Web3 Regulation

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Who am I?

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General Counsel and Head of Decentralization

LATHAM & WATKINS LLP

CONSENSYS

- Got started in crypto in 2017 working with Consensys
- Co-chaired its global blockchain and cryptocurrency task force of 80 lawyers around the globe.
- Worked with almost every prominent venture firm and was counsel to dozens of startups in the sector.

Paradigm

connext

PANTERA

AZTEC

ElementFi

AAVE

Idle

Ribbit Capital

PARAFI CAPITAL

USV

Basics of Regulation

Who makes and enforces regulations?

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

Where are they codified?

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

How should you think about them?

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

Basics of Regulation

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

Securities Laws

The Securities and Exchange Commission

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

Securities Laws in Web3

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

Commodities Laws

The Commodity Futures Trading Commission

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

CFTC vs. SEC "Turf War"

- Are digital assets securities (SEC) or commodities (CFTC)?
- The battle for jurisdiction over crypto spot markets: Gensler v. Benham
- General industry preference for CFTC given commodity-like characteristics of digital assets

Anti-Money Laundering Laws

The Financial Crimes Enforcement Network

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

AML in Web3

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

Building in a maze of regulatory complexity

Building in web3 takes you down a very different regulatory path than what traditional startups experience.

I'll guide you through three parts:

- Decentralization
- Token launches
- Corporate structuring

DECENTRALIZATION

Decentralization democratizes the internet by *turning* web3 systems *into* public infrastructure

Decentralization: Frameworks

Technical Decentralization

Blockchains and smart contract protocols provide **trustless** and **autonomous** computational platforms upon which disintermediated web3 products and services can be built.

Economic Decentralization

Digital assets unlock the possibility of these web3 products and services having their own **decentralized economies** that encompass trade, borrowing, lending, content creation and licensing, etc.

Legal Decentralization

Decentralization **eliminates many risks** that existing laws were intended to address, thereby obviating the need to apply them.

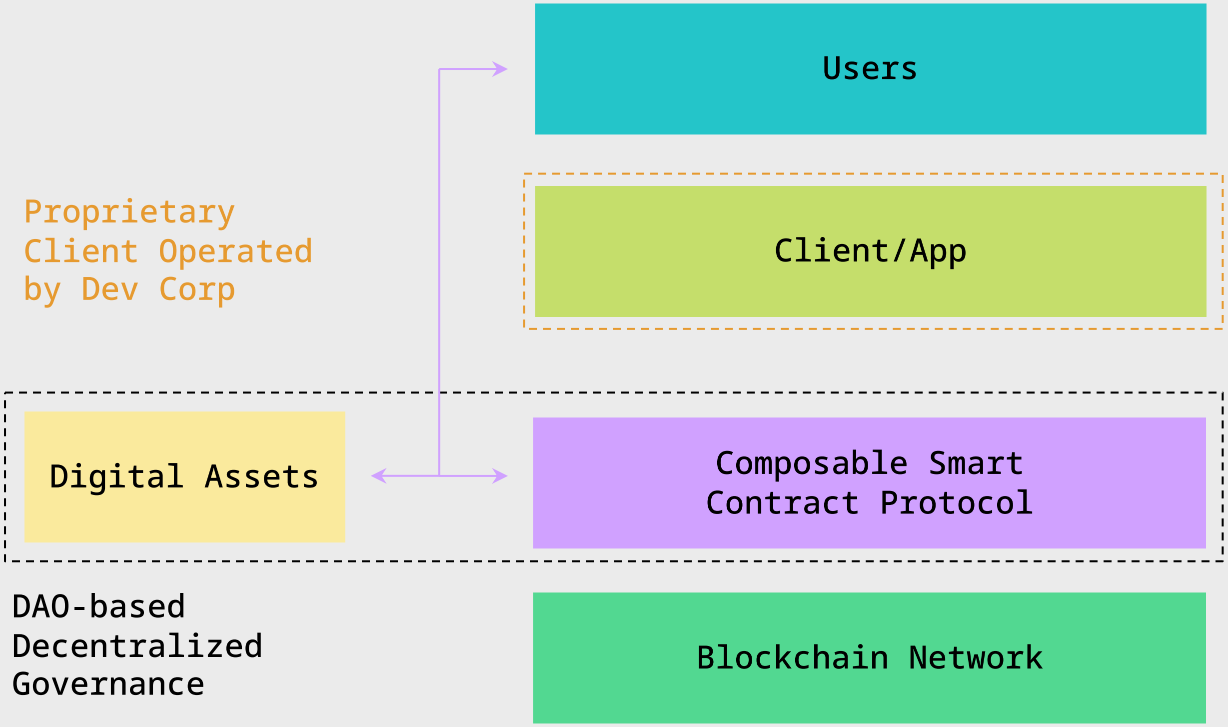
Models of Decentralization

This model adds:

1. Immutable smart contract protocol controlled by a DAO

1. Single “client” or “app” providing access to the protocol.

1. Digital asset incentives for users

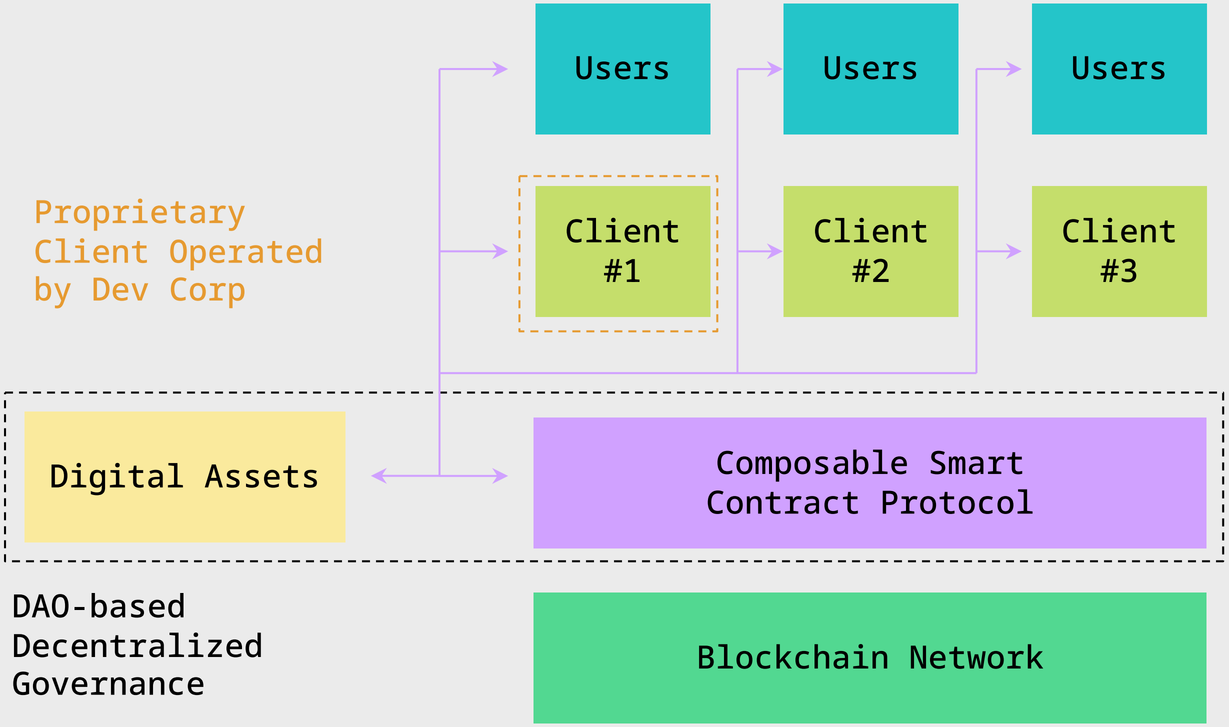


Models of Decentralization

This model adds:

1. Several “clients” or “apps” providing access to the protocol.

1. Digital asset incentives for users and clients/app operators/developers



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LAUNCHING COMPLIANT TOKENS

There’s a lot of noise about tokens…

The chair of the SEC is fond of saying that **all tokens are securities** and that **the rules are clear**.

If the rules were clear, why are there so many outstanding tokens and so few successful enforcement actions?

In reality, *not* all tokens are securities and the rules are *anything but* clear.

In reality…

Many tokens should be subject to securities laws, and many tokens should not be subject to securities laws.

Drawing that line is difficult, but the SEC has refused to improve the situation by working constructively with industry.

It’s default line of “come in and register” is disingenuous - **SEC registration is a death sentence for web3 projects**.

“Regulators themselves cannot seem to agree as to whether cryptocurrencies are commodities that may be subject to regulation by the CFTC, or whether they are securities...subject to securities laws, or neither, or even on what criteria should be applied in making the decision.”
- Honorable Michael E. Wiles

It’s frustrating…

Tokens ≠ equity

No contractual or statutory rights

Holders of **equity** are entitled to contractual and statutory rights than ensure management maximizes the value of the equity.

No one is under an obligation to maximize the value of **tokens**.

Protocols ≠ companies

Equity is about company ownership.

Tokens afford a much broader design space, and ownership is only one potential characteristic. Others include community membership, consumptive use, preferential access, etc.

Voting rights are limited

Equity entitles holders to control a company.

Tokens typically only enable holders to control limited elements of a protocol (fees, collateral types, grant programs, upgrades, deployment to additional chains, etc.).

THE BASICS OF LAUNCHING A TOKEN

Why are tokens necessary?

Decentralization

Tokens enable web3 projects to decentralize and operate in a **credibly neutral** way. By empowering **decentralized governance**, they also enable decentralized projects to continue to evolve and improve.

Incentivization

Tokens are the mechanism by which web3 networks can transform from being **closed networks** (where network effects accrue to the creator) to **open networks** (where network effects accrue to the users).

Security

The economic value ascribed to tokens is critical for the **security** of decentralized and open networks.

When are you ready?

Simple Answer: The Bahamas Test

When are you ready?

Real Answer: It’s complicated

Product market fit

It’s critical for projects to find product market fit ***before*** launching a token, as ongoing development efforts post-launch can be challenging and increase regulatory risk.

Sustainable token model

Projects should have a plan for a sustainable token model. Tokens are not magic beans. Regardless of a project’s use of tokens, unit economics apply.

Decentralization progress

Projects must be sufficiently decentralized or be pursuing progressive decentralization and using risk mitigation strategies.

Risks Addressed by Securities Laws

- U.S. securities laws apply to a subcategory of assets called “securities”.
- They **do not** limit what types of assets people can invest in - but they **do** seek to create a level playing field wherever **investments in securities** are being made.
- They do this by applying **disclosure requirements** to eliminate significant **information asymmetries** that may be relevant to the given price/value of a security.
- Such **information asymmetries** are particularly likely to arise when essential **managerial efforts** are the driving force behind the value of a security.
- As a result, securities laws are most likely to apply to transactions of digital assets where the value of such digital assets is dependent on the **managerial efforts** of others.

Legal Decentralization

So, if a web3 system can:

- eliminate the potential for **significant information asymmetries** to arise, and

- eliminate reliance on **essential managerial efforts** of others to drive the success or failure of that system,

then the system may be "**sufficiently decentralized**" such that the application of U.S. securities laws to its digital assets is unnecessary.

BEST PRACTICES FOR CORPORATE STRUCTURE

Corporate Structures

Corporations

The corporate entity form is the entity of choice for nearly every startup and every public company.

Owners (shareholders) get limited liability protection and are taxed separately from the entity.

Directors & Officers have fiduciary duties to maximize shareholder value.

LLCs & Partnerships

LLCs are used by closely held companies and partnerships are used by law firms, accounting firms, etc.

Provide varying degrees of limited liability protection and corporate or pass through taxation.

LLCs are hybrid entities that combine the characteristics of a corporation with those of a partnership.

Unincorporated Associations

Unincorporated associations arise out of common law and can apply whenever parties haven't created a formal legal entity.

Many states have made these entity forms statutory and provide limited liability in some cases.

Like LLCs, they can elect for passthrough or corporate taxation.

Decentralized Ecosystems

Developer Corporation

Post-token launch, the developer corporation is just a single member of the decentralized ecosystem, often responsible for opining on and potentially contributing to the further development of the protocol or tools and products for such protocol.

Foundations

Many decentralized ecosystems make use of foundations to accomplish a number of tasks, including being responsible for ecosystem funds, community management, representing the DAO, etc.

DAOs

A Decentralized Autonomous Organization is an organization whose activities are facilitated by blockchain technology. The governance activity of DAOs is most-commonly orchestrated through on-chain voting mechanisms that utilize governance tokens as voting instruments.

Why DAO?

- The Internet began with the **open source and decentralized protocols of web1** (http, smtp, ftp), but is now dominated by **closed/captive/private web2 systems** with the power to extract significant take rates.

- Web3 makes it possible for **open source and decentralized web3 protocols to compete** with the operational functionality of web2 systems.

- DAOs facilitate the decentralized ownership and operation of these web3 protocols, thereby enabling them to deliver on the promise of decentralization**: the democratization of the Internet**.

Which DAO?

There are numerous types of DAOs with varying purposes

Protocol DAOs

DAOs that administer and maintain the affairs of a given blockchain or smart contract protocol and any treasury associated with such protocol.

Examples: MakerDAO, Compound DAO, Uniswap DAO

Social DAOs

DAOs that are formed and operate as social clubs, often using token-based gating for attendance of events and access to content.

Examples: FWB, LinksDAO

Investment DAOs

DAOs that pool assets of members and allocate those resources to invest or to collect art, collectibles, real estate, etc.

Examples: PleasrDAO, FingerprintsDAO

Collective DAOs

DAOs that act as digitally organized collectives of artists, engineers, and others, who coordinate to provide services to web3.

Examples: VectorDAO, WorkDAO

How DAO?

- Traditional C-Corp DevCo creates a smart contract protocol (e.g., Uniswap, Compound, Aave, etc.) that is deployed to a blockchain (e.g., Ethereum, Optimism, Solana, etc.).

- DevCo gives up control of the protocol by forming a DAO and distributing governance tokens to employees, investors and users. The token enables holders to govern the protocol.

- The DAO also often has control over a “treasury” (a stored pool of unissued governance tokens) that it can use to fund improvements of the protocol or on business development efforts.

- This decentralization makes the protocol “**credibly neutral**” **-** builders can now have greater confidence building on top of such protocol, knowing that it will not be arbitrarily changed.

- **The handing of control of the protocol helps turn the protocol into a public good, like public infrastructure**.

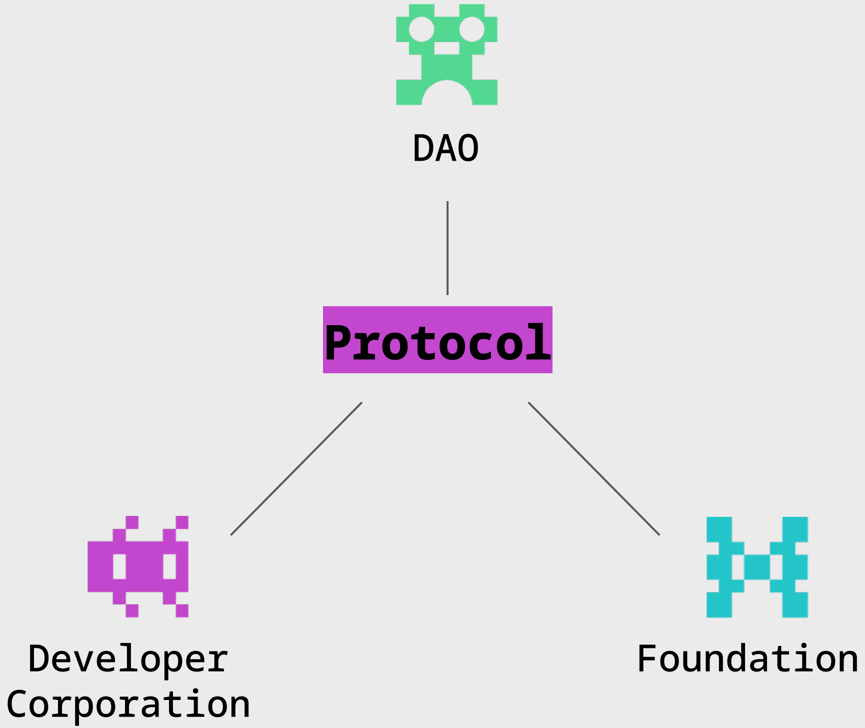
Key issues for DAOs without legal structures

For DAOs with no legal entity structure (i.e., Entityless DAOs), the key challenges are:

1. **No legal existence** – No ability to contract – Can’t hire services providers to administer the affairs of the DAO (e.g., can’t hire auditors to perform code audits).
2. **No ability to pay taxes** – Income for DAOs can arise through operation of the protocol or the treasury over which they exercise control, but Entityless DAOs have no way of paying taxes.
3. **Potential unlimited liability** – Lack of clarity on liability could result in any number of potential harms that could arise through the operation of the protocol.

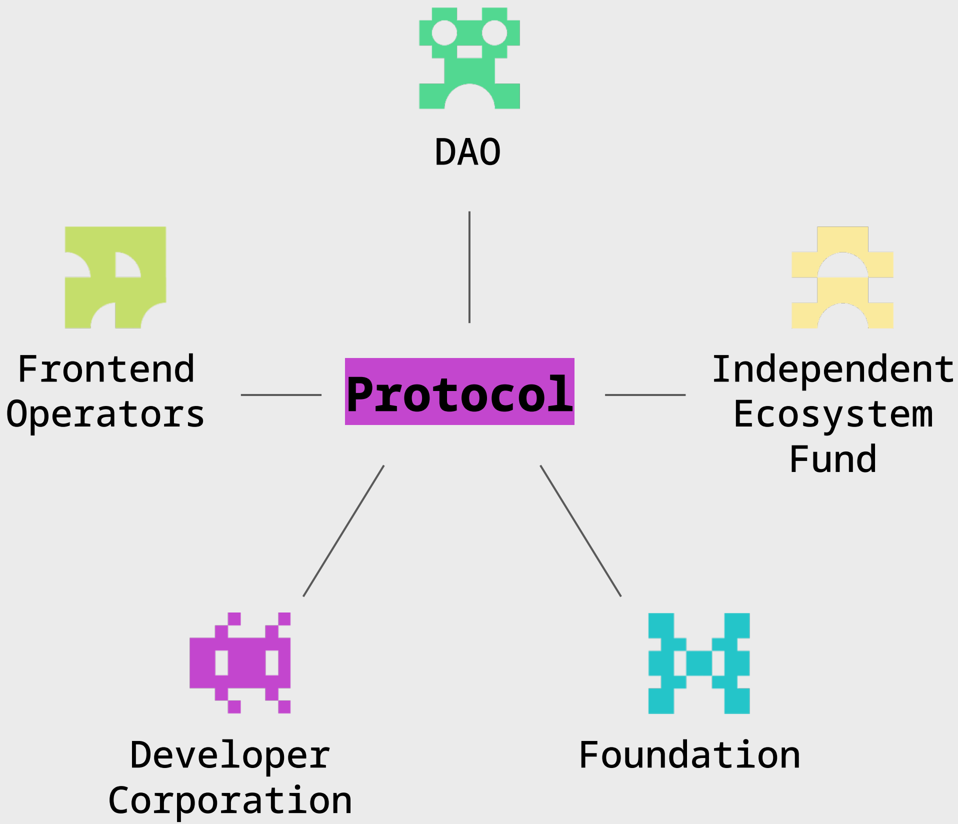
Utilize foundations to grow from here…

- DevCo launches DAO and Foundation.
- DAO controls any protocol upgrade, protocol parameter changes and use of protocol treasury.
- Foundation administers grant program from initial endowment and organizes community.
- DevCo works on tooling and other projects for the ecosystem.



To here…

- DAO controls any protocol upgrade, protocol parameter changes or use of protocol treasury.
- Foundation administers grant program from initial endowment and organizes community.
- Small ecosystem fund run independently of foundation.
- Multiple frontends deployed by independent parties.
- Initial DevCo is one of many working on tooling and other projects for the ecosystem.



QUESTIONS

Important Disclosures