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February 15, 2019

Christopher Kirkpatrick, Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

Re: Virtual Currency RFI - Token-Compensation Arrangements

Dear Mr. Kirkpatrick:

Perkins Coie LLP ("**Perkins Coie**") welcomes the opportunity to provide comments to the Commodity Futures Trading Commission ("**CFTC**" or "**Commission**") on its request for input regarding the technology, mechanics, and markets for virtual currencies[1] beyond Bitcoin (in particular Ether and its use on the Ethereum Network) (the "**RFI**"). We appreciate the thoughtful approach taken by the Commission concerning the regulation of this new and promising asset class and its underlying technology. We also recognize the challenges in providing regulatory oversight with respect to transactions involving blockchain-based protocols and products.

We respectfully submit this comment letter to address arrangements ("**Token-Compensation Arrangements**" or "**TCAs**") in which a digital asset,[2] such as a virtual currency

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1 The CFTC defined "virtual currency" to mean "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, but does not have legal tender status in any jurisdiction." See In the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Dkt. No. 15-29 at n.2 (Sept. 17, 2015) (the "Coinflip Order"), available at: http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliprorder09172015.pdf.

2 We understand that the CFTC has generally referred to a broad swath of digital assets as "virtual currencies" in past releases and statements. While many digital assets do function as currencies, this terminology originated with the Financial Crimes Enforcement Network ("**FinCEN**") and obfuscates the nature of these novel instruments. We recommend that the Commission view digital assets as an asset class that spans the jurisdiction of the Commission and other agencies. All digital assets that do not constitute securities, which may include virtual currencies such as bitcoin as well digital tokens that have a consumptive use case other than payment or store of value, are within the jurisdiction of the Commission. FinCEN may characterize many digital assets as "convertible virtual currencies" for purposes of its regulations but these assets may nevertheless have a consumptive use case and, for purposes of the Commission's regulations, should be more appropriately thought of as digital versions of oil or electricity that enable

or token issued on the Ethereum network,[3] is used to directly compensate developers, founders, employees and other individual consultants and advisors for their performance of *bona fide* services in the technology development and creation of blockchain-based protocols and products ("**Compensation Recipients**"). For the reasons explained herein, we do not believe that TCAs should be substantively regulated under the CEA.

While there were twenty-five questions posed by the RFI, we wish to clarify that this letter is intended to provide general input on the topic of digital assets (not solely Ether) which we believe should be considered by the Commission. However, the Commission may also find this letter helpful in its consideration of some of the enumerated questions: 1 (*the impetus for Ethereum network development*), 2 (*the current functionalities and capabilities of Ether*), 3 (*how the developer community currently utilizes the Ethereum network*), and 4 (*are there any existing or developing commercial enterprises that are using Ether and if so how is it accounted for on financial statements*).[4]

TCAs SHOULD NOT BE SUBSTANTIVELY REGULATED UNDER THE CEA

TCAs can be put into place while a project is still under development, or after a project has been developed and the related technological network has been decentralized (or at any point in between those two outer bands of project development). Under any scenario, we believe that TCAs should not be substantively regulated under the Commodity Exchange Act ("CEA"), since:

1) If a TCA is put into place while a project is under development, then we believe that Rule 701 of the Securities Act of 1933, as amended (the "**1933 Act**"), provides an appropriate analytical and regulatory framework.[5] In this instance, we believe that a TCA is likely to be subject to the jurisdiction of the Securities and Exchange Commission (the

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digital commerce.

3 A variety of tokens can be used as compensation under TCAs. We use the term 'token' here to reflect both the current parlance of blockchain industry participants, and as a generic descriptor of a blockchain-based digital asset that may be a commodity overseen by the CFTC (*e.g.*, a virtual currency) or other form of regulated digital asset (*e.g.*, an investment contract or other form of security).

4 For brevity and ease of comprehension, we have summarized these questions in parentheses.

5 Further information on Rule 701 is hosted on the SEC's website, available at: https://www.sec.gov/smallbusiness/exemptofferings/rule701. Rule 701 was implemented more than 30 years ago and has been regularly reviewed and updated by the SEC since that time. See Employee Benefit and Compensation Contracts, Release No. 33-6726 (Jul. 30, 1987) [52 FR 29033 (Aug. 5, 1987)] ("Rule 701 Proposing Release"), Compensatory Benefit Plans and Contracts, Release No. 33-6768 (Apr. 14, 1988) [53 FR 12918 (Apr. 20, 1988)] ("1988 Adopting Release"), Rule 701 – Exempt Offerings Pursuant to Compensatory Arrangements, Release No. 33-7645 (Feb. 25, 1999) [64 FR 11095 (Mar. 8, 1999)] ("1999 Adopting Release") at https://www.sec.gov/rules/final/33-7645.htm, Exempt Offerings Pursuant to Compensatory Arrangements, Release No. 33-10520 (July 18, 2018) at https://www.sec.gov/rules/final/2018/33-10520.pdf ("2018 Concept Release") and Concept Release on Compensatory Securities Offerings and Sales, Release No. 33-10521 (July 18, 2018) ("2018 Concept Release") at https://www.sec.gov/rules/concept/2018/33-10521.pdf.

"**SEC**") as a security or a hybrid instrument, as such term is defined by section 1a(29) of the Commodity Exchange Act ("**CEA**"), rather than the jurisdiction of the CFTC;

2) In the alternative, regardless of when a TCA is put into place, we believe that TCAs can qualify as forward contracts or commercial agreements that are outside of the scope of regulation under the CEA; and

3) In any event, we believe that TCAs are not contracts of sale of a commodity for future delivery or swaps, two CFTC Regulated Products (as defined herein) that we believe are most relevant to the consideration of TCAs.

Consistent with these positions, our comment letter first addresses TCAs under Rule 701 of the Securities Act and then discusses the application of the CEA and regulations thereunder (the "**Commodity Laws**") to these compensation arrangements.

(I) TCAs AND RULE 701 OF THE SECURITIES ACT

As previously explained, we believe that Rule 701 is an appropriate framework for a TCA that is put into place while a project is under development and prior to the decentralization of the related technological network. Rule 701 provides a limited securities exemption for issuers of securities from the registration provisions of the 1933 Act for certain offers and sales of securities (including option grants and restricted unit awards) to then-current Compensation Recipients pursuant to written compensatory benefit plans or contracts established by issuers that are not subject to the reporting requirements of the Securities Exchange Act of 1934 (the "**1934 Act**"). As noted in the 2018 Concept Release, "[t]he SEC has long recognized that offers and sales of securities as compensation present different issues than offers and sales that raise capital for the issuer of the securities."[6] Rule 701 strikes a balance between providing flexibility to issuers to align their Compensation Recipients' interests with those of the issuer and its owners, while fulfilling the SEC's investor protection mandate by (1) providing award recipients with sufficient information to make an informed decision regarding the compensatory award and (2) simultaneously limiting the potential for an issuer to use the exemption for capital-raising purposes.

The Rule 701 exemption is limited in size and scope based on the SEC's determination that these limited offerings are (1) solely to individuals who are closely related to the issuer via a service relationship and (2) are structured to prohibit the resale of the securities or property absent

[6] See https://www.sec.gov/rules/concept/2018/33-10521.pdf, page 4, which cites the following: "See, e.g., Release No. 33-3469-X (Apr. 10, 1953) [18 FR 2182 (Apr. 17, 1953)] and Registration of Securities Offered Pursuant to Employees Stock Purchase Plans, Release No. 33-3480 (Jun. 16, 1953) [18 FR 3688 (Jun. 27, 1953)], each observing that the investment decision to be made by the employee is of a different character than when securities are offered for the purpose of raising capital."

compliance with additional exemptions from registration or registration of the underlying security or property with the SEC. Specifically:

- The Rule 701 exemption does not cover the securities themselves - only the transaction in which securities are offered or sold, given the nature of the relationship between the issuer and the recipient, including the information available to the Compensation Recipient (as compared to the general public) given that service relationship.

- Because Rule 701 does not exempt the underlying securities or property, the Rule 701 exemption does not cover resales of the securities or property by the recipient. Rule 701 prohibits the transfer of the derivative securities issued in reliance on the Rule 701 exemption other than limited transfers to immediate family members or for estate planning purposes. That is, transfers for value of derivative securities issued in reliance on Rule 701 are prohibited. Instead, any resales of securities issued under Rule 701 generally must be undertaken only in compliance with Rule 144 of the Securities Act of 1933 - which imposes significant post-acquisition holding periods and limits on the size of such resales - or following the registration of the benefit plan and the securities issued thereunder pursuant to registration on Form S-8 or other more detailed registration statement. Rule 144 imposes a statutory holding period of six months to one year, and, thereafter, volume resale restrictions.[7] As a result of these limitations and restrictions, and to promote compliance therewith, these instruments therefore generally carry legends informing any subsequent recipient that the securities have not been registered with the SEC and are subject to restrictions on transfer and resale

- Because these grants are compensatory in nature, the issuer typically imposes a continued service requirement of one to four years on the recipient to earn the right to retain the underlying securities or property, thereby further minimizing the potential for a

[7] See Rule 144: Selling Restricted and Control Securities, January 16, 2013 at https://www.sec.gov/reportspubs/investor-publications/investorpubsrule144htm.html. See also the SEC's Compliance Discussion & Interpretation 532.06 at https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm: "Question 23 of Securities Act Release No. 6099 (Aug. 2, 1979), dealing with the commencement of the Rule 144(d) holding period for restricted securities issued pursuant to a written agreement, provides that the holding period starts when the person who will receive the securities is deemed to have paid for the securities and thereby assumed the full risk of economic loss with respect to them. The holding period for restricted securities that an employee receives pursuant to an individually negotiated employment agreement commences when investment risk for the securities passes to the employee (which is the date that the employee is deemed to have paid for them). For full value awards, if the vesting of the securities is conditioned solely on continued employment and/or satisfaction of performance conditions that are not tied to the employee's individual performance and the employee pays no further consideration for the securities, that date would be the date of the agreement. For awards that require additional payment upon exercise, conversion or settlement, that date would be the date on which such payment is made. [October 19, 2016]"

Compensation Recipient to receive and immediately turn around and sell the security or property.

- The Rule 701 exemption was designed to permit the issuance of limited amounts of the issuer's securities to Compensation Recipients who are not otherwise able to avail themselves of an exemption from registration based on their status as sophisticated or accredited investors such as Regulation D of the Securities Act of 1933, as amended. This exemption allows issuers to provide incentive compensation to a range of Compensation Recipients, down to the entry level and hourly workers. As a consequence, the typical individual recipient of a grant made in reliance on Rule 701 is not generally receiving securities in sufficient amounts to have a significant impact on the market price of the security on a subsequent resale.

- The Rule 701 exemption does not relieve the issuer of liability under the anti-fraud, civil liability and other regulatory provisions of federal securities laws or from state laws relating to the offer and sale of securities.[8] The SEC retains enforcement powers over exempted Rule 701 transactions and has regularly exercised that power to ensure compliance with the eligibility, size limits and information requirements of Rule 701.[9]

- Finally, while Rule 701 was adopted nearly 30 years ago, the SEC has regularly reviewed and revised the exemption in efforts to keep pace with changes in technology and changes in how issuers use the exemption to prevent the use of Rule 701 as a means of distributing securities to unrelated third parties or other forms of potential market manipulation.[10]

The Rule 701 exemption can be used for the direct issuance of securities (such as payment for services in stock or the sale of vested or unvested stock at a price determined by the issuer) or for the granting of derivative instruments that convey a right to receive a security, cash or other property in connection with the performance of services and for the ultimate transfer of the underlying security, cash or property. Common derivative structures used by issuers in reliance on Rule 701 include stock options and restricted unit awards.

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[8] See Preliminary Note 1 to Rule 701: "Issuers and persons acting on their behalf have an obligation to provide investors with disclosure adequate to satisfy the antifraud provisions of the federal securities laws."

[9] See https://www.sec.gov/Archives/edgar/data/1288776/000119312505005775/dex992.htm regarding the SEC's 2005 cease and desist actions against Google in respect of its compensatory stock option offerings under Rule 701. More recently, see also https://www.sec.gov/litigation/admin/2018/33-10469.pdf, a cease and desist order against Credit Karma, Inc. In the summer of 2016, the SEC's San Francisco office issued nonpublic information requests to at least 10 mostly large, later-state private companies regarding their manner of compliance with Rule 701. It appears the Credit Karma settlement is a result of that sweep.

[10] See Rule 701 Proposing Release, 1988 Adopting Release, 1999 Adopting Release, 2018 Adopting Release and 2018 Concept Release.

In the context of TCAs, issuers desire the ability to issue options to purchase the underlying digital assets, restricted units conveying a right to receive the underlying digital assets at a date in the future on satisfaction of service conditions, or the issuance of digital assets directly as compensation for services rendered under bonus plans or as partial payment for base remuneration. Open source blockchain projects require the creation of a community invested in the development and maintenance of the underlying protocol or decentralized application. By using TCAs, an issuer can attract Compensation Recipients who are predisposed to participate in that community, facilitate the ability of the Compensation Recipients to develop the protocol or application, and provide compensation via a digital asset or digital security that has the potential for appreciation in value due to the appreciation in value of the underlying protocol or application created in part through the efforts of these Compensation Recipients.

The Rule 701 exemption applies only to offers and sales made pursuant to written compensatory benefit plans established by the issuer, its parent or its majority-owned subsidiaries, or written contracts relating to compensation. The exemption applies to offers and sales to current directors, officers and employees, as well as to current consultants and advisors.[11] With respect to consultants and advisors, *bona fide* services must be rendered by the consultants and advisors and those services cannot be in connection with the offer and sale of the company's securities in a capital-raising transaction or directly or indirectly promote or maintain a market for the company's securities.

The Rule 701 exemption covers the sale of securities where the aggregate sales price or amount of securities sold in reliance on Rule 701 during any consecutive 12-month period does not exceed the greatest of the following: (i) $1,000,000, (ii) 15% of the issuer's total assets measured at the company's most recent balance sheet date (if no older than its last fiscal year end), or (iii) 15% of the "outstanding securities of the class" being offered measured at the company's most recent balance sheet date (if no older than its last fiscal year end).[12]

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[11] Under Rule 701, offers and sales must be made to natural persons, not entities (unless the entity is simply the "alter ego" of an individual, such as a sole proprietorship). Per the 2018 Concept Release, page 10, "a person in a *de facto* employment relationship with the issuer, such as a non-employee providing services that traditionally are performed by an employee, with compensation paid for those services being the primary source of the person's earned income, would qualify as an eligible person under the exemption. Such services, however, must not be in connection with the offer or sale of securities in a capital-raising transaction, and must not directly or indirectly promote or maintain a market for the issuer's securities."

[12] The sales price for stock options is measured on each grant date calculated as the number of shares subject to stock options granted multiplied by the exercise price per share. The "outstanding securities of the class" include (a) all securities currently outstanding (including securities acquired through the early exercise of an option, or securities subject to the company's right of repurchase) and (b) securities underlying all currently exercisable or convertible options, warrants, rights or other convertible securities (collectively, "derivative securities"), other than derivative securities issued under Rule 701.

The Rule 701 exemption also includes disclosure requirements that arise *prior* to the sale of the securities.[13] For any award granted in reliance on Rule 701, the issuer must provide a copy of the company's benefit plan under which the securities are issued to each participant in the plan. In addition, if the value of all securities issued under Rule 701, determined as of the date of grant based on then-current fair market value, exceeds $10,000,000 in a 12-month period, additional disclosure is required. This additional disclosure would include: (i) a summary of the material terms of the company's benefit plan; (ii) risk factors associated with an investment in the securities sold pursuant to the plan; and (iii) unaudited financial statements of the company, in the form required under Regulation A of the 1933 Act, as of a date no later than 180 days before the sale of such securities.[14] The application of these disclosure provisions provide protection to Compensation Recipients.

From the Commission's perspective, Rule 701 reflects many of the market integrity concerns which could apply to tokens *qua* commodities. We recognize that the CFTC has undertaken considerable effort to address fraud and market manipulation in spot markets for tokens through enforcement of Section 6(c) of the CEA and associated Part 180 Regulations.[15] In the explanatory release of Part 180 Regulations, the Commission explicitly acknowledged that it "will be guided, but not controlled, by the substantial body of judicial precedent applying the comparable language of SEC Rule 10b-5".[16] Although there is no comparable CEA provision to Rule 701 of the Securities Act, we respectfully suggest that a similar approach of looking to existing securities law precedent makes sense in the context of TCAs, particularly where Rule 701 cannot be used to facilitate sales to unrelated third parties and imposes restrictions on resales, all of which serve to restrict insider trading and other potential forms of market manipulation. We are not suggesting that Rule 701 or other securities law provisions are necessarily appropriate for spot markets of tokens *qua* commodities generally. Indeed there are likely to be circumstances and considerations that are unique to tokens *qua* commodities, particularly given the novel features of blockchain-based tokens. In such circumstances, we would expect that the Commission would want to consider the application of the Commodity Laws independent of historical securities law precedence as appropriate.[17] However in the context of TCAs, we hope this letter has served to

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13 In the context of full value awards (that is, not an option), the "sale" is deemed to occur on the date of grant, not at the subsequent vesting or delivery date.

14 These documents must be delivered to plan participants a reasonable time before the date a participant exercises an option after the date on which the issuer exceeds the $10 million limit.

15 See 7 U.S.C. 6c(a), 9, 12(a)(5), and 17 C.F.R. Part 180 ("**Part 180 Regulations**").

16 See Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398 (Jul. 11, 2011).

17 For example, the resale restrictions would do little to counteract certain other forms of market manipulation, such as pump and dump schemes by third-parties who acquired tokens outside of a Rule 701 exemption. We view the continued application of the CFTC's Section 6(c) enforcement power as the most effective means of policing such conduct.

demonstrate that Rule 701 serves as a pragmatic regulatory framework, particularly if a TCA is being put into place while a project is under development.

(II) TCAs UNDER THE COMMODITY LAWS

The Commodity Laws provide for a somewhat opaque "regulatory impression" regarding the types of arrangements that may constitute a product that is within the jurisdiction of the CFTC (a "**CFTC Regulated Product**"), two of which are noteworthy in respect of TCAs:

- Contracts of sale of a commodity for future delivery ("**futures contracts**"); and
- Swaps.[18]

As a general matter, we acknowledge that any arrangement that involves the deferred delivery of a commodity has the potential to be subject to regulation as a futures contract or a swap.[19] Nevertheless, we do not believe that TCAs should be substantively regulated under the CEA, as a futures contract, swap or otherwise, for the reasons next discussed.

(A) Exclusions and Interpretative Guidance from Substantive Regulation As Applied to TCAs

We believe that TCAs should not be substantively regulated under the CEA. First, we believe that a TCA is likely to be subject to the jurisdiction of the SEC, rather than the jurisdiction of the CFTC, if the arrangement is put into place while a project is under development. Alternatively, regardless of when a TCA is put into place, we believe that such an arrangement can qualify as a forward contract or a commercial agreement that is outside of the scope of regulation under the CEA. For purposes of the commercial agreement and forward contract analysis, we have assumed that TCAs are not subject to the exclusive jurisdiction of the SEC.

1. *TCAs That are Subject to the Exclusive Jurisdiction of the SEC*

We believe that a TCA that is put into place prior to the launch of a particular token's blockchain-based protocol or application is likely to constitute a security (most likely in the form of an investment contract) for purposes of the federal securities laws. At the time of the token's

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18 We assume that absent factors indicating evasion, TCAs themselves would not be considered to have been willfully structured to evade Subtitle A of Title VII of the Dodd-Frank Act under CFTC Rule 1.3(xxx)(6).

19 Another form of CFTC Regulated Product, retail commodity transactions, are not addressed within this letter. The most common application of the Commodity Law's retail commodity transaction provisions apply where there is leverage, margin or financing present. Unless relevant exceptions under the Commodity Laws are satisfied (*e.g.*, where actual delivery occurs within 28 days), retail commodity transactions are regulated 'as if' they are futures contracts. The Commission sought comment on their interpretation of actual delivery in the context of virtual currencies in December 2017. The CFTC Proposed Interpretation and Request for Comment regarding retail commodity transactions involving virtual currency is available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2017-27421a.pdf

launch, or at a later point in time, the token is likely to exist as some form of commodity (either a security or a non-security commodity).[20]

Section 2(a)(1)(A) of the CEA excludes federally-regulated securities from regulation by the CFTC. This exclusion applies, even if a security is offered under the various statutes and rules that permit a limited private offering, including one that involves accredited investors. If the TCA is a security in the pre-launch stage (*i.e.*, at the time the arrangement is put into place), then we believe, in the first instance, that the TCA would be subject to the jurisdiction of the SEC, rather than the CFTC.

a. The Hybrid Instrument Exclusion

For the sake of argument, we also believe that Hybrid Instrument Exclusion may apply to TCAs, provided that the arrangement in question satisfies the requirements of that exclusion. In short, this exclusion guides the analysis of jurisdictional boundaries between the SEC and the CFTC and ascribes regulatory oversight and responsibility for the regulation of securities to the SEC, notwithstanding the fact that a hybrid instrument may require the delivery of a commodity at settlement.[21] Section 2(f) of the CEA, the Hybrid Instrument Exclusion, provides as follows:

> *(1) In general*
>
> *Nothing in this chapter (other than section 16(e)(2)(B) of this title)*[22] *governs or is applicable to a hybrid instrument that is predominantly a security.*
>
> *(2) Predominance*
>
> *A hybrid instrument shall be considered to be predominantly a security if —*
>
> *(A) the issuer of the hybrid instrument receives payment in full of the purchase price of the hybrid instrument, substantially contemporaneously with delivery of the hybrid instrument;*
>
> *(B) the purchaser or holder of the hybrid instrument is not required to make any payment to the issuer in addition to the purchase price paid under*

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20 We reference here remarks regarding the ongoing question of a token's potential 'mutability' under federal securities laws. *See* William Hinman, Dir. of the Div. of Corp. Fin., Sec. & Exch. Comm'n, Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018) (speech), available at https://www.sec.gov/news/speech/speech-hinman-061418

21 The CFTC Regulations retain a separate 'hybrid instrument exemption' at 17 C.F.R. 34.3 that pre-dates the statutory Hybrid Instrument Exclusion. The 'hybrid instrument exemption' is an example of earlier regulatory efforts to address the jurisdictional boundaries between the SEC and the CFTC and is not relevant to this letter.

22 Section 16(e)(2)(B) of the CEA is a reference to state or local law bucket shop laws.

> *subparagraph (A), whether as margin, settlement payment, or otherwise, during the life of the hybrid instrument or at maturity;*
>
> *(C) the issuer of the hybrid instrument is not subject by the terms of the instrument to mark-to-market margining requirements; and*
>
> *(D) the hybrid instrument is not marketed as a contract of sale of a commodity for future delivery (or option on such a contract) subject to this chapter.*
>
> *(3) Mark-to-market margining requirements*
>
> *For the purposes of paragraph (2)(c), mark-to-market margining requirements do not include the obligation of an issuer of a secured debt instrument to increase the amount of collateral held in pledge for the benefit of the purchaser of the secured debt instrument to secure the repayment obligations of the issuer under the secured debt instrument."*

Section 1a(29) of the CEA defines a "hybrid instrument" as "a security having one or more payments indexed to the value, level, or rate of, or providing for the delivery of, one or more commodities."

b. <u>The Hybrid Instrument Exclusion As Applied to TCAs</u>

A TCA would need to meet the enumerated requirements of the Hybrid Instrument Exclusion in order to satisfy the exclusion. We see no reason why appropriately drafted documentation of a TCA (the "**TCA Documents**") would not satisfy these requirements, as long as the TCA Documents do not: (i) require the Compensation Recipient to make payments to the technology company that has established the TCA (the "**TCA Sponsor**") on an on-going basis during the term of the arrangement;[23] (ii) subject the Compensation Recipient or the TCA Sponsor to any sort of a mark-to-market margining requirement, and (iii) market the TCA as a futures contract or other type of CFTC Regulated Product.[24] In respect of this last restriction on marketing,

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23 We do not believe that either (1) the provision of continued services in the amount as *determined on the original date of grant* in order to earn/vest in the award, or (2) the Compensation Recipient's obligation to make a payment, at the time of exercise, of the option exercise price equal to the fair market value of the underlying security *as determined on the original date of grant*, constitutes an on-going payment obligation within the meaning of Section 2(f) of the CEA. These payment obligations - either in services or fiat - are not severable from the underlying award and are imposed in part as a means to limit compensatory tax obligations otherwise imposed on the award recipient. In addition, generally, due to contract law, qualified tax status rules, and accounting considerations, neither the vesting schedule nor the exercise price may be modified in a manner adverse to the Compensation Recipient without the Compensation Recipient's consent.

24 Regarding the final requirement that a hybrid instrument not be "marketed as a contract of sale of a commodity for future delivery (or option on such a contract) subject to this chapter," (the "**Marketing Requirement**") we note two important considerations. First, the Marketing Requirement addresses only the '*marketing*' of the hybrid

we have assumed that the TCA Documents would include a legend that confirms the TCA is subject to SEC oversight and not a CFTC Regulated Product.[25] We believe that such a legend is consistent with the regulatory goal of clear oversight by a single regulatory agency (*i.e.*, the SEC in the case of a security), as reflected by Section 2(a)(1)(A) and Section 2(f) of the CEA.

Due to the broad definition of "commodity" under the CEA, the Hybrid Instrument Exclusion is agnostic as to what is ultimately delivered under the TCA:[26]

- in the event that the token that is ultimately delivered is not a security, and thus can be properly categorized as a non-security commodity, the SEC would appear to retain jurisdiction and regulatory oversight of the TCA *qua* an investment contract up until the point in time when the token is delivered (as a non-security commodity).

- in the event that the token that is ultimately delivered is a security, the SEC would appear to retain jurisdiction and regulatory oversight of the TCA *qua* an investment contract, and also would appear to retain jurisdiction and enforcement oversight of the delivered token (as a security itself).

Of these two possibilities, only the former raises potential questions under Commodity Laws, since some uncertainty remains with respect to the appropriate regulatory status while a TCA's underlying non-security token is pending delivery. However, our view is that the Hybrid Instrument Exclusion provides a path to resolve this uncertainty.

The regulatory classification of the TCA should be established at the time the transaction is entered into, rather than at settlement. This regulatory classification is consistent with contracts

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instrument in question - it does not purport to dictate the economic substance of a transaction, only its form. Second, it specifically restricts marketing regarding a futures contract (or option on such a contract) "*subject to this chapter*" [emphasis our own]. The Marketing Requirement is concerned with marketing that might suggest an instrument is subject to CFTC oversight when it is not. These two aspects are consistent with the legislative history of the Hybrid Instrument Exclusion and its goal of demarcating clear regulatory oversight between the SEC and the CFTC. Indeed, if one were to consider the Marketing Requirement as a requirement that the instrument in question not be 'a contract of sale of a commodity for future delivery (or option on such a contract)' at all, the terms "marketed" and "subject to this chapter" would be negated of any meaning.

[25] As noted above, most securities issued in reliance on Rule 701 generally already carry restrictive legends regarding oversight by the SEC, the lack of registration, and prohibitions on resales.

[26] A security is a type of commodity, albeit an excluded commodity which is subject to exclusive SEC oversight under Section 2(a)(1)(A) of the CEA. This position is also consistent with the legislative history and general position of both the Commissions that products should generally be regulated by a single agency - the Hybrid Instrument Exclusion is a direct result of consideration of products that escaped clear classification. The Commissions have considered questions relating to hybrid instruments since the 1980s (of particular note is the report of the President's Working Group on Financial Markets in 1999) *See* Report of the President's Working Group on Financial Markets, '*Over-the-Counter Derivatives Markets and the Commodity Exchange Act*', November 9, 1999. Available at: https://www.treasury.gov/resource-center/fin-mkts/Documents/otcact.pdf

that settle by delivery of an asset generally - delivery is merely the performance of an obligation, not the creation of a new transaction. Additionally, this classification is supported by statements made by the CFTC and the SEC (together, the "**Commissions**") in 2012 regarding the exclusion for the forward sale of securities from the swap and security-based swap definitions:

> *As with other purchases and sales of securities, security forwards are excluded from the swap and security-based swap definitions. The sale of the security in this case occurs at the time the forward contract is entered into with the performance of the contract deferred or delayed.*[408]
>
> > [408]*The purchase or sale of a security occurs at the time the parties become contractually bound, not at the time of settlement (regardless of whether cash or physically settled). See Securities Offering Reform (Aug. 3, 2005).*[27]

Applying an additional regulatory classification test (*i.e.*, at the time a token is delivered) conflates the status of the TCA with the status of the underlying token. The terms of the TCA Documents are agreed to, and the TCA Documents are executed, at the time the TCA Sponsor puts the arrangement into place. The deferred delivery of the tokens does not alter this fact. It is rational and consistent therefore that the application of the Hybrid Instrument Exclusion should apply for the entire life of a TCA. This would result in the clear application of established and appropriate securities law practices as previously discussed in this letter (*see <u>TCAs and Rule 701 of the Securities Act</u>*).

2. *<u>Interpretive Guidance Regarding Commercial Agreements</u>*

In 2012, the Commissions indicated that customary commercial agreements should not be considered to be CFTC Regulated Products (i.e., such agreements are not swaps or security-based swaps). In issuing their joint interpretation, the Commissions enumerated several characteristics and factors that are common to commercial agreements. In particular, such agreements:

- Do not contain payment obligations, whether or not contingent, that are severable from the agreement, contract, or transaction;
- Are not traded on an organized market or over-the-counter;
- Are entered into by commercial or non-profit entities as principals (or by their agents) to serve an independent commercial, business, or non-profit purpose, and

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[27] The <u>Commodity Futures Trading Commission and the Securities Exchange Commission, Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping</u>, 77 Fed. Reg. 48207, 48245 (August 13, 2012), at 48229 (hereinafter "**Swap Definitional Release**").

- Are entered into for a purpose other than for speculative, hedging, or investment purposes.[28]

We believe that an application of these characteristics and factors supports the characterization of TCAs as commercial agreements:

- The payment obligations of TCAs are not severable. TCAs are non-transferable compensatory agreements or will otherwise contain a provision that provides that the TCA cannot be assigned without the consent of both parties.

- The TCA (and any associated right to receive tokens) will not be traded on an organized market or over-the-counter, but rather is a bilateral service or employment contract that, by its terms, will not be capable of being "traded" at all.

- The TCA Sponsor in almost all cases is a commercial or non-profit entity, as those terms are conventionally understood. Additionally, TCAs are entered into in connection with the performance of labor or services for a commercial or non-profit purpose related to a blockchain-based protocol or application.

- TCAs are entered into to obtain the labor or services of a particular person (*i.e.*, for compensatory purposes), and not entered into on a speculative, hedging or investment basis. While the dedication of non-monetary resources to an agreement may present challenges of economic valuation, absent clear indicia to the contrary speculative or investment purpose should not be inferred under Commodity Laws merely by virtue of being a transaction settled in tokens.

For these reasons, we believe that TCAs may be properly characterized as a commercial agreement.

3. *Forward Contract Exclusion*

The CEA excludes a transaction from substantive regulation if it involves the deferred delivery of a nonfinancial commodity, provided that the parties intend for that transaction to be

28. Swap Definitional Release at 48247. The Commissions clarified that their interpretation is not the exclusive means by which an entity could determine whether its arrangement falls within the swap or security-based swap definition and that any arrangement should be analyzed on the basis of its particular facts and circumstances. *Id.* at 48248. The Commissions also stated that, "Parties to such an agreement, contract or transaction may also seek an interpretation from the Commissions as to whether the agreement, contract or transaction is a swap or a security-based swap." *Id*. We are not aware of any such interpretations having been granted by the Commissions.

physically settled. This exclusion is frequently referred to as the "**Forward Contract Exclusion**" and applies to both futures contracts and swaps.

The CFTC has specifically interpreted the term "nonfinancial commodity" to mean a commodity that can be "physically delivered" and that is an exempt commodity or an agricultural commodity.[29] Furthermore, the CFTC has taken the position that an intangible commodity can be physical delivered if ownership of the commodity can be conveyed and the commodity can be consumed.[30]

The CFTC has expressed the view that a contract will qualify for the Forward Contract Exclusion if it allows a party that uses a commodity in its business to obtain that commodity for those business purposes. .[31] In 2012, the CFTC analyzed the availability of the Forward Contract Exclusion for secondary market transactions that involve environmental commodities. In that context, the CFTC focused on the intent of the parties to deliver the commodities along with two characteristics of these intangible commodities: ownership transfer and consumption. In response to one comment that it received, the CFTC specifically suggested that speculative intent will not disqualify a transaction that by its terms requires physical delivery, absent the presence of facts that may indicate evasion of the requirements of the CEA applicable to swaps.[32] In analyzing the

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[29] *Id*. at 48232.

[30] *Id.* at 48233. We note that, in the commercial context, the Commission stated that no CFTC authority requires payment for a forward delivery to be made in cash, and clarified settlement methods such as bartering and physical exchange of commodities are therefore not inconsistent with the Forward Contract Exclusion. We see no reason why this would not apply to settlement in tokens (*qua* commodities). See Swap Definitional Release at 48230.

[31] *See*, Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. 39656 (Sept. 30, 1985) ("forward contracts are commercial merchandising transactions which result in delivery").

[32] The following is the relevant selection from the Swap Definitional Release:

> *One commenter stated its view that the forward exclusion from the swap definition should not be available for carbon transactions because they should be standardized and conducted on open, transparent and regulated exchanges.[296] This commenter acknowledged the possibility that carbon transactions can be physically settled (as the statute requires of excluded forward contracts) but argued that, in light of the fact that there is no cost associated with making or taking delivery of carbon, there is no cost to store it, and there is no delay in delivering it, a forward exclusion for carbon transactions may allow financial speculators to escape regulation otherwise required by the Dodd-Frank Act. The CFTC believes that if a transaction satisfies the terms of the statutory exclusion, the CFTC lacks the authority to deprive the transaction of the exclusion, absent evasion.[297]*
>
> > [296] *[Omitted]*
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> > [297] *While the commenter contended that ''the intangible nature of carbon makes it much easier for speculators or those simply seeking to hedge carbon price risk to take delivery of the carbon itself rather than enter into a derivatives transaction," . . . deciding to enter into a forward transaction rather than a swap does not constitute evasion.* ***Thus, if the transaction in question is a forward contract, that is the end of the analysis, absent the presence of other facts that may indicate evasion.*** *[Emphasis added; Remainder of footnote omitted].*

application of the Forward Contract Exclusion to environmental commodities, the CFTC focused on the absence of any comprehensive regulatory regime that applied to those commodities.[33]

There is no guidance from the CFTC regarding the application of the Forward Contract Exclusion to a transaction that involves a token.[34] We believe that a TCA that by its contractual terms requires the deferred delivery of tokens should qualify for the Forward Contract Exclusion, since tokens are nonfinancial commodities that can be consumed and the ownership of which can be transferred. Further, we believe that the application of the exclusion to TCAs is supported by the fact that any such arrangement would have been entered into by a business in connection with a particular technological project.[35] Finally, TCAs clearly require deferred delivery of tokens: since the CFTC has acknowledged the unique circumstances surrounding the application of Forward Contract Exclusion to emerging technologies that do not have a comprehensive regulatory structure (i.e., the secondary markets for carbon allowances and offsets) we believe that there is a reasonable basis upon which to conclude that a similar approach should be taken in the context of the deferred delivery of a token under a TCA, particularly since such an arrangement is entered into for compensatory purposes.

(B) TCAs Do Not Constitute Futures Contracts or Swaps

We believe that TCAs do not constitute futures contracts or swaps and should not be subject to regulation under the CEA. For purposes of the futures contract and swap analysis, we have assumed that TCAs are not subject to the exclusive jurisdiction of the SEC.

1. TCAs Are Not Futures Contracts

The term "futures contract" is not defined in the CEA but rather the Commodity Laws, provide definitions for each of the terms that comprise the phrase "contract of sale of a commodity for future delivery". In addition, case law and CFTC staff guidance has provided several indicia of futures contracts, including that futures contracts: (i) trade on a centralized exchange, (ii) are

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Swap Definitional Release at 48235.

33 No set of laws currently exist [*sic*] that apply a comprehensive regulatory regime - such as that which exists for derivatives - specifically to secondary market trading of carbon allowances and offsets. Thus, for the most part, absent specific action by Congress, a secondary market for carbon allowances and offsets may operate outside the routine oversight of any market regulator." Swap Definitional Release at 48233 n. 277 (citing Interagency Working Group for the Study on Oversight of Carbon Markets, *Report on the Oversight of Existing and Prospective Carbon Markets* (January 2011), *available at* http://www.cftc.gov/idc/groups/public/@swaps/documents/file/dfstudy_carbon_011811.pdf.

34 For purposes of this paragraph, we have assumed that a particular token is not a security.

35 Similarly, blockchain-based protocol and application developers seem to have a technological and business purpose when such developers have an ongoing need to use a particular token within a particular ecosystem designed for use with that token.

not subject to individual negotiation, and (iii) include terms related to the payment of initial or variation margin.[36]

A full review of each term in the phrase "contract of sale of a commodity for future delivery" is beyond the scope of this letter. Rather, as previously discussed, we reiterate in this context that a TCA is a commercial agreement to incentivize the development of technology by current Compensation Recipients as part of the services they provide to the issuer, rather than a "contract of sale," which is defined under the CEA to include any sales, purchases, agreements of sale or purchase and agreements to sell or purchase.[37]

Additionally most, if not all, TCAs do not bear any indicia of futures contracts. For example, TCAs generally (i) are not traded on a centralized exchange, (ii) are subject to negotiation on a variety of terms associated with the work or service provided by the person in question, (iii) do not include either initial or variation margin terms, (iv) do not contain close out netting provisions, and (v) are settled by the delivery of the token to the Compensation Recipient. Accordingly, we believe that TCAs are not futures contracts.

2) TCAs Are Not Swaps

Section 1a(47) of the CEA broadly defines a swap, in pertinent part, to include: (i) an option of any kind for the purchase or sale, or based on the value of, a financial or economic interest or property of any kind; (ii) a contract or transaction that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence; and (iii) a contract that provides, on an executory basis, for the exchange of one or more payments based on the value of the commodity (or economic interests or property of any kind) and that transfers the financial risk associated with a future change in any such value without also conveying a current or future ownership interest in an asset or liability incorporating such financial risk.

Because of the breadth of this definition, the CFTC and SEC issued interpretative guidance in the Swap Definitional Release that outlined circumstances under which an agreement, contract or transaction would not be considered to be a swap or a security-based

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[36] Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, and Nicolas Grabar "U.S. Regulation of Markets" *in* U.S. Regulation of the International Securities and Derivatives Markets, (11th ed., 2014), § 12.16 at at 12-106 (citing to Statutory Interpretation Concerning Forward Contracts, 55 Fed. Reg. 39188 (Sept. 25, 1990); OGC Forward Interpretation, 50 Fed. Reg. 39656 (Sept. 30, 1985); and 1986 Report of the Committee on Futures Regulation of the Association of the Bar of the City of New York, reprinted at 41 Bus. Law. 903 (May 1986)).

[37] Section 1a(13) of the CEA, as implemented by CFTC Regulation 1.3(i).

swap. In particular, as previously discussed, eligible commercial agreements do not constitute swaps.[38]

We acknowledge that certain aspects of some TCAs may be viewed as having swap-like features.[39] Nevertheless, we believe that TCAs constitute commercial agreements, in the first instance and as previously discussed, with any such features being a consequence of the commercial purpose of these arrangements. Accordingly, we do not believe that TCAs are swaps.

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In closing, we note that regulatory certainty with respect to TCAs directly relates to innovation in respect blockchain-based protocols and applications, both at the individual project and industry levels.

On an individual project level, blockchain-based protocols and applications often have very different structures and incentives to traditional company-based products and services (for example, a company associated with a particular blockchain-based protocol or application may not receive any direct income from the protocol or application in question), meaning traditional equity is inappropriate for compensation. If Compensation Recipients were not able to be compensated with the token they assisted in creating, they would in essence be denied compensation for their work and effort which would likely further chill blockchain-based innovation.

On an industry level, blockchain-based protocols and applications often require the widespread use and adoption of a token to effectively function. Applying the Commodity Laws to TCAs without regard to industry level considerations could interfere with the incentive structures of particular blockchain-based protocol or application, unfairly disrupting the protocol or application's likelihood of use or adoption and unnecessarily favoring existing virtual currencies.

We appreciate the desire of the Commission to seek greater understanding of Ethereum and virtual currencies. We encourage the Commission to consider the role that compensation and incentives play in the evolving blockchain ecosystem, and hope that the information contained in this letter provides understanding and clarity as to how responsible market participants can approach the development of TCAs.

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[39] For example, a TCA may have option-like features (e.g., a right to purchase additional tokens), the existence of certain consequential terms within the TCA documents (e.g., a TCA may be linked to an event of financial, economic or commercial consequence, like reaching a milestone in respect of the technological project under development), or if exchange occurred on an executory basis (e.g., if the delivery under the TCA was within the discretion of the TCA Sponsor with respect to the exact timing of the deferral).

If there are any questions relating to these comments they should be directed to Wendy Moore (wmoore@perkinscoie.com; 650-838-4307, Andrew Cross (across@perkinscoie.com; 202-654-6379) or Conor O'Hanlon (cohanlon@perkinscoie.com; 650-838-4751).[40]

Sincerely,

/s/ Wendy L. Moore

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[40] Mr. Cross is based out of the Washington, D.C. office of Perkins Coie. Neither Mr. Cross nor Mr. O'Hanlon is admitted in the State of California.