Not all cryptocurrencies are securities: SEC starts providing guidance

MICAH MARCUS, CHRISTOPHER RILEY | BUSINESS INSIGHTS | JUN 21, 2018

As the number and variety of cryptocurrencies available throughout the world increases, individuals and entities engaged in the sale and trade of such cryptocurrencies have been left to guess as to whether their practices constitute illegal sales or trades of unregistered securities, potentially exposing sellers to liability under federal law and the regulations of the Securities and Exchange Commission. The call for guidance from the SEC has increased through the growing number of industries utilizing distributed ledger technology. Now, the SEC has begun to respond, including recent indications that the two largest cryptocurrencies in circulation, bitcoin and ether, do not qualify as securities.

SEC concern focuses on the sale of tokens or coins operating on a distributed ledger network. With increasing frequency, network developers are offering tokens for sale prior to the creation and launch of the underlying network with the money generated from such token sales used to fund the initial build of the network. The purchasers of these tokens via such presales expect the developers to eventually deliver a functional distributed ledger network for use by holders of the tokens, with the purchaser earning a return on their initial investment by reselling the token on a secondary market once the network has been established and the value of the token increased. These presales of tokens, however, can seem similar to securities offerings, and the SEC is currently evaluating this new technology to determine whether the sale of certain tokens would trigger regulation by the SEC under its securities offering regulatory framework.

THE HOWEY TEST

To date, the SEC has relied on the investment contract test established in *SEC v. Howey* to determine whether tokens are actually securities and subject to its regulation. If an economic transaction constitutes an investment contract under the *Howey* test, it is most likely a security under the Securities Act of 1933 and the Securities Exchange Act of 1934 that must be registered with the SEC in advance of any sale or trade absent certain defined exceptions. The *Howey* test mandates an economic transaction is an investment contract if the transaction involves an investment of money, in a common enterprise, with an expectation of profit which is derived from the efforts of others.[1]

The *Howey* test is designed to be flexibly applied to any economic transaction. Therefore, if the sale of a token qualifies as an investment contract using the *Howey* test, the sale or trade of that token without prior registration with the SEC may constitute an offering for sale of an unregistered security, which could lead to substantial liability under federal law.

As of now, the SEC remains unwilling to apply a blanket application of the *Howey* test to all cryptocurrencies and instead focuses on a case-by-case application. William Hinman, director of the division of corporation finance for the SEC, spoke at the recent Yahoo Finance All Markets Summit, Crypto, and his comments reiterated this approach while providing some limited guidance on how the SEC intends to interpret and apply the *Howey* test in this continually shifting market.[2] In emphasizing the SEC's role and the importance of the Securities Act and the Exchange Act in removing information asymmetry between promoters of cryptocurrencies and potential investors, Hinman stated the central determination as to whether a token constitutes a security rests on how the token is sold and the reasonable expectations of the purchaser. This analysis focuses on the fourth aspects of the *Howey* test, with Hinman concluding the sale or trade of a token may not represent a security offering "if the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts."

TOKENS IN DECENTRALIZED NETWORKS

In decentralized networks, the network on which a token operates is run by the participants themselves without oversight by a third party and expands based on active network participation. As a result, an investor purchasing a token does not rely solely on the efforts of the network's developers to generate value for the network's token but instead relies on the increased demand to use the network to increase the value of the tokens. This decentralization lessens information asymmetry and the corresponding need for SEC oversight. Uncovering entities that have access to nonpublic information becomes increasingly difficult and the value of any nonpublic information becomes increasingly less meaningful as network participation increases and diversifies. For example, Hinman pointed to the Bitcoin and Ethereum networks, both of which currently operate without central, third party governance outside of the network's code. Bitcoin and Ethereum are fully developed and operational, and the purchasers of bitcoin or ether can obtain the benefits of the network now. Moreover, the value of bitcoin and ether is derived from the holders of bitcoin and ether using their respective underlying networks. Further, the respective networks are operational, and bitcoin and ether are finite in amount, so more willing participants leads to more demand for bitcoin/ether which leads to an increase in the value of bitcoin/ether. This increase in value will occur without further work on the part of the developers of Bitcoin or Ethereum. Therefore, Hinman stated bitcoin and ether are not securities, meaning the sale and trade of bitcoin and ether can occur without SEC oversight.

MORE INTERPRETATIONS ARE COMING

While Hinman's comments provide some guidance and assurance related to sale and trade of bitcoin and ether, the sale or trade of other cryptocurrencies may still constitute a securities offering. Ultimately, the economic substance of a transaction will always determine the legal analysis, not the labels or associated marketing tactics. Instead, the primary consideration must rest on whether a third party or coordinated group generates the expectation of a return on investment, which depends on the form of the token and network at issue and method of sale. For those engaging in the sale or purchase of these cryptocurrencies, the SEC has begun providing some guidance. In particular, on June 14, the SEC released a number of factors that may indicate whether the sale of a token constitutes a securities offering, such as a token's utility independent of price, the means of setting a token's price, the governance of the underlying network. Hinman reiterated the SEC's willingness to provide more formal interpretations of the law through a no-action guidance letter for individual tokens/networks sometime in the future. Nevertheless, until the SEC enacts a broad regulatory scheme to address this issue one way or another, the ultimate determination of whether the sale or trade of a coin or token on a secondary market constitutes a securities offering requires a thorough, fact-sensitive legal analysis.

[1] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946)

[2] Full text of Mr. Hinman's remarks, "Digital Asset Transactions: When Howey Met Gary (Plastic)", are available at https://www.sec.gov/news/speech/speech-hinman-061418.

MICAH MARCUS

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