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ABSTRACT

The Securities and Exchange Commission (SEC) seeks both to protect investors and to promote efficient capital formation, but in the context of cryptoassets these goals sometimes collide. The SEC vigorously reacts to fraudulent offerings of cryptoassets but has had to do so by forcing crypto into an antiquated framework designed with very different interests in mind. Even worse than the convoluted and complex arguments needed to force crypto into the existing category of "investment contracts," once crypto is treated as a security, a host of onerous and inapt disclosure requirements and regulations follows. Developers, promoters, exchanges, and others who might assist in the sale of such assets are all forced into a regime that was never intended to cover this new class of assets.

This Article therefore suggests changes to the existing regulatory regime to more fairly apportion duties and responsibilities between regulators, issuers, promoters, and purchasers. This Article suggests that the SEC is the appropriate agency to oversee transactions in cryptoassets, but the underlying legislation should be amended to create a new category of securities, with different disclosure requirements and exemptions tailored to the informational needs of potential crypto purchasers. Maintaining the current anti-fraud rules will protect the public while allowing for innovation in this rapidly moving space. It will avoid wasting assets of both regulators and the regulated by eliminating the debate over whether crypto is or is not a security and will avoid duplication of efforts between the SEC and other federal regulators. It will also improve the relevance of available information for potential purchasers. This approach has the dual advantage of facilitating

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both parts of the SEC's mission: protecting investors while supporting innovative capital formation for legitimate crypto enterprises.

I. INTRODUCTION

In the original Grimm fairy tale, one of Cinderella's stepsisters "cuts off her toes, and the other her heel so they can both fit into the tiny glass slipper."[1] There was no other way for them to make their feet fit into the shoe that was intended for someone else. Unfortunately, there are some parallels between this tale and the SEC's current approach to cryptoassets.[2] To date, the SEC has worked to force cryptoassets into the definition of investment contract as described in *SEC v. W.J. Howey Co.*,[3] and to impose disclosure obligations on issuers of cryptoassets and persons involved in sales and resales of crypto that are ill-fitting at best.[4]

The mission of the Securities and Exchange Commission (SEC) is "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."[5] In furtherance of these objectives,

1. Zoë Triska, *The REAL Stories Behind These Disney Movies Will Ruin Your Childhood,* HuffPost (Dec. 6, 2017), https://www.huffpost.com/entry/the-real-story-behind-eve_n_4239730 [https://perma.cc/66FM-LAKU].

2. The first time the SEC responded to crypto, it called the new assets "virtual currencies." OFFICE OF INVESTOR EDUCATION AND ADVOCACY, SEC. EXCH. COMM'N, SEC PUB. NO. 153, PONZI SCHEMES USING VIRTUAL CURRENCIES (2013). In an April 2019 pronouncement, the agency chose to call the same interests "digital assets." *See Statement on "Framework for 'Investment Contract' Analysis of Digital Assets",* U.S. SEC. EXCH. COMM'N, https://www.sec.gov/news/public-statement/statement-framework-investment-contract-analysis-digital-assets (Ap. 3, 2019). This article uses "cryptoassets" or "crypto" as more reflective of the terminology in the mainstream commentary on such assets. This terminology is also more in line with how the rest of the world tends to speak about these interests. As one commentator noted, "cryptoasset is a blanket term which isn't limited to cryptocurrencies." Aashish Pahwa, *What is a Cryptoasset? Types of Cryptoassets [Ultimate Guide]*, FEEDOUGH, https://www.feedough.com/what-is-a-cryptoasset-types-of-cryptoassets-ultimate-guide/ (May 19, 2018).

3. S.E.C. v. W. J. Howey Co., 328 U.S. 293 (1946).

4. *See, i.e.*, Carol Goforth, *Using Cybersecurity Failures to Critique the SEC's Approach to Crypto Regulation*, 65 S. Dakota L. Rev. 433 (2020) (forthcoming) (hereinafter "*Cybersecurity*"). The SEC has itself acknowledged the difficulty of navigating between the competing pressures of encouraging crypto innovation while adequately protecting investors. Ted Knutson, *Jay Clayton: SEC Balancing Crypto Innovation and Investor Protection*, FORBES (Dec. 11, 2018, 12:22 PM), https://www.forbes.com/sites/tedknutson/2018/12/11/jay-clayton-sec-balancing-crypto-innovation-and-investor-protection/?sh=279ee4083bd9.

5. *About the SEC*, SEC. EXCH. COMM'N, https://www.sec.gov/about.shtml (last modified Nov. 22, 2016).

the SEC has been particularly active in asserting its authority over transactions involving the sale of cryptoassets.[6]

Clearly there are legitimate reasons for the SEC's concern about crypto transactions. Crypto is an emerging technology that has captured the public's interest.[7] It both involves relatively large amounts of money[8] and is subject to significant levels of abuse.[9] It is

6. For a list of various SEC enforcement actions involving cryptoassets, *see Cyber Enforcement Actions,* SEC. EXCH. COMM'N, https://www.sec.gov/spotlight/cybersecurity-enforcement-actions (last modified Feb. 18, 2021). Note that the original releases from the SEC talked about crypto as "virtual currencies." For example, in 2014 the SEC issued an investor alert about Bitcoin and "other virtual currency-related investments." *Investor Alert: Bitcoin and Other Virtual Currency-Related Investments*, SEC. EXCH. COMM'N, https://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia_bitcoin.html (May 7, 2014). *See also* SEC. EXCH. COMM'N, OFFICE OF INVESTOR EDUCATION AND ADVOCACY, SEC PUB. NO. 153, PONZI SCHEMES USING VIRTUAL CURRENCIES (July 1, 2013). More recently, the SEC has apparently switched to using "Digital Assets." SEC. EXCH. COMM'N, FRAMEWORK FOR "INVESTMENT CONTRACT" ANALYSIS OF DIGITAL ASSETS (last visited Feb. 21, 2021) [hereinafter *Framework*]. In a joint staff statement (issued with the Office of General Counsel for FINRA), the SEC referred to covered cryptoassets as "digital asset securities." *See Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, SEC. EXCH. COMM'N, https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities, (July 8, 2019) [hereinafter *Digital Asset Securities*].

7. For example, some commentators compare the development of cryptoassets to the internet. "[M]any pundits, both in and out of the crypto ecosystem, have likened Bitcoin's parabolic rally in 2017 to the Dotcom Boom and Bust at the turn of the millennia. Sure, there are similarities, like the fact that both industries were revolutionary, were initially misunderstood and hated, and were rife with bad actors looking only to turn a quick buck." Nick Chong, *Crypto Adoption is Like Internet in 1990s With 50M+ Users, Massive Potential Left,* NEWSBTC, https://www.newsbtc.com/news/crypto-adoption-is-like-internet-in-1990s-with-50m-users-massive-potential-left/ (Apr. 25, 2019).

8. "The amount of money that ICOs have raised over the last two years is truly astonishing. In 2017, ICOs raised a total of $5.6 billion." *The Initial Coin Offering gold rush – the future of fundraising or just another crypto scam?* BLOCKGEEKS, (updated Feb. 21, 2019), [https://perma.cc/QEB7-DF3W].

9. To discover the range of fraudulent activities that have occurred in the context of crypto-offerings, one need look no further than the numerous SEC warnings and actions involving fraudulent crypto offerings. Investor.gov, *Investor Bulletin: Initial Coin Offerings*, SEC. EXCH. COMM'N (July 25, 2017), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-16; Investor.gov, *Investor Alert: Public Companies Making ICO-Related Claims*, SEC. EXCH. COMM'N (Aug. 28, 2017), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investor-25; Investor.gov, *Investor Alert: Celebrity Endorsements*, SEC. EXCH. COMM'N (Nov. 1, 2017), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investor-22; *Statement on Cryptocurrencies and Initial Coin Offerings*, SEC. EXCH. COMM'N, https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11#_ftnref8 (Dec. 11, 2017); *The SEC has an Opportunity You Won't Want to Miss: Act Now!*, SEC. EXCH. COMM'N, https://www.sec.gov/news/press-release/2018-88 (May 16, 2018); Investor.gov, *Watch Out For False Claims About SEC And CFTC Endorsements Used To Promote Digital Asset*

therefore completely understandable that the SEC wants to protect the investing public from the fraud that, at times, has seemed to permeate transactions involving cryptoassets.[10]

However, because the federal securities laws were not designed to apply to cryptoassets, and do not identify anything like crypto as being within the ambit of the securities statutes, the only option for the SEC has been to treat crypto as "investment contracts," one of the catch-all phrases contained in the federal securities laws' definition of security.[11] Cryptoassets, unfortunately, do not fit easily into this framework, with the SEC's explanation of how to apply this test changing rather significantly in a relatively short period of time.[12] Moreover, the SEC is (as of the date this Article was written) involved in major litigation over this approach to crypto as an investment contract.[13]

The SEC insists that it looks at all facts and circumstances under the *Howey* test,[14] which requires an investment in a common

Investments, SEC. EXCH. COMM'N (Oct. 11, 2018), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investor-10.

10. For example, one study reported that 80% of initial coin offerings (ICOs) conducted in 2017 were fraudulent. 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. The SEC appears to recognize these risks, steadily maintaining that crypto enforcement is one of its priorities. *See, e.g.*, William Suberg, *SEC Chairman Flags Crypto as Continued Regulatory Focus in Latest Speech*, COINTELEGRAPH (Apr. 10, 2019), https://cointelegraph.com/news/sec-chairman-flags-crypto-as-continued-regulatory-focus-in-latest-speech.

11. *See, e.g.*, Securities Act of 1933, ch. 38, title I, § 2, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77b (2006)); Securities Exchange Act of 1934, ch. 404, title I, § 3, 48 Stat. 882 (codified as amended 15 U.S.C. § 78c (2006)).

12. For a discussion of how the SEC's position has had to evolve rapidly, *see infra* Part II.A.

13. On December 22, 2020, the SEC initiated what may be one of the most significant crypto enforcement cases to date. The commission filed a complaint against Ripple Labs and two insiders, Brad Garlinghouse and Chris Larsen, the current and former C.E.O.'s of the company. SEC v. Ripple Labs, Inc., 20 Civ. 10832, Complaint (S.D.N.Y. Dec. 22, 2020). The lawsuit alleges that the XRP token that has been in circulation since 2013 is a security, and the Ripple's ongoing sales have been illegal because of a failure to register them. *See* Carol Goforth, *SEC vs. Ripple: A predictable but undesirable development*, COINTELEGRAPH (Dec. 27, 2020), https://cointelegraph.com/news/sec-vs-ripple-a-predictable-but-undesirable-development [https://perma.cc/XBT6-3LWP]. According to reports, the case is not likely to settle. Tanzeel Akhtar, *Ripple, SEC Say Settlement Unlikely Before Trial Over Alleged Securities Violations,* COINDESK (Feb. 16, 2021), https://www.coindesk.com/ripple-sec-say-settlement-unlikely-before-trial-over-alleged-securities-violations [https://perma.cc/MJN7-BBXG].

14. This test comes from S.E.C v. W. J. Howey Co., 328 U.S. 293 (1946).

enterprise where the purchasers are hoping for profits based on the essential entrepreneurial efforts of others.[15] In reality, however, the SEC has a pronounced tendency to conclude that almost all cryptoassets are securities. This, in turn, means that persons who seek to offer such assets for sale are being forced into the existing registration regime unless an appropriate exemption for the sale can be found.[16] In essence, this often subjects sellers to burdensome disclosure and reporting obligations.[17] In fact, compliance is so burdensome that the existing paradigm runs the risk of stifling desirable innovation.[18] This is especially likely in the context of crypto-based offerings because of the extensive regulations imposed by other federal agencies such as the I.R.S. (which classifies crypto as property rather than a security),[19] the Commodities Futures Trading Commissions (CFTC) (which says crypto is a commodity),[20] and the Financial Crimes Enforcement Network (FinCEN) (which treats crypto as a virtual currency).[21] This does not even consider the

15. *See infra* notes 28-35 for a more thorough discussion of the *Howey* test.

16. Section 5 of the Securities Act of 1933 (codified as amended 15 U.S.C. § 77e (2006)) prohibits the offer or sale of securities unless they are first registered with the SEC or an exemption from registration is available.

17. *See Cybersecurity*, *supra* note 4.

18. This is so even if there is only the risk that the securities laws will be found to apply. Thus, when the SEC issues a *Framework*, *see supra* note 6, with 38 distinct considerations, many of which have subparts and some of which focus on the manner of distribution rather than the asset being distributed, the concern over which interests will be subject to the disclosure obligations can by itself be overly burdensome. SEC Commissioner Hester Peirce shared this concern in remarks made at a May 2019 SEC Enforcement Forum. Comm'r Hester M. Peirce, *How We Howey*, SEC. EXCH. COMM'N (May 9, 2019), https://www.sec.gov/news/speech/peirce-how-we-howey-050919 [hereinafter *Peirce Speech*].

19. The I.R.S. announced in March 2014 that "[f]or federal tax purposes, virtual currency is treated as property." *Virtual Currency Guidance*, I.R.S., https://www.irs.gov/irb/2014-16_IRB#NOT-2014-21 (Apr. 14, 2014). In its most recent pronouncement on the subject, dealing with airdrops and forks, the agency continued this general approach. *See* I.R.S. Rev. Rul. 2019-24, 26 C.F.R. 1.61-1.

20. The CFTC first asserted jurisdiction over Bitcoin in 2015. *Release Number 7231-15*, U.S. COMMODITY FUTURES TRADING COMM'N, (Sept. 17, 2015), [https://perma.cc/J7Z7-6JFG]. It did so more recently in a potential cryptocurrency offering that involved no future contract or swap. Keith Miller, Andrew P. Cross, and J. Dax Hansen, *CFTC Flexes Its Regulatory Muscle in a Case Involving a Virtual Currency*, VIRTUAL CURRENCY REPORT, https://www.virtualcurrencyreport.com/2018/01/cftc-flexes-its-regulatory-muscle-in-a-case-involving-a-virtual-currency/ (Jan. 29, 2018).

21. FinCEN was one of the earliest regulatory actors in the crypto space, taking the position that the Bank Secrecy Act provisions applied to persons involved in certain transactions in "virtual currencies." *See Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, FIN. CRIMES ENF'T NETWORK, https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering (Mar. 18, 2013). More recently, this approach was

involvement of state tax, securities, and banking authorities, many of which also regulate crypto.[22]

The focus of this Article is on how best to utilize the SEC's considerable expertise and resources in addressing problems posed by the creation and sale of cryptoassets.[23] Following this introduction, Part II describes the regulatory paradigm in which the SEC operates, including an exploration of how that regime has been applied to crypto. Part III then evaluates how well this system is working in the context of cryptoassets. Part IV considers some of the other suggestions for change that have been made, and Part V presents an alternative approach to regulation designed to strike a balance between the need to protect the public and the need to facilitate capital formation and innovation. The Conclusion reminds readers of why change is needed and why the suggestions in this Article could benefit regulators, entrepreneurs, and the public.

II. REGULATION OF CRYPTO IN THE CURRENT SYSTEM

A. CRYPTO AS A SECURITY

refined but essentially continued. FIN. CRIMES ENF'T NETWORK, U.S. TREASURY, FIN-2019-G001, APPLICATION OF FINCEN'S REGULATIONS TO CERTAIN BUSINESS MODELS INVOLVING CONVERTIBLE VIRTUAL CURRENCIES (2019).

22. Most commonly, state involvement with crypto focuses on the issue of whether crypto-based businesses are money transmitters. For a comparison of how states approach crypto regulation, *see* Frederick Reese, *Bitcoin Regulation by State (Updated 2018*), BITCOIN MARKET JOURNAL (Aug. 4, 2017, 9:49 PM), https://www.bitcoinmarketjournal.com/bitcoin-state-regulations/. However, state securities officials can also be involved. For example, in November 2018, "[t]he Securities Commissioner of the U.S. State of Texas … issued an Emergency Cease and Desist Order … against crypto investment firm My Crypto Mine and its principal Mark Steven Royer." Marie Huillet, *Texas Securities Commissioner Issues Cease and Desist Order to Crypto Investment Firm*, COINTELEGRAPH (Nov. 28, 2018), https://cointelegraph.com/news/texas-securities-commissioner-issues-cease-and-desist-order-to-crypto-investment-firm.

23. This Article assumes a basic familiarity with cryptoassets and blockchain, and therefore does not include an extended explanation of these terms and concepts. There are now several other articles that can provide this kind of background. For a consideration of important terminology relating to cryptoassets, *see* Carol Goforth, *The Lawyer's Cryptionary: A Resource for Talking to Clients About Crypto-Transactions,* 41 CAMPBELL L. REV. 47 (2019). For a more general discussion of how crypto and how the U.S. securities laws have been applied, albeit before the most recent pronouncements from the SEC, *see* Carol Goforth, *Securities Treatment of Tokenized Offerings Under U.S. Law*, 46 PEPP. L. REV. 405 (2019), and Thomas Lee Hazen, *Tulips, Oranges, Worms, and Coins - Virtual, Digital, or Crypto Currency and the Securities Laws*, 20 N.C. J.L. & TECH. 493 (2019).

In very general terms, the most important piece of legislation for persons seeking to sell securities is the Securities Act of 1933 (the '33 Act).[24] This act prohibits the offer or sale of securities in the U.S. without first being registered with the SEC or being exempt from registration.[25]

The '33 Act was obviously enacted long before the development of cryptoassets, but the drafters of the federal securities laws certainly foresaw the likelihood of future developments in fundraising and the capital markets, even if particular innovations were not predictable. The certainty that business and investment opportunities would change over time made it important for the securities statutes to include terms that clearly explained what a security was, while being flexible enough to encompass interests developed in the future.

Section 2 of the '33 Act contains a lengthy statutory definition of "security," which includes terms with specific, well-understood meanings as well as words that are more elastic and possess less defined parameters.[26] For purposes of crypto, the most important category of "securities" is anything that qualifies as an "investment contract."[27]

The phrase "investment contract" is not defined in the statute but rather by case law. In 1946, the U.S. Supreme Court held that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. . .."[28] Now simply known as the *Howey* test, this approach has been clarified so that it is clear that investments other than money will be sufficient,[29] and minor investor

24. The '33 Act is codified at 15 U.S.C. §§ 77a et seq. although many references to the Act are to sections from the Act, rather than relying on references to the U.S. Code.

25. This requirement appears in section 5 of the '33 Act, codified at 15 U.S.C. § 77e.

26. 15 U.S.C. § 77b(1).

27. The Securities Exchange Act of 1934 (usually '34 Act or Exchange Act), codified at 15 U.S.C. § 78, includes rules applicable to brokers and exchanges and has a definition that is similar albeit not identical to the definition that appears in the '33 Act. *Compare* 15 U.S.C. § 77b(1) *with* 15 U.S.C. § 78c(a)(10). Notwithstanding the differences in wording, the U.S. Supreme Court has indicated that the provisions should be interpreted as meaning the same things, or in other words, *in pari materia*. *E.g.,* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

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

29. While the *Howey* test originally spoke only of "money," subsequent opinions have made it clear that "cash is not the only form of contribution or investment that will create an investment contract. Instead, the 'investment' may take the form of 'goods and

participation will not prevent the last part of the test from being satisfied.[30] Thus, modern courts have rephrased the *Howey* test as requiring the following elements:

there is an investment of money (or something else of value);[31]

in a common enterprise;[32]

(iii) where the purchaser expects to receive profits;[33] and

(iv) the expectation of profits is from the essential entrepreneurial efforts of others.[34]

Even outside the context of cryptoassets, application of the *Howey* test is neither simple nor straightforward.[35] After adding in the complexities associated with the issuance and sale of cryptoassets,

services' or 'some other exchange of value.'" Uselton v. Commercial Lovelace Motor Freight, Inc., 940 F.2d 564, 574 (10th Cir. 1991) (internal citations omitted).

30. Although the Court in *Howey* said the expectation of profits needed to be based "solely" on the efforts of others, the rule has also been modified or clarified over time. *See* S.E.C. v. Glenn W. Turner Enterprises, 474 F.2d 476, 482 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973) (finding that the appropriate inquiry is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise"). *See also* Hocking v. Dubois, 885 F.2d 1449, 1455 (9th Cir. 1989) (holding that the test should be whose efforts are "significant" and "essential").

31. *See* Uselton, 940 F.2d at 574.

32. Howey, 328 U.S. at 299. The requirement of a "common enterprise" is the element of the *Howey* test that appears to have received the most comment over the years, in part because there is a divergence among the federal circuits. Some courts appear to require "horizontal commonality," some accept "strict vertical commonality," while others accept "broad vertical commonality." *See* Maura K. Monaghan, *An Uncommon State of Confusion: The Enterprise Element of Investment Contract Analysis,* 63 FORDHAM L. REV. 2135, 2152–63 (1995) (discussing the various judicial applications of the *Howey* "common enterprise" element). Horizontal commonality requires that investors' contributions be pooled together so their fortunes rise and fall together; strict commonality requires the investor and promoter or investment manager to have interests that are tied together, and broad commonality generally looks to whether the investor is depending heavily on the promoter in deciding whether to invest. *Id*. *See also* Benjamin Akins, Jennifer L. Chapman & Jason Gordon, *The Case for the Regulation of Bitcoin Mining as a Security*, 19 VA. J.L. & TECH. 669, 690 (2015). On the other hand, while cases and academic commentators alike have relied on these elements for decades, officials at the SEC have taken issue with the "common enterprise" requirement, suggesting in recent documents that the SEC "does not … view a 'common enterprise' as a distinct element of the term 'investment contract.'" *Framework, supra* note 6, at 12, n.10. Ironically, the text to which note 10 is appended and the note itself specifically recognize that courts do treat the *Howey* test as requiring a common enterprise as a distinct element.

33. Howey, 328 U.S. at 299. The "expectation of profits" element has also been addressed numerous times. The U.S. Supreme Court held in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), that in order for this element to be met, "the primary motivation for investing must be to achieve a return on the value invested." Akins et al, *supra* note 32, at 691.

34. *See* Glenn W. Turner Enterprises, 474 F.2d at 482; Dubois, 885 F.2d at 1455.

35. *See Id.; see also* Akins, *supra* note 32; *see also* Howey, 328 U.S. at 299.

and in particular the incredible diversity of crypto and ways in which such assets are distributed,[36] it is no surprise that the SEC has found it necessary to modify its position on cryptoassets multiple times and that entrepreneurs express widespread concern about the lack of clarity and certainty.[37]

The SEC's first position on cryptoassets was announced in connection with a digital venture capital fund that in some respects resembled conventional investment business models.[38] To many it was not surprising that this set up was treated as involving the proposed sale of securities under the *Howey* investment contract test. The apparent position that this kind of crypto-business involved the sale of securities quickly morphed into repeated statements that all cryptoassets appeared to be investment contracts,[39] and then that position evolved to exempt Bitcoin and Ether from securities regulation.[40] The original four-part *Howey* analysis was then converted into a framework with more than three dozen distinct sub-parts,[41] and there are indications under this approach that an interest that is a not a security at one point might later become one, or vice

36. Although Bitcoin and the first altcoins shared similar characteristics, generally having been designed simply to substitute for fiat currencies, there are now a wide range of interests that can function as cryptoassets. Some crypto might involve tokenized equity or debt interests. For example, a cryptotoken might include the right to repayment of the purchase price with interest, in lieu of more conventional bonds or debentures (depending on whether the repayment obligation is secured). Alternatively, a cryptoasset might be designed to function as an equity interest, conveying a right to share in an underlying business venture's anticipated profits or appreciation, possibly even giving voting rights on certain matters. In these cases, requirements designed for conventional debt or equity securities would make sense. On the other hand, crypto can have a wide range of functions, including membership privileges, rights of access, payment rights, the ability to stake claims to underlying assets or services, or otherwise. Treating all of these assets as if they all work in the same way creates a host of problems.

37. Even after the more recent guidance from the SEC in April 2019, one commentator expressly complained that the SEC "has so far failed to provide any reliable guidance as to which criteria it uses to determine whether a token qualifies as a security." Diego Zuluaga, *The SEC Can't Keep Kik-ing the Crypto Can Down the Road,* COINDESK (June 5, 2019, 18:45 UTC) [https://perma.cc/Y9JM-MHPQ]. The frustration evident in that comment is repeated by those involved in crypto businesses. *See, e.g.*, Laura Shin, *Crypto Companies and Investors Fed Up With The SEC,* FORBES (May 29, 2019, 7:00 AM), https://www.forbes.com/sites/laurashin/2019/05/29/crypto-companies-and-investors-fed-up-with-the-sec/?sh=49189da47701 (noting that crypto entrepreneurs have "been impatient with the lack of clarity from the SEC for months, or earnestly developing workarounds right into their technology so as to not serve U.S. customers…").

38. *See infra* Part II.A.1.

39. *See infra* Part II.A.2.

40. *See infra* Part II.A.3.

41. *See infra* Part II.A.4.

versa.[42] Recent no-action letters point to a very limited set of circumstances under which new cryptoassets are not likely to be securities,[43] leaving most crypto businesses in a very uncomfortable and uncertain position. The following paragraphs trace through these developments in somewhat cursory fashion.

i. *The DAO Report (2017)*

The initial position of the SEC with regard to when crypto should be treated as a security came in 2017,[44] in connection with an offering of DAO tokens.[45] The DAO was the brainchild of Slock-it, a foreign company established by some of the founders of the Ethereum blockchain.[46] As described in the SEC's 2017 report, The DAO "began as an effort to create a 'crowdfunding contract' to raise 'funds to grow [a] company in the crypto space.'"[47] In other words, the plan was that The DAO would operate as a kind of venture capital fund for other crypto projects.[48] Ownership of DAO tokens entitled the holder to vote on proposals by other crypto-based businesses. Successful proposals would be funded by The DAO, and DAO tokenholders would receive a share of anticipated earnings from those projects. The DAO was set up in such a way that a group of curators was required to screen and approve potential projects before making them available for a vote. If approved by a curator, a proposal would be submitted to a vote of DAO tokenholders, and any proposals

42. *See infra* Part II.A.5.

43. *See infra* Part II.A.6.

44. SEC, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, '34 Act Release No. 81207 (July 25, 2017), https://www.sec.gov/litigation/investreport/34-81207.pdf [https://perma.cc/F862-YS5V] (hereinafter *DAO Report*).

45. Usually, "DAO" stands for decentralized autonomous organization, which is an entity that is organized on a blockchain and operates through smart contracts. By coding the rules by which an organization is to operate on a blockchain, the organization becomes both decentralized and autonomous. "The DAO" project was a specific example of this kind of entity.

46. The coding for The DAO was developed by Slock.it, a German corporation created by some of the founders and early members of the Ethereum Community. For a recital of the facts surrounding the creation, rise, and fall of The DAO, see Samuel Falkon, *The Story of the DAO – Its History and Consequences*, Medium (Dec. 24, 2017), https://medium.com/swlh/the-story-of-the-dao-its-history-and-consequences-71e6a8a551ee [https://perma.cc/LU7M-BDM5].

47. *DAO Report, supra* note 44, at 4.

48. Falkon, *supra* note 46.

receiving a 20% vote of the total of outstanding tokens would be funded.[49]

Approximately 1.15 billion DAO tokens were issued in May 2016 in exchange for other tokens (Ether) then worth about $150 million,[50] making it one of the largest early ICOs (Initial Coin Offerings) to occur on the Ethereum platform.[51] The DAO failed not because of intervention by the SEC but as a result of an infamous hacking incident.[52] That episode eventually led to a much-publicized hard fork of the Ethereum blockchain.

At this time, the SEC's Division of Enforcement was investigating whether The DAO, its founders, and various intermediaries had violated U.S. securities laws by selling interests in The DAO in the U.S. without registering the offering or complying with any of the exemptions from registration. In July 2017, the SEC released its report.[53] After describing the offering, the SEC concluded that the tokens sold by The DAO were "investment contracts" under

49. *DAO Report, supra* note 44.

50. *Id*. at 2-3.

51. The entire process is described in some detail in the *DAO Report, supra* note 44 at 4-8. "ICO" was the label used to describe most early public sales of cryptoassets. While ICOs continue to occur, other kinds of distributions have been gaining in popularity. *See, i.e.,* Sam Stone, *Binance and the Rise of the Initial Exchange Offering (IEO)*, Medium (Jun 12, 2019), https://medium.com/cointracker/binance-and-the-rise-of-the-initial-exchange-offering-ieo-c45802e97fd3 [https://perma.cc/M7ER-FZPM]; Yuvai Halevi, *ICO vs STO: All You Need to Know About the New Fundraising Method in the Crypto World*, HackerNoon (Jan. 8, 2019), https://hackernoon.com/ico-vs-sto-all-you-need-to-know-about-the-new-fundraising-method-in-the-crypto-world-54a1a43a08d6 [https://perma.cc/3FUY-ZDCZ]; and Alvin Hagg, *ICO vs STO vs IEO,* FreeWallet (May 21, 2019), https://freewallet.org/blog/ico-sto-ieo.

52. The DAO also included an "out" in the event that the community invested in a proposal that a particular investor objected to, otherwise known as the "split function." The split function allowed users to back out of The DAO by creating a "Child DAO," to which contributed Ether would be returned after 28 days. On June 17, 2016, unidentified hackers found a loophole in this "split function," which allowed them to drain 3.6 million Ether (then worth about $70 million) by requesting multiple refunds of the same tokens before The DAO could update its records. The end result was a division in the Ethereum community.

The community at first considered a soft fork that would have blacklisted transactions from The DAO, but this was ultimately determined not to be a viable solution. Instead, the community split on the hard fork solution, which was designed to return the stolen Ether. Approximately 89% of Ether holders voted for this alternative, and it occurred in July of 2016, allowing the Ethereum Foundation to recover the stolen funds by unwinding certain transactions. This "hard fork" (essentially a mandatory revision to the coding of the smart contract) had "the sole function of returning all the Ether taken from The DAO to a refund smart contract."

53. *See DAO Report*, *supra* note 44.

the *Howey* test.[54] The SEC considered what it deemed to be the elements of *Howey*, beginning with the requirement that there be an investment of money.[55] The absence of a cash payment was found to be irrelevant, and instead, the SEC concluded that the payment of other cryptoassets was a sufficient contribution of value.[56] The second articulated element was the requirement that there be "a reasonable expectation of profits."[57] The payment of dividends or other periodic distributions from funded projects, such as those contemplated by The DAO, was found to meet this requirement.[58] The last identified element, whether the investors were relying on the managerial efforts of others, received a more detailed analysis.[59]

In concluding that this final element was present, the SEC focused first on the fact that "[t]he efforts of Slock.it, Slock.it's co-founders, and The DAO's curators were essential to the enterprise."[60] As noted by the SEC, "[t]he creators of The DAO held themselves out to investors as experts in Ethereum, the blockchain protocol on which The DAO operated, and told investors that they had selected persons to serve as Curators based on their expertise and credentials."[61] The selected curators had the power and responsibility to "(1) vet Contractors; (2) determine whether and when to submit proposals for votes; (3) determine the order and frequency of proposals that were submitted for a vote; and (4) determine whether to halve the default quorum required . . .."[62] The proper exercise of these powers was deemed by the SEC to constitute essential managerial efforts.

In addition, the SEC articulated several ways DAO tokenholders' voting rights were restricted,[63] further supporting the agency's conclusion that investors had to be relying on others. First, tokenholders could only vote on proposals that were pre-approved

54. *Id*. at § III.B.1, p. 11 (noting that "[a]n investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.").

55. *Id*. at § III.B.2, p.11.

56. *Id*.

57. *Id*. at § III.B.3, p. 11.

58. *Id*. at § III.B.3, p. 11-12 (finding that "The DAO was a for-profit entity whose objective was to fund projects in exchange for a return on investment.").

59. *Id*. at § III.B.4, p. 12-15.

60. *Id*. at § III.B.4(a), p. 12.

61. *Id*.

62. *Id*. at § III.B.4(a), p. 13.

63. *Id*. at § III.B.4(b), p. 13-15.

by the curators,[64] with limited information.[65] Proposals were not subject to feedback, instead being presented on a take-it or leave-it basis.[66] Tokenholders were widely dispersed, making it difficult for them to effectuate concerted change.[67] Even though online forums allowed communication, those were pseudonymous, making them an impractical mechanism for consolidating control.[68]

Given the combination of the important role of the curators and the practical barriers to effective communication and concentration of control by the tokenholders, the SEC concluded that The DAO's tokens were investment contracts. Because they had been sold without registration or an exemption, the sales violated the '33 Act prohibitions. The SEC declined to impose penalties because The DAO had immediately cooperated with the investigation, the operation had shut down (as a result of the hack), and funds had been returned to purchasers.

ii. *Everything is a Security (2017-18)*

The 2017 DAO Report was issued amidst a spate of critical statements made by SEC leadership in the context of ICOs, which had been quickly gaining in popularity since the initial success of The DAO offering in 2016. For example, in September 2017, Co-Director of the SEC's Enforcement Division, Steven Peikin, analogized persons seeking quick profits from ICOs to cockroaches.[69] Beginning in December 2017, then then-Chairman of the SEC, Jay Clayton, began repeating the mantra that most, if not all, ICOs involved the sale of

64. *Id*. at 14.

65. *Id*.

66. *Id*. at § III.B.4(b), p. 14.

67. *Id*.

68. *Id*. at 15.

69. Rachel-Rose O'Leary, *'Roaches': SEC Chief Speaks Out Against Malicious ICOs*, CoinDesk (Sept. 6, 2017), https://www.coindesk.com/roaches-sec-chief-speaks-malicious-icos [https://perma.cc/4T3L-FCW2]. Shortly before these remarks, the SEC announced that trading in three blockchain-related companies was suspended, further demonstrating the SEC's concern over crypto transactions. *SEC Suspends Trading in Securities of Three Blockchain-Related Companies*, Reed Smith (Aug. 29, 2017), https://www.reedsmith.com/en/perspectives/2017/08/sec-suspends-trading-in-securities-of-three-blockchain-related-companies [https://perma.cc/M8P6-RUEZ]. *See also* Michael Mendelson, *From Initial Coin Offerings to Security Tokens: A U.S. Federal Securities Law Analysis*, 22 Stan. Tech. L. Rev. 52, 69–70 (2019).

securities.[70] In February 2018, in testimony before the Senate Committee on Banking, Housing, and Urban Affairs, he testified that "every ICO token the SEC has seen so far is considered a security . . .."[71] While Chairman Clayton was always careful to explain that the SEC's approach required a consideration of the facts and circumstances of each transaction,[72] his comments were widely accepted as reflecting at least a rebuttable presumption that all ICOs involved the sale of securities.[73]

iii. *Except for Bitcoin and Ether (2018)*

In the summer of 2018, the SEC's Director of the Division of Corporate Finance, William Hinman, refined this general approach somewhat at the Yahoo Finance Summit.[74] To the surprise of some

70. *See, i.e.,* SEC, Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings,* SEC (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11 [https://perma.cc/TY9T-MKWX] ("By and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws.").

71. *See* Joseph Young, *SEC Hints at Tighter Regulation for ICOs, Smart Policies for "True Cryptocurrencies,"* CoinTelegraph (Feb. 9, 2018), https://cointelegraph.com/news/sec-hints-at-tighter-regulation-for-icos-smart-policies-for-true-cryptocurrencies [https://perma.cc/Z5KF-BXG9].

72. For example, in an explanation to the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Chairman Clayton emphasized that "determining what falls within the ambit of a securities offer and sale is a facts-and-circumstances analysis, utilizing a principles-based framework that has served American companies and American investors well through periods of innovation and change for over 80 years." SEC, Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings,* SEC (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11 [https://perma.cc/TY9T-MKWX] ("By and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws.").

73. *See, e.g.,* Daniel C. Zinman, et al., *SEC Issues Warning to Lawyers on ICOs,* Bloomberg Law (Feb. 22, 2018), https://news.bloomberglaw.com/tech-and-telecom-law/sec-issues-warning-to-lawyers-on-icos [https://perma.cc/FBB5-AWF9]. This source examines a number of recent pronouncements and actions taken by the SEC and concludes that "the SEC has essentially adopted a rebuttable presumption that ICO tokens are securities that must comply with the registration requirements of the securities laws." Evelyn Cheng, *The SEC Just Made it Clearer That Securities Laws Apply to Most Cryptocurrencies and Exchanges Trading Them,* CNBC (Mar. 7, 2018, 5:14 PM), https://www.cnbc.com/2018/03/07/the-sec-made-it-clearer-that-securities-laws-apply-to-cryptocurrencies.html [https://perma.cc/J7CY-CEZH].

74. *See* SEC, William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic),* SEC (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418 [https://perma.cc/H3YU-DX3K].

and the relief of others, Director Hinman acknowledged that not all cryptoassets are securities, specifically pointing to Bitcoin and Ether as examples of tokens that should not be viewed as securities. In the case of those two assets, Hinman suggested that the underlying network was "sufficiently decentralized," so that "purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts. . .."[75] He concluded that "[a]pplying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would seem to add little value."[76]

In his April 2018 testimony before the House Appropriations Committee, Chairman Clayton appeared to acquiesce in the view that Bitcoin, at least, would not be a security. He explained that "there are different types of cryptoassets. . .. A pure medium of exchange, the one that's most often cited, is Bitcoin. As a replacement for currency, that has been determined by most people to not be a security."[77] This is a relatively odd rationale to adopt, since, in fact, Bitcoin generally does not function well as a medium of exchange, given the high volatility of its pricing and the relatively small number of users who accept this asset as payment in lieu of fiat currency.[78] Nonetheless, the remarks appeared to confirm the SEC's position that older, well-established, decentralized cryptoassets might not all be securities.

iv. ***Supplementing Howey with a "Framework"***

A more recent development from the SEC regarding the appropriate treatment of cryptoassets is also its most comprehensive. On April 3, 2019, FinHub (an SEC portal designed to specifically engage with companies using blockchain and other innovative technologies)[79] released a detailed "Framework" explaining how the

75. *Id*.

76. *Id*.

77. Neeraj Agrawal, *SEC Chairman Clayton: Bitcoin is not a security*, COINCENTER (Ap. 27, 2018), https://www.coincenter.org/sec-chairman-clayton-bitcoin-is-not-a-security/ [https://perma.cc/S8MF-7AKH].

78. In fact, one commentator has posited eight distinct reasons why Bitcoin fails as a currency. Alex Dumortier, *8 Reasons Bitcoin Fails as a Currency*, THE MOTLEY FOOL (Ap. 18, 2019), https://www.fool.com/slideshow/8-reasons-bitcoin-fails-currency/ [https://perma.cc/QU3E-3D8P]. The listed reasons include at the very outset the reality that Bitcoin "has virtually zero acceptance as a means of payment." *Id*.

79. *See* Michael del Castillo, *SEC Launches Fintech Hub To Engage With Cryptocurrency Startups And More*, FORBES (Oct. 18, 2018), https://www.forbes.com/sites/michaeldelcastillo/2018/10/18/sec-launches-fintech-

SEC now plans to apply the *Howey* test to cryptoassets.[80] The Framework refers to crypto as "digital assets," and sets out a lengthy multi-factored approach to determine whether a particular form of crypto is a security.

In the Framework, the SEC suggests that the first two elements of *Howey* (an investment of money or something of value,[81] and a common enterprise[82]) are generally present in crypto sales.[83] Most of the document's discussion therefore focuses on whether a purchaser of a given cryptoasset has the reasonable expectation of profits derived from the efforts of others.[84]

In analyzing the third element, the Framework sets out dozens of considerations, some with multiple subparts.[85] While various characteristics are described as "especially relevant,"[86] the Framework also notes that no single characteristic is "necessarily" determinative.[87] Perhaps even more confusingly, the Framework suggests that interests may have to be reevaluated after the initial sale to determine whether an interest that was not originally a security might have become one.[88] With regard to whether there is a reasonable expectation of profits, the Framework lists several characteristics and suggests that the more that are present, the more likely the interest is to be a security.[89] The Framework does not,

hub-to-engage-with-cryptocurrency-startups-and-more/?sh=3c9e55135978 [https://perma.cc/2DJK-7RG2].

80. *Framework, supra* note 6. The accuracy of this assertion, especially in the context of transactions such as airdrops, is not universally accepted. *See infra* note 144. For a brief explanation of the framework, see SEC, Bill Hinman & Valerie Szczepanik, *Statement on "Framework for 'Investment Contract' Analysis of Digital Assets"* (Ap. 3, 2019), https://www.sec.gov/news/public-statement/statement-framework-investment-contract-analysis-digital-assets [https://perma.cc/5CVA-RYFB] (hereinafter referred to as "*Statement.*").

81. "The first prong of the *Howey* test is typically satisfied in an offer and sale of a digital asset because the digital asset is purchased or otherwise acquired in exchange for value, whether in the form of real (or fiat) currency, another digital asset, or other type of consideration" *Framework, supra* note 6 at § II.A, p. 2.

82. "Based on our experiences to date, investments in digital assets have constituted investments in a common enterprise because the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter's efforts. *See S.E.C. v. Int'l Loan Network, Inc.*, 968 F.2d 1304, 1307 (D.C. Cir. 1992)." *Framework, supra* note 6, at 2, n.11.

83. *Id.* at 2.

84. *Framework, supra* note 6, at 2-11.

85. *Id.*

86. *Id.* at § II.C.1, p. 3.

87. *Id.*

88. *Id.* a 5.

89. *Id.* at § II.C.2, p. 6.

however, give any indication of how many of the described characteristics will be necessary or sufficient and does not indicate if any of the specified items will be weighted more heavily than the others.

v. *Now it is; Now it isn't*

As previously mentioned, the Framework takes what appears to be the highly unusual position that a particular asset might be a security at one point, and then become something other than a security at a later point, or vice versa. In other contexts, the rule that "once a security, always a security" has been widely applied.[90] A classification scheme that changes over time poses significant problems for crypto businesses, since even if a particular form of crypto is not an investment contract at the time of the initial sale or issuance, later events outside the control of the developer, issuer, or initial seller might somehow convert the interest into a security, with an unpredictable impact on earlier transactions.[91] For example, suppose a crypto developer makes a token sale to persons that the developer has every reason to believe are purchasing for use rather

90. This is not actually a phrase typically used in connection with the investment contract analysis, although in practice it has generally taken a change in the nature of the interest being conveyed to turn something into a security when it previously lacked that characteristic. Consistent with this view, in *Marine Bank v. Weaver,* 455 U.S. 551 (1982), the U.S. Supreme Court rejected the argument that a certificate of deposit could change character "into a security when pledged, even though it was not a security when purchased." *Id*. at 559, n.9. Similarly, in *Gould v. Ruefenacht*, 471 U.S. 701(1985), the Court rejected the argument that corporate stock should cease being a security if the purchaser acquired control of the corporation. The Court disagreed, concluding that this "would lead to arbitrary distinctions between transactions covered [by securities laws] and those that are not." *Id*. at 702.

91. This is not at all the same thing as subsequent events that impact the availability of exemptions for particular sales. It is absolutely true, for example, that resales before a security come to rest may be integrated with initial sales, sometimes destroying the availability of exemptions. THOMAS LEE HAZEN & KRIS MARKARIAN, FEDERAL SECURITIES LAW (2011), § D. *Exemptions from Registration Under 1933 Act,* 2003 WL 23841279. This treatise explains that "[t]ransaction exemptions rise and fall with both the form and substance of the transaction and the nature of the participants. These exemptions, once available, can be destroyed when purchasers under the exemption resell the securities. Downstream sales have the potential to eradicate an existing exemption." Intrastate and private offerings could be impacted in this way, which is why issuers are generally well advised to place limitations on resales. *Id*. In all of these cases, however, the interest is a security; it is only the availability of the exemption that is in question. The general applicability of the securities laws does not change. This is a very different scenario than the situation when the same interest may on day one be something other than a security, and on day two suddenly become one even if the interest itself has not changed.

than as a speculative investment. Suppose also that some of those tokens are resold to persons clearly hoping to make a profit on their investment. The presence of investors at a later date could conceivably convert something that was not a security into a security long after the initial sale. Alternatively, if the developer conducts an airdrop where the recipients make no contribution at all and therefore have no expectation of profits or anything else, it might be expected that this is not the sale of investment contracts. However, if the crypto is later sold to third parties, you could easily find investors who do expect profits, which could theoretically convert everything into securities. On the other hand, an asset that is sold as a security might later become something other than a security if it becomes so widely held that only market forces are expected to control pricing.

The fact that a security might at some future point cease to be a security may not present any significant risks to entrepreneurs or others.[92] Unfortunately, a test that does not yield consistent results could be highly problematic and unpredictable when something that is not a security at the time of sale later becomes subject to the requirements of the federal securities laws.

vi. *No Action Letters*

Alongside the Framework, the SEC released its first no-action letter opining that a newly created cryptoasset would not be a security under the terms described in the request.[93] Unfortunately, factors that the SEC mentions as being important to its decision in the TurnKey Jet case also reveal that the no-action letter is unlikely to be relevant to most cryptoassets.[94] First, the applicant made it clear that the token-generated funds could not be used to develop the underlying technology, which was already functional. [95] The tokens were to be sold at a fixed price of one dollar, and could be used only

92. For example, the SEC has hinted that the widespread distribution of both Bitcoin and Ether have allowed them to become so "decentralized" that they can no longer be considered securities. *See supra* Part II.A.3. Presumably, when these cryptoassets were originally issued, the distribution would have been narrower, meaning that the securities laws could have applied to the asset, which has not significantly changed its nature in the intervening period of time.

93. TurnKey Jet, Inc., *Response of the Division of Corporation Finance* (Apr. 3, 2019), https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm [https://perma.cc/E399-FSR3] (hereinafter "*TurnKey Jet*").

94. *Id*.

95. *Id*.

to obtain air charter services. [96] Repurchases would only be made at a discount, and there was to be no representation that there would be any profit potential because the tokens were not transferable.[97] It is the non-transferability, in particular, that radically limits the general usefulness of this particular no-action letter.

A second no-action letter involving a cryptoasset was issued by the SEC a few months later.[98] Pocketful of Quarters, referred to as "PoQ" in the letter, asked for the SEC to opine on its ERC-20 "Quarters," a token that represents a small amount ($0.0025 in Ether) that would be locked up on a smart contract functioning in the context of online gaming platforms.[99] As was the case in the earlier TurnKey no-action letter,[100] the PoQ Quarters were already functional, and funds raised from the sales of the tokens would not be used to fund development of the programming.[101] In addition, the Quarters were not designed to be resold or transferrable outside of the PoQ closed platform and could not be traded between players.[102] Given these factors, PoQ represented, and the SEC relied on the argument, that price appreciation would be "highly unlikely, if not practically impossible."[103]

As with the TurnKey tokens,[104] the proposed PoQ Quarters appear to be substantially different from typical cryptoassets. On the other hand, at least some commentators regarded this second no-action letter as a progressive development since Quarters are potentially transferable to third-parties, albeit only on the closed PoQ platform.[105]

96. *Id*.

97. *Id*.

98. Pocketful of Quarters, Inc., (July 25, 2019), *Response of the Division of Corporation Finance* https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1 [https://perma.cc/6GTP-7Z7C] (hereinafter "*PoQ*").

99. For a thoughtful explanation of the PoQ request and the SEC response, see Mitchell Moos, *SEC issues no-action letter for Ethereum token "Quarters," what it means for crypto,* CryptoSlate (July 26, 2019), https://cryptoslate.com/sec-issues-no-action-letter-ethereum-quarters-crypto/ [https://perma.cc/52JC-HLWJ].

100. *TurnKey Jet, supra* note 93.

101. *PoQ, supra* note 98.

102. *Id*.

103. *Id*.

104. *See supra* notes 93-97 and accompanying text.

105. Among the commentators who have applauded the PoQ no-action letter as a step in the right direction are Caitlan Long, a well-known and respected blockchain lawyer who co-founded the influential Wyoming Blockchain Coalition and Marco Santori, an influential fintech attorney formerly with Cooley LLP who helped develop the original Protocol Labs SAFT white paper. *See* Moos, *supra* note 99.

vii. *Confusion and Uncertainty*

The FinHub Framework was clearly intended to be helpful to members of the crypto community, including developers, issuers, and their counsel. However, the overall utility of a framework that is not an official rule or pronouncement, includes 38 different considerations (some with additional subparts), and neither prioritizes nor indicates the degree of significance for any such consideration, is questionable at best.

Shortly after the Framework and TurnKey no-action letters were released, SEC Commissioner Hester Peirce gave a speech addressing her concerns about the approach suggested by the new document.[106] Her assessment of the Framework was less than glowing, noting that the document could "raise more questions and concerns than it answers."[107] As she observed:

While *Howey* has four factors to consider, the framework lists 38 separate considerations, many of which include several sub-points. A seasoned securities lawyer might be able to infer which of these considerations will likely be controlling and might therefore be able to provide the appropriate weight to each. . . . [N]on-lawyers and lawyers not steeped in securities law and its attendant lore will not know what to make of the guidance. Pages worth of factors, many of which seemingly apply to all decentralized networks, might contribute to the feeling that navigating the securities laws in this area is perilous business.[108]

The SAFT project was an attempt to create relatively simple documentation for a two-step fund-raising process through which businesses would first sell contractual rights to tokens to be delivered when developed, followed by a second broader public distribution of the functional tokens. The intent was to create a process whereby companies could comply with one or more exemptions for the first stage of the fundraising process, which was anticipated to involve the sale of a security, followed by a wider sale of utility tokens that would not be securities and therefore would fall outside the scope of the federal securities laws. For a fuller discussion of the SAFT process see the whitepaper: Juan Batiz-Benet, Jesse Clayburgh, & Marco Santori, *The SAFT Project: Toward a Compliant Token Sale Framework (*Oct. 2, 2017), https://www.cooley.com/~/media/cooley/pdf/reprints/saft-project-whitepaper.ashx [https://perma.cc/XDP4-MQU5].

106. *See* Peirce Speech, *supra* note 18.

107. *Id*.

108. *Id*.

However, on July 8, 2019, the SEC, in a Joint Statement along with FINRA,[109] reiterated its commitment to the positions taken in the Framework. This Joint Statement did, however, more definitively articulate the position that some cryptoassets would not be securities. In explaining the decision to utilize the phrase "digital asset security" in that statement, the SEC and FINRA explained that in their view, digital assets, defined to include (without limitation) virtual currencies, coins, and tokens, "may or may not meet the definition of a 'security' under the federal securities laws."[110] The precise parameters of when such interests would be regulated as securities were not laid out in the statement.

B. KIK AND TELEGRAM

The reality is that the "correct" application of the *Howey* investment contract test to cryptoassets has yet to be determined. This might not be surprising given that most entrepreneurs in the crypto space lack the resources to go head-to-head with the SEC in protracted litigation. It appeared this might change in the summer and fall of 2019 with not one but two major cases being initiated.

On June 6, 2019, the SEC filed a lengthy complaint in the Southern District of New York, alleging that a Canadian social media company, Kik Interactive Inc., had violated the federal securities law by selling a trillion unregistered tokens which it called "Kin."[111] Kik promptly launched a crowdfunding initiative to help oppose the SEC's attempted enforcement action, creating a defense fund of more than $5 million.[112] A significant basis of its defense is that the Kin tokens it sold were not investment contracts.[113] Kik also asserted that

109. *Digital Asset Securities, supra* note 6. It should, however, be noted that this statement is not a rule, regulation, guidance, or official pronouncement of the SEC and has no legal force or effect. *Id*. at n. 2.

110. *Id*. at n.1.

111. *See* S.E.C. v. Kik Interactive Inc., Complaint, https://www.sec.gov/litigation/complaints/2019/comp-pr2019-87.pdf [https://perma.cc/R8KU-CJD3].

112. Kik's crowdfunding initiative, called "Defend Crypto," collected approximately $1.9 million by the end of June 2019, in addition to the $5 million paid in by Kik itself. Nikhilesh De, *Blockchain Association Takes Over Kik's 'Defend Crypto' Crowdfunding Effort*, YAHOO! FINANCE (June 28, 2019), https://finance.yahoo.com/news/blockchain-association-takes-over-kik-130040612.html [https://perma.cc/LM8W-2SB4].

113. The Kik answer has been described as "fairly combative." *BitBlog Weekly Summary: Kik Kicks Back and the SEC continues its enforcement campaign against ICOs*, THE NAT'L L. REV. (Aug. 19, 2019), https://www.natlawreview.com/article/bitblog-weekly-

the SEC's approach to defining when cryptoassets were investment contracts is unconstitutionally vague.[114]

Parallel to the Kik litigation, the SEC also initiated an enforcement action against Telegram Group Inc. and Ton Issuer Inc. (jointly referred to as Telegram in the complaint and in this Article) alleging that they violated the federal securities laws by conducting an unregistered digital token offering in the U.S. and overseas.[115] Telegram had already raised $1.7 billion from accredited investors who had purchased contractual rights (SAFTs)[116] that were designed to allow them to acquire digital tokens to be known as Grams when those assets were released. Before the Grams could be issued, the SEC filed an emergency action and obtained a TRO to prevent Telegram from "flooding the U.S. markets with digital tokens that we allege were unlawfully sold."[117]

Both Kik and Telegram had significant assets at their disposal to fight the SEC and considerable financial incentives to oppose the SEC approach. The Telegram suit moved faster, and on February 19, 2020, the SEC and Telegram presented arguments on the "economic realities" of the tokens that were to be issued, presenting their positions on the issue of whether the securities laws had been violated.

summary-kik-kicks-back-and-sec-continues-its-enforcement-campaign [https://perma.cc/3ZAY-QSRL]. A copy of Kik's answer can be found online at https://www.scribd.com/document/420998937/Kik-Response-to-SEC#from_embed?campaign=SkimbitLtd&ad_group=100652X1574425X2ec01739337c375e5407e33ba209d751&keyword=660149026&source=hp_affiliate&medium=affiliate

114. *Id*.

115. S.E.C. v. Telegram Group, Inc., No. 19 Civ. 9439 (PKC) (S.D.N.Y. filed Oct. 11, 2019). A copy of the SEC's complaint is available online at https://www.sec.gov/litigation/complaints/2019/comp-pr2019-212.pdf.

116. A SAFT, or Simple Agreement for Future Tokens, is a process that was designed to allow crypto entrepreneurs to raise funds in anticipation of the development of a functional "utility token." The goal of the project was to facilitate compliant token sales through the sale of contractual rights that would be securities and would require registration or an exemption, followed by a later distribution of a functional token that would not qualify as an investment contract. For a fuller discussion of the SAFT process see the whitepaper: Juan Batiz-Benet, Jesse Clayburgh, & Marco Santori, *The SAFT Project: Toward a Compliant Token Sale Framework* (Oct. 2, 2017), https://www.cooley.com/~/media/cooley/pdf/reprints/saft-project-whitepaper.ashx [https://perma.cc/XDP4-MQU5]. Both the Kik and Telegram sales were conducted through SAFTs or SAFT-like processes.

117. SEC, Press Release, SEC Halts Alleged $1.7 Billion Unregistered Digital Token Offering (Oct. 11, 2019), https://www.sec.gov/news/press-release/2019-212 [https://perma.cc/759K-97DH].

On March 24, 2020, the court granted the SEC's request for a preliminary injunction, halting the proposed sale of Grams on the grounds that the SEC had "shown a substantial likelihood of success in proving that the contracts and understandings . . . would be an integral part of the sale of securities without a required registration statement."[118] Telegram sought to limit the scope of the order to U.S. purchasers, but on April 1, 2020, Judge Castel refused to limit his ruling on the basis that there was a substantial risk of resales to U.S. citizens.[119] Telegram abandoned its proposed crypto-offering in the wake of this decision,[120] discontinuing an appeal to the Second Circuit and agreeing to return $1.2 billion to investors worldwide and to pay a fine of $18.5 million to the SEC.[121]

On September 30, 2020, the court ruled in favor of the SEC on its motion for summary judgment, concluding that the "two phases" of the Kik offering were intertwined so that the sale of contractual rights and the eventual public offering of Kin tokens were part of a single plan of financing with a single purpose amounting to "an unregistered offering of securities that did not qualify for exemption."[122] The judge relied on an extensive analysis of the *Howey* investment contract test in determining that the Kik had conducted an illegal sale of securities.[123]

The ultimate impact of these two decisions, both of which came out of the Southern District of New York, is uncertain. There is no way of knowing if other courts will agree with the analysis employed in those cases, and that uncertainty is likely to continue until and

118. S.E.C. v. Telegram Group, Inc., No. 19 Civ. 9439 (PKC) at 2 (S.D.N.Y., order of March 24, 2020), https://s3.cointelegraph.com/storage/uploads/view/c527a1e90d0e61f7470ee7ffca156e03.pdf?_ga=2.187482024.1278622065.1585599576-2031387624.1582929207 [https://perma.cc/4WWK-LKBX].

119. *See S.E.C. v. Telegram Group Inc*, No. 1:2019cv09439 - Document 234 (S.D.N.Y. 2020), https://law.justia.com/cases/federal/district-courts/new-york/nysdce/1:2019cv09439/524448/234/ [https://perma.cc/G585-TSFC].

120. *See* Kevin Helms, *Telegram Drops TON Cryptocurrency Project After US Prohibits Global Distribution,* Bitcoin.com (May 13, 2020), https://news.bitcoin.com/telegram-ton-cryptocurrency/ [https://perma.cc/9K2N-VWTU].

121. SEC Press release, *Telegram to Return $1.2 Billion to Investors and Pay $18.5 Million Penalty to Settle SEC Charges,* Rel. 2020-146 (June 26, 2020) (https://www.sec.gov/news/press-release/2020-146).

122. SEC v. Kik Interactive Inc., No. 19 Civ. 5244 (AKH) (S.D.N.Y. Sept. 30, 2020) (Opinion and Order on Motions for Summary Judgment) at 17, https://www.courtlistener.com/docket/15722539/88/us-securities-and-exchange-commission-v-kik-interactive-inc/ [https://perma.cc/43WJ-K7JA].

123. *Id*. at 8-14.

unless the Supreme Court issues a definitive ruling on the subject. Until then, considerable resources are being devoted to the preliminary question of whether and when crypto is within the regulatory authority of the SEC, a problem for entrepreneurs and regulators alike. Not only is the lack of clarity inefficient, it stifles innovation with no clear offsetting benefits. And, in the final analysis, even if crypto is eventually found to be a security by the courts in most cases, the underlying regulatory framework is still out of step with the needs of potential entrepreneurs and investors alike.

C. TO WHOM DO THE REQUIREMENTS APPLY?

Assuming that the position of the SEC is correct, and that most offerings of crypto do involve the sale of securities, the federal securities laws make it illegal to offer or sell the cryptoasset unless it is first registered or exempt from registration.[124] The registration process is incredibly expensive and time consuming[125] and requires voluminous disclosures. Much of the required information seems to have little direct relevance to the primary interests of crypto investors and some of required data is simply outside the knowledge or control of the issuer.[126] Many potential exemptions are also expensive and require similar disclosures.[127] They are also often complex enough to require the assistance of experienced securities counsel.[128]

124. This is the clear import of section 5 of the '33 Act. 15 U.S.C. § 77e.

125. The first time a business sells its securities publicly, it is said to be conducting an initial public offering, or IPO. The registration expenses incurred in an IPO are costly. One survey conducted by Oxford Economics reported that 83% of CFOs estimated spending more than $1 million on one-time costs associated with the IPO, not including underwriting fees. Results reported in PWC, *Considering an IPO to Fuel your Company's Future?*, https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf [https://perma.cc/8P62-Q97X]. (A summary is archived at https://www.pwc.com/us/en/services/deals/library/cost-of-an-ipo.html [https://perma.cc/459M-57PS). PWC suggests that the average total cost of an IPO (with underwriting, legal and accounting fees included) is approximately $4.2 million. In addition to the expense, the time required is also significant. An IPO takes between 90 days to 6 months to complete (from the company's decision to go public up through the SEC's declaration that the registration is "effective"), depending on the complexity of the underlying transactions necessary to get the company in shape for the sale. *Id*. at 2.

126. For a consideration of how the kinds of disclosures required in a registration mesh with the probable needs of most crypto purchasers, see *Cybersecurity, supra* note 4, at Part III.A.

127. *Id.,* at Parts III.B & C.

128. Even attorneys are often cautioned about the complexities of the law in this arena. Raising capital is often a necessary step for any business seeking to grow. Although an ordinary, seemingly straightforward business decision, capital raising operates within a

The '33 Act prohibits all public sales of securities unless there is an available exemption, regardless of who created the security or whether the transaction involves an initial sale or a resale.[129] Fortunately, there is a general exemption for anyone other than the issuer, underwriter, or any securities dealer,[130] but in the context of cryptoassets, the "issuer" of the securities may not be clear, and the question of who counts as an underwriter or dealer may be equally complicated.

These are defined terms, but the statutory provisions were not written with cryptoassets in mind. For example, the term "issuer" is defined in the '33 Act as "every person who issues or proposes to issue any securities" with certain exception for certificates of deposit; voting-trust certificates; unincorporated investment trusts; unincorporated associations, trusts, or entities providing limited liability to members; and undivided fractional interests in mineral rights.[131] To say that an issuer is someone who issues something is completely circular, especially when "issue" is never defined.

Perhaps in the context of conventional securities there was no need for greater clarity because the legal person creating the equity or debt interest is generally readily identifiable. That is not necessarily the case for cryptoassets.

In one sense, the "issuer" of crypto is the computer program, which operates to create the unique string of numbers that constitutes the totality of a cryptoasset's physical existence. Unfortunately, as mentioned above, "issuer" is defined in the federal securities laws to include "persons" which means legally recognized individuals,

heavily regulated arena—at both the state and federal levels. The substantial regulation stems from the fact that when outside funding is sought for a business operation, it often, if not usually, involves the sale of a "security." This is critical, as the sale of a security requires SEC compliance, and failure to comply can result in potentially severe consequences. For this reason it is imperative that attorneys practicing in this area be familiar with the definition of a security and how to identify when a security is present in order to avoid the consequences of selling a security in violation of the securities laws.

Zachary Bruchmiller, *Navigating the Private Offering Exemptions: A Guide for Practitioners*, 46 No. 1 SEC. REG. L.J. (Spr. 2018) (fn omitted).

129. 15 U.S.C. § 77e.

130. Section 4(a)(1) of the '33 Act exempts transactions by "any person other than an issuer, underwriter, or dealer." 15 U.S.C. § 77d(a).

131. 15 U.S.C. § 77b(a)(4). The '34 Act similarly defines "issuer" to mean "any person who issues or proposes to issue any security," with a shorter list of exceptions. 15 U.S.C. § 78c(8). Neither the '33 nor '34 Act defines what it actually means to "issue" a security.

associations, and entities.[132] To date, computer programs are not generally recognized as legal persons.[133]

If you disregard the computer program, that leaves the persons who wrote the protocol, those who control its refinement, those who promote it, those who install it on their computers and act as nodes, and those who mine the asset (assuming the asset is one of the minable forms of crypto). That is an incredibly wide and diverse group of persons who are unlikely to be acting in concert on most "decisions." The consensus protocol that replaces management decisions in a conventional business enterprise is so distributed for many cryptoassets that identifying "the" issuer responsible for disclosures may often be impossible.

Consider what this means for a cryptoasset such as Bitcoin. The person or persons who used the pseudonym "Satoshi Nakamoto" wrote about the potential to create blockchains for digital assets using new consensus protocols in 2008 and launched the Bitcoin protocol with open-source software in 2009.[134] Thereafter, he, she, or they allowed the program to operate with new Bitcoins being "created" and credited to Bitcoin miners in accordance with the terms of the underlying software. Who is "issuing" those cryptoassets? No one has definitively identified the "real" Satoshi Nakamoto, and the

132. In both the '33 and '34 Acts, "person" is also specifically defined. In the '33 Act, the definition is "an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or a government or political subdivision thereof," with further limitations on the when a "trust" is within the scope of the Act. 15 U.S.C. § 77b(a)(2). "Person" is defined in the '34 Act as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government." 15 U.S.C. § 78c(a)(9). Note that neither definition of "person" references anything like a computer program or artificial intelligence.

133. Restatement (Third) of Agency § 1.04 (Am. Law. Inst. 2006) ("Likewise, a computer program is not capable of acting as a principal or an agent as defined by the common law. At present, computer programs are instrumentalities of the persons who use them."). A decade earlier, two commentators offered three reasons for conferring legal personhood on autonomous computer programs, including moral expediency (which even the authors acknowledged to be controversial), social reality given that the law already recognizes other artificial legal persons, and legal expediency. *See* Tom Allen & Robin Widdison, *Can Computers Make Contracts?*, 9 HARV. J.L. & TECH. 25, 35-43 (1996). However, it is generally accepted that, as of yet, the law has declined to extend the rights and responsibilities of legal personhood on computer programs. *See* Bert-Jaap Koops et. al, *Bridging the Accountability Gap: Rights for New Entities in the Information Society*?, 11 MINN. J.L. SCI. & TECH. 497, 512 (2010) ("[S]o far, only natural persons, specific types of companies, associations, a trust fund, and public bodies have been attributed legal personhood.").

134. Satoshi Yakamoto, *Bitcoin – A Peer-to-Peer Electronic Cash System*, [https://bitcoin.org/bitcoin.pdf.2008]. This "whitepaper" originally appeared in an online discussion of cryptography.

wallets used by that person or persons have been untapped for some time. We do not even know if Satoshi is still alive. But if the issuer is not Satoshi, who is it? If the computer program itself cannot be the issuer because it is not a legal person, then this question is difficult to answer.

In the context of most, but not all, cryptoassets, it is possible to identify the programmers, and often the legal person who has commissioned the development of the program. Sometimes the "token" is actually pre-functional and is being developed on behalf of an entity or association of persons as a work for hire, in which case the issuer may be easy to identify (as in the case of traditional securities). In some instances, however, the programmers may be working alone, and their actual identities may not be known.[135] In addition, even if authorities can identify who wrote the code, that does not necessarily mean those persons are responsible for "issuing" the resulting digital assets.

Further complicating matters is the definition of "underwriter" which as used in the '33 Act means:

[A]ny person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such

135. Obviously, the programmers know who they are, but this information is not necessarily shared with others. For example, in addition to Bitcoin (where no programmer's identity is known), five of the seven developers for Monero have kept their identities secret. *The Complete Guide to Monero Cryptocurrency,* BITDEGREE (Dec. 31, 2019), [https://perma.cc/P2A9-KRYZ].In other cases, there are conflicting reports about who created the programming needed to develop particular cryptoassets. Cardano claims that it was developed by a "global team of leading academics and engineers." *What is Cardano?* CARDANO (Jan. 17, 2020, 9:02 AM), [https://perma.cc/6UA5-T27K]. *What is Cardano*? CARDANO ROADMAP (Jan. 17, 2020, 9:09 AM), [https://perma.cc/M4UH-LAAH] ("Cardano is designed by a global team of experts who are leaders in disciplines ranging from distributed systems to programming languages and game theory and is jointly developed by IOHK and partners."). Other sources credit Charles Hoskinson with being the "creator" of Cardano. *See* Marie Huillet, *If Bitcoin fails, Crypto Industry in for a Bad Time: Cardano Founder*, COINTELEGRAPH (Oct. 11, 2019), [https://perma.cc/EZS7-Z3XQ]. This kind of information makes it hard to pinpoint who actually developed the cryptoasset in question. Even where there is agreement on the identity of the development team, if the group is too dispersed or amorphous, identification of who has sufficient responsibility to make them a promoter of the asset may be challenging. For example, NEO is a decentralized, open-source cryptocurrency launched in China. *See NEO Cryptocurrency: Everything You Need to Know about China Ethereum*, CoinSutra (Aug. 12, 2019), [https://perma.cc/DU8M-FPC9]. Da Hongfei and Erik Zhang are identified as co-founders of the platform and "co-developers," along with "other community developers" and contributors. *Id*.

term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.[136]

To determine who is considered an underwriter, it is first necessary to identify the issuer, since an underwriter includes anyone who "purchased" from the issuer or is acting for the issuer in connection with a distribution of securities as well as anyone participating in those efforts. Without knowing who counts as the issuer, it is virtually impossible to know who counts as an underwriter. In addition, there are some kinds of transactions that may or may not lead to someone being a potential underwriter. For example, can you classify the recipient of an airdrop or a crypto miner as a purchaser who has acquired the cryptoasset with a view to distributing it?[137] These are not simple questions to answer.

In addition, dealers are also ineligible for the usual exemption for resales.[138] A "dealer" under the '33 Act is "any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person."[139] To apply this definition, it may again be necessary to know what other "person" "issued" the securities, although it is also

136. 15 U.S.C. § 77b(a)(11).

137. An airdrop is "the process whereby a cryptocurrency enterprise distributes cryptocurrency tokens to the wallets of some users free of charge. Airdrops are usually carried out by blockchain-based startups to bootstrap their cryptocurrency projects." *What are "Airdrops" in Crypto World?* MEDIUM (Feb 15, 2018), [https://perma.cc/DCN8-TB8E]. For a further description of airdrops, *see* Carol Goforth, *It's Raining Crypto: The Need for Regulatory Clarification When it Comes to Airdrops*, 15 INDIAN J. OF LAW AND TECH 322, 323-26 (2019). It should be fairly obvious why these transactions may be distinguishable from "purchases," which generally required payment of something as consideration.

"Mining" also differs from conventional purchase transactions. Instead of "paying" the seller to obtain something of value, a miner participates in the process of validating and verifying transactions in order to add them to the blockchain's public ledger. Successful mining typically requires being the first to solve a computationally difficult mathematical problem, which is incentivized by the reward of new cryptoassets. For a more detailed description of the process and what it entails, s*ee* Jason Evanelho, *Mining 101: An Introduction To Cryptocurrency Mining*, FORBES (Mar. 13, 2018), [https://perma.cc/ZPE7-VFBX].

138. *See* 15 U.S.C. § 77d(a)(1), *see generally* note 137.

139. 5 U.S.C. § 77b(a)(12).

possible that the SEC or the courts could simply say that the dealer is someone who did not issue the securities, meaning some other person had to have issued it. Thus, if an individual is "in the business" of trading in crypto, they could be a dealer. Since the usual function of many forms of crypto is to trade to make a profit (since it is relatively difficult to use most crypto to pay for goods or services),[140] this could theoretically mean that almost all crypto purchasers are "dealers," even if they trade only sporadically.

The uncertain breadth of the '33 Act is not the only problem associated with classifying crypto as a security under the *Howey* test. Under the Securities Exchange Act of 1934 ('34 Act or Exchange Act), when crypto is classified as a security, anyone acting to provide brokerage services becomes subject to the federal securities laws.[141] As explained in a recent statement from the SEC (and FINRA), this can potentially apply to anyone who "buys, sells, or otherwise transacts or is involved in effecting transactions in digital asset securities for customers or its own account . . .."[142] In addition to serving as a trap for the unwary or uninformed, one of the potentially more problematic requirements when crypto brokers are regulated under the securities laws involves custodial requirements that even the SEC and FINRA recognize as including "established laws and practices regarding the loss or theft of a security, that may not be available or effective in the case of certain digital assets . . .."[143]

140. A list of places where it was possible to "spend" cryptocurrencies in 2020 can be found at Aziz Bin Zainuddin, *Spend Bitcoin: Top Places Accepting Crypto Payments in 2020*, https://masterthecrypto.com/spend-bitcoin/ [https://perma.cc/8H58-9QR7]. Note that some of the sites listed accept very limited forms of crypto.

In stark contrast to the limited venues in which to spend crypto, there are literally thousands of calls to "invest in" or "profit" from trading in various cryptoassets. *See,* Hunter Kuffel, *How (and Where) to Invest in Cryptocurrency*, SMARTASSET (Jan. 15, 2020), [https://perma.cc/9BS6-8X4Y] (touting the opportunity for "big gains" for those who tolerate big risks); *How to Profit from Cryptocurrency,* HACKERNOON (Ap. 20, 2019), [https://perma.cc/SP6K-QBS4]; Top *13 Top Ways to Make Money with Cryptocurrency* (In 2020), COINSUTRA (Dec. 9, 2019), [https://perma.cc/DA8V-YYHL]; *8 Ways to make money with crypto,* BITSPARK (Dec. 11, 2019), [https://perma.cc/RP9U-A7WX]; *How to Make Money Investing in Cryptocurrency (in 2019),* TRADING STRATEGY GUIDES (Jul. 29, 2019), [https://perma.cc/FZN6-MFNR]; Ameer Rosic, *How to Invest in Cryptocurrencies: The Ultimate Beginners Guide,* BLOCKGEEKS (Feb. 21, 2019), [https://perma.cc/8C5B-QDYF].

141. *See Digital Asset Securities, supra* note 6.

142. *Id*. These rules may require any such person to register with the SEC, and "become a member of and comply with the rules of a self-regulatory organization ("SRO"), which in most cases is FINRA." *Id*. This includes financial responsibility rules such as those embodied in Rules 15c3-1, 15c3-3, 17a-5, and 17a-13 under the '34 Act. These rules are codified at 17 CFR §§ 240.15c3-1, 15c3-3, 17a-5, 17a-13 (1934).

143. *Digital Asset Securities, supra* note 6. *See* 17 CFR § 240.15c3-3 (1934).

Finally, there are unique problems for crypto exchanges, which may also be within the reach of securities regulators if the underlying assets are classified as securities.[144] The SEC has taken the position that crypto exchanges are subject to these rules.[145] A public statement issued by the SEC on November 16, 2018, explicitly declared that "[a] platform that offers trading in digital asset securities and operates as an "exchange" (as defined by the federal securities laws) must register with the Commission as a national securities exchange or be exempt from registration."[146]

Exchange Act Rule 3b-16 provides a functional test to assess whether an entity meets the definition of an exchange under Section 3(a)(1) of the Exchange Act. An entity that meets the definition of an exchange must register with the Commission as a national securities exchange or be exempt from registration, such as by operating as an alternative trading system ("ATS") in compliance with Regulation ATS.[147]

This array of regulatory responses makes it very difficult for crypto businesses to function effectively within the borders of the U.S. As a result, several crypto offerings have been designed to exclude

144. Exchanges are also regulated under the '34 Act. *See* 15 U.S.C. §78c(a)(1) (defining "exchange,"). *See also* 15 U.S.C. § 78e (making it unlawful for brokers, dealers, or exchanges to effect transactions in securities on any unregistered, non-exempt exchange).

145. In the Matter of Zachary Coburn, Exchange Act Release No. 84553 (Nov. 8, 2018) [hereinafter *EtherDelta Opinion*] the SEC brought an enforcement action against Zachary Coburn, who had created and operated the EtherDelta crypto exchange. In that opinion, the SEC assessed a fine against Coburn, but provided scant guidance on why the exchange was subject to its jurisdiction. Following citations to the SEC's *DAO Report* (*see supra* note 44), the EtherDelta Opinion merely emphasizes that EtherDelta was designed to operate with Ether and ERC-20 tokens. *EtherDelta Opinion*, *supra* this note, at 9. This appeared to be sufficient for the SEC to conclude that the exchange needed to operate in compliance with the securities laws. *Cf.* Michael J. O'Connor, *Overreaching Its Mandate? Considering the Sec's Authority to Regulate Cryptocurrency Exchanges*, 11 DREXEL L. REV. 539, 539 (2019).

146. *Statement on Digital Asset Securities Issuance and Trading*, PUBLIC STATEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION (Nov. 16, 2018), [https://perma.cc/XKY2-ZHV8].

147. *See* SEC, Regulation of Exchanges and Alternative Trading Systems, Exchange Act Rel. No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998), https://www.gpo.gov/fdsys/pkg/FR-1998-12-22/pdf/98-33299.pdf.

U.S. investors from participating.[148] The *Telegram* order[149] makes the viability of this approach uncertain, but it may still be the best available option.[150]

III. AN EXAMINATION OF HOW THE CURRENT SYSTEM IS WORKING

Consider the way in which the federal securities laws have been applied to cryptotransactions. The focus of the '33 Act is two-fold: it requires registration or an exemption, and (regardless of whether an offering is registered or exempt) it prohibits deceptive, fraudulent, or manipulative selling practices.[151] In furtherance of these objectives, federal law relies primarily on mandatory disclosures from persons seeking to sell securities to U.S. citizens. The ostensible benefits of this kind of disclosure regime include: (1) providing investors with a reasonable basis on which to make informed investment decisions; (2) establishing a more equitable apportionment of the costs of investigating and providing material information; and (3) facilitating comparison of investment opportunities by mandating uniform format and content.[152] In the context of crypto, however, these benefits may be more apparent than real.

Even if the special character of cryptoassets was not involved, there are general criticisms that have been leveled against the SEC's

148. "Some companies are shunning U.S. investors altogether in order to avoid U.S. securities law, which generally focuses on where investors are from rather than where the company is based." Anna Irrera & Michelle Price, *Cryptocurrency issuers clean up, shun U.S. investors as SEC gets tough*, REUTERS (Mar. 21, 2018), [https://perma.cc/D34G-DTMR]. "Executives at Estonia-based iOlite, Scotland-based CaskCoin, UK-based Celsius Network, and Auctus, told Reuters they were barring U.S. citizens to steer clear of the SEC." *Id*. "Anyone who has recently participated in a cryptocurrency ICO or pre-ICO may have noticed how these offerings are, in theory not available to residents in the US. … To put this into perspective, the United States is quite strict when it comes to investment regulations." JP Buntinx, *Why Can't US Citizens Participate in Cryptocurrency ICOs?* THE MERKLE (June 29, 2017), [https://perma.cc/A4UW-EB7W].

149. *See supra* note 118.

150. Although this article does not focus on the role of other agencies, it is probably worth mentioning that other agencies also regulate crypto in the U.S. The CFTC has been active in this space, sometimes overlapping with the anti-fraud authority of the SEC. *See CFTC v. McDonnell*, 287 F. Supp.3d 213, 222 (E.D.N.Y. 2018). For a more detailed consideration of the role of the CFTC, *see* CAROL GOFORTH, REGULATION OF CRYPTOTRANSACTIONS Chapters 11 & 12 (West Academic, 2020).

151. *See The Laws that Govern the Securities Industry*, U.S. SECURITIES AND EXCHANGE COMMISSION, https://www.sec.gov/answers/about-lawsshtml.html.

152. *See generally Securities Disclosure: Background and Policy Issues*, CONGRESSIONAL RESEARCH SERVICE (June 25, 2019), https://fas.org/sgp/crs/misc/IF11256.pdf.

insistence on disclosure.[153] One of the most common complaints is the sheer expense of complying with these reporting obligations.[154] Given the complexities of modern financial markets, the cost of preparing the required disclosures can easily outweigh any benefits gained by preparing standardized disclosures. As one commentator observed, "[t]he key SEC disclosure requirements have been substantially frozen even as banking and financial innovation have undergone epochal changes."[155] In reality, it is widely recognized that few investors read or even attempt to understand the disclosures that are provided.[156]

The larger problem for offerings of cryptoassets, however, is that the required disclosures do not hit at the center of issues relevant to a potential crypto-investor's interests. Under current rules, the focus of the mandated disclosures for "securities" offerings is on the issuer and its business.[157] The required offering materials, whether in the form of a prospectus for a registered offering or offering circular for private offerings, emphasize the overall financial health of the issuer's business, its management, sources of competition, and risks related to its operations and projections.

These may have nothing to do with the primary risks for investors in tokens, with the general exception of tokenized securities[158] (unless, for example, the tokens convey an interest in the issuer's profits). Perhaps a concrete example will make this clearer. Consider a social media giant that is publicly held and worth (based on revenue and profits) more than $100 billion. It wants to issue a

153. "As disclosure requirements and related costs have generally increased over time, questions have arisen over whether disclosed information is readable and understandable to investors." *Id*. at 2.

154. *See Considering an IPO? The Costs of Going and Being Public May Surprise You*, *PwC* 1 (2012), https://www.deschenaux.com/general-informations/E_pwc-cost-of-ipo.pdf. This source suggests that a company might expect an average of $3.7 million of costs "directly attributable to their IPO," plus another $2 million in one-time costs, and about $1.5 million in recurring costs associated with being public. *Id*. at 1 fig.1, 10. This is not an option for the faint of heart. *See id*.

155. Henry T. C. Hu, *Disclosure Universes and Modes of Information: Banks, Innovation, and Divergent Regulatory Quests,* 31 YALE J. ON REG. 565, 565–66 (2014).

156. Tom C.W. Lin, *Reasonable Investor(s),* 95 B.U. L. REV. 461, 461 (2015) ("Much of financial regulation is built on a convenient fiction. This fundamental discord has resulted in a modern financial marketplace of mismatched regulations and misplaced expectations--a precarious marketplace that has frustrated investors, regulators, and policymakers.")

157. *See Cybersecurity, supra* note 4, at 447.

158. *See infra* notes 188-91 and accompanying text for a discussion of tokenized securities.

cryptocurrency that can be used to purchase goods and services through its social media platform. While the social media company plans to have its own wallet service available for users, a tokenholder can also elect to use third-party wallets and exchange services, and other users are free to accept the cryptoasset for whatever purposes they deem appropriate. In this kind of situation, the ultimate success of the coin has very little to do with the historical value and operation of the company that is issuing it.[159] Nonetheless, the current regime would require massive disclosures about the social media company's owners, its business and operations, even if those are fundamentally unrelated to the new cryptoasset. Traditional investors in the issuer, whether they are buying debt or equity interests, are likely to be very concerned about this kind of information. Someone considering the new crypto is almost certain to have entirely different concerns and questions. To the extent that the SEC insists that crypto is a security and must fit into existing regulatory structures, it is unfortunate that the securities regulations focus only on the informational needs of traditional investors.

To understand the interests of crypto-investors, it is important to consider the nature of the cryptoassets being acquired. In some cases, a cryptoasset may so closely resemble a traditional security that the interests of an owner will align with interests of persons who have purchased conventional debt or equity securities. The reality is that some forms of crypto will essentially be tokenized securities.[160] In other words, by utilizing smart contracts hosted on a blockchain, an issuer might choose to issue cryptotokens designed to mirror either traditional equity or debt interests.[161] Under this approach, the tokens

159. The resemblance of this hypothetical asset to Facebook's originally planned Libra token is superficial. First, Libra was not being issued by Facebook; it was to be created and overseen by the Libra Association, which is a Swiss organization of which Facebook was only one of numerous founding members. Second, Facebook planned to use a subsidiary, Calibra, to act as the wallet service for the new coin. For various reasons, this separation of ownership is wise, but it would not have served the purposes of the hypothetical. *See An Introduction to Libra*, LIBRA (Sept. 20, 2019, 11:37 AM), [https://perma.cc/DJ6Z-7VQV]. *See also* Nick Statt, *Facebook Confirms it will Launch a Cryptocurrency Called Libra in 2020*, THE VERGE (June 18, 2019), [https://perma.cc/7JKH-H9J6]; Josh Constine, *Highlights from Facebook's Libra Senate Hearing*, TECHCRUNCH (June 2019), [https://perma.cc/XR69-YE4G].

160. William Restis, tZERO's Security Token Offering (STO) Unpacked, RESTISLAW (Ap. 4, 2018), [https://perma.cc/P5LT-ZT3C].

161. Note that not every reference to a "security token" in public and academic commentary about crypto means a cryptoasset that resembles traditional debt or equity. Some commentators use "security token" to refer to any token that is regulated as a security, regardless of its functional characteristics. Pierre Villenave, *Understanding the*

might convey voting rights, a right to share in profits or appreciation, or a right to interest and principal repayments. For this narrow class of cryptoasset, it may indeed make sense to impose disclosure obligations that mirror the kinds of information that must be provided to potential purchasers of conventional debt and equity interests.

This is not merely a theoretical possibility. In 2018, Overstock's portfolio company tZero issued a token specifically designed to resemble preferred stock.[162] One description of the offering was that it involved "an 'exempt' offering of preferred stock to accredited and non-U.S. investors . . . issued as an ERC-20 compatible token."[163] For this kind of crypto offering, traditional disclosure obligations may work as well as they do for other investors.

However, most tokens are not being structured to operate in this manner. Either they are structured as cryptocurrencies (designed to replace government-backed currency),[164] or they are designed with

Regulatory Framework of Security Tokens, MEDIUM (Aug. 1, 2018), https://medium.com/lgogroup/understanding-the-regulatory-framework-of-security-tokens-9b231118cab4 (stating that "[i]n the present state and given the SEC comments, it seems that most tokens issued through ICO's will [be] qualified as a security.") The BitcoinWiki also uses this definition. *See Token*, BITCOINWIKI (Oct. 22, 2018, 2:33 PM), [https://perma.cc/EPT4-T7PN].

162. Alex Lielacher, *ICO Tokens 101: Understanding Token Types*, BITCOIN MARKET JOURNAL (Nov. 21, 2017), [https://perma.cc/5CNF-ZFJG] (suggesting that new tokens from tZero, a portfolio company of Overstock, Inc., would fit this categorization.).

163. Restis, *supra* note 160.

164. "Cryptocurrency" is also a word that is not used consistently. While it has been widely used, its meaning must be ascertained from the context in which it is employed. Often, "cryptocurrency" is used to describe both coins and tokens, regardless of how they are intended to function. One source, for example, says that "cryptocurrency" is generally understood as covering the realm of exchangeable value coins and tokens. *See* Aziz Bin Zainuddin, *Coins, Tokens & Altcoins: What's the Difference?*, MASTERTHECRYPTO (Apr. 11, 2019, 8:22 AM), [https://perma.cc/M4RA-CQHP] (". . . [A]ll coins and tokens are regarded as cryptocurrencies, even if most of the coins do not function as a currency or medium of exchange."). This same source suggest that "cryptocurrency" is a misnomer, since many coins and tokens that followed Bitcoin do not possess the traditional characteristics of currency such as being a unit of account, a store of value, and a medium of exchange. *Id*. Coinmarketcap, a website that tracks what it calls cryptocurrency capitalization, divides cryptocurrencies into coins and tokens. *See Today's Cryptocurrency Prices by Market Cap*, COINMARKETCAP, https://coinmarketcap.com. Some sources disagree with this taxonomy and instead limit "cryptocurrency" to the world of coins, using the term "cryptotoken" to refer to tokens. *See* Bin Zainuddin, *supra* this note. Tokens often have functions other than serving as a substitute for traditional currencies, which is why some commentators object to them being classified as cryptocurrencies. Some early commentators also appear to have assumed that "coin" meant something that was like a currency, while token must have been intended to have a different meaning. In still other contexts, the word "cryptocurrency" is used to describe all cryptoassets that are designed and intended to function as replacements for traditional currency. In this case, the

functions other than replacing debt or equity investment (such as access to goods and services, enriching user experience, as an in-application reward, or otherwise).[165] Investors in these kinds of cryptoassets are likely to have concerns that differ considerably from those of conventional investors.

For example, it is not likely to be important to a crypto-investor (excluding cases involving tokenized securities) to know who owns the outstanding shares of the issuer. The qualifications and management of the issuer may be similarly disconnected from the primary interests of a crypto-investor, unless their function is to work with the new cryptoasset. The financial history and business operations of the issuer may also be unrelated to the concerns of someone interested in a new cryptoasset, as will sources of competition faced by the issuer in a pre-existing line of business.

What are the primary interests of someone contemplating an investment in crypto? First, it will be important for the coin or token to be described. What is it intended to do? How far along is it in development? How will it operate? How will it be issued? How many coins or tokens have been pre-mined or distributed, and for what consideration? Is there a cap on the total number of tokens to be created, and if so, what is it? Can the cap be changed? How disperse is the ownership of the cryptoasset?[166] How many of the outstanding coins or tokens are owned by the issuer, the team creating the asset, or an affiliate of such person(s)? Who are the members of the token development team, and what are their qualifications? What will be the policies on hard forks? How are errors or weaknesses in the protocol to be addressed or remedied? Under what circumstances will transactions be reversed or stopped? What privacy protocols are in place, and are they mandatory or optional? Who will be working on promotion of the coin or token? Are there restrictions or limitations on resale? Are there existing exchanges that accept the asset? If not, will anyone be working on finding an exchange or trading platform that will include the coin or token among their interests? Even though these are issues likely to be the most relevant

designation refers to the currency function of the cryptoasset, rather than describing a presumed technical difference between coins and tokens. *See Cryptionary*, *supra* note 23 at 69.

165. For an explanation of some of these functions, *see The Importance of Token Utility, Function & Purpose*, THE COINIST, https://www.coinist.io/ico-importance-of-designing-utility-function-purpose-into-coin/.

166. This is different from the equity ownership in the issuer.

for crypto investors, these are not the kind of disclosures that are specifically mandated for securities.

It might be argued that because this information is "material," it needs to be disclosed even under the existing requirements.[167] However, the securities laws do not mandate disclosure of everything that an issuer might know. That is part of the proposal that this Article makes: the SEC needs to devote resources to articulating the types of disclosures particularly germane to crypto offerings rather than having to litigate the preliminary question of whether the asset is a security at all. It is not enough for the SEC to argue that crypto is a security, and then expect that compliance with inapt disclosure requirements will adequately protect investors. Instead, the requirement simply halts innovation or drives it out of the country.

When plaintiffs allege that the defendants violated the Securities Act by omitting information required to be included in the registration statement, courts employ two accepted methods of determining whether a duty exists for the offeror to disclose certain information. First, an offeror is duty-bound to disclose all material information required to be disclosed by statute. Second, an offeror has a duty to disclose any additional information required to make another statement, whether required or voluntarily made, not misleading.[168]

In other words, liability exists when an issuer fails to include material information that is "required to be stated."[169] It is widely recognized by the federal courts that not everything known or knowable by an issuer must be disclosed simply because investors would regard it as important.[170] Thus, under current rules some relevant risks may not be disclosed, while the company is forced to

167. This might be in accordance with the overall objectives of the federal securities laws, and the '33 Act in particular. "The primary goal of the 1933 Securities Act was simply to require securities issuers to disclose all material information necessary for investors to be able to make informed investment decisions on stocks." *The 1933 Securities Act - "The Truth in Securities Act,"* CFI, https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/1933-securities-act-truth-securities/.

168. ELGA A. GOODMAN ET. AL, *Elements of a Section 11 claim – Omissions, materiality, and the duty to disclose, in* 50A N.J. PRAC., BUSINESS LAW DESKBOOK § 30:54 (2018-2019 ED.) (footnotes omitted). A third option is also suggested by the authors of this practice note, but that option focuses on situations involving insider trading.

169. Securities Act of 1933 § 11, 15 U.S.C. § 77k(a).

170. J & R Marketing, SEP v. General Motors Corp., 549 F.3d 384, 384 (6th Cir. 2008); Basic Inc. v. Levinson, 485 U.S. 224, 239 (1988); Mayer v. Mylod, 988 F.2d 635, 639 (6th Cir. 1993).

prepare and present irrelevant information that purports to be what investors need to know.

In addition, even if the crypto-specific information is disclosed, it would be buried in a mountain of information that is not particularly relevant. This would substantially decrease the chance that the important information would be reasonably accessible while simultaneously increasing the expense of preparing the disclosure document.

Moreover, if the law is read as requiring such disclosures, by failing to include any explanation of what kind of information is "material" in the context of a crypto distribution, the risk that an issuer could inadvertently omit relevant information later deemed important is substantially increased. Finally, by requiring disclosure of all material information, the securities laws appear to be placing an unreasonable burden on issuers. As described earlier in this Article,[171] even if it is possible to identify an issuer, that person is unlikely is unlikely to be in a good position to report on the kinds of information that might be deemed material, under the vague current standards.

For example, one of the most significant considerations for persons contemplating an investment in crypto relates to market volatility. In most cases, however, that risk is not attributable to the developer or issuer of a cryptoasset.[172] The issuer or developer of a cryptoasset is typically in no better position than investors to predict how the market will behave. In addition, some crypto investors actively seek to benefit from volatility,[173] and the degree to which individual investors tolerate risk will also vary widely. These factors make it virtually impossible for an issuer to accurately warn every investor about the "problem" of volatility-based risks.

171. *See supra* Part II.C.

172. It is, of course, possible that a crypto developer could create a cryptoasset with the intention of manipulating its subsequent market price in order to benefit from ensuing volatility. A developer willing to do this, however, is unlikely to voluntarily disclose this intention regardless of the existence of a regulatory mandate to do so. The mandate would thus apply to developers and issuers attempting to act in good faith, leaving them with an obligation to predict the behavior of others, including those who might seek to increase price volatility.

173. As one source notes, volatility means that the crypto market "has the potential to generate massive amounts of return." Aziz Bin Zainuddin, *Crypto Volatility: Why Volatility is Important in the Cryptocurrency Market*, MASTERTHECRYPTO, https://masterthecrypto.com/crypto-volatility-important-cryptocurrency-market/ (noting that investors face a "high risk of losing a significant amount of capital," and warns that investors need to assess their ability and willingness to accept those risks before purchasing crypto.)

Another potential problem outside the issuer's knowledge or control is the risk that the crypto will be lost because of a failure of cybersecurity.[174] This is, in fact, one of the largest risks faced by purchasers. Despite the increases in cyber security practices and procedures, the rate of hacking of crypto exchanges and wallet services actually appears to be increasing.[175] On the other hand, not only is the issuer unlikely to have any special knowledge about cyber security risks, the issuer does not necessarily have anything to do with selecting the exchange or wallet service upon which the purchaser ultimately relies.[176] Requiring the issuer to explain and evaluate risks that are in the control of the purchaser than the issuer seems counterintuitive at best.

In evaluating the scope of the SEC's current approach, SEC Commission Hester Peirce, sometimes called the Crypto Mom because of her pro-crypto remarks in various venues,[177] has complained about the agency's failure to provide clear guidelines for crypto businesses.[178] One of her more colorful complaints is that the

174. *See Cybersecurity, supra* note 4.

175. *Can They Be Stopped?*, COINTELEGRAPH (June 18, 2019), https://cointelegraph.com/news/round-up-of-crypto-exchanges-hack-so-far-in-2019-how-can-it-be-stopped. *See also* Clare Baldwin, *Bitcoin Worth $72 Million Stolen from Bitfinex Exchange in Hong Kong*, REUTERS (Aug. 3, 2016, 1:30 AM), https://www.reuters.com/article/us-bitfinex-hackcd-hongkong/bitcoin-worth-72-million-stolen-from-bitfinex-exchange-in-hong-kong-idUSKCN10E0KP; Olga Kharif, *Record Crypto Heist Raises the Appeal of a New Type of Exchange*, BLOOMBERG (Jan. 29, 2018, 6:00 PM) [https://perma.cc/32R3-UL8A].

176. In the case of an IEO, or Initial Exchange Offer, this might not hold true. In a more conventional ICO, a token development company or team generally sells its newly created tokens directly to investors (or sells the right to obtain tokens once they are fully functional). In an IEO, the development group sells its tokens through a crypto exchange platform. The exchange essentially acts as a broker, dealer, or underwriter for the distribution, and in this case, the actual creator of the crypto does have something to do with at least the initial exchange that will host the crypto. *See generally* Benjamin Vitaris, *What Is an Initial Exchange Offering (IEO) and How It Differs From ICO?* CRYPTOPOTATO (updated Ap. 29, 2019), https://cryptopotato.com/what-is-an-initial-exchange-offering-ieo-and-how-it-differs-from-ico/; Brian Curran, *What Is an IEO? Complete Guide to Initial Exchange Offerings*, BLOCKONOMI (Ap. 5, 2019), https://blockonomi.com/what-is-an-ieo/. Note, however, that the mere fact that the issuer selects the initial exchange does not mean that the issuer is in a better position than anyone else to assess the probability of the exchange being hacked. There seems to be no reason why an issuer would willfully or intentionally select an exchange that lacks reasonable security precautions.

177. *See* Christine Kim, *Crypto Mom's Crusade: Inside the SEC, Hester Peirce Is Putting Up a Fight*, COINDESK (Dec. 31, 2018), https://www.coindesk.com/coindesks-most-influential-2018-blockchain-hester-peirce.

178. *See* Ana Alexandre, *SEC Commissioner Hester Peirce Concerned Crypto Industry Hindered by Regulatory Delays,* COINTELEGRAPH (May 9, 2019),

SEC has engaged in a "Jackson Pollock approach" to regulation.[179] When this scattershot approach is applied to the kinds of disclosures that are required, with many requirements being relevant to only a small fraction of crypto offerings, it paints the picture of a regulatory approach that fails in the ultimate mission of the agency: the protection of the public and the markets.

None of this should be taken as a blanket condemnation of the SEC's efforts. The SEC's vigilance in warning about fraudulent practices, investigating problematic issuers, and enforcing antifraud requirements are all commendable.[180] Unfortunately, the value of these efforts does not justify the wasted assets in pursuing expensive litigation over what constitutes a security and whether legally required disclosures have been made (regardless of the value of such information to potential purchasers).[181]

IV. EARLIER SUGGESTIONS FOR CHANGE

https://cointelegraph.com/news/sec-commissioner-hester-peirce-concerned-crypto-industry-hindered-by-regulatory-delays.

179. Peirce Speech, *supra* note 18. This observation was made in the context of considering the multi-factored approach currently being taken by the SEC in evaluating whether a particular cryptoasset qualifies as a security.

180. A list of SEC investor warnings and alerts related to digital assets can be found by a search of "digital assets" on the SEC's Investor.gov pages. *See Investor.gov*, U.S. SECURITIES AND EXCHANGE COMMISSION, https://www.investor.gov/search?keys=digital%20assets. A list of enforcement actions by the SEC relating to ICOs (including those that do not involve fraud) can be accessed. *See Cyber Enforcement Actions*, U.S. SECURITIES AND EXCHANGE COMMISSION, https://www.sec.gov/spotlight/cybersecurity-enforcement-actions (listing a few actions that allege only a failure to register the offering, but the vast majority of the SEC's complaints also involve claims of fraud, non-disclosure, and/or manipulation.).

181. This is not the only inefficiency in the current system. Another problem, not highlighted in great detail in this Article, is the existence of overlapping concurrent jurisdiction as between the SEC and CFTC. The CFTC has extensive experience in regulating derivatives and derivative exchanges, and since it is possible to have crypto derivatives the involvement of that agency seems entirely appropriate. *See Written Testimony of Chairman J. Christopher Giancarlo before the Senate Banking Committee, Washington, D.C.*, CFTC (Feb. 6, 2018), https://cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo37. On the other hand, it seems duplicative to have both the SEC and CFTC expend time and effort in overseeing fraud in the spot markets (where actual transactions in the underlying commodities take place). Unfortunately, "[u]ntil Congress clarifies the matter, the CFTC has concurrent authority, along with other state and federal administrative agencies, and civil and criminal courts, over dealings in virtual currency." CFTC v. McDonnell, 287 F. Supp. 3d 213, 217 (E.D.N.Y.), *adhered to on denial of reconsideration*, 321 F. Supp. 3d 366 (E.D.N.Y. 2018).

Other commentators have noted the disconnect between what the SEC is supposed to do and what its extensive disclosure requirements are actually accomplishing.[182] Some have simply concluded that the SEC needs to add precision to its approach to crypto,[183] while others have offered more detailed proposals. None of these proposals, however, fully address the shortcomings of the current system, or they introduce problems of their own.

One commentator has suggested that the U.S. should move to a system that allows accredited institutional investors, and perhaps other wealthy investors with slightly reduced sophistication standards, to invest freely in cryptoassets.[184] This approach would not impose mandatory affirmative disclosures and instead would impose liability only for fraud or other deceitful behaviors. Unfortunately, moving solely to this type of anti-fraud regime[185] has some significant problems. First, it fails to recognize that some crypto is likely to take the form of tokenized securities that genuinely mirrors traditional debt or equity.[186] In these cases, it seems appropriate to retain current disclosure obligations. Even for other kinds of crypto, while most current disclosures are unlikely to be helpful, a limited amount of information probably should be required.[187] For example, information about the function, design, control, and pre-sale ownership of the particular cryptoasset would be relevant when an

182. *See* Shlomit Azgad-Tromer, *Crypto Securities: On the Risks of Investments in Blockchain-Based Assets and The Dilemmas of Securities Regulation*, 68 AM. U. L. REV. 69, 112–30 (2018); Nathan J. Hochman, *Policing the Wild West of Cryptocurrency Part II*, L.A. LAW. 26, 28 (Dec. 2018).

183. *E.g.,* Allen Kogan, *Not All Virtual Currencies Are Created Equal: Regulatory Guidance in the Aftermath of CFTC v. McDonnell,* 8 Am. U. Bus. L. Rev. 199, 199 (2019).

184. *See* Azgad-Tromer, *supra* note 182 at 131. This does not address the problem of how to allow smaller investors to participate in crypto markets. Limiting them to secondary trading transactions where there are no minimum disclosures expected may make the system harder for them to navigate, although this proposal would certainly offer major relief to the entrepreneurs seeking to participate in the space.

185. Azgad-Tromer's objections to the current disclosure regime start with the reality that the reason behind the current paradigm is the SEC's desire "to remove the information asymmetry between investors and offerors so as to promote informed investment decisions." *See* Azgad-Tromer, *supra* note 182 at 105.

186. Some commentators have suggested that this will be the next direction for crypto. *See The Next Big Wave is Security Tokens or Tokenized Securities to Provide Liquidity*, BITCOIN EXCHANGE GUIDE (Sept. 12, 2018), [https://perma.cc/5WER-H632]. However, as of the date of this article this has not yet materialized, possibly because of the uncertain regulatory regime.

187. While much of this may already appear somewhere in the whitepaper or investment information provided by the issuer or promoter of particular crypto-projects, there is a significant benefit to having consistent, uniform platforms for providing basic data. *See* Azgad-Tromer, *supra* note 182 at 107.

issuer releases tokenized securities, or when an issuer or other person in the business of promoting the asset seeks to sell "true" cryptocurrencies (i.e., cryptoassets specifically designed to serve as fiat currency substitutes). Other forms of crypto specifically marketed as speculative investments might also require specific disclosures in order to protect potential purchasers.

In addition, this suggested approach would limit sales of crypto to wealthy, sophisticated investors, which seems antithetical to the democratic ideals of blockchain technology and is therefore likely to be objectionable to many within the crypto community.[188] Finally, it is unlikely that legislators will have the political will to force the SEC to abandon its emphasis on disclosure,[189] while a change to reviewing different kinds of disclosures might be more palatable.

Another possibility that has been raised is to create a new regulatory agency to oversee cryptoassets in lieu of the Securities and Exchange Commission and other authorities.[190] Admittedly, the current situation, which involves multiple federal and state authorities with concurrent and overlapping jurisdiction over cryptoassets, includes a substantial risk of over-regulation and unnecessary complexity.[191] It is certainly possible that a new agency could be created to avoid the problems currently faced by the SEC. Similarly, a new agency could remedy the CFTC's inability to

188. The SEC is logically more concerned about protecting the average citizen, or "main street investor." The presumption is that persons who have sufficient expertise in investing or the wealth to hire professional advisors are less in need of the SEC's protection and regulated disclosures. However, this approach means that sales designed to comply with an exemption by being limited to wealthy, well-educated persons excludes the average citizen. It is this which is antithetical to the original underpinnings of Bitcoin and blockchain technology. *See* Alex Tapscott, *Blockchain Democracy: Government Of The People, By The People, For The People*, FORBES (Aug. 16, 2016), [https://perma.cc/9CED-PVF3] ("Blockchain is a vast, global distributed ledger or database running on millions of devices and open to anyone, where not just information but anything of value – money, but also titles, deeds, identities, even votes – can be moved, stored and managed securely and privately– and where trust can be established through mass collaboration and clever code rather than by powerful intermediaries like governments and banks.").

189. This is a problem noted by other scholars. Azgad-Tromer, *supra* note 182 at 119 (commenting on probable political opposition by the SEC and politically powerful stock exchanges).

190. *See* Hochman, *supra* note 182 at 31. Hochman argues, "[n]ow, it is time for Congress to create the CEC as the federal 'crypro-sheriff' to strike the right balance in reining in the Wild West of Cryptocurrency." *Id*. at 31.

191. At the federal level, FinCEN, the CFTC, the SEC, and the IRS have authority over cryptoassets. This does not even include state authorities and other agencies, such as the FTC, that may have jurisdiction over limited aspects of crypto. *See* Carol Goforth, *US Law: Crypto is Money, Property, a Commodity, and a Security, all at the Same Time*, OXFORD BUS. L. BLOG (Dec. 7, 2018), [https://perma.cc/4ZNM-7WBM] [hereinafter *US Law*].

regulate spot market transactions, and FinCEN's "inability to impose uniform national regulation and enforcement of money series businesses currently subject to the myriad of state licensing regimes."[192]

Despite the superficial attractiveness of this alternative, it is not likely to be a realistic option. First, consider the current anti-regulatory environment in which we operate.[193] The myriad problems posed by the Covid-19 pandemic caused the Trump administration to further push its anti-regulatory agenda.[194] In addition to the political obstacles, there are real world reasons to avoid this approach. The U.S. budget deficit is a bigger problem than crypto is likely to be in the foreseeable future.[195] A new agency would have to

192. Hochman, *supra* note 182 at 31.

193. Jeff Cox, *The anti-regulatory environment that Trump promised just got a big boost*, CNBC (Nov. 19, 2017), [https://perma.cc/W8AQ-YECL] (commenting on President Donald Trump's promises to create a less restrictive regulatory environment, particularly in banking). Obviously, the political regime has changed, but opposition to what is widely seen as excessive regulation goes far beyond the Trump administration. *See, e.g., Over-regulated America*, THE ECONOMIST (Feb. 18, 2012), [https://perma.cc/G8F9-Z25M]. This statement seems to encapsulate widely held views about the value of regulation. H. Beales, et al., "*Government Regulation: The Good, The Bad, & The Ugly*", REGULATORY TRANSPARENCY PROJECT OF THE FEDERALIST SOCIETY (June 12, 2017), https://regproject.org/wp-content/uploads/RTP-Regulatory-Process-Working-Group-Paper.pdf [https://perma.cc/J2K3-MYYS] ("The American free enterprise system has been one of the greatest engines for prosperity and liberty in history, and has the potential to deliver a promising future for the United States and the world. . . . Yet, the United States faces growing challenges in an increasingly competitive global economy. Recent decades have seen a decline in economic growth and innovation, and one important cause is poorly-designed government policies. Large swaths of the American economy are distorted by government mandates and incentives, and the vast majority of binding "laws" are not enacted by our elected representatives in Congress, but are promulgated by agencies as regulations.")

194. *See generally* Jeff Stein & Robert Costa, *White House readies push to slash regulations as major part of its coronavirus economic recovery plan*, THE WASHINGTON POST (Ap. 21, 2020), https://www.washingtonpost.com/business/2020/04/21/white-house-coronavirus-regulations/. The anti-regulatory approach was initiated early in President Trump's term when he signed an executive order requiring agencies to identify at least two regulations that could be targeted every time a new regulation is proposed. Nolan D. McCaskill & Matthew Nussbaum, *Trump signs executive order requiring that for every one new regulation, two must be revoked*, POLITICO (Jan. 1, 2017), https://www.politico.com/story/2017/01/trump-signs-executive-order-requiring-that-for-every-one-new-regulation-two-must-be-revoked-234365. *See* Richard L. Revesz, *Congress and the Executive: Challenging the Anti-Regulatory Narrative,* 2018 MICH. ST. L. REV. 795, 795 (2018) (noting the in midst of the current anti-regulatory zealousness, cost-benefit analysis of various regulations being repealed has been over-looked).

195. For a simplified explanation of the problems posed by the federal deficit, *see* Heather Long, *Why America's return to $1 trillion deficits is a big problem for you*, WASH. POST (Ap. 9, 2018), [https://perma.cc/4EAV-J3BL]. This assessment was written before the massive increases in our national debt that have occurred since that date. During 2019, the

be authorized, housed, staffed, and provided with sufficient resources to fulfill its mandate. It would need to be able to investigate and enforce crypto-focused requirements, presumably taking over issues currently regulated by the SEC and CFTC, as well as possibly implicating FinCEN's jurisdiction. In addition, each of these agencies is likely to object to having their jurisdiction reduced simply in order to create a new agency that will have to be created, funded, staffed, and generally brought up to speed (with concomitant delays and expense). Finally, the success of a new agency would depend entirely on the mandate that it was handed.[196] If it, too, chooses or is directed to start from the current disclosure paradigm, focusing on information about the business of the issuer or creator of a cryptoasset, it will suffer from many of the same problems as the existing system.

Other suggestions have focused on modifying the existing paradigm affecting cryptoassets in more limited ways. One such approach would be to reconfigure the *Howey* test. Probably the simplest option would be for courts to narrowly construe *Howey* so as to exclude most "utility tokens" from its reach.[197] This approach has been advocated by SAFT proponents for some time,[198] but the SEC seems disinclined to follow it.[199] The most recent judicial

national debt swelled by $1.1 trillion to exceed $23 trillion. The Treasury Department projected a budget deficit of nearly $400 billion for the first four months of fiscal 2020, a 25% gain over the prior year.

Jeff Cox, *US deficit surges 25% in fiscal 2020 and is $1.1 trillion over the past year,* CNBC (Feb 12, 2020), https://www.cnbc.com/2020/02/12/us-deficit-swells-25percent-in-fiscal-2020-up-1point1-trillion-over-past-year.html. These numbers do not take into account the additional $2 trillion coronavirus stimulus bailout passed in March 2020. Emily Cochrane & Nicholas Fandos, *Senate Approves $2 Trillion Stimulus After Bipartisan Deal,* THE N.Y. TIMES (March 25, 2020), https://www.nytimes.com/2020/03/25/us/politics/coronavirus-senate-deal.html.

196. In fact, adding another agency to the mix is only likely to complicate matters. Current agencies are unlikely to voluntarily cede their authority, meaning that a new agency is likely to have to deal with rules and requirements overseen by FinCEN (the Financial Crimes Enforcement Network), the CFTC (the Commodities Futures Trading Commission), the SEC (Securities and Exchange Commission), and the IRS (Internal Revenue Service), unless the new agency is given exclusive authority. *See US Law, supra* note 191. It would, of course, also need preemptive authority to ameliorate the impact of diverse regulations at the state level as well.

197. Nate Crosser, *Initial Coin Offerings As Investment Contracts: Are Blockchain Utility Tokens Securities*?, 67 U. KAN. L. REV. 379, 409 (2018).

198. *See generally* Batiz-Benet, Clayburgh, & Santori, *supra* note 116 (giving a brief description of SAFTs).

199. *See supra* Part II.B., discussing the Kik and Telegram litigation in which the SEC strongly asserted its position that a SAFT offering for utility tokens were securities. The

pronouncement also suggests that this is unlikely to prevail in the courts under current rules.[200]

A similar, but more complicated, suggestion would require the courts to adopt some specific requirements in order for a cryptoasset to be classified as a security under *Howey*.[201] This proposal, advanced by Professors M. Todd Henderson and Max Raskin in 2019, suggests the use of two specific tests, one affecting the "efforts of others" prong, and the other relating to the "expectation of profits" prong.[202]

Under the first prong, a cryptoasset would be excluded from the definition of a security if it is sufficiently decentralized because there would then be no "other" party to satisfy the *Howey* requirement that a purchaser be relying on the "essential efforts" of others.[203] This is not a huge leap from the analysis advocated by the SEC or employed by most courts, but unless the Supreme Court adopts this approach, the SEC will continue to focus resources on litigating the issue.

The second element would prevent an asset from being classified as a security so long as the promoters are making good faith efforts to develop a product reasonably intended to have functionality for some users beyond a profits interest.[204] This would require a significant shift in focus for the SEC, since it deviates from the notion that a token "in development" generally involves reliance on the efforts of the promoter or associated persons for a return on the investment.[205] Moreover, it is a far different thing to say that an asset should not be considered a security so long as some purchasers may be acquiring the asset for its functionality rather than asking whether it is foreseeable that some purchasers will be making a speculative investment. Since the SEC's objective is to protect investors, and the

utility of the Kin token and the Grams at issue in those two cases related to the underlying Kik and Telegram social media platforms.

200. *Id*.

201. 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, 491 (2019). For a reminder about the elements of the conventional *Howey* test, see *supra* notes 28-35 and accompanying text.

202. *Id*. This article labels the first the "Bahamas test," which is explained as asking whether the sudden departure of the sellers to someplace like the Bahamas for a perpetual retirement would affect the value of the asset. *Id*. at 461. The second is referred to as the "Substantial Steps Test." *Id*. at 478. This test essentially says that the asset will not be a security if the promoters are "taking good faith, substantial steps towards completion of a product that they believe will have use to some users of the token beyond resale value or economic income." *Id*. at 483.

203. *Id*. at 460-61.

204. *Id*. at 483.

205. *See Framework, supra* note 6 at 3-4.

agency shows no indication that it is willing to find a pre-functional interest to be anything other than a security,[206] this is unlikely to be a practical suggestion.

Other more complicated options have also been advanced. One commentator suggested relying on token protocols to establish terms that could be codified into a new exemption from registration.[207] Advocates of this suggestion proposed that regulators and Ethereum, as the platform that originally hosted the large majority of tokens and from which most ICOs were launched, jointly agree on best practices which, if adopted as part of the computer coding for new tokens, would support exempting the new assets from existing registration requirements.[208] Even assuming such agreement is possible, it is not certain that Ethereum will continue to be the primary platform for hosting tokens and ICO; certainly other options now exist.[209] It is also likely that it would be difficult for regulators to monitor coding for new assets and ensure that work-arounds were not also embedded into the software.[210] Importantly, the SEC shows no indication that it is even willing to consider this approach.

Many other suggestions, some very narrow and some quite broad, have also been advance. One particularly narrow alternative would simply exclude tokens issued by a DAO from the ambit of the

206. Even the proponents of the SAFT generally concur that the initial pre-functional stage where purchasers are asked to buy contractual rights to purchase utility tokens when issued involves the sale of a security. *See generally supra* note 116 (giving a brief discussion of the SAFT process).

207. Randolph A. Robinson II, *The New Digital Wild West: Regulating the Explosion of Initial Coin Offerings,* 85 TENN. L. REV. 897, 957 (2018).

208. *Id*. at 956. The author posits that "[b]ecause the majority of ICOs are currently launched on the Ethereum platform the SEC should encourage and work with Ethereum developers to integrate legal principles directly into the code that governs the platform." *Id*.

209. *See Where to Issue ICO Tokens: Platforms Review,* COINTELEGRAPH, https://cointelegraph.com/ico-101/where-to-issue-ico-tokens-platforms-review (noting a number of issues with Ethereum as a platform, as well as identifying a number of alternatives, including Eos, Tezos, Waves, NEO, NEM, and Stellar).

210. Current review of textual information in the very-familiar registration statement already takes the SEC weeks or months. *See* Steven Skolnicka & Alan Wovsanikera, *The Jobs Act: Improving Access To Capital Markets For Smaller Businesses* in RECENT DEVELOPMENTS IN SECURITIES LAW 1, 3 (ed. 2016); Stuart R. Cohn, *The Impact of Securities Laws on Developing Companies: Would the Wright Brothers Have Gotten Off the Ground?,* 3 J. SMALL & EMERGING BUS. L. 315, 366 n.104 (1999) (noting that first time filers can generally expect "weeks" of review of their registration statement). There is no way to predict how long it might take the SEC to review disclosures embedded in computer code.

securities laws.[211] This would only address a small number of distributions as most tokens would not fit within that categorization. At the other end of the spectrum, another approach would completely remove crypto from the reach of the securities laws by treating it as virtual currency.[212] This approach seems overly broad, as the SEC does have an extremely reasonable interest and expertise in the case of tokenized securities cast as cryptoassets and certainly has a legitimate concern about fraud in the broader crypto setting. Other advocates for "clarity" in the SEC's approach make the case that it is desirable to readily distinguish between interests that are securities and those that are not,[213] but fail to consider that there may be benefits to applying the anti-fraud requirements even if would make little sense to apply existing registration requirements.

One final proposal merits discussion, and that is one advanced by SEC Commissioner Hester Peirce. On February 6, 2020, Commissioner Peirce unveiled a proposal that in her words would "fill the gap between regulation and decentralization."[214] At the time of her original proposal, Commissioner Peirce was very careful to remind everyone that the opinions she expressed were her own and that the proposal was "not fully formed in my own mind and may not reflect my own opinions in the months to come."[215] Her proposal started with the belief that the SEC's current approach resulted in "well-intentioned" persons "struggling to find a way both to comply with the law and accomplish their laudable objectives."[216] As a result, Commissioner Peirce proposed a safe harbor for network developers in which they would have three years in which to "facilitate participation in and the development of a functional or decentralized network" that would not be within the ambit of the securities laws presumably because market forces rather than the efforts of any identifiable persons would dictate pricing.[217]

211. Tiffany L. Minks, *Ethereum and the Sec: Why Most Distributed Autonomous Organizations Are Subject to the Registration Requirements of the Securities Act of 1933 and A Proposal for New Regulation*, 5 TEX. A&M L. REV. 405, 405 (2018).

212. *See* Susan Alkadri, *Defining and Regulating Cryptocurrency: Fake Internet Money or Legitimate Medium of Exchange?*, DUKE L. & TECH. REV., 71, 77 (2018).

213. *See* Justin Henning, *The Howey Test: Are Crypto-Assets Investment Contracts?*, 27 U. MIAMI BUS. L. REV. 51, 52 (2018) (advocating for clarification in the definition).

214. Hester M. Peirce, *Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization*, U.S. SECURITIES AND EXCHANGE COMMISSION (Feb. 6, 2020), https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06.

215. *Id*.

216. *Id*.

217. Peirce, *Empty*, *supra* note 214.

The conditions for the proposed safe harbor include the following: (1) the development team must intend to reach network maturity (defined as either decentralization or token functionality) within three years; (2) key information would need to be publicly disclosed;[218] (3) the token would need to be sold for the purpose of facilitating access to, participation on, or development of the network;[219] (4) there must be reasonable efforts to create liquidity for users; and (5) the developers would need to notify the SEC that it is relying on the safe harbor.[220]

While this proposal generated considerable comment among crypto-enthusiasts, it has not gained any traction at the SEC.[221] It has been said that "the commission has little motivation and limited time to devote to helping the crypto industry given that the industry has been so problematic, having been an outsized thorn in their side for the last few years . . .."[222] In addition, this approach still leaves the SEC in the position of having to argue that crypto is a security under the existing statutory definition,[223] and it cannot remove problems caused by overlapping authority with the CFTC.[224]

V. A DIFFERENT APPROACH

Rather than suggesting that the courts and the SEC modify the *Howey* test to avoid classifying some forms of crypto as securities, or

218. The proposal discusses the kind of information that would need to be disclosed, and it focuses on the source code and transaction history as being of "primary importance." *Id*. In reality, very few individuals would be capable of understanding the source code or the significance of many provisions included in the programming. However, the proposal would also require disclosure of information that is of more obvious importance to potential purchasers, including information about the launch and supply process, the total number of authorized tokens, the release schedule, how tokens are generated or mined, the process for burning tokens, the transaction validation process, the consensus mechanism and governance mechanisms for implementing changes to the network. *Id*. Information about the plan of development and intended functionality would also be needed. *Id*.

219. Commissioner Peirce explains that this element is intended to prevent "equity or debt securities masquerading as tokens" from relying on this safe harbor. *Id*.

220. *Id*.

221. *See, i.e.*, Ben Jessel, *Can Hester Peirce's Safe Harbor Proposal Save Cryptocurrency? Experts Weigh In*, FORBES (Apr. 1, 2020), [https://perma.cc/XL6E-X2JB] ("While the proposal has attracted a lot of interest and commentary it has little chance of making it into law, for a multitude of reasons.").

222. *Id*.

223. *See supra* Part II.B. for a consideration of two of the latest cases where this has been (and as of this writing, for one of those cases still is) an issue.

224. *See supra* note 181 for a brief explanation of this issue.

that the SEC alone should be counted on to remedy the problems created by the current regime, this Article suggests that almost all[225] of such assets should be included within the ambit of the federal securities laws. This would require legislative intervention, and ideally the amendments would also provide the SEC with exclusive and preemptive jurisdiction over the new asset class while incorporating a legislative mandate that the SEC adopt appropriate exemptions premised on limited disclosure obligations. This suggestion is developed more fully in the next section of this Article.

Both the SEC and courts are currently wed to the *Howey* investment contract analysis in considering which cryptoassets are securities. As described above, this leads to extensive and expensive delays and uncertainties, and it has spawned a wide range of suggestions (often at odds with each other) about how the test might be modified. In reality, the *Howey* test is much like forcing Cinderella's slipper onto the feet of her stepsisters; it does not fit well, and it is painful.[226] The solution is not to try and lop off toes and heels, but to find a different choice of footwear.

In order to move away from *Howey*, however, a number of things must happen. The first four steps all take Congressional action. First, Congress should amend the definition of security in the federal securities laws to explicitly recognize cryptoassets as a new class of security. Second, Congress should give the SEC exclusive authority over this asset class, although the CFTC would retain jurisdiction over derivatives of such assets and the exchanges upon which such derivatives are traded. Third, Congress should give the SEC preemptive authority in order to ensure that conflicting state regulations will not overly complicate the regulatory response. Fourth, the SEC should be given explicit authority and direction to create exemptions for this new class of security. In particular, the SEC should be directed to create an exemption from registration for crypto

225. Under this definition, cryptoassets not convertible, directly or indirectly, into fiat currency would not be securities and neither would any such interest that cannot reasonably be foreseen to be of interest as a speculative investment. If "cryptoasset" was added to the laundry list of things that count as a security in section 2 of the '33 Act, the phrase "unless the context otherwise requires" might be sufficient to exclude those kinds of interests from regulation as securities. Defining cryptoasset would, of course, be preferable in order to avoid any potential confusion.

226. Jeremy Allaire, CEO and co-founder of Goldman Sachs-backed crypto finance company Circle, has opined that the lack of clarity from the SEC over how crypto should be defined is "[t]he biggest and most immediate regulatory hurdle" facing crypto today. Marie Huillet, *Circle CEO Says More Regulatory Clarity From US SEC Will Help Unlock Crypto Markets*, COINTELEGRAPH (Jan. 11, 2019) [https://perma.cc/6L3V-WLRW].

offerings that disclose meaningful information about the token project itself, rather than about the issuer. Obviously, the SEC would then have to promulgate these exemptions. The next sections of this Article examine each of these steps in turn.

A. A NEW DEFINITION OF SECURITY

As mentioned, the first step requires legislative intervention to amend the federal securities laws[227] to specifically include all cryptoassets that are convertible, directly or indirectly, into fiat currency[228] so long as it is reasonably foreseeable that there is a substantial likelihood[229] that they will be sold for investment rather than consumptive purposes.[230]

227. For example, section 2 of the Securities Act of 1933 and section 3 of the Securities Exchange Act of 1934 would both need to be amended to add a new category of interests to the current definition of "security." 15 U.S.C. §§ 77(b) & 78(c), respectively. Other securities laws would need similar updates. The list of items defined as a security could simply be amended to add "cryptoassets," and then the specific limits on the kinds of assets that qualify could be included in a definition of the word "cryptoasset."

228. Note that Bitcoin and Ether would both be securities under this approach. Because a decentralized cryptoasset that is widely dispersed is not controlled by any person or associated group of persons, the SEC should be expected to develop an exemption for such assets. Both Bitcoin and Ether have been held not to fit under the current regime, and statements have been made to the effect that there is little to be gained by trying to impose securities registration requirements on them. *See supra* note 76 and accompanying text. There is therefore little reason to suspect that the commission would attempt to require registration or an exemption under an amended approach. This would, however, leave in place the anti-fraud provisions for persons who are engaged in selling these assets, which seems quite appropriate.

229. Securities lawyers may recognize part of this language. In considering the question of materiality in the context of allegedly defective proxy disclosures, the U.S. Supreme Court has held that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." TSC Indus., v. Northway, Inc., 426 U.S. 438, 449 (1976). This formulation threaded the needle between the overly lenient test of information that "might" be important and the excessively restrictive test of information that "would" be important. The same approach was adopted in the context of materiality in securities fraud cases in Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988).

230. Claims are still being made that specific tokens are not securities at all. *See* Stephen Brown, *The Cryptocurrency World Deliberates On The Security Status Of Ripple's XRP*, ZYCRYPTO (Dec. 12, 2018) [https://perma.cc/A7RP-KJ4Z]. Further muddying already opaque waters, Penn State Law visiting Assistant Professor Michael O'Connor has argued that the SEC is "wrong" in attempting to regulate crypto exchanges. Tom Rodgers, *Analysis: SEC Securities Definition of Crypto 'Unlawful', says Research*, CRYPTO NEWS REVIEW (Dec. 21, 2018) [https://perma.cc/84JT-P8U4]. It would greatly clarify things to know that crypto is a security (just one with convenient and workable exemptions from the registration requirement).

Adding a new class of securities would resolve some of the problems that are currently plaguing entrepreneurs and regulators alike. It would no longer be necessary to apply the *Howey* test, avoiding continued uncertainty and complexity.[231] A straightforward definition avoids the confusion created by a test that says some forms of crypto may be securities at one time but at some future time may no longer be securities, or even more confusingly, they may not be securities initially but later might become subject to securities laws.[232] This would simultaneously allow the SEC to shift resources to more productive areas, such as considering disclosures that should apply to the new class of interests, while providing certainty for entrepreneurs. In addition, it would align the SEC's approach more closely with the positions taken by other countries, which tend to refer to crypto as a cryptoasset rather than a digital asset.[233]

The requirement that the cryptoasset be convertible is consistent with the approaches taken by the SEC, CFTC and FinCEN, all of which recognize that a cryptoasset, digital asset, or virtual currency that cannot be converted into conventional currency, either directly or indirectly, and therefore cannot substitute for it, requires little in

231. To demonstrate the lack of clarity and consistency in the SEC's definitional approach to when cryptoassets are securities, see *supra* Part II.A.

232. A new framework for evaluating whether "digital assets" are securities was announced by the SEC on April 3, 2019. *See Framework, supra* note 6. The framework includes specific warnings that various conditions may make it necessary to reevaluate "whether a digital asset previously sold as a security" might have become a security at the time of later offers or sales. *Id*. at 5, 8.

233. As noted earlier, authorities in other countries tend to have adopted "cryptoasset" as the appropriate label by which to refer to such assets. For example, in the E.U., the European Securities and Markets Authority (ESMA), published advice to European institutions in January 2019, acknowledging that cryptoassets with certain characteristics are financial instruments and should be supervised as such, although this requires action by individual countries in order to be effective. ESMA, *Crypto-Assets Need Common EU-Wide Approach to Ensure Investor Protection* (Jan. 9, 2019) [https://perma.cc/45CM-GHYE]. U.K. officials have also adopted this terminology. *See* Mike Orcutt, *Cryptocurrency is terrible as money but "crypto-assets" are for real, says Bank of England's chief,* MIT TECH. REV. (Mar. 2, 2018) [https://perma.cc/CB4R-4MS5] (noting the Bank of England Governor's comments on the need for a measured response to crypto-assets). Other international organizations use "cryptoassets" in their work as well. *I.e.,* FSB, *FSB reports on work underway to address crypto-asset risks* (May 31, 2019), https://www.fsb.org/2019/05/fsb-reports-on-work-underway-to-address-crypto-asset-risks/. This report was prepared for the G20 meeting of Finance Ministers and Central Bank Governors, June 8–9, 2019. A copy of the report can be found at FSB, *Crypto-assets – Work underway, regulatory approaches and potential gaps* (May 31, 2019), https://www.fsb.org/wp-content/uploads/P310519.pdf. *See also* FSB, *Crypto-assets – Report to the G20 on Work by the FSB and Standard-Setting Bodies*, 1 (July 16, 2018) [https://perma.cc/E3E5-6NFG]. *Cf. Framework, supra* note 6.

the way of regulation.[234] Finally, any asset that has no investment value does not carry the kind of risks that the SEC generally regulates. It would further neither the goals of protecting capital markets nor mainstream investors to impose existing requirements on crypto if the assets have no speculative value.

Admittedly, a change in policy requiring that all cryptoassets be classified and treated as securities is not likely to be universally welcomed by crypto-entrepreneurs, but their concerns might be mitigated by adoption of exemptions geared specifically toward cryptoassets. The reality is that there are too many bad actors in the crypto space and the costs associated with involvement of criminal enterprises interested in bilking the investing public are too significant for crypto to be unregulated.[235] The current system, where multiple regulatory agencies claim authority and where the new assets are forced into existing rules and structures[236] is clearly less desirable than a single, more tailored approach.

B. EXCLUSIVITY OF JURISDICTION AND THE CFTC'S ROLE

Under the current regime, the SEC and CFTC have concurrent jurisdiction over various aspects of cryptoassets.[237] This is a result of the SEC's interpretation of the *Howey* investment contract test,[238] and

234. *See generally* SEC, Public Statement, *Leaders of CFTC, FinCEN, and SEC Issue Joint Statement on Activities Involving Digital Assets* (Oct. 11, 2019) [https://perma.cc/3S3Q-9AF3].

235. *See supra* note 10.

236. As noted earlier at note 191, there are multiple federal and state authorities that currently have jurisdiction over cryptoassets. At the federal level, the overlap between the SEC and CFTC jurisdiction is probably the most problematic. *See supra* note 181 for an explanation of the overlap. This point is also made in the next section of this Article.

237. "The Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") have both claimed ability to regulate this space, with the SEC deeming virtual currencies to be securities by reason that they are investment contracts and the CFTC looking to classify them as commodities." Victor N.A. Metallo, *Are They Commodities or Securities? Virtual Currency Markets – Congress Must Create A New Regulatory Entity*, 8 WAKE FOREST L. REV. ONLINE 44 (Sept. 30, 2018). *See also* T. Gorman, *Blockchain, Virtual Currencies and the Regulators*, DORSEY & WHITNEY LLP (Jan. 11, 2018), https://www.secactions.com/blockchain-virtual-currencies-and-the-regulators/. "As the CFTC recently admitted, U.S. law does not provide for 'direct comprehensive U.S. regulation of virtual currencies. To the contrary a multi-regulatory approach is being used.'").

238. *See supra* notes 28-35 and accompanying text.

the extremely broad definition of commodity in the Commodity Exchange Act (CEA).[239]

In 2014, the CFTC first declared virtual currencies to be a "commodity" subject to its authority under the CEA,[240] and on September 17, 2015, the CFTC issued its first administrative order confirming the position that Bitcoin and other virtual currencies were commodities under the CEA.[241] In addition to various enforcement actions involving derivatives,[242] the CFTC has also claimed authority to regulate fraud in the crypto spot markets.[243] Originally, it claimed such authority for fraud in connection with Bitcoin trades.[244] This makes sense under the current statutes because Bitcoin is an asset in which futures are traded. However, the CFTC has also initiated anti-

239. Section 1(a)(9) of the Act defines "commodity" to include, among other things, "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1(a)(9). Not surprisingly, this has been broadly construed to cover "virtual currencies," which the CFTC has defined to include any "digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value." CFTC, *An Introduction to Virtual Currency* [https://perma.cc/4CS9-2MJ9]. For a more complete description of the CFTC's approach to crypto (which it calls virtual currencies), see LabCFTC, *A CFTC Primer on Virtual Currencies* (Oct. 17, 2017) [https://perma.cc/Y8YE-E2CE] (hereinafter *Primer*).

240. CFTC, *Testimony of CFTC Chairman Timothy Massad before the U.S. Senate Committee on Agriculture, Nutrition and Forestry* (Dec. 10, 2014), http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6).

241. CFTC, *CFTC Orders Bitcoin Options Trading Platform Operator and its CEO to Cease Illegally Offering Bitcoin Options and to Cease Operating a Facility for Trading or Processing of Swaps without Registering*, REL. NO. 7231-15 (Sept. 17, 2015), https://www.cftc.gov/PressRoom/PressReleases/pr7231-15. For additional details about this action, see Conrad Bahlke, *Recent Developments in the Regulatory Treatment of Bitcoin,* 28 No. 1 INTELL. PROP. & TECH. L.J. 6 (2016) (citations omitted).

242. *See In re TeraExchange LLC*, Dkt. No. 15-33 (CFTC Sept. 24, 2015), http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfteraexchangeorder92415.pdf (action to prohibit wash trading and prearranged trades on a crypto-derivatives platform); *In re BXFNA Inc. d/b/a Bitfinex*, Dkt. No. 16-19 (CFTC June 2, 2016), http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfbfxnaorder060216.pdf (action against unregistered Bitcoin futures exchange).

243. A "spot market," also known as the actual or physical market, involves transactions in the actual commodity rather than in derivative interests such as futures.

244. *See, e.g., CFTC v. Gelfman Blueprint, Inc.*, Case No. 17–7181, 2017 WL 4228737 (S.D.N.Y. filed Sept. 21, 2017) (involving a Bitcoin Ponzi scheme). In 2018, the court ruled in favor of the CFTC, ordering Gelfman to pay more than $2.5 million in civil monetary penalties and restitution. CFTC, *Federal Court Orders Trading Firm and CEO to Pay More than $2.5 Million for Fraudulent Bitcoin Ponzi Scheme,* REL. NO. 7831-18 (Oct. 18, 2018), https://cftc.gov/PressRoom/PressReleases/7831-18 ("This case marks yet another victory for the Commission in the virtual currency enforcement arena. As this string of cases shows, the CFTC is determined to identify bad actors in these virtual currency markets and hold them accountable.").

fraud actions against other cryptoassets in which no futures have ever been traded or contemplated.[245]

In *CFTC v. McDonnell*,[246] the CFTC alleged that Patrick McDonnell and his company CabbageTech, Corp., dba Coin Drop Markets, sold memberships in crypto trading groups by falsely promising profits up to 300% per week.[247] The CFTC specifically asserted that it had "concurrent regulatory power over virtual currency in certain settings . . .." including the spot markets if fraud is involved.[248] The District Court for the Eastern District of New York agreed,[249] while noting that other administrative agencies such as the SEC also have partial authority over cryptoassets.[250]

This decision is problematic not because it recognizes a division of responsibility, but because it allows for a duplication of efforts. While the CFTC, under the terms of the CEA, has exclusive jurisdiction over most derivative contracts and exchanges that trade such derivatives, it also has jurisdiction when there is fraud in the spot markets for commodities.[251] Normally this would not result in

245. *CFTC v. McDonnell*, 287 F. Supp. 3d 213, 216 (E.D.N.Y.), adhered to on denial of reconsideration, 321 F. Supp. 3d 366 (E.D.N.Y. 2018).

246. *Id*.

247. *Id*. at 217.

248. *Id*. at 220 (citing testimony by the Chairman of the CFTC acknowledging that "current law does not provide any U.S. Federal regulator with such regulatory oversight authority over spot virtual currency platforms [not involving fraud] operating in the United States or abroad.").

249. *Id*. at 221, noting actions by the SEC such as SEC v. Plexcorps, 17–CV–7007, 2017 WL 5988934 (E.D.N.Y. Filed Dec. 1, 2017) ("This is an emergency action to stop Lacroix, a recidivist securities law violator in Canada, and his partner Paradis-Royer, from further misappropriating investor funds illegally raised through the fraudulent and unregistered offer and sale of securities called 'PlexCoin' or 'PlexCoin Tokens' in a purported 'Initial Coin Offering.'").

250. Christopher Giancarlo, *Chairman Giancarlo Statement on Virtual Currencies*, CFTC (Jan. 4, 2018) ("One thing is certain: ignoring virtual currency trading will not make it go away. Nor is it a responsible regulatory strategy. The CFTC has an important role to play."). Cited in *McDonnell*, 287 F. Supp. 3d at 221-222.

251. *See* 7 U.S.C. § 9 (banning the use of any "manipulative or deceptive device or contrivance" in connection with the sale of a commodity); 17 C.F.R. § 180.1(a) (banning the use of "any manipulative device, scheme, or artifice to defraud," the making of "any untrue or misleading statement of a material fact," or the use of "any act, practice, or course of business, which operates . . . as a fraud or deceit . . . ." in connection with the sale of a commodity). There are several reported decisions from various court recognizing the CFTC's power to prosecute fraud under these provisions. *See* CFTC v. S. Tr. Metals, Inc., 894 F.3d 1313, 1319, 1325, 1334 (11th Cir. 2018) (affirming judgment for CFTC in "commodities-fraud case" alleging violations of Regulation 180.1 that "involve[d] no allegation . . . that the Defendants manipulated the price of a commodity"); *McDonnell*, 287 F. Supp. 3d at 229 ("Language in 7 U.S.C. § 9(1), and 17 C.F.R. § 180.1, establish the CFTC's regulatory authority over the manipulative schemes, fraud, and

significant duplication of efforts, but in the case of a commodity that is a security, this can result in both the CFTC and SEC devoting resources to address the same conduct.[252] Even though both agencies have indicated a desire to avoid over-regulation and work together,[253] the CFTC and SEC continue to duplicate efforts.[254]

While one option to avoid duplication would be to leave the matter to the CFTC, the reality is that agency has no experience in establishing standards for the cash or spot market of commodities. Since that is where most of the trading of Bitcoin and other cryptoassets occurs, and because crypto is not well understood or subject to self-regulation, it is especially important that the agency overseeing crypto have appropriate experience and authority to

misleading statements alleged in the complaint."), *aff'd on reconsideration,* 321 F. Supp. 3d 366, 2018 WL 3435047 at 368 (E.D.N.Y. 2018) ("Title 7 U.S.C. § 9(1) gives the CFTC standing to exercise its enforcement power over the fraudulent schemes alleged in the complaint."); CFTC v. Hunter Wise Commodities, *LLC*, 21 F. Supp. 3d 1317, 1348 (S.D. Fla. 2014) (finding defendants liable for violating Section 6(c)(1) and Regulation 180.1 in fraud case not involving allegations of market manipulation). *But see* CFTC v. Monex Credit Co., 311 F. Supp. 3d 1173, 1185–89 (C.D. Cal. 2018) (finding that Section 6(c)(1) prohibits only fraud-based market manipulation). In the specific context of cryptoassets, *see* CFTC v. My Big Coin Pay, Inc., 334 F. Supp. 3d 492, 498–99 (D. Mass. 2018).

252. For example, on September 27, 2018, the SEC and CFTC filed parallel cases in the same court against the same defendant. *See* SEC v. 1pool Ltd., No. 1:18-cv-02244 (D.D.C. Sept. 27, 2018) and *CFTC v. 1pool Ltd*., No. 1:18-cv-02243 (D.D.C. Sept. 27, 2018).

253. *See* CFTC, *CFTC and SEC Announce Approval of New MOU*, REL. NO. 7745-18 (June 28, 2018), https://www.cftc.gov/PressRoom/PressReleases/7745-18 (noting that the SEC and CFTC "announced today that the two agencies have approved a Memorandum of Understanding (MOU) that will help ensure continued coordination and information sharing between the two agencies.") In addition, both agencies have independently proclaimed a desire not to stifle innovation in the crypto arena. *See* CFTC, *Remarks of Commissioner Brian Quintenz before the Eurofi High Level Seminar 2018* (Apr. 26, 2018), https://www.cftc.gov/PressRoom/SpeechesTestimony/opaquintenz11 (stating that "it is incumbent upon regulators to create a workable and appropriate regulatory framework that facilitates market-enhancing innovation. This means adopting regulation that is fair, technology-neutral, and does not stifle positive innovations."); Emily Gordy & Molly M. White, *SEC 2019 FinTech Forum,* CONSUMER FINSIGHTS, MCGUIREWOODS (June 13, 2019) [https://perma.cc/S462-J3NU] ("The SEC's stated goal is to regulate without inhibiting innovation.").

254. Nikhilesh De, *US Authorities Charge Crypto 'Trading Club' Operators With Defrauding 150 Investors*, COINDESK (Feb. 11, 2020), https://www.coindesk.com/us-authorities-charge-crypto-trading-club-operators-with-defrauding-150-investors ("The U.S. Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) and the U.S Attorney for the Southern District of New York have charged Ohio resident Michael Ackerman and two unnamed business partners with defrauding some 150 investors by claiming to offer "extraordinary profits" from a cryptocurrency trading scheme."). The involvement of the U.S. Attorney General signifies that the matter is criminal rather than civil and is not the same as having two agencies responsible for the investigation of the same behaviors.

promulgate requirements for compliant sales.[255] Therefore, it makes sense to use the SEC as the starting point for targeted regulation outside the limited area of derivatives and exchanges for those derivatives.

C. PREEMPTIVE AUTHORITY OVER STATE REGULATIONS

Another important component of productive change is to give the SEC preemptive authority over state securities regulation of cryptoassets. At the current time, every state retains authority to regulate cryptoassets as securities if they so choose, and the reality is that state treatment of crypto varies widely.[256]

Some states have issued guidance, opinion letters, or other information from their financial regulatory agencies regarding whether virtual currencies are "money" under existing state rules, while others have enacted piecemeal legislation amending existing definitions to either specifically include or exclude digital currencies from the definition. To use a pun those in the blockchain space should understand, there is a complete lack of consensus as to whether they do or not.[257]

By way of example, Wyoming is widely recognized as being the most pro-crypto U.S. state.[258] The Wyoming statutes exempt "digital

255. Timothy G. Massad, *It's Time to Strengthen the Regulation of Crypto-Assets Crypto-Assets*, ECONOMIC STUDIES AT BROOKINGS, 32-33 (Mar. 2019), https://www.brookings.edu/wp-content/uploads/2019/03/Timothy-Massad-Its-Time-to-Strengthen-the-Regulation-of-Crypto-Assets-2.pdf ("When it comes to many commodities, such as oil or wheat, the fact that the CFTC does not have authority to set standards for the cash market is usually not critical, because the cash market has developed standards and norms over decades and may even be subject to other regulatory oversight. But the cash market for crypto-assets—which is where most of the trading takes place today—does not have well-developed standards.").

256. As one source explains, "all states can assert jurisdiction over securities transactions involving crypto-related subject matter because there is no blanket federal jurisdictional preemption in securities regulation." Bryan K. Prosek & John R. Chadd, *State Securities Regulators Are Increasing Actions Against Cryptocurrency Issuers and Exchanges,* NAT. L. REV (Nov. 28, 2018) [https://perma.cc/9JDZ-SCND]. The result is a patchwork of inconsistent approaches. *Id*.

257. Matthew E. Kohen & Justin S. Wales, *State Regulations on Virtual Currency and Blockchain Technologies—(Updated)*, CARLTON FIELDS (Oct. 17, 2017; updated Apr. 19, 2019), https://www.carltonfields.com/insights/publications/2018/state-regulations-on-virtual-currency-and-blockchain-technologies.

258. Caitlan Long, *What Do Wyoming's 13 New Blockchain Laws Mean*?, FORBES (Mar. 4, 2019), https://www.forbes.com/sites/caitlinlong/2019/03/04/what-do-wyomings-new-blockchain-laws-mean/#789ad4785fde.

consumer assets" from the definition of a digital security.[259] "Digital consumer asset" is defined as "a digital asset that is used or bought primarily for consumptive, personal or household purposes" other than as a virtual currency that is to be used "as a medium of exchange, unit of account or store of value."[260]

Montana is also regarded as have a pro-crypto securities regime, but its statutes provide an exemption for utility tokens whose purpose is primarily consumptive. [261] The specifics of this exemption require an issuer to prove that it has marketed the token for consumptive purposes and "does not market the utility token to be used for a speculative or investment purpose."[262] In addition, the utility token must be available at the time of the sale or within 180 days so long as the initial buyers knowingly agree that their purchase is for consumption and that no resales are permitted until the functionality of the token is available.[263]

In contrast, not every jurisdiction has enacted exemptive or exclusionary language for any kind of crypto assets or offerings. For example, on January 3, 2019, the North Dakota House introduced a bill which would have exempted "an open blockchain token from specified securities transactions and dealings."[264] The bill was, however, defeated on January 11, 2019. The Rhode Island House similarly proposed a bill that, among other things, would have exempted virtual currency from securities requirements.[265] The bill was referred to the House Finance Committee and died there.

Naturally, there are a number of arguments that can be made in favor and against federal preemption generally:

Arguments commonly made in favor of federal preemption in a particular area include the creation of a uniform national standard, ease of commerce in markets of a national or global nature, and the concentration of expertise with a single federal regulator . . . Arguments against federal preemption generally include encouragement of policy experimentation, democratic accountability

259. WYO. STAT. ANN. § 34–29–101(a)(iii).
260. *Id*. at §§ 34–29–101(a)(ii) & (iv).
261. MONT. CODE ANN. § 30–10–105(23).
262. *Id*. at § 30-10-105(23)(a)(ii).
263. *Id*. at § 30-10-105(23)(a)(iv).
264. H.B. 1043, 2019 66th Leg. Assemb., (N.D. 2019) [https://perma.cc/RE22-D5XK].
265. 2019 RI H5776 (NS) (Feb. 28, 2019). – 2020 RI H7989 (March 11, 2020).

and maintaining the regulator as close as possible to the regulated entities.[266]

In the context of cryptoassets, which are not local in character and where over-regulation runs the risk of stifling technological innovation, the advantages of preemption would appear to outweigh the disadvantages.

It is noteworthy that this would not be the first time that the federal securities laws will have preempted inconsistent state securities regulation. The National Securities Market Improvement Act of 1996 (NSMIA)[267] included the first express federal preemption of state blue-sky laws. NSMIA grants the SEC broad authority to preempt state regulation over any offerings to "qualified purchasers," requiring only that the definition of that phrase be "consistent with the public interest and the protection of investors."[268] Nonetheless, the SEC has not generally taken advantage of this authority, which is why this Article suggests that Congress direct such preemption.[269]

D. NEW EXEMPTIONS

Assuming the SEC is given exclusive and preemptive authority over cryptoassets as a new category of securities, it is also important that the agency be directed to establish appropriate, targeted standards for distributions of cryptoassets. While antifraud requirements can and should continue to be enforced based on the history of fraudulent distributions involving crypto,[270] Congress should direct the SEC to promulgate exemptions from the registration requirements for various kinds of crypto.

266. Philip C. Berg, *State vs. Federal Laws in Cryptocurrency: Blue Sky, or Running in the Red?* MEDIUM (Dec. 4, 2018) [https://perma.cc/6A4S-F6YC].

267. National Securities Market Improvement Act of 1996, Pub. L. No. 104–29, 110 Stat. 3416 (Oct. 11, 1996) (the text of the law is available online at https://www.congress.gov/104/plaws/publ290/PLAW-104publ290.pdf).

268. 15 U.S.C. § 77r(b)(3).

269. Rutheford B. Campbell, *The Role of Blue Sky Laws After NSMIA and the JOBS Act*, 66 DUKE L.J. 605, 617 (2016). "State regulators have vigorously and seemingly with renewed energy opposed the expansion of preemption. The Commission, on the other hand, has been unwilling to any significant degree to promote preemption."

270. Creative criminals have already found myriad ways to abuse the crypto markets; there is no reason to suspect this will stop. *See* Tyler Elliot Bettilyon, *Cryptocurrency's Criminal Revolution*, MEDIUM (Jul. 12, 2018), https://medium.com/s/story/cryptocurrencys-criminal-revolution-6dae3cdf630f.

It is true that the SEC already has broad authority to promulgate exemptions from registration for classes of securities "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."[271] Notwithstanding this authority, the need for a Congressional mandate is clear since the SEC has shown no inclination to adopt new regulations, choosing instead to regulate based on preexisting rules.

Congress could choose to amend section 4 of the Securities Act of 1933[272] to add a new exemption from registration for cryptoassets, with the exception of tokenized securities that provide investors with governance rights and/or profits in the issuer/creator or provide for redemption at a profit or with interest to be paid by the issuer.[273] (Those should be treated in the same way as other equity or debt securities, and ordinary registration or exemption alternatives and conditions should apply.) Rather than spelling out the terms of such an exemption, the new statutory provision could provide for exemptions that cover such sales as the Commission may, by regulation, provide. The SEC could then seek input from industry about the parameters of the exemptions.

Presumably, a new exemption for forms of crypto that cannot be characterized as tokenized debt or equity would be conditioned upon disclosure of certain information relevant to the value of the crypto (and not particularly the business of the issuer outside that context),[274] as specified by the SEC. This could include information such as the qualifications and background of any token development team (not of the issuer's management as current forms emphasize), with more

271. 15 U.S.C. § 77z-3 (granting the SEC general exemptive authority:
The Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.)

272. 15 U.S.C. § 77d (dealing with exempted transactions).

273. Those kinds of crypto would essentially be tokenized forms of traditional debt or equity securities and could be treated under existing provisions of the law without the need for a new exemption. Moreover, the new exemption would not adequately protect investors who believe they are obtaining a debt or equity stake in a business as disclosures would not adequately convey information about the entity in which a purchaser would be investing.

274. Note that this is a change from the current regulatory disclosure model, which specifically references the need to disclose information not merely about the security being issued but also about the company (a requirement that makes sense only if there is to be an investment in the company itself). *See supra* Part II of this Article.

detail being required if the token is pre-functional.[275] It could also include a description of how outstanding coins or tokens were issued or pre-mined, and for what consideration, along with information about the extent to which the issuer and those affiliated with the token project retain ownership of any of those outstanding interests.

A possible starting point for the kinds of disclosures is to consider who would be required to make them. For cryptoassets being sold by or in connection with a development team, the disclosures might include response to the following kinds of questions. What is the intended function of the token? How far along is it in development? Who is working on the development, and what are their qualifications? How will the token be issued? How many coins or tokens have been pre-mined or distributed, and for what consideration? Is there a cap on the total number of tokens to be created, and if so, what is it? Can the cap be changed? How disperse is the ownership of the token? How many of the outstanding tokens are owned by the issuer, the team creating the asset, or an affiliate of such person(s)? What will be the policies on hard forks? How are errors or weaknesses in the protocol to be addressed or remedied? Under what circumstances will transactions be reversed or stopped? What privacy protocols are in place, and are they mandatory or optional? Who will be working on promotion of the coin or token? Are there restrictions or limitations on resale? Are there existing exchanges that accept the asset? If not, will anyone be working on finding an exchange or trading platform that will include the coin or token among their interests? Note that answering these questions would require disclosures very similar to those proposed by SEC Commissioner Hester Peirce's as part of suggestion that the SEC adopt a 3-year safe harbor.[276]

This Article suggests that particular plans for or limits on transferability and liquidity should also be part of the required disclosures, particularly if non-accredited investors are involved. (This is different from the Peirce proposal, which would be limited to tokens that are designed to be liquid.)[277] In addition, the greater the amount to be raised, the more detailed the required disclosures can reasonably be expected to be, although the SEC should learn from its

275. A pre-functional token is a cryptoasset that is not fully functional as of its launch, or in other words, it lacks completed programming upon issuance.

276. *See supra* notes 214-20 and accompanying text.

277. Peirce, *Empty, supra* note 214.

Regulation CF rules[278] and avoid setting fundraising limits that are unrealistically low or imposing unduly burdensome ongoing reporting requirements.

The '33 Act should also be amended to address what occurs when the person selling the token is not the actual developer. For someone not engaged in regular sales, or the business of profiting from speculation in crypto, it may be appropriate to have a specific exemption, because it is not always clear who will count as an issuer and therefore who would count as an underwriter. For persons who are engaged in the business of selling crypto, or who own a significant amount of a particular token, different kinds of disclosures may be required. For these kinds of sellers, important questions may include how many tokens the seller owns or controls, any connection to the issuer or developer(s), and what communications the seller has made or directed others to make that are designed to influence the pricing of the token. These persons may not have the other kinds of information that would be accessible to developers or conventional issuers of securities, so the required disclosures need to be appropriately tailored.

The point of this discussion is not to fully describe the exemptions that need to be drafted. That is a process best informed by the notice and comment process that federal agencies such as the SEC are directed to follow. However, a legislative mandate is needed at this point to ensure that the commission does indeed adopt changes to help balance the need for investor protection with the legitimate needs of crypto entrepreneurs.

E. RECAP OF RECOMMENDATIONS

The proposal outlined in this Article would result in the following changes.

i. *From the Regulators' Perspectives*

278. Regulation CF was designed to allow smaller entities to conduct crowdfunded securities offerings. *See* SEC, *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers* (May 13, 2016 with Apr. 5, 2017 updates), https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm. It was originally limited to offerings that did not exceed $1,000,000 in any 12-month period, although that amount is now at $1,070,000. Because of the low offering limit, few Reg CF offerings have been conducted, prompting the SEC to propose raising the limit to $5,000,000. For a discussion of this proposal, see *SEC Proposed Major Changes to Regulation Crowdfunding (Reg CF),* INFRASHARES (Mar. 13, 2020) [https://perma.cc/Y3E3-VD8B].

The most important benefit of these changes from the SEC's perspective is that it would no longer need to spend resources litigating what is a security. By specifically including cryptoassets in the definition, the time and resources spent on trying to clarify or arguing about whether the securities laws apply to crypto would come to an end. This would give the SEC additional time and resources to provide more accurate warnings about crypto fraud. It would also allow the SEC to focus more of its attention on fraud, without needing to coordinate with or worry about overlapping with the CFTC's enforcement efforts.

In addition, the SEC would be better able to accomplish its mission of facilitating capital formation and avoiding the risk of stifling innovation by having the impetus and resources to craft more focused disclosures for these kinds of assets. Because crypto is a security, this would not compromise the commission's ability to protect the public from fraudulent transactions, making the option a win-win.

From the perspective of other regulators, the CFTC would no longer be called upon to regulate in the crypto spot markets, and state securities regulators would also be free to focus on fraudulent activity without needing to regulate the process of registration or exemptions.

ii. *From the Entrepreneur's Perspective*

The benefits to crypto-entrepreneurs would seem to be relatively obvious. Instead of needing to coordinate with both the CFTC and SEC at the federal level, there would be a single regulator. In addition, and more importantly, they could expect (and have input into the creation of) reasonable and targeted exemptions and disclosure regimes. This should mean that crypto-developers would no longer be forced out of the U.S. markets or out of the realm of innovation altogether. Similarly, other crypto-based businesses such as exchanges and investment advisors should be able to develop strategies for compliance with regulatory requirements once appropriate rules are in place.

iii. *From the Public Investor's Perspective*

As for investors, they would still be as protected from fraud. In fact, the SEC should have additional resources to focus on this kind of problem. At the same time, persons desiring to participate as an

investor in the crypto markets could expect more opportunities for investment. This would also be facilitated by the expansion of crypto-based businesses such as exchanges and investor services enterprises, which can be expected when there is a reasonable path to regulatory compliance.

VI. CONCLUSION

The result of the proposal presented in this Article could be a regime that appropriately assigns responsibilities to the SEC and recognizes its expertise and superior position when it comes to knowledge about systemic risks associated with cryptoassets. Under this approach, the SEC should be able to satisfy both parts of its mission: protection of the public and facilitating innovative capital formation. As a consequence of these changes in regulatory direction, the U.S. should wind up with a fairer and more efficient disclosure regime suitable for both the issuer and investors. Finally, investors would be recognized as being responsible for their own decisions. To the extent that it is their decision where to store and exchange their crypto, they should be responsible for the risks of cyber failures. They should also accept the risk of problems such as those caused by market volatility, and other risks that are outside the control of any particular person.

The thrust of this Article is not that regulation of cryptoassets is unnecessary or that the SEC is the wrong regulator for the developing technology. However, the current system creates a number of issues that could be resolved with legislative intervention. These include the current resources that are devoted to trying to apply the *Howey* test, the awkwardness of applying existing disclosure obligations to an asset that simply works differently than conventional securities, and a regulatory focus that duplicates efforts.

As a result of the inefficiencies and uncertainties associated with the current regime, potential issuers are prevented from offering potentially valuable interests or from funding potentially viable businesses because of the cost of regulatory compliance, and investors are foreclosed from opportunities in which they may desire to participate. Even entrepreneurs who elect to proceed with offerings are often driven out of the U.S. or forced to pass along unnecessarily higher costs to potential purchasers. Investors who think they are being protected by current disclosure requirements are

not, because the most relevant information is either not provided or buried in so much other information that it is not accessible.

Making it clear that crypto is a security (and therefore subject to the anti-fraud provisions of the federal securities laws), but presumptively exempting it from the requirements of registration seems to be the most efficient approach. An exemption from registration does not mean that no disclosures are required, but instead it allows the disclosure paradigm of a generally available exemption to focus on the actual concerns that are likely to be most relevant to potential purchasers. It will allow the SEC take resources away from the focus on "when is crypto a security," and direct them instead to "what kinds of information do purchasers of crypto reasonably need to know, that issuers/developers can reasonably be expected to provide"? That seems to be a far more efficient and productive utilization of resources than is currently being witnessed.

Obviously, as is the case with current exemptions, if a distribution is accomplished through fraud or deception, with misleading or inaccurate information in the offering or advertising materials, a cause of action for fraud should still be available. But for compliant issuers, a different approach would definitely seem to be superior to the current regulatory structures that leaves too many possible crypto developers with the equivalent of bleeding feet crammed into an ill-fitting slipper.

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