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Quest for regulatory clarity over digital assets in the US

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In May 2018, Hester M. Peirce, a commissioner of the US Securities and Exchange Commission (SEC), stood before a crowd in Los Angeles and spoke about sandboxes, beaches and how the lack of regulatory clarity over cryptocurrencies and other digital tokens might stifle innovation.

"There comes a point where regulatory uncertainty is a greater roadblock than confinement within a particular regulatory regime," she observed, after dismissing the temptation to envision what might come to pass if a digital token concept were free to develop without being labelled as 'security', 'commodity', 'currency', 'asset' or 'forward contract'. These types of labels are, of course, critical in determining whether one is transacting within the jurisdiction of the SEC, the Commodity Futures Trading Commission (CFTC) or another US regulator altogether.

Nearly five years later, the roadblock of uncertainty is still here, as the SEC (which regulates securities) and the CFTC (which regulates derivatives markets in commodities) jockey for position to assert their authority over the regulation of digital assets. The fundamental question – whether a particular digital asset is a security under US federal securities law – remains murky at best.

The question looms over most digital asset activities in the US. If a digital asset is a security, then it cannot be bought and sold on popular crypto trading platforms, which are not subject to SEC oversight as securities exchanges or operated by SEC-registered broker-dealers as alternative trading systems. At a more basic level, the digital asset cannot move freely on a peer-to-peer basis over a decentralised network of computer servers – in all likelihood rendering it useless for its intended purpose. Present day securities markets operate within an infrastructure of actors with defined roles and responsibilities who are comprehensively supervised by multiple federal, state and industry regulatory authorities. In addition to securities exchanges, brokers and dealers, these actors include intermediaries such as clearing organisations and transfer agents, and specialised service providers such as underwriters, investment advisers and custodians.

To put it plainly, the SEC has yet to undertake the kind of comprehensive overhaul of its rulebook that would be necessary to accommodate SEC regulation of most digital assets as securities. And until a workable regulatory framework for digital asset securities is implemented, many market participants who transact in digital assets in the US must conclude that such digital assets are not securities in order to claim ongoing compliance with applicable laws and regulations.

Is it a security?

At present, we continue to rely on the 1946 Supreme Court decision in *SEC v. W.J. Howey Co.,* and the so-called '*Howey* test', to determine whether an "investment contract" exists by reason of there being an "investment of money" in a "common enterprise" with a "reasonable expectation of profits" to be derived from the "efforts of others". If it is an "investment contract", then it is a security.

The decision centred on a World War II-era Florida real estate and agricultural entrepreneur, William J. Howey, who sold contractual rights in citrus groves to investors around the country. The investors put up cash, Mr Howey's employees planted and raised the crop and then sold it, and Mr Howey divvied up any remaining profits with the investors. The SEC successfully sued Mr Howey for having conducted an unregistered securities offering. But instead of likening his enterprise to an unregistered common stock offering, to which it bore marked similarities, the Supreme Court said it was an "investment contract", which is one of a laundry-list of items included in the statutory definition of "security".

Despite the SEC's attempt to provide an analytical framework for applying *Howey* to digital assets in 2019, uncertainty persists, as the *Howey* test does not foster reproducible results that market participants can rely on with reasonable confidence. Instead, when analysing a particular digital asset, the SEC suggests that market participants should consider a non-exclusive list of 50 or 60 "characteristics", none of which is "necessarily determinative", on the understanding that when their "presence" is "stronger" it is "more likely" that the digital asset is an "investment contract" and thus a security. This is not a recipe for predictability.

SEC staff and some commissioners have acknowledged that Bitcoin itself is not a security, and in 2018 a senior SEC official suggested that "current offers and sales of Ether are not securities transactions". But aside from Bitcoin and Ether, the SEC has never identified a digital asset that it is willing to say is not a security, and Gary Gensler, current SEC chair, like his predecessor Jay Clayton before him, have suggested that most digital assets are, actually, securities.

Of course, the Supreme Court did not say in *Howey* that oranges, grapefruits and lemons are securities. But in applying *Howey* to transactions in digital assets, and indeed in suggesting that Ether sales may once have amounted to investment contracts but no longer do, the SEC has helped foment a significant amount of confusion over whether a digital asset sold in what may be characterised as a capital-raising transaction is itself a security. Complicating matters further, 'profits', according to the SEC's interpretation of *Howey*, can come in many forms, including capital appreciation. And the SEC is likely to detect "efforts of others" whenever there is arguably an identifiable individual, entity or group – even if not the original promoters – whose future activities a hypothetical investor might look to when speculating on the value of the asset.

In addition to stymying innovation, this confusion requires market participants to operate at their own peril. As of October 2022, the SEC has brought over 100 enforcement actions related to digital assets. And while charlatans and fraudsters do plague this burgeoning industry, well-intentioned actors, including publicly traded companies and trusted financial institutions, must tiptoe across a regulatory minefield should they choose to participate in it.

In July, Coinbase Global, Inc. filed a lengthy petition requesting that the SEC begin rulemaking on digital asset securities, detailing the many ways in which the SEC's existing rules governing the regulation of securities simply do not work for digital assets, and imploring the commission to abandon its enforcement-first approach. All the while, Mr Gensler has repeatedly defended the SEC's stance on digital assets, asserting that the regulator treats crypto like it does the rest of the capital markets. He has openly invited crypto exchanges, crypto lending platforms and other players to "come in and register" under the SEC's supervision.

But it is far from that simple. Until the SEC's rulebook is updated to accommodate digital assets that are securities, any invitation to "come in and register" sounds to many in the industry a bit like the spider beckoning the fly into its parlour. And until one can confidently predict which digital assets will actually be categorised as securities, and which ones will not, many would-be entrants to the digital asset space will opt to remain on the sidelines.

Congress inspires hope

Clarity may be on the horizon, as two bipartisan crypto bills introduced in the Senate in recent months aim, among other things, to strengthen the role of the CFTC instead of fully empowering the SEC to regulate the digital asset industry. In June, senators Cynthia Lummis and Kirsten Gillibrand unveiled the Lummis-Gillibrand Responsible Financial Innovation Act, and in August, senators Debbie Stabenow and John Boozman announced they would introduce the Digital Commodities Consumer Protection Act of 2022, with support from senators John Thune and Cory Booker.

However, while each bill would bring welcome clarity to the regulatory landscape, neither would tackle head-on the fundamental riddle of whether most digital assets are securities subject to SEC oversight, instead perpetuating reliance on the *Howey* test.

The Lummis-Gillibrand bill introduces the defined term "digital asset", which includes, among other things, an "ancillary asset" – an intangible that is sold through an arrangement involving an "investment contract". The bill makes clear that the ancillary asset – in other words, the crypto token – is not a "security" under the federal

securities laws, even if it is sold as part of an arrangement involving an investment contract. Therefore, dealings in the token itself, such as secondary market trading, would not be regulated as securities transactions. But unfortunately, the bill excludes from the definition of "ancillary asset" any asset that gives its holder a "profit or revenue share" in an entity "solely from the entrepreneurial or managerial efforts of others". This peculiar phrase is, according to the SEC's framework, the defining characteristic of an investment contract under *Howey*.

So, a crypto token that might appreciate in value from those efforts is not an ancillary asset under Lummis-Gillibrand – but a security. This would leave the SEC free to make the same argument that it does today – that most digital assets are securities, because holders may expect capital appreciation from someone else's efforts.

Meanwhile, the Stabenow-Boozman bill introduces the defined term "digital commodity", and states that it "includes property commonly known as cryptocurrency or virtual currency, such as Bitcoin and Ether", but then expressly excludes any "security" from the definition. However, the bill makes no change to the definition of "security", implicitly leaving the *Howey* test in place – and leaving market participants to guess which digital assets will ultimately be categorised as securities or commodities.

So, Howey going to solve this?

Congress can put the *Howey* enigma out to pasture. It is an incredibly positive development that the legislative branch is affirmatively writing laws for digital assets with cross-aisle support. But in order to solve the puzzle once and for all, Congress must expressly prescribe when digital assets are to be regulated by the SEC, and when by the CFTC – or by another regulator altogether – lest we immortalise a 76-year-old judge-made divining rod that, in its many incarnations, relies on analogies to citrus fruit, cooperative apartments and whiskey warehouse receipts to determine whether lines of software code are securities. ■

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