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Restaking Services such as EigenLayer and Japanese Law

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This article discusses the structure of EigenLayer, which has recently gained rapid attention in the DeFi space, and the applicable regulation on it under Japanese law.
Our firm is a law firm well-versed in the Web3 domain, and we have published numerous articles in both Japanese and English on legal issues related to the Web3 field[1]. In May 2024, we published a Japanese article titled "Structure of Restaking Services such as EigenLayer and Japanese Law[2]." While the Japanese version of the article provides a more detailed analysis, this article summarizes the conclusions of the Japanese version to facilitate easy understanding for overseas entities considering offering restaking services in Japan.

I Overview of EigenLayer

The Structure of Restaking in EigenLayer

EigenLayer is a service designed to ensure secure execution for programs running outside of the Ethereum Virtual Machine (EVM) by using ETH.
For instance, when a DeFi application that uses the Ethereum blockchain consists of parts that operate within the EVM and parts that do not, the security for the EVM parts is guaranteed by the Ethereum blockchain. However, the parts that run outside the EVM are not covered by the security of the Ethereum blockchain, making them vulnerable. The traditional approach to this issue has been to issue native tokens for that application, but this comes with several problems:

1. If the native tokens have low value, the threat of "slashing" is less effective.
2. If the native tokens are not widely distributed (e.g., if the initial developers hold many tokens), the system may not function effectively.

[1] For example, the article about LIDO related to liquid staking in English can be found at this link: https://innovationlaw.jp/en/liquid-staking-lido-en/

[2] https://innovationlaw.jp/eigenlayer/

3. There is little incentive for users to purchase native tokens.

EigenLayer aims to provide a solution to these problems.

In simple terms, EigenLayer "reuses" ETH that is already staked on Ethereum to provide security to services built on EigenLayer (Actively Validated Services, or AVS). For example, consider an AVS that periodically surveys numerous crypto exchanges and DeFi protocols to collect token price information and calculate their average values. In this case:

1. Only those who have staked a certain amount of ETH can act as "operators" and provide price information.
2. If false information is provided, the ETH, etc.[3] restaked by the operator on EigenLayer will be slashed.
3. Operators are rewarded by the AVS for providing accurate information.

A key feature is that ETH staked for the regular Proof of Stake mechanism on Ethereum can also be used as collateral for multiple AVS, allowing operators to earn additional rewards. Furthermore, users who are not operators can deposit their ETH, etc. into EigenLayer, restake it through selected operators, and receive a share of the rewards that operators earn from the AVS. The advantage for users is that they can earn multiple layers of rewards through EigenLayer restaking compared to simple ETH staking.

Liquid Restaking

In addition, external entities offer a service related to EigenLayer known as Liquid Restaking. This service involves users depositing their ETH with a liquid restaking provider, who then stakes the ETH on Ethereum and restakes it through EigenLayer once the minimum staking unit of 32 ETH is accumulated. In this case, users only interact with the liquid restaking provider, while the provider handles transactions with EigenLayer. This arrangement frees users from the responsibility of selecting operators. Liquid restaking services thus play an important role in providing users with the opportunity to generate revenue through EigenLayer.

II Laws to Consider and Conclusions

Restaking and Japanese Law

[3] Liquid staking services like LIDO allow users to pool ETH amounts smaller than the minimum staking unit (32 ETH) for staking. When users utilize these services, they receive Liquid Staking Tokens (such as stETH in LIDO's case). In EigenLayer, it is possible to restake not only ETH but also these Liquid Staking Tokens. Therefore, in this document, "ETH, etc." refers to both ETH and Liquid Staking Tokens.

(1) Legal Considerations for Restaking services such as EigenLayer

When considering restaking services such as EigenLayer under Japanese law, it is primarily necessary to evaluate the applicability of:

1. Custody regulations under the Crypto Act (a subset of the Payment Services Act);
2. Fund regulations under the Financial Instruments and Exchange Act (FIEA);
3. Regulations under the Act against Unjustifiable Premiums and Misleading Representations (UPMR).

(2) Custody Regulations under the Crypto Act

If the act of depositing ETH, etc. into EigenLayer is viewed as the entrustment of crypto, the custody regulations under the Crypto Act may apply. However, if the deposit is made to a smart contract and the smart contract technically prevents EigenLayer, the AVS, the operators and other people except for users to transfer the ETH, etc., we believe the custody regulations would not apply.

(3) Fund Regulations under the Financial Instruments and Exchange Act

FIEA regulates funds that collect money, use such money for some kinds of investment or some business activities, and distribute the profits to investors. There is a concern about whether the fund regulations under the FIEA apply to the mechanism where EigenLayer receives deposits of ETH, etc., operators provide security to the AVS in return for rewards, and a portion of these rewards is distributed to users, who also bear the risk of penalties such as slashing. However, if the deposited ETH, etc. is not used for investment or business activities but merely locked in a smart contract as a form of collateral to address penalties like slashing, we believe that the fund regulations under the FIEA would not apply.

(4) Regulations under the Act against Unjustifiable Premiums and Misleading Representations

In restaking services such as EigenLayer, users may receive points[4] as rewards. These points might lead to future airdrops. The potential applicability of the UPMR, which prohibits excessive premiums provided in connection with transactions of goods and services, needs to be considered. Under UPMR, premiums refer to (1) economic benefits such as goods or money that are provided (2) as a means to attract customers, and (3) in connection with transactions. In this respect, users

[4] In EigenLayer, users who restake can earn "EigenLayer Points," which are points that can be exchanged for EigenLayer's native token (EIGEN).

of restaking services likely view these points as part of the rewards associated with restaking, and the high yields might incentivize them to restake. Therefore, these points can be seen as part of the primary transaction, not as "premiums" provided in connection with the transaction, implying that the UPMR might not apply.

Liquid Restaking and Japanese Law

(5) Legal Considerations for Liquid Restaking Providers

Liquid restaking providers, being external entities, likely operate under various structure. It is necessary to evaluate the applicability of:

1. Custody regulations under the Crypto Act;
2. Trading regulations under the Crypto Act;
3. Fund regulations under the FIEA;

(6) Custody Regulations under the Crypto Act

If the act of depositing ETH for liquid restaking is deemed as custody, the custody regulation under the Crypto Act may apply. Whether liquid restaking providers manage private keys is a critical issue. We believe, however, it seems that most liquid restaking providers do not own private keys and thus the custody regulation do not apply.

(7) Exchange Regulations under the Crypto Act

There is a concern about whether issuing Liquid Restaking Tokens upon depositing ETH constitutes crypto exchange. Legally, if tokens are issued as proof of deposit, it would not be considered trading or exchange under the Crypto Act, and thus, the trading and exchange regulations would not apply.

(8) Fund Regulations under the Financial Instruments and Exchange Act

Fund regulations must also be considered for liquid restaking providers. Key considerations include how private keys are managed. If the smart contract ensures that the deposited ETH is used solely as collateral and cannot be otherwise utilized, we believe the operation may not be classified as a fund. Conversely, if the smart contract is not properly set up and allows the provider to use the private keys and crypto assets, the operation may be subject to fund regulations.

Disclaimer

The content of this article has not been confirmed by the relevant authorities or organizations

mentioned in the article but merely reflects a reasonable interpretation of their statements. The interpretation of the laws and regulations reflects our current understanding and may, therefore, change in the future. This article does not recommend the use of staking, liquid staking, liquid restaking, EigenLayer or LIDO, etc.. This article provides merely a summary for discussion purposes. If you need legal advice on a specific topic, please feel free to contact us.