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Digital Assets: At the Intersection of Law, Regulation, ?Public Policy and Technological Innovation

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Over the past year, digital assets have exploded on the mainstream and many believe that cryptocurrencies are the currency of the future.[1] The number of cryptocurrencies that are being created are multiplying; in fact, there are thousands of different cryptocurrencies currently in existence. Although the crypto economy continues to be unpredictable in certain respects, one thing is certain – government regulation is rapidly increasing. Accordingly, it is important that industry participants ensure compliance with the existing regulatory landscape and, perhaps more importantly, stay abreast of regulatory changes – including the introduction of new laws and/or additional restrictions on an ongoing basis.

While there are frequent and increasing calls for a dedicated crypto regulatory body to bring clarity to the space, there are also concerns that the end result will just be yet another regulator added to the existing and growing list. Indeed, numerous regulatory authorities have already taken steps to issue statements, guidance, and/or regulations about the offer, sale and/or taxation of these assets – including the Commodity Futures Trading Commission (CFTC)[2], the Consumer Financial Protection Bureau (CFPB)[3], the Financial Crimes Enforcement Network (FinCEN)[4], the Office of the Comptroller of the Currency (OCC), the Internal Revenue Service (IRS), the Federal Deposit Insurance Corporation (FDIC), the U.S. Department of Justice (DOJ), and other individual state regulatory bodies. Like any other financial instrument, the use of digital currency brings with it the inherent risks of fraud and abuse, and thus, federal and state securities laws require all offers and sales of securities, including some digital assets, to either be registered under its provisions or to qualify for an exemption from registration.

The U.S. Securities and Exchange Commission ("SEC"), under the leadership of current Chair Gary Gensler, has

taken a more aggressive role and has made clear that digital assets fall within the "broad remit" at the SEC.[5] Indeed, in line with his stated focus on establishing a regulatory framework for crypto, on January 3, 2022, Gensler appointed Corey Frayer to serve as a crypto-focused senior adviser, further signaling that the SEC could step up its efforts to regulate the industry in 2022. The SEC's remit, however, depends on whether the particular digital asset or assets at issue meet the definition of a "security" under the Securities Act of 1933 and the Securities Exchange Act of 1934. The criteria utilized by the SEC and the federal courts to evaluate if a digital asset classifies as a security is based on a host of factors, including whether the asset qualifies as an "investment contract."[6] The SEC has previously concluded that certain digital assets do in fact constitute securities, specifically in its Report of Investigation of The DAO,[7] and in the SEC's Order Instituting Administrative and Cease-and-Desist Proceedings against Tomahawk Exploration LLC.[8] Likewise, in connection with its ongoing litigation against Ripple Labs and its CEO Brad Garlinghouse, the SEC has declared that Ripple's XRP constituted a security.[9]

The Howey Test developed by the U.S. Supreme Court in SEC v. Howey and its progeny has provided guidance on what meets the definition of an investment contract for purposes of federal securities laws.[10] Under the Howey Test, a transaction is considered an investment contract if: (i) it is an investment of money; (ii) in a common enterprise; (iii) with an expectation of profits derived from the efforts of others. If a digital asset meets the Howey Test for an investment contract, then it is considered a security and subject to federal securities laws.[11] The Howey Test applies to any contract, scheme, or transaction, regardless of whether it has any characteristics of typical securities. Whether a particular digital asset satisfies the Howey Test – regardless of the terminology used – will depend on specific facts and circumstances at the time it is being sold.[12]

The first and second prongs are fairly evident and typically satisfied. First, there is usually a purchase or some exchange of consideration for the digital assets to satisfy the "investment of money" factor. Second, if a company is raising funds via the sale of a cryptocurrency to the public, both parties want the asset to increase in value, and is thus considered a "common enterprise." As such, the crux of the Howey Test typically turns to the third factor.

When assessing whether there is a reasonable expectation of profit derived from the efforts of others, courts look to the economic reality of the transaction.[13] For example, the existence of a promoter or third party (other than the investor) who provides, for example, essential managerial efforts, such as fundraising to develop a digital platform, software, or other projects that affect the success of the enterprise, the digital asset is likely relying on the efforts of others. Likewise, when investors reasonably expect to derive profit from those efforts, for example, by realizing the gain of the increase of those assets, the final prong is likely satisfied. This analysis, however, is a very fact-specific determination and a look into what promoters do (or do not do) must be examined to determine if a given digital asset meets the Howey Test and is considered a security.

While these factors are not intended to be exhaustive and no single factor is determinative, the SEC Strategic Hub

for Innovation and Financial Technology ("FinHub") published a detailed framework (the "Framework") regarding its views on particular factors to be considered in the application of the Howey Test.[14] The Framework also provides a further objective analysis of the last prong and provides further considerations to be examined.[15]

At present, certain digital assets have been classified as securities, while others have not. The SEC, and most market participants, seems comfortable treating bitcoin as a commodity (a tangible item or item made to be bought, sold, or interchanged in commerce) to be regulated by the CFTC, and not a security, due to its lack of a central third party or promoter whose efforts are critical to the success of the enterprise. Meanwhile, many still have concerns and questions as it relates to Ethereum, among others, due to its concentration of control and perceived lack of decentralization.

The legal ramifications of this critical question are apparent – if a digital asset is ultimately considered a security, federal securities laws require all offers and sales to be registered, unless an exemption applies, and that certain information be disclosed to potential investors. The express objective of the SEC is investor protection, and entities and exchanges offering crypto securities will be expected to comply with all applicable securities laws.[16] Additionally, anyone selling digital assets that are likely to constitute a security should be aware of the potential applicability of state securities laws. Indeed, the state regulators of New York and New Jersey, and various other states, have taken an active interest in the issuance and sale of digital assets within their jurisdiction, and any exchange dealing with digital assets will be expected to comply with individual state securities laws.

Accordingly, whether you are involved in the crypto space as a creator, issuer, promoter, seller, or investor, you should be aware of various legal, regulatory, and policy considerations that could affect your interests based on the nature of the applicable digital asset.

If you have any questions about the issues discussed in this article, please contact any of the following attorneys, who are part of our Digital Assets and Blockchain Group.

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[1] The term "digital asset" refers to an asset that is issued and transferred using blockchain technology, including, but not limited to, virtual currencies, coins, and tokens.

[2] See Commodity Exchange Act § 1a(9); *See also* CFTC v. McDonnell et al., 287 F. Supp. 3d 213, 228 (E.D.N.Y. Mar. 6, 2018) (finding that cryptocurrency, including Bitcoin, is a commodity under § 1a(9) of the Commodity Exchange Act).

[3] On November 1, 2021, CFPB Director Rohit Chopra issued a statement indicating the steps that the CFPB plans to take to regulate the stablecoin market. The term "stablecoin" refers to any cryptocurrency designed or intended to have a relatively stable price, typically by pegging it to an external commodity or currency or otherwise having its supply regulated by algorithm.

[4] On November 15, 2019, FinCEN Director Kenneth A. Blanco stated that transactions in stablecoins are covered under FinCEN's definition of "money transmission services." Specifically, he clarified that someone who accepts and transmits stablecoins is considered a money transmitter under the Bank Secrecy Act, and administrators of stablecoins must register as money transmitter businesses with FinCEN.

[5] *See generally* WSJ Journal Reports: Leadership, SEC Chairman on New Regulations on Cryptocurrencies and Climate Risk, Wall St. J. (Dec. 12, 2021), https://www.wsj.com/articles/sec-chairman-on-regulations-on-cryptocurrency-and-climate-risk-11639165931.

[6] See U.S. v. Zaslavskiy, 2018 WL 4346339 (E.D.N.Y. Sept. 11, 2018) (holding that securities laws could be used to prosecute fraud cases over virtual currency Initial Coin Offerings).

[7] See SEC Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934:

The DAO, Release No. 81207 (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf.

[8] See In the Matter of Tomahawk Exploration LLC et al., Securities Act Rel. No. 33-10530, Exchange Act Rel. No. 34-83839, Admin. Proc. File No. 3-18641 (Aug. 14, 2018) (issuance of tokens under a "bounty program" constituted an offer and sale of securities because the issuer provided tokens to investors in exchange for services designed to advance the issuer's economic interests and foster a trading market for its securities).

[9] See SEC v. Ripple Labs, Inc. et al., 1:20-cv-10832 (S.D.N.Y.).

[10] See *generally* SEC v. W.J. Howey Co., 328 U.S. 293 (1946); see *also* United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975); see *also* Tcherepnin v. Knight, 389 U.S. 332 (1967).

[11] However, sales made on decentralized networks without a third party promoter, such as cryptocurrencies Bitcoin and Ether, are not considered securities transactions under the *Howey* Test. See William Hinman, Director, Division of Corporate Finance, Remarks at the Yahoo Finance All Markets Summit: Crypto, Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418 (Bitcoin lacks "a central third party whose efforts are a key determining factor in the enterprise", "applying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would seem to add little value", and "based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions").

[12] See Tcherepnin, 389 U.S. at 336 (holding that in searching for the meaning and scope of the word "security" in the federal securities acts, form should be disregarded for substance and the emphasis should be on economic reality).

[13] See Howey, 328 U.S. at 298 ("Form was disregarded for substance and emphasis was placed upon economic reality.").

[14] See Framework for "Investment Contract" Analysis of Digital Assets (last modified April 3, 2019), https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

[15] For example, on April 3, 2019, the SEC issued a no-action letter to TurnKey Jet, Inc. ("TKJ") finding that digital tokens issued by TKJ were not securities. In its no-action letter, the SEC noted six factors in support of its decision, including the fact that the funds from the sale of tokens would not be used to develop TKJ's blockchain platform, and that the token was marketed in a manner that emphasized the functionality of the token and not the potential for the increase in the market value of the token. See *generally* TurnKey Jet, Inc., SEC No-Action Letter (Apr. 3, 2019), https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.html; *compare with* SEC Release No. 81207, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf (determining that DAO Tokens are considered securities under the *Howey* Test and are subject to federal securities laws, and making clear that federal securities laws apply to those who offer and sell securities "regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed

ledger technology").

[16] Stretching back to 2013, the SEC has taken enforcement action against a number of digital assets in connection with their Initial Coin Offerings. *See* Cyber Enforcement Actions (last modified Jan. 6, 2022), https://www.sec.gov/spotlight/cybersecurity-enforcement-actions.

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