Securities Regulation and Crypto Assets Markets

Distinguished Visitor Lecture,
E.W. Barker Centre for Law & Business,
Faculty of Law, NUS, December 6, 2023

Vikramaditya S. Khanna,
William W. Cook Professor of Law,
University of Michigan Law School &
Visiting Research Professor, EWBCLB, NUS Law

Overview

- What are Crypto Assets; why might they be valuable?
- What areas of law might they implicate? Focus on Securities Regulation (Sec Reg) with a policy lens. Overview of US Sec Reg:
  - Concerns: Asymmetric Information & conflicts of interest in raising capital and trading securities. But regulatory burden can be high so take steps to contain it.
  - Primary Responses: Compel production of information from issuers and others; police information's veracity, monitor conflicts of interest in trading/transacting, and contain regulatory costs.
  - Structure of regulation: Broad definition of security, but then exemptions from full extent of securities regulation where concerns are thought to be less and regulatory costs relatively high.
  - Core legal question: Are crypto assets "securities" and hence subject to US Sec Reg? *Howey* analysis. Not a model of clarity.
- **But,** do crypto assets raise same kinds of policy concerns as securities (functionally)? Would Sec Reg really help?
  - Reasons to think the answer is not entirely obvious.
  - If concerns (and players) are somewhat different to standard securities regulation, then how should regulation of trading in crypto assets proceed?
  - Compare to emerging regulation – Singapore, EU, and elsewhere.
- Connect to other areas of law – anti-money laundering and more.

What are Crypto Assets? How "might" they add value?

- Crypto assets have garnered a great deal of attention – Bitcoin, Ether, "Smart Contracts", Doge Coin, NFTs, and more.
- To explore the potential value of crypto assets let us start with how they "might" be useful in reducing the costs of transacting by reducing verification costs. Consider the following example:
  - In a typical real estate transaction both the seller and buyer face costs of transacting that often involve verifying things e.g., the buyer needs to verify the seller has title to the property, etc…; while the seller has to verify the buyer has funds to pay for the property, etc… .
  - In the US the process of purchasing property after finalizing price, etc… often takes 4-6 weeks which reflects verification efforts.
  - There are many intermediaries who "ease" the process along, charge fees for doing so, and raise concerns about conflicts of interest, corruption, acquiring market power, etc… .
  - This pattern is present in many markets (e.g., concerns with Big Tech).
- ***But,*** what if there were ways to use technology to reduce verification costs? If so, then we might reduce some of the concerns and costs noted above and obtain other benefits.

What are Crypto Assets? How "might" they add value? Part II

- Blockchain is a set of technologies that may reduce these costs. If information is digital (*) then blockchain can provide speedy, accurate, and often cheaper verification while relying less on intermediaries (*).

- Lower verification costs reduce the cost of transacting (facilitating more transactions), reduce the concerns with intermediaries, and may enable the creation of newer categories of assets that the law did not recognize before (e.g., resale royalties).

- But, blockchain is not free – verification requires entities to expend resources and they need compensation. This varies between private and public blockchains.

What are Crypto Assets? How "might" they add value? Part III

- Blockchain is not free…
  - In "private" blockchains (e.g., JP Morgan coins) an entity controls verification and pays the verifiers (often in cash). Concerns about powerful intermediaries arise.
  - In "public" blockchains there is usually no central party controlling verification (cf. Wikipedia). Verifiers are usually paid in digital assets (DA) and often in the DA whose transactions they are verifying (eg Bitcoin miners). The key thing is that the value of these DA depends on use and trading in them – the verifiers then have an incentive (a conflict?) to encourage this. These are usually called "crypto" assets.
- Concerns – e.g., conflicts of interest, manipulation, fraud (eg FTX).
  - This suggests where crypto may be useful – when verification and intermediary costs are high and cash payments may not be sufficient or feasible. But must balance against the costs (eg fraud) which can be potentially reduced via regulation as well as the notion that there may be less expensive technologies that have higher net gains.
  - Assume for now that crypto can be useful on net at times and then explore how we might regulate it. We return to more critically examining crypto's usefulness later.

Securities Regulation

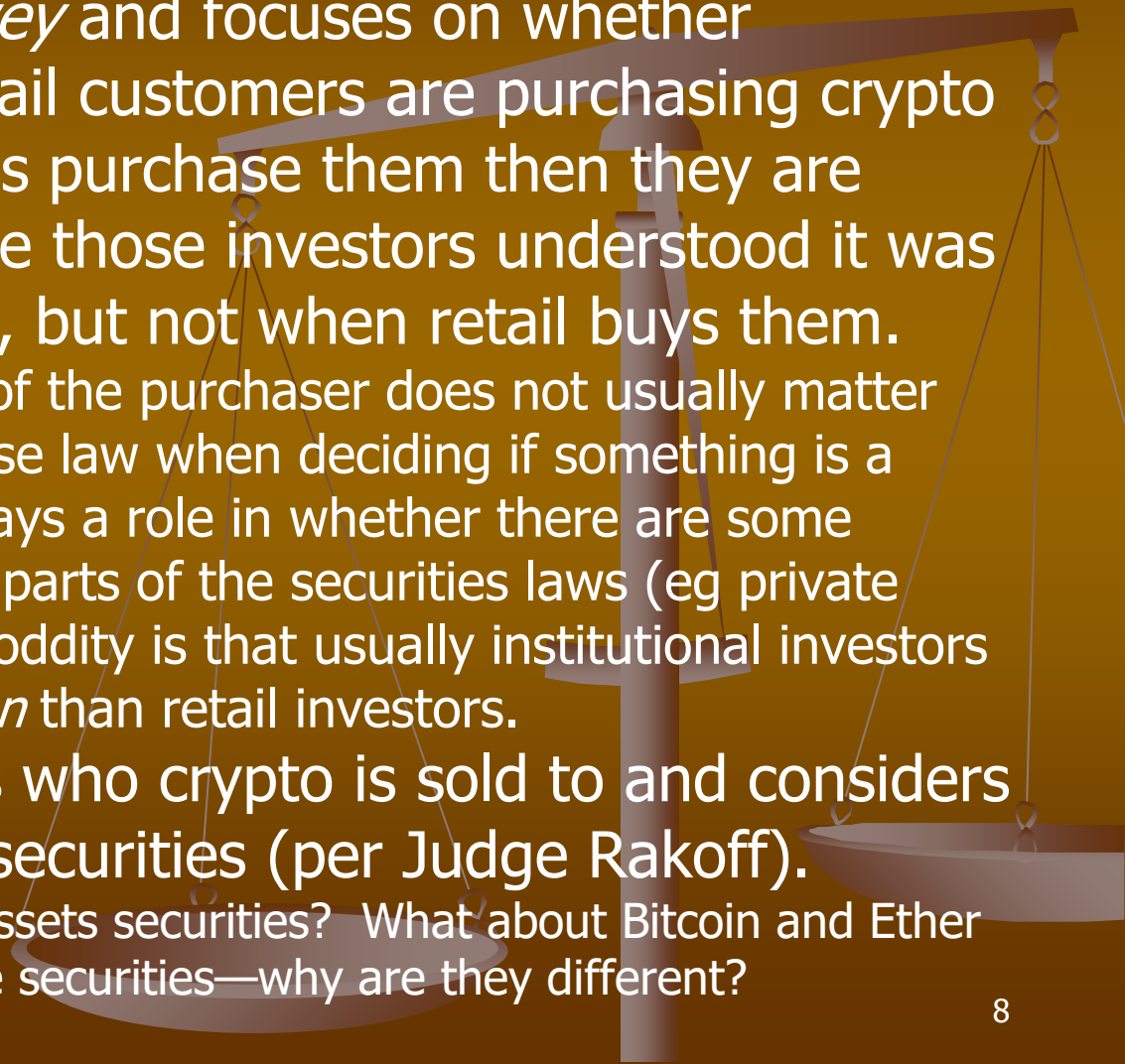
- Given the importance of trading to crypto assets markets we should look at the areas of law regulating trading which includes securities regulation.
- Securities Regulation is primarily concerned with policing issues arising from the issuance and trading of "securities". These include:
  - Asymmetric information – the issuing firm knows much more about its prospects than likely investors creating potentially bad incentives. Thus, we compel disclosure of information about the firm and its prospects and police with anti-fraud rules. But often when problems arise the issuing firm may not have enough money to pay for harm, so the law also imposes duties and liabilities on third parties and intermediaries (gatekeepers).
  - But gatekeepers can have conflicting interests and that are policed through detailed rules applying to many of these players (eg Brokers, Exchanges).
  - The costs of disclosure and policing can be high and may deter some firms from accessing the public capital markets.
- Securities Regulation (in the US and elsewhere) addresses these, often conflicting, concerns by how it defines what it covers (what are "securities") and then through a series of partial exemptions to the full securities laws that reduce the regulatory burdens/costs when the concerns about asymmetric information and conflicts of interest are thought to be less.
- So a threshold question becomes: are crypto assets "securities"?

Securities Regulation, Part II

- When is something a "security"?
  - US Securities Regulation asks first whether the title of the thing/item being traded is on a long statutory list of things that are presumptively thought to be securities (eg stocks, bonds, shares….) and if it isn't then it asks whether the thing is an "investment contract" under *Howey* as adjusted by later cases. *Howey* asks whether the thing is an:
    - Investment of money/other things of value,
    - In a common enterprise,
    - With the primary object of profit,
    - Primarily from the efforts of another/issuer (or its management), and
    - Where no other existing regulatory regime applies.
- So, what do Case Law and Regulation say about Crypto Assets being securities?

Securities Regulation, Part III

- Case Law
  - *Ripple* elides *Howey* and focuses on whether institutional or retail customers are purchasing crypto – when institutions purchase them then they are securities (because those investors understood it was a speculative bet), but not when retail buys them.
    - But, the identity of the purchaser does not usually matter under existing case law when deciding if something is a security, but it plays a role in whether there are some exemptions from parts of the securities laws (eg private placement). The oddity is that usually institutional investors get *less protection* than retail investors.
  - *Terraform* ignores who crypto is sold to and considers them likely to be securities (per Judge Rakoff).
    - But are all crypto assets securities? What about Bitcoin and Ether – thought not to be securities—why are they different?



Securities Regulation, Part IV

- Regulatory Responses
  - SEC treats most crypto as securities (except Bitcoin and Ether). But some Commissioners (Hinson) said that crypto assets can start out as being a security (or not) and then morph into not being one (or becoming one). The key feature is extent of decentralization.
    - The fact that some things can be securities when marketed in a particular way, and not otherwise, is not new, but saying that something that was once a security can change its status by how it is later used is unusual.
  - CFTC treats many crypto assets as commodities, but considers the DAOs creating them to be liable for certain defects or harms (*Ooki DAO* settlement).
- Commentators
  - Some argue that the value of many crypto assets are not determined by the issuer or affiliated parties and do not meet *Howey's* 4th prong (efforts of another) and are not securities.
    - This argument is unconvincing because at times there are things/items where the issuer's role in profits is more limited, but those things are still securities (eg viatical settlements). This seems motivated by a sense that investors' payoffs are influenced by things the issuer does (or did).

Securities Regulation, Part V

- Although interesting, these approaches do not engage much with policy. Let us bring them in.
  - Asymmetric information and crypto assets on public blockchains.
    - In theory, decisions about a crypto asset on public blockchains are visible and transparent so there should be *less* asymmetric information relative to securities.
    - But, often we do not know who is trading; whether there are side deals; and so forth.
    - A recent survey we ran (Khanna, Prabhala and Puri, 2023) found the general public was more interested in who uses crypto assets (eg big firms, institutions or gov't) and the identities of those designing the asset rather regulation of crypto generally.
    - So there is some asymmetric information, but it appears a little different to the standard concerns of securities.

Securities Regulation, Part VI

- More on Policy… .
  - Gatekeepers:
    - A strategy of relying on gatekeepers (eg underwriters, lawyers, accountants) is attractive for securities where the market has numerous intermediaries who can influence/monitor the content of disclosure.
    - This maps awkwardly on to crypto markets where there are fewer intermediaries (e.g., exchanges) and they do not appear as well positioned to influence disclosure.
    - This suggests some adjustment in how we think about third party monitors for crypto asset markets (e.g., would DAO members be a good option as in Ooki DAO).
  - Conflicts of interest:
    - Given relatively low level of participation in crypto asset markets and difficulties in identifying the transacting parties the prospect for conflicts is pretty high.
    - So, some regulation seems merited on this front.

Securities Regulation, Part VII

- The analysis suggests that current securities rules probably need much adjustment before being applied to crypto asset markets.
- Here is one potential approach to regulation of trading in crypto assets (it is very early stage, largely to spark discussion).
  - First, is the crypto asset being used to raise capital (eg an Initial Coin Offering). A *Howey*-like test may be useful but perhaps with a more explicit focus on whether the aim is investment (as opposed to use) and whether some significant part of the return is determined by others. That suggests asymmetric information will be important.
    - If yes, then we can ask what sorts of information might investors find useful and require production of that (see earlier survey KPP, 2023). Who uses the crypto asset and the identifies of the people designing the crypto asset seem important.

Securities Regulation, Part VIII

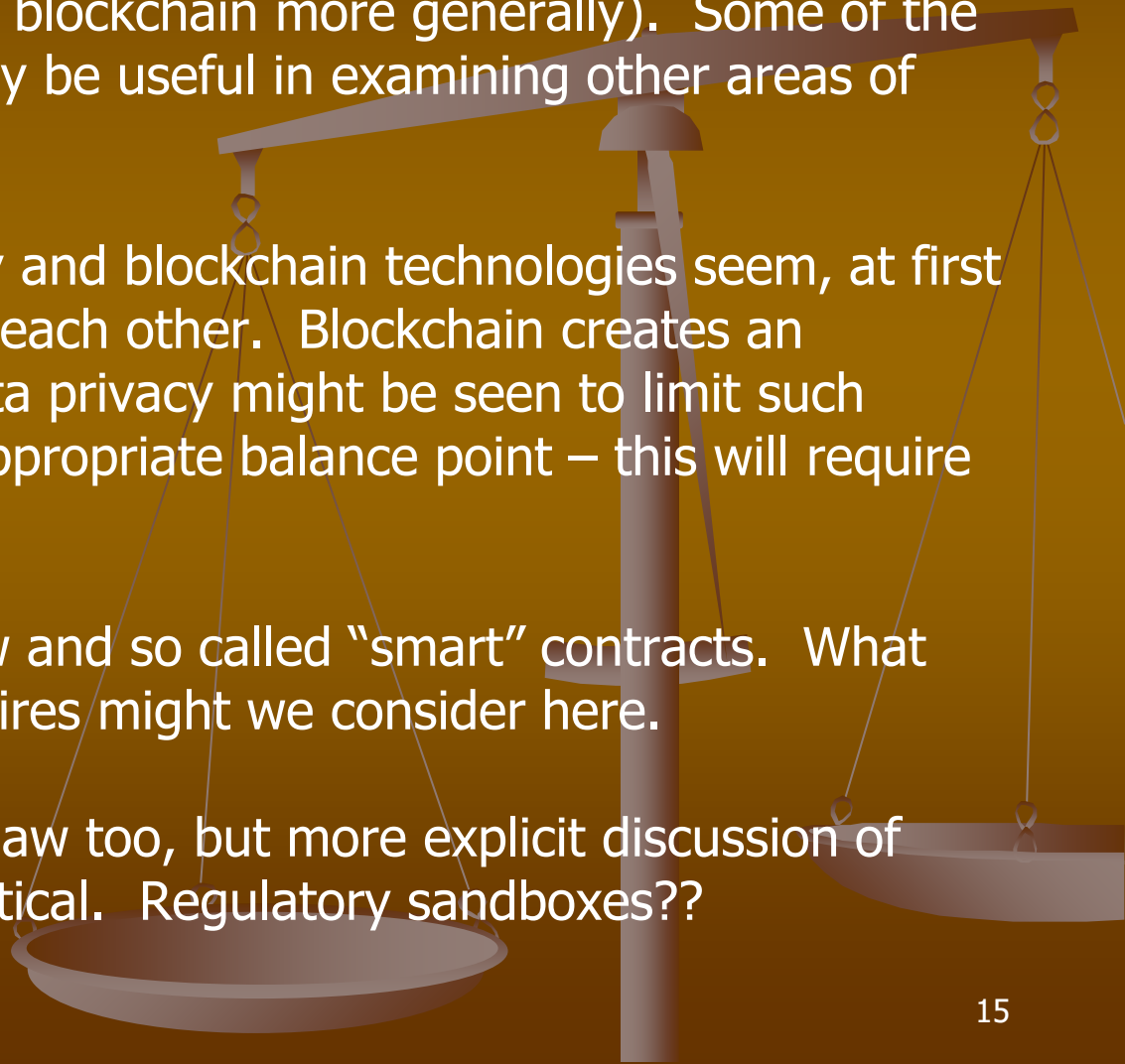
- One potential approach, cont'd….
  - Crypto asset being used to raise capital.
    - Who should we impose duties and liabilities on? The intermediaries are different in crypto asset markets and their ability to influence the issuer of the coin (and indeed the issuer's ability to influence the value of the coin) are not generally the same as in standard securities where underwriters, lawyers, et al have considerable influence.
    - In crypto perhaps focus on large traders, exchanges, brokers, and/or DAO members? But query how much influence each of these players has on a consistent basis. Who are the market gatekeepers now who we might rely upon? If there aren't significant ones then we need to re-assess the effectiveness of a gatekeeper strategy and consider more ex ante regulation.
  - If the crypto asset is not being primarily used to raise capital then a different regulatory approach may be more valuable (eg one concerned with conflicts of interest or even how the crypto asset affects other areas of potential regulation – privacy, money laundering).

Securities Regulation IX - Emerging Approaches to Crypto Regulation

- US: Does not have specific legislation yet (some draft bills), but regulatory agencies are assertively pursuing enforcement actions.
- UK: Financial Conduct Agency regulates digital assets it considers investments, but "payment tokens" like Bitcoin or "utility tokens" that provide access to a service are unregulated.
- EU: MiCA coming into effect in 2024 which regulates crypto trading along a licensing/gatekeeping model with rules designed more for crypto. Much of the regulation also targets stablecoins.
- Hong Kong: developing new regulatory regime to regulate crypto via licensing.
- India: concerned about financing terrorism and imposed a tax on trading – not so much because it thinks these are securities but to reduce the large influx of money and volatility.
- Singapore: Crypto Asset trading is legal (but if they are digital representations of other assets they are treated as securities). Cryptocurrencies not legal tender. Regulation is guided in part by anti-money laundering and risks of insolvency of digital payment token providers.

What other areas of law are implicated?

- Securities Regulation is not the only area of law potentially implicated by crypto (and blockchain more generally). Some of the policy driven analyses may be useful in examining other areas of law.
- For instance, data privacy and blockchain technologies seem, at first cut, to run headlong into each other. Blockchain creates an immutable ledger and data privacy might be seen to limit such things. How to find an appropriate balance point – this will require explicit policy analysis.
- Another – commercial law and so called "smart" contracts. What safety measures or trip wires might we consider here.
- There are other areas of law too, but more explicit discussion of policy concerns seems critical. Regulatory sandboxes??



Circling Back - Is Crypto Worth It?

- Is Crypto worth it?
  - Earlier we assumed that the net gains from reducing transaction (verification) costs was worth it. However, this is too simplistic.
    - First, other technologies might provide verification services at perhaps cheaper cost and comparable gains.
    - Second, sometimes the reduction in verification costs may not be enough. If changes in behavior won't occur until verification costs drop by 40% then anything less won't generate much change.
    - Third, there are few examples of crypto use cases thus far. Many uses of blockchain verification are via private blockchains so little need for crypto there. It may also be there aren't many feasible crypto use cases for public blockchain.
    - Fourth, why can't verifiers in public blockchains be paid in cash? The argument often made is that paying with crypto enhances adoption of the coin (via a sort of network effect). Although plausible, it seems unlikely that a network effect can be created for all cryptos. Perhaps a few, but all?
- But even if crypto is not terribly useful it does not by itself mean securities regulation should prohibit it… .

Concluding Thoughts

- Crypto asset markets have attracted great attention and raise many regulatory questions – a central one has been the application of securities regulation to trading in crypto asset markets. Policy informed discussion (functional analysis) seems important.
- Securities Regulation motivated by concerns with asymmetric information, conflicts of interest and gatekeeper liability regimes.
- But application by case law and regulation not very policy oriented.
- Closer analysis suggests that a policy focus underscores that the concerns raised by crypto asset trading are not exactly the same as in securities and the intermediaries in the market are different with different monitoring abilities and propensities.
- This calls for an adjusted approach to regulating crypto asset trading. I suggest a few first steps in that direction.
- Global regulatory regimes are experimenting with different models and likely would benefit from the policy focus as might other areas of law implicated by crypto assets.