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SEC begins to clarify application of federal securities laws to crypto

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The SEC has issued a much-anticipated interpretation regarding when the federal securities laws apply to certain types of crypto assets and transactions. It is an important step forward, but reflecting the difficulty in drawing clear lines, critical uncertainties persist. Most prominent is the question of when and how long a non-security crypto asset remains subject to an investment contract. The SEC may resolve these lingering questions in forthcoming rules.

Background

The Securities and Exchange Commission (**SEC**) issued a Commission-level interpretive release that provides its views on how the federal securities laws apply to certain types of crypto assets and activities. The Commodity Futures Trading Commission (**CFTC**) joined the interpretation to affirm that it will administer the Commodity Exchange Act in a manner consistent with the SEC's interpretation.

The interpretation:

- establishes a token taxonomy for digital commodities, digital collectibles, digital tools, stablecoins and digital securities;
- addresses how a crypto asset that itself is not a security may become subject to, and cease to be subject to, an investment contract that is a security; and
- confirms the SEC's view regarding the non-applicability of the federal securities laws to qualifying airdrops, protocol mining, protocol staking, liquid staking tokens and the wrapping of a non-security crypto asset, consistent with recent SEC staff guidance.

Takeaways

1. Token taxonomy provides a way to look at the market through the lens of the federal securities laws

The interpretation classifies crypto assets into five categories based on their characteristics, uses and functions:

- digital commodities;
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- digital collectibles;
- digital tools;
- stablecoins; and
- digital securities.

The interpretation states that digital commodities, digital collectibles and digital tools are not securities, GENIUS Act compliant and similar stablecoins are not securities and digital securities are (of course) securities.

This taxonomy provides a useful framework for market participants to understand how the SEC views various crypto assets. Reflecting the ever-evolving nature of the crypto asset market, market participants will still have to grapple with some important interpretive considerations:

- The interpretation notes that "[g]iven the variations in crypto assets and the constantly evolving nature of the crypto asset markets, including the underlying technology, there may be crypto assets that do not fall within any of these five categories, as well as crypto assets with hybrid characteristics that may fall within more than one category." As a result, a crypto asset may not fit into any of the four non-security categories and thus may fall into the definition of a security.
- The interpretation specifies that a crypto asset is not a digital commodity if it has "intrinsic economic properties or rights, such as generating a passive yield or conveying rights to future income, profits, or assets of a business enterprise or other entity, promisor, or obligor… ." The interpretation specifically lists 18 examples of crypto assets that the SEC believes are digital commodities. Presumably none of the economic features exhibited by those assets or their accompanying protocols qualify as passive yield. Various tokens have embedded features that, economically, could potentially be viewed as generating yield for holders. The meaning of passive yield is not defined in the interpretation and may need to be considered as part of future SEC rulemaking.

2. The interpretation helps recalibrate *Howey,* but important questions remain—especially for secondary market transactions

The interpretation marks the SEC's most comprehensive effort to date to bring a semblance of clarity to the application of the federal securities laws to the crypto asset market. But to understand these efforts requires a quick look back in history.

Since as far back as the 2017 DAO Report, the SEC has grappled with the challenging question of when and how to apply the federal securities laws to crypto assets and transactions. Faced with a new asset class that did not fall neatly into any of the traditional instruments enumerated in the definition of "security," the SEC applied the "*Howey* test," which the U.S. Supreme Court has used since 1946 to determine whether a contract, transaction or scheme is an investment contract and therefore a security. As the Court announced in 1946, the *Howey* test deliberately embodies a "flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."

The *Howey* test's flexibility makes it very useful to the SEC and private plaintiffs as a retrospective test for isolating transactions that, in hindsight, bear enough of the hallmarks of a securities offering that they should have been treated as such, with investors given the benefit of full and fair disclosure about how their money was going to be used and what they might expect to get in return. But its flexibility comes at the cost of predictability. The *Howey* test simply does not foster bright-line reproducible results that market participants can rely on with reasonable confidence to settle jurisdictional boundaries.

The interpretation walks back expansive theories expounded under former Chair Gary Gensler's leadership, which often conflated securities *transactions* with *assets* that are securities. And in contrast to prior assertions that the "vast majority" of crypto assets are themselves securities, the interpretation seeks to establish that most crypto assets, outside of tokenized versions of traditional securities, are not securities.

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But even if a crypto asset itself is deemed to be a non-security crypto asset (such as a “digital commodity”), the SEC states in the interpretation that the non-security crypto asset may still be subject to an investment contract. It also states that such assets can remain subject to an investment contract in the secondary market. And, if a non-security crypto asset is subject to an investment contract, then transactions in that non-security crypto asset are nevertheless securities transactions.

Although the interpretation seeks to put some structure around the *Howey* test by focusing on the representations and promises of an issuer, as an interpretation of existing law, it remains subject to the inherent difficulties of applying *Howey*. We expect it will be challenging for market participants to:

- compile every representation or promise an issuer (including affiliates and agents of the issuer or a promoter) has made and conveyed to purchasers;
- assess each of the facts and circumstances described in the interpretation to determine whether those representations or promises gave rise to a reasonable expectation of profits based on the person’s essential managerial efforts, such that transfers give rise to an investment contract; and then
- proceed to determine whether each promise has, at a given moment, effectively been fulfilled or abandoned such that the investment contract has terminated.

This challenge could be particularly acute for the roughly 10,000 crypto assets already in existence, for which the associated issuers did not have the benefit of this interpretation before conveying any representations or promises to the market. We posit a common scenario:

> *Consider a foundation associated with a crypto system that regularly publishes roadmaps for the future development of the system and its related digital commodity. One would first need to determine whether the foundation is the “issuer” of the investment contract to which the digital commodity is subject, or an affiliate or agent of the issuer or a promoter. If so, one must next determine whether the roadmap constitutes a representation or promise to engage in the activity and achieve the planned objectives, and if so, whether doing so is an “essential” managerial effort that would give rise to a reasonable expectation of profit. If the answers to these are yes, then the interpretation takes the view that the resulting investment contract could “continue to be transferred to subsequent purchasers of the non-security crypto asset in secondary market transactions until the non-security crypto asset separates from the issuer’s representations or promises.”*

The interpretation also raises a metaphysical question: what does it mean for a token to not itself be a security, yet for each transaction in the token to “transfer” an ongoing investment contract? While there are examples of “stapled” securities (such as common stock and warrants which are transferred together), those scenarios involve two distinct, identifiable instruments.

It is less clear how intermediaries should treat an investment contract that is not embodied in any form. For example, it seems persons who would meet the definition of broker, dealer, exchange or clearing agency, if engaged in these activities in connection with a non-security crypto asset that is subject to a continuing investment contract, would be subject to registration requirements.

Similar questions arise with respect to investment advisers and companies (although, by its terms, the interpretation is adopted under only the Securities Act of 1933 and the Securities Exchange Act of 1934, not the Investment Advisers or Company Acts of 1940). The practical result for intermediaries may be little different than if the crypto asset was in fact itself a security.

3. The interpretation seems to move away from the SEC’s previous focus on decentralization

The interpretation explicitly supersedes the SEC staff’s 2019 Framework for “Investment Contract” Analysis of Digital Assets—which we’ve previously argued had proven difficult to apply in a manner that yields consistent results. The 2019 framework built heavily on the “Hinman Speech,” which focused on decentralization as a key concept for determining whether offers or sales in a crypto asset are securities transactions.

The theory was that when a system is sufficiently decentralized, purchasers of the crypto asset no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts, material information asymmetries

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recede and the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult. The speech announced the view that offers and sales of bitcoin and ether were not securities transactions because, for each asset, there was no central third party whose efforts are a key determining factor in the enterprise.

The interpretation seems to move away from the SEC's prior focus on decentralization. As noted, the investment contract analysis focuses on an issuer's promises, rather than features of the crypto asset. The definition of digital commodity also does not require any decentralization.

That said, a digital commodity must relate to a functional crypto system, which in turn cannot "have a central party that oversees participation or distributes rewards to users," and defines a central party as "a person, entity, or group of persons or entities having operational, economic, or voting control of a crypto system." While "control" is not defined in the interpretation itself, in practice, the SEC may look to the federal securities laws' expansive definition of control. Decentralization could also play into the question of whether it continues to be reasonable to rely on the promises or representations of any particular person, such that an investment contract may never have been formed or no longer exist.

4. Rulemaking and/or legislation will be needed for long-term clarity

Chairman Atkins described the interpretation as "a beginning and not the end," noting the SEC is working on a broader exemptive rulemaking—called "Regulation Crypto Assets"—that would draw heavily from congressional work over recent years, particularly the CLARITY Act. This rulemaking could include:

- a "startup exemption," which could be a time-limited registration exemption for offerings of investment contracts involving certain crypto assets;
- a "fundraising exemption," which could be another registration exemption for investment contracts involving certain crypto assets; and
- an "investment contract safe harbor," which could align with the principles articulated in the interpretation to clarify when an issuer has completed or otherwise permanently ceased all essential managerial efforts that the issuer represented or promised that it would engage in under the investment contract.

This rulemaking, and the investment contract safe harbor in particular, can provide clear rules of the road so that market participants can determine with confidence which transactions in non-security crypto assets are subject to the securities laws. It could also add bright lines on what features cause a crypto asset to fall within or outside of each of the proposed categories. Indeed, the SEC appears to have submitted a crypto-related rulemaking to the Office of Management and Budget for review, indicating that the release of a rule proposal may be nearing—though the specifics of the rulemaking have not been disclosed. But thoughtful congressional legislation would be a more durable way to enable market participants to determine, from the outset and on a prospective basis, where the boundaries of federal securities jurisdiction start and end.

Token taxonomy

Digital commodities

A digital commodity is described as "a crypto asset that is intrinsically linked to and derives its value from the programmatic operation of a crypto system that is 'functional,' as well as supply and demand dynamics, rather than from the expectation of profits from the essential managerial efforts of others." A crypto asset that "generat[es] a passive yield or convey[s] rights to future income, profits, or assets of a business enterprise or other entity, promisor, or obligor" would not be a digital commodity. A crypto system is "functional" if "the system's native crypto asset can be used on the system in accordance with the programmatic utility of the system."

The interpretation further provides that a digital commodity is "necessary" and "integral" to the operation of the associated functional crypto system. Necessary and integral functions consist of:

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- facilitating and incentivizing the validation, ordering and confirmation of transactions on the associated system;
- serving as a mechanism to maintain the functioning and/or security of the associated system; and
- fostering network effects.

Network effects are defined as "the phenomenon where the value, use, and security of a crypto system increase as more users participate and interact with the crypto system." The interpretation states that fostering network effects does not involve essential managerial efforts.

Examples of use cases that qualify as necessary and integral functions include:

- participating in the system's consensus mechanism by staking (or locking up) the token;
- conveying governance rights with respect to the associated crypto system; and
- serving as the medium for paying transaction (or "gas") fees.

The interpretation lists 18 crypto assets that, as of the date of the release, the SEC says qualify as digital commodities, including BTC, ETH, SOL and XRP. The interpretation notes 16 of these crypto assets currently underlie futures contracts that have been made available to trade on a designated contract market operating under the regulatory oversight of the CFTC, but that it is not necessary that a crypto asset underlie a futures contract to be a digital commodity. It then notes two examples of crypto assets that do not underlie a futures contract but are nonetheless digital commodities, ALGO and LBRY Credits (LBC). Interestingly, in 2022, LBC was the subject of an SEC enforcement action resulting in a federal district court finding, on summary judgment, to have been offered and sold in unregistered securities offerings.

Digital collectibles

A digital collectible is described as "a crypto asset that is designed to be collected and/or used and may represent or convey rights to artwork, music, videos, trading cards, in-game items, or digital representations or references to internet memes, characters, current events, or trends, among other things."

Digital collectibles include crypto assets like non-fungible tokens (**NFTs**), meme coins and fan tokens. The interpretation notes that digital collectibles may be programmed to automatically transmit a portion of the sale price of the collectible to the creator as a royalty each time that it is resold or otherwise transferred, and states that the existence of a creator royalty does not change a digital collectible into a security. It cautions, however, that fractionalization or other structures that rely on essential managerial efforts could result in an investment contract.

Digital tools

A digital tool is described as "a crypto asset that performs a practical function, such as a membership, ticket, credential, title instrument, or identity badge." The interpretation states that a digital tool's value is derived from its practical functionality. It also notes that some crypto assets have hybrid features that could result in them being classified as both digital collectibles and digital tools.

Stablecoins

A stablecoin is described as "a crypto asset that is designed to maintain a stable value relative to a reference asset like the U.S. dollar." The interpretation discusses the status of two categories of stablecoins it says are not securities:

- "Payment stablecoins" issued by a "permitted payment stablecoin issuer" under the GENIUS Act, which will be statutorily excluded from the definition of "security" upon the effective date of that Act.

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- "Covered stablecoins," as defined in the SEC staff Statement on Stablecoins. The interpretation also notes that payment stablecoins issued by a "foreign permitted stablecoin issuer" (as the term is defined in the GENIUS Act) registered with the Comptroller of the Currency, while not benefiting from the GENIUS Act's statutory exclusion from being a "security," will generally be considered "covered stablecoins" and thus not securities.

The interpretation does not apply to other stablecoins that do not meet those definitions or requirements, which may or may not be securities depending on their characteristics.

Digital securities

A digital security (commonly known as a "tokenized" security) is described as "a financial instrument enumerated in the definition 'security' that is formatted as or represented by a crypto asset, where the record of ownership is maintained in whole or in part on or through one or more crypto networks." As a result, the interpretation notes that a non-security crypto asset that is subject to an investment contract is *not* a digital security, whereas a stablecoin that meets the definition of "security" based on its particular facts and circumstances *is* a digital security.

The interpretation notes that digital securities generally fall into two categories:

- securities tokenized by or on behalf of the issuers of such securities; and
- securities tokenized by third parties unaffiliated with the issuers of such securities, which may involve the third party issuing a separate security that derives its value from or is otherwise linked to the subject security.

The interpretation further notes that many digital securities convey the same legal rights with respect to a business enterprise or other entity, promisor or obligor as offchain securities. In contrast, some digital securities do not convey the same legal rights as offchain securities but instead entitle the holder to receive economic distributions from a central party that manages a business enterprise or other entity, promisor or obligor on behalf of digital security holders.

When is a non-security crypto asset subject to an investment contract?

While the token taxonomy is helpful in clarifying which crypto assets are not inherently securities, the interpretation makes clear that the status of the crypto asset itself does not resolve the question of whether the federal securities laws apply to transactions in such crypto asset due to the crypto asset being subject to an investment contract. Even if a crypto asset is not itself a security, market participants must determine:

- Whether the non-security crypto asset is or was subject to an investment contract and, if so,
- Whether the asset has "separated" from the investment contract because the issuer's promises have been fulfilled or failed to have been fulfilled.

Importantly, and in contrast to some federal district court decisions, the interpretation takes the view that a non-security crypto asset may remain subject to an investment contract even in secondary market transactions:

If, on the other hand, purchasers would reasonably expect such representations or promises to remain connected to the non-security crypto asset, the non-security crypto asset would continue to be subject to the associated investment contract in secondary market transactions. Under such circumstances, secondary market offers and sales of such a non-security crypto asset would constitute securities transactions that must be registered under the Securities Act or conducted pursuant to an available exemption from registration. The associated investment contract will continue to be transferred to subsequent purchasers of the non-security crypto asset in secondary market transactions until the non-security crypto asset separates from the issuer's representations or promises, as discussed below.

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This raises the question whether the current SEC may be adopting an analytical framework that is functionally the same as the controversial "embodiment" theory at times advanced during the Gensler era: even if the crypto asset does not embody an investment contract, if an investment contract is "attached" to it indefinitely until "separation," the effect may be the same. To resolve these issues and clarify when an investment contract terminates, the market will welcome notice-and-comment rulemaking, which Chairman Atkins has indicated is forthcoming.

Below we outline each step of the interpretation's analytical framework.

Step one: Is the crypto asset subject to an investment contract?

The interpretation instructs that "a non-security crypto asset becomes subject to an investment contract when an issuer offers it by inducing an investment of money in a common enterprise with representations or promises to undertake essential managerial efforts from which a purchaser would reasonably expect to derive profits." Put simply, it applies the *Howey* test.

The interpretation notes that each prong of the *Howey* test must be satisfied to find an investment contract. But it focuses primarily on the importance of the representations and promises made by the "issuer" (which the interpretation defines to include affiliates and agents of the issuer or a promoter) and, in particular, how "reasonable" it is for a purchaser to rely on them.

The interpretation implicitly acknowledges, however, that this mode of inquiry may not yield bright-line results. It notes that the analysis "depends on the facts and circumstances, taken as a whole, under which those representations and promises are made." With echoes of the 2019 Framework, the interpretation then covers a non-exhaustive set of facts and circumstances relevant to whether it would be reasonable for a purchaser to expect profits based on the issuer's promise:

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Factor	Facts and circumstances	
Source of promise	***Reasonable if*** made by or on behalf of issuer	***Not reasonable if*** made by third party—unless authorized by issuer or third party colludes with issuer
Time of promise	***Reasonable if*** conveyed prior to or contemporaneously with offer or sale	***Not reasonable if*** conveyed after sale
Manner in which promise is made	***Reasonable if***: – Written or oral agreement – Public communications through which the issuer has established a regular pattern of communicating (such as issuer's website or official social media accounts) – Direct private communications – Publicly available regulatory filings – Documents clearly attributable to the issuer (such as a whitepaper)	No examples provided

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<table>
<tr><td>Other factors</td><td colspan="2">Reasonableness also depends on:

– How widely disseminated the promises are made

– Specific means by which the promises are conveyed

– Issuer’s established communication practices

More likely to be reasonable if:

– Explicit and unambiguous

– Contain sufficient details demonstrating the issuer’s ability to implement the proposed project

– Explain how the issuer’s efforts will produce the profits that purchasers reasonably expect</td></tr>
<tr><td>Examples</td><td>More likely to create a reasonable expectation of profit from the promoter’s efforts

Promises by an issuer conveyed to purchasers to develop and achieve functionality for a non-security crypto asset and/or develop an associated crypto system (i.e., associated crypto networks and applications) together with a business plan containing detailed milestones, a timeline, information about personnel, sources of funding and other resources needed to meet those milestones, and an explanation of how holders of the non-security crypto asset will profit from those efforts</td><td>Less likely to create a reasonable expectation of profit from the promoter’s efforts

Promises that are vague or contain no semblance of an actionable business plan, such as those lacking milestones, funding or other plans for needed resources</td></tr>
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Step two: Has the crypto asset separated from the investment contract?

If a non-security crypto asset is found to have been subject to an investment contract, market participants would then have to determine whether such crypto asset has “separated” from the investment contract.

Like the first step, this analysis focuses on the representations or promises of the issuer, and the reasonableness of a purchaser’s continued reliance on them. “When a purchaser of a non-security crypto asset that has been subject to an investment contract could no longer reasonably expect the issuer’s representations or promises to engage in essential managerial efforts to remain connected to the non-security crypto asset, the non-security crypto asset separates from such representations or promises, and thereafter the non-security crypto asset is not subject to the Federal securities

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laws."

The interpretation instructs that this separation "may occur at any time" after the investment contract first formed and provides "non-exclusive indicia" for finding such separation:

- **Fulfillment of issuer's representations or promises**: this could occur, for example, because the issuer has completed (1) developing certain functionalities or features for the non-security crypto asset or the associated crypto system or other software project, (2) achieving certain software development milestones on a roadmap or (3) open-sourcing related computer code.

- **Failure to satisfy issuer's representations or promises**: a crypto asset could separate from the investment contract if (1) a "sufficiently long period of time" passes and it becomes clear that the issuer will not achieve its promises, or (2) the issuer "abandons" performance of any unfulfilled representations or promises, which it could affirmatively announce.

The interpretation notes that an issuer could incur liability under the securities laws for an abandonment.

Mining, staking, wrapping and airdrops

The interpretation elevated a number of positions, previously appearing only in staff statements, to Commission-level guidance, while adopting similar positions with regard to other activities.

Protocol mining, protocol staking and liquid staking

The interpretation confirms the SEC staff's view that protocol mining (including proof-of-work mining such as Bitcoin mining) and protocol staking (including staking-as-a-service and liquid staking) generally do not involve the offer or sale of a security because they involve activities that are administrative or ministerial in nature, rather than essential managerial efforts.

It also affirms staff guidance that determined that certain "ancillary activities" in connection with protocol staking do not constitute essential managerial efforts. The ancillary services covered by the interpretation are:

- **Slashing coverage**: where a staking service provider reimburses or indemnifies a staking customer against loss resulting from slashing.

- **Early unbonding**: where a staking service provider allows digital commodities to be returned to the staking customer before the end of the applicable unbonding period of a proof of stake network's software protocol.

- **Alternative rewards payment schedules and amounts**: where a staking service provider delivers earned rewards at a cadence and in an amount that differs from the set schedule of a proof of stake network's software protocol and/or where the rewards are paid earlier or less frequently than a proof of stake network's software protocol distributes them, provided the reward amounts are not fixed, guaranteed or greater than those awarded by the proof of stake network's software protocol.

- **Aggregation of digital commodities to meet minimum staking requirements**: where a staking service provider offers the staking customer to aggregate their digital commodities to meet any applicable staking minimum of a proof of stake network's software protocol.

The above activities are contrasted with other activities that are expressly outside the scope of the interpretation and thus must be analyzed separately:

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- restaking—i.e., a process that allows digital commodities staked on their associated crypto network to be used on additional crypto systems;
- guaranteeing or otherwise setting or fixing the amount of rewards owed to stakers (which does not include fees); and
- selecting whether, when or how much of a staker's digital commodities to stake.

The interpretation also confirms the SEC staff's view that "staking receipt tokens"—tokens issued as receipts for a digital commodity—are not securities provided the underlying digital commodity is not subject to an investment contract. The interpretation also provides that persons involved in generating, issuing, and redeeming a staking receipt token (that is a receipt for a non-security crypto asset that is not subject to an investment contract), as well as secondary market sales of such staking receipt tokens are not subject to the Securities Act registration provisions.

Wrapping

The interpretation confirms that the offer or sale of a wrapped token, i.e., a token that is a receipt for a non-security crypto asset that is not subject to an investment contract, generally does not involve the offer or sale of a security.

The "wrapping" of a crypto asset refers to the process through which a person deposits a crypto asset with a custodian or cross-chain bridge and in return the custodian or cross-chain bridge generates a redeemable wrapped token that is exchangeable on a one-for-one basis without offering any additional return, yield, profit opportunity or good or service. The interpretation is limited to wrapping constructs where the tokens delivered in exchange for the wrapped tokens are effectively locked-up and cannot be transferred, lent, pledged, rehypothecated, or otherwise used for any reason.

Airdrops

The interpretation confirms that certain airdrops are not securities transactions. Specifically, an airdrop of a non-security crypto asset by an issuer to recipients who do not provide the issuer with money, goods, services or other consideration in exchange for the airdropped asset fails the *Howey* test because it does not involve an "investment of money."

The interpretation also discusses various features that could cause an airdrop to either fall within or outside of the scope of the interpretation. For example, the interpretation does not apply to an airdrop where the recipient performs particular activities in exchange for receiving the airdropped non-security crypto asset—such as if the issuer announced the airdrop, in advance, to incentivize prospective recipients to engage in those activities.

The interpretation's treatment of airdrops underscores the uncertainties inherent in the interpretation's investment contract analytical framework discussed above. Notably, the interpretation warns that even where an airdrop is not an investment contract, if the airdrop recipient subsequently sells the non-security crypto asset in a secondary market transaction, it would still need to consider whether an investment contract relating to that non-security crypto asset was separately formed and remains in effect—even though the airdrop recipient did not itself receive the crypto asset under an investment contract. The interpretation states explicitly that it does not address airdrops of digital securities.

What's next?

The SEC issued the interpretation as an interpretive rule that is exempt from the Administrative Procedure Act's notice and comment requirements. The SEC has nonetheless requested comments and stated that it "may refine, revise, or expand upon the interpretation in order to provide further clarity regarding the Commission's treatment of crypto assets under the Federal securities laws."

As noted above, Chairman Atkins has positioned the interpretation as the first step in providing clarity to market participants while the SEC pursues formal rulemaking and Congress advances comprehensive crypto market structure legislation.

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