CRYPTOCURRENCY AND BLOCKCHAIN LAW: SEC’S HEIGHTENED ENFORCEMENT AGAINST DIGITAL ASSETS

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I. INTRODUCTION

[1] The creation of Bitcoin, a decentralized peer-to-peer cryptocurrency, forever changed how information and asset ownership are transferred, verified, and processed via the internet. The technology that underlies bitcoin, called Blockchain, spawned a technological revolution that sought to alter the global system of asset ownership. Moving away from centralization and governance, Blockchain and cryptocurrencies provided a decentralized alternative ownership option that challenged traditional finance and jurisdictional considerations. With limited legal precedent and academic research, regulators and lawmakers struggled to apply traditional legal rules to this nascent technology, leaving significant legal questions unanswered. At the center of this confusion was whether certain cryptocurrencies would be categorized as a security under U.S. law.

[2] For years, industry stakeholders operated with little to no clarity regarding whether the tokens they were creating could run afoul of U.S.

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1 Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System 1, 8 (2008).


Securities laws.\(^6\) That is until 2017, at the height of the cryptocurrency market boom, with crypto prices hitting all-time highs, and companies raising billions of dollars through initial coin offerings (“ICOs”),\(^7\) the United States Securities and Exchange Commission (the “Commission” or the “SEC”) saw its opportunity and issued a seminal administrative ruling which categorized a cryptocurrency as a security under the United States Securities Act of 1933 (the “Securities Act”) for the first time in history.\(^8\)

[3] Since 2017, several key points of clarity have come from the SEC and other U.S. governmental agencies.\(^9\) However, while the SEC has

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progressively worked to refine its guidance, it has only stated that Bitcoin and Ethereum\(^\text{10}\) ("ether" or "ETH") are not securities; whether other digital assets are securities will be determined on a case-by-case basis.\(^\text{11}\) This lack of clear regulation creates an undesirable market for entities contemplating issuing a token within the U.S.\(^\text{12}\) Several entities vacated the U.S. because of their heightened concerns over securities regulations.\(^\text{13}\) The lack of clarity has also stifled innovation in the blockchain industry due to the strict requirements to which even the smallest entities must adhere.\(^\text{14}\) Further clarity is needed, or else the U.S. will be left behind the many other jurisdictions fostering innovation for fundraising and technological development through Blockchain.\(^\text{15}\)

(explaining that digital tokens offered through a phone app were classified as securities).


\(^{12}\) See Jeff Kauflin, Crypto Startups Are Fleeing the U.S.—This Bill is Trying to Stop Them, FORBES (Jan. 10, 2019, 12:25 PM), https://www.forbes.com/sites/jeffkauflin/2019/01/10/crypto-startups-are-fleeing-the-us-this-bill-is-trying-to-stop-them/?sh=3f577f8d2267 [https://perma.cc/BPX4-S6R7] (explaining how the current regulations in the United States have created an uncertainty).


\(^{15}\) See generally id. (discussing the settlement with Unikrn, Inc.).
II. A PRIMER ON CRYPTOCURRENCY REGULATION: THE DAO REPORT, MUNCHEE, AND BEYOND

[4] Blockchain technology requires lawyers and regulators to combine technology and law. A legal structure predicated on Blockchain’s technological innovation must adhere to the technical differences that separate cryptocurrencies from traditional assets. While authoritative decisions have provided some clarity, these opinions are insufficient due to the lack of legislative precedent that would allow judges and regulators to expand upon traditional notions of securities regulation.

[5] A comprehensive change requires increasing access to digital assets and reconsidering the specific factors used to determine whether digital assets are “investment contracts” under the Securities Act. Indeed, while new factors may be difficult to generate via the judiciary, Congress and/or the SEC should focus on creating a more robust framework molded with modern concepts of decentralization and digital transactions. To better frame this discussion, we must first evaluate the way U.S. federal courts and regulatory administrative agencies have applied extant laws to digital assets.


17 See generally id. (outlining how blockchain technology will impact the legal industry).


20 See, e.g., DAO Report, supra note 8 (applying the traditional securities Howey Test to conclude the DAO Token was a security).
A. Securities Law: A Brief History of the Howey Test

[6] Section 77b(a)(1) of the Securities Act of 1933 defines “securities” as:

“any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement … investment contract … or, in general, any interest or instrument commonly known as a ‘security,’ or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

A broad definition, Section 77b (a)(1) carries significant precedent regarding statutory interpretation.  

[7] The seminal Supreme Court case for interpreting Section 2(a)(1) is SEC v. Howey. Howey established a test to determine whether an instrument meets the definition of a “security” under the Securities Act. In Howey, the Court held that units of a citrus grove, coupled with a contract for serving the grove, was an investment contract. The defendants offered

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22 Cf. DAO Report, supra note 8, at 11 (considering the importance of a flexible definition for security under Section 2(a)(1) of the Securities Act).

23 Howey, 328 U.S. at 301.

24 See United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975) (stating that the test established by Howey for determining whether an instrument is a security as, “in shorthand form, [embodied] the essential attributes that run through all of the Court’s decisions defining a security”). But see Landreth Timber Co. v. Landreth, 471 U.S. 681, 691 (1985) (emphasizing that the Howey test was meant to apply only in the context of determining whether an instrument is an investment contract).

25 Howey, 328 U.S. at 299.
buyers the option of leasing any purchased land back to the defendants, who would then tend to the land, and harvest, pool, and market the citrus. The SEC sued defendants over these transactions, claiming they broke the law by not filing a securities registration statement. The Supreme Court, in issuing its decision finding the defendants' leaseback agreement is a form of security, developed a landmark test for determining whether certain transactions are investment contracts.

[8] The Court in Howey specifically defined the term “investment contract” within the definition of a “security.” The court noted “security” has been used to classify instruments that are of a “more variable character” that may be considered a form of “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.” The Supreme Court recognizes that lower courts require both (i) an expectation of profits; and (ii) from the efforts of others when determining whether a financial instrument is a security. The Howey test is divided into four prongs: An investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his [or her] money in [2] a common enterprise and is led to [3] expect profits [4] solely from the efforts of the promoter or a third party, [excluded factors] it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the

26 Id. at 296.

27 Id. at 294, 297.

28 Id. at 301.

29 Id. at 297–99 (stating that “[s]uch a definition necessarily underlies this Court’s decision” in SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943)).

enterprise. In order to be considered a security, all four factors must be met. In other words, if an instrument does not satisfy the requirements of the Howey test, it is not an investment contract, and thus not a security.

For example, in International Brotherhood of Teamsters v. Daniel, the Court held that interests in a noncontributory, compulsory pension plan were not investment contracts because there was “no investment” of money and no expectation of profit from a common enterprise. In United Housing Found., Inc. v. Forman, the Court held an investment contract is not present “when a purchaser is motivated by a desire to use or consume the item purchased.” The Forman Court also held, among other things, that shares in a nonprofit cooperative housing corporation were not investment contracts because “investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments.”

Considering this precedent, U.S. Courts have interpreted the Howey test broadly. For example, an investment of money may include not only the provision of capital, assets, and, cash but also goods, services, or a promissory note. According to the Supreme Court, the Howey test

31 See Howey, 328 U.S. at 298–99; see also Forman, 421 U.S. at 852 (“The touchstone [of an investment contract] is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”).

32 See Forman, 421 U.S. at 852.

33 See id.


35 See Forman, 421 U.S. at 852–53.

36 Id. at 853.

37 Hocking v. Dubois, 885 F.2d. 1449, 1471 (9th Cir. 1988) (holding that “commit[ting] the use of the condominium apartment to the rental pool” is “fully consistent with the Supreme Court's decision in Howey” where “the ‘investment of money’ needed for the
“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.”

[11] This consumer protection precedent provides a fact-specific application to ensure any interpretation does not go beyond the intended purpose of the Howey test or the statutory language within the Securities Act. Overall, the test eschews classification based on formalities, such as offering stock certificates, or terminology, such as selling “shares” or “stock,” in favor of a flexible test based on economic circumstances. As the Tcherepnin v. Knight opinion affirms, “in searching for the meaning and scope of the word ‘security’ . . . form should be disregarded for substance and the emphasis should be on economic reality.”

[12] Generating tokens via a blockchain platform can create a security and be characterized as taking “nominal interests in the physical assets employed in the enterprise.” Cryptocurrency technology has assuredly been utilized in certain circumstances as persuasive window-dressing in the marketing of Ponzi schemes, or to use the Howey Court’s terms, “schemes devised by those who seek the use of the money of others on the promise of

first prong of the Howey test was [] satisfied by . . . foregoing the use of an asset in order to commit it to the use of another on the promise of profits”).


39 See generally id. at 298 (explaining how the public policy of “afford[ing] the investing public a full measure of protection” motivates the flexible definition of an investment contract).


41 Howey, 328 U.S. at 299.


43 See Howey, 328 U.S. at 299.
profits.” This is a reality of the industry, and certain regulatory actions regarding cryptocurrency projects are certainly justified.

With that said, each case requires a fact-specific application, and Courts and administrative agencies are continually hard-pressed to properly apply the Howey test without forgoing unique considerations applicable to digital assets, such as borderless transactions, decentralized governance, and an ever-expanding global marketplace. Indeed, as detailed in the SEC’s administrative opinions (described below), an industry-wide takeaway is that single-point administrative opinions should not be the stand-alone resource for constructing an evaluation framework for digital assets.

B. SEC Targets Cryptocurrency

In July 2013, the SEC brought its first enforcement action, SEC v. Shavers, directed at the cryptocurrency industry by filing a federal action against an operator of an alleged Ponzi scheme based on “bitcoin denominated investments.” There, the SEC argued the “investments” fell under the catch-all category of securities known as “investment contracts,” and thus constituted securities. Conversely, the defendant argued that, because investors paid in Bitcoin, rather than money, the first prong (i.e.,

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44 Id.
45 Id.
49 Id. at *6.
investment of money) was not satisfied.\textsuperscript{50} The Court disagreed, holding that Bitcoin, as a cryptocurrency, could be considered a “form” of money, and as a token, the investments were securities.\textsuperscript{51} That following month, then-SEC Chair Mary Jo White elaborated that the SEC has jurisdiction over “interests issued by entities owning virtual currencies or providing returns based on assets such as virtual currencies” regardless of whether the underlying cryptocurrency, \textit{e.g.}, Bitcoin, is itself a security.\textsuperscript{52}

\[15\] However, actions taken by the SEC over the next few years would contradict both the \textit{Shavers} ruling as well as Chairman White’s statements.\textsuperscript{53} The cryptocurrency and blockchain industry as a whole lacked significant regulatory guidance regarding the application of securities laws towards tokens up until the SEC issued \textit{The DAO Report} in July 2017.\textsuperscript{54} This report not only launched the SEC to the forefront of the industry as a leading regulatory agency, but it also represented the first time the SEC categorized a token as a security.\textsuperscript{55}


\textsuperscript{51}Id. at *2.

\textsuperscript{52}Letter from Mary Jo White, SEC Chair, to Sen. Thomas R. Carper, Chair, Committee on Homeland Security and Governmental Affairs (Aug. 30, 2013).

\textsuperscript{53}See, \textit{e.g.}, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Action of 1933, Making Findings, and Imposing a Cease-and-Desist Order, Erik T. Voorhees, File No. 3-15902 (June 3, 2014) (determining Mr. Voorhees solicitation for shares in two of his companies in exchange for Bitcoin without registering the offerings violated Section 5(a) and 5(c) of the Securities Act); \textit{see also} Press Release, U.S. SEC. & EXCH. COMM’N, SEC Sanctions Operator of Bitcoin-Related Stock Exchange for Registration Violation (Dec. 8, 2014) (on file with author), https://www.sec.gov/news/press-release/2014-273 [https://perma.cc/QDF3-UM2V] (stating the owner of two online cryptocurrency exchanges violated the Securities Act by failing to register either as an exchange or a broker-dealer).

\textsuperscript{54}DAO Report, \textit{supra} note 8.

\textsuperscript{55}Id. at 1.
1. The DAO Report

[16] The DAO Report targeted the Decentralized Autonomous Organization (the “DAO”), an organization offering its own tokens for purchase using the Ethereum Blockchain token, Ether. The tokens represented interests in the DAO platform, and its organizers would invest in projects that received a majority vote from DAO token holders. Created by Slock.it, the platform was marketed as a “for-profit entity whose objective was to fund projects in exchange for a return on investment.” The DAO, despite conducting a massively successful fundraiser and accepting over $150 million in investment, was not registered in any sovereign jurisdiction. The DAO also failed to register the offering and elect a board of directors, a CEO, or management team. The rationale behind the crowdfunding was the creation of new software applications, but before the venture took flight, it was hit with a cyber-attack draining one-third of its funds.

56 Id. at 2–3.

57 Id.


59 DAO Report, supra note 8, at 11-12.


61 See Nathaniel Popper, A Hacking of More Than $50 Million Dashes Hopes in the World of Virtual Currency, N.Y. TIMES (June 17, 2016), https://www.nytimes.com/2016/06/18/business/dealbook/hacker-may-have-removed-
[17] The SEC investigated the DAO in connection with the offering’s potential applicability to federal securities laws and whether the tokens constituted securities. Applying the Howey test, the SEC focused on the fact that Slock.it used “various promotional materials disseminated by Slock.it and its cofounders informed investors that [t]he DAO was a for-profit entity whose objective was to fund projects in exchange for a return on investment.” Additionally, the DAO token satisfied the expectation of profits prong because “[t]he DAO’s investors relied on the managerial and entrepreneurial efforts of Slock.it and its co-founders, and the DAO’s Curators, to manage the DAO and put forth project proposals that could generate profits for the DAO’s investors.” Lastly, while DAO token holders had certain voting rights, this did not grant them “control over the enterprise,” and thus the fourth prong of the Howey test was also satisfied.

[18] Overall, The DAO Report stated that U.S. federal securities laws “may apply” to “virtual tokens” and confirmed the analysis would depend on an application of the Howey test to the specific “facts and circumstances” of each token sale. Applying this guidance, The DAO Report concluded that the DAO token in question constituted a security for at least three reasons: (1) purchasers jointly contributed funds to invest in projects; (2)

more-than-50-million-from-experimental-cybercurrency-project.html#:~:text=A%20hacker%20on%20Friday%20siphoned,of%20participants%20who%20wanted%20to [https://perma.cc/Q7QX-3MU9].

62 See DAO Report, supra note 8, at 1; see also Popielarski supra note 4, at 10–11.

63 DAO Report, supra note 8, at 11–12.

64 Id. at 12.

65 Id. at 14.

66 See id. at 10–11.
token holders obtained the right to vote on where to invest; and (3) holders received pro rata dividend payments from each project’s profits. 67

[19] While seminal in nature, The DAO Report cannot be read to suggest all virtual currencies are subject to federal securities laws, and the SEC has stated on several occasions that certain tokens, e.g., Ether and Bitcoin, are not securities. 68 If anything, The DAO Report solidified the notion that the SEC has authority to regulate cryptocurrencies and that each token evaluation is on a case-by-case basis. 69 In other words, no set token standard exists for whether one type of token is or is not a security. Applying this precedent to token frameworks provides insight into compliance requirements, if any.

[20] Since The DAO Report, the SEC has brought a number of enforcement actions targeting token-based projects. 70 Several enforcement actions are brought by the SEC Cyber Unit, an entity formed to “focus the Enforcement Division’s substantial cyber-related expertise on targeting cyber-related misconduct,” including “[v]iolations involving distributed ledger technology and initial coin offerings.” 71 As the SEC noted in a court filing, certain offerings are effectively “old-fashioned fraud dressed in a new-fashioned label.” 72

67 See id. at 11–12.


69 See DAO Report, supra note 8, at 10.


72 See, e.g., U.S. v. Zaslavkiy, No. 1:17-cr-647, 2018 WL 4346339 (E.D.N.Y. Sept. 11, 2018) (upholding a criminal indictment for securities fraud involving the sales of
Overall, these cases show the SEC’s intention to combat fraud and bad actors as applied to cryptocurrencies and token offerings. In fact, the agency issued several alerts to warn potential investors about the risks involved in participating in token offerings (also referred to as Initial Coin Offerings (“ICOs”)). Therefore, a specific analysis of the facts of the token is necessary, as well as how and when information was presented to those who receive tokens.

2. Munchee and Beyond

Only a handful of cases exist where the SEC categorized a token as a security. Even more scant are cases where there was an absence of fraud and no purchasing of the actual token occurred. The first of these cases came shortly after The DAO Report, against Munchee, Inc., and provided needed clarity because sales of “useful items” are generally not regulated as securities offerings.

cryptocurrency tokens in an ICO); Commodity Futures Trading Commission v. McDonnell, 287 F. Supp. 3d 213 (E.D.N.Y. 2018) (determining that fraudulent ICOs can be subject to enforcement proceedings under the antifraud provisions of the Commodities Exchange Act).


76 See Munchee Inc., SEC Release No. 10445 (determining that the MUN tokens are regulatable securities).
[23] On December 11, 2017, the SEC targeted an ICO launched by Munchee Inc., which raised $15 million to develop an App that used blockchain technology to allow users to write restaurant reviews. The Munchee team stated it would pay food reviewers and allow restaurant owners to purchase advertising in the Munchee Token (“MUN”). According to the white paper, once the app was built, MUN tokens would be used to make purchases in the app or at participating restaurants. At the time of the offering, the MUN tokens served no commercial purpose because the platform did not exist yet.

[24] The SEC issued an order concluding that the ICO “constituted unregistered securities offers and sales.” In support of this conclusion, the SEC applied the Howey analysis and noted, among other things, that the marketing materials for the ICO (i) described how the new app would “create demand for MUN tokens;” (ii) “likened MUN to prior ICOs and digital assets that had created profits for investors;” (iii) were “specifically marketed to people interested in those assets – and those profits – rather than to people who, for example, might have wanted MUN tokens to buy advertising or increase their ‘tier’ as a reviewer on the Munchee App;” and (iv) noted the potential creation of a secondary market for MUN tokens.

77 Id. at 1–2.

78 See id. at 4.


80 See Munchee, supra note 75, at 2.


82 Munchee, supra note 75, at 3, 8–9.
The SEC explained that “[b]ecause of these and other company activities, investors would have had a reasonable belief that their investment in tokens could generate a return on their investment.” 83

[25] Furthermore, the SEC highlighted that tokens were sold to the general public and investors reasonably expected a profit from the rise in value of the token derived from the efforts of Munchee, Inc., and its agents. 84 The SEC targeted the fact that the Munchee team promised a rise in value to investors due to the token being listed on an exchange. 85 The SEC stated, “Munchee described the way in which MUN tokens would increase in value as a result of Munchee’s efforts and stated that MUN tokens would be traded on secondary [crypto] markets.” 86

[26] Specifically, the Munchee team published a blog post on October 30, 2017 that was titled “7 Reasons You Need To Join The Munchee Token Generation Event.” 87 Reason 4 listed on the post was “[a]s more users get on the platform, the more valuable your MUN Tokens will become.” 88 The blog “went on to describe how MUN purchasers could ‘watch[] their value increase over time’ and could count on the ‘burning’ of MUN Tokens to raise the value of remaining MUN Tokens.” 89 The SEC focused on two key factors in the order: (i) the strong emphasis by Munchee and its agents on the potential profits of an investment in the MUN Tokens, both in the white paper and other social media outlets and in the Token design itself, and (ii)

83 SEC, supra note 81.

84 Id.

85 See Munchee, supra note 75, at 5, 9.

86 Id. at Summary.

87 Id. at 15.

88 Id.

89 Id.
the inability to use the MUN Tokens for any purpose for a substantial period of time.\footnote{See id. at 3–5, 10.}

[27] Overall, the SEC’s approach towards Munchee clarified that a token presented as a “utility token” does not exempt it from the definition of a security. However, the SEC did not resolve the substantive issue of whether and how a utility Token may fall outside the securities definition. It was not clear from the Order whether the SEC would have reached the same conclusion – that the MUN Tokens qualified as investment contracts – if the Munchee App were fully operational and the Tokens could immediately be used to buy and sell goods or services. With that said, the Order cautioned that “[e]ven if MUN Tokens had a practical use at the time of the offering, it would not preclude the token from being a security” and stated that “[d]etermining whether a transaction involves a security does not turn on labelling – such as characterizing an ICO as involving a ‘utility token’ – but instead requires an assessment of ‘the economic realities underlying a transaction.’”\footnote{Munchee, supra note 75, at 35.} In other words, even if the platform was fully operational, there could still be a chance the Tokens were investment contracts. Therefore, while a fully functional platform is not the only factor to consider, if it does exist, this does not necessarily contribute to the Token being a security.

[28] Several months after the Munchee ruling, William Hinman, Director of the SEC’s Division of Finance, provided guidance to the industry regarding the SEC’s position on “utility tokens.”\footnote{Hinman’s Statements, supra note 68. (“[I]ndustry participants are beginning to realize that, in some circumstances, it might be easier to start a blockchain-based enterprise in a more conventional way. In other words, conduct the initial funding through a registered or exempt equity or debt offering and, once the network is up and running, distribute or offer blockchain-based tokens or coins to participants who need the functionality the network and the digital assets offer.”).} He observed that “virtually any asset[s]” can be securities “provided the investor is
reasonably expecting profits from the promoter’s efforts.” In doing so, he referenced a 1985 Second Circuit case suggesting that certain representations by the seller of a product could convert the product into a security offering. Seen in this light, even a true utility token with an immediate use case could fall within the ambit of the federal securities laws depending on the presence of investment intent and how it was marketed. Director Hinman underscored that the Howey analysis “is not static and does not strictly inhere to the instrument.”

[29] Consistent with the concept of Howey as a moving target, Director Hinman stated that “a digital asset offered as a security can, over time, become something other than a security.” For example, a digital token used to purchase goods and services within a “sufficiently decentralized” network – i.e., one “where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts” – could evolve beyond its initial classification as a security. As such, Director Hinman intimated that a fully functioning utility token may fall outside of the SEC’s jurisdiction.

[30] Director Hinman provided a number of factors in assessing whether a digital token is offered as an investment contract and thus a security,

93 Id.

94 See Gary Plastic v. Merrill Lynch, 756 F.2d 230, 240 (2d Cir. 1985) (applying Howey and concluding that, although bank certificates of deposit (CDs) are generally not securities, they were in this case because “a significant portion of the customer’s investment depends on Merrill Lynch’s managerial and financial expertise” – including its promises regarding the existence of a secondary market and its continuing marketing efforts, which would impact the value of the CDs and the potential for profit).

95 Hinman’s Statements, supra note 68.

96 Id.

97 Id.

98 Id.
including the role of the promoter and whether the asset is designed for investment or consumptive purposes.\textsuperscript{99} Importantly, he concluded that current offers and sales of Ether and Bitcoin are not securities transactions.\textsuperscript{100} Hinman’s speech suggests a clarification of the SEC’s stance towards ICOs and a path forward for certain tokens.\textsuperscript{101} Moreover, the SEC expressed a willingness to provide market participants with case-specific guidance on these issues, thereby further reducing the regulatory risk of token transactions.\textsuperscript{102} For example, Director Hinman has stated that “[w]e stand prepared to provide more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use.”\textsuperscript{103}

[31] More recently, the SEC issued additional guidance in the Tomahawk,\textsuperscript{104} Airfox,\textsuperscript{105} and Paragon\textsuperscript{106} opinions. In Tomahawk, the SEC alleged the issuance of tokens in exchange for services rather than any form of money constitutes an offering of securities for an investment of money.\textsuperscript{107}

\textsuperscript{99} Id.
\textsuperscript{100} Hinman’s Statements, supra note 68.
\textsuperscript{101} Id.
\textsuperscript{102} See id.
\textsuperscript{103} Id.
\textsuperscript{106} See id.
\textsuperscript{107} See In the Matter of Tomahawk Exploration LLC and David Thompson Laurence, supra note 104, at 2.
In addition to conducting an ICO, Tomahawk Exploration LLC operated a “Bounty Program,” whereby 200,000 TOM tokens were allocated to pay third parties in exchange for defined activities. Amongst these activities were making requests to list TOM tokens on trading platforms as well as promoting TOM tokens on social media platforms. These promotions targeted potential investors and directed them to Tomahawk’s offering materials.\(^\text{108}\)

[32] Tomahawk issued more than 80,000 TOM tokens as bounties to approximately forty wallet holders on Tomahawk’s decentralized platform in exchange for the activities listed above.\(^\text{109}\)

[33] The SEC reasoned that the TOM tokens were considered securities because “[t]he TOM tokens were offered in exchange for the investment of money or other contributions of value” and that “[t]he representations in the online offering materials created an expectation of profits derived from the efforts of others, namely from the oil exploration and production operations conducted by Tomahawk and Laurance and from the opportunity to trade TOM tokens on a secondary trading platform.”\(^\text{110}\) Importantly, the SEC Staff stated the Bounty Program constituted an offer and sale of securities because Tomahawk provided tokens to investors in exchange for investors’ services designed to advance the company’s economic interests and foster a trading market for its securities.\(^\text{111}\) The SEC explained how distributing tokens in exchange for services could still be deemed an offer of securities under Section 2(a)(3) of the Securities Act because it involved “an attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.” The SEC determined that notwithstanding “[t]he lack of monetary consideration for purportedly ‘free’ shares,” the issuance

\(^{108}\) See id. at 5.

\(^{109}\) See id. at 2.

\(^{110}\) Id. at 30.

\(^{111}\) Id. at 33–34.
as a “gift” through the Bounty Program constituted a “sale” or “offer to sell” within the meaning of the Securities Act. Therefore, when tokens are provided through a bounty program in exchange for services, this alone can still result in the token being a security.

[34] Additionally, in two SEC administrative rulings, Airfox and Paragon, tokens were offered with the promise that the tokens provided utility to investors within the applications developed by the companies. However, the companies intended to add new functionality to their platforms after the offerings and primed investors’ expectations to profit from such functionality in online promotional material. Each of the companies also assured investors that they would promote a secondary market for their tokens and control the supply of their tokens. Given these entrepreneurial efforts and their actual and marketed link to the value of the tokens, the SEC found investors reasonably expected to profit from the efforts of Airfox and Paragon.


113 Statement on Digital Asset Securities Issuance and Trading, supra note 105.

114 Id.


117 Id.

118 Id.
3. SEC v. Ripple

[35] On December 22, 2020, the SEC filed a Complaint against Ripple Labs Inc. (“Ripple”), a San Francisco-based financial technology corporation and one of the largest Blockchain development companies in the world. The Complaint alleges Ripple, along with Brad Garlinghouse and Chris Larsen, both Ripple executives, raised $1.3 billion in capital for Ripple by selling over 14.6 billion XRP tokens (“XRP”) through an unregistered security offering.

[36] The SEC’s Complaint centers on sections 5(a) and 5(c) of the Securities Act, which requires businesses to register sales of securities with the SEC. Registration requires the issuer to disclose material information that a reasonable investor would find substantial in their decision to invest. Determining if Ripple offered XRP as a security is central to the Complaint. In 2019, the SEC published guidance stating “[b]oth the Commission and the federal courts frequently use the ‘investment contract’ analysis to determine whether unique or novel instruments or arrangements, such as digital assets, are securities subject to the federal securities laws.” The guidance explains how the SEC analyzes what it says are the three Howey test elements for digital assets.

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120 Id. at 1.

121 Id. at 3.


124 Id.
While this action by the SEC may do damage to Ripple, it will most likely not have a larger effect on XRP and the crypto industry as a whole. The Complaint focuses on the alleged violations of Ripple, Garlinghouse, and Larsen. As a result, this case will most likely result in a fine, instead of needed regulatory clarity. This case represents a significant step by securities regulators in the U.S. and highlights the necessity for legislation from Congress and further governmental agency guidance.

C. Howey Test Applied: Ripple (XRP)

1. Background: Ripple and XRP

In 2012, Mr. Larsen and two others (not named in the Complaint) created Ripple Labs Inc. to develop a software code known as the “XRP Ledger.” The XRP ledger runs on a “peer-to-peer network.” XRP is a digital asset; issued and transferred on the XRP ledger. This type of digital asset, also known as a digital token, is “native” to the ledger because

125 Complaint, supra note 119.


128 Id.
it is represented on the XRP ledger. The XRP token is meant to serve as On-Demand Liquidity for international payments, eliminating the need to convert one currency into another to make a purchase.

When Ripple first deployed the XRP Ledger, it created 100 billion XRP tokens and transferred 80 billion to itself, 9 billion to Co-founder and Mr. Larsen each, and 2 billion to an individual labeled in the complaint as Ripple Agent-1. Unlike other cryptocurrencies such as Bitcoin or Ethereum, only Ripple and its agents owned 100% of the existing XRP tokens. While this is proven by the XRP ledger, which can be viewed publicly, Ripple denies this allegation in their response to the SEC.

a. XRP validation

The XRP Ledger is “peer-to-peer” because each member is a peer to the other. No one peer in the network has greater authority over the ledger than any other. Every time a peer makes a change to the ledger, such as recording the sale of a token, they send the ledger with the changes

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131 Complaint, supra note 119, at 46 (alleging Co-Founder and Mr. Larsen received 9 billion XRP each and Ripple Agent-1 received 2 billion XRP); but see, Answer, supra note 127, at 46 (denying the alleged breakdown but admitting Mr. Larsen, Co-Founder and Ripple Agent-1 own a combined 20 billion XRP).

132 Complaint, supra note 119, at 46 (alleging Ripple and its agents own 100% of the existing XRP); but see, Answer, supra note 129, at 46 (denying the allegation that Ripple owns 100% of existing XRP).

133 See XRP Ledger Overview, supra note 127.

134 See id.
made to the other peers so the updated ledger can be verified by other peers.\textsuperscript{135} To confirm the change, other peers must reach a consensus about which changes are valid.\textsuperscript{136}

[41] The XRP ledger software includes a validation protocol to determine how peers will validate the changes to the ledger.\textsuperscript{137} XRP uses a specialized consensus method; only giving the authority to validate changes to a select group of peers in the network.\textsuperscript{138} When a peer makes a change to the ledger, they send it out to the other peers to validate the transaction.\textsuperscript{139} Those validating peers take in multiple transactions at a time and place them in a cue, or the “candidate set”, to await validation.\textsuperscript{140} Each validating peer keeps its own Unique Node List, which is the list of peers it trusts to only send valid transactions.

[42] Simultaneously, the validating peer receives transactions in the candidate set, and proposals come from other peers in the network, which are groups of transactions another peer validated. Proposals must come from a peer on the validating peers Unique Node List, otherwise the proposal is ignored. Transactions in the validating peer’s candidate set are


\textsuperscript{136} See \textit{id}.

\textsuperscript{137} XRP Ledger Overview, supra note 127.


\textsuperscript{140} See \textit{id}.
compared to the proposals it received from its trusted peers. Once the trusted peers agree a transaction is valid, it is added to the ledger.

2. Application

[43] As stated above, this Howey test contains four elements; (1) an investment of money, (2) in a common enterprise, (3) with profits to come (4) solely from the efforts of others. If a contract meets all of these elements, it is an investment contract and falls within the Section 2(a)(1) definition of a security. However, because digital assets are a novel technology and constantly developing, determining whether a digital asset meets the Howey test can be difficult.

a. Investment of Money

[44] The first element prong of the test requires an investment of money. Guidance from the SEC states that a digital asset typically meets this element because investors purchase or exchange valuable consideration for the asset. The Complaint states Ripple sold at least 3.9 billion XRP through Market Sales and 4.9 billion through institutional sales from 2013 to 2020. These sales generated at least $1.3 billion for Ripple. The Complaint also alleges Ripple traded XRP for non-cash consideration as well, such as labor and market-making services, which the Complaint alleges was worth at least $500 million. As a result, Ripple most likely

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142 See id.
143 See id.
145 Complaint, supra note 119, at 14.
146 Id. at 14–15.
exchanged XRP for valuable consideration, satisfying the first element of
the Howey test.147

b. Common Enterprise

[45] The second element requires the investment to be made in a common
enterprise. The guidance says the SEC finds a common enterprise “typically
exists” because the fortunes of digital asset purchasers are often linked to
each other or the success of the issuer.148 For example, in the case SEC v.
Kik Initiative, Inc., the court found there was a common enterprise between
the purchasers of the Kin token and the seller, Kik Initiative Inc. (“Kik”).
Kik developed a blockchain-based messaging service in 2009. The
messaging service was not generating revenue, so Kik decided to raise
money by selling its native Kin token. The SEC brought an enforcement
action against Kik for the unregistered sale of a security. The court agreed
with the SEC that Kik’s offer and sale of the token was an investment
contract and therefore subject to SEC regulation. When considering the
common enterprise element of Howey, the court found horizontal
commonality, or the “tying of each individual investor's fortunes to the
fortunes of the other investors by the pooling of assets, usually combined
with the pro-rata distribution of profits” between the purchasers of the Kin
tokens.149

[46] The Complaint alleges that because XRP is fungible, the fortunes of
those who purchased XRP from Ripple were tied to each other and
depended on the success of Ripple’s strategy to increase XRP’s value and
create profit for all XRP holders equally.150 The SEC also alleges Ripple


148 Id.

149 SEC v. Kik Interactive Inc., No. 19 CIV. 5244 (AKH), 2020 WL 5819770, at *5

150 Complaint, supra note 119, at 45.
pooled funds it raised from selling XRP to pay for Ripple’s operations.\footnote{151} This shows horizontal commonality.\footnote{152}

c. Reasonable Expectation of Profits Derived from Efforts of Others

[47] The third element requires the investors must have expected profits to come solely from the efforts of others.\footnote{153} The SEC guidance explains that an investor might expect a return through many avenues, like distributions or the asset’s appreciation.\footnote{154} When investors expect these profits to come from the managerial or entrepreneurial efforts of others, a digital asset will meet the third element of the \emph{Howey} test.\footnote{155} The guidance breaks this element into three characteristics; (1) reliance on the efforts of others, (2) reasonable expectation of profits, and (3) other relevant considerations.\footnote{156} The Complaint alleges that due to Ripple’s actions, and the economic reality surrounding them, “XRP investors… had a reasonable expectation of profiting from Ripple’s efforts to deploy investor funds to create a use for XRP and bring demand and value to their common enterprise.”\footnote{157} The SEC claims Ripple’s efforts include “(1) using algorithms to time the amount and

\footnote{151} See Complaint, supra note 119.
\footnote{152} See id.; Kik, 2020 WL 5819770 at *5.
\footnote{153} See SEC v. W.J. Howey Co., 328 U.S. 293 (1946); see, e.g., Edwards, 540 U.S. at 390.
\footnote{155} Id.
\footnote{156} Id.
\footnote{157} Complaint, supra note 119, at 216.
price of Defendants’ XRP sales into the market; (2) paying incentives to certain market makers—some of which Ripple engaged to effect the Market Sales—if the sales reach certain trading volume levels on XRP; and (3) paying digital asset trading platforms to permit XRP trading”. \footnote{\textit{Id.} at 170.}

[48] Even though Ripple’s stated use of XRP is On Demand Liquidity, the SEC argues the value of XRP for On Demand Liquidity was not market-driven but subsidized by Ripple. \footnote{\textit{Id.} at 257.} The Complaint alleges Ripple promised to undertake significant efforts to develop and foster uses for XRP, as well as create, maintain, and protect secondary resale markets for XRP. \footnote{\textit{Id.} at 237.} According to the SEC, purchasers of XRP relied on Ripple’s efforts to create uses and secondary markets for XRP so the value of the token would appreciate, generating profit for the purchasers solely by Ripple’s efforts. \footnote{\textit{Id.} at 289.} In the Eleventh Circuit’s analysis of whether certain transactions met this prong of the \textit{Howey} test, the Court interpreted \textit{Forman} to determine that profits “require either a participation in earnings by the investor or capital appreciation.” \footnote{SEC v. ETS Payphones, Inc., 300 F.3d 1281, 1284 (11th Cir. 2002).} Therefore, no expectation of profits exists where no capital appreciation or participation in earnings exists for investors.

[49] The Complaint further alleges that “economic realities” made it impossible for anyone \textit{but} Ripple to build value for XRP. \footnote{Complaint, \textit{supra} note 119, at 256.} Most, if not all, XRP investors lacked the technical expertise and resources to grow the XRP ecosystem and increase demand for XRP. \footnote{\textit{Id.} at 259.} After analyzing the third...
element of the *Howey* test by the SEC guidance, the Complaint concludes XRP meets the final element of the test and should be defined as an investment contract under §2(a)(1).\(^{165}\)

[50] The SEC asks the court to enjoin the Defendants, Ripple, Garlinghouse, and Larsen from further violations of the Securities Act through the following steps: (1) delivering XRP or taking steps to offer or sell XRP; (2) to prohibit defendants from participating in any offering of digital asset securities; (3) paying civil money penalties, and (4) disgorging all gains from the illegal sales of XRP.\(^{166}\)

[51] If the court grants the first prayer for relief, to enjoin the defendants from selling XRP, it will only mean Ripple, along with Garlinghouse and Larsen, can no longer sell XRP tokens without registering the sale with the SEC.\(^{167}\) Ripple could still maintain the XRP ledger, and XRP tokens could still be used for On Demand Liquidity. Disgorgement would force the defendants to give back the money they received selling XRP.\(^{168}\) This would amount to $1.3 billion from Ripple, and approximately $600 million from both Garlinghouse and Larsen.\(^{169}\) The SEC has chosen not to ask for a declaratory judgment regarding whether XRP is a security. The SEC is only seeking to stop Ripple, Garlinghouse, and Larsen from selling XRP as a security in Ripple without registering the sale.\(^{170}\) This means Holders could still use XRP for its intended use.\(^{171}\)

\(^{165}\) *Id.* at 205–206.

\(^{166}\) *Id.* at 70.

\(^{167}\) *Id.* at 12.

\(^{168}\) *Complaint,* supra note 119, at 12.

\(^{169}\) *Id.*

\(^{170}\) *See id.* at 5–6, 9.

\(^{171}\) *See id.* at 13–14, 45–46.
[52] Regardless of the final ruling, the Complaint has already had a significant effect on XRP. The day after the SEC filed the Complaint the value of XRP dropped more than 20%.\textsuperscript{172} In fear that XRP might be a security, crypto exchanges like Coinbase began to delist XRP as well.\textsuperscript{173} Subsequent lawsuits were filed against Ripple for selling an unregistered security.\textsuperscript{174} Tetragon, a Ripple shareholder, filed in Delaware to compel Ripple to redeem its stock in the company.\textsuperscript{175}

3. What Does This Mean for Crypto?

[53] In the Complaint, the SEC focused a great deal on the substance rather than the form of Ripple’s distribution of XRP, looking into the economics of the sales, the actions by the defendants to create value for XRP, and the legitimate use of the token.\textsuperscript{176} The SEC may come after other U.S. based companies who create a distributed ledger and sell the native tokens in the same manner as Ripple, but this would be on a case-by-case basis. For example, Ripple and XRP are distinct from Bitcoin and Ethereum.


\textsuperscript{176} See generally Complaint, supra note 119, at 12.
since XRP is more centralized and only a small group controlled XRP when Ripple began to initially distribute the token. Additionally, according to the SEC, Ripple focused on increasing value over market adoption of XRP Ledger and may have been manipulating markets. The SEC is not looking for the court to declare XRP as a security and destroy its use for On Demand Liquidity. Instead, the court is going to determine the best way to prohibit what the SEC believes is the sales of an unregistered security offering. As such, this case may not bring as much regulatory clarity to the crypto industry as many initially thought.

[54] However, if Ripple prevails on its defense for Lack of Due Process and Fair Notice, it may force the SEC either to publish an Administrative Rule, abiding by the processes prescribed by the Administrative Procedures Act, or Congress will have to create new legislation regarding digital assets to provide clarity. In the past, many companies who have gone down this path with the SEC have paid fines or returned funds to purchasers.

[55] We anticipate Ripple will fight aggressively against the SEC, but may ultimately pay a fine. This case shows how comprehensive legislation from Congress is needed as well as further administrative clarity that includes rules allowing companies operating in the cryptocurrency industry the ability to foster development without concern over violating securities laws.


178 See Complaint, supra note 119, at 29–33.


III. CONCLUSION

[56] The main takeaway from these SEC administrative rulings and judicial precedent is: (1) tokens that satisfy the Howey test are securities;\textsuperscript{181} (2) each token is evaluated on a case-by-case basis;\textsuperscript{182} (3) utility and the lack of a monetary investment does not absolve tokens from a securities designation;\textsuperscript{183} and (4) tokens that instill an expectation of profits due to the efforts of the token issuer will almost always result in a securities designation.\textsuperscript{184} These conclusions are based on traditional notions of securities regulations and fall short of the framework needed for this revolutionary technology. Cryptocurrency and Blockchain are nascent technologies with ever-expanding use cases. With the recent expansion of decentralized finance,\textsuperscript{185} we see many more issues down the road the SEC will need to address. At the current rate, we anticipate regulatory uncertainty will continue to prevail in the United States.

\textsuperscript{181} See, e.g., SEC v. Howey, 328 U.S. 293 (1946), 298–99 (1946) (defining “investment contract” as “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 other on the promise of profits,” which could include tokens); DAO Report, supra note 8, at 11.

\textsuperscript{182} See DAO Report, supra note 8, at 17–18.

\textsuperscript{183} See Munchee Inc., supra note 75, at 9; see also Tomahawk Exploration LLC, supra note 70, at 2 (stating that providing tokens in exchange for services constituted an offer of sale and thus a finding that the tokens were ultimately securities).

\textsuperscript{184} See DAO Report, supra note 8, at 11–12.

\textsuperscript{185} See, e.g., Goldberg, supra note 3 (noting that blockchain technology, “is starting to show the potential to transform other sectors of the global physical commodities markets.”).