

Regulating Crypto Shouldn't Hinge On Securities Status

By **Joseph Hall and Jai Massari** (March 17, 2022, 5:32 PM EDT)

President Joe Biden issued Executive Order No. 14067 on March 9 directing agencies across the federal government to examine the impact of crypto assets on the economy and to coordinate their regulatory efforts.

The effort, which will be led directly from the White House, enlists powerful Cabinet departments including the U.S. Department of the Treasury, the U.S. Department of Justice, the U.S. Department of State and the U.S. Department of Homeland Security, all major financial services regulators including the Federal Reserve and the U.S. Securities and Exchange Commission, several science and technology offices and the intelligence community.

The president's order is a welcome signal that the U.S. government recognizes the potential and importance of the crypto markets — by some measures a \$2 trillion or \$3 trillion industry. We are, however, unlikely to achieve the desired "evolution and alignment of the United States Government approach to digital assets" described in the text of the executive order unless the agencies reevaluate some of the basic ideas that have grounded their approach so far.

U.S. regulators, by necessity, have looked to existing law to address crypto market activities. But this approach is broken, and federal securities regulation shows us why. It will either regulate crypto markets out of existence or leave them without necessary consumer protections. Neither result makes sense.

Today, how any crypto token is regulated hinges on the answer to one question: Is the token a security under the federal securities laws? One might assume that the word "security" is clearly defined in the law. It isn't.

The most familiar types of securities are things like stocks and bonds issued by companies, and shares of mutual funds. These instruments typically represent a claim of ownership over a business or a company's promise to use its earnings and assets to pay a future stream of cash.

But securities also include investment contracts, a term first given meaning by the U.S. Supreme Court in a 1946 case involving a citrus fruit growing venture. William John Howey was a self-made real estate developer who built a fiefdom a few miles south of what's now Disney World.



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Howey bought 60,000 acres of land and turned it into citrus groves. He sold half of the acreage to investors around the country, promising he would take care of the messy work of growing, tending and picking the trees and marketing the crop. The investors would then get a share of the profits.

The simple purpose of what's now called the Howey test was to make clear that an equity stake in Howey's business — "You give me cash, I'll grow oranges and grapefruit, sell them, and we'll split the profits." — was an investment contract covered by securities laws enacted the previous decade.

And the Howey test has served its purpose well: It's not possible today for a business to raise capital from the public and ignore the SEC's comprehensive disclosure requirements and market oversight.

To be sure, some crypto token offerings have involved investment contracts because, among other things, they were used to raise investment capital. But the Howey test, a single sentence in the Supreme Court's opinion, was never imagined as a way to answer the questions we face today in regulating crypto markets, where many tokens represent no ownership of a business and no claim on the revenues, income or assets of an economic enterprise.

When we ask whether a crypto token is an investment contract and therefore a security, we are simply asking the wrong question. And the evidence of this is clear.

If crypto tokens are securities under the Howey test, in most cases the regulations governing securities render them unusable. Today there is no place to trade tokens that are securities, and you cannot hope to build a networked business model that depends on the flow of crypto securities from the company to its customers and then among customers and other users of the network.

Our current dysfunctional approach is on display in the ongoing Ripple Labs Inc. litigation, in which the SEC alleges that sales of XRP amounted to sales of securities. But if XRP is a security, it likely would be impossible to trade on a peer-to-peer basis as a bridge currency in the Ripple foreign exchange payments network.

And so the SEC's position — "Hey, all you had to do was register the sales with us." — which sounds reasonable on its face, loses its appeal when you realize the practical consequences of security status.

Making existing federal securities laws workable for crypto would require a roots-up overhaul of the market structures and regulatory frameworks that have developed over decades to handle assets used for capital-raising purposes.

We believe this is one unspoken reason why the SEC has largely shied away from rulemaking in favor of enforcement — it would be enormously difficult to adapt the existing securities regulatory apparatus to crypto.

So that's what happens if crypto tokens are securities.

What if they aren't? If tokens are not securities under Howey, then we require no information about them from their promoters or large holders; we impose no comprehensive regulation on their trading venues; and for the most part we allow investors to fend for themselves. This is not good for the industry or the public. Not for nothing is today's crypto marketplace sometimes compared to the Wild West.

Set aside the practical difficulty of actually using Howey to produce results about which regulators, courts and market participants can all agree. If there is no good answer to the question of whether a token is a security, why do we keep asking?

Nearly eight decades after Howey, we are stuck trying to apply it to crypto tokens that might have been designed to send cash inexpensively to a relative, securely store large data files, protect a computer network from fraudulent activity or in countless applications having nothing to do with ownership or creditor interests in a business.

What should we be asking?

The president's March 9 executive order provides a nudge for government agencies to ask a different question: What's the appropriate regulatory approach to crypto markets?

We think this is the better focus of our attention, rather than continuing down a path of trying to retrofit the 20th century securities regulatory machinery onto the 21st century crypto economy.

In the cryptoverse there is much frustration with the SEC, but it's unproductive to blame the regulator.

The SEC exists to protect investors, and it administers statutes that extend to some crypto activities. If the agency opens up aspects of the securities regulatory framework to accommodate the crypto economy, the Pottery Barn rule will be invoked by politicians and journalists alike when the inevitable scandal occurs.

The SEC has not forgotten the criticism it endured after the 2008 financial crisis for relaxing its rules in order to rely more heavily on financial institutions' internal risk management systems to regulate their activities.

There is nothing in the SEC's statutory mandate that directs it to foster innovation in the crypto industry. And so it is rational, from the SEC's point of view, to insist on a strict and expansive reading of its authority despite the debilitating effect on crypto activities.

We think the key to a sensible regulatory model for crypto markets rests with Congress — and the president seems to agree.

His executive order commissions an ambitious report from a range of regulators on "the conditions that would drive mass adoption of different types of digital assets and the risks and opportunities such growth might present to United States consumers, investors, and businesses" — and asks for policy recommendations, including potential legislative actions.

The executive order sets the stage for a blueprint that Congress can use to develop standards governing crypto activities and then allocate rulemaking and enforcement authority among the federal regulators depending on the particular activity.

This may be the SEC for some activities, the Federal Trade Commission for some, and the banking regulators for others, like issuing stablecoins. Or maybe Congress will decide that a purpose-built regulator is needed for this new industry.

Although major financial services legislation usually only comes on the heels of a disaster — think the

Great Depression, the Enron and WorldCom scandals or the Great Recession — sometimes Congress is able to get ahead of the game.

The Credit Rating Agency Reform Act of 2006 is a good example of bipartisan cooperation before a financial crisis, and while that act had nothing in particular to do with conditions in the mortgage securitization market, after the markets melted down in 2008 the SEC was equipped with useful tools to address some of the contributing causes.

Consumers, investors, entrepreneurs and the crypto economy generally would benefit from that kind of congressional foresight now.

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