's say New York or Florida or Texas or somewhere else.

Lewis: I dunno, Greg, if you just as a former litigator yourself, take a first shot at that. [00:16:00] I think just acknowledging that, obviously Eric, we have no idea what factors were taken into account and can just speculate of course,

Eric: we're speculating.

Greg: Yeah. I, I've heard a lot of people ask that same question and I, I've heard different sort of thoughts on the response.

For me, I don't know that it was necessarily like, an attempt to file the case in a jurisdiction that would be more favorable or not. So, I don't personally put a lot of stock into that theory. That's just my take.

Eric: Fair enough.

Lewis: Maybe I'll just add to that, Greg. Obviously, the SEC has brought, at this point, at least what, 20 enforcement actions on ICOs, somewhere in that ballpark.

And remember, there's a lot of work that gets done before the enforcement action even commences, [00:17:00] the prosecutors involved at the commission don't know who's gonna settle and who's not. They may have a guess as to who's more likely to settle, but they don't really know. So, it's important to bear in mind just on that theory.

One doesn't know whether, a particular company that an action is brought against is gonna settle or not, or if it's gonna, make its way all the way around to litigation. To be hyper-technical, I think you may be alluding to the presence of a relatively favorable case s e C versus s g Limited, which was a kind of interesting and slightly unusual case, which is in the first circuit.

And where the Southern district, or whichever district of New Hampshire they were in but fundamentally, I don't think that changes things in the SG case. It was a sort of unusual

Ponzi scheme in the early days of the internet in which something was presented as a game in which you can buy imaginary stocks and imaginary companies and. [00:18:00] Potentially make money or lose money. And there were certain imaginary stocks that were special and you were told you'd only make money if you gave us that. And they just, Ponzi did and gave new investors money to, to the former investors and, until it exploded. A Ponzi scheme is a Ponzi scheme.
That was, people sometimes I think colorfully refer to crypto as a Ponzi scheme, but it, whatever it is, and you may not like it, but it's not a Ponzi scheme. This was a Ponzi scheme in that there was an operator, the operator took money from later investors and gave it to older investors.
I don't know. I think the SCC liked it because it was, is a looser example of an investment scheme. But at the end of the day, the issue with libraries are a bit different, but I'll let you, I think you've probably got some follow up questions on that. And I know, Greg, you were gonna talk a bit more about, that decision.
Yeah. And
Eric: so, I jumped into the jurisdictional question for LBRY without even maybe taking a step back on the, on, [00:19:00] on introducing it and the significance of LBRY. It was a summary judgment motion that LBRY ultimately lost. But it unlike a lot of the prior ICO cases, the facts were certainly would be more supportive of it being found to have not been a security by most analysis and certainly the analysis put forth in the paper.
Maybe let's take a second to just sketch out the contours of that dispute and then maybe dig a little bit into it. Who wants to take that one? Greg's raising his hand.
Greg: Yeah, that sounds I'll get us started. How about that? So, I think, LBRY was around before the Dao report.
And I think when we think about the s e c guidance with respect to digital assets, crypto assets and the securities laws the Dow [00:20:00] report was really the first marker that the s e C put down indicating that that they were going to be viewing. Arrangements involving digital assets to determine whether or not they constituted securities and that, if they did constitute investment contracts the arrangement constituted an investment contract that consequences would flow from that determination.
Around, whether or not registration as a broker dealer, as an investment advisor as an exchange, all of these other sorts of regulated participants in the securities markets. That we see in traditional markets when they're engaging with securities, they need to be registered.
And those are strict liability offenses if you fail to do that. And so, the Dao report laid all of that out and the SEC filed a, an action against LBRY in March of [00:21:00] 2021 for, allocations of the LBC token LBRY credits token that occurred starting in 2016 before that guidance had ever come out in the Dao report.
And but continuing, over time. The SEC's allegation is that those allocations of tokens which, by the way were sold, after the blockchain had been developed, so they weren't

sold in an effort to actually fund the development of at least the initial sort of version of the blockchain,
or the protocol, and so it is a little bit of a different context than some of the ICO cases that we saw in 2017 where people were, creating [00:22:00] assets, selling them, and then telling everybody what they were gonna build, using the proceeds to fund it. And so, the s e c brought their action,
and I think just like stepping back, a lot of people held that project in pretty high. They were communicative and I think there were a lot of questions about of all the things that are going on out there in this space, how did the s e c choose to devote its resources to this project when I think a lot of people saw lots of other things happening
that, seem to be more egregious. And so, I think that sort of leaves a particularly bad taste in the mouth of people in the space with respect to this particular action. At the end of the day the s e c I'm skipping [00:23:00] way far ahead, so please fill in with questions if you want, Eric.
But at the end of the day, there were motions for summary judgment filed. The court agreed that the s e c motion for summary judgment should be granted that the motion for summary judgment from libraries should be denied. And so, we're at the very tail end of this case at this point where the only open dispute is with respect to the appropriate remedies that will be imposed at the end of the case.
And I think after the summary and judgment order for the s e C was entered. The court instructed the parties to discuss what the remedies should be and try and come up with an agreement as to how that should work. And I think the parties were unable to come to an agreement. And there's expedited briefing with respect to remedies that is I think due either today [00:24:00] initially and then a response and a reply.
I think within the next week or two weeks, we'll be able to see what the parties say about the appropriate remedy given the summary judgment order. But I think getting to the actual meat of the order, the court uses language that really, I think indicates that the court viewed the L B C token itself as security.
It says in a variety of places that LBRY sold the LBC token as a security. And so, it's really difficult to know exactly what was going on in the judge's mind when he was concluding that LBRY was selling the token as a security. My inference is that he's saying LBC token is a [00:25:00] security.
And that obviously is contrary to the arguments that we set forth in the paper where we think the better way to go about it would be to say, if there are facts sufficient to establish the elements of Howey. You apply Howey, you determine that there is a security and that the security at issue is
all the facts and circumstances around the allocations of those tokens, the sales of those tokens but that security shouldn't attach to the token itself. And so, I think it's very easy for judges at the district court level to get locked into the facts. And also, because they're usually not confronted with any sort of allegation related to a secondary transaction.

It becomes very easy to just say, okay, yes, the token is a [00:26:00] security. We've found that you violated the securities laws. If the judge feels that these transactions, are securities transactions, which is what he found, he could have also said I find that there were investment contracts that were unregistered.

Without, taking the step to say the token itself is a security. So, I think, one of the questions that that we had talked about in preparing was, how would this look under the analysis that we set forth in the paper? And I think, without getting into the facts, relied upon by the court to reach the conclusion that there was a securities transaction, we would've preferred it if the court had said there was a securities transaction based on the facts. But didn't take that second step to say that the L BC token itself was sold as a security.

Eric: There's [00:27:00] even arguably I think, a compelling case that due to the presale and due to the fact, due to the consumptive use case, I'd love to hear you develop a little bit on it, that it also wasn't a security for those reasons, that the nature of the distribution really didn't align with that finding, or at least certainly narrowly aligned, particularly as it relates to deeming the token itself. Like it's odd that under the facts and circumstances, th in this particular case, they went to the token. Given the way it was, given its distribution, and given its consumptive use case, I'd love to hear one of you develop on that a little bit or respond.

Lewis: Maybe I'll pick up on that one there.

Yeah, so it's a great question. Eric and what I'd say is that I think there's both a legal question and a factual question that somewhat got overlooked in the judge's decision. Under the case you referred to earlier, [00:28:00] foreman the Supreme Court held that when shares in a cooperative apartment were sold, that those were not securities transactions.

I was standing the fact that they were couched as shares because the primary purpose of the people buying the shares in the cooperative apartment was to dwell on the apartment. And there were a variety of other, factors that were cited that. Caused the court to conclude that it was a bonafide, decon consumptive purpose.

They, it was, rather than signing a deed to a property, they were acquiring these shares in the cooperative. In order to dwell in a particular apartment. And since then, the courts have pretty consistently viewed consumptive use as somewhat of an exception to the Howey test. If there's a bonafide intention to consume something, then that's the opposite in effect of an investment intent. And you're not really seeking to profit, you're seeking to consumer or use whatever it is that you're buying. The [00:29:00] judge largely dismissed in LBRY. The judge largely dismissed this idea that some of the purchases, purchasers of the LBC token had consumptive intent, and were we're doing that.

I think, to, to my mind as a matter of law, just dismissing that outright without, a fact finding at trial is not really appropriate. He concluded to the country as a matter of law that it was irrelevant whether or not there was bonafide consumptive intent because the structure of the transaction, which really is something that's very typical of almost all.

Blockchain based projects. The project team retained a significant portion of the original tokens presumably for later sale, and that because of the alignment of interest of the project team and the other LBC holders. Vis-a-vis the tokens that of necessity, the only possible [00:30:00] reason that you could realistically buy are the tokens was for investment purposes.

And hence, as Greg was saying a moment ago, they were sold as securities. I'm not sure Greg. I agree completely that he meant they were securities, but it's ambiguous. And the fact that two reasonable people can, disagree about that a little bit, just shows you what does it mean you sold it as a security.

In any event, the consumptive interest was waived off, and I think the litigants would've been better suited if there was a fact finding on that. Nevertheless, even if you had the facts finding, there would still be a question of law, and that question is, To what extent, do like how do you apply Howey In those cases where perhaps some of the transactions were with a consumptive intent and others were of an investment intent, I think at least one purchaser identified, put them in a cold storage wallet and held them and seemed to have no [00:31:00] consumptive intent whatsoever.

So, are those investment contract transactions and others not? I think, but that's the tangled facts that a really, a trial would've brought out. And I think by deciding this on summary judgment the judge unfortunately missed the opportunity to have a more nuanced understanding of what was going on.

Eric: And, whether it's in fairness or maybe even in, in criticism of the judge, in this case, it was a summary judgment decision. And to wade into areas of the law that extended beyond the kind of review that you would do. For example, in Ripple, like you may not like what ultimately comes out of Ripple, but one thing's for sure that Judge has understood, has read everything up and down. There, when the opinion's released when the decision is made, it will be well reasoned. It's Clear. It may not be reason everybody likes, but it will be well reasoned, it'll be fully [00:32:00] informed, and it'll obviously carry a lot of weight.

In this case perhaps a summary judgment nature of it makes it less weighty, yet it's still it's still relevant precedent. And also, sadly for the case of LBRY, they are out of funds. They're not gonna be able to appeal it. And this is gonna be hanging out there. Having said, it in many ways, it doesn't really what happened in LBRY is in many ways in opposite to, to the points that you're raising in your paper, cuz you are fundamentally getting to the secondary transactions.

And if the law would recognize that, hey, when you first do your issuance, you do have to register. But when, but subsequently during the secondary transactions the, there, there're no longer securities under the Howey test that actually would solve a lot of problems. Because it's often this notion of the secondary market that [00:33:00] gets very c complicated as it relates to digital assets. I don't know, maybe you'd wanna comment on that.

Lewis: Yeah. It is an opposite, I would say in that really, we're, there are a lot of nuances when tokens are sold by the person that initially created them.
And there are a lot of policy issues and other concerns around that. And I'm not saying those are all securities transactions, only that those are complex and different questions and really, should be treated elsewhere. One of the things we cite in our papers, the tremendous work done by
one of the SEC's Commissioners Hester Purse to create a safe harbor for the front end. Really a different issue than we're dealing with. And then another group of lawyers that I think you might participate in Lex Punk riffed off of that and expanded and elaborated on it.
And I think you called it Regulation X in, in, in theory, at [00:34:00] least. Recently, I thought today, earlier today, Coinbase published something that was another. Take on that. Which they propose for rulemaking in which the tokens would actually be treated as securities and trade in some sort of regulated market, but eventually could change out of that status. That, that's broadly speaking, not something we think as an optimal outcome. But yeah. So those are really, as you said the ultimate light LBRY was just a different set of issues than the ones we're dealing with in our paper. I'd love to maybe have one of the team talk a little bit about this idea of morphing.
I know we're running out of time, so I don't know if you're the mc, but if we could get a because I think that's, it's a super interesting question and I don't know if Sarah Freeman, Greg wanna talk at least a little bit about morph.
Greg: Yeah, I think I'll just jump in. I think, we need to [00:35:00] have a way for all of this to work practically.
We talked a little bit about notes earlier, and there's a presumption that a note is a security because everybody, when they look at a note, they understand that, okay there are rights and obligations here. It's likely to be treated as a security. And then there are some ex- exceptions to the rule that a notice of security.
For certain identified circumstances. The problem with morphing is there's no way to know at any given time whether a particular digital asset continues to embody the elements of an investment contract or not. And, without a very clear threshold that is accepted by both the industry and the regulators for making that determination.
It is a practically unworkable state of affairs. [00:36:00] And that's particularly true because as we discussed earlier, intermediaries are subject to strict liability for failing to register. And if a participant or an intermediary in a transaction involving digital assets has to apply the Howey test to an asset every single time it is transaction transacted and in a transaction that they're involved in to determine whether at that moment in time the asset should be treated as a security or treated as something other than a.
Then that's, that is just not a workable situation, practically speaking. And so, I think the concept was well intended because we needed, we needed a way to distinguish [00:37:00]

assets that had that were associated with protocols that had matured very significantly over time.
But I think from a practical perspective it presents problems and also, I look at sufficiently decentralized as more of a proxy for a central managerial effort. And whether or not, the initial sort of sponsor of the asset continued to play an important role in the development of the of the protocol or the asset or what have.
But sufficient decentralization does not have any basis in the law or in the Howey tests. So, unless you view it as a proxy for essential managerial efforts there's not a lot to support that idea conceptually. So, I think there are lots of practical [00:38:00] issues with this idea that a digital asset can morph over time.
Eric: And the Hinman test was what, 2018? It was about a year before they came out with the DLT framework and started to refer to AP or active participant. And in, in many ways, I think Lewis, you made a point that that the sufficient decentralization was really intended as a proxy for that because, One of the things, and again, going back to your paper when I was reading your paper and I specifically got to the discussion regarding the Hinman test, I really I like when I said that, that the paper kind of read itself for me that actually was true as and some people will say that.
It was a pace. Honestly, for me it really was. Which, that, that may say something about me as opposed to, what a normal person. But when I got to the Hinman the test section, it really [00:39:00] I, I thought applying the paper in the context of the Hinman test, really made you see like the flaws in the Hinman speech.
And I think you used the term and you know I'm summarizing, but I'm, there's Lewis's words. It was very results driven. I called it Warped. Lewis corrected me and said, no, I think you mean the results driven. So, I'm, I can be a little more inflammatory cause I'm the podcaster. But it more results driven and. It's, it may have and Jay Masar made this point in her paper. It did solve a problem for Bitcoin and Ethereum at the time. Like how we make sure that everybody who's buying this doesn't have to like, where oh my God, I got Ethereum.
And it creates this big run cuz everybody's in it now of course it's proof of steak and the S ECC might be, throwing some shade on that original analysis. But what it did in many ways, and I'd love to hear your comment on this is I [00:40:00] feel, particularly in my practice, I find like I almost wish we could drop the word sufficient decentralization because it just, it's the wrong test, it's the wrong thing to think about it and
this is, I know there's a little bit of passion in this, but it drives these projects to pursue this Excalibur sword, which they're never gonna achieve. And it's a warp test and it's warped the whole way. The digital asset space has approached things like DAOs. I did a podcast with Dan Lund talking about the, Doos DOS and os because a lot of Doos aren't, truly, don't have those, all those features, and sometimes they're not even sufficiently decentralized and it's the wrong thing.

To focus on. It's not productive for our society to continue to focus on that as a regulatory imperative. But maybe someone else wants to
speak about that. Sarah or Freeman.

Lewis: I'll jump in just quickly cuz [00:41:00] we're wrapping up especially. Okay. Yeah, no, I think that that's great.

The idea of sufficient decent centralization, I think it was, a good results-oriented ID at the time. It does not stand up as a fundamental jurisprudential concept, and it's not because I wanna clarify freeman, you've noted correctly that it's cumbersome and difficult, which is true, but that's not really the problem.

The problem if it were just cumbersome and you're like, oh, it's those crypto people whining again, it's that it's impossible. That's the point. It's not just cumbersome, it's impossible. Because the Howey Jurisprudence makes very clear that all facts and circumstances need to be taken into account whenever one is trying to figure out whether a particular contract, transaction, or scheme meets, meets the test.

And that very much and very clearly include non-public statements. There's nothing [00:42:00] remotely that suggests. It's limited to information in the public sphere because all Howey cases relate to transactions in retrospect with parties who were dealing with each other. And so, they obviously all knew what was going on because it went for that relationship.

And an example I like to use without any, Specific token is, let's say token X concludes that is sufficiently decentralized y because they had a white paper three years ago, and in the white paper they undertook to do five different things and they undertook to no longer be doing two other things or whatever it may be.

And so here we are X years later and they've done all the things they said they would do and they're not doing the other things they said they're not doing. And therefore, wow, we're sufficiently decentralized. Isn't that. Wonderful. So, people say, whoof, now I can trade this token without it being concerned about being a security transaction.

And two weeks later, for whatever sad reason, the founder comes along and makes [00:43:00] a bunch of new promises, tweets 'em out with rocket ships, and moons and gives specific prices. This token's gonna be at a hundred bucks in six months. Man, if my life, I'm putting my, everything I got on this man, go all in.

and what are you supposed to do with that? Did that one tweet, did that one, statement. Did that one blog post. Just read, destroy everything. Start again. Security again. How does that work? What if it wasn't a tweet? What if it wasn't a public statement? What if it was a statement, he or she made just at a dinner party?

But with a bunch of influential people, maybe a couple of journalists and a venture capitalist, they hear it. They start telling others maybe they don't remember exactly what the founder said, but they got the idea, right? And it starts, hey, I heard that. How does that work? Are people who are dealing in that asset now supposed to some people who, whoa, we should get ahold of [00:44:00] this one because the founder's gonna build and add all these things.

It's an impossible test. And I wanna cite something as we wrap up here. It's the very last quote in the legal part of us of our article and it's from an important Supreme Court case called Landreth versus Landreth Timber. And in that case, the court was looking at another arrangement in whether or not the securities law applied and the court says just as they explain they write as we explain in, in a in a recent case, decided the same day.

The coverage by the securities acts, if that this other position were adopted would be, in most cases, unknown and unknowable to the parties at the time the transaction occurred. I'm slightly paraphrasing. It's on page 102. These uncertainties attending the applicability of the acts would hardly be in the best interest of either of the parties.

And then they [00:45:00] cite another of the Supreme Court cases, no Marine Bank versus Weaver, and they characterized that Marine Bank case as rejecting the argument that an object of a scheme. In that case, it was a certificate of deposit that the object of a, the scheme there was transformed chameleon-like into a security

quotes in there, once it was pledge. The Supreme Court clearly understood that this idea of morphing just does not make any practical sense, and I think the words unknown and unknowable to the parties at the time the transaction occurred is really the key thing. This is not about, winy crypto people.

It's about law abiding citizens in doing the best to apply the law. We can't create a legal framework that is unknown and unknowable, and that's really the bottom.

Eric: I'm, I got one last follow up question. When I when we were preparing for this and I was going through the [00:46:00] paper I didn't initially connect the informational asymmetry point as neatly as I did in reviewing it in preparation for this.

So, I'm going to underscore it just for the, just for others. So, when you take a look at Howey and you say it doesn't really capture secondary transactions, what I'm suspecting, and I'd love to hear your thoughts on it, was that you said, hold it. We don't want to just simply say that Howey doesn't apply to secondary transactions because the retort is going to be, hold it.

Then what are you saying? Nothing applies. What I suspect, and don't let me put words in your mouth and frame it, was that you said, yes, it, it does create this vacuum where it doesn't cover those secondary transactions. But the way that you would address that is through thinking through informational asymmetries and the disclosure regime that could capture [00:47:00] some of the things that you're concerned.

But that's not within Howey, Howey doesn't require that. It's something that you have to recognize as a limitation of Howey, of all these things you're trying to drive into Howey, that you're trying to create this massive, expansive interpretation of Howey Pardon? Of my my, my framing of it. And it doesn't w it doesn't work.

And the limitation needs to be addressed through another avenue. And that's why you chose to link this sort of notion of information asymmetry. With the analysis of Howey in the paper to cover that, that if you accept the premise of the paper, then you immediately identify there's a shortfall in Howey.

Lewis: Yes. No, that's exactly right. And there's some, a variety of great legislation that had been introduced. One of those, the Lummis-Gillibrand Responsible Financial Innovation Act does endeavor to address this. By adding to the Exchange [00:48:00] Act and creating, it would create a new Section 41 and the Exchange Act, and that would address this gap in information.

The problem of information asymmetries by stating that if a project team sold something and it's any intangible asset, but most likely a crypto asset if it sold that asset and that asset albeit not a security became widely traded, then at that point, the project team that sold the asset to raise the money got a benefit because they got this liquidity from an asset and the consequence of getting that liquidity.

Is the statute the new section 41 would impose disclosure liabilities on the team that raised the money. So, the disclosure is now attaching not to the asset, but to the investment contract transaction where the money was raised, and that allows the statute to work in a much more sensible way by toggling not whether a [00:49:00] token is or is not a security on and off, on and off, on and off, like a light switch.

which is, wholly impracticable to something that we well understand as securities lawyers. Does a particular company have reporting obligations or do they not? And that is something that's toggled and it puts the burden of figuring that out on the party that raised the money and the party that's best positioned to bear that burden and figure that out, work with their counsel.

and they have, by the way, a simple way. If they're uncertain about the status, the whole project doesn't die. And there's a summary judgment and there's an injunction and the whole thing is shut down. They go through another year of providing transparency, and at the time when they're no longer required to provide reporting, they can stop and move on. And so rather than this kind of draconian and unsupported idea that if they're information asymmetries, we just have to shut the whole project down, or cause, [00:50:00] the company to register the token as a security. Just doesn't work.

We have a much better solution out there, and hopefully in the next Congress, whichever, set of committees in either the Senate where it originated, or in the house, we'll take that up and find a way to incorporate that as part of a practical solution to address legitimate concerns and not create impossible tests for market participants.

Eric: Great. I think that's a good anything else that we should cover before we, we wrap up.

Lewis: David, why don't we go around the team and let everybody get a last slot in.

Jacob: Yeah. As I reiterated at the start it's very much a discussion draft and I think we're looking forward to welcoming comments with open arms and if you have any thoughts or comments, please feel free to shoot them our way.

Eric: Greg, [00:51:00] anything to add that you want to cut touch on before we break?

Greg: Yeah, no, I just wanted to thank both you and Jacob for having us on and I think there's such intense interest in this technology and in crypto assets that, we will be talking about crypto assets for a long time to come and the securities law issues will get worked out.
And I think these protocols are going to continue to exist and people are gonna continue to use them. And I'm looking forward to the future in this space.
Eric: And Lewis, why don't we wrap up with you?
Lewis: I just really thank as Greg said, thank you and Jacob, and applaud if people listening to this podcast aren't familiar with either series or Jacob series.
They're both fantastic. I try and listen to as many of them as I can, and really, I hope others go back and really just the tremendous [00:52:00] content the insightful questions and the great guests that you guys have and it's just a real honor to be among those folks today. So, thank you.
Eric: Thank you and so we'll break here, so thanks so much.