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NOTE FROM THE EDITOR-IN-CHIEF

DR. MATTHIAS ARTZT
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Dr. Matthias Artzt is a certified lawyer and senior legal counsel at Deutsche Bank AG since 1999. He has been practicing data protection law for many years and was particularly involved in the implementation of the GDPR within Deutsche Bank AG. He advises internal clients globally regarding data protection issues as well as complex international outsourcing agreements involving data privacy related matters and regulations.

Welcome back to the 7th issue of the IJBL which offers a variety of insightful and thrilling crypto- and DeFi-related topics covering current developments in the U.S., UK and Singapore.

First and foremost, I am happy to announce that Laura Douglas from the London office of Clifford Chance and Elçin Karatay from the law firm Solak Partners in Istanbul have recently joined the editor's board. A warm welcome to both! You may find their profiles on the next page.

We start off with an article from Preston J. Byrne from the Washington, D.C office of Brown Rudnick who sheds light on the development of the cryptocurrency regulation in the UK starting from 2009 until now. He compares the key milestones in the UK crypto space with the diverging U.S. approach and concludes the UK currently shows U.S. regulators that there is another, more effective way to regulate cryptocurrency by recognizing that cryptocurrency is not a security in the same sense that the U.S. Congress intended it when it enacted the U.S. securities laws 90 years ago. Overall, the UK arguably remains far better positioned to exploit the crypto revolution than the U.S.

Norton Rose lawyers Stephen Aschettino, Rachael Browndorf, Kevin J. Harnisch, Andrew James Lom, Ryan Meltzer, Magdalena Oropeza, Sandeep Savla and Robert A. Schwinger touch on the Ripple case which was subject to the ruling of the United States District Court for the Southern District of New York on July 13, 2023. For cryptocurrency companies, the decision marks the first time a U.S. judge has held that a token issuer's sale of digital assets did not constitute a security offering (at least in some circumstances).

It remains to be seen whether other courts will take a similar approach and how different types of token issuances will be assessed under the *Howey* test—or other applicable law.

Daniel Chan from Wong LLP Singapore office explores the Algorand case, which was also subject to a ruling of the Singapore High Court. In this decision, the High Court held that, in the context of insolvency, a debt denominated cryptocurrency could not be regarded as a debt in money or fiat currency. The court's view has important repercussions for commercial parties who have chosen to transact in cryptocurrency, with the expectation that cryptocurrency and fiat currency are functional equivalent.

Finally, Eric Hess (founder of Hess Legal Counsel and host of the "Encrypted Economy" podcast) analyses the DeFi Consultation Report of the International Organization of Securities Commissions (IOSCO). He advocates a "hybrid finance" model which offers a path to achieve the core aims of the Consultation Report's recommendations without inadvertently placing undue responsibility on investors, governance members, as well as core and technical team contributors. Adopting a hybrid finance approach ensures that implementation follows a collaborative approach while retaining the fundamental features of DeFi. This paves the way for continued innovation in open source fintech, inviting both regulated and unregulated players globally to contribute.

Happy reading!

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ARTICLE I

NEW UK RULES, WHILE STRICT, NONETHELESS AVOID AMERICA'S SECURITARIAN[1] TRAP

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INTRODUCTION: UK ENTERS THE CHAT

The United Kingdom's ("UK") Financial Conduct Authority ("FCA"), announced new proposed rules in May 2023, [2] following recently-enacted secondary legislation,[3] governing the financial promotion of cryptoassets within the country. These new rules, taken together with the enactment of the UK Financial Services and Markets Act 2023[4] (the "2023 Act") in June of 2023, bring crypto-assets under the UK's broader financial regulatory regime contained in the UK Financial Services and Markets Act 2000 ("FSMA"), and the Financial Services and Markets Act 2000 (Financial Promotion) (Amendment) Order 2023 ("FPAO 2023"),[5] which in turn brings so-called "qualifying cryptoassets" into the financial promotions regime set out in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Financial Promotion Order").

As the rules entered into force on October 8th, 2023, awareness of and adherence to these new rules is now mandatory for anyone conducting cryptocurrency business in the United Kingdom. The UK's new rules on financial promotions – which include criminal penalties – have been criticized by market observers as being too strict. Closer review of the rules, however, reveals a delicate balance between consumer protection and support for business growth and development.

It is true that these rules are a departure from the UK's prior hands-off approach. Historically, the UK took a more laissez-faire approach to cryptoasset regulation than the United States. New rules change this.

Historically, the United Kingdom's financial regulators have, by their own admission,[6] not had the power to regulate – and thus have not regulated – crypto-assets such as Bitcoin, Ethereum, Cardano, or Cosmos as investments, at least not in the same manner that they regulated TradFi instruments such as securities.

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1 The term "securitarian" means "with security as an absolute priority; inordinately obsessed with security." This paper utilizes the term as a *double entendre* to mean both the obsession with national security as well as classification of crypto as a security for the purposes of the Securities Act of 1933. See *Securitarian*, Wiktionary, September 26th, 2023; see also John R. Hibbing, Populists, Authoritarians or Securitarians? Policy preferences and threats to democratic governance in the modern age. *Global Public Policy and Governance*, 47-65 (2022).

2 Policy Statement PS23/6, "Financial promotion rules for cryptoassets." UK Financial Conduct Authority. https://www.fca.org.uk/publication/policy/ps23-6.pdf

3 The Financial Services and Markets Act 2000 (Financial Promotion) (Amendment) Order 2023, 20202 No. 612

4 Financial Services and Markets Act 2023 c. 29

5 2023 No. 612

6 "Initial Coin Offerings." UK Financial Conduct Authority, September 12th, 2017. Available at: https://www.fca.org.uk/news/statements/initial-coin-offerings (Accessed: September 23rd, 2023).

This differs significantly from the position in the United States ("US") where the US Securities and Exchange Commission ("SEC") asserts enforcement authority over the cryptocurrency sector through the use of 90-year-old securities legislation, with critics alleging it has been prosecuting a politically motivated, bad faith regulation-by-enforcement[7] campaign in the federal courts.

This essay describes how differing regulatory approaches in the UK and the US have evolved to address the challenges posed by the cryptocurrency sector's growth. All in all, despite the strictness of the UK's new rules, meaningful – and, from a commercial perspective, material – differences in regulatory philosophies between the two countries remain. Chief among these is that US regulators' insistence on using securities laws from the era of wireless telegraphy to regulate decentralized crypto-protocols, an approach this writer refers to as "securitarian," while the UK, despite adopting strict rules around marketing cryptocurrencies, has, with its newest reforms, narrowly avoided falling into this trap. The UK's approach, while strict, more accurately reflects underlying economic realities and real-world usage of cryptocurrency as encountered in the wild – and as likely to be encountered in the wild over the coming decade. **The UK's model is, therefore, a regulatory model more likely to survive and succeed in the medium-term.**

2009-2018: CRYPTOCURRENCY'S EARLY DAYS AND THE GOLDEN ERA OF THE ICO

Early litigation surrounding cryptocurrency dealt with fundamental legal questions, the answers to which had titanic and long-lasting effects on entrepreneurs who would start future crypto businesses.

For example, it was in the 2013-14 period, around the collapse of the first major cryptocurrency exchange, Mt Gox, that two of the most legally significant American Bitcoin cases in history – *Securities and Exchange Commission v. Trendon Shavers aka Pirateat40*[8] and *United States v. Robert M. Faiella*[9] – were decided. Taken together, these two cases established the simple but, in hindsight, obvious principle that, in America, for legal purposes, Bitcoin should be regarded as money. That this question should have needed to be asked might seem, today, absurd, but the fact is that in 2013 that no one had yet asked a court to render an opinion on the question.

As of the present day, Ethereum and its programming languages have emerged as the most successful implementations of Nick Szabo and Ian Grigg's expansive early visions of what smart contracts might become – as Grigg put it simply in 2015, "state machines with money." For many years, Ethereum DApp developers have exhibited a preference for, and reliance upon, user-friendly, low-code solutions and hosted user interfaces which interacted with services like Infura, rather than burdening users with responsibility for operating a full node – a task which even professional developers find extremely challenging on consumer-grade hardware.[10]

This current architectural approach was recently described by Vitalik Buterin as one which tries "to do as little as possible itself, [and leaving] almost everything up to users to build on top."[11]

7 Jesse Hamilton. *As SEC Leans on Enforcement to Regulate, Crypto Lawyers Study Every Word*. https://www.coindesk.com/policy/2022/08/18/as-sec-leans-on-enforcement-to-regulate-crypto-lawyers-study-every-word/

8 *Securities and Exchange Commission v. Trendon T. Shavers and Bitcoin Saving and Trust*, No. 4:13-CV-416, United States District Court, E.D. Texas, Sherman Division (E.D. Tex. 2013). In *Shavers*, the defendant collected 263,104 BTC (then $1.8 million, now $7.8 billion) in a Ponzi scheme called "Bitcoin Savings and Trust," contrary to the registration and antifraud provisions of the Securities Act of 1933 (the "1933 Act"). In an effort to defeat the SEC's claims that it had jurisdiction over the matter, Shavers argued that the investments he took were not money because Bitcoin was not money, i.e. not legal tender or specie. As a consequence of the fact that "no money ever exchanged hands," he argued, there was no "investment of money," one of the four prongs required by the test set out in *SEC v. W.J. Howey Co.* (the "*Howey Test*") before a court will find that a contract, transaction or scheme which is otherwise uncategorizable would be an "investment contract" and therefore a security regulated by the provisions of the Securities Act.

9 *United States of America v. Robert M. Faiella*, No. 14. -cr-243(JSR), United States District Court (39 F. Supp. 3d 544 2014).

10 Steve Anderrson, *Popular Cypherpunk Jameson Lopp Finds Parity Ethereum Sync To Be Disk I/O Bound* (February 2, 2023), https://www.thecoinrepublic.com/2020/02/02/popular-cypherpunk-jameson-lopp-finds-parity-ethereum-sync-to-be-disk-i-o-bound/

11 Vitalik Buterin, *Should Ethereum be okay with enshrining more things in the protocol?* (September 30 2023), https://vitalik.eth.limo/general/2023/09/30/enshrinement.html

Unfortunately for Ethereum, leaving critical market infrastructure out of the protocol, and therefore reliant on centralized systems, has exposed DApp developers to legal attack vectors which the U.S. SEC,[12] Commodity Futures Trading Commission,[13] and Department of Justice[14] have reliably exploited since 2018.[15]

2018-2022: THE SECURITIES AND EXCHANGE COMMISSION AT WAR

During the height of the 2017-18 ICO boom, after the DAO Report and before the first enforcement actions, the question of whether, when, and how the United States would seek to enforce its securities laws in the cryptocurrency space remained, for the most part, theoretical.

Among practicing attorneys, there were two camps. It was the author's observation that attorneys over the age of 40, or not directly in the employ of cryptocurrency companies, tended to adopt the view that cryptocoin ICOs were "investment contracts" per *Howey* and, accordingly, that consequences for issuing those tokens without a registration statement being in effect, or listing those tokens on crypto exchanges, should follow.

This view was reinforced by the pronouncements of then-SEC Chair Jay Clayton, who claimed in Senate hearings and television appearances that "every ICO [he'd] seen"[16] was a security. Clayton's earlier remarks were recently echoed by SEC Chair Gensler, who quipped that while "Congress could have said in 1933 or 1934 that securities laws applied only to stocks and bonds… Congress included a long list of 30-plus items in the definition of a security, including the term 'investment contract'… These laws have been on the books for decades."[17]

In the other camp, a number of law firms publicly advanced the theory, often in law review-length papers, that cryptocurrency tokens on completed networks should be treated as consumptive and thus not satisfying the "expectations of profits" limb of the *Howey* test, per precedents such as *Forman*.[18] This view was, confusingly, reinforced by a speech by then-Director of the Corporation Finance Division of the SEC Bill Hinman in May of 2018, which has come to be known by practitioners simply as the "Hinman Speech." During this speech, Hinman further confused the matter by pronouncing, *sans precedent*, that "[i]f the network on which the token or coin is to function is sufficiently decentralized – where purchasers could no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract."[19]

In the fall of 2018, fourteen months after publishing its written warning shot, the SEC began a campaign of enforcement which continues to the present day against issuers, promoters, centralized exchanges, and decentralized exchanges alike.

12 U.S. Securities and Exchange Commission, *SEC Charges EtherDelta Founder with Operating an Unregistered Exchange* (Press Release, November 8, 2018), https://www.sec.gov/news/press-release/2018-258

13 U.S. Commodity Futures Trading Commission, *CFTC Issues Orders Against Operators of Three DeFi Protocols for Offering Illegal Digital Asset Derivatives Trading* (Press Release, September 7, 2023), https://www.cftc.gov/PressRoom/PressReleases/8774-23

14 U.S. Securities and Exchange Commission, *U.S. Department of Justice, Tornado Cash Founders Charged With Money Laundering and Sanctions Violations* (Press Release, August 23rd, 2023), https://www.justice.gov/usao-sdny/pr/tornado-cash-founders-charged-money-laundering-and-sanctions-violations

15 This is a fate which developers might be able to avoid if they would cease relying on centralized infrastructure for their applications, such as hosted web interfaces, and would release source for fully-functional applications which allowed users to interact directly with the blockchain without hitting any third party endpoints, paired with careful regulatory advice. See e.g. *Bernstein v. United States Department of Justice et al.*, 922 F. Supp 1426 (N.D. Cal. 1996).

16 Stan Higgins, *SEC Chief Clayton*: "Every ICO I've Seen Is a Security" (February 6, 2018),CoinDesk, https://www.coindesk.com/markets/2018/02/06/sec-chief-clayton-every-ico-ive-seen-is-a-security/

17 Gary Gensler, Chair, *Testimony of Chair Gary Gensler*, Before the United States House of Representatives Committee on Financial Services, Sept. 27, 2023.

18 *United Housing Foundation v. Forman*, 421 U.S. 837, 854-55

19 William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)* (Speech, June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418

THE UK MIRROR UNIVERSE: FROM LAISSEZ-FAIRE TO FSMA 2023

Simultaneous to the ramping-up of the United States' regulation-by-enforcement campaign, the UK financial conduct regulator was charting an entirely different course by declaring crypto largely "hands-off." While conceding, like the SEC, in a noncommittal fashion that "[w]hether an ICO falls within the FCA's regulatory boundaries can only be decided case by case[,] [m]any ICOs will fall outside of the regulated space" – i.e., the Financial Conduct Authority conceded that it had no specific power to regulate initial coin offerings. This hands-off approach by the FCA was likely meant to signal that cryptocurrencies which were designed to be an integral part of a "state machine with money" and conferred no rights to or promises of future returns, within the UK's borders, were fair game to develop and sell to consumers.

Unlike the United States, the UK FCA's authority to intervene over particular products and asset classes, for years, was close to non-existent. The FCA's authority over financial promotions and financial products more generally could, and can be, found in various places e.g. Section 21 of FSMA 2000, as amended, and the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, as amended (commonly referred to as the "Regulated Activities Order" or the "RAO"), neither of which – prior to the entry into force of the changes in the FSMA 2023 – made any reference whatsoever to cryptocurrency.

Circa 2017, the Parliament of the United Kingdom had granted its regulators little by way of authority to interfere in cryptocurrency except in very limited circumstances. As is commonly known among American lawyers, the SEC derives practically all of its authority to govern the cryptocurrency market from a definition in a 90-year-old law, Section 2 of the Securities Act of 1933,[20] which defines a "security" as including something called an "investment contract."

"Investment contracts" have been defined, in turn, by a 76-year-long string of precedents beginning with the case *Securities and Exchange Commission v. W.J. Howey Co.*,[21] which holds in relevant part that an investment contract is a contract, transaction, or scheme in which an investor makes an investment of money into a common enterprise in a manner giving rise to an expectation of profit arising from the efforts of others.[22]

Put another way, the SEC has the power to regulate something as a "security" even if the thing being regulated is not a "security" in the sense that the word is defined in a dictionary or was understood by anyone prior to cryptocurrency being invented, as long as the fact pattern surrounding that thing can be fairly described by the *Howey* limbs.

The openness of the *Howey* definition, and the fact that the primary way users of cryptocurrency interact with it is through purchase for investment purposes, necessarily means that the SEC has a claim to authority over cryptocurrency, and has exercised that authority, to regulate the US cryptocurrency markets in aggressive fashion, against issuers (via Section 5 of the Securities Act of 1933) and against spot exchanges which permit cryptocurrencies to be traded (via Section 6 of the Securities Exchange Act of 1934).

The UK's rules never historically permitted this kind of intervention in the cryptocurrency markets. Its equivalent to Section 5 of the 1933 Act, Section 85 FSMA, states in relevant part that "[i]t is unlawful for transferable securities… to be offered to the public in the United Kingdom unless an approved prospectus has been made available to the public before the offer is made," and furthermore that it is unlawful "to request the admission of transferable securities… to trading on a regulated market… unless an approved prospectus has been made available to the public before the request was made."[23]

20 15 U.S.C. § 77b(a)(1)

21 328 U.S. 293 (1946)

22 *Id.* at 328

23 Financial Services and Markets Act 2000, c. 8, § 85

The key question for an American practitioner is what, exactly, the UK means by the term "transferable security." The answer, in 2017 and today, is "anything which is a transferable security for the purposes of Directive 2009/39/EC" (commonly known as the Markets in Financial Instruments Directive, or MiFID, and, in the wake of the UK's exit from the European Union ("EU"), replaced by the retained EU law, the Markets in Financial Instruments Regulation (or "UK MiFIR"). MiFID told, and its successor legislation MiFIR tells, us that "transferable securities" means "those classes of securities which are negotiable on the capital market (with the exception of instruments of payment) such as – (a) shares in companies and other securities equivalent to shares… (b) bonds or other forms of securitized debt… [and] (c) "any other securities giving the right to acquire or sell any such securities or giving rise to a cash settlement determined by reference to such securities… or other indices or measures[.]"[24]

Interpreting this statute through the lens of the English language, since most fungible cryptocurrencies are neither "securities", nor "shares," nor negotiable, nor debt, nor granting the right to acquire or sell other securities, the prohibition on selling securities from Section 85 does not apply to the sale of cryptocurrency.

For this reason, in the 2014-2022 period the UK regulators largely stuck to the course the United States charted after *Faiella* but before its regulation-by-enforcement campaigns of 2018. To wit, they were fairly hands-off. The UK treated crypto business as, first and foremost, a counter-terrorist financing risk rather than as a consumer protection risk. For this reason, the UK eventually imposed a tailor-made requirement that crypto-asset business should be registered with the FCA under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017.[25]

24 Directive 2009/39/EC, 2009 O.J. (L 142) 3(EC)/ Markets in Financial Instruments Regulation, 2017 O.J. (L 87) 331 (UK)

25 2017 No. 692 (UK)

What the UK never did, and still has not done with the reforms under FSMA 2023 and the Financial Services and Markets Act 2000 (Financial Promotion) (Amendment) Order 2023 ("FPAO 2023")[26] , is treat cryptocurrency like a security. Although HM Treasury does have powers under FSMA 2023 to introduce authorization and conduct regulation requirements for firms trading in cryptoassets, specifically under its amendments to Section 21 FSMA 2000[27] which added "cryptoassets" to the list of investments in relation to which the Treasury was granted express power to regulate – defining "cryptoassets" as "a cryptographically secured digital representation of value or contractual rights […] which may include [distributed ledger technology"[28] - so far, any proposals that the securitarianization of crypto should be enacted would be just that, proposals, and not the law of the land.

The most immediately relevant provisions from the various changes to the UK's financial regulatory regime for cryptocurrency developers are changes which bring cryptocurrency marketing fully under the existing "financial promotions" regime.[29] Section 21(1) of FSMA 2000[30] prohibits, "in the course of business… an invitation or inducement to… engage in investment activity, or… to engage in claims management activity." Section 21(9) of FSMA 2000[31] defines "engaging in investment activity" as "entering or offering to enter into an agreement the making of performance of which by either party constitutes a controlled activity; or exercising any rights conferred by a controlled investment to acquire, dispose of, underwrite, or convert a controlled investment."[32]

26 2023 No. 612 (UK)

27 Section 21, Financial Services and Markets Act 2000 c. 8 (UK)

28 Section 417(1), Financial Services and Markets Act 2000 c. 8 (UK)

29 See Tim Davison, Preston Byrne, *Marketing Cryptoassets to Consumers in the UK*, (June 29 2023), https://brownrudnick.com/wp-content/uploads/2023/06/Brown-Rudnick-Client-Alert-Marketing-Cryptoassets-to-Consumers-in-the-UK.pdf

30 Section 21(1), Financial Services and Markets Act 2000 c. 8

31 Ibid.

32 Ibid.

"Controlled activities" and "controlled investments" are themselves defined on a list, Schedule 1, Parts I and II, respectively, of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Financial Promotion Order"). The FPAO 2023 adds "qualifying cryptoassets" to that list.

"Qualifying cryptoassets" are defined in the FPAO, and post-October 8th, the Financial Promotions Order, as assets which are (a) fungible and transferable where "transferable" means where the asset "confers transferable rights; or… a communication made in relation to the cryptoasset describes it as being transferable or conferring transferable rights," which is not e-money, fiat currency, digitally issued fiat currency, or redeemable only from the issuer. Neither the term "fungible" nor "transferable" is defined; an English court is likely to look to the plain meaning of each term and conclude that it does not discriminate between "decentralized" cryptocurrencies like Bitcoin, Dogecoin, and Litecoin on the one hand and cryptocurrencies which were sold through an ICO, such as Ripple, Ethereum, and Onecoin, on the other.

Due to the requirement that "qualifying cryptoassets" be fungible, products which use a non-fungible data structure such as procedurally generated art NFT collections are more likely to not be captured by the new regulations, although whether a particular product is or is not affected by the incoming rules will always be an analysis of the totality of the facts. The rules also prohibit incentives to invest such as "refer a friend" bonuses, mandate a 24-hour "cooling off" period between a consumer receiving a direct offer financial promotion and being able to invest, and more robust appropriateness rules for cryptoassets.

In summation, under the new law, inducements to invest in crypto made in the course of business cannot be communicated to consumers unless they are made by an entity with the right license and the marketing complies with certain rules about its content.

The rules are sufficiently broad that a number of firms including ByBit[33] and PayPal[34] have elected to temporarily suspend operations in the UK, presumably to develop UK-specific marketing copy and web presences which comply with the new rules. The types of marketing covered by the financial promotion regime could include not only marketing in a formal sense like a television advertisement or an investment memorandum, but also less formal communications where cryptocurrency companies usually market their protocols such as podcasts, hackathons, conference events, and meetups, or online banner ads and Tweets.

The new regime also includes communications to high-net-worth and sophisticated investors. How these communications may be made and what they must contain is governed by complex rules; given that breaching the financial promotion restriction is a criminal offence, with penalties for noncompliance including fines and potential imprisonment, strict adherence to the rules is a must.

What the FSMA 2023 regime does *not* do, however, is to follow the American securitarian impulse to the same degree: critically, it leaves spot crypto trading, the principal source of liquidity for and transactions in the cryptocurrency markets, more or less alone. Peer to peer use of cryptocurrency – its original intended use – or the manner in which users interact with spot crypto exchanges for the better part of a decade, should be able to continue largely without interruption for UK residents. FSMA 2023 also does not require exchanges to register with the government as securities exchanges over and above existing rules, nor indeed for any purpose other than AML compliance, as has been the case for half a decade.

The law is, for the moment, also silent on communications which are not financial promotions, and communications made otherwise than in the course of business.

33 Announcements, *Notice on Exit from the United Kingdom Market* (September 22, 2023), https://announcements.bybit.com/en-US/article/announcement-bybit-to-suspend-services-in-the-uk-blt286daa9208c8f3aa/.

34 Elizabeth Howcroft, *PayPal to halt UK crypto sales until 2024* (August 16, 2023), Reuters https://www.reuters.com/technology/paypal-halt-uk-crypto-sales-until-2024-2023-08-16/.

This means that UK residents will likely continue to be free to discuss, buy, sell, and trade spot crypto much in the way that American cryptocurrency communities could prior to the US' post-2018 enforcement drive, and much as they could in the 2013, 2017, and 2020 bull markets. Contrast this position with the United States, where the SEC takes the position that, since most cryptocurrencies are in its view securities, they cannot be publicly traded without re-inserting the full range of traditional intermediaries including broker-dealers, transfer agents, and registered national securities exchanges; and rules which are not only difficult to comply with, but if complied with in full, deprive any cryptocurrency which is locked up in such a system of much of its utility, chiefly that it is pseudonymous, censorship-resistant, immutable, and irreversible. Putting cryptocurrency on a share ledger with a transfer agent defeats the entire purpose for using the technology to begin with.[35]

THE FUTURE: SALUS POPULI SUPREMA LEX ESTO

The United Kingdom shows American regulators that there is another way to regulate cryptocurrency: one which recognizes that cryptocurrency, despite the availability of a Supreme Court case from 1946 which gives those regulators grounds to argue otherwise, is not, in any meaningful sense, a security in the same sense that Congress intended it when it enacted America's securities laws 90 years ago and, despite being capable of being treated as an investment, is, increasingly, used in ways that no investment ever has.

Regulators are tasked with enforcing the law as it is; other practitioners have the luxury and privilege, if they wish, to peek over the horizon. In the current environment of extremely rapid technological innovation, to the extent there are critics who currently think cryptocurrency does not yet have product-market fit, and/or that the Securities Act of 1933 is the right long-term regulatory regime for the asset class, and to the extent those critics are currently right based on present technology levels, it is unlikely that they will be right for much longer.

If it were true that in 2009 nobody needed the double-spending problem fixed, or that in 2014 nobody needed cryptographically secure state machines with money to execute contractual obligations, or that today anyone needs their transactions encrypted and hidden from AI-powered surveillance bots run by criminals or foreign threat actors, by 2029, it is entirely possible, even probable, that everyone will. These are functions that no stock, nor bond, nor evidence of indebtedness, nor any investment contract has ever performed, but are ones at which cryptocurrencies of various kinds routinely excel.

We are already at a point where machines and software are so advanced, so capable of portraying human voices, faces, and emotions, that, among other things, soon we will not even be able to trust our eyes when having video calls with our own loved ones or speeches from our leaders, due to so-called "deepfakes." This is a world where authentication, "proof of human," and, in particular, strong cryptography, will become exceedingly important. This alone should be enough for America to realize that a course correction is necessary.

35 "The cost of mediation increases transaction costs, limiting the minimum practical transaction size and cutting off the possibility for small casual transactions... What is needed is an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party." Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (2008)

There is still time for America to come to its senses and win the future. In a world where jurisdictions like the UK are its competition, that window is closing. Accepting that the fundamental difference between the United States and much of the rest of the world lies in the securitarianization of cryptocurrency is a necessary prerequisite for attacking – politically – the current, unfit-for-purpose regulatory regime, and crafting solutions that will provide us with a robust crypto industry for years to come. In the U.S., we should understand that incremental legislative measures will be insufficient to overcome the overbroad powers wielded, fairly or not, by the SEC, and that we should be more radical in our proposed policy prescriptions. Offshore, lawyers should take advantage of America's folly, encourage legislators to "let crypto be crypto" within their borders, and be sure – above all – to not try to shoehorn crypto into securities law regimes for which it is not suited.

How we Americans should change our law, if at all, is, ultimately, a matter for Congress to decide. We should not hesitate to point out to Congress that the United Kingdom has had a more permissive regime than ours for years, and that after these reforms it continues to have one more permissive. It was not, and is not, a securitarian regulatory regime, and this permissiveness has not led to, as Senator Elizabeth Warren fears, some kind of "disaster."[36]

As a result of avoiding the securitarian trap, despite the new restraints on financial promotions in that country, the UK remains far better positioned to exploit the crypto revolution than the United States. The key to the UK's future in crypto, going forward, is whether the regulators can exercise restraint. If so, there is a good possibility UK could dominate the decentralized web for decades to come. Whether the country's leadership has the ability, or the wisdom, to resist the temptation to over-regulate remains to be seen.

36 Warren, Elizabeth, *Senator Warren Calls for Answers from Silicon Valley Bank CEO* (March 14, 2023), https://www.warren.senate.gov/oversight/letters/senator-warren-calls-for-answers-from-silicon-valley-bank-ceo-following-collapse

ARTICLE II

US FEDERAL COURT ISSUES MIXED RULING IN WATERSHED SEC ACTION ON RIPPLE'S XRP

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INTRODUCTION

On July 13, 2023, the United States District Court for the Southern District of New York issued a mixed decision as to whether various sales and issuances of the XRP token (XRP) by Ripple Labs, Inc. (Ripple) and two of its executives (collectively the defendants) constituted the sale of an unregistered security in violation of Section 5 of the Securities Act of 1933 (the Securities Act), holding on cross-motions for summary judgment that some were and some were not. *SEC v. Ripple Labs, Inc. et. al.*, No. 1:2020cv10832 - Document 103 (S.D.N.Y. 2021).

Grounding its decision in the longstanding *Howey* test, the court (1) rejected the defendants' argument that additional factors beyond the *Howey* test—so called "essential ingredients"—needed to be applied to determine whether a token is a security, (2) rebuffed the defendants' due process challenge based on claimed lack of fair notice and vagueness and (3) denied the Securities and Exchange Commission's (SEC) motion for summary judgment on its aiding and abetting claim against Ripple's executives, finding a triable issue of material fact.

HOWEY GOVERNS AND IS NOT SUBJECT TO AN ADDITIONAL "ESSENTIAL INGREDIENTS" TEST

The SEC alleged that the defendants violated Section 5 of the Securities Act because they sold XRP as an investment contract, a type of security that must be registered. The defendants argued that XRP is not an investment contract, and therefore not a security that must be registered.

Under these circumstances, the court held it must use the test set forth in *SEC v. WJ Howey Co.*, 328 US 293 (1946) (the *Howey* test), which provides that an investment contract is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *Howey*, 328 US at 298–99. In analyzing whether a "contract, transaction or scheme" is an investment contract, "form should be disregarded for substance and the emphasis should be on economic reality" and the "totality of circumstances." *Tcherepnin v. Knight*, 389 US 332, 336 (1967).

The defendants argued that in addition to satisfying the *Howey* test, all investment contracts must also have three "essential ingredients," based on a survey and analysis of the case law cited in *Howey*. This "essential ingredients test" would impose additional requirements in determining whether a token was an investment contract, specifically: (1) a contract between a promoter and an investor that establishes the investor's rights as to an investment, which contract (2) imposes post-sale obligations on the promoter to take specific actions for the investor's benefit and (3) grants the investor a right to share in profits from the promoter's efforts to generate a return on the use of investor funds.

The court declined to adopt this test because it would go beyond the plain words of *Howey*, impose additional requirements and stray from *Howey*'s directive to "embod[y] a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." 328 US at 299.

Therefore, when analyzing whether XRP was an investment contract, the court evaluated the economic reality and totality of circumstances and held that XRP could constitute an investment contract under certain conditions. The court then considered three different contexts in which XRP had been issued.

INSTITUTIONAL SALES SATISY *HOWEY*

Institutional sales included the sale and distribution of XRP through wholly owned subsidiaries to certain counterparties, such as institutional buyers, hedge funds and on demand liquidity customers pursuant to written contracts. Following the *Howey* test, the Court determined that Ripple received money for XRP and rejected the defendants' argument that an "investment of money" required some mental state by the payor different from "merely payment of money." The court found the existence of a common enterprise because the record demonstrated that there was a pooling of assets and that the fortunes of the institutional buyers were tied to the success of the enterprise as well as to the success of other institutional buyers. The court found that reasonable investors, situated in the position of the institutional buyers, would have purchased XRP with the expectation that they would derive profits from Ripple's efforts, relying heavily on evidence of Ripple's communications and marketing campaign, and the nature of the institutional sales.

The court specifically pointed to the sales contracts and the inclusion of lockup provisions, resale restrictions, indemnification clauses and recitals that the institutional buyer was purchasing XRP "solely to resell or otherwise distribute" to reject claims that XRP had been purchased for consumptive or utilitarian rather than investment purposes. These provisions, the court reasoned, supported its conclusion that the parties understood the sale of XRP to be an investment in Ripple's efforts.

Holding that a common enterprise existed between Ripple and the institutional buyers, the court did not reach the question of whether the common enterprise extended to "other XRP holders," Ripple's executives or the "XRP ecosystem."

PROGRAMMATIC SALES DO NOT SATISFY *HOWEY*

XRP was also sold on digital asset exchanges "programmatically" or through trading algorithms as blind bid/ask transactions, where Ripple did not know who was buying the XRP and the purchasers did not know who was selling the XRP. The court held that the anonymity between programmatic buyers and Ripple meant that programmatic sales did not satisfy the *Howey* test, because these transactions could not lead to an expectation of profits solely from the efforts of the promoter or a third party. With respect to programmatic sales, the court found that Ripple did not make any promises or offers because Ripple did not know who was buying the XRP, and the purchasers did not know who was selling it. In fact, many programmatic buyers were entirely unaware of Ripple's existence. Because programmatic sales failed this aspect of the *Howey* test, the court declined to analyze whether or not *Howey*'s other requirements were met.

Similar to programmatic sales, the court held that sales of XRP by the Ripple executives did not satisfy the *Howey* test because they were made on various digital asset exchanges and through blind bid/ask transactions. The court similarly declined to analyze the other *Howey* requirements for such sales in light of this determination.

OTHER DISTRIBUTIONS DO NOT SATISFY *HOWEY*

Other distributions included circumstances where Ripple distributed XRP as a form of payment for services, such as employee compensation. The court determined that since the recipients of the other distributions did not pay any money or "some tangible and definable consideration" to Ripple, these distributions did not satisfy the *Howey* test. The SEC argued that the other distributions could be transferred in exchange for currency, goods or services to another holder and therefore should be considered an investment contract. However, the court concluded there was insufficient evidence to make such a finding, and it declined to analyze the other *Howey* factors as to these distributions.

DUE PROCESS CHALLENGE FAILS

The court rejected the defendants' due process challenge to the SEC's enforcement action based on claimed vagueness and a lack of fair notice that institutional sales were subject to Section 5. The defendants argued that the SEC had failed to issue guidance on digital assets and had taken inconsistent approaches to regulating the sale of digital assets as investment contracts. The court determined that the SEC's approach to enforcement, specifically with respect to the institutional sales, was consistent with the enforcement actions that the agency had brought relating to the sale of other digital assets to buyers pursuant to written contracts and for the purpose of fundraising. Moreover, the court observed that the law does not require the SEC to specifically warn all potential violators of the law's application to them on an individual or industry level.

LOOKING FORWARD

Both sides have hailed the decision as a partial victory. For cryptocurrency companies, the decision marks the first time a US judge has held that a token issuer's sale of digital assets did not constitute a securities offering (at least in some circumstances). For the SEC, the decision supports the Commission's theory of Section 5 liability for the issuer of a token as a matter of law as to certain types of sales.

The decision confirms the staying power of the *Howey* test nearly eighty years on. Relying on this opinion, future defendants may argue that their particular token should not be considered an "investment contract" based on the "economic reality" and the "totality of circumstances" around the contract or transaction involved in their particular case. Especially important is the court's determination that "blind" transactions in which Ripple was the seller did not satisfy the *Howey* test. At the same time, the court provided guidance on the types of contractual provisions that may bring a transaction within the scope of *Howey*, including lockup provisions, resale restrictions and indemnification clauses.

These provisions, the court reasoned, are fundamentally inconsistent with the claim that tokens were being sold for a purely consumptive purpose.

The decision is also significant for what it leaves open. In a significant footnote, the court observed that the question as to whether secondary market sales of tokens constituted offers and sales of investment contracts was not before it. Nevertheless, the court signaled that the answer to that question likewise would seem to depend on the totality of circumstances and the economic reality of that specific "contract, transaction or scheme."

It remains to be seen whether other courts will take a similar approach when analyzing investment contracts involving digital assets under Section 5, and how different types of token issuances will be assessed under the *Howey* test—or other applicable law.

ARTICLE III

CRYPTO DEBT NOT MONEY DEBT FOR PURPOSES OF STATUTORY DEMAND, SINGAPORE HIGH COURT RULES

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In a significant ruling, the General Division of the Singapore High Court (High Court), on the hearing of the application for a winding-up order in *Algorand Foundation Ltd v Three Arrows Capital Pte Ltd* (HC/CWU 246/2022), held that a debt denominated in cryptocurrency is not a money debt capable of forming the subject matter of a statutory demand under section 125(2)(a) of the Insolvency, Restructuring and Dissolution Act 2018 (IRDA).

Specifically, while a party owed a sum denominated in cryptocurrency is a "creditor" under section 124(1)(c) of the IRDA for the purposes of establishing the party's standing to bring a winding-up application, the High Court clarified that such a party does not possess a claim for a money debt; accordingly, a statutory demand for a debt denominated in cryptocurrency would be invalid for the purposes of the deeming provision in section 125(2)(a) of the IRDA (Section 125(2)(a)).

If there were a country in the world that uses seashells as currency, would the court be obliged to recognise it as money? This was one of the analogical questions raised by the High Court in considering the question of whether the law should regard cryptocurrency as a form of money.

In this decision, the High Court considered (among other issues) the novel question whether, in the context of insolvency, a debt denominated in cryptocurrency could be regarded as a debt in money.

In short, the High Court held that it could not; a debt denominated in cryptocurrency is not a money debt capable of forming the subject matter of a statutory demand under Section 125(2)(a). Central to this conclusion was the High Court's finding that the word "indebted" in Section 125(2)(a) was limited to a debt denominated in fiat currency.

The High Court's reluctance to regard a debt denominated in cryptocurrency as being equivalent to a debt denominated in fiat currency has important implications for commercial parties who have chosen to transact in cryptocurrency with the commercial expectation that cryptocurrency and fiat currency are functionally equivalent. These parties should be cognisant of the more limited remedies available in law to a creditor seeking redress for the breach of a payment obligation expressed in cryptocurrency compared to one expressed in fiat currency, as explained further below.

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BACKGROUND

Algorand Foundation Ltd (claimant) was a Singapore-incorporated public company which sought to promote and support the development of the Algorand ecosystem. Three Arrows Capital Pte Ltd (defendant), also incorporated in Singapore, was a registered fund management company.

In 2021, the claimant entered into a one-off transaction with the defendant and Three Arrows Capital, Ltd (3AC BVI). In mid-2022, upon discovering that the defendant (and 3AC BVI) had breached the terms of the transaction, the claimant sought payment of approximately 53.5 million USD Coin (USDC). USDC is a cryptocurrency managed by an American company known as Circle. Circle claims that USDC is a fully-reserved stablecoin on the premise that each dollar of USDC is 100% backed by cash and short-dated United States of America (US) treasuries, and therefore redeemable 1:1 for US dollars at all times.

In late 2022, the claimant applied to wind up the defendant on the basis of an unsatisfied statutory demand for the sum of 53.5 million USDC.

THE HIGH COURT'S DECISION

The Honourable Justice Vinodh Coomaraswamy (High Court Judge) dismissed the winding-up application. No written grounds for his decision have to date been issued and this summary refers to the brief oral grounds given by the High Court Judge at the end of the hearing. **While the High Court Judge accepted that the claimant was a "creditor" of the defendant within the meaning of section 124(1)(c) of the IRDA, he did not accept that a claim for a sum denominated in cryptocurrency could be considered a money debt for the purposes of a statutory demand under Section 125(2)(a).**

This appears to be the first time that the Singapore courts have sought to define the scope and meaning of the word "creditor" in section 124(1)(c) of the IRDA.

Claimant had locus standi to bring winding-up application

The High Court Judge held that the claimant had the requisite standing to apply for the defendant to be wound up. He accepted the claimant's submission that a "creditor" in section 124(1)(c) of the IRDA refers to any person who has a provable debt under section 218 of the IRDA.

In reaching this conclusion, the High Court Judge adopted the position taken by Crossman J in Re North Bucks Furniture Depositories Ltd [1939] Ch 690, namely that the term "creditor" includes every person who has the right to prove in a winding-up. The High Court Judge reasoned that adopting such a definition would have the practical benefit of aligning a creditor's standing at the outset of bringing a winding-up application with the creditor's interest in proving his debts in winding-up.

Cryptocurrency such as USDC was held not to be money and cannot be the subject of a valid statutory demand

Despite his conclusion that the claimant had locus standi to bring the winding-up application, the High Court Judge did not accept that cryptocurrency was money for the purposes of the court's jurisdiction to grant a winding-up order, or to give rise to the presumption of insolvency under Section 125(2)(a).

He found that, regardless of the meaning of the term "creditor" in section 124(1)(c) of the IRDA, the term "creditor" in Section 125(2)(a) was hedged with various restrictions, and the practical result was that a person could be a creditor for the purpose of section 124 of the IRDA, but not section 125 of the IRDA. He further held that it was essential under Section 125(2)(a) that the subject matter of the statutory demand be for an "indebtedness then due". In the High Court Judge's view, the word indebtedness required a debt in fiat currency.

The High Court Judge cited the following reasons for his decision:

(a) The court should not adopt and apply the societal view of money in the context of winding-up applications and the presumption of insolvency. **Determining whether or not a particular intangible such as cryptocurrency was money would require a detailed examination of evidence which was not appropriate in the context of insolvency.**

(b) On the other hand, the state theory of money had the benefit of being easy to apply such that in almost all situations, there would be no issue as to whether a particular intangible was or was not money so as to give rise to indebtedness.

(c) While this was admittedly a technical point because of the nature of USDC as a stablecoin, a creditor who wished to rely on Section 125(2)(a) had to fulfill its requirements to gain the benefit of the presumption. Unfortunately, those requirements might operate in a technical manner, but that was the price to pay to establish one of the grounds for the making of a winding-up order without the benefit of positive evidence establishing that the debtor was unable to pay its debts.

For the above reasons, the High Court Judge dismissed the winding-up application.

CONCLUDING OBSERVATIONS

Parties are generally free to choose the currency in which they wish to express, record and settle monetary obligations and transactions. In Singapore, this is arguably reflected in section 12 of the Currency Act 1967.

Moreover, following the decision of the Court of Appeal in *Tatung Electronics (S) Pte Ltd v Binatone International Ltd* [1991] 2 SLR(R) 231, the Singapore courts may award monetary damages in a foreign currency without conversion into its Singapore dollar equivalent. As such, it appears that, although foreign currencies are not legal tender in Singapore (see section 13(1) of the Currency Act 1967), the law may nevertheless regard them as money for the purpose of enforcing monetary obligations between parties.

Perhaps a day may come when the definition of money is extended to include certain forms of cryptocurrencies, in particular stablecoins. Unlike perhaps the analogical example of seashells, stablecoins are fungible, easily divisible, and can function as a unit of account, thereby potentially fulfilling the economic functions of money. Stablecoins are not immune to price fluctuation or market volatility, but neither is fiat currency. On the other hand, it may be said that cryptocurrencies, including stablecoins, have yet to demonstrate sufficient traction and permanence to justify their recognition as a form of money. **Being a form of private money that is not backed by any state, cryptocurrencies may struggle to attain the same level of public confidence that established fiat currencies may possess.**

If and until that day comes, parties who use cryptocurrency as a medium of exchange or for discharging debt obligations should be mindful of the more limited remedies available in law to a creditor seeking redress for the breach of a payment obligation denominated in cryptocurrency compared to one requiring payment in fiat currency.

First, creditors who hold debts denominated in cryptocurrency will not be able to easily avail themselves of the remedy of applying to wind up a debtor.

As a debt denominated in cryptocurrency cannot be the subject matter of a valid statutory demand, a creditor of a debt denominated in cryptocurrency would be unable to rely on the deeming provision in Section 125(2)(a). Accordingly, while such a creditor would have the legal standing to commence winding-up proceedings and submit a proof of debt for its claim after the debtor enters into liquidation, it would first need to adduce evidence to satisfy the court that the debtor is unable to pay its debts. Satisfying this evidential threshold without the ability to rely on the deeming provision in Section 125(2)(a) is likely to present a major difficulty for creditors who typically would not have access to the debtor's internal financial information and records.

Moreover, if a debt denominated in cryptocurrency is not regarded in law as a money debt, this would appear to preclude a common law action for a debt. Instead, a creditor who is owed a sum of cryptocurrency would first have to bring a claim for unliquidated damages for breach of an obligation. In doing so, such a creditor may have to surmount the common law obstacles of remoteness, mitigation and the law on penalties, if applicable. These potentially pose additional hurdles for creditors of debts in cryptocurrency as compared to creditors of debts in fiat currency.

For these reasons, where a debtor has failed to comply with a payment obligation expressed in cryptocurrency, a creditor may have to first obtain a court judgment for a liquidated sum of money denominated in fiat currency before contemplating insolvency proceedings against the debtor. This may leave creditors who are owed debts in cryptocurrency at a disadvantage compared to creditors who are owed debts in fiat currency, given that the former would likely have to incur additional costs and time to first obtain a court judgment before being able to commence winding-up proceedings even if the debt is undisputed.

ARTICLE IV

HYFI: A COUNTER TO THE U.S.' GLOBAL VISION FOR DEFI?

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INTRODUCTION TO IOSCO'S DEFI CONSULTATION REPORT

The International Organization of Securities Commissions (IOSCO), is the international body that brings together the world's securities regulators and is recognized as the global standard setter for the securities sector. IOSCO develops, implements and promotes adherence to internationally recognized standards for securities regulation. IOSCO recently released a consultation report titled "Policy Recommendations for Decentralized Finance" (hereafter the Consultation Report).[1]

The Consultation Report was the work product of the IOSCO Fintech Network, and was led out of their Decentralized Finance (DeFi) Working Group which is chaired by the U.S. Securities and Exchange Commission (SEC) and included participation from the U.S. Commodities Futures Trading Commission (CFTC), among other global securities regulators.

On the same day as the Consultation Report's release, the CFTC announced three settlement actions with decentralized finance protocols, signaling its alignment with the report's expanded jurisdictional interpretations.[2] **The U.S.'s push to export its stringent regulatory stance on DeFi to other jurisdictions is understandable, as its approach risks positioning it as an outlier if DeFi protocol contributors block the U.S. and despite this, protocols are still able to thrive globally.** Some might label this as regulatory arbitrage, but for these contributors it may be a necessary adaptation to evolving and murky financial regulation.

The Consultation Report's recommendations, while framed around securities, broadly categorizes digital assets or products serviced by a DeFi protocol as securities or effectively close enough to merit classification as securities.[3] This wide categorization seems to overlook distinctions for tokens with specific utility[4] or asset references,[5] as well as avoiding consideration of unique regulatory and policy considerations designed to ensure competitiveness in emerging financial markets.

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1 OICV-IOSCO, POLICY RECOMMENDATIONS FOR DEFI CONSULTATION REP. (2023) https://www.iosco.org/library/pubdocs/pdf/IOSCOPD744.pdf

2 COMMODITY FUTURES TRADING COMM'N, Press Release Number 8774-23, CFTC Issues Orders Against Operators of Three DeFi Protocols for Offering Illegal Digital Asset Derivatives Trading (Sept. 07, 2023).

3 DeFi Consultation Report, p. 17.

4 See, e.g., *European Parliament, Legislative resolution of 20 April 2023 on the proposal for a regulation of the European Parliament and of the Council on Markets in Crypto-assets and amending Directive (EU) 2019/1937, Recia* (9) (2020) [hereafter MiCA Regulation]

5 See MiCA Regulation at FN 4, Article 3(6).

The report's overarching theme, particularly evident in the Preamble and Recommendations 2 and 3,[6] (hereafter the DeFi Negation Guidance) urges global regulators to adopt a broad interpretation of the concepts of "control" and "influence" to identify "Responsible Persons" associated with DeFi protocols meriting regulation. Once so identified, the report advises its members to integrate DeFi entities into traditional finance licensing and regulatory frameworks after merely noting the existence of newer frameworks. It's noteworthy that, despite the participation of European Union (EU) regulatory representatives in the working group that are knowledgeable with respect to the EU's Markets in Crypto Assets regulations,[7] the report doesn't examine alternative regulatory paradigms.

By hinging its analysis on expansive interpretations of control and influence, the report sidesteps the differentiation of DeFi protocols from the products and services built on top of them. Making this critical distinction would support a more balanced approach that empowers regulators to use their existing tools to regulate CASPs and other clearly defined centralized entities within existing frameworks. It would also avoid encouraging a more aggressive interpretation by regulators worldwide towards the scope of their jurisdiction and facilitate more holistic, policy-driven consideration of alternative financial classifications and regulatory frameworks.

The implications of the DeFi Negation Guidance essentially suggests that global securities regulators should: (i) largely classify digital assets exchanged through DeFi protocols as securities; (ii) identify unregulated individuals or entities contributing to fintech systems; and (iii) require these entities to conform to licensing or other regulatory standards or integrate into pre-existing regulated entities, failing which they would face the threat of enforcement.

Implementing such recommendations would effectively operate as a ban of DeFi protocols and would have broader ramifications. Fintech service providers for other types of financial systems, including cloud-based systems and open-source communities ranging from Hyperledger to GitHub, might also fall into the heightened scrutiny and jurisdictional reach recommended. **The recommendations provide little in the way of guidance as to what differentiates an unlicensed DeFi contributor from other individuals or entities involved in financial technologies that support the exchange of financial assets.**

The distinctions between outsourced technology providers, whom would generally not be regulated in traditional financial markets, and the new regulatory categorization of such entities are conflated. This, would result in more subjective interpretations and less clarity. Ironically, in this manner the DeFi Negation Guidance relies upon the very concept of labeling that it urges regulators to eschew in the Consultation Report.

Furthermore, the DeFi Negation Guidance encourages the application of jurisdiction-specific licensing, which would constrain the ability of DeFi protocols to be deployed and used globally. **While the Consultation Report calls for increased cooperation among regulators, it stops short of suggesting any type of mutual recognition of licensing across borders.** Mutual recognition would be consistent with the borderless nature of DeFi and would greatly alleviate resource constraints on all DeFi stakeholders, regulators included. Rather, the DeFi Negation Guidance suggests that regulators should be focused on regulating DeFi "Responsible Persons" within their respective jurisdictions.

6 DeFi Consultation Report, p. 16-19, 22-24.

7 See MiCA Regulation generally at FN 4.

HISTORICAL CONTEXT: ENCRYPTION AND THE RISE OF EMERGING TECHNOLOGIES' RISK AVERSION

While the above analysis primarily centers on IOSCO, their views represent a growing perception of financial regulators (at the very least, among the other members of the working group) as to how DeFi should be regulated globally.[8]This increasingly cautious viewpoint is likely influenced by significant incidents like the FTX implosion[9] as well as high profile hacks impacting DeFi protocols.[10] The regulatory inclination to adopt overarching frameworks for new technologies isn't exclusive to digital assets. For instance, areas like predictive analytics and artificial intelligence are now drawing heightened scrutiny from bodies like the SEC.[11] Even before the rise of digital assets, automated trading was a focal point for regulatory action.[12]

The perspective of U.S. financial regulators towards emerging technologies began to shift in the years following 2008. Using the SEC as a case study (and further detailed in my article), financial regulators have traditionally sought to regulate activities within financial markets through intermediaries. By the 1960s, the SEC was proactively leveraging emerging technologies to redefine the roles and functions of these intermediaries, aiming to enhance transparency and enhance market efficiency.[13]

In doing so, it took a bottom-up approach towards working with affected stakeholders, incorporating their feedback from engagement with industry groups and concept releases into rule proposals. A notable instance of this collaborative approach was the introduction of Regulation ATS in 1998.[14] Reg ATS permitted the performance of exchange functions by broker dealer networks that were exempt from exchange registration. Another directly related example of the SEC's active intervention with regards to disruptive technologies was Regulation National Market System (Reg NMS) in 2005.[15] Both these initiatives exemplify the SEC's progressive stance in reshaping intermediary roles and tapping into emerging financial technologies to optimize outcomes for markets and investors.

However, the 2008 financial crisis, sparked by the fall of mortgage-backed securities and financial giants like Bear Stearns and Lehman Brothers,[16] marked a pivot in the perspective of bodies like the SEC and CFTC towards emerging financial technologies. Post-crisis events, including the "flash crashes",[17] extended the shift in the SEC's and CFTC's approach towards emerging financial technologies, such as automated trading (also known as algorithmic trading). As a result of this shift, the financial regulators such as the CFTC and SEC began to increasingly view emerging financial technologies as potential threats to the stability of the financial system.

In response to the crisis, the Financial Stability Oversight Council (FSOC) was established to synchronize efforts of U.S. financial regulators and the Department of Treasury towards ensuring financial stability.[18] Automated trading was an early focus of FSOC and later its attention turned to digital assets.

8 Working group members include, in addition to the SEC and the CFTC, financial regulators from Australia, Bahamas, Canada, the European Union, France, Hong Kong, Ireland, Italy, South Korean Mauritius, Singapore, Spain, and the United Kingdom.

9 See DeFi Consultation Report at p. 10

10 See DeFi Consultation Report at Annex B; See also Tyler Pearson, *Top 10 crypto hacks of 2023 — Stake ranks fifth as hackers wipe $735m,* DL News (September 7, 2023) https://www.dlnews.com/articles/defi/top-10-crypto-hacks-of-2023-ranked-as-stakecom-is-fifth/

11 Conflicts of Interest Associated with the Use of Predictive Data Analytics by BrokerDealers and Investment Advisers, Exchange Act Rel. No. 97990; Release Nos. 34-97990; IA-6353; File No. S7-12-23 (July 26, 2023).

12 See, e.g. *Regulation Automated Trading*, 80 Fed. Reg. 78824 (Dec. 17, 2015); For full discussion see also Hess, Eric, *Bridging Policy and Practice: A Pragmatic Approach to Decentralized Finance, Risk, and Regulation*, p. 14-28 (September 13, 2023). 128 PENN ST. L. REV. 2 (forthcoming Feb. 2024), Available at SSRN: https://ssrn.com/abstract=4571106 [hereafter the Bridging Policy and Practice Article]

13 See, e.g., U.S. Sec. and Exch. Comm'n, Report of Special Study of Securities markets of the Securities and Exchange Commission to the House Commerce Committee,, H.R. DOC. NO. 95, 88th Cong., 1st Sess. (1963)

14 Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70844 (Dec. 22, 1998).

15 Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496 (June 29, 2005).

16 The Financial Crisis Inquiry Report, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, Feb. 25, 2011

17 See, e.g., Jill Treanor, The 2010 'Flash Crash': How It Unfolded, GUARDIAN (Apr. 22, 2015, 1:43 PM)

18 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 111-203, 124 Stat. 1376 at §§ 111-23 (2010) (codified in scattered sections of the U.S. Code).

While ensuring financial stability is undeniably crucial, the post-crisis era saw a pronounced tilt towards risk aversion at the expense of nurturing innovation, leading to a predominantly top-down regulatory strategy. As of 2023, with digital assets and DeFi becoming focal points for bodies like the SEC and CFTC, this risk-averse attitude appears to be intensifying. This trajectory, especially when dealing with fledgling technologies, seems misguided. A recalibrated approach, focusing on facilitating the integration of DeFi into the broader financial framework, is essential to strike the right balance between innovation and regulation.

I recently published a different perspective on the regulation of emerging financial technologies, specifically DeFi, in my article: "Bridging Policy and Practice: A Pragmatic Approach to Decentralized Finance, Risk, and Regulation."[19] This conceptual framework acknowledges that DeFi protocols operate within expansive ecosystems, which encompass both centralized and decentralized components, including a mix of regulated and unregulated entities and individuals.

Hybrid finance envisions a strategic interplay between centralized and decentralized services, guided by considerations like specific use cases, efficiency requirements, and risk factors. This perspective is different from the "enterprise level" view which broadly categorizes a diverse set of DeFi ecosystem participants — from contractors to governance participants — under one organizational umbrella, encapsulating even those who develop and deploy code to support DeFi protocols.[20]

HYBRID FINANCE: A BOTTOM-UP ALTERNATIVE APPROACH FOR BETTER OUTCOMES

The broader definition of stakeholders in the hybrid finance ecosystem permits a wide range of collaboration across stakeholders, including regulators, with the goal of harmonizing investor protection and innovation. As I outlined in my article, a practical starting point for this collaboration could be the establishment of working groups. These groups would be instrumental in shaping upcoming legislation or rulemaking, ensuring a balance between various policy objectives, including investor protection and innovation.

Key benefits of these working groups include greater regulatory clarity as well as earlier development and implementation of industry standards. Regulated entities and other DeFi users can actively participate in these groups, contributing to the creation of technical and regulatory frameworks that facilitate their interaction with DeFi protocols. An early objective of such working groups would necessarily be to identify necessary regulatory relief, including safe harbors or temporary regulatory exemptions, necessary for achieving its goals pending the adoption of clarifying legislation or rulemaking.

In the U.S., as with most IOSCO members, a forward-thinking bottom-up approach would consider how currently regulated financial institutions can uphold their Anti Money Laundering (AML) and Controlling the Financing of Terrorism (CFT) requirements, especially concerning counterparty risk. Such collaborations might explore varied strategies, encompassing credential verification to transaction tracing analytics.

19 Bridging Policy and Practice Article at FN 12.
20 DeFi Consultation Report at p. 8-9.

As further elaborated upon in my article, integrating both permissioned and permissionless access into a permissionless DeFi protocol exemplifies how hybrid finance could cater to diverse requirements based on specific use cases and risks for both the regulated and unregulated actors.

The Consultation Report outlines three areas ripe for a cooperative, bottom-up methodology.[21] Recommendation 4 in the report relates to the identification and management of conflicts of interest within DeFi products and services, particularly stemming from the diverse roles of contributors and products offered. The recommendation emphasizes the need for transparency, advocating for disclosures concerning financial stakes related to user activities. Engaging collaboratively with stakeholders would be particularly effective when addressing such disclosure standards.

Recommendation 5 relates to the identification and management of material risks, especially operational and technological ones. Pointing to risks associated with DLT, smart contracts, oracles, and bridges, IOSCO asserts that DeFi providers must establish a risk management framework that addresses risks from products, participants, and the markets they operate in. Traditional risk management strategies are suggested for use, even if certain functionalities are outsourced. Drawing parallels to my article, I see this as an opportunity for a shared effort among hybrid finance stakeholders.

Existing frameworks that guide evaluations of outsourced service providers can offer invaluable insights for financial institutions venturing into the DeFi space. Notably, many DeFi entities already release third-party risk evaluations and system-centric risk minimization strategies, which can guide these evaluations. This parallels the AML-CFT point mentioned earlier, underscoring how hybrid finance can tailor risk management techniques to cater to diverse participants based on specific risks and scenarios.

Recommendation 6 aligns well with Recommendations 4 and 5, with calls for requiring the disclosure of clear information on DeFi products, services, operations, governance, risks (including technology risks), and financial conditions, including plain-language descriptions of risks, details on crypto-assets, and organizational accountability. Ironically, the SEC has resisted pursuing a more tailored disclosure regime for digital assets, despite recommendations of one of its own Commissioners to do so.[22]

Using a bottom-up approach can lead to more efficient regulatory results, sidestepping potential challenges associated with top-down methods. Even though Recommendations 4-6 lean towards a top-down perspective, they rightly pinpoint aspects that would benefit from a more collaborative, bottom-up strategy, leading to more precise and adaptable solutions.

The conceptual framework for a hybrid finance ecosystem is neither inconsistent with regulatory collaboration and standards, nor inconsistent with the core principles of DeFi. Collaborative working groups across hybrid finance stakeholders could ensure greater efficiencies in achieving more finely tuned outcomes. Such groups would mitigate the risk of unanticipated implementation issues arising from the application of a regulatory framework to DeFi that negates its primary features and benefits.

21 See DeFi Consultation Report, Recommendations 4, 5 and 6, p. 30-36.

22 Hester Peirce, Commissioner, Sec. & Exch. Comm'n, Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization (Feb. 6, 2020), https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06

CONCLUSION

The “hybrid finance” model offers a path to achieve the core aims of the Consultation Report’s recommendations without inadvertently placing undue responsibility on investors, governance members, as well as core and technical team contributors.

The extension of licensing or other regulatory obligations to parties within the hybrid finance ecosystem, if appropriate, would be grounded in in-depth analysis and understanding. Importantly, adopting this model ensures that implementation follows a collaborative approach while retaining the fundamental features of DeFi. This paves the way for continued innovation in open source fintech, inviting both regulated and unregulated players globally to contribute.

DeFi remains in its early stages. It’s essential for regulators to work alongside hybrid finance stakeholders instead of trying to force them back into traditional molds. This is the time to press for creative solutions that harness DeFi’s potential without stifling its unique features. Through the hybrid finance approach, global collaborative efforts can amplify DeFi’s advantages and address its challenges.

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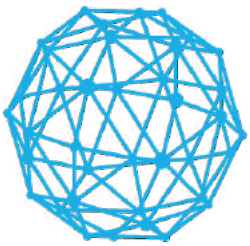
Length	3-4 print pages including footnotes
Target Audience for Submission	Broader business community aiming to better understand the technology and the legal issues associated with it
Content	All legal areas related to blockchain technology and digital assets
Structure	Introduction - Description of legal matter - Proposed solution - Conclusion/key takeaways
Writing Style	Not too academic; lucid and clear-cut language
What can I Submit?	Previously published work is welcome for submission to the IJBL



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