

# The Dual Classification Paradox

*A Public Comment on the SEC/CFTC Joint Interpretive Release's Treatment of Governance Tokens and Decentralized Protocol Revenue*

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**Re:** File No. S7-2026-09 | *Application of the Federal Securities Laws to Certain Types of Crypto Assets and Certain Transactions Involving Crypto Assets (Release Nos. 33-11412; 34-105020)*

## I. Introduction

This submission responds to the Commission's invitation to comment on the joint interpretive release regarding the application of the Federal securities laws to crypto assets.<sup>1</sup> As a Partner at Manatt, Phelps & Phillips LLP specializing in digital asset securities law and the author of *Crypto Law Tactics & Observations*, a publication written primarily for legal counsel advising clients on complex, leading edge innovation, my comments are informed by the practical realities of structuring compliant decentralized systems.

While the Release makes significant strides in providing a regulatory framework, particularly through its five-category taxonomy and the investment contract separation doctrine, this letter addresses a critical, internal contradiction within Section III.A. As currently drafted, the Release's definition of a "digital commodity" creates an irreconcilable paradox for "decentralized network equity," a commercially significant class of crypto assets that powers many of today's most robust protocols.

## II. The Dual Classification Problem

The Release provides that a digital commodity is a crypto asset that "is intrinsically linked to and derives its value from the programmatic operation of a crypto system that is 'functional,' as well as from supply and demand dynamics, rather than from the expectation of profits from the essential managerial efforts of others." In the very next sentence, the Release further provides that "[a] digital commodity does not have intrinsic economic properties or rights, such as generating a passive yield or conveying rights to future income, profits, or assets of a business enterprise or other entity, promisor, or obligor, but may have certain other rights."<sup>2</sup>

This paragraph establishes two conditions for digital commodity status. The first defines where value may come from: the programmatic utility of the system and market forces appraising that utility. The second defines where value may not come from: the essential managerial efforts of others, or intrinsic economic rights such as passive yield or claims on the income, profits, or assets of a business enterprise, entity, promisor, or obligor. The permitted sources are utility and the market's appraisal of it. The prohibited sources are managerial effort and built-in economic claims against identifiable parties.

**ISSUE: *decentralized network equity issued or authorized by a decentralized governance system may satisfy both arguably mutually exclusive conditions simultaneously.***

Decentralized network equity is the term I use to describe governance tokens that carry economic rights to protocol-generated revenue, directed through decentralized governance mechanisms. The Release acknowledges that digital commodities may grant holders governance rights, including the ability to vote on software upgrades and treasury expenditures.<sup>3</sup> Multiple live protocols have activated or are in the process of activating fee mechanisms through governance votes that direct a portion of protocol-generated revenue to token holders.<sup>4</sup>

The mechanisms through which protocol revenue reaches token holders are varied and structurally distinct. Understanding this range is essential because the Release's disqualifying condition captures all of them identically despite their fundamental differences.

At one end of the spectrum, direct fee distributions send protocol-generated revenue to holders' wallets pro rata. This is the mechanism most analogous to a traditional dividend and the one the Release most clearly targets. Vault mechanisms are a variation: fees accumulate in a protocol-controlled vault and holders burn governance tokens to withdraw proportional value. The holder must take an affirmative action to realize value. The fees are not pushed; they are pulled through token destruction. Staking models add a service dimension, directing protocol fees to holders who lock tokens and provide security, liquidity backstop, or governance commitment in exchange for revenue share. VeToken models layer time-weighted commitment on top of staking: longer lockups yield greater fee share and governance weight. Rebasing protocols mint additional tokens and distribute them to holders pro rata, increasing wallet balances automatically to reflect accrued protocol revenue. No claim is filed. No intermediary acts. The rebase executes programmatically against protocol-determined inputs.

At the other end, indirect mechanisms increase per-token value without delivering anything to any holder's wallet. Buy-and-burn protocols use collected fees to purchase the governance token on the open market and permanently remove it from circulation. No value is formalistically "delivered" to any holder. Supply decreases. Per-token claim on future protocol activity increases. Treasury accumulation works similarly: protocol revenue accrues in a governance-controlled treasury, increasing the net asset value each token represents, but no distribution occurs unless governance votes one. Revenue-funded ecosystem development directs protocol fees to grants and infrastructure that expand usage, which generates more fees, which the token captures through the extrinsic value condition.

The economic logic connecting these value accrual variants is well established.<sup>5</sup> In traditional corporate finance, Modigliani-Miller indifference holds that under idealized conditions, a dollar returned via dividend and a dollar returned via share buyback produce the same shareholder wealth effect. The form of the payout is irrelevant. Only the total value returned matters. A buy-and-burn is the protocol equivalent of a share buyback: fees purchase the token on the open market and permanently retire it, increasing the per-token claim on future protocol activity. The arithmetic is identical to a pro rata fee distribution followed by mandatory reinvestment. If a direct fee distribution is a disqualifying intrinsic economic right, then a buy-and-burn is the same transaction in different packaging.

The Release's formulation does not distinguish among these mechanisms. A direct fee distribution and a buy-and-burn that never delivers anything to any holder are both potentially "intrinsic economic properties or rights." A buy-and-burn executed by immutable code against autonomously generated

fees involves no promoter, no managerial effort, and no delivery of anything to anyone. Calling that arrangement a “passive yield” or an “intrinsic economic property” stretches the terms past recognition. Yet the Release’s language, as currently drafted, reaches all of these structures without differentiation.

### **A. The Permitted Sources: Utility and Market Forces**

Decentralized network equity tokens satisfy the permitted-source condition for inclusion as a digital commodity. They are intrinsically linked to a functional crypto system. They derive their value from the programmatic utility of that system and from market forces appraising that utility. The protocol’s automated market maker, lending pool, or other core mechanism may generate economic activity through autonomous code execution with no identified person exercising managerial discretion over the protocol’s core value-generating functions. Transaction fees accrue because traders use the protocol. Lending interest accrues because borrowers borrow. The native asset’s value derives from the protocol’s utility and the market’s appraisal of it. It does not derive from any identified party’s managerial effort. The native token is likely to have consumptive benefits in connection with its crypto system, therefore it follows that the greater the unmet market demand for the crypto system’s product or service, the greater the secondary market value of the crypto system’s native token.

The revenue generated by such a protocol, in the decentralized context, may not be the result of a third party’s “essential managerial efforts.”<sup>67</sup> Rather, in many cases, it is the result of autonomous smart contract execution. The Release itself characterizes certain protocol activities as “administrative or ministerial” in nature and distinguishes them from essential managerial efforts.<sup>8</sup> The core operations of a decentralized protocol, specifically smart contract execution, order matching, fee collection, and settlement, are precisely the kinds of administrative and ministerial functions the Release contemplates.

### **B. The Prohibited Sources: Managerial Effort and Intrinsic Economic Rights**

The same tokens that satisfy the permitted-source condition potentially trigger the prohibited-source condition. When governance activates a fee switch and protocol-generated value flows to token holders, the token arguably acquires “intrinsic economic properties or rights” in the form of what the Release characterizes as “passive yield” or “rights to future income, profits, or assets.”<sup>9</sup>

Protocol fee revenue, in the decentralized context, is a product of utility and market demand. It satisfies the permitted-source condition. But when governance directs that revenue to token holders, the Release seems to recharacterize the same economic output as an intrinsic economic right, triggering the prohibited-source condition. The permitted source and the prohibited source describe the same event, creating a paradox, not a classification.

## **III. Decentralized Network Equity Is Not Passive Yield, and a Decentralized Governance System Is Not a “Business or Other Entity, Promisor, or Obligor”**

### **A. The Doctrinal Purpose of the Disqualifying Condition**

The disqualifying condition serves a specific doctrinal function. In *Forman*, the Supreme Court identified two independent pathways to satisfy Howey’s “expectation of profits” prong: capital appreciation resulting from the development of the initial investment, or a participation in earnings

resulting from the use of investors' funds.<sup>10</sup> These pathways are independent. Satisfying either one is sufficient. A holder who expects no capital appreciation but receives periodic yield still has an expectation of profits through the earnings-participation pathway.

*Edwards* confirmed this. The Court held that a fixed rate of return satisfies the profits prong, rejecting the argument that “profits” requires variable or speculative returns.<sup>11</sup> The Court defined “profits” as “income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment.” An asset that delivers yield satisfies the Howey profits prong, irrespective of whether the asset, itself, is expected to appreciate in value. The yield is the expected profit.

But profit, alone, is insufficient. Howey requires profits from the “essential managerial efforts of others.” The disqualifying condition conflates two analytically distinct questions. The first is whether the asset delivers yield. The second is whether that yield derives from a party whose managerial efforts the holder relies upon. The Release treats the first question as dispositive. If the asset generates passive yield, it is seemingly disqualified from digital commodity characterization. But Howey requires both. Yield that derives from autonomous code execution and collective governance, not from the essential managerial efforts of an identified party, does not complete the Howey analysis. The Release’s disqualifying condition skips the second question entirely.

The disqualifying condition in the Release’s digital commodity definition assumes that yield implies a manager. Each term in the condition reinforces this: “business enterprise” implies managers making discretionary decisions; “promisor” implies a party with contractual obligations voluntarily assumed; “obligor” implies a debtor servicing an enforceable claim. That assumption is sound for traditional yield-bearing instruments. It has no logical purchase, however, for protocol fee distributions generated by autonomous code and directed by decentralized governance.

## **B. Network Equity Is Not Passive Yield**

Protocol fee distributions directed by a decentralized governance system are structurally different from passive yield in every dimension relevant to the securities analysis.

Passive yield presupposes a manager. A bank pays interest because the bank’s management deploys deposited capital in loans and investments. A REIT pays dividends because the REIT’s management team selects, acquires, and operates properties. The yield is passive for the investor because it is active for the manager. The investor’s return is a direct function of management’s skill. The paradigm holds, even in the centralized crypto context. A yield bearing stablecoin, for example, backed by an investment basket that includes U.S. treasuries generates interest income share by means of the issuer’s reserve management efforts.

Decentralized protocol fees generated by autonomous smart contract operation, in contrast, have no manager. An automated market maker generates trading fees because liquidity providers deposit assets and traders execute swaps against the pool. The smart contract collects fees according to immutable rules. No centralized party decides which trades get executed (and when), which assets to accept, or how to allocate the fee revenue. The code executes and its “decision-making” is predetermined and transparent. The fees accrue. If governance votes to direct a portion of those fees to token holders, that distribution is the product of autonomous code plus a governance decision, not managerial effort. No person’s “skill, judgment, or ongoing management” generated the revenue.

The Howey framework does not ask whether value flows to a holder. It asks whether that value derives from the essential managerial efforts of others. Where it does not, the economic arrangement falls outside the securities laws. Labeling protocol fee distributions as “passive yield” collapses the distinction between managed and autonomous sources of economic value. It treats the existence of value flow as dispositive, rather than the character of its source.

### **C. A Decentralized Governance System Is Not a Business Enterprise, Other Entity, Promisor, or Obligor**

The disqualifying condition specifies rights to income, profits, or assets of a “business enterprise or other entity, promisor, or obligor.” Each of these terms implies an identifiable legal person with obligations running to the holder. A business enterprise has owners, directors, and managers who make discretionary decisions. A promisor has contractual obligations it has voluntarily assumed. An obligor owes a debt enforceable at law.

A decentralized governance system is none of these things. It is a rules-based mechanism for collective decision-making. It does not have owners, it has participants. It does not make promises. It does not incur obligations. It does not exercise managerial discretion. It executes predetermined logic in accordance with governance votes. When a decentralized governance system directs protocol fees to token holders, there is no “business enterprise” generating the returns, no “promisor” fulfilling a commitment, and no “obligor” servicing a debt. There is code executing a governance-approved instruction.

The CLARITY for Digital Assets Act, though still pending in Congress, is instructive with respect to the unique position a decentralized governance system occupies. CLARITY defines a decentralized governance system as “any transparent, rules-based system permitting persons to form consensus or reach agreement” in the administration of a blockchain system, where participation is “not limited to, or under the effective control of, any person or group of persons under common control.”<sup>12</sup> CLARITY expressly excludes from the securities regulatory regime investments in “revenues, profits, obligations, or debts of... a decentralized governance system”.<sup>13</sup>

CLARITY further provides that “delegation of ministerial or administrative authority at the direction of the participants in a decentralized governance system shall not be construed to be centralized management.”<sup>14</sup> It provides that the decentralized governance system itself and persons participating in it are to “be treated as separate persons unless such persons are under common control or acting pursuant to an agreement to act in concert.”<sup>15</sup> These provisions operationalize a framework and principled basis for viewing decentralized governance as a wholly different animal, for Howey purposes. The Release would benefit from formally adopting the same framework.

## **IV. Footnote 50 Must Be Reconsidered**

### **A. The Standard Is Incompatible with Governance Tokens**

Independent of the disqualifying rights problem, Footnote 50 defines decentralization as a crypto system that “functions and operates autonomously with no person, entity, or group of persons or entities having operational, economic, or voting control of the crypto system.”<sup>16</sup> This standard, read together with Footnote 54’s elaboration on autonomous operation,<sup>17</sup> describes a theoretical ideal that almost no

operating protocol meets.

Governance tokens exist to confer voting rights. That is their design. Token holders vote on protocol parameters, treasury allocations, software upgrades, and risk management decisions. If voting control by any group disqualifies a system from decentralization under Footnote 50, then governance tokens are structurally incompatible with the standard. Footnote 50 does not merely set a high bar. It describes a system in which governance tokens serve no purpose.

Multiple law firm analyses have identified this incompatibility, particularly where founder or foundation influence persists after governance token distribution.<sup>18</sup> But the concern extends beyond concentrated holdings. Even a perfectly distributed governance token with no single holder exceeding a minimal threshold still involves collective voting control. Footnote 50 does not distinguish between centralized control by one party and distributed control by many. Both are “voting control” under the standard’s plain language.

## **B. Decentralization as the Minimization of Reliance Dependencies**

The securities laws apply where investors must rely upon a promoter’s managerial judgment and integrity to generate returns. That reliance creates the information asymmetry and potential for self-dealing that disclosure requirements and antifraud provisions are designed to address. Where those reliance dependencies are minimized through transparent, rules-based mechanisms that no single party controls, the regulatory purpose of the securities regime is correspondingly diminished.

Decentralization in the context of the securities laws should therefore be understood as the minimization of reliance dependencies, not as the complete absence of all human coordination. A protocol where thousands of independent token holders vote on parameter changes through transparent onchain governance does not create the concentrated reliance on an identified party that Howey targets. The information is public. The decision-making is distributed. The execution is programmatic. No single person’s judgment determines the outcome.

Footnote 50’s formulation does not measure reliance. It measures coordination. The standard asks whether any group has “voting control” of the system. But voting control and reliance dependence are not the same thing. A single founder holding 51% of governance tokens creates concentrated reliance: the holder base depends on that founder’s judgment, is subject to that founder’s self-dealing risk, and faces the information asymmetry the securities laws exist to correct. Ten thousand independent holders each casting a fractional vote through transparent onchain mechanisms create none of those conditions. The information is symmetric. The self-dealing risk is dispersed to the point of practical elimination. No individual’s judgment is essential to the outcome.

Yet Footnote 50 treats both arrangements identically. Both constitute “voting control.” The standard cannot distinguish between the scenario that triggers every concern Howey was designed to address and the scenario that eliminates them. A standard that cannot make that distinction is not measuring decentralization. It is measuring the absence of governance. Decentralization is a distribution of authority that minimizes concentrated reliance. The absence of governance is the absence of human participation entirely. Footnote 50 conflates the two, and in doing so, defines decentralization as a condition that governance tokens are structurally incapable of satisfying.

## V. Proposed Revisions

I respectfully urge the Commission to address these issues through the following revisions.

**First**, replace the Footnote 50 binary standard with a functional threshold consistent with the principle of reliance minimization. Decentralization should not require the complete absence of all human coordination. The standard should target centralized control by an identified party or group of persons under common control. The CLARITY Act’s decentralized governance system definition provides a model: transparent, rules-based, not under the effective control of any person or affiliated group. A bright line backed by a principle. This could take the form of a specified maximum voting power threshold for any single person or coordinated group, combined with a qualitative assessment of whether effective control exists.

**Second**, clarify that network equity issued or authorized by a decentralized governance system does not constitute passive yield within the meaning of the disqualifying rights condition. Protocol fee distributions directed by a decentralized governance system are the product of autonomous code execution and collective governance, not the managerial efforts of an identified party. The economic value is generated programmatically. The distribution mechanism is governance-activated and code-executed. These are not “passive yields” in any sense relevant to the Howey analysis. They are programmatic value flows from autonomous systems. The Commission should clarify that value derived from autonomous protocol operation and distributed through governance-activated mechanisms does not trigger the disqualifying condition.

**Third**, clarify that a decentralized governance system is not a “business enterprise or other entity, promisor, or obligor” within the meaning of the disqualifying rights condition. A decentralized governance system is a rules-based governance mechanism. It has no owners, no managers, no contractual obligations, and no debt. Economic flows directed by it are not “rights to future income, profits, or assets of a business enterprise.” They are distributions from an autonomous system governed by transparent, collective decision-making. The Commission should adopt a position consistent with CLARITY’s structural distinction between a decentralized governance system and a business enterprise.

**Fourth**, incorporate the CLARITY Act’s decentralized carveout into the Release’s framework. Whether through formal incorporation of the statutory language or through independent interpretive guidance, the Commission should exclude economic flows directed by a qualifying DGS from the disqualifying rights condition. Not in deference to legislative intent that has yet to crystallize, but because the carveout provides a workable, principled boundary consistent with the spirit of Howey. Alternatively, the Commission could announce that the forthcoming formal rulemaking<sup>19</sup> will address DGS-directed economic flows specifically, and commit to an enforcement standstill on the question of DGS-directed economic flows during the rulemaking period.

**Fifth**, distinguish between centralized control and distributed governance. Footnote 50 should specify that distributed governance voting by token holders does not constitute “control” within the meaning of the decentralization standard. The standard targets the concentrated reliance on an identified promoter that Howey was designed to address. Thousands of independent token holders voting through transparent onchain mechanisms is the structural opposite of that concentrated reliance. The Commission should clarify that the decentralization inquiry asks whether an identified party holds

effective control, not whether collective governance exists.

## **VI. Conclusion**

The Release represents the most significant step toward regulatory clarity for digital assets since the Commission began applying the securities laws to this asset class. The five-category taxonomy, the investment contract separation doctrine, and the asset-versus-transaction distinction are meaningful contributions that give market participants a workable analytical framework. This letter does not question those contributions. It identifies a narrow but consequential gap in a single definitional sentence that, if left unaddressed, will create classification uncertainty for the protocols most committed to decentralized governance and transparent operation.

The gap is correctable. The revisions proposed in this letter ask the Commission to align the disqualifying condition with the analytical framework that Howey and its progeny establish, to adopt a definition of decentralization that measures reliance rather than coordination, and to provide a workable path for protocols building toward the decentralized ideal the Release itself contemplates. Each proposal is doctrinally grounded in existing precedent and consistent with the structural distinctions Congress drew in the CLARITY Act. The forthcoming formal rulemaking offers an appropriate vehicle for these refinements.

The protocols affected are not the bad actors the securities laws are designed to reach. They are the systems that have moved farthest from centralized control, that operate through transparent code, and that distribute governance authority to their users. A framework that penalizes these protocols for delivering economic value through the very mechanisms that make them decentralized will not drive compliance. It will drive structuring—toward opacity, jurisdictional arbitrage, and the kind of information asymmetry that disclosure requirements exist to prevent. That outcome serves neither investor protection nor market integrity.

As a practitioner advising clients at the intersection of securities law and decentralized protocol design, I encounter the practical consequences of this definitional ambiguity regularly. Protocols that want to comply cannot determine whether compliance is possible. Counsel cannot advise with confidence whether a governance-activated fee distribution disqualifies an asset that otherwise satisfies every element of the digital commodity definition. That uncertainty does not protect investors. It deters the transparent, governance-driven development that the Commission's framework is designed to encourage.

I appreciate the Commission's consideration of these comments and welcome the opportunity to discuss them further.

Respectfully submitted,

**James Williams**

## Footnotes

[1] Release Nos. 33-11412; 34-105020; File No. S7-2026-09 (the “Release”), at 8 (“The Commission and the CFTC invite public comment on this interpretation.”).

[2] Release Section III.A, at 14-15 (defining digital commodity).

[3] Release at 15 (acknowledging that digital commodities may “grant holders governance rights, such as the ability to vote on certain technical or governance matters, such as software upgrades and treasury expenditures”).

[4] See, e.g., Uniswap’s UNification governance proposal, Aave’s fee distribution mechanism, Maker’s surplus buffer distribution, and Lido’s stETH protocol fee allocation.

[5] Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 Am. Econ. Rev. 261 (1958). The theorem establishes that under idealized conditions, a firm’s choice between dividend and buyback is irrelevant to total shareholder wealth. The SEC itself recognizes this equivalence through Rule 10b-18 disclosure requirements for share repurchases.

[6] SEC v. W.J. Howey Co., 328 U.S. 293, 298-299 (1946) (defining an investment contract as “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party”).

[7] SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476 (9th Cir. 1973) (refining the Howey test to require “essential” managerial efforts, i.e., those “without which [the enterprise] would not be expected to succeed”).

[8] Release at fn. 42 and accompanying text (characterizing certain protocol activities as “administrative or ministerial” in nature).

[9] Release Section III.A (disqualifying tokens with “intrinsic economic properties or rights, such as generating a passive yield or conveying rights to future income, profits, or assets of a business enterprise or other entity, promisor, or obligor”).

[10] United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975) (“By profits, the Court has meant either capital appreciation resulting from the development of the initial investment, or a participation in earnings resulting from the use of investors’ funds.”).

[11] SEC v. Edwards, 540 U.S. 389, 394 (2004) (holding that an investment scheme offering a fixed rate of return can be an “investment contract” and defining “profits” as “income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment”).

[12] The CLARITY for Digital Assets Act of 2025 (H.R. 3633), Section 2(a) (defining “decentralized governance system” as “any transparent, rules-based system permitting persons to form consensus or reach agreement” in the administration of a blockchain system, “where participation is not limited to, or under the effective control of, any person or group of persons under common control”).

[13] CLARITY Act Section 2(a)(3) (providing that a digital commodity excludes investments in “revenues, profits, obligations, or debts of the issuer, other than a decentralized governance system”) (emphasis added).

[14] CLARITY Act (providing that “delegation of ministerial or administrative authority at the direction of the participants in a decentralized governance system shall not be construed to be centralized management”).

[15] CLARITY Act (providing that “with respect to a decentralized governance system, the decentralized governance system and any persons participating in the decentralized governance system shall be treated as separate persons unless such persons are under common control or acting pursuant to an agreement to act in concert”).

[16] Release at fn. 50 (defining decentralization as a crypto system that “functions and operates autonomously with no person, entity, or group of persons or entities having operational, economic, or voting control of the crypto system”).

[17] Release at fn. 54 and accompanying text (describing the autonomous operation requirement and defining a “centralized party” as a person or coordinated group with the ability to materially affect the value or operation of the crypto system).

[18] See Gibson Dunn, *SEC Issues Interpretive Guidance on Application of Federal Securities Laws to Crypto Assets* (Mar. 2026) (noting ambiguity in governance token treatment); Chapman & Cutler, *SEC and CFTC Clarify Crypto Asset Taxonomy* (Mar. 2026) (flagging uncertainty where governance structures persist); Jenner & Block, *Crypto Asset Classification Under the Joint Interpretive Release* (Mar. 2026) (identifying the passive yield disqualifier as broadly capturing yield-bearing structures regardless of source).

[19] Chairman Paul S. Atkins, Remarks at the SEC Speaks Conference (Mar. 17, 2026) (announcing the Commission’s intention to commence a formal rulemaking process for digital asset securities regulation).