

The Lesson of Prometheus – A Special Purpose Broker Dealer May Cause Havoc in TradFi by Unilaterally Declaring ETH To Be A Security

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As referenced in the opening scene of the 2023 Oscar-winning film *Oppenheimer*, Prometheus, the Greek god of forethought, is best known for stealing fire from the gods to give to humanity. As punishment, Zeus had Prometheus bound to a rock and created Pandora's box, which eventually released suffering and despair upon humankind.¹ Prometheus serves as a reminder of the risk of unintended consequences from well-meaning actions.

In December 2020, the Securities and Exchange Commission (SEC) created a new type of broker-dealer known as a "special purpose broker-dealer" (SPBD).² Under the SEC's statement on the "Custody of Digital Asset Securities by Special Purpose Broker-Dealers" (Statement), if an SPBD is approved by the Financial Industry Regulatory Authority (FINRA), it can transact in and custody digital asset securities. The SEC clarified that an SPBD following the requirements in the Statement would not be subject to an enforcement action for a period of five years. Since 2020, it appears that only one SPBD has been approved by FINRA to maintain custody of and transact in digital asset securities.³

Recently, an SPBD with a name similar to Prometheus reportedly proposed to begin custodying Ether (ETH) as a digital asset security in the near future.⁴ However, like Prometheus' theft of fire, this decision could result in a Pandora's box of unintended consequences, principally transforming futures based on ETH that routinely trade today on Commodity Futures Trading Commission- (CFTC) licensed exchanges from futures based on a non-security commodity to futures based on a security which would become subject to dual SEC and CFTC oversight as "security futures." This could potentially and immediately subject relevant CFTC registrants to a host of new requirements, let alone raise fundamental questions regarding the legitimacy of such products in the first place. This could all happen overnight, without any transition period and without any real clarity regarding the legal and regulatory consequences of such a transition.

Background

An SPBD apparently has wide latitude in deciding if a product it wishes to trade and/or maintain custody of qualifies as a digital asset security. An SPBD is subject to numerous requirements under the Statement to transact in or maintain custody of digital asset securities, including:

- limiting its business to transacting, dealing, maintaining custody of, and/or operating an alternative trading system (ATS) for digital asset securities;

¹ "Prometheus," *Britannica* (Feb. 16, 2024), available at: <https://www.britannica.com/topic/Prometheus-Greek-god>.

² SEC, "Custody of Digital Asset Securities by Special Purpose Broker-Dealers," Exchange Act Release No. 34-90788 (Dec. 23, 2020), available at: <https://www.sec.gov/files/rules/policy/2020/34-90788.pdf>.

³ See Jason Foye, "An Inside Look into FINRA's Crypto Asset Work," FINRA (Aug. 3, 2023), available at: <https://www.finra.org/media-center/blog/inside-look-finras-crypto-asset-work>.

⁴ Jesse Hamilton, "Prometheum, The Only U.S.-Registered Crypto Platform, Picks Ether as Its First Product," *CoinDesk* (Feb. 7, 2024), available at: <https://www.coindesk.com/policy/2024/02/07/prometheum-the-only-us-registered-crypto-platform-picks-ether-as-its-first-product/>.

- establishing, maintaining, and enforcing policies and procedures that determine whether a digital asset is a security offered and sold pursuant to an effective registration statement or an exemption from such registration; and
- establishing, maintaining, and enforcing policies and procedures regarding whether the SPBD meets the requirements of federal securities laws when effecting transactions in and maintaining custody of the digital asset security.⁵

However, it does not appear that the offering of qualified custodian services with respect to a particular digital asset security requires affirmative approval by the SEC that the digital asset to be custodied is, in fact, a security, let alone even submission to the SEC for its review.⁶ The Statement merely provides that for a period of five years, the SEC will not commence an enforcement action against an SPBD so long as it establishes, maintains and enforces policies and procedures that determine whether a digital asset is a security offered and sold pursuant to an effective registration statement or an exemption from such registration.

The Regulatory Status of ETH is Unclear

Current Doctrine

It is unclear the basis under which the SPBD believes ETH is a security. According to the CFTC, ETH is a commodity, and the CFTC has asserted that view through various enforcement actions⁷ and approvals or non-objections to multiple futures contracts based on ETH. Indeed, various CFTC-registered exchanges currently list ETH derivatives products (presumably all of which were self-certified or affirmatively approved by the CFTC), including commodity-based futures, swaps, and options. These CFTC-registered designated contract markets (DCMs) include CME Group,⁸ CBOE Digital,⁹ LedgerX¹⁰ and Coinbase Derivatives.¹¹

In 2018, William Hinman, the SEC's then Director of Corporate Finance, unequivocally suggested that ETH was a non-security at the time, although it likely was initially issued as a security.¹² In addition, the SEC implicitly agreed that ETH is a non-security commodity when it approved ETH futures exchange-traded funds (ETFs) in October 2023¹³ as well as by not objecting to the listing of ETH futures on CFTC-regulated DCMs, which are subject to different regulatory requirements than security futures as discussed below.

⁵ See *supra* note 2.

⁶ Futures exchanges that are also registered or notice registered as a national securities exchange (NSE) with the SEC and thus are permitted to list security futures product may self-certify security futures products pursuant to the CFTC's self-certification process set forth in CFTC Rule 40.2. Rule 40.2 requires, among other things, the exchange to submit "a certification by the designated contract market . . . that the product to be listed complies with the [Commodity Exchange Act (CEA)] and Commission regulations thereunder." 17 C.F.R. § 40.2(a)(3)(iv). The CFTC may object to a self-certification and require formal approval of the security futures product. See 17 C.F.R. § 40.2 ("(2) The Commission may in its discretion require a registered entity to withdraw its certification under § 40.2(d)(1) and to submit each individual swap or certain individual swaps within the submission for Commission review pursuant to § 40.2 or § 40.3").

⁷ See e.g., *In the Matter of: J Squared Invest LLC*, CFTC No. 21-06 (Apr. 19, 2021) (finding that respondents "violated Section 6(c)(1) of the [CEA] and [CFTC] Regulation 180.1 when they either knowingly or recklessly made false and misleading statements and omissions in connection with contracts of sale of virtual currencies in interstate commerce such as Ether . . ."). Although a finding by the CFTC that a digital asset is a commodity under the Commodity Exchange Act does not preclude the SEC from also finding that the same digital asset is a security under the federal securities laws, Congress in the Dodd-Frank Act specifically excluded "any security" from the CFTC's expanded enforcement jurisdiction under Section 6(c)(1) of the CEA.

⁸ "Ether Futures Product Overview," CME Group (last accessed Mar. 11, 2024), available at: <https://www.cmegroup.com/education/courses/introduction-to-ether/ether-futures-product-overview.html>.

⁹ "Cboe Digital Launches Margined Bitcoin and Ether Futures, Announces Successful First Trade," Cboe (Jan. 12, 2024), available at: <https://ir.cboe.com/news/news-details/2024/Cboe-Digital-Launches-Margined-Bitcoin-and-Ether-Futures-Announces-Successful-First-Trade/default.aspx>.

¹⁰ See "Options," LedgerX (last accessed Mar. 11, 2024), available at: <https://ledgerx.com/options>; see also "Swaps," LedgerX (last accessed Mar. 11, 2024), available at: <https://ledgerx.com/swaps>.

¹¹ "Institutional-Sized Bitcoin and Ether Futures Contracts Launching on Coinbase Derivatives Exchange," Coinbase (June 1, 2023), available at: <https://www.coinbase.com/blog/coinbase-derivatives-exchange-will-launch-institutional-sized-bitcoin-and>.

¹² SEC, Director William Hinman, "Remarks at the Yahoo Finance All Markets Summit: Crypto, Digital Asset Transactions: When Howey Met Gary (Plastic)," (June 14, 2018), available at: <https://www.sec.gov/news/speech/speech-hinman-061418>.

¹³ Sabrina Toppa, "SEC 'Implicitly' Accepts Ethereum as Commodity in Major Regulatory Boost," *TheStreet* (Jan. 10, 2024 8:50 PM), available at: <https://www.thestreet.com/crypto/policy/sec-implicitly-accepts-ethereum-as-commodity>.

A recent February 2024 filing by Coinbase summarizes the market’s understanding of ETH’s current regulatory status.¹⁴ The filing explains:

ETH’s status as a commodity and not a security has been recognized in a variety of circumstances, including the CFTC’s regulation of ETH futures, public statements by [SEC] officials, and rulings by federal courts. In addition, the [SEC] has never publicly taken the position that ETH is a security and has not publicly objected to the CFTC’s decision to permit ETH futures contracts to trade on the CME and other designated contract markets. . . . The [SEC] has had opportunities to challenge the status of ETH as solely a commodity and has not done so. . . . Senior officials of the [SEC] have publicly said as much on several occasions over the past six years, and neither the [SEC] nor its staff has disavowed this position.¹⁵

However, during a Congressional testimony in 2023, SEC Chair Gary Gensler repeatedly refused to state whether he viewed ETH as a security.¹⁶ Moreover, the SEC has not publicly challenged or disapproved the recent claim by the SPBD that ETH may be a digital asset security.

In a March 6, 2024, Congressional testimony, CFTC Chair Rostin Behnam reiterated his view that ETH is a commodity, while also noting that if the SEC takes any action to validate the SPBD’s decision to custody ETH as a security, “it will then put our registrants, our exchanges who list [ETH] as a futures contract sort of in non-compliance of SEC rules as opposed to CFTC rules.”¹⁷

Current ETH Futures Could Become Security Futures

As Chairman Behnam noted in his Congressional testimony, if the SEC allows the SPBD to offer qualified custodial services or trade ETH as a digital asset security, it might mean that ETH arguably is no longer a non-security commodity and instead should be regarded as a security. As a result, a futures contract based on ETH could arguably be a single “stock” security futures product.

To list security futures products, a CFTC-regulated futures exchange must also be registered or notice registered with the SEC as a national securities exchange (NSE).¹⁸ Any CFTC-registered intermediary like a futures commission merchant (FCM) or introducing broker would also have to be registered or notice registered with the SEC in an equivalent registration category (e.g., broker-dealer) and comply with additional National Futures Association (NFA) and FINRA requirements to offer and sell security futures products.¹⁹ Moreover, the security underlying a single “stock” security futures product must ordinarily be registered pursuant to Section 12 of the Securities Exchange Act of 1934, as amended (Exchange Act), unless the SEC and CFTC jointly allow a non-registered security to underlie a security future as described below.

Section 2(a)(1)(D)(i)(I) of the CEA provides that, “[e]xcept as otherwise provided in a rule, regulation, or order issued pursuant to clause (v) of this subparagraph, any security underlying the security futures . . . is registered pursuant to section 12 of the Securities Exchange Act of 1934.”²⁰ Section 2(a)(1)(D)(i)(III) of the CEA further

¹⁴ See “Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to List and Trade Shares of the Grayscale Ethereum Trust under NYSE Arca Rule 8.201-E,” Coinbase (Mar. 11, 2024), available at: https://assets.ctfassets.net/c5bd0wqjc7v0/5ffePeAh1qv8p7Bk sKFctz/e17307dfe5d692002c6f842807ff4272/Grayscale_Ether_ETP_Application_-_Coinbase_Response_Letter_to_SEC.pdf.

¹⁵ *Id.*

¹⁶ Nikhilesh De, “SEC Chair Gensler Declines to Say if Ether Is a Security in Contentious Congressional Hearing,” *CoinDesk* (Apr. 19, 2023), available at: <https://www.coindesk.com/policy/2023/04/19/sec-chair-gensler-declines-to-say-if-ether-is-a-security-in-contentious-congressional-hearing/>.

¹⁷ Jesse Coghlan, “CFTC Chair Warns of Conflict with SEC Over Prometheus’s ETH Play,” *CoinTelegraph* (Mar. 6, 2024), available at: <https://cointelegraph.com/news/cftc-rostin-behnam-warns-conflict-sec-prometheum-eth-custody>.

¹⁸ 15 U.S.C. § 78f(g) (“An exchange that lists or trades security futures products may register as a national securities exchange solely for the purpose of trading security futures products if – (A) the exchange is a board of trade, as that term is defined by the Commodity Exchange Act . . . , that has been designated a contract market by the [CFTC] . . .”).

¹⁹ Both FINRA and NFA have continuing education requirements for persons who offer and sell security futures and their supervisors. See FINRA, “Security Futures,” (last accessed Mar. 3, 2024), available at: <https://www.finra.org/rules-guidance/key-topics/security-futures>. In addition, FINRA and NFA worked together to create a uniform security futures risk disclosure statement that must be given to customers approved for trading in security futures. *Id.*

²⁰ 7 U.S.C. § 2(a)(1)(D)(i)(I); see also 15 U.S.C. § 78f(h)(3)(A).

provides that “[e]xcept as otherwise provided in a rule, regulation, or order issued pursuant to clause (v) of this subparagraph, the security futures is based upon common stock and such other equity securities as the [CFTC] and the [SEC] jointly determine appropriate.”²¹

The CFTC has incorporated most of these requirements in its Rule 41.21(a), which provides that “[a] futures contract on a single security is eligible to be traded as a security futures product only if:

- (1) The underlying security is registered pursuant to section 12 of the Exchange Act;
- (2) The underlying security is:
 - (i) Common stock;
 - (ii) Such other equity security as the Commission and the SEC jointly deems appropriate; or
 - (iii) A note, bond, debenture, or evidence of indebtedness; and
- (3) The underlying security conforms with the listing standards for the security futures product that the designated contract market has filed with the SEC under section 19(b) of the Exchange Act.”²²

However, the SEC and CFTC may by rule, regulation, or order, “jointly modify the criteria specified in subclause (I) or (III) of clause (i), including the trading of security futures based on securities other than equity securities, to the extent such modification fosters the development of fair and orderly markets in security futures products, is necessary or appropriate in the public interest, and is consistent with the protection of investors.”²³ Pursuant to this authority, the SEC and CFTC later jointly determined to authorize security futures based on debt securities that are registered notes, bonds, debentures, or evidences of indebtedness and indexes composed of such securities in 2006, despite the fact that such instruments are not equity securities.²⁴

Further, the CFTC and SEC (Commissions) in November 2009 issued a joint order permitting unregistered debt securities to underlie security futures.²⁵ The CFTC and the SEC also have “jointly determined that certain American Depositary Receipts, Exchange Traded Funds, Trust Issued Receipts, closed-end funds, and debt securities also are eligible to underlie security futures products.”²⁶

As discussed above, ETH futures currently trade on CFTC-regulated and approved DCMs. Some of these DCMs are not registered with the SEC and, therefore, potentially permitted to trade security futures products.²⁷ However, because ETH is not registered pursuant to Section 12 of the Exchange Act, it appears that there is no basis today for it to be a security underlying a valid security futures product. This is because there is no public information indicating that the Commissions have jointly dealt with this potential change in the classification of futures based on ETH or are in the process of doing so.

The Timing for When ETH Transforms From a Commodity to a Security is Unclear

It also is unclear exactly when the legal characterization of ETH might change or has already changed, if at all, from a non-security commodity to a security if the SPBD initiates its proposed custody arrangements. As a result,

²¹ 7 U.S.C. § 2(a)(1)(D)(i)(III); see also 15 U.S.C. § 78f(h)(D).

²² 17 C.F.R. § 41.21(a). The SEC separately provides that an NSE or a national securities association “may trade only security futures products that (A) conform with listing standards that such [NSE] or association files with the [SEC] under [15 U.S.C. § 78s(b)] and (B) meet the criteria specified in section 2(a)(1)(D)(i) of the CEA.” 15 U.S.C. § 78f(h)(3).

²³ See 7 U.S.C. § 2(a)(1)(D)(v)(I); 15 U.S.C. § 78f(h)(4).

²⁴ “Joint Final Rules: Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities,” 71 *Federal Register* 39,534 (July 13, 2006).

²⁵ “Joint Order Modifying the Listing Standards Under Section 6(h) of the Securities Exchange Act of 1934 and the Criteria Under Section 2(a)(1) of the Commodity Exchange Act,” 74 *Federal Register* 61,380 (Nov. 24, 2009).

²⁶ CFTC, “Security Futures Product,” (last accessed Mar. 11, 2024), available at: <https://www.cftc.gov/IndustryOversight/ContractsProducts/SecurityFuturesProduct/sfpoverview.html>.

²⁷ SEC, “Self-Regulatory Organization Rulemaking,” (last accessed Mar. 11, 2024), available at: <https://www.sec.gov/rules/sro>.

it is unclear as to when industry participants might be or might have been required to begin treating ETH as a security and futures on ETH as security futures.

The concept of a transition period as applied to an instrument underlying a futures product is not new. Security futures on narrow-based and broad-based security indexes provide the best example of financial products that regularly change characteristics subject to an orderly transition period. Specifically, the CEA and the Exchange Act both expressly provide that an index underlying a futures product is a narrow-based security index if it meets any of the following four tests:

- (1) it has nine or fewer component securities;
- (2) any one component security constitutes more than 30 percent of the index's weighting;
- (3) the five highest weighted component securities constitute more than 60 percent of the index's weighting; or
- (4) the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting have an aggregate dollar value of average daily trading volume of less than \$50,000,000.²⁸

An index is generally a broad-based security index if it does not meet any of the above tests.²⁹ A futures contract based on a narrow-based security index is a security futures contract subject to the joint jurisdiction of the CFTC and the SEC, while a futures contract based on a broad-based security index is subject to the exclusive jurisdiction of the CFTC.³⁰

Of course, an index may change from a narrow-based security index to a broad-based security index or vice versa depending on whether it meets one of the four tests outlined above. In these circumstances, there are minimum time periods that a narrow-based security index must meet the characteristics of a broad-based security index before a security futures contract on the index begins the path to formally morph into a futures contract on a broad-based security index under law,³¹ and even then there is an additional time period before a security futures contract on narrow-based index begins to be treated as a future on a broad-based security index.³² An equivalent protocol exists for transitions from broad-based security indices to narrow-based security indices.³³ These delays are intended to avoid disruption to the relevant marketplaces and provide market participants sufficient time to implement a futures contract's changed regulatory status.

Specifically, a security futures contract on a narrow-based security index generally continues to trade as a security futures contract if the underlying index changes and meets the definition of a broad-based security index for 46 days during three consecutive calendar months.³⁴ The contract will then continue to trade as a security futures contract for the following three calendar months.³⁵ After this transition period, the security futures contract will be regarded as a futures contract on a broad-based security index.³⁶ Identical transition periods apply when a futures contract on a broad-based security index morphs into a security futures contract on a narrow-based security index.³⁷

²⁸ See 7 U.S.C. § 1a(35); 15 U.S.C. § 78c(a)(55).

²⁹ See *id.*; see also "Security Futures – The Incredible Potentially Morphing Financial Instrument," FIA & Katten (Apr. 30, 2020), available at: <https://www.fia.org/sites/default/files/2020-04/Security%20Futures%20-%20The%20Incredible%20Potentially%20Morphing%20Financial%20Instrument.ppt>.

³⁰ *Supra* note 28.

³¹ 17 C.F.R. § 41.14(a).

³² 17 C.F.R. § 41.14(b).

³³ See 17 C.F.R. § 41.12(c); see also SEC, "Joint Proposed Rules: Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities," Release No. 34-53560 (Mar. 29, 2006), available at: <https://www.sec.gov/rules/proposed/2006/34-53560.pdf>.

³⁴ 17 C.F.R. § 41.14(a).

³⁵ 17 C.F.R. § 41.14(b).

³⁶ *Id.*

³⁷ 17 C.F.R. § 41.12(c).

Futures on KOSPI 200. In 2020, the futures on the KOSPI 200 stock index transformed from a broad-based security index contract, which is subject to the exclusive jurisdiction of the CFTC, to a narrow-based security index futures contract, which is subject to the joint jurisdiction of the CFTC and the SEC.³⁸ Then, the KOSPI 200 contract reverted to the status of a broad-based security index futures contract in December 2020 due to a weighting change in the KOSPI 200 index, making it subject to the exclusive jurisdiction of the CFTC once again. In both cases, the transitions did not happen the first day the underlying index changed characteristics but began when it changed characteristics for 46 days during a three-month period, and only then was finalized after three additional calendar months.

Cboe Futures Exchange, LLC v. SEC. A recent decision involving futures contracts based on the SPIKES Volatility Index is evidence of a court’s recognition of the importance of providing a transition period when a futures contract may change its characteristic from a futures contract to a security futures contract. In *Cboe Futures Exchange, LLC v. SEC*, the DC Circuit agreed with a challenge by the Cboe Futures Exchange LLC of an SEC Exemptive Order permitting security futures on SPIKES (that were traded on the Miami International Securities Exchange) to trade as futures – in order to be more competitive with equivalent products traded on Cboe Futures.³⁹ However, the Court granted a three-month grace period to accommodate a transition, consistent with what the SEC and CFTC apply under the direction of Congress in connection with transitions from futures on broad-based security indices to security futures on narrow-based security indices and vice versa.⁴⁰

Potential Lessons Learned. Likewise, if ETH is determined to be a security, in order to avoid extreme market chaos, the SEC and CFTC should give market participants a similar time period to wind down current ETH futures transactions rather than force an immediate wind-down of all current ETH futures. As mentioned above, a similar process is followed when a narrow-based security index underlying a futures contract becomes a broad-based security index and vice-versa.

It is potentially the case that, in the view of the SEC, ETH changed from a non-security commodity to a security in 2022 when the Ethereum blockchain changed its consensus mechanism from proof-of-work (PoW) to proof-of-stake (PoS) in a transition generally referred to as “The Merge.”⁴¹ Indeed, Chairman Gensler has repeatedly emphasized that tokens using staking protocols could be securities under US law and has focused on staking in recent enforcement actions.⁴²

However, this view seems unsupported by law or even by guidance issued by SEC staff. For example, SEC staff in its 2019 guidance, “Framework for Investment Contract Analysis,” explained that the decentralization of a blockchain could be relevant in assessing whether its native digital asset was a security or not.⁴³ Notably, however, staff did not provide any guidance on whether a blockchain network achieving consensus through PoS would be more or less likely to be deemed a security.

Other Concerns

What Exemption Might Apply to ETH

Even if ETH is a security, it is unclear if there is a valid exemption from registration that would apply to ETH. The single approved SPBD reportedly believes that ETH could be an exempt security under SEC Rule 144.⁴⁴

³⁸ Gary DeWaal & James Brady, “Commentary – The Morphing US Treatment of the Kospi 200 Futures,” *FIA Market Voice* (Mar. 8, 2022), available at: <https://www.fia.org/marketvoice/articles/commentary-morphing-us-treatment-kospi-200-futures>.

³⁹ *Cboe Futures Exchange, LLC v. SEC*, 77 F.4th 971, 976-77 (D.C. Cir. 2023).

⁴⁰ *Id.* at 974.

⁴¹ See “The Merge,” Ethereum.org (last accessed Mar. 11, 2024), available at: <https://ethereum.org/en/roadmap/merge/>.

⁴² Andrew Ross Sorkin, “The S.E.C. Signals a Crackdown on Another Crypto Practice,” *New York Times* (Feb. 10, 2023), available at: <https://www.nytimes.com/2023/02/10/business/dealbook/sec-kraken-staking.html>; see also Colin Wilhelm, “Gensler Suggests Proof-of-Stake Tokens are Securities,” *The Block* (Mar. 15, 2023 3:46 PM), available at: <https://www.theblock.co/post/220297/gensler-suggests-proof-of-stake-tokens-are-securities>.

⁴³ SEC, “Framework for “Investment Contract” Analysis of Digital Assets” (last accessed Mar. 4, 2024), available at: <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>.

⁴⁴ Dave Michaels, “Brokerage Firm Prometheus Wants to Use Exemption to Trade Crypto,” *The Wall Street Journal* (June 27, 2023 7:57 AM), available at: <https://www.wsj.com/articles/brokerage-firm-prometheus-wants-to-use-exemption-to-trade-crypto-2cb51f72>.

As background, Rule 144 allows for the public resale of “restricted securities”⁴⁵ if several conditions are met, including that the owners of the restricted securities must generally hold the security for a period of one year since acquiring the security from the issuer or an affiliate of the issuer before selling.⁴⁶

Rule 144 imposes different requirements depending on whether the seller of the restricted securities is an affiliate of the issuer. Specifically, the SEC explains that any person who is not and has not been an affiliate of the company issuing the securities for at least three months and has held the restricted securities for at least one year may sell the securities without regard to the conditions in Rule 144.⁴⁷ Since the SPBD is not an affiliate of any supposed issuer or active participant of ETH, it apparently believes it can resell any ETH as long as that person has held ETH for one year.⁴⁸

There are several potential issues with this theory. For example, as transactions on a blockchain protocol are pseudonymous, it is unclear how the SPBD intends to reliably and accurately identify specific units of ETH that meet the definition of “restricted securities.”⁴⁹ It also is unclear who or what entity the SPBD believes is the “issuer” of ETH, and whether the SPBD believes staking rewards generated by the Ethereum protocol meet the definition of restricted securities. Rule 144 is also unavailable to securities of issuers with no or nominal operations and no or nominal non-cash assets,⁵⁰ and thus, Rule 144 would likely be unavailable to ETH since it arguably has no identifiable issuer.

Potential Trading of ETH on ATS Approved as an SPBD

Additionally, pursuant to Regulation ATS (Reg ATS), the SPBD or another qualified affiliate could seek to offer the trading of ETH on its ATS. In general, ATSs can trade unregistered securities.⁵¹ Specifically, Form ATS-R, which an ATS registered with the SEC must file on a quarterly basis, contemplates an ATS facilitating the trading of unregistered securities.⁵² As mentioned above, it does not appear that the SEC is legally required to affirmatively approve a decision by an ATS licensed as an SPBD to trade ETH on its platform on the basis that ETH is a security, so long as the ATS is already approved to trade in digital asset securities.⁵³ As a result, an SPBD is presumably not prohibited from trading ETH as an unregistered security on its ATS.

Final Thoughts

An SPBD’s bold plan to offer qualified custodian services on ETH under its license introduces yet another wrinkle to the regulatory status of ETH and could potentially jeopardize the legality of certain derivatives products based on ETH that currently trade on CFTC-regulated exchanges and introduce chaos to persons offering and selling futures on ETH.

In order not to create unintended chaos in the futures industry, ETH should continue to be regarded as a non-security commodity and not a security. The SEC should not permit the SPBD to unilaterally determine that ETH is a security.

If the SEC tends to agree with the SPBD’s determination of ETH as a digital asset security, it should, at a minimum, first consult with the CFTC, and if the CFTC also tends to agree, the Commissions should jointly propose this change in classification, and only after public input, should any change be codified.

⁴⁵ In general, under Rule 144, “restricted securities” are securities acquired in unregistered, private sales from the issuing company or from an affiliate of the issuer. SEC Office of Investor Education and Advocacy, “Rule 144: Selling Restricted and Control Securities,” (Jan. 16, 2013), available at: <https://www.sec.gov/reportspubs/investor-publications/investorpubsrule144>; see also 17 C.F.R. § 230.144(a)(3).

⁴⁶ See SEC Office of Investor Education and Advocacy, *supra* note 47; see also 17 C.F.R. § 230.144(d).

⁴⁷ See 17 C.F.R. § 230.144(d).

⁴⁸ Michaels, *supra* note 46.

⁴⁹ See 17 C.F.R. § 230.144(a)(3).

⁵⁰ See 17 C.F.R. § 230.144(h)(i).

⁵¹ See SEC, Form ATS, Item 4, available at: <https://www.sec.gov/files/formats.pdf> (last accessed Mar. 11, 2024) (requiring entities seeking registration with the SEC as an ATS to “[n]ote whether any types of securities are not registered under Section 12(a) of the Exchange Act.”).

⁵² SEC, Form ATS-R, Item 4, available at: <https://www.sec.gov/files/formats-r.pdf> (last accessed Mar. 11, 2024).

⁵³ “The Digital Asset Securities Ecosystem for Institutions,” Prometheus (last accessed Mar. 11, 2024), available at: <https://www.prometheum.com/institutions> (“Prometheum ATS is a FINRA member and SEC registered ATS and broker-dealer, approved to operate an Alternative Trading System (ATS) for digital asset securities.”).

Moreover, if the CFTC and SEC jointly agree that ETH is a security, the agencies should adopt rules or issue guidance authorizing ETH to be the underlying reference instrument in a security futures contract, and provide transition rules to ensure the orderly evolution of futures to security futures on ETH. Just like Prometheus' unintended consequences were better to have been avoided, so should the unintended consequences of the SPBD's proposed unilateral actions be avoided or, at least, mitigated.

Any person or entity that trades or otherwise lists ETH derivatives products should closely monitor updates concerning the SPBD's decision to custody ETH as a digital asset security and confirm that such products comply with the SEC's and CFTC's respective regulatory regimes.

Correction: A previous version of this advisory incorrectly listed Kraken and Tradovate as DCMs registered with the CFTC. Katten regrets the error.

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