

SEC AND ETHEREUM, SECURITY OR COMMODITY?



BACS
Blockchain Arbitration
& Commerce Society

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ABOUT ABOUT BACS

BACS is an association of private law and commerce, legally constituted and formed by members of the community empowering businesses and resolving internal conflicts. That is; a legal environment that respects, fosters and resolves crypto problems from within.

Through an association of members from the legal and technological environment, to whom we offer training in this new technology, networking, audits and quality seal. BACS operates as a Legal Oracle in legal businesses that employ blockchain and cryptocurrencies. We have the first specialized Arbitration Court, internationally recognized, and whose rulings are enforceable.

BACS' activity is critical because current law is not prepared to assume this new technology. Classical legal systems resolve conflicts between hierarchical and centralized organizations, but the new blockchain technology requires new legal institutions. Blockchain, like smart contracts and tokens, surpasses the current regulatory system.

BACS is formed by a crypto commercial and legal community that, respecting the private and autonomous law that arises in this new context, resolves private conflicts in a secure and transparent manner. In the crypto world, regulation is the community itself, so the community must create and respect its own law.



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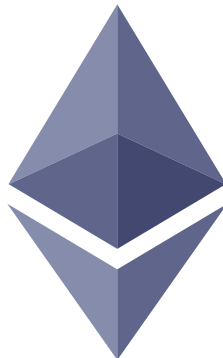
INDEX

- 01 OFFICIAL POSITION OF SEC REGARDING ETHEREUM.
- 02 SOME SIMILARITIES BETWEEN ETHEREUM AND CARDANO.
- 03 ACCORDING TO BINANCE AND COINBASE CASE, ETHEREUM COULD BE CLASSIFIED AS SECURITY.
- 04 COMMODITY AND DECENTRALIZATION
- 05 ACCORDING TO SEC, ETHEREUM IS SIMILAR TO BITCOIN
- 06 SEC CRITERIA FOR CONSIDERING A SECURITY, AND HOW THEY APPLY TO ETHEREUM.
- 07 APPARENTLY ETHEREUM WAS BORN SECURITY AND TURNED INTO COMMODITY.

OFFICIAL POSITION OF SEC REGARDING ETHEREUM

As of today, there is no official or clear decision on whether Ether, the token of the Ethereum blockchain, is a security.

The only publicly available information from the SEC found on this matter is a speech dated June 14, 2018, by William Hinman, Director of the Division of Corporation Finance, titled "Digital Asset Transactions: When Howey Met Gary (Plastic)"¹.



¹ [SEC.gov | Digital Asset Transactions: When Howey Met Gary \(Plastic\)](https://www.sec.gov/corpfin/Digital-Asset-Transactions-When-Howey-Met-Gary-Plastic).

02 SOME SIMILARITIES BETWEEN ETHEREUM AND CARDANO

However, the recent lawsuits by the SEC against Binance and Coinbase have included tokens like ADA (from Cardano) as securities. Cardano could closely resemble how Ethereum is governed, with a foundation based in the canton of Zug, Switzerland. In fact the SEC plaintiff against Binance states that three entities are responsible for Cardano among them the Cardano Foundation, a Swiss entity that is the legal custodian of the Cardano protocol and owner of its brand.

Both the Ethereum and Cardano networks were funded through the issuance of their respective native tokens, ETHER and ADA, respectively. The Ethereum team raised roughly \$18.3 million worth of Bitcoin in the token sale, which was more than 31,500 BTC at the time of the ICO.² In the case of Cardano, from 2015 to 2017, Input Output Hong Kong (“IOHK”), a company founded by Hoskinson and Wood, conducted a token sale during which they sold approximately 25.9 billion ADA in exchange for bitcoin, at what equates to an average price of \$0.0024 per token, raising approximately \$62 million for Cardano.

²<https://coincodex.com/ico/ethereum/>

07 ACCORDING TO BINANCE AND COINBASE CASE, ETHEREUM COULD BE CLASSIFIED AS SECURITY

Also, one of the criteria for considering a token as a security in the SEC's lawsuits against Binance and Coinbase is how many tokens have been allocated to the team, and the team's efforts to increase the token's value, for example, through burning measures to make the token deflationary. This way, investors can perceive the token as an investment with expectations of value appreciation.

In the case of Ether, 18.80% of the ICO was allocated to founders and the foundation. This meets the criteria of the SEC's lawsuit. On the other hand, Ethereum announced time ago a deflationary policy with its token. All of this leads us to conclude that the decisions of the SEC are not coherent or do not follow a clear criterion. This undoubtedly creates significant legal uncertainty and insecurity. It also creates a perception that not everyone is judged by the same standards. This is the reason why Coinbase recently sued the SEC, demanding regulatory and normative clarity.

³ <https://moralismoney.com/blog/what-is-eip-1559-and-will-ethereum-go-deflationary-with-it>

03

If ADA is considered a "security" by the SEC, the logical consequence would be to consider Ether as a security as well. The reality is that Ether is not mentioned as a security in the SEC's lawsuits against Binance and Coinbase, and therefore we can deduce that, in any case, it is not classified as a security by the SEC.

It is true that both Ethereum and Bitcoin have been classified as commodities by the CFTC in the lawsuit against Binance (march 2023).



04

COMMODITY AND DECENTRALIZATION

Regarding why Ethereum has not been considered a security, it seems that the central criterion is its decentralization. But this concept would require further clarification by the SEC.

The only publicly available information from the SEC found on this matter is a speech dated June 14, 2018, by William Hinman, Director of the Division of Corporation Finance, titled "Digital Asset Transactions: When Howey Met Gary (Plastic)"⁴.

Mr Hinman stated that "the digital asset itself is simply code. But the way it is sold – as part of an investment; to non-users; by promoters to develop the enterprise – can be, and, in that context, most often is, a security – because it evidences an investment contract".

⁴ [SEC.gov | Digital Asset Transactions: When Howey Met Gary \(Plastic\)](https://www.sec.gov/corpfin/20180614-digital-asset-transactions-when-howey-met-gary-plastic).



04



That is why he thought that regulating these transactions as securities transactions makes sense. That is way, according to him, impetus of the Securities Act is to remove the information asymmetry between promoters and investors. In a public distribution, the Securities Act prescribes the information investors need to make an informed investment decision, and the promoter is liable for material misstatements in the offering materials. These are important safeguards, and they are appropriate for most ICOs.

The central question is whether a digital asset is or is not a security. In this regard, Mr. Hinman pointed out that...

"if the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract".

In this sense,

"when the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful".

05

ACCORDING TO SEC, ETHEREUM IS SIMILAR TO BITCOIN



Mr. Hinman also highlighted Bitcoin as an example of decentralization: *“I do not see a central third party whose efforts are a key determining factor in the enterprise. The network on which Bitcoin functions is operational and appears to have been decentralized for some time, perhaps from inception. Applying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would seem to add little value”.*

Following this example, Mr. Hinman explained the reasons why Ether is not a security, following the example of Bitcoin: *“And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value”.*

05

But fundraising has indeed been one of the criteria applied in the SEC's lawsuit against Binance and Coinbase to classify tokens as securities. This is the case for ADA, MATIC, AXIE, SAND, MANA, and others. That is why it is inconsistent not to apply this criterion to the case of Ethereum.

Mr. Hinman also stressed that using tokens in a decentralised network can also qualify as securities: *“even digital assets with utility that function solely as a means of exchange in a decentralized network could be packaged and sold as an investment strategy that can be a security. If a promoter were to place Bitcoin in a fund or trust and sell interests, it would create a new security. Similarly, investment contracts can be made out of virtually any asset (including virtual assets), provided the investor is reasonably expecting profits from the promoter’s efforts”.*



06

SEC CRITERIA FOR CONSIDERING A SECURITY, AND HOW THEY APPLY TO ETHEREUM

For Mr. Hinman some facts and circumstances to consider are:, and this list is illustrative, not exhaustive:

6.1

A group who sponsor or promote

Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?

For example, in the Ethereum case, clearly the answer is yes. The founder team (Vítálik Buterin among others) and Ethereum Foundation are behind Ethereum. Is not the case of Bitcoin, we do not even know who Satoshi Nakamoto is. Should Vitalik Buterin resign and let the DAO organize itself without anyone in charge to resemble Bitcoin more?



6.2 Interest of the group to increase the value

Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?

In the Ethereum case the answer is yes.

Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?

In the Ethereum case, the answer can be yes for both questions.

6.3 Purchasers are seeking a return

Are purchasers “investing,” that is seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?

In the Ethereum case, yes.

6.4 Person or entity that plays a key role in the succeed of the project

Does application of the Securities Act protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?

It seems that it is also the case for Ethereum.

Do persons or entities other than the promoter exercise governance rights or meaningful influence?

It is clear that Vitalik Buterin wields a significant influence. This is evident in the case of the Ethereum Classic fork and "The DAO," notwithstanding that it was a community decision.



07

APPARENTLY ETHEREUM WAS BORN A SECURITY AND BECAME A ACOMMODITY.

So we can deduce from Mr Hinman's statement: *"And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions"*.

According to this statement, Ethereum's fundraising may have resembled that of a security, but now, being a decentralized platform, it is no longer considered one. However, the SEC should provide information on when a token can cease to be classified as a security. And, more importantly, what decentralization requirements exist to stop being classified as a security.

To finish, in a clip is from a Fall 2018 Graduate MIT course called "Blockchain and Money" Gary Gensler - the current President of the SEC, was the professor. Once again, I will let the below video speak for itself. Lecture 6: Smart Contracts and DAPPs-September 25, 2018. He said: *"In 2018, the Securities and Exchange Commission has said regardless of what it might have been in 2014, it's now sufficiently decentralized that we'll consider not a security."*




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