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TULIP OR GOLD? HOW THE SECURITIES AND EXCHANGE COMMISSION SHOULD REGULATE CRYPTOCURRENCIES

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Arya Ghadimi, University of California, Irvine College of Law Graduate



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TULIP OR GOLD? HOW THE SECURITIES AND EXCHANGE COMMISSION SHOULD REGULATE CRYPTOCURRENCIES

Arya Ghadimi*

“Bitcoin is probably rat poison squared.”

- Warren Buffett, CEO of Berkshire Hathaway¹

“I really like Bitcoin ... It’s a store of value, a distributed ledger. It’s also a good investment vehicle if you have an appetite for risk.”

- David Marcus, former CEO of PayPal and co-founder of Facebook’s cryptocurrency, Libra²

In the mid-1600s, the price of a tulip in the Netherlands rose to about ten times the average annual salary of a skilled worker.³ The price of tulips continued to rise because speculators believed that the tulip would be a profitable purchase, as others would be willing to buy it for even a higher price than they did.⁴ This mass belief that a tulip could be sold for an exponentially higher price eventually ceased, and the price crashed.⁵ As the story goes, many people went into bankruptcy, and some even committed suicide by drowning themselves in canals.⁶ Though Europeans of the time may have wished to put this story behind them, “tulip mania” lives today as a parable of how mass psychology, greed, and foolishness can distort asset prices.⁷

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¹ Neel Mehta, Aditya Agashe, & Parth Detroja, *Bubble or Revolution? The Present and Future of Blockchain and Cryptocurrencies* xi (2d ed. 2020).

² *Id.* at 185.

³ Tim Hartford, *Was Tulip Mania Really The First Great Financial Bubble?*, BBC (Mar. 4, 2020), <https://www.bbc.com/news/business-51311368>.

⁴ *Tulip Mania*, ENCYCLOPEDIA BRITANNICA, <https://www.britannica.com/event/Tulip-Mania> (last visited Nov. 5, 2021).

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

Nearly 400 years later, the first cryptocurrency,⁸ Bitcoin, was trading for \$66,000 per coin.⁹ This represented a 9,315% increase from its price just five years prior.¹⁰ Around the same time, when a company changed its name from “Long Island Iced Tea” to “Long Blockchain Corp.,” its stock price rose 289% within hours.¹¹ This sudden jump in the stock price is even more surprising given that the company said that iced tea and other juices would still be its primary source of revenue, and it was only “shifting its primary corporate focus” to evaluating potential business opportunities in blockchain.¹²

The parallels that can be drawn between “tulip mania” and Bitcoin are a natural cause for concern. Will cryptocurrencies be this century’s parable of “tulip mania,” or will they become a mainstream store of value and an extremely valuable commodity like gold? Although reasonable minds differ, one thing is certain: many laypeople are being defrauded.¹³ For instance, one study concluded that 80% of initial coin offerings (ICOs), a mechanism to raise capital to build a new cryptocurrency, conducted in 2017 were scams.¹⁴ Ponzi schemes, such as a platform called PlusToken, are abundant.¹⁵ In addition,

⁸ A cryptocurrency is a digital money. *Cryptocurrency*, MERRIAM-WEBSTER DICTIONARY (2021). Mainstream currencies are regulated by the Office of the Comptroller of the Currency, an independent bureau within the United States Department of Treasury that was established by the National Currency Act of 1863 (now known as the National Bank Act). *Office of the Comptroller of the Currency*, USA.GOV, <https://www.usa.gov/federal-agencies/office-of-the-comptroller-of-the-currency> (last visited Nov. 5, 2021); Robert Hockett, *What is ‘The Comptroller of the Currency’ – And Why Does it Matter?*, FORBES (Jan. 19, 2021), <https://www.forbes.com/sites/rhockett/2021/01/19/what-is-the-comptroller-of-the-currency--and-why-does-it-matter/>.

⁹ Ryan Haar, *What is Bitcoin?*, TIME (Aug. 12, 2021), <https://time.com/nextadvisor/investing/cryptocurrency/what-is-bitcoin/> (discussing the first cryptocurrency). This was the trading price of Bitcoin on October 20, 2021. Bovaird, Charles, *Bitcoin Prices Hit Fresh, All-Time High Above \$66,000*, FORBES (Oct. 20, 2021), <https://www.forbes.com/sites/cbovaird/2021/10/20/bitcoin-prices-hit-fresh-all-time-high-above-66000/?sh=6a6305241dee>; Billy Bambrough, *Bitcoin is Braced for A Huge \$6 Billion Price Earthquake This Week*, FORBES (Mar. 22, 2021), <https://www.forbes.com/sites/billybambrough/2021/03/22/bitcoin-is-braced-for-a-huge-61-billion-price-earthquake-this-week>.

¹⁰ Raynor de Best, *Bitcoin BTC/USD Price Per Day from October 13 to December 14, 2021*, Statista (Dec. 14, 2021), <https://www.statista.com/statistics/326707/bitcoin-price-index/>. This is even more stunning after noting that the S&P 500, which is generally touted as the best overall gauge of the stock market, has averaged an annualized total return of 9.8% over the past 90 years, which would return about 60% after five years. Michael Santoli, *The S&P 500 Has Already Met Its Average Return for a Full Year, But Don’t Expect it to Stay Here*, CNBC (June 18, 2017), <https://www.cnbc.com/2017/06/18/the-sp-500-has-already-met-its-average-return-for-a-full-year.html>.

¹¹ Arie Shapira & Kailey Leinz, *Long Island Iced Tea Soars After Ranging Its Name to Long Blockchain*, BLOOMBERG (Dec. 21, 2017), <https://www.bloomberg.com/news/articles/2017-12-21/crypto-craze-sees-long-island-iced-tea-rename-as-long-blockchain>.

¹² Evelyn Cheng, *\$24 Million Iced Tea Company Says It’s Pivoting to the Blockchain, and its Stock Jumps 200%*, CNBC (Dec. 21, 2017), <https://www.cnbc.com/2017/12/21/long-island-iced-tea-micro-cap-adds-blockchain-to-name-and-stock-soars.html>.

¹³ See, e.g., Press Release, U.S. Sec. & Exch. Comm’n, Unregistered ICO Issuer Agrees to Disable Tokens and Pay Penalty for Distribution to Harmed Investors (Sept. 15, 2020), <https://www.seclaw.com/unregistered-ico-issuer-agrees-to-disable-tokens-and-pay-penalty-for-distribution-to-harmed-investors/>; Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges Film Producer, Rapper, and Others for Participation in Two Fraudulent ICOs (Sept. 12, 2020), <https://www.seclaw.com/sec-charges-film-producer-rapper-and-others-for-participation-in-two-fraudulent-icos/>.

¹⁴ Ana Alexandre, *New Study Says 80 Percent of ICOs Conducted in 2017 Were Scams*, COINTELEGRAPH (July 13, 2018), <https://cointelegraph.com/news/new-study-says-80-percent-of-icos-conducted-in-2017-were-scams>.

¹⁵ Paul Virginia & Eun-Young Jeong, *Cryptocurrency Scams Took in More than \$4 Billion in 2019*, WALL STREET J. (Feb. 8, 2020), <https://www.wsj.com/articles/cryptocurrency-scams-took-in-more-than->

several celebrities have promoted fraudulent ICOs, making it more difficult for laypeople to distinguish between legitimate and fraudulent offerings.¹⁶ This may not be surprising given that in its first few years Bitcoin was commonly associated with e-criminals, such as online drug dealers and hackers.¹⁷

Because of this fraudulent activity, a reaction may be to ban cryptocurrencies outright; however, cryptocurrencies have beneficial uses. For instance, Bill Gates, co-chair of the Bill and Melinda Gates Foundation, has said that his foundation is using digital currencies to help the indigent get access to banking services.¹⁸ Accordingly, both proponents, who believe that cryptocurrencies can revolutionize business and currencies, and critics, who believe that cryptocurrencies are headed for the same fate as “tulip mania,” should agree that regulatory bodies need to act to prevent crime and fraud in this space.¹⁹ Indeed, government agencies have acted.²⁰ The Federal Trade Commission (FTC) has issued warnings and published guidance on its website for consumers.²¹ The Internal Revenue Service (IRS)²² and Commodity Future Trading Commission (CFTC)²³ have also both

4-billion-in-2019-11581184800. In fact, the SEC has also warned of the prominence of Ponzi schemes through its Office of Investor Education and Advocacy. SEC OFFICE OF INV’R EDUC. & ADVOCACY, *Ponzi Schemes Using Virtual Currencies*, https://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf. Additionally, pump-and-dump schemes, a form of price manipulation that involves artificially inflating an asset price before selling the cheaply purchased assets at a higher price, are common in the cryptocurrency markets. See Tao Li, Donghaw Shin, & Baolian Wang, *Cryptocurrency Pump-and-Dump Schemes*, SSRN (Feb. 10, 2021),

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3267041#:~:text=This%20paper%20studies%20%E2%80%9Cpump%2Dand, falls%2C%20and%20investors%20lose%20money.

¹⁶ See, e.g., Matt Robinson, *Rapper T.I. to Pay \$75,000 Fine for Promoting Fraudulent Initial Coin Offering*, FORTUNE (Sep. 11, 2020), <https://fortune.com/2020/09/11/rapper-t-i-fine-fraudulent-initial-coin-offering/>.

¹⁷ Mehta, Agashe, & Detroja, *supra* note 1, at 70. The most famous criminal enterprise built using Bitcoin as a currency was the Silk Road, which was similar to Amazon.com but used for illegal activities. *Id.* In addition, there was a website named Cthulhu that allowed people to hire hitmen, offering the services of “an organized criminal group” of former soldiers and mercenaries. *Id.* at 71.

¹⁸ *Id.* at 63. In fact, the International Money Fund (IMF) and the World Bank have jointly launched a private blockchain and a quasi-cryptocurrency, called “Learning Coin.” Ana Berman, *IMF and World Bank Launch Quasi-Cryptocurrency in Exploration of Blockchain Tech*, COINTELEGRAPH (Apr. 14, 2019), <https://cointelegraph.com/news/imf-and-world-bank-launch-quasi-cryptocurrency-in-exploration-of-blockchain-tech>.

¹⁹ See Donald F. Kettl, *How Do We Regulate Bitcoin and Other Cryptocurrencies*, GOVERNING.COM (Aug. 2018), <https://www.governing.com/columns/washington-watch/gov-bitcoin-regulations-states.html> (saying that there is “hope for more detailed crypto regulations under the upcoming Biden Administration”).

²⁰ See generally Staff of Global Legal Research Directorate, *Regulation of Cryptocurrency Around the World* (June 2018) (available at <https://tile.loc.gov/storage-services/service/l1/l1glrd/2018298387/2018298387.pdf>).

²¹ Christina Miranda, *Avoiding a Cryptocurrency Scam*, FED. TRADE COMM’N (July 16, 2020), <https://www.consumer.ftc.gov/blog/2020/07/avoiding-cryptocurrency-scam>.

²² The IRS has designated cryptocurrencies as “property” subject to capital gains tax reporting. I.R.S. Notice 2014-21. The IRS’s mission is to provide america’s tax payers top quality service by helping them understand and meet their tax responsibilities and enforce the law with intergrity and fairness to all. *The Agency, Its Mission and Statutory Authority*, INTERNAL REVENUE SERV., <https://www.irs.gov/about-irs/the-agency-its-mission-and-statutory-authority> (last visited Nov. 5, 2021).

²³ The CFTC has stated that cryptocurrencies are commodities even when they lack a future component. Press Release, Commodity Futures Trading Comm’n, IN CASE YOU MISSED IT: Chairman Tarbert Comments on Cryptocurrency Regulation at Yahoo! Finance All Markets Summit (Oct. 10, 2019), <https://www.cftc.gov/PressRoom/PressReleases/8051-19>. The CFTC, per the Commodity Exchange Act, 7 U.S.C. § 1, is charged with regulating derivative markets, which includes futures, swaps, and certain

addressed the issue to some extent.²⁴ This Article, however, focuses on another regulatory body, the Securities and Exchange Commission (SEC), because the SEC is the primary securities regulator in the United States.²⁵

Before introducing the SEC's position on cryptocurrencies, it is important to briefly introduce cryptocurrencies. Cryptocurrencies are the coins that (1) can be used to purchase goods and services, or (2) coins that represent an ownership stake in a company, whereas an ICO is a capital-raising event used to obtain the funds to build a new cryptocurrency.²⁶ The development of technology and mechanisms to raise capital in this space is developing extremely quickly.²⁷ SEC officials have unofficially stated that Bitcoin is not subject to regulation.²⁸ However, many ICOs will be deemed a sale of "securities" and thus subject to the SEC's jurisdiction.²⁹ Still, the SEC has not provided definitive guidance on *what* makes an ICO subject to its regulation.³⁰

options. *Commodity Exchange Act & Regulations*, COMMODITY FUTURES TRADING COMM'N, <https://www.cftc.gov/LawRegulation/CommodityExchangeAct/index.htm> (last visited Nov. 5, 2021).

²⁴ In addition to these entities, the Federal Crimes Enforcement Network (FinCEN), an entity within the Department of Treasury, has responsibility for regulating virtual currencies. FINANCIAL CRIMES ENFORCEMENT NETWORK, <https://www.fincen.gov/> (last visited Nov. 25, 2020). FinCEN is responsible for enforcing the Bank Secrecy Act, a major federal anti-money laundering statute, and has issued guidance clarifying the BSA's application to various cryptocurrencies. *FinCEN's Mandate from Congress*, FINANCIAL CRIMES ENFORCEMENT NETWORK, <https://www.fincen.gov/resources/statutes-regulations/fincens-mandate-congress> (last visited Nov. 5, 2021).

²⁵ The SEC is the primary securities regulator in the United States. *What We Do*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/Article/whatwedo.html> (last visited Nov. 5, 2021). In fact, it seems like the SEC is headed in the direction of promoting the new technology while ensuring investor protections. Chris Prentice & Pete Schroeder, *Analysis: Biden's SEC Chair Nominee Signals More Regulation for Cryptocurrencies*, REUTERS (Mar. 2, 2021), <https://www.reuters.com/article/us-usa-crypto-currency-gensler-analysis/analysis-bidens-sec-chair-nominee-signals-more-regulation-for-cryptocurrencies-idUSKCN2AV02H>. Before the Senate Banking Committee, Gary Gensler said that it is important for the SEC to provide guidance and clarity: "Sometimes that's a clarity that will be a thumbs up, but even if it's thumbs down, it's important to provide that." *Id.*

²⁶ *Investor Bulletin: Initial Coin Offerings*, U.S. SEC. AND EXCH. COMM'N (July 25, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings.

²⁷ See *infra* note 81 for a discussion of the other types of securities offerings.

²⁸ The ex-SEC chairman Jay Clayton stated in an interview with CNBC that Bitcoin is a currency and not a security.

Chermaine Ng, *SEC Chairman Jay Clayton on Bitcoin: Not a Security, But More Regulation Needed*, SUPERCRYPTONEWS (Nov. 22, 2020), <https://www.supercryptonews.com/sec-chairman-jay-clayton-on-bitcoin/>.

²⁹ See, e.g., *U.S. Sec. & Exch. Comm'n v. Kik Interactive Inc.*, 492 F. Supp. 3d 169 (S.D.N.Y. 2020).

³⁰ The SEC has given guidance on its website regarding how cryptocurrencies will be regulated and said a determination will be made through an analysis of whether the cryptocurrency is a "security" through *Howey*. *Framework for "Investment Contract" Analysis of Digital Assets*, U.S. SEC. AND EXCH. COMM'N (Apr. 3, 2019), <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>. Ex-SEC chairman Clayton did not comment on cryptocurrencies besides Bitcoin, and he made clear that the SEC still was going to regulate tokens. *Id.* The ex-SEC Director of the Division of Corporation Finance, William Hinman, has also commented on whether cryptocurrencies will be regulated by the SEC. William Hinman, Dir., Div. of Corp. Fin., Sec. & Exch. Comm'n, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018).

Because of this unclarity, there has been litigation in this area.³¹ In fact, the unclarity has reached a point where defendants have used the lack of clarity itself as a defense.³² Furthermore, most of the relevant literature has discussed the SEC’s “selective enforcement regime,” the lack of guidance, and ways to bypass SEC jurisdiction.³³ In April 2021, SEC Commissioner Hester Peirce proposed a safe-harbor, Rule 195, which permits an issuer to bypass registration with the SEC for three years so long as it takes certain actions, such as making certain information about the cryptocurrency and its developers available on a publicly accessible website.³⁴ Most recently, the SEC attempted under new Chairman Gary Gensler to classify cryptocurrencies as security-based swaps.³⁵ Still, neither the literature, courts, nor lawmakers have addressed the problem by proposing a cryptocurrency-specific legal standard for determining whether a cryptocurrency offering should be subject to SEC’s jurisdiction. This Article seeks to fill that gap by proposing a new framework that Congress can adopt so the SEC can move away from the current *Howey*³⁶ framework and toward a cryptocurrency-specific legal standard. A cryptocurrency-specific legal standard will be specifically tailored toward this new technology and will provide more clear guidance than the *Howey* framework does to legitimate companies that want to raise capital to start a new cryptocurrency.³⁷

This Article, in Part I, provides a background of cryptocurrencies, including Bitcoin, altcoins, and ICOs. It then briefly discusses the excitement around blockchain technology. Part II discusses one mechanism by which the SEC exercises its jurisdiction, the registration requirements, and the exemptions that companies can use to bypass

³¹ See, e.g., *Sec. & Exch. Comm’n v. Telegram Grp. Inc.*, 448 F. Supp. 3d 352 (S.D.N.Y. 2020), *appeal withdrawn sub nom. United States Sec. & Exch. Comm’n v. Telegram Grp., Inc.*, No. 20-1076, 2020 WL 3467671 (2d Cir. May 22, 2020).

³² See Reply, *Sec. & Exch. Comm’n v. Ripple Labs, Inc.*, No. 20-CV-10832 (AT)(SN), 2021 WL 1335918 (S.D.N.Y. Apr. 9, 2021)

³³ See, e.g., James J. Park & Howard H. Park, *Regulation by Selective Enforcement: the SEC and Initial Coin Offerings*, 61 WASH. UNIV. J.L. & POL’Y 99 (2020). Some of the other literature in this space includes proposals to create a specialized agency for cryptocurrencies, Tyler C. Lee, *Decrypting Crypto: Issues Plaguering Today’s Hottest Regulatory Nightmare*, 16 NYU J.L. & BUS. 551 (2020); to create an exemption for virtual currencies, Michael Segal, *Cryptocurrency Regulation Under U.S. Securities Law and Proposed Amendments*, 26 No. 1 PIABA B.J. 97 (2019); and to make amendments to *Howey* so that it can be specifically tailored to cryptocurrencies, M. Todd Henderson & Max Raskin, *A Regulatory Classification of Digital Assets: Toward an Operational Howey Test for Cryptocurrencies, ICOs, and other Digital Assets*, 2019 COLUM. BUS. L. REV. 443 (2019).

³⁴ Press Release, Comm’r Hester M. Peirce, Token Safe Harbor Proposal 2.0 (April 13, 2021), <https://www.sec.gov/news/public-statement/peirce-statement-token-safe-harbor-proposal-2.0>. At the end of the three-year grace period, the issuer must decide whether the cryptocurrency should be registered with the SEC or meets an exemption, and act accordingly. *Id.* Although this is just a proposal, it does carry substantial weight since it is proposed by a SEC commissioner. *See id.*

³⁵ Landon McBride, *SEC Chairman Says Cryptocurrency Falls Under Security-Based Swaps Rules*, COINTELEGRAPH (July 21, 2021), <https://cointelegraph.com/news/sec-chairman-says-cryptocurrency-falls-under-security-based-swaps-rules>.

³⁶ In *SEC v. Howey*, the defendant owned a citrus orchard and offered portions of it to the public to finance additional development. *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 295 (1946). Buyers were enticed by the seller with the promise of substantial profits from the sale of the citrus fruit. *Id.* at 296. The U.S. Supreme Court held that this “investment contract” was a “security.” *Id.* at 298-300.

³⁷ Securities and corporate lawyers may be most concerned about cryptocurrencies because their clients may desire to move into the area, but this issue is important for all lawyers to understand. Among other reasons, this is because cryptocurrencies can be used as consideration in certain contracts, and clients may want to pay attorneys’ fees in cryptocurrencies. Even an ethical argument can be made that every lawyer should know about cryptocurrencies. ABA Rule of Ethics 1.1, comment 8 says that lawyers should keep up with changes in the law and its practice, “including the benefits and risks associated with relevant technology.” MODEL CODE OF PROF’L CONDUCT r. 1.1 cmt. 8 (AM. BAR ASS’N 2020).

registration. Part III elaborates on the publicly available information regarding whether the SEC has jurisdiction over an ICO or cryptocurrency. This includes the *Howey* framework, Director Hinman’s speech, the DAO Report, the Munchee order, no-action letters, and the *SEC v. Kik* summary judgment ruling. In Part IV, this Article synthesizes these materials into a cryptocurrency-specific legal standard to determine whether a cryptocurrency is subject to the SEC’s jurisdiction.³⁸ The benefits of moving away from the *Howey* framework include that the *Howey* test will be kept for its intended use as a catchall category and that issuers can more reliably predict whether their cryptocurrency is subject to the SEC’s jurisdiction. Subsequently, in Part V, this Paper addresses two additional considerations: why courts need to view any bright-line rules drawn within the context of this balancing test in light of the purposes of the securities laws, and why Congress may be reluctant to give the market clearer guidance. Finally, in Part VI, it concludes by emphasizing that principled guidance in this area would best achieve the balance of protecting laypeople while allowing companies to innovate.

I. A Background on the First Decade of Cryptocurrencies

Cryptocurrencies can best be understood through a discussion of Bitcoin, the most famous cryptocurrency, and the historical background of its emergence during the 2009 Great Recession.³⁹ After the advent of Bitcoin, altcoins became popular, and subsequently, ICOs became a way for companies to raise capital to build a new cryptocurrency.

³⁸ The U.S. Supreme Court has previously adopted a balancing test similar to this in *Reves v. Ernst & Young* to address the issue of whether notes are “securities.” *Reves v. Ernst & Young*, 494 U.S. 56 (1990). The fact that the cryptocurrency-specific balancing test proposed in this Article is similar to the “family resemble” test in *Reves* supports the argument that this legal standard embodies Congress’ purpose in enacting the securities laws: to regulate investments in whatever form they are made and by whatever name they are called. *See SEC v. Howey*, 328 U.S. 293, 299 (1946) (saying that in defining the scope of the market that it wishes to regulate, Congress painted with a broad brush and recognized the limitless scope of human ingenuity, especially the creation of variable schemes devised by those who seek to use the money of others on the promise of profits).

In *Reves*, the Court held that “notes” are presumed to be “securities,” but that presumption can be rebutted by a strong showing that they should not be, via the “family resemblance” test, which consists of four factors. *Id.*

Factor one of the “family resemblance” test assesses the motivations for the reasonable seller and buyer to enter into the transaction. *Id.* Specifically, if the seller’s purpose is to raise money for its business and the buyer is interested in profit, the instrument is likely to be a “security.” *Id.* If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good or to advance some other commercial or consumer purpose, the note is less likely to be a “security.” *Id.* The second factor examines the “plan of distribution” of the instrument to determine if the instrument at issue is used for “common trading for speculation or investment.” *Id.* The third factor is the reasonable expectations of the investing public. *Id.* The fourth and final factor is an assessment of the existence of another regulatory scheme which would significantly reduce the risk of the instrument, thereby rendering application of the securities laws unnecessary. *Id.*

³⁹ Noogin, *The Financial Crisis and History of Bitcoin*, MEDIUM (May 15, 2018), <https://medium.com/@noogin/the-financial-crisis-and-history-of-bitcoin-27ebdb932b99>.

a. It is Important to Differentiate Amongst Bitcoin, Altcoins, and ICOs

i. *Bitcoin Set the Stage for the Cryptocurrency Boom*

Amidst the Great Recession, the first cryptocurrency, Bitcoin, was born.⁴⁰ The Great Recession was a period of declining economic activity; it was characterized by high unemployment, low economic growth, and decreasing asset prices.⁴¹ During this downturn, the U.S. government handed a \$700 billion bailout to the financial sector to rescue the economy.⁴² When the government gave money to the wealthy and powerful, many citizens developed a general distrust toward the government and other powerful institutions. This distrust can best be exemplified by the Occupy movement, which included rallies against financial and social inequality as well as the influence of corporate money in politics.⁴³

During this era of distrust, an anonymous user (or group) who went by the name of Satoshi Nakamoto set out to solve a problem: governments and financial institutions were in control of the money supply and could not be trusted.⁴⁴ Nakamoto did so by creating a decentralized currency called Bitcoin; Bitcoin is a digital form of money that operates on a peer-to-peer network with no middleman or institutions in control.⁴⁵ Nakamoto created Bitcoin by publishing a white paper⁴⁶ that detailed the methods of how this new currency would operate.⁴⁷

⁴⁰ The specific date that Bitcoin's white paper was published is January 9, 2009. Elizabeth Schulze, *Bitcoin Turns 10: The Obscure Technology that Became a Household Name*, CNBC (Jan. 4, 2019), <https://www.cnbc.com/2019/01/04/bitcoin-turns-10-the-obscure-technology-that-became-a-household-name.html>.

⁴¹ Robert Rich, *The Great Recession*, FEDERALRESERVEHISTORY.ORG (Nov. 22, 2013), https://www.federalreservehistory.org/essays/great_recession_of_200709. One statistic that portrays the magnitude of this recession is that home prices fell nearly 30%. *Id.*

⁴² *Great Recession*, HISTORY (Oct. 11, 2019), <https://www.history.com/topics/21st-century/recession>.

⁴³ See Alan Taylor, *Occupy Wall Street*, THE ATLANTIC (Sept. 31, 2011), <https://www.theatlantic.com/photo/2011/09/occupy-wall-street/100159/>; Heather Gautney, *What is Occupy Wall Street? The History of Leaderless Movements*, THE WASH. POST (Oct. 10, 2011), https://www.washingtonpost.com/national/on-leadership/what-is-occupy-wall-street-the-history-of-leaderless-movements/2011/10/10/gIQAwkFjaL_story.html.

⁴⁴ Elizabeth Lopatto, *How Bitcoin Grew Up and Became Big Money*, THE VERGE, <https://www.theverge.com/2019/1/3/18166096/bitcoin-blockchain-code-currency-money-genesis-block-silk-road-mt-gox>; Dong He, *Monetary Policy in the Digital Age*, INT'L MONETARY FUND, <https://www.imf.org/external/pubs/ft/fandd/2018/06/central-bank-monetary-policy-and-cryptocurrencies/he.html> (last visited Nov. 18, 2021).

⁴⁵ See Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, BITCOIN.ORG, <https://bitcoin.org/bitcoin.pdf>. (last visited Nov. 5, 2021).

⁴⁶ A white paper is a document which includes an outline of a problem that the project is looking to solve, the solution to that problem, as well as a detailed description of the product, its architecture, and its interaction with users. *What is a White Paper and How to Write It*, COINTELEGRAPH, <https://cointelegraph.com/ico-101/what-is-a-white-paper-and-how-to-write-it> (last visited Nov. 3, 2020). The content of a white paper normally includes an introduction, disclaimer, table of contents, description of the market and the problem. It also describes the product and how it's going to solve the problem. *Id.*

⁴⁷ See Nakamoto, *supra* note 46. In addition, because Bitcoin is a digital currency, Nakamoto confronted one major problem: the same Bitcoin could be sent to multiple parties. Nakamoto solved this problem through a process called "mining," a process whereby users can verify a transaction and get paid in the form of Bitcoin. Rene Millman & Stephen Graves, *What is Bitcoin Mining and How Does it Work?*, DECRYPT (Oct. 14, 2020), <https://decrypt.co/resources/what-is-bitcoin-mining-and-how-does-it-work>. This is one way that new Bitcoins are obtained by users; the other way is through a standard purchase. *Id.* Additionally, in this white paper, Nakamoto used the term "block chain" to describe the ledger which would store all of the verified transactions and would be available to all users. Nakamoto, *supra* note 46.

Additionally, because Bitcoin is a decentralized peer-to-peer platform, it has advantages that fiat currencies do not.⁴⁸ For instance, Bitcoin removes middlemen from taking a fee for processing a transaction.⁴⁹ In transactions that are processed via a credit card, the credit card company pays the merchant and is later reimbursed by the customer.⁵⁰ However, the merchant has to pay a transaction cost to the credit card company (e.g., Visa, Mastercard, Discover, or American Express) between 1.5% and 3.5%.⁵¹ The merchant also is required to follow the credit card company's rules, which can include disclosing private information.⁵² An alternative to a credit card company, PayPal, also charges merchants 3% of the transaction cost.⁵³ In addition to this problem, credit card companies (and other middlemen such as PayPal) can get hacked and compromise private information.⁵⁴

Ultimately, Bitcoin was seen as a solution that eliminated the problems of untrustworthy institutions and could be used as a modern form of a physical currencies.⁵⁵ However, this is only a discussion of the benefits of Bitcoin—it also has shortcomings that need to be fixed or addressed, possibly through an altcoin, in order for it to become an effective currency.⁵⁶

This concept later became adopted in other contexts and is now known as “blockchain;” it is an exciting new technology and should not be confused with cryptocurrencies themselves. Marco Iansiti & Karim R. Lakhani, *The Truth About Blockchain*, HARV. BUS. REV. (Jan. 2017), <https://hbr.org/2017/01/the-truth-about-blockchain>.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ Ben Dwyer, *Credit Card Processing: How it Works*, CARDFELLOW (Apr. 6, 2020), <https://cardfellow.com/blog/how-credit-card-processing-works/>.

⁵¹ Mehta, Agashe, & Detroja, *supra* note 1, at 9.

⁵² *Id.* at 10.

⁵³ *Id.*

⁵⁴ *Id.* This was the case in 2014 when hackers stole data of 100 million JPMorgan customers. *Id.* Another example of a hack is when sensitive information, such as birth dates and addresses, were stolen from 100 million Capital One customers in 2019. *Id.* Another feature of Bitcoin that has contributed to its popularity is that the only substitute for middlemen are physical currencies (e.g., gold), which have their own problems. *Id.* at 8. For example, physical currencies can be stolen, cannot be used for long-distance or online transactions, are hard to transport, and can be counterfeited.

⁵⁵ *Id.* at 8.

⁵⁶ *Id.* at 48. Cryptocurrencies, such as Bitcoin, also have many shortcomings that may need to be addressed if cryptocurrencies are not to become obsolete. One major problem is that the price of Bitcoin is very volatile, whereas a currency needs to maintain a stable price and be subject to low and constant inflation. *Id.* at 65. Among other problems, the volatility of the price of Bitcoin makes it risky for merchants to accept it in exchange for goods or services. *Id.* Another problem is that the total number of Bitcoins that can ever be issued is capped; once this limit is met, there can be no more supply of Bitcoin. See Bradbury, *infra* note 71. This, along with the fact that many Bitcoins are lost (one study indicates that nearly 30% are lost), will lead to a decreasing supply, which will distort the supply and demand and not allow it have the proper inflation to function properly as a currency. *Id.* at 46. Another flaw of Bitcoin is that it is actually not immune to hacking. *Id.* at 48. In 2014, for example, there was a hack of 740,000 Bitcoins from the exchange Mt. Gox (then the largest Bitcoin exchange in the world). *Id.* Even more, Bitcoin is prone to deflation because the money supply grows too slowly, which may be the most disastrous problem. *Id.* at 55. In an environment with a deflationary currency, there is little reason to save or invest money. Kate Ashford & John Schmidt, *What is Deflation?* FORBES (Aug. 25, 2021), <https://www.forbes.com/advisor/investing/what-is-deflation/>. Deflation prevents an economy from functioning smoothly, as savings and investment are crucial to an economy. *Id.* A final problem is that Bitcoin cannot process transactions very quickly and also has very high transaction costs. *Id.* at 67. Nevertheless, an altcoin may be able to fix these shortcomings while adopting the benefits that Bitcoin has.

ii. Many Altcoins Soon Followed the Success of Bitcoin

Following the success of Bitcoin, many startups sought to create their own cryptocurrency; the group of cryptocurrencies that followed Bitcoin is commonly known as altcoins.⁵⁷ They are digital money that operate on a blockchain platform, like Bitcoin, and many altcoins market themselves as solving one of Bitcoin's shortcomings, such as lack of scalability or transaction speed.⁵⁸ As of early 2020, some estimate that over 5,000 altcoins and 20,000 cryptocurrency markets exist.⁵⁹

The second-largest cryptocurrency is Ether, which operates on the Ethereum blockchain.⁶⁰ The Ethereum blockchain was created by Vitalik Buterin in late 2013, and it has applications beyond money systems.⁶¹ It is a multipurpose platform, and its cryptocurrency, Ether, is just one feature of its smart contract applications.⁶² There are many differences between Bitcoin and Ether, some of which include that Bitcoin is capped at 21 million Bitcoins while the supply of Ether can be unlimited, and Bitcoin's average mining time is 10 minutes, whereas Ether's aims to be no more than 12 seconds.⁶³

Other altcoins include Namecoin, Litecoin, and Peercoin.⁶⁴ For example, the earliest notable altcoin, Namecoin, was introduced in April 2011, and it primarily differentiated itself from Bitcoin by making user domains less visible, which increased anonymity.⁶⁵ Another notable alternative to Bitcoin is Litecoin, which was launched in 2011—hence its nickname “silver to bitcoin's gold.”⁶⁶ Other altcoins have their own unique features.

After Bitcoin and numerous altcoins became popular, ICOs emerged as a way for startups to raise capital to develop a platform for their own cryptocurrency.⁶⁷

⁵⁷ Jamie Redman, *What are Altcoins and Why are There Over 5,000 of Them?*, BITCOIN.COM (Feb. 10, 2020), <https://news.bitcoin.com/altcoins-why-over-5000/>.

⁵⁸ See Erin Fonte, *Cryptocurrency vs. Initial Coin Offerings (ICO): Different Animals, Different Regulatory Concerns*, DYKEMA (July 23, 2018), <https://www.nextgenfinancialservicesreport.com/2018/07/cryptocurrency-vs-initial-coin-offerings-ico-different-animals-different-regulatory-concerns/> (explaining that altcoins are made by changing Bitcoin's blockchain to add features or by creating a new blockchain to support a new currency).

⁵⁹ Redman, *Supra* note 58.

⁶⁰ COINTELEGRAPH, *What is Ethereum. Guide for Beginners*, <https://cointelegraph.com/ethereum-for-beginners/what-is-ethereum> (last visited Nov. 4, 2021).

⁶¹ *Id.*

⁶² *Id.*

⁶³ Prabath Siriwardena, *The Mystery Behind Block Time*, MEDIUM (Oct. 14, 2017), <https://medium.facilelogin.com/the-mystery-behind-block-time-63351e35603a>; see also Bradbury, *supra* note 71.

⁶⁴ Kai Sedgwick, *Bitcoin History Part 5: A Wild Altcoin Appears*, BITCOIN.COM (Apr. 3, 2021), <https://news.bitcoin.com/bitcoin-history-part-5-a-wild-altcoin-appears/>.

⁶⁵ *Id.*

⁶⁶ Danny Bradbury, *What are Altcoins?: Definition and Examples of Altcoins* (Aug. 30, 2020), <https://www.thebalance.com/altcoins-a-basic-guide-391206>. It differs from Bitcoin in that it allows mining transactions to be approved more frequently, and it also provides for a total of 84 million coins to be created (which is four times Bitcoin's limit of 21 million coins). *Id.* See also Izobelle, *Why Litecoin is Considered the Silver to Bitcoin's Gold*, MEDIUM (Jan. 29, 2019), <https://medium.com/pdax/litecoin-and-why-its-considered-the-silver-to-bitcoin-s-gold-ce64ad3c0fbc>.

⁶⁷ Laura Shin, *Here's the Man who Created ICOs and this is the New Token He's Backing*, FORBES (Sep. 21, 2017), <https://www.forbes.com/sites/laurashin/2017/09/21/heres-the-man-who-created-icos-and-this-is-the-new-token-hes-backing/?sh=2f1eb1711839>.

iii. ICOs Became a Way for Issuers to Raise Capital to Build a Cryptocurrency

An ICO is an event where a start-up entity sells a yet-to-be-issued cryptocurrency to the public in exchange for a fiat currency⁶⁸ (or a more established cryptocurrency) with the promise that the money will be used to develop this new cryptocurrency's platform.⁶⁹ Simply put, the start-up is giving investors an early chance to acquire a yet-to-be-issued cryptocurrency at a low price.⁷⁰ The investors' hope is that the cryptocurrency will eventually operate as the medium of exchange on a digital platform (or will represent ownership in the company) and will be more valuable than they bought it for.⁷¹ Clearly, given the very early stage that investors are buying the cryptocurrency, these are speculative investments.⁷² A huge ICO explosion occurred in 2017 with over 800 ICOs in an eighteen month span, and in just three months that year, ICOs raised over \$3.23 billion.⁷³

ICOs can be divided into two categories: utility tokens, those where the purchaser receives future access to the blockchain's services, and equity (sometimes called dividend) tokens, which represent a ownership stake in the company.⁷⁴

Utility ICOs sell platform-dedicated cryptocurrencies which serve as the medium of exchange for the platform's services.⁷⁵ They take their value from the value of the platform.⁷⁶ Once the network is initially active, tokens can be acquired through mining or purchasing them directly.⁷⁷ Selling utility tokens at such an early stage allows start-ups to gauge demand for the network.⁷⁸ If a large number of investors participate in the ICO, the issuer is provided the capital needed to scale the network. However, if demand does

⁶⁸ CORP. FIN. INST. (CFI), *Fiat Money*,

<https://corporatefinanceinstitute.com/resources/knowledge/economics/fiat-money-currency/> (last visited Nov. 4., 2021). A fiat currency is a currency that has been backed by a nation-state as legal tender but has no underlying anchor of value. *Id.*

⁶⁹ Erin Fonte, *Cryptocurrency vs. Initial Coin Offerings (ICO): Different Animals, Different Regulatory Concerns*, DYKEMA (July 23, 2018),

<https://www.nextgenfinancialservicesreport.com/2018/07/cryptocurrency-vs-initial-coin-offerings-ico-different-animals-different-regulatory-concerns/>; see PWC, *infra* note 82.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ Daniel Roberts, *CoinDesk Report: ICO Funding Exploded in December*, YAHOO! (Feb. 7, 2018),

https://finance.yahoo.com/news/coindesk-report-ico-funding-exploded-december-145432664.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAFaOvJzedeC9pj8khH9F5e7emA9GLQ0Y_3ME-FZnybv8DPmt2Wg_QxyiFYhiXTs8Eq3andAhcVzvbAwH4Gm1THs4DZYA8s4JuHLLsIVj98ju_0dmHJ7eNYxt25IKgVkkYiH3flYV3TKVzo2Lch1TrKBVKg4LAZovyypJVpj46_v; Jeff Kauflin, *Where Did the Money Go? Inside the Big Crypto ICOs of 2017*, FORBES (Oct. 29, 2018), <https://www.forbes.com/sites/jeffkauflin/2018/10/29/where-did-the-money-go-inside-the-big-crypto-icos-of-2017/?sh=478ec205261b>.

⁷⁴ Aloaha Blockchain Provider, *The Difference Between Utility Tokens and Equity Tokens*,

<https://www.chain-provider.com/the-difference-between-utility-tokens-and-equity-tokens/> (last visited Nov. 4, 2021).

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.*

not reach a certain threshold, the start-up has the option of halting the project, which could avoid wasting substantial capital on a project with little or no appeal.

Equity ICOs, another type of ICO, are more similar to traditional IPOs.⁷⁹ They represent an ownership interest in the project.⁸⁰ By using blockchain technology, the issuer can forgo a traditional IPO and instead issue shares and voting rights over blockchain.⁸¹ The issuer uses the capital to grow the network's services, and purchasers of equity ICOs are more likely to consider their tokens as an investment rather than a commodity.⁸²

In summary, the world of ICOs can be broken down into two categories: utility ICOs and equity ICOs.⁸³

b. People Are Excited About Blockchain Technology Apart from its Application in Cryptocurrencies.

Blockchain is the underlying technology on which cryptocurrencies operate.⁸⁴ Simply stated, blockchain is a network of computers that together creates an open, distributed database that records transactions between parties in a verifiable and permanent manner.⁸⁵ The main purpose of blockchain technology is to maintain a verified history of information, such as transactions.⁸⁶ It does this by recording a running list of transaction which cannot be tampered with or changed retrospectively because it is synchronized across a number of computers.⁸⁷

⁷⁹ Bankrate, *Initial Public Offering (IPO)*, <https://www.bankrate.com/glossary/i/ipo-initial-public-offering/> (last visited Nov. 4, 2021). An IPO refers to the process of offering shares of a private corporation to the public in a new stock issuance. This process allows companies to raise capital from private investors. PWC, *Considering an IPO to Fuel Your Company's Future?*, (Nov. 2017), <https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf>.

⁸⁰ Aloaha Blockchain Provider, *supra* note 75.

⁸¹ *Id.*

⁸² *Id.*

⁸³ Tyler Salathe, *US Regulation of Coin Offerings: Registering Your Token with the SEC*, CAPCO (Aug. 23, 2019), <https://www.capco.com/intelligence/capco-intelligence/us-regulation-of-coin-offerings-registering-your-token-with-the-sec>. Technology is rapidly emerging in that space, and this is one way to categorize the world of cryptocurrencies and ICOs. Additionally, there are new types of offerings, called Security Token Offerings (STOs) and Initial Exchange Offerings (IEOs). *Id.* An STO is a regulated coin offering, used to raise funding for a blockchain project or release equity or cash in a physical asset. *Id.* There are many potential uses for STOs, and new use cases are still emerging. *Id.* Ownership information for an STO can be recorded on a blockchain and given to the owner as a security token. *Id.* IEOs are projects that issue tokens through a cryptocurrency exchange to raise funds. *Id.* The key difference between IEOs and ICOs is that an existing crypto exchange issues and administers the newly released coins. *Id.* For an ICO, the counterparty to the recipient of the newly released tokens is the token developer, whereas in the IEO the exchange functions as an intermediary. *Id.*

⁸⁴ BANKRATE, *Blockchain: What is a Blockchain?*, <https://www.bankrate.com/glossary/b/blockchain/> (last visited Nov. 4, 2021).

⁸⁵ *Id.*

⁸⁶ Ross Bulat, *Why the Blockchain is Needed*, MEDIUM (Jun. 30. 2018), <https://rossbulat.medium.com/why-the-blockchain-is-needed-1b79acc47fe1> (This relates to the problem it was created to solve: to achieve and maintain integrity of a system in a purely distributed peer-to-peer system that consists of an unknown number of peers with unknown reliability and trustworthiness.).

⁸⁷ *Id.*

Regardless of whether cryptocurrencies are widely adopted, blockchain has the potential to be widely used for other purposes due to its transparency, security, and traceability.⁸⁸ Blockchain technology has provoked sufficient interest such that non-cryptocurrency users have begun to adopt it.⁸⁹ For example, the U.S. State Department has explored blockchain technology: a spokesperson for the Department identified foreign aid as one possible application for blockchain and stated that the technology will help combat fraud, corruption, and inefficiency within the distribution chain.⁹⁰ The legal profession has also noted the usefulness of blockchain technology.⁹¹

Briefly said, the world of cryptocurrencies can be broken down into Bitcoin, altcoins, and initial coin offerings (ICOs)—and these should not be confused with the underlying technology which they operate on (i.e., blockchain). Once an issuer decides it wants to start a new cryptocurrency, it then has to consider how SEC regulations apply.⁹²

II. ICO Issuers Offering “Securities” Can Either Register Their Offerings or Circumvent SEC Registration Requirements Via an Exemption

The SEC is the primary securities regulator in the United States.⁹³ Its mandate “is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.”⁹⁴ The SEC only has jurisdiction over a “security,”⁹⁵ which is defined under the Securities Act of 1933 § 2(a)(1)⁹⁶ and includes a catchall category called an “investment contract” as interpreted by *Howey*.⁹⁷

⁸⁸ Ilker Koksak, *The Benefits of Applying Blockchain Technology in Any Industry*, FORBES (Oct. 23, 2019), <https://www.forbes.com/sites/ilkerkoksak/2019/10/23/the-benefits-of-applying-blockchain-technology-in-any-industry/#e73ead549a56>. For instance, blockchain can be used to remove third party data breach problems, such as the Equifax hack, a hack of one of the largest consumer credit reporting agencies in the United States. *Equifax Data Breach*, EPIC.ORG, <https://www.epic.org/privacy/data-breach/equifax/> (last visited Nov. 4, 2021).

⁸⁹ See, e.g., Kyree Leary, *The U.S. State Department is Embracing Blockchain to “Advance Diplomacy,”* FUTURISM (Oct. 13, 2017), <https://futurism.com/the-u-s-state-department-is-embracing-blockchain-to-advance-diplomacy>.

⁹⁰ *Id.*

⁹¹ Legal Executive Institute, *The Application of Blockchain in the Legal Sector* (Jan. 4, 2019), <https://blogs.thomsonreuters.com/legal-uk/2019/01/04/the-application-of-blockchain-in-the-legal-sector/>.

⁹² See *SEC v. Howey*, 328 U.S. 293, 299 (1946) (discussing which securities constitute an “investment contract” and thus are subject to SEC regulation). This Article does not discuss state “blue sky” regulations.

⁹³ See U.S. Sec. & Exch. Comm’n, *About the SEC*, <https://www.sec.gov/about.shtml> (last visited Nov. 4, 2021).

⁹⁴ *Id.*

⁹⁵ 15 U.S.C. § 77b(a)(1). The securities laws define what constitutes a “security” in the Securities Act of 1933 §2(a)(1). As part of that, there is a catchall category known as an “investment contract” as defined in *SEC v. W.J. Howey Co.* 328 U.S. 293, 298 (1946).

⁹⁶ *Id.* Another provision in the securities laws, §3(a)(10) of the Securities Exchange Act of 1934 also contains a definition of “security.” 15 U.S.C. § 78c(a)(10). However, the U.S. Supreme Court has said that these definitions are “slightly different formulations” of the term “security” but essentially treats them as identical in meaning. See *SEC v. Edwards*, 540 U.S. 389, 393 (2004).

⁹⁷ *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (holding that an “investment contract” was a “security” where the defendant owned a citrus orchard and offered portions of it to the public to finance additional development, enticing buyers with the promise of substantial profits from the sale of the citrus fruit.).

One way the SEC exercises its jurisdiction over “securities” is by requiring issuers to register with it, so it can better monitor that entity and release certain information to the investing public.⁹⁸ The securities laws only permit a company that has registered with the SEC or qualifies for an exemption to sell “securities” to the general public.⁹⁹ Of course, if an issuer is not selling “securities,” then the federal securities laws do not apply, and, consequently, the SEC’s registration requirements are inapplicable.

a. Registration

In order to register a security with the SEC, the issuer must file forms with the SEC Division of Corporation Finance.¹⁰⁰ The filed information should provide important information to the public, including a description of the company’s property, a description of the company’s business, information about the management of the company, and financial statements certified by independent accountants.¹⁰¹ The statements and prospectuses that issuers file with the SEC become public after they are filed with the SEC; investors can access registration and other company filings using EDGAR.¹⁰²

To date, the SEC has cleared one company, a Gibraltar-based private company named INX Limited, to issue a registered security token its initial public offering.¹⁰³ INX Limited filed a Form F-1 with the SEC, and when it was approved, it became the first instance in which the SEC gave clearance to a registration statement for a public offering of cryptocurrencies.¹⁰⁴ In this offering, INX offered 130 million INX tokens for \$.90 each, potentially netting \$117 million.¹⁰⁵ The company has been using this money to develop a platform that will allow trading of cryptocurrencies, security tokens, and their derivatives.¹⁰⁶ The INX cryptocurrency holders will be entitled to a 40% profit share of the company’s net cash flow, not including revenues from the initial sale, but they will not be equity holders of the firm.¹⁰⁷ The total cost for registration was about \$5,000,000, with approximately \$3,750,000 of that comprising legal fees and expenses.¹⁰⁸

⁹⁸ U.S. Sec. & Exch. Comm’n, *Registration Under the Securities Act of 1933*, (Sept. 2, 2011), <https://www.sec.gov/fast-answers/answersregis33htm.html>.

⁹⁹ *Id.*; see also 15 U.S.C. § 5.

¹⁰⁰ U.S. Sec. & Exch. Comm’n, *About the Division of Corporation Finance*, (Sept. 27, 2019), <https://www.sec.gov/divisions/corpfin/cfabout.shtml>.

¹⁰¹ *Id.*

¹⁰² *Id.* Additionally, the SEC has tested the waters with other types of registration mechanisms. See Paul Vigna, *SEC Clears Blockstack to Hold First Regulated Token Offering*, WALL STREET J. (July 10, 2019), <https://www.wsj.com/articles/sec-clears-blockstack-to-hold-first-regulated-token-offering-11562794848>. In July 2019, the SEC cleared the startup Blockstack to sell a \$28 million cryptocurrency offering under Regulation A+, which is an alternative to an initial public offering meant to help young businesses raise capital. *Id.*

¹⁰³ Christopher Murrer, *U.S. SEC Approves the First Full Securities Registration for a Company Issuing Crypto-tokens*, BAKER MCKENZIE (Aug. 31, 2020), <https://blockchain.bakermckenzie.com/2020/08/31/u-s-sec-approves-the-first-full-securities-registration-for-a-company-issuing-crypto-tokens/>.

The form can be accessed online at

https://www.sec.gov/Archives/edgar/data/0001725882/000121390019016285/ff12019_inxlimited.htm. It shows how much INX Limited spent to register with the SEC.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ INX Limited, Registration Statement Under the Securities Act of 1933 (Form F-1) (Aug. 19, 2019).

¹⁰⁸ INX Limited, Prospectus Supplement No. 1 (Form 6-K) (Sept. 10, 2020).

However, as displayed by the INX offering, because registering securities with the SEC is expensive, takes months to accomplish, and also includes extensive quarterly and annual reporting updates, issuers often want to find an exemption to the registration requirements.¹⁰⁹

The remainder of this Section briefly summarizes possible exemptions that an issuer can use to bypass registration requirements.¹¹⁰ By using these exemptions, an issuer concedes that its cryptocurrency or ICO is a “security” but nevertheless is exempt from registration requirements.¹¹¹

b. Section 3(a)(11)

Section 3(a)(11) of the Securities Act is generally known as the “intrastate offering exemption.”¹¹² This exemption is intended to finance local business operations. In order to qualify for this exemption, a company must be organized in the state where it is offering the securities, carry out a significant amount of its business in that state, and make offers and sales only to residents of that state.¹¹³ This exemption does not limit the offering’s size or the number of purchasers.¹¹⁴ If any of the securities are offered or sold to even one out-of-state person, the exemption may be lost.¹¹⁵ Given that issuers of cryptocurrencies will want to sell broadly, this may not be a practical option for many issuers.

c. Regulation S

Similar to intrastate offerings, where the security is exempt for geographical purposes, an issuer has the option to not direct the sale to anyone in the United States.¹¹⁶ Under Regulation S, if an issuer does not make the offering to U.S. investors, the offering does

¹⁰⁹ Joel Arberman, *Going Public: How Long Does it Take?*, STREETDIRECTORY.COM, https://www.streetdirectory.com/travel_guide/18694/corporate_matters/going_public_how_long_does_it_take.html; see also PWC, *Considering an IPO to Fuel Your Company’s Future?*, (Nov. 2017), <https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf>.

¹¹⁰ Ori Oren, *ICO’s, DAO’s and the SEC: A Partnership Solution*, 2018 COLUM. BUS. L. REV. 617, 642 (2018). This section should not be construed as legal advice and is merely intended to inform what avenues ICO issuers have considered to avoid registration requirements. The following exemptions are not an exhaustive list and are subject to change.

¹¹¹ See, e.g., U.S. Sec. & Exch. Comm’n, *Regulation D Offerings*, <https://www.investor.gov/introduction-investing/investing-basics/glossary/regulation-d-offerings> (last visited Nov. 5, 2021). When an issuer uses these exemptions and admits that it is issuing a “security,” the SEC still has jurisdiction over it via the federal securities laws, such as Rule 10b-5. See, e.g., 17 C.F.R. § 240.10b-5. Additionally, the issuer has to comply with certain requirements for each exemption. See U.S. Sec. & Exch. Comm’n, *Regulation D Offerings*, <https://www.investor.gov/introduction-investing/investing-basics/glossary/regulation-d-offerings> (last visited Nov. 5, 2021). But if the cryptocurrency is not a “security,” then the federal securities laws do not apply at all. See U.S. Sec. & Exch. Comm’n, *The Laws That Govern the Securities Industry*, <https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry> (last visited Nov. 5, 2021).

¹¹² U.S. Sec. & Exch. Comm’n, *Intrastate Offerings* (Mar. 12, 2020), <https://www.sec.gov/smallbusiness/exemptofferings/intrastateofferings> (last visited Nov. 5, 2021).

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ 17 C.F.R. §§ 230.901-903 (2017); Lloyd S. Harmetz, FREQUENTLY ASKED QUESTIONS ABOUT REGULATION S 1, 3 (2017) (available at <https://media2.mofo.com/documents/faqs-regulation-s.pdf>).

not need to be registered.¹¹⁷ Regulation S is available only for “offers and sales of securities outside the United States” made in good faith and not as a means of circumventing the registration provisions.¹¹⁸ If the sale is made available to investors inside and outside of the United States, then it does not comply with this exemption.¹¹⁹

d. Regulation D

Regulation D, through Rules 504 and 506, is an attractive option for ICO issuers.¹²⁰ Regulation D is intended to make access to the capital markets possible for small companies that could not otherwise bear the cost of a standard SEC registration.¹²¹

Rule 504 is an exemption for the offer and sale of up to \$10,000,000 of securities in a 12-month period as long as they are offered solely to accredited investors.¹²² Generally, the sale qualifies as “restricted securities” subject to certain resale restrictions for certain time periods.¹²³

Rule 506 is an exemption from the requirement to register the securities for offerings that satisfy a variety of conditions.¹²⁴ For example, unless certain specific requirements are met, the offering must not involve general solicitation or advertising, and it must be limited to no more than 35 non-accredited investors but may have an unlimited number of accredited investors.¹²⁵ There is no limit on the amount of money that can be raised in a Rule 506 offering.¹²⁶

e. Regulation A

Smaller, early-stage companies can also use Regulation A to access capital.¹²⁷ Specifically, Regulation A is a set of rules that allow issuers to publicly sell securities under procedures that are less burdensome than the standard procedures.¹²⁸ Under Regulation A, issuers have varying requirements depending on the tier of offering. However, in any case, no sale of a security may occur under Regulation A until the issuer has filed a Form 1-A offering statement with the SEC, and the SEC has issued a notice of qualification.¹²⁹

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ See 17 C.F.R. §§ 230.501, 502, 504, 506 (2017). It is promulgated under the Securities Act.

¹²¹ U.S. Sec. & Exch. Comm’n, *Regulation D Offerings*, <https://www.investor.gov/introduction-investing/investing-basics/glossary/regulation-d-offerings> (last visited Nov. 5, 2021).

¹²² 17 C.F.R. § 230.504 (2017). See also U.S. Sec. & Exch. Comm’n, *Exemption for Limited Offerings Not Exceeding \$10 Million – Rule 504 of Regulation D*, <https://www.sec.gov/smallbusiness/exemptofferings/rule504> (last visited Nov. 5, 2021).

¹²³ *Id.*

¹²⁴ 17 C.F.R. § 230.506 (2017). See also U.S. Sec. & Exch. Comm’n, *Rule 506 of Regulation D*, <https://www.investor.gov/introduction-investing/investing-basics/glossary/rule-506-regulation-d> (last visited Nov. 27, 2021).

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ U.S. Sec. & Exch. Comm’n, *Regulation A*, <https://www.sec.gov/smallbusiness/exemptofferings/rega> (last visited Nov. 5, 2021).

¹²⁸ *Id.*

¹²⁹ U.S. Sec. & Exch. Comm’n, *Updated Investor Bulletin: Regulation A*, https://www.sec.gov/oiea/investor-alerts-bulletins/ib_regulationa.html. (last visited Nov. 16, 2021).

There are two options under Regulation A.¹³⁰ Under Tier 1, an issuer can raise up to \$20 million, and the offering is open to accredited investors and non-accredited investors. Tier 2 allows issuers to raise up to \$75 million but includes limitations on the amounts that non-accredited investors can invest.¹³¹ However, issuers that qualify for the exemption under Regulation A are still required to file an offering statement and disclose a variety of information that would also be required in a registration statement.¹³² Assuming all requirements of Regulation A are satisfied, purchasers in the Regulation A offering acquire unrestricted securities that may be resold without further registration.¹³³

f. Regulation Crowdfunding

Regulation Crowdfunding applies to offerings of up to \$5 million.¹³⁴ This exemption, however, limits the amount that certain individuals are allowed to invest, requires that issuers conduct the offering through a single portal registered with the SEC and FINRA,¹³⁵ and imposes a variety of disclosure obligations on the issuer.¹³⁶ Therefore, because of its limitations, it may not be very attractive to ICO issuers.¹³⁷

In summary, if an offering is a “security,” a company can either register it with the SEC or bypass registration requirements by satisfying the requirements of either Regulation S, Regulation D, Regulation A, or Regulation Crowdfunding. If a company neither registers nor complies with an exemption, it can argue that its ICO and cryptocurrency are not “securities,” exempting them from the SEC’s jurisdiction. Currently, issuers figure this out by applying the *Howey* framework in conjunction with other guidance the SEC has released regarding how it will interpret this test for purposes of ICOs.¹³⁸

III. ICO Issuers Unsure of Whether They are Offering “Securities” Must Rely on SEC Guidance Elaborating on *Howey*

The SEC only has jurisdiction over transactions involving a “security,” which is defined under § 2(a)(1)¹³⁹ of the Securities Act, which includes a catchall category called an “investment contract,” as interpreted by *Howey*.¹⁴⁰ Because Securities Act § 2(a)(1) does not specify “initial coin offerings” or “cryptocurrencies” as securities, the SEC’s current approach for determining whether a cryptocurrency falls under its jurisdiction is whether

¹³⁰ *Id.*

¹³¹ 17 C.F.R. § 230.251(a)(2); 17 C.F.R. § 230.251(a)(2).

¹³² 17 C.F.R. §§ 230.251-259.

¹³³ U.S. Sec. & Exch. Comm’n, *Updated Investor Bulletin: Regulation A*, https://www.sec.gov/oiea/investor-alerts-bulletins/ib_regulationa.html (last visited Nov. 16, 2021).

¹³⁴ 17 C.F.R. §227.100(a)(1) (2017).

¹³⁵ An issuer alternatively may use an online platform operated by a registered broker-dealer.

¹³⁶ 17 C.F.R. § 227.100; 17 C.F.R. §§ 227.201-206 (2017).

¹³⁷ 17 C.F.R. § 227.100; 17 C.F.R. §§ 227.201-206 (2017).

¹³⁸ See generally U.S. Sec. & Exch. Comm’n, *Framework for “Investment Contract” Analysis of Digital Assets* (Apr. 3, 2019), <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>.

¹³⁹ 15 U.S.C. § 77b(a)(1). Another provision in the securities laws, §3(a)(10) of the Securities Exchange Act of 1934 also contains a definition of what constitutes a “security.” 15 U.S.C. § 78c(a)(10). However, the U.S. Supreme Court has said that these contain “slightly different formulations” of the term “security” but has treated them as essentially identical in meaning. *SEC v. Edwards*, 540 U.S. 389, 393 (2004).

¹⁴⁰ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946).

it constitutes an “investment contract” under *Howey*; issuers must apply this framework to determine whether their offering constitutes a “security” when they do not want to register or comply with an exemption.¹⁴¹ *Howey* specifies that a transaction is an “investment contract” when (1) there is an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived from the efforts of others.¹⁴² This places an emphasis on the economic realities of the transaction.¹⁴³ The SEC has provided further guidance on applying this framework to ICOs on its website.¹⁴⁴

The problem issuers have with using the *Howey* framework to assess whether an ICO is an “investment contract” is that *Howey* is a very broad catchall category and does not give them enough information to make a reliable decision *ex ante* whether to register their offering.¹⁴⁵ Accordingly, this Section discusses other available information that issuers can rely on to interpret *Howey*. These include written reports, speeches from supervisors, and no-action letters.

a. DAO Report Was the SEC’s First Encounter with ICOs

The DAO report is widely regarded as the SEC’s first inquiry into ICOs.¹⁴⁶ In this case, an organization called the DAO sold its unregistered cryptocurrency to the public, and the holders of the cryptocurrency had various voting rights.¹⁴⁷ The SEC applied the *Howey* test and concluded that the DAO tokens were “securities” and accordingly fell under its jurisdiction.¹⁴⁸

The bulk of the SEC’s analysis focused on the “efforts of others” prong of the *Howey* test.¹⁴⁹ In evaluating this prong, the SEC concluded that investors expected profits to be derived primarily from the “efforts of others” because the efforts of the DAO’s promoters and managers were essential to the relevant enterprise, and investors had only limited voting rights.¹⁵⁰ The SEC concluded that the voting rights did not provide the token holders with meaningful control over the enterprise because their ability to vote for proposed projects was perfunctory in light of the managers’ authorities and the absence of concrete information available in proposals.¹⁵¹

Soon after the DAO Report, the SEC again acted in the cryptocurrency world when it issued a cease-and-desist order against Munchee, Inc.

¹⁴¹ U.S. Sec. & Exch. Comm’n, *Framework for “Investment Contract” Analysis of Digital Assets* (Apr. 3, 2019), <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>.

¹⁴² *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

¹⁴³ *Id.* at 298.

¹⁴⁴ U.S. Sec. & Exch. Comm’n, *Framework for “Investment Contract” Analysis of Digital Assets* (Apr. 3, 2019), <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>.

¹⁴⁵ For instance, officers of Ripple in *SEC v. Ripple* are arguing that the SEC has released so little information about whether to register that they should not be held liable. Reply Brief at 6, *SEC v. Ripple Labs Inc. et al.*, No.20-cv-10832 (AT) (SN) (S.D.N.Y. July 23, 2021), Document 268.

¹⁴⁶ DAO, Exchange Act Release No. 34-81207, 117 S.E.C. Docket 745 (July 25, 2017).

¹⁴⁷ *Id.* Some of the voting rights of the holders of the cryptocurrencies included that they could propose projects, vote on whether to pursue a particular project, and share in any profits generated by these projects. Christoph Jentzsch, *Decentralized Autonomous Organization to Automate Governance Final Draft—Under Review*, at 1, <https://download.slock.it/public/DAO/WhitePaper.pdf>.

¹⁴⁸ DAO, Exchange Act Release No. 34-81207, 117 S.E.C. Docket 745 (July 25, 2017).

¹⁴⁹ *Id.* at 12-15.

¹⁵⁰ *Id.* at 12-13.

¹⁵¹ *Id.* at 14.

b. The Munchee Cease-and-Desist Order Provides Further Guidance

In December 2017, the SEC issued a cease-and-desist order to Munchee Inc., a creator of a mobile application for restaurant reviews.¹⁵² The SEC held that Munchee's ICO qualified as a "security" under the *Howey* framework.¹⁵³

The purpose of Munchee's ICO was to develop a platform where users could write reviews in exchange for tokens, restaurants could purchase ads, and users could purchase goods and services.¹⁵⁴ Prior to the ICO, Munchee issued a white paper explaining that it would use the proceeds to hire employees for its development team, market and promote the application, pay for legal expenses, and maintain and ensure the smooth operation of the MUN token ecosystem.¹⁵⁵ The white paper also outlined additional information about how the company would create a market to buy and sell the tokens and other ways purchasers could make money through the appreciation of the cryptocurrency.¹⁵⁶

Subsequent to these two reports, Director Hinman elaborated on some factors the SEC would look for when determining whether an ICO falls under its jurisdiction.

c. Director Hinman's Speech in June 2018 Elaborates on the *Howey* Framework.

In June 2018, the Director of the SEC's Division of Corporation Finance, William Hinman, delivered a speech that provided further guidance on the SEC's position on ICOs.¹⁵⁷ In this speech, Hinman outlined thirteen factors for determining whether a cryptocurrency qualifies as an "investment contract" under the *Howey* test.¹⁵⁸ He noted that the factors are illustrative and not exhaustive and are mainly intended to begin a conversation.¹⁵⁹ These factors are to be used to determine whether application of the Securities Act makes sense and whether there are informational asymmetries that warrant disclosure.¹⁶⁰

Hinman's speech can be summarized as focusing on three topics: the issuer, the purchasers, and the cryptocurrency itself.¹⁶¹ With respect to the issuers, in his speech, Hinman asked questions regarding their efforts, interests, and motivations.¹⁶² For example, is the issuer trying to increase its value?¹⁶³ How much of its own capital has the

¹⁵² Munchee, Inc., Exchange Act Release No. 33-10445, 118 S.E.C. Docket 975 (Dec. 11, 2017).

¹⁵³ *Id.* at 3-4.

¹⁵⁴ *Id.* at 4.

¹⁵⁵ *Id.* at 3-5.

¹⁵⁶ *Id.* at 5-6.

¹⁵⁷ William Hinman, Dir., Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018) (transcript available at <https://www.sec.gov/news/speech/speech-hinman-061418>). However, the SEC has qualified his position by noting that the views are his only. *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.*

issuer contributed?¹⁶⁴ Is the issuer advertising to the general public or just its user base?¹⁶⁵ For the purchasers, Hinman asked questions such as who they are, what they will be doing with the cryptocurrency, why they are buying it, and whether they have governance rights.¹⁶⁶ Finally, Hinman focused on the cryptocurrency itself.¹⁶⁷ Hinman asked whether the price of the cryptocurrency will correlate with the market value of the good or service.¹⁶⁸ He also asked who is setting the price of the initial cryptocurrency sale and whether the tokens are usable on the platform.¹⁶⁹

Subsequent to Director Hinman’s talk, the SEC issued three no-action letters giving issuers more information to rely on in determining whether their ICO will be considered a “security.”

d. The SEC Has Issued No-Action Letters, Including to TurnKey Jet, Inc., Pocketful of Quarters, Inc., and IMVU, Inc.

The SEC has issued no-action letters addressing the issue of whether ICOs need to be registered to TurnKey Jet, Inc., Pocketful of Quarters, Inc., and IMVU, Inc.¹⁷⁰

In April 2019, the SEC issued its first no-action letter for cryptocurrencies in the case of TurnKey Jet, Inc, a company that provides interstate air charter services and is a licensed U.S. air carrier and air taxi.¹⁷¹ TurnKey wanted to launch a cryptocurrency to facilitate purchases for its air charter services via a private network.¹⁷² This cryptocurrency would decrease the settlement time and improve the efficiency of paying for its air charter services (i.e., the company would not have to pay large transaction costs to financial institutions and the platform would diminish the possibility of fraud).¹⁷³ The company’s argument was that its cryptocurrencies were not “securities” under *Howey* because they were merely a right to redeem escrowed funds to pay for the air charter services.¹⁷⁴

The SEC agreed and decided that the ICO was not a “security;” therefore, the company did not have to register its ICO.¹⁷⁵ In the no-action letter, the SEC emphasized that

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ An individual or entity who is not certain whether a product, service, or action would constitute a violation of the federal securities law may request a “no-action” letter from the SEC staff. U.S. Sec. & Exch. Comm’n, *No Action Letters*, INVESTOR.GOV, <https://www.investor.gov/introduction-investing/investing-basics/glossary/no-action-letters> (last visited Nov. 5, 2021). If the SEC grants the request for no action, it means that the SEC will not take enforcement action against the requester based on the facts and representations described in the individual’s or entity’s request. *Id.* In some cases, the SEC staff may permit parties other than the requestor to rely on the no-action relief to the extent that the third party’s facts and circumstances are substantially similar to those described in the underlying request. *Id.*

¹⁷¹ Memorandum from James Prescott Curry, Esq. on TurnKey Jet, Inc. to Office of Chief Counsel for the U.S. Sec. & Exch. Comm’n 1 (Apr. 2, 2019) (available at <https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1-incoming.pdf>).

¹⁷² *Id.*

¹⁷³ *Id.* at 2.

¹⁷⁴ *Id.* at 9-10.

¹⁷⁵ Turnkey Jet, Inc., SEC No-Action Letter, 2019 WL 1471132 (Apr. 3, 2019).

TurnKey must meet certain requirements, which ultimately led to its decision.¹⁷⁶ One requirement was that the platform would be fully developed and operational at the time any tokens would be sold.¹⁷⁷ Another requirement was that the tokens would be immediately usable for their intended functionality.¹⁷⁸ Other requirements included that the company would sell tokens for the same price throughout the life of the program and would be limited in its repurchasing of the tokens.¹⁷⁹ Finally, the tokens had to be marketed in a manner that emphasized their functionality and not their potential for a market value increase.¹⁸⁰

Just a few months later, the SEC issued another no-action letter in the case of Pocketful of Quarters, Inc.¹⁸¹ This company was founded to address a large frustration of online video gamers: the inability to use credits from one video game in another video game.¹⁸² To address this, the company sought to develop a platform to prevent the loss of value by creating a universal gaming token.¹⁸³

The SEC responded to the company's request and said that the ICO was not an offering of "securities," and thus it was not required to register its ICO.¹⁸⁴ The SEC outlined nine factors that led to its decision. Some of the more important provisions included that the platform would already be established before the issuance of the cryptocurrency, the cryptocurrency would be immediately usable once sold, the cryptocurrency would be made available in unlimited quantities at a fixed price, and the cryptocurrency would be sold solely for the purpose of consumption. The SEC also noted that if any of the factors changed once the ICO was issued, then its position could also change, so it would be monitoring the status of this ICO.¹⁸⁵

Recently, on November 17, 2020, the SEC issued a no-action letter to IMVU, Inc., a digital avatar company, allowing it to sell its VCOIN cryptocurrency (an Ethereum-based token) to users with strict restrictions on how the cryptocurrency can be sold.¹⁸⁶ Among the restrictions that the SEC placed were that IMVU would place limits on VCOIN purchases, conversions, and transfers; holders of VCOIN would be subject to KYC/AML checks when they establish Open Wallets and thereafter on an ongoing basis; IMVU would maintain VCOIN's fixed price; and that IMVU would not promote or support listing or trading of VCOIN on any third-party trading platform.¹⁸⁷

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ Pocketful of Quarters, Inc., SEC No-Action Letter (July 25, 2019).

¹⁸² Memorandum from Lewis Rinaudo Cohen, Esq. on Pocketful of Quarters, Inc. to Office of Chief Counsel for the U.S. Sec. & Exch. Comm'n 1 (July 25, 2019) (available at <https://www.sec.gov/divisions/corpfin/cf-noaction/2019/pocketful-of-quarters-inc-072519-2a1-incoming.pdf>).

¹⁸³ *Id.* at 2.

¹⁸⁴ Pocketful of Quarters, *supra* note 182.

¹⁸⁵ *Id.*

¹⁸⁶ IMVU, Inc., SEC No-Action Letter (Nov. 17, 2020).

¹⁸⁷ *Id.*

e. A Recent Major Court Ruling is *SEC v. Kik*

A recent case to reach a summary judgment ruling was *SEC v. Kik*.¹⁸⁸ Kik, a company that operates an instant messaging mobile application, issued \$100 million of coins in a two-phase offering.¹⁸⁹ The district court concluded that the two-phase offerings constituted a single offering and that it was subject to SEC registration requirements under the *Howey* test.¹⁹⁰ The district court focused its analysis on two prongs of the *Howey* test—whether there was a “common enterprise” and whether profits were being derived solely from the “efforts of others.”¹⁹¹

With respect to the issue of whether there was a “common enterprise,” the court held that there was because the success of the messaging platform drove the demand for the tokens.¹⁹² This success dictated the investor’s profits.¹⁹³ The court also determined that the company took the money from its sales of its tokens and used it to create an infrastructure for the tokens.¹⁹⁴

Next, the court discussed another prong of the test: whether profits were being derived solely from the “efforts of others.”¹⁹⁵ The court ruled that this prong was satisfied because the buyers of the tokens expected to profit from the efforts of the company’s management.¹⁹⁶ The management of the company also touted that investors could make a profit through the company altering the supply and demand of the tokens.¹⁹⁷

In short, ICO issuers can draw inferences from the DAO Report, Director Hinman’s 2018 speech, the Munchee Report, two no-action letters, and the *SEC v. Kik* ruling to piece together if their ICO constitutes a “security” under the *Howey* framework.

The next Section seeks to solve the problem that drawing inferences from these various sources and using them in the context of the *Howey* test may be difficult by proposing a cryptocurrency-specific balancing test that will allow issuers to make a more reliable decision of whether they need to register their offering with the SEC.

¹⁸⁸ *U.S. Sec. & Exch. Comm’n v. Kik Interactive Inc.*, 492 F. Supp. 3d 169 (S.D.N.Y. 2020).

New litigation is arising very quickly in this field. On December 22, 2020, the SEC filed a lawsuit against Ripple Labs Inc. and two of its executives alleging that they raised over \$1.3 billion through an unregistered, ongoing digital asset securities offering. Press Release, U.S. Sec. and Exch. Comm’n, *SEC Charges Ripple and Two Executives with Conducting \$1.3 Billion Unregistered Securities Offering* (Dec. 22, 2020), <https://www.sec.gov/news/press-release/2020-338>). For a copy of the complaint, visit <https://www.sec.gov/litigation/complaints/2020/comp-pr2020-338.pdf>.

¹⁸⁹ *U.S. Sec. & Exch. Comm’n v. Kik Interactive Inc.*, 492 F. Supp. 3d 169, 173-74. (S.D.N.Y. 2020).

¹⁹⁰ *Id.* at 182.

¹⁹¹ *Id.* at 178-80.

¹⁹² *Id.* at 178-79.

¹⁹³ *Id.*

¹⁹⁴ *Id.*

¹⁹⁵ *Id.* at 179-180.

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

IV. Congress Should Amend the Securities Laws to Add “Cryptocurrencies” As Defined by This Legal Standard to Provide Issuers With Greater Guidance and Clarity

The SEC has jurisdiction over “securities” as defined by the Securities Act of 1933 § 2(a)(1).¹⁹⁸ Because Congress has not addressed how cryptocurrencies should be regulated under the federal securities laws, an issuer is left with three options: to admit its ICO is a “security” and register with the SEC, acknowledge its ICO is a “security” and use an exemption to bypass SEC registration requirements, or to decipher whether its ICO constitutes a “security” under the *Howey* framework.¹⁹⁹ Both registration and using the *Howey* framework are mechanisms that may not be feasible.²⁰⁰ Accordingly, this Article proposes that Congress amend Section 2(a)(1) of the Securities Act²⁰¹ to include “cryptocurrencies,” as defined by a four-prong balancing test. If this test is satisfied, then the offering would be considered a “security;” conversely, if the test is not satisfied, then the security would not be considered a “security.”

The Congressional legislation should consist of four factors that encapsulate whether a cryptocurrency falls under the SEC’s jurisdiction: the intent of the issuer; whether the issuer is taking a hands-on approach to make the cryptocurrency a profitable investment; whether the platform for the cryptocurrency has been developed; and the intent of the purchasers.

a. Factor (1): What is the Issuer’s Intent?

A factor that has been important in determining whether an ICO falls under the SEC’s jurisdiction, although it has not been explicitly stated by the SEC, is the issuer’s intent.²⁰²

¹⁹⁸ Another provision in the securities laws, §3(a)(10) of the Securities Exchange Act of 1934, also contains a definition of what constitutes a “security.” 15 U.S.C. § 78c(a)(10). However, the Supreme Court has said that these statutes contain “slightly different formulations” of the term “security” but has treated them as essentially identical in meaning. *SEC v. Edwards*, 540 U.S. 389, 393 (2004).

¹⁹⁹ See Bill Clark, *Learning the Equity Alphabet: Regulation A, Regulation CF, and Regulation D*, MICROVENTURES BLOG (May 31, 2019), <https://microventures.com/learning-the-equity-alphabet-regulation-a-regulation-cf-and-regulation-d>.

²⁰⁰ The problem with registration is its expense and the inability of many issuers to afford it especially when the company is just beginning operations and may not have the necessary capital, although any issuer should take that route if feasible. See *INX Limited*, *supra* note 106 and accompanying text. The problem with the *Howey* framework is that it is a very broad catchall category and is not intended to be used for a specific asset class—it should be left to serve that purpose; it should not be used to determine whether a cryptocurrency is a “security.” See *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (holding that an “investment contract” was a “security” where the defendant owned a citrus orchard and offered portions of it to the public to finance additional development, enticing buyers with the promise of substantial profits from the sale of the citrus fruit.). Additionally, the *Howey* framework does not provide sufficient guidance to issuers to allow them to make a reliable decision of whether their cryptocurrency offering is considered a “security.” *Id.* When relying on the *Howey* framework, issuers have to piece together the SEC’s guidance in conjunction with the four *Howey* factors to determine whether to register their ICO. *Id.* If the issuer is wrong, it can face penalties from the SEC.

²⁰¹ While the body of this paper explicitly suggests that Congress should amend Section 2(a)(1) of the Securities Act, that suggestion also encapsulates all the securities laws, including any other acts where “security” is defined, such as Section 3(a)(10) of the Exchange Act and Section 1(a)(36) of the Investment Company Act of 1940.

²⁰² This is how the SEC has assessed this concept. For example, in the case of *Munchee*, where the ICO was deemed a “security,” the company touted that the price of the cryptocurrencies would appreciate and emphasized to purchasers that they could profit more than how they could use it as a currency. See

This factor seeks to determine whether the issuer is creating a platform that will enable legitimate transactions or is creating a scheme whereby it and purchasers can profit. If the intent is to enable legitimate transactions, then the cryptocurrency is likely to not be a “security,” but if the ICO is a scheme to profit, it is more likely to be considered a “security.” The rationale behind this factor is that the SEC does not have jurisdiction over currencies.²⁰³ Further, an issuer should have the right to innovate and create a legitimate cryptocurrency if it would be beneficial to its operations.

The most reliable way of determining the issuer’s intent is by analyzing the issuer’s own words and actions, usually expressed through the white paper.²⁰⁴ The customer base that the company is marketing to is also very important—if the company is marketing to its user base, then it more likely wants to enable legitimate transactions. On the other hand, if it is marketing to outsiders, especially those who have not been affiliated with the industry, then it is more likely creating a scheme to profit. Another way to assess this factor is how the cryptocurrency will be integrated with the company’s current operations: if the integration of the cryptocurrency within the company’s current infrastructure fits naturally, then the ICO is less likely to be considered a “security.” For example, if Starbucks creates a cryptocurrency that can be used on its mobile application to order coffee and redeem rewards, that would be a legitimate use. However, if Starbucks creates a cryptocurrency for a task unrelated to its business, such as buying homes, then that is more likely to be a profit-seeking scheme.²⁰⁵

Ultimately, this factor is meant to gauge if the issuer is intending to enable legitimate transactions and how the cryptocurrency will operate within the company’s current operations.

Munchee Inc., Exchange Act Release No. 10445, 2017 WL 10605969 (Dec. 11, 2017). Similarly, in the no-action letter to TurnKey, the SEC emphasized that a condition of the ICO not being subject to its reporting requirements was that if the company wants to re-purchase the tokens, it could not do so for below the price that it sold them for. Turnkey Jet, Inc., SEC No-Action Letter, 2019 WL 1471132 (Apr. 3, 2019).

²⁰³ See, e.g., Chris Prentice & Pete Schroeder, *Analysis: Biden’s SEC Chair Nominee Signals More Regulation for Cryptocurrencies*, REUTERS (Mar. 2, 2021), <https://www.reuters.com/article/us-usa-crypto-currency-gensler-analysis/analysis-bidens-sec-chair-nominee-signals-more-regulation-for-cryptocurrencies-idUSKCN2AV02H>.

²⁰⁴ See Cointelegraph, *What is a White Paper and How to Write It*, <https://cointelegraph.com/ico-101/what-is-a-white-paper-and-how-to-write-it>. In fact, in *SEC v. Kik*, the SEC cited in their motion for summary judgment Kik’s executive actions and comments surrounding its ICO. See *U.S. Sec. & Exch. Comm’n v. Kik Interactive Inc.*, 492 F. Supp. 3d 169, 175 (S.D.N.Y. 2020). For example, the SEC stated that “[K]ik’s CEO explained how people could make money from early purchases of Kin. For example, at an event five days before the beginning of the public sale of Kin, he said, ‘if you set some aside for yourself at the beginning, you could make a lot of money.’” *Id.* at 174. Also, the SEC can interview company officials and subpoena minutes of board meetings to assess the issuer’s intent.

²⁰⁵ The SEC has also weighed whether a issuer’s intent is legitimate in its analysis. For example, in the Pocketful of Quarters no-action letter, the cryptocurrency was used to transfer money from one video game to a different video game, which is a legitimate and practical use. Video game players lose value when they have excess money in a video game they no longer play, so transferring the money to a new game they are playing is beneficial and is within the company’s industry of video games. Pocketful of Quarters, Inc., SEC No-Action Letter (July 25, 2019).

b. Factor (2): Is the Issuer Taking a Hands-On Approach to Make the Cryptocurrency Profitable?

A second factor is whether the issuer is taking a hands-on approach to increase the price of its cryptocurrency. This factor emulates the “efforts of others” prong of the *Howey* test, since that prong has been emphasized most when the *Howey* test has been applied.²⁰⁶ In addition to its application in the *Howey* framework, this factor has also been emphasized in other SEC guidance.²⁰⁷ This factor will weigh toward an ICO not being a “security” if the issuer does not take action to increase the value of the cryptocurrency; conversely, if the issuer takes action for the price to appreciate, then will be more likely to be found to be a “security.” The policy behind this factor is that a legitimate cryptocurrency that is used for exchanges (like a regular currency) should not quickly appreciate or depreciate in price and instead should remain relatively stable in price.²⁰⁸

In application, this factor can be assessed by determining whether the issuer is taking financial action to stabilize or increase the price of its cryptocurrency. Any financial action that the issuer is taking to stabilize or increase the value of its cryptocurrency should be scrutinized very cautiously. For example, is the company retaining a high percentage of the cryptocurrency so it can later sell it for a profit? Can the issuer create more of the cryptocurrency at a later date and sell it? Is the issuer advertising that it will buy back the cryptocurrency in the future? Another way to assess this factor, already stated by the SEC in Hinman’s speech and in the Munchee Report, is by seeing if the issuer is creating a secondary market for the cryptocurrency to increase the market value of the cryptocurrency.²⁰⁹ The issuer creating a secondary market or using any manipulative techniques to orchestrate buying or selling is a hint that the issuer is actively trying to raise the price.

Assessing whether the issuer is actively attempting to increase the price of the cryptocurrency is meant to gauge whether the issuer wants the cryptocurrency to be used as a medium of exchange.

c. Factor (3): Has the Platform for the Cryptocurrency Been Developed, or Is It in Its Infancy Stages?

The third factor to scrutinize is the stage of development that the cryptocurrency and its platform are in. The earlier the stage of development, the more likely the ICO is a

²⁰⁶ See *U.S. Sec. & Exch. Comm'n v. Kik Interactive Inc.*, 492 F. Supp. 3d 169, 179 (S.D.N.Y. 2020).

²⁰⁷ For example, in the DAO Report, where the SEC held that the ICO was subject to its reporting requirements, the SEC emphasized the “efforts of others” prong and noted that the cryptocurrency holder’s voting rights were not meaningful—because the managers were the ones making decisions to boost the value of the cryptocurrency. Report of Investigation Pursuant to Section 21(a) of the Sec. Exch. Act of 1934: The Dao, Exchange Act Release No. 81207, 2017 WL 7184670 (July 25, 2017). This meant that the holders of the cryptocurrency were relying on the efforts of others to increase the value of the cryptocurrency. See, e.g., TurnKey Jet, Inc., SEC No-Action Letter, 2019 WL 1471132 (Apr. 3, 2019).

²⁰⁸ See Chris Prentice & Pete Schroeder, *Analysis: Biden’s SEC Chair Nominee Signals More Regulation for Cryptocurrencies*, REUTERS (Mar. 2, 2021), <https://www.reuters.com/article/us-usa-crypto-currency-gensler-analysis/analysis-bidens-sec-chair-nominee-signals-more-regulation-for-cryptocurrencies-idUSKCN2AV02H>.

²⁰⁹ William Hinman, Dir., Div. of Corp. Fin., SEC, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018) (transcript available at <https://www.sec.gov/news/speech/speech-hinman-061418>); *Munchee, Inc.*, Securities Act Release No. 10445, 2017 WL 10605969 (Dec. 11, 2017).

“security.” The platform and cryptocurrency do not have to be complete by the time of the initial sale but should be very close. This factor is meant to gauge the level of risk an investor takes when buying into the ICO, given that early-stage investments are riskier and accordingly warrant more protection by the SEC.²¹⁰ It is also meant to keep an issuer honest in developing the platform by making sure that it has taken at least some action, such as investment of its own capital, without additional funding. This factor also has support in many of the SEC’s statements to date.²¹¹

This factor is the simplest of the four to assess because it only requires determining what stage of development the platform and cryptocurrency are in at the time of the sale. The best way to determine the stage of development of the cryptocurrency and its platform are to assess how much code has been completed up to the date of the sale. If there is no way to determine that, then interviewing purchasers can determine if they could use the cryptocurrency soon after they bought it, implying that the cryptocurrency was developed. An alternative way to assess this factor includes interviews with the coders responsible for creating the platform. Of course, standard upkeep and maintenance of the platform should be expected, but any major development that has not yet been completed should be scrutinized cautiously by the SEC and will weigh toward the ICO being considered a “security.” Additionally, development of a better platform in the future is permissible, but the platform should be ready to enable exchanges very soon after the sale of the ICO.

This factor gauges whether the issuer is willing to invest in its own cryptocurrency—which reflects how it views its cryptocurrency.

d. Factor (4): What is the Intent of the Purchasers? Do They Expect to Use the Cryptocurrency?

The final factor to determine whether the SEC has jurisdiction over an ICO is the intent of the purchasers. Why is the public buying the cryptocurrency? Purchasers who want to enter into legitimate exchanges on the platform will support the cryptocurrency not being a “security,” while speculation and profit-motive will weigh toward the ICO sale being deemed a “security.” This is important as a final consideration because even if the issuer wants to establish a stable and usable cryptocurrency, and if the public is using the

²¹⁰ One primary mandate of the SEC is to protect investors. SEC, *About the SEC*, <https://www.sec.gov/about.shtml> (last modified Nov. 22, 2016). The consensus in the investment community is that early-stage investments are riskier than late-stage investments. See Manhattan Street Capital, *What Are the Risks From Investing in Early Stage Companies*, <https://www.manhattanstreetcapital.com/faq/for-investors/what-are-risks-investing-early-stage-companies> (last visited Oct. 31, 2021).

²¹¹ In Director Hinman’s speech, for example, he lists the factor of how operable or close-to-operable the cryptocurrency is—and whether the issuer has already created the platform that the cryptocurrency will operate on. Hinman, *supra* note 158. Additionally, the Munchee Report, which said that the ICOs were subject to SEC regulation, rested its decision in part on the fact that the platform was undeveloped and the ICO was in a very early stage. *Munchee, Inc.*, Securities Act Release No. 10445, 2017 WL 10605969 (Dec. 11, 2017). Conversely, in the SEC’s two no-action letters (TurnKey and POQ), the SEC noted that its decision to not require the ICO be subject to regulation rested in part on the fact that the platform and cryptocurrency was already developed and usable. See TurnKey Jet, Inc., SEC No-Action Letter, 2019 WL 1471132 (Apr. 3, 2019). Finally, the court in *SEC v. Kik* also rested its ruling on the fact that the ICO constituted a selling of “securities” on this idea and specifically stated that the ICO was in its very early stages when sold to the public. *SEC v. Kik Interactive, Inc.*, 492 F. Supp. 3d 169, 180 (S.D.N.Y. 2020).

cryptocurrency for speculative purposes, then the SEC should have jurisdiction over it since one of the SEC's mandates is to protect investors.²¹²

The SEC has already communicated this factor when it applies the *Howey* test, specifically in the “expectation of profits” prong. Director Hinman’s speech most directly elaborated on this point when he stated that one factor should be what the purchaser’s purpose is when buying the cryptocurrency: speculation or actual use.²¹³

To administer this factor, courts should scrutinize the actions of purchasers after they buy the cryptocurrency: are purchasers using the coin in exchanges, or are they holding it and hoping the price appreciates? The quickest gauge of this factor is determining if purchasers had been previous customers of the issuer, or at least in the industry, before the creation of the cryptocurrency. For example, in the case of TurnKey Jet, Inc., where a cryptocurrency is used to purchase private jet charters, courts should scrutinize whether the purchasers of these tokens use private jets; if the purchasers do not use private jets, the cryptocurrency is more likely to be considered a “security.”²¹⁴ A more mundane example is a cryptocurrency used to buy Oreo cookies: if the purchasers have purchased Oreo cookies in the past and are regular customers of Oreo, then it is more likely that the cryptocurrency is not a “security.”

Other facts can shine light on this determination as well. For example, if there is a derivative market for the cryptocurrency, it is more likely that purchasers are using the cryptocurrency to make a profit. Another way to determine this factor is by seeing whether the purchasers are recommending the cryptocurrency to their friends or family to make a profit—if they are, the ICO is more likely to be a security offering. A final way to assess this factor is to look at online forums where purchasers are discussing why they purchased the cryptocurrency.

In essence, these four factors create a cryptocurrency-specific balancing test that can provide issuers with better guidance about whether to register their offering with the SEC when the current *Howey* framework and other current guidance is inadequate. It also keeps the *Howey* test reserved for what it was intended to be: a catchall category.

²¹² See SEC, *supra* note 211.

²¹³ Hinman, *supra* note 212. Other no-action letters have also touched on this point. See, e.g., TurnKey, *supra* note 208. For example, in the TurnKey no-action letter, the SEC made clear it wanted a stable price for the tokens and that it does not want purchasers to be selling the cryptocurrency for appreciation. *Id.* Instead, the SEC emphasized that the cryptocurrency should be purchased for use on the platform. *Id.* Additionally, in the POQ no-action letter, the SEC effectuated this same idea by stating that the supply of the cryptocurrency should be unlimited, which will prevent the price from appreciating. Pocketful of Quarters, Inc., SEC No-Action Letter (July 25, 2019), <https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1>. Additionally, this no-action letter made clear that the tokens should be used for consumption and not for speculative purposes. *Id.*

²¹⁴ Letter from James Curry, Esq., to Off. of Chief Counsel, Div. of Corp. Fin., SEC (Apr. 2, 2019), <https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1-incoming.pdf>.

V. Addressing the Trepidations of New Legislation: Referring Back to the Legal Standard and Acknowledging that Private Parties Have State-Law Remedies

This Section addresses Congress's possible trepidations to adopting a cryptocurrency-specific balancing test.²¹⁵ Namely, Congress may be concerned that if it adopts a legal

²¹⁵ Regardless of how lawmakers decide to regulate cryptocurrencies, it remains unclear whether they will continue to be popular. This Footnote offers a rationale for why Bitcoin and other altcoins may become obsolete: they are different from traditional securities, such as equities, bonds, and derivatives, and they are being purchased primarily for speculative purposes (i.e., the hope that in their price will appreciate in the future). See Will Kenton, *Capital Investment*, INVESTOPEDIA (July 20, 2020), <https://www.investopedia.com/terms/c/capital-investment.asp>. However, a counter-consideration to this Footnote is that cryptocurrencies have the possibility to be useful outside of the capital markets; for example, they can serve a function similar to gold and diamonds—they can be a store of value and maintain a high price due to popular consensus. See *What Makes Diamond So Valuable?*, TRUEFACET (June 29, 2017), <https://www.truefacet.com/guide/makes-diamonds-valuable/> (“MYTH BUSTER: So, what makes diamonds so valuable? It’s simple: market demand.”). However, this Footnote discusses the practical application of cryptocurrencies as instruments in the capital markets, similar to equities, bonds, and derivatives.

In theory, Nakamoto did not intend for Bitcoin to be purchased for speculative purposes because it is a currency. The hallmark of a good currency is *stability* in price (i.e., should not appreciate quickly). Neel Mehta et al., *supra* note 1, at 58. However, the popular appeal of Bitcoin and other altcoins is their appreciation and volatility—this is what made the extraordinary profits possible. *Id.* at 59-60. This incongruity is not a formula for long-term success as a currency for Bitcoin and other altcoins.

Importantly, if ICOs are going to be successful long-term in the capital markets, they need to have the qualities that have made other securities successful: providing investors with returns while helping the issuer meet its capital needs—or supplying players in the capital markets with insightful information (although some securities exist solely for speculative purposes).

For example, a holder of stock is a partial owner of the company, and therefore is entitled to vote for company events, elect the board of directors, and receive a share of the company's profits. *What are the Rights of Shareholders in a Corporation?*, UPCOUNSEL, <https://www.upcounsel.com/rights-of-shareholders-in-a-corporation> (last visited Nov. 5, 2021). An investor buys stock with the hope that the company will make money and grow—and the investor gets part of that profit. *Id.* The issuer of the stock benefits because it is raising money to meet its capital needs, including, for example, hiring employees, building a new manufacturing site, and investing in research and development. *Id.*

Bonds similarly provide tangible benefits to the issuer and lender. Jason Fernando, *Bond*, INVESTOPEDIA (Aug. 13, 2020), <https://www.investopedia.com/terms/b/bond.asp>. Bonds, simply put, are an “I owe you.” *Id.* An issuer that borrows money can also use it to invest in itself, and the holder of the bond will be entitled to interest payments along with their principal back once the bond matures. *Id.*

Derivatives, a category of more complicated securities, do not play a direct role in the capital markets, because the money invested in derivatives does not go directly to issuers. See James Chen, *Derivative*, INVESTOPEDIA (Sept. 17, 2020), <https://www.investopedia.com/ask/answers/12/derivative.asp>. Instead, derivatives play an important role in the capital markets by highlighting areas where price corrections may be necessary. *Id.* In addition, they help to maintain market equilibrium by providing liquidity and leverage to the markets. *Id.*

Cryptocurrencies do not share these qualities—and to the extent that cryptocurrencies will be successful, they must embody some of these principles that have made other securities successful. See Benjamin Sherry, *What is an ICO?*, INVESTOPEDIA (June 25, 2019), <https://www.investopedia.com/news/what-ico/>.

In other words, an ICO should be a mechanism to move capital from people who have an excess to those who have a productive use for it. The most likely route is for ICOs to be similar to equities. In fact, many ICOs have embodied this role which may make their success more likely. For example, in the case of DAO, the holders of the tokens could propose projects to pursue, vote on whether to pursue certain projects, and share in any profits generated by these projects. The DAO, Securities Exchange Act of 1934 Release No. 81207, 117 SEC Docket 5 (July 25, 2017). Regardless of this prediction regarding cryptocurrencies—and the forewarning about ICOs—the free markets must continue to operate, because the United States is built on its free enterprise system. *How Does the U.S. Free Enterprise System*

standard in this area of rapidly changing technology, it may not give the SEC the necessary flexibility to regulate new cryptocurrencies. Congress might believe that ICO issuers would be able to formulaically create a cryptocurrency that passes the test so it is not a “security” while actually resembling a “security.” Accordingly, the SEC runs the risk of losing its jurisdiction over a certain ICO. This problem is best addressed by emphasizing that courts applying bright-line rules should still keep this standard and its purposes in mind. Further, Congress should acknowledge that the various states’ common law causes of action permit wronged private plaintiffs to bring lawsuits when necessary.²¹⁶

In a law review article, “Crystals and Mud in Property Law,” Professor Carol Rose discusses how common law courts often alter legal standards (i.e., balancing tests) into legal rules (i.e., bright-line rules) and vice versa.²¹⁷ Although she discussed this phenomenon within the context of property law, it is applicable in all areas of the law.²¹⁸ One example Professor Rose uses to illustrate her point is the doctrine of caveat emptor.²¹⁹ The doctrine of caveat emptor originated as a simple bright-line rule, but courts slowly carved into it by creating exceptions and then certain words within the exceptions, such as “material,” “know,” and “reasonably” were litigated, causing this once simple bright-

Operate?, SOC. STUD. HELP CTR., http://www.socialstudieshelp.com/Eco_Free_Enterprise.htm (last visited Nov. 5, 2021) (acknowledging that the free market system includes freedoms, such as the right to choose a business, the right to private property, the right to a profit motive, the right to competition, and the right to consumer sovereignty). The SEC has acknowledged the importance of the free market enterprise system—for example, when the S&P 500 fell nearly 33% in a few weeks during the COVID-19 crisis, SEC Chairman Jay Clayton stated that the market would not close due to free market principles. Shaina Mishkin, *What Would it Take for Coronavirus to Shut Down the Stock Market? A Lot*, BARRON’S (Mar. 16, 2020), <https://www.barrons.com/articles/nyse-floor-closings-markets-open-electronic-trading-coronavirus-51584385919>. One example where these free market principles have flourished is in the venture capital space, where investors make very risky, speculative investments in companies losing millions of dollars. A few of these seemingly failing investments become profitable and can revolutionize an industry. See Linda Ray, *Top Risk Factors in Venture Capital Investments*, CHRON, <https://smallbusiness.chron.com/top-risk-factors-venture-capital-investments-75055.html> (last visited Nov. 5, 2021). In addition, when free markets operate, a small tweak to any seemingly bad product can turn it into a successful one. *Id.*

²¹⁶ See RESTATEMENT (SECOND) OF TORTS § 874 (A.L.I. 1979) (“One standing in a fiduciary relation with another is subject to liability to the other for harm resulting from a breach of duty imposed by the relation . . . [and] [o]ne standing in a fiduciary relation with another is subject to liability to the other for harm resulting from a breach of duty imposed by the relation.”); RESTATEMENT (SECOND) OF TORTS § 525 (A.L.I. 1977). However, in the class action context, Congress has limited such state law causes of action under the Securities Litigation Uniform Standards Act (SLUSA). Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.).

²¹⁷ Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 578 (1988). Professor Rose calls this the transformation from “crystal,” or bright-line rules, into “mud,” or balancing tests *Id.* at 579 (“... for example, what seemed to be a workable crystalline rule about sunlight rights ... has been transformed into a mud doctrine.”).

²¹⁸ For example, this phenomenon can also be seen in patent law, especially with the tension between the U.S. Supreme Court and the Federal Circuit Court of Appeals in the obviousness doctrine under 35 U.S.C. § 103. In *KSR Int’l Co. v. Teleflex, Inc.*, 550 U.S. 398 (2007), for example, the U.S. Supreme Court overturned the Federal Circuit’s rule-based approach to the obviousness inquiry and held that the obviousness is a legal standard and bright-line rules are not suitable. This is a good example, because the U.S. Supreme Court often needs to correct the Federal Circuit in patent law jurisprudence due to the Federal Circuit being the sole appellate court with jurisdiction over patent law appeals from U.S. District Courts and therefore creating a tremendous body of law without input from other appellate courts. 35 U.S.C. § 141.

²¹⁹ Rose, *supra* note 219, at 580-83.

line rule to effectively become a legal standard.²²⁰ As Professor Rose explains, the phenomenon can also work in reverse, by turning a balancing test into a bright-line rule.²²¹ Importantly here, courts must be aware that by attempting to clean up this balancing test by proposing bright-line rules, courts, in some scenarios, alter the doctrine and actually create the possibility that new ICO issuers can find creative ways to bypass SEC regulations.²²²

These changes are especially worrisome in the ICO context given that cryptocurrencies are in their infancy stages and issuers are innovating at extremely high rates.²²³ Many issuers, especially fraudulent ones, are creatively attempting to make ICOs with different qualities to make a profit.²²⁴ For that reason, it is crucial for courts to refer back to this balancing test instead of relying on bright-line rules that originated from the interpretation of this standard.

Further, Congress's qualms should be further mitigated by acknowledging that wronged private plaintiffs have other remedies outside of the federal securities laws if a certain offering does not constitute a security.²²⁵ These include common law fraud, common law deceit, breach of fiduciary duty, misrepresentation, and even breach of contract.²²⁶ Allowing defrauded private parties to sue under state law causes of action may not have the same deterrent effect on the market, but it still provides relief in individual cases that may not fall under a cryptocurrency-specific legal standard.²²⁷

In short, by providing a clear cryptocurrency-specific legal standard, ensuring that courts relate back to the balancing test when bright-line rules are created, and allowing private parties to bring lawsuits under state law remedies, Congress can allow the SEC to protect investors while also providing legitimate issuers the clarity they need to operate effectively.²²⁸

²²⁰ *Id.*

²²¹ *Id.* at 580.

²²² *Id.* at 579-80.

²²³ Nikolaus Lipush, *Initial Coin Offerings – A Paradigm Shift in Funding Disruptive Innovation* (Mar. 23, 2018), <https://papers.ssrn.com/sol3/papers.cfm?abstractid=3148181>.

²²⁴ *Id.*

²²⁵ See RESTATEMENT (SECOND) OF TORTS § 874 (A.L.I. 1979) (“One standing in a fiduciary relation with another is subject to liability to the other for harm resulting from a breach of duty imposed by the relation.”); RESTATEMENT (SECOND) OF TORTS §§ 525, 552 (A.L.I. 1977) (fraudulent misrepresentation and negligent representation, respectively); W. Prosser, *Torts* 700 (3d ed. 1964) (saying that the elements of deceit are: (1) a false misrepresentation; (2) that representation must be of a material fact; (3) the defendant must know of the falsity (scienter) but make the statement nevertheless for the purpose of inducing the plaintiff to rely on it; (4) the plaintiff must justifiably rely on it; and (5) suffer damages as a consequence); see generally RESTATEMENT (SECOND) OF CONTRACTS (A.L.I.) (describing various remedies in contract law)

²²⁶ See *supra* text accompanying note 226.

²²⁷ *Id.*

²²⁸ ²²⁸ A hypothetical that applies this balancing test to Bitcoin will demonstrate its applicability and show that the test is consistent with the SEC's unofficial position on Bitcoin--namely, that Bitcoin is not a “security.” Chermaine Ng, *SEC Chairman Jay Clayton on Bitcoin: Not a Security, But More Regulation Needed*, SUPERCRYPTONEWS (Nov. 22, 2020), <https://www.supercryptonews.com/sec-chairman-jay-clayton-on-bitcoin/>. First, Nakamoto's intent when creating Bitcoin was to make a currency to enable legitimate exchanges. See Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, BITCOIN.ORG, <https://bitcoin.org/bitcoin.pdf> (explaining that Bitcoin is the easiest way to transact at a very low cost). This can be determined by reading the white paper and noting the purpose and context for which he created Bitcoin: during the 2009 Great Recession to bypass middlemen. *Id.* This factor cuts toward Bitcoin not being a “security.” Second, Nakamoto does not have an active mechanism to increase

VI. Conclusion: This Approach Best Protects Investors and Promotes Innovation

Only a decade ago, Bitcoin and cryptocurrencies were words unknown to this world. Since then, cryptocurrencies have become a household name, and innovation in this space continues at a breakneck pace.²²⁹ Given the amount of fraud in this space; however, the priority must be regulation.²³⁰ The SEC has acted, but, given the tools it has at its disposal, its actions have left issuers uncertain as to whether their ICO is a “security” under the *Howey* framework.²³¹

Congress should step in and provide a cryptocurrency-specific legal standard that provides issuers with greater clarity to address this problem, while still giving issuers the freedom to innovate. By adopting this legal standard that follows the SEC’s enforcement actions to date, Congress can allow the SEC to continue to further its mandate by protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.²³² In doing so, the SEC will be able to play its proper role in determining the fate of cryptocurrencies—whether they turn out to be a serious forewarning like “tulip mania” was in 16th century Europe or a stable back of currency, valuable commodity, and store of value, like gold.

the price of Bitcoin. *Id.* The only counter-argument is that the supply of Bitcoin is limited, but once Bitcoin is on the market, there is nothing that Nakamoto can do to increase the price. *Id.* The totality of the facts here cut toward Bitcoin not being considered a “security.” Third, Bitcoin’s platform was established around the time that the white paper was published and Bitcoin was not just an idea when it came to the market. *Id.* This weighs toward Bitcoin not being considered a “security.” Fourth, the majority of Bitcoin purchasers are buying Bitcoin with the intent to make a profit, which weighs toward Bitcoin being considered a “security.” Therefore, three out of the four factors in this balancing test control, and Bitcoin is not a “security.” This is consistent with the SEC’s position. Chermaine Ng, *SEC Chairman Jay Clayton on Bitcoin: Not a Security, But More Regulation Needed*, SUPERCRYPTONEWS (Nov. 22, 2020), <https://www.supercryptonews.com/sec-chairman-jay-clayton-on-bitcoin/>.

²²⁹ See Jared Polites, *How the Pandemic is Stimulating Innovation*, BENZIGA.COM (Oct. 1, 2020, 10:49 AM), <https://www.benziga.com/markets/cryptocurrency/20/10/17739147/how-the-pandemic-is-stimulating-innovation-in-crypto>.

²³⁰ See *supra* note 14.

²³¹ Cooley, *SEC v. Telegram: Key Takeaways and Implications* (May 7, 2020), <https://www.cooley.com/news/insight/2020/2020-05-07-sec-v-telegram-key-takeaways-implications> (“[T]he *Telegram* opinion continue[s] to demonstrate the opacity of the regulatory landscape and highlight the risk to the industry of retroactive, selective enforcement rather than principles based guidance from the SEC. It continues to be difficult to draw broader conclusions or extrapolate rules or principles from enforcement actions that, as the Telegram court notes, are specific to the facts of a particular project and digital asset.”); see, e.g., *supra* note 14.

²³² See SEC, *supra* note 213.