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The SEC's Approach to Regulating Cryptocurrency: A Preliminary Analysis into Regulation of Initial Coin Offerings

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**THE SEC’S APPROACH TO REGULATING CRYPTOCURRENCY:
A PRELIMINARY ANALYSIS INTO REGULATION OF INITIAL COIN OFFERINGS**

INTRODUCTION: ‘Online Money’

The financial world has evolved from the age of Tulip Mania’s¹ trading colorful Tulips as valued commodities to a truly modern age: one that is filled with ApplePay on mobile devices and investments in Bitcoins vis-à-vis Initial Coin Offerings (“ICOs”). Bitcoin in particular poses particular new challenges, deriving largely from our difficulties in understanding and classifying of such virtual currency. The leading reason to regulate cryptocurrency is to protect United States consumers against fraud and deception,² as consumers buying into ICOs are at many times unaware of how it operates and can often end up losing life savings.³ And “[s]ince virtually all cryptocurrency transactions are not reversible and cryptocurrency accounts are pseudonymous⁴, a user who is the victim of theft has virtually no recourse.”⁵ Thus investors have no proper legal channels to protect themselves when theft occurs.⁶

¹ See Chas Craig, *Capital Perspectives: History lesson Tulip Mania*, THE JOURNAL RECORD (2018).

² See *Coinlab Inc. v. Mt Gox KK*, 513 B.R. 576 (W.D. Wash. 2014) (although cryptocurrency exchanges are harder to hack than other traditional methods, a cryptocurrency transaction is nonetheless vulnerable to hackers. Prime example is the case of *Coinlab v. Mt Gox*, a hack of 850,000 Bitcoins, worth \$473 million which had been stolen out of Mt. Gox’s digital wallet without further trace. Similarly, a South Korean Bitcoin Exchange went out of business after declaring bankruptcy resulting from a major hack of its coins).

³ See *United States v. Zaslavskiy*, No. 17CR647(RJD) (E.D.N.Y. Sep. 11, 2018).

⁴ See Danny Bradbury, *How Anonymous is Bitcoin?*, COINDESK (June 7, 2013, 10:04 AM), <http://www.coindesk.com/how-anonymous-is-bitcoin/> (“[b]itcoin addresses do not contain any personally identifiable information, but a log of all transactions is available to the public. Using deanonymization techniques, however, it may be possible to discover the identity of a person with publicly available data.”)

⁵ See 4-3 *Pratt’s Privacy and Cybersecurity Law Report* 02, 1 (2018).

⁶ See *Investor Bulletin: Initial Coin Offerings*, SEC INVESTOR ALERTS AND BULLETINS, (Jul. 25, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings (The SEC’s warnings about “investing in an ICO [which] may limit your recovery in the event of fraud or theft. While you may have rights under the federal securities laws, your ability to recover may be significantly limited.”)

As of 2018, many attempts to regulate cryptocurrency have failed, reflecting haphazard attempts at pigeonholing cryptocurrencies into one or two categories while attempting to apply current laws meant for traditional players to a non-traditional space.⁷ Regulators in various government agencies like the Commodities Futures and Trading Commission⁸ (“CFTC”), the Internal Revenue Service⁹ (“IRS”), and most notably the Securities and Exchange Commission¹⁰ (“SEC”) have recently established frameworks to deal with cryptocurrency and ICOs. In practice, the several forms of regulations proved to be inadequate and both over- and under-inclusive in relation to the special sorts of problems to which cryptocurrencies give rise (i.e. lack of investors’ knowledge, and legal discrepancies in treatment of ICOs).

Whether they involve colorful Tulips, gold or silver, paper money or Bitcoins, Whether it involves colorful tulips, gold or silver, paper money, or Bitcoins, sound regulation of financial markets must always orient itself towards two fundamental questions. One, is the SEC’s current approach to regulating ICOs as securities appropriate? And two, are there alternative means of regulation that would as severely hinder the marketplace of advances enabled by this crowdfunding method? This Note provides a preliminary analysis of the manner in which the SEC regulates ICOs, then offers an alternative approach to regulating these cryptocurrencies. Specifically, this Note proposes creating a compromise between the polar extremes of treating cryptocurrencies as sui generis entities on the one hand and relying on status quo regulatory regimes on the other. While this Note supports the SEC’s classification of certain cryptocurrencies—based on the nature of their use— as ‘securities,’ it instead suggests an alternative method that calls for the creation of

⁷ *Id.*

⁸ See Joseph D. Moran, *The Impact of Regulatory Measures Imposed on Initial Coin Offerings in the United States Market Economy*, 26 Cath. U. J. L. & Tech (2018).**

⁹ *Id.*

¹⁰ See Nikolei M. Kaplanov, *Nerdy Money: Bitcoin, the Private Digital Currency, and the Case Against its Regulation*, 25 LOY. CONSUMER L. REV. 111, 117 (2012).**

measures to educate the investor or consumer while allowing for compliance with the law. It also calls for the centralization of regulatory responsibility within one single agency, the SEC.

Part I of this Note provides a background overview of the cryptocurrency market, focusing, in particular, on the growth and adoption of ICOs into our financial markets. Part II explains current ICO regulation measures taken by the SEC. Part III then analyzes the propriety of the SEC's authority in regulating ICOs, both as a legal matter and as a policy matter. Part IV argues for an alternative approach in regulating ICOs that resemble 'securities' but still retains much of the appealing characteristics inherent within cryptocurrencies. The approach is designed to build onto the basic framework created by the SEC's use of the *Howey test* in regulating cryptocurrency, specifically, ICOs. Lastly, Part V concludes the preliminary analysis. This Note will not proscribe a formulaic set of rules for regulating ICOs; rather, it merely aims to provide a foundation for regulators to tackle current financial concerns associated with ICOs while avoiding undue legal confusion or the detrimental hindering of useful financial innovation.

PART I: Background

A. What are cryptocurrencies?

To understand 'Cryptocurrency,' we must grasp the basic idea of 'Virtual Currencies' and 'Digital Currencies.'¹¹ Virtual currency exists only online but it may also represent physical hard currency; it is "any currency that is not printed on paper or stamped into metal."¹² Digital currency is a type of virtual currency that explicitly exists in the digital space, "meaning that it maps to some digital storage, likely a hard drive somewhere."¹³ Cryptocurrency is a mix of digital and virtual

¹¹ *Id.*

¹² See Matt Bernier, *What is the difference between a cryptocurrency, a digital currency, and a virtual currency?*, QUORA. BLOG (Aug. 1, 2014), <https://www.quora.com/What-is-the-difference-between-a-cryptocurrency-a-digital-currency-and-a-virtual-currency>. (last visited Nov. 15, 2018).

¹³ *Id.*

currency, which uses a cryptographic algorithm¹⁴—essentially a public key encryption¹⁵—through a technology called the ‘blockchain.’¹⁶ The blockchain is a record of online transactions placed on an online accounting ledger that is then copied and distributed publicly around the world and is constantly being updated as users share and synchronize in the digital database.¹⁷ The ledger is not controlled by a single central party, but rather by a peer-to-peer network.¹⁸ This requires the entire network of participants to update their online ledgers by making and verifying new additions (transactions) to the blockchain.¹⁹

Accurate updating of the distributed ledger comes from users verifying the transactions by solving a cryptographic algorithm in the process of *mining coins*.²⁰ The mining process involves using computer hardware and electricity to solve mathematical problems; whoever solves a given problem first has *mined* fractions of a *coin*, which equates to a currency with value or an asset at least.²¹ For instance, if *A* transacts with *B*, the details of the transaction are encrypted into the peer-to-peer network using the blockchain technology, where miners rush to solve the mathematical problem and properly verify the transaction on the public ledger. Once verified, a record of the block is added to the chain, and the miner is rewarded with a coin. Mining coins is not the only manner to transact using the blockchain technology because once the set number of coins are all

¹⁴ *Id.* Cryptographic algorithm is an encryption technique that essentially solves a mathematical problem.

¹⁵ *Id.* (A public key encryption produces two mathematically-related keys, a private key that only the holder of the account accesses “—somewhat like a private password or pin—” and a public key distributed to the public.)

¹⁶ See Michelle Ann Gitlitz, Grant Buerstetta, and Gregory Cronin Note, *Potential Pitfalls of the BitLicense*, 152 NY. L.J. 259 (May 21, 2018).

¹⁷ *Id.*

¹⁸ See Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (Oct. 31, 2008), available at <https://bitcoin.org/bitcoin.pdf>; see also Nikolei M. Kaplanov, *Nerdy Money: Bitcoin, the Private Digital Currency, and the Case Against its Regulation*, 25 LOY. CONSUMER L. REV. 111 (2012).

Available at: <https://lawcommons.luc.edu/cgi/viewcontent.cgi?article=1920&context=lclr>

¹⁹ See Joseph D. Moran, *The Impact of Regulatory Measures Imposed on Initial Coin Offerings in the United States Market Economy*, 26 Cath. U. J. L. & Tech (2018).

²⁰ See Nikolei M. Kaplanov, *Nerdy Money: Bitcoin, the Private Digital Currency, and the Case Against its Regulation*, 25 LOY. CONSUMER L. REV. 111, 117 (2012).

Available at: <https://lawcommons.luc.edu/cgi/viewcontent.cgi?article=1920&context=lclr>

²¹ *Id.*

mined, transactions using that particular currency move from mining transactions to exchanges. Thus, when *A* and *B* are not transacting with one another for the purpose of mining coins, they can simply exchange, buy, or sell goods and services using these mined coins.²²

The first cryptocurrency, Bitcoin, was published for exchange of electronic cash in 2008 by the infamous Satoshi Nakamoto²³ and released in January of 2009.²⁴ Although thousands of cryptocurrencies exist today, “Bitcoin is by far the most widely used, with a market capitalization of over \$70 billion,”²⁵ having grown by a staggering 1300%.²⁶ Nakamoto’s vision for Bitcoin introduced a key characteristic of cryptocurrency, its ability to use the encryption technique to facilitate secured transactions while remaining decentralized and free from any central bank ties.²⁷ That decentralization in turn allows for a form of self-governance and independent operations which traditional currencies lack.²⁸ Unfortunately, the anonymity of a cryptocurrency transaction has also enabled its use for eliciting activities such as money laundering, developing a black market for drug dealing, and holding assets in a manner that evades auditing by the Internal Revenue Service (“IRS”) and other governmental agencies.²⁹ Such uses of the currency assist in consumer

²² *Id.*

²³ *Id.* (The real identity of the creator of Bitcoin is not actually known, “Nakamoto’s interaction on bitcoin online forums ceased about a year after bitcoin was created. Additionally, it is unlikely that Satoshi Nakamoto is the creator of bitcoin’s actual name. Many believe that he is a Japanese citizen.”); *see also Who is Satoshi Nakamoto, CoinDesk (Last Updated: 19th February 2016)*, available at, <http://www.coindesk.com/information/who-is-satoshi-nakamoto>.

²⁴ *Id.* (Nakamoto’s Bitcoin system was geared to enable “payments to be sent between users without passing through a central authority”); *see also* Sumit Agarwal, *Note: Bitcoin Transactions: A Bit Of Financial Privacy*, 35 *Cardozo Arts & Ent LJ* 153 (2016) (Bitcoin technology ensures online transactions are secure, efficient and free of third party presence).

²⁵ Coinmarketcap.com lists market capitalizations for 1,140 of what it calls “crypto-currencies.” *See* CoinMarketCap, <https://coinmarketcap.com/all/views/all> [<https://perma.cc/7238-GDCZ>] (last visited Sept. 29, 2017).

²⁶ <https://www.intelligenthq.com/resources/security-currency-utility-classify-cryptocurrency/>

²⁷ *See* Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (Oct. 31, 2008), available at <https://bitcoin.org/bitcoin.pdf>.

²⁸ *See* Michelle Ann Gitlitz, Grant Buerstetta, and Gregory Cronin, *Note: Potential Pitfalls of the BitLicense*, 152 *NY L.J.* 259 (May 21, 2018).

²⁹ *See* Annie Lowery, *My Money Is Cooler Than Yours: Why the New Electronic Currency Bitcoin is a Favorite of libertarian hipsters and criminals.*, *SLATE* (May 18, 2011), available at <https://slate.com/business/2011/05/bitcoin-why-the-new-electronic-currency-is-a-favorite-of-libertarian-hipsters-and-criminals.html> (describing the government’s limited access to punish wrong doers due to the private nature of cryptocurrency: “[n]o third-party intermediary, such as a payment processor or a bank, needs to keep tabs on or process the electronic transactions.”)

fraud and display the lack of uniformity in the sparked attention from various U.S. agencies³⁰ who attempted to regulate this new space.³¹ Years later and regardless of the risks associated with this decentralized currency, the blockchain technology remains “an exciting new technology” with the capability of “revolution[izing] transactions in a wide range of fields.”³² But the demand and need for proper regulation remains a priority of U.S. and international governmental agencies, particularly the SEC.³³

B. What are ICOs?

An Initial Coin Offering (“ICO”) is a crowdfunding technique that offers sale of digital coins—or cryptocurrencies—to the public.³⁴ In 2017, cryptocurrency investments saw tremendous growth, thanks to the activities of hundreds of start-up businesses raising capital through ICOs.³⁵ An ICO’s method of raising capital in exchange for digital coins entitles its holders to certain future rights, some application or perhaps “future service in the entity.”³⁶ ICOs, in a way, are the counterpart to Initial Public Offerings (“IPOs”)³⁷ through which investors acquire traditional securities. An issuer seeking to raise money via an ICO does so by selling his or her own-created virtual currency; normally with a cap on the amount of coins offered.³⁸ The cap aids

³⁰ *Id.*

³¹ *Id.*

³² See 4-3 Pratt’s *Privacy and Cybersecurity Law Report* 02, 1 (2018).

³³ Bitcoin is no longer ‘*Nerdy Money*’³³ because it has made its way into mainstream trading worldwide.

³⁴ See Joseph D. Moran, *The Impact of Regulatory Measures Imposed on Initial Coin Offerings in the United States Market Economy*, 26 Cath. U. J. L. & Tech (2018).

³⁵ See Lauren Harrington, *Security, Currency or Utility, How Do You Classify Your Cryptocurrency?*, INTELLIGENT (Mar. 26, 2018) available at <https://www.intellegenthq.com/resources/security-currency-utility-classify-cryptocurrency/>

³⁶ See Jay B. Sykes, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, CRS REPORT (Aug. 31, 2018); Joseph D. Moran, *The Impact of Regulatory Measures Imposed on Initial Coin Offerings in the United States Market Economy*, 26 Cath. U. J. L. & Tech (2018).

³⁷ See Nathaniel Popper, *An Explanation of Initial Coin Offerings*, N.Y. TIMES (Oct. 27, 2017), <https://www.nytimes.com/2017/10/27/technology/what-is-an-initial-coin-offering.html>.

³⁸ Footnote needed.

in establishing a monetary value over time and such currency generally operates using systems³⁹ similar to the infamous virtual currency, Bitcoin.⁴⁰ ICOs are now a new—and highly demanded—tool to raise money using virtual currency. They are raising more than any other crowdfunding method in history as of 2017.⁴¹ An attractive feature of ICOs is the incredibly diversity of their use⁴² due to their ability to raise money without issuing stocks⁴³ or procuring venture capital funding.⁴⁴ Moreover, ICOs' varied nature allows the coins to be resold on secondary markets using the virtual currency exchanges and thereby diversifying an investor's holdings.⁴⁵ By January 2018, the cryptocurrency market reached an all-time high of raising over \$700 billion.⁴⁶

C. Demand and attempts to regulate cryptocurrencies

Unlike fiat currency, cryptocurrency lacks a central bank behind it, and therefore its true monetary value is not understood nor is its value able to be properly stabilized.⁴⁷ Yet, more and more investors are buying and selling into ICOs, and cryptocurrencies in general, attempting to capitalize on the price volatility of these currencies.⁴⁸ For instance, the price of Bitcoin was on a

³⁹ The blockchain distributed ledger system. A system and structure that allows these coins to operate decentralized, entirely outside the existing financial and regulatory sphere. See Nathaniel Popper, *An Explanation of Initial Coin Offerings*, N.Y. TIMES (Oct. 27, 2017), <https://www.nytimes.com/2017/10/27/technology/what-is-an-initial-coin-offering.html>.

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⁴¹ *Id.* stats to prove ICO have raised more than any other method.

⁴² See Jay B. Sykes, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, CRS REPORT (Aug. 31, 2018).

⁴³ According to the New York Times, “[p]rogrammers have raised over \$3.2 billion this year by selling their own virtual currencies to investors. That is 3,000 percent more than the amount raised using coin offerings in 2016.” Nathaniel Popper, *An Explanation of Initial Coin Offerings*, N.Y. TIMES (Oct. 27, 2017), <https://www.nytimes.com/2017/10/27/technology/what-is-an-initial-coin-offering.html>.

⁴⁴ See Jay B. Sykes, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, CRS REPORT (Aug. 31, 2018); Nathaniel Popper, *An Explanation of Initial Coin Offerings*, N.Y. TIMES (Oct. 27, 2017), <https://www.nytimes.com/2017/10/27/technology/what-is-an-initial-coin-offering.html>.

⁴⁵ See Jay B. Sykes, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, CRS REPORT (Aug. 31, 2018).

⁴⁶ For instance, FileCoin raised \$257 million in 2017 becoming the largest coin offering. It was “designed to pay for storage on a global cloud storage network that the creators of Filecoin are promising to build.” See Nathaniel Popper, *An Explanation of Initial Coin Offerings*, N.Y. TIMES (Oct. 27, 2017), <https://www.nytimes.com/2017/10/27/technology/what-is-an-initial-coin-offering.html>.

⁴⁷ *Id.*

⁴⁸ *Id.*

constant rise in 2017; the monetary value per Bitcoin risen from \$1,000 to \$ 19,783.21 by December 2017.⁴⁹ As for its demand, Bitcoin and other cryptocurrencies like it are becoming common methods of conducting business around the world.⁵⁰ Traditional financial institutions as banks are not sure how to approach this market; the demand for business in the cryptocurrency market is high and banks are interested in getting involved but with little to no legal protection, financial institutions are shying away from incorporation of cryptocurrency’s blockchain technology.⁵¹

The attempts to regulate cryptocurrencies “focused almost exclusively... in the context of money transmission and the twin regulatory objectives of crime prevention and consumer protection.”⁵² “The Commodities Futures and Trading Commission (“CFTC”), the Department of Justice (“DOJ”), the Financial Crimes Enforcement Network (“FinCEN”), the Internal Revenue Service (“IRS”), and the Securities and Exchange Commission (“SEC”) have all exercised jurisdiction... to varying degrees in differing circumstances.”⁵³ However, the agencies have not agreed as to the proper characterization of a cryptocurrency: the CFTC classified it as a ‘commodity,’⁵⁴ while the IRS views it as ‘property,’ and the SEC calls it a ‘security.’⁵⁵

⁴⁹ See Stan Higgins, From \$ 900 to \$ 20,000: Bitcoin’s Historic 2017 Price Run Revisited, CoinDesk (Dec. 29, 2017, 1:30 AM), <https://www.coindesk.com/900-20000-bitcoins-historic-2017-price-run-revisited/>.

⁵⁰ *Id.* (“growing mainstream acceptance as an alternative to money and other traditional methods of payment like checks, and credit and debit cards.”) For instance, large corporations such as Walmart, Inc., are employing the blockchain technology to stay informed with their supply-chain management, allowing for low cost and efficient mode of data storage in blockchains accounting for all stages of its operations—from farmer to distributors.

⁵¹ *Id.* (“Tracing money. Traditional financial institutions (such as banks) often are not involved with ICOs or virtual currency transactions, making it more difficult to follow the flow of money.”)

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.* (“In 2015, the CFTC declared virtual currencies commodities. See In the Matter of Coinflip and Francisco Riordan, CFTC Docket No. 15-29 (Sept. 17, 2015). The U.S. District Court for the Eastern District of New York recently agreed, holding that “virtual currencies can be regulated by CFTC as a commodity.”)

⁵⁵ *Id.*

The first attempt at regulating cryptocurrency was by the Department of Financial Services (DFS) in New York.⁵⁶ The DFS devised a “BitLicense” requirement in June 2015 as means of regulating Virtual Currency Business Activities (“VCBA”) by any businesses involved in the cryptocurrency market.⁵⁷ The license requirement applies to New York residents or those conducting business within the state, and a VCBA encompasses those who purchase cryptocurrency, store it, exchange it, transmit it, or issue it for financial purposes.⁵⁸ Many private actors opposed the regulation, and a group even went as far as challenging the licensing requirement in court.⁵⁹ With no major success in raising the issue, the IRS and DOJ challenged whether federal law preempts New York’s BitLicense requirements.⁶⁰ For now, any business using cryptocurrency and is within the definition of VCBA “may be subject to regulatory oversight and reporting to DFS under the BitLicense paradigm.”⁶¹

Other state entities have adopted criteria similar to New York’s BitLicense requirements. For example, the Department of Financial Institutions (DFI) in the State of Washington recently included cryptocurrency in its definition of “Money Transmissions”⁶² within its Uniform Money

⁵⁶ See N.Y. Comp. Codes R. & Regs. tit. 23, § 200.2. (As of June 2015, New York established guidelines for regulating cryptocurrency businesses). Available at, <https://www.dfs.ny.gov/legal/regulations/adoptions/dfsp200t.pdf>

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ See generally, *Chino v. N.Y. Dep't of Fin. Servs.*, 2017 NY Slip Op 51908(U), 58 Misc. 3d 1203(A) (Sup. Ct.). (Private actor Chino brought action against DFS to enjoin and permanently restrain the DFS from enforcing Title 23, Chapter 1, Part 200 of the New York Codes, Rules, and Regulations (NYCRR). Chino argued the DFS’s regulation attempts on cryptocurrency exceeds the Department’s jurisdiction, “violates the separation-of-powers doctrine, is arbitrary and capricious and that federal law preempts the regulation.)

⁶⁰ See N.Y. Comp. Codes R. & Regs. tit. 23, § 200.2. (As of June 2015, New York established guidelines for regulating cryptocurrency businesses). Available at, <https://www.dfs.ny.gov/legal/regulations/adoptions/dfsp200t.pdf>

⁶¹ See *Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, FIN-2013-G001 (Mar. 18, 2013) (The Financial Crimes Enforcement Network (“FinCEN”) of the Department of the Treasury released in 2014 a guideline for regulating virtual currency under the Bank Secrecy Act (“BSA”). Any persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies and is attempting to operate as a money business service (“MSB”) is classified as a “money transmitter.” Money transmitters must to register with FinCEN and abide by the reporting, and recordkeeping regulations, unless otherwise exempt.)

⁶² See *Bitcoin and Virtual Currency Regulation*, Wash. Dep’t Fin. Insts., <http://www.dfi.wa.gov/bitcoin> (last visited Nov. 15, 2018) at <https://dfi.wa.gov/documents/money-transmitters/virtual-currency-regulation.pdf>. “‘Money transmission’ means receiving money or its equivalent value to transmit, deliver, or instruct to be delivered the money

Services Act (UMSA), characterizing the technology as an ‘extra’ payment system under Washington state law.⁶³ The agency released a short list of companies holding virtual currency licenses as of September 2018.⁶⁴ Companies within state limits wanting to transmit digital money submit license applications to the DFI.⁶⁵ The UMSA excludes some entities like governments, bank and credit unions from being subject to the Act so the DFI makes its determination based on the business model of the applicant’s company.⁶⁶ And once again, businesses may be subject to regulations from other federal agencies. The IRS treats cryptocurrency as ‘property’ for U.S. tax purposes thus general tax principles apply to virtual currency transactions.⁶⁷

PART II: SEC’s Regulation of ICOs

In recent years, there has been ample discussion surrounding the demand to understand what cryptocurrencies are and the importance of regulating such technology due to their impact on the U.S. financial market.⁶⁸ ICOs, for instance, received considerable attention from courts and regulators as each attempted to grapple with the technology in an effort to protect U.S. consumers. Yet, failures in classifying ICOs and varying application of existing laws and regulations called for a re-evaluation by the SEC because traditional means of regulating a non-traditional technology proved unworkable. Hence the SEC’s intervention resulted. So how is the SEC regulating ICOs?

or its equivalent value to another location, inside or outside the United States, by any means including but not limited to by wire, facsimile, or electronic transfer.”

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ See *Bitcoin and Virtual Currency Regulation*, WASH. DEP’T FIN. INSTS., <http://www.dfi.wa.gov/bitcoin> (last visited Nov. 15, 2018).

⁶⁸ *Id.*

A. *The SEC’s classification of ICOs as ‘security’ transactions*

The SEC has claimed jurisdiction over many ICOs by defining a coin offered in an ICO as a ‘security’ under the U.S. Securities Act⁶⁹ of 1933 and the Securities Exchange Act⁷⁰ of 1934.⁷¹ While the SEC has not released an official method of identifying which ICOs coins count as securities and which do not, it has developed a method of classification.⁷² According to the SEC, its role involves a three-part mission geared to protect investors, maintain efficient markets, and facilitate capital formations.⁷³ The SEC applies the *Howey test* —introduced in the seminal Supreme Court case of *SEC v. W.J. Howey & Co.*,—in support of defining ICOs as securities’ transactions.⁷⁴ An examination of the *Howey test* is warranted for a comprehensive analysis⁷⁵ of the SEC’s approach. However, application of the *Howey test* is not the focus of discussion; instead, the manner in which the SEC regulates ICOs in practice is the central topic of this section.

The SEC’s Chairman Jay Clayton⁷⁶ recently said he believes every coin he has seen is a ‘security,’ classifying ICOs as securities and imposing U.S. security laws on its use.⁷⁷ According to the SEC⁷⁸ and supporting case law,⁷⁹ the term “security” is construed broadly to embrace “investment contracts” which include a wide range of financial and commercial transactions,

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ See Global Legal Insights, *Initial Coin Offerings: A Comparative Overview of Securities Regulatory Environment in the US, UK, and Asia Pacific*, <https://www.globallegalinsights.com/practice-areas/blockchain-laws-and-regulations/5-initial-coin-offerings-a-comparative-overview-of-securities-regulatory-environments-in-the-us-uk-and-asia-pacific>.

⁷² *Id.*

⁷³ See *The Role of the SEC*, SEC. AND EXCH. COMM’N, <https://www.investor.gov/introduction-investing/basics/role-sec> (identifying investor protection as part of the SEC’s mission);

⁷⁴ *Id.*

⁷⁵ Examination of the SEC’s authority to regulate with support from the *Howey test* is discussed in Part IV of this Note.

⁷⁶ See *SEC Targets ICOs in Broad Cryptocurrency Markets Investigation*

⁷⁷ See *Chairman’s Testimony on Virtual Currencies: The Roles of the SEC and CFTC*, SEC. AND EXCH. COMM’N (Feb. 6, 2018), <https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission> [hereinafter “Chairman’s testimony”].

⁷⁸ *Id.*

⁷⁹ *Id.* Define security.

including ICOs.⁸⁰ Under the *Howey test*—which is explored further in Part III of this Note—if all four conditions are met, then a transaction will qualify as offering a security.⁸¹ An ICO transaction qualifies as a security transaction if it offers an investment of money, in a common enterprise, with a reasonable expectation of profit to be derived from the effort of others.⁸² This threshold is easily attainable since courts’ applications of the *Howey test* tend to focus on the “economic realities” in its analysis rather than the issuer’s label of the ICO.⁸³ In other words, it is important to “emphasize that regulators and courts will look past the purported form of the coin and examine its substance” in determining classification of an ICO.⁸⁴ Thus, an ICO will qualify as a security transaction when the purchased coins are primarily driven by a desire to be an investment for future gain. For instance, a designated label of “utility token” to an ICO that functions economically as a security will not preclude the SEC from designating it as a security for regulation purposes.⁸⁵

Once an ICO is classified as offering a ‘security’ transaction, issuers must: (1) comply with Section 5 of the Securities Act,⁸⁶ which requires the, to register the offering with the SEC or apply for a specific exemption from registration; and (2) be subject to anti-fraud liability under the Securities Act and the Securities Exchange Act of 1934.⁸⁷ The disclosure and anti-fraud

⁸⁰ See Global Legal Insights, Initial Coin Offerings: A Comparative Overview of Securities Regulatory Environment in the US, UK, and Asia Pacific, <https://www.globallegalinsights.com/practice-areas/blockchain-laws-and-regulations/5-initial-coin-offerings-a-comparative-overview-of-securities-regulatory-environments-in-the-us-uk-and-asia-pacific>.

⁸¹ *Id.*

⁸² See Jay B. Sykes, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, CRS Report (Aug. 31, 2018).

⁸³ See Jay B. Sykes, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, CRS Report (Aug. 31, 2018).

⁸⁴ See Global Legal Insights, Initial Coin Offerings: A Comparative Overview of Securities Regulatory Environment in the US, UK, and Asia Pacific, <https://www.globallegalinsights.com/practice-areas/blockchain-laws-and-regulations/5-initial-coin-offerings-a-comparative-overview-of-securities-regulatory-environments-in-the-us-uk-and-asia-pacific>.

⁸⁵ See Global Legal Insights, Initial Coin Offerings: A Comparative Overview of Securities Regulatory Environment in the US, UK, and Asia Pacific, <https://www.globallegalinsights.com/practice-areas/blockchain-laws-and-regulations/5-initial-coin-offerings-a-comparative-overview-of-securities-regulatory-environments-in-the-us-uk-and-asia-pacific>.

⁸⁶ See 15 U.S.C. § 77(e)- 77(f).

⁸⁷ See Jay B. Sykes, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, CRS Report (Aug. 31, 2018).

requirements operate as mechanisms for protecting investors and for promoting accurate pricing and representations made to the public.⁸⁸

B. Enforcement measures by the SEC

As of late 2017, the SEC has pursued enforcement measures against unregistered ICOs it classified as securities.⁸⁹ The SEC conducted broad investigations into ICOs, issuing numerous pre-offering subpoenas and related requests to blockchain startups regarding their planned ICOs.⁹⁰ In July 2017 the SEC released an investigative report pursuant to Section 21(a) of the Securities Exchange Act of 1934 on a virtual currency organization called “The DAO.”⁹¹ The DAO uses the distributed ledger technology of cryptocurrency to facilitate offering and selling of DAO ‘Tokens’⁹² valued at approximately \$150 million at the time.⁹³ The investigation began after theft of \$53 million worth of DAO’s digital Tokens.⁹⁴ “After DAO Tokens were sold to investors, but before The DAO began funding projects, a hacker utilized a flaw in The DAO’s code to steal approximately one-third of The DAO’s assets, prompting the SEC’s investigation.”⁹⁵ The SEC classified the Token as a security under the *Howey test* and applied existing U.S. federal securities laws to the new paradigm.⁹⁶ Although the SEC did not take any legal action toward the DAO, it issued the report and made clear points regarding the classification and regulation of

⁸⁸ See Jay B. Sykes, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, CRS Report (Aug. 31, 2018).

⁸⁹ See 15 U.S.C.A. § 78e, 15 USCA § 78e. See also Gerelyn Terzo, *SEC Targets ICOs in Broad Cryptocurrency Markets Investigation*, CRYPTO COINS NEWS (Mar. 1, 2018), <https://www.ccn.com/sec-targets-icos-in-broad-investigation/>. (“The US Securities and Exchange Commission is pursuing a broad investigation into ICOs, one in which numerous subpoenas and requests for information have been issued to a number of blockchain startups, according to *The Wall Street Journal*. The SEC apparently wants insight into the moving parts that comprise both the ICO and the pre-sale leading up to the public crowdsale.”)

⁹⁰ *Id.*

⁹¹ See *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, SEC Rel. No. 81207, 34-81207, (July 25, 2017) available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ See Jay B. Sykes, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, CRS Report (Aug. 31, 2018).

⁹⁶ *Id.*

cryptocurrencies such as DAO Tokens.⁹⁷ For instance, the SEC stressed that securities laws apply any time an offeror attempts to sell securities within the United States, “regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology.”⁹⁸

In late September 2017, the SEC did take action by issuing formal charges against businessman Maksim Zaslavsky⁹⁹ and two companies for investor fraud resulting from the alleged sale of fraudulent, unregistered securities in digital token form.¹⁰⁰ According to the SEC, Zaslavsky’s scheme purportedly raised funds via ICOs¹⁰¹ and claimed to invest the money it raised in diamonds and real estate.¹⁰² Soon after, the SEC’s Office of Investor Education and Advocacy¹⁰³ published a statement on its site warning from ICOs’ risks to investors.¹⁰⁴

Also, in December 2017, the SEC served Munchee, Inc., creator of an iPhone application, with a cease-and-desist letter in response to its operation “MUN tokens”.¹⁰⁵ This letter too took the position that cryptocurrencies were securities subject to the SEC’s jurisdiction. The white

⁹⁷ *Id.*

⁹⁸ See *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, SEC Rel. No. 81207, 34-81207, (July 25, 2017) available at <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

It is also important to note how the cryptocurrency market reacted on the release of the DAO Report.

Cryptocurrency values dropped significantly but rebounded within the week. The price of *Bitcoin* as of January 10, 2018 was nearly five and a half times greater than its price on the date the DAO Report was released. ARTICLE: From Initial Coin Offerings to Security Tokens: A U.S. Federal Securities Law Analysis, 22 Stan. Tech. L. Rev. P52 See *Bitcoin (BTC)*, COINMARKETCAP, <https://perma.cc/2LL3-Q6XW> (archived Dec. 19, 2018) (compare price between January 10, 2018 and July 25, 2017).

⁹⁹ *Id.*

¹⁰⁰ See generally *SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds*, SECURITIES AND EXCHANGE COMMISSION-PRESS RELEASE, (Sep. 29, 2017) <https://www.sec.gov/news/press-release/2017-185-0>.

¹⁰¹ Initial Coin Offerings. Refer to Footnote 27.

¹⁰² See *SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds*, SECURITIES AND EXCHANGE COMMISSION-PRESS RELEASE, (Sep. 29, 2017) <https://www.sec.gov/news/press-release/2017-185-0>.

¹⁰³ *Id.*

¹⁰⁴ See *Investor Bulletin: Initial Coin Offerings*, SEC INVESTOR ALERTS AND BULLETINS (Jul. 25, 2017) available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings

¹⁰⁵ See Jay B. Sykes, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, CRS Report, 29 (Aug. 31, 2018).

paper further claimed that Munchee had conducted a “*Howey analysis*” and found the coin offered a ‘utility token’ which “does not pose a significant risk of implicating federal securities laws.”¹⁰⁶ The MUN token started selling in October 2017 but the SEC soon issued the order stopping future sales and ordering a refund to buyers.¹⁰⁷ The SEC justified its ruling by findings the tokens offered to qualify as investments in money thus “investment contracts” under the *Howey test* due to the nature of their operation along with the expectation of profit by investors derived primarily by the effort of others.¹⁰⁸ Today, every ICO coin classified as a security and offered to the public must be registered with the SEC or be exempt under an offered exemption by the SEC.¹⁰⁹ That way, every piece of crowdfunding item is accounted for by the SEC.¹¹⁰

PART III: Is the SEC’s Method of regulating ICO’s Appropriate?

The SEC is the right agency for regulating ICOs that offer cryptocurrencies in a crowdfunding manner. One, the legal definition of a ‘security’ closely resembles the major use of cryptocurrency—as an investment tool—in ICOs. Two, textual support and legislative intent in drafting the Federal Securities Act of 1933 and 1934 suggest that the SEC is the precise agency with authority to regulate. And lastly, the impact of having a sole governing body will prohibit current misuses of some cryptocurrencies without hindering the fruition of the technology. Each point is explored below in a form of two legal arguments followed by policy consideration.

¹⁰⁶ See Jay B. Sykes, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, CRS Report, 29 (Aug. 31, 2018) (quoting white papers of Munchee).

¹⁰⁷ *Id.*

¹⁰⁸ *Id.* More recently, in 2018, the “SEC created a new Cyber Unit in the Enforcement Division, with broad mandate to address cyber-related misconduct, including, expressly, ICOs and digital token sales. Within days, the new unit brought charges against two ICOs, one involving investments in real estate (“RECoin”) and diamonds (“DRC World”) for fraud and the unregistered sale of securities. Fraud and investor protection appear to be the main focus of this unit on the ICO front, and more, similar investigations and charges are likely to follow.” See ARTICLE: From Initial Coin Offerings to Security Tokens: A U.S. Federal Securities Law Analysis, 22 Stan. Tech. L. Rev. P52 citing Press Release, U.S. Securities and Exchange Commission, SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors (Sept. 25, 2017), <https://perma.cc/4GPW-KEB4>.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

A. Legal definition of a ‘security’ includes cryptocurrency

The Securities Act of 1933 prohibits the offer and sale of any unregistered, non-exempt security.¹¹¹ The Act’s definition of a ‘security’ include the common investment forms like notes and stocks but the definition also encompasses any “certificate of interest or participation in any profit-sharing agreement,” and “investment contracts.”¹¹² As early as 1946, the Supreme Court in *SEC v. Howey*¹¹³ utilized this definition while expanding on it to answer whether an investment qualifies as an “investment contract” within the definition of a security.¹¹⁴ In *Howey*, the Supreme Court introduced the *Howey test*,¹¹⁵ holding that certain transactions constituted “investment contracts” and thereby fell within the scope of the Securities Act.¹¹⁶ The transactions in question involved the offering of a citrus grove development with later proceeds paid out to investors.¹¹⁷ The Court’s application of the *Howey test* looked to the function, not form, of the scheme to determine whether a scheme implicated money investments in a “common enterprise with the expectation of profits solely through the efforts of another.”¹¹⁸ If the test is met, an investment

¹¹¹ See 15 U.S.C.A. § 78e, 15 USCA § 78e; 15 U.S.C.S. § 77b; see *S.E.C. v. W. J. Howey Co.*, 328 U.S. 293, 301 (1946).

¹¹² Section 2(a)(1) defines a security:

“The term ‘security’ means 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, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, 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.”

15 U.S.C.S. § 77b(a).

¹¹³ See *S.E.C. v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946).

¹¹⁴

¹¹⁵ *Id.*

¹¹⁶ *Id.* 15 U.S.C.S. § 77b.

¹¹⁷ *Id.*

¹¹⁸ See *S.E.C. v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946); see also Securities and Exchange Commission. (2018, May 21). *Beaches and Bitcoin: Remarks before the Medici Conference*. [Press Release] available at <https://www.sec.gov/news/speech/speech-peirce-050218>.

contract is a security and is subject to the Securities Act regardless of “whether the enterprise is speculative . . . or whether there is a sale of property with or without intrinsic value.”¹¹⁹ Thus the provisions of the Act applied to the development sellers requiring registration with the SEC before being offering investments in the project to the public.¹²⁰

SEC v. Howey provides a logical starting point for assessing whether the SEC may permissibly regulate ICOs. Application of the *Howey test* is warranted in classifying cryptocurrency offered in ICOs for the similarities in functions between investment contracts—as defined by the *Howey*—and coins offered for capital raising. The test clarifies, a transaction qualifies as an investment contract if:

- (1) There is an investment of money;
- (2) There is an expectation of profits;
- (3) The investment of money is in a common enterprise; and
- (4) Any profit comes from the efforts of a promoter or third party.¹²¹

When all four criteria are met, the contract in question is classified as security and must conform to the SEC’s requirements before operating. And under this well established definition, most cryptocurrencies should rather easily qualify as securities.¹²² Bitcoin for example is: (1) an investment of money because investors place fiat currency to back up their interest; (2) invested with the generation of profits in mind, through price and value increases of coins, payments of dividends and investors’ ability to hold shares in the company; (3) a common enterprise; and (4) returning an average of triple an investor’s investment and all to generated profits are due to the

¹¹⁹ *Id.*; see also *See United Hous. Found., Inc.*, 421 U.S. at 852 (applying the *Howey* test to determine whether investment contract falls within the purview of either the Securities Act of 1933 or the Securities Exchange Act of 1934).

¹²⁰ *Id.*

¹²¹ See Lauren Harrington, *Security, Currency or Utility, How Do You Classify Your Cryptocurrency?*, INTELLIGENT (Mar. 26, 2018) available at <https://www.intellichq.com/resources/security-currency-utility-classify-cryptocurrency/>

¹²² <https://www.intellichq.com/resources/security-currency-utility-classify-cryptocurrency/>

seller's effort, not the buyer of the coin.¹²³ The seller who is asking to raise funds in this way is the party with the ideas, thus his or her efforts generate profit, if any. "Put simply, if there is any expectation of a profit from the purchase of a [coin], it's more likely to be considered a security."¹²⁴

There is no consensus among the courts in their interpretation of the third element, a 'common enterprise,' and this Note proposes amending the Statue to embrace the "horizontal commonality" approach as the determining test. The Act mentions:

"There is no uniformly accepted method of determining whether a transaction satisfies the common enterprise requirement of *Howey*. Instead, the courts employ various interpretations, with most circuits embracing the 'horizontal commonality' approach. Under that interpretation, courts find the common enterprise requirement satisfied where 'pooling' of investor funds is shown, through which the individual investors share all the risks and benefits of the business enterprise."¹²⁵

Pooling of investments is a logical approach to determine commonality in an enterprise because the collective gathering of money in exchange for cryptocurrency serves the same function as a traditional security being offered. The crucial support for this approach is in the language of the Act, which states "the individual investors share all the risks and benefits of the business enterprise."¹²⁶ This description is the exact manner in which cryptocurrency is raised during ICOs; if the whole operation fails, everyone in the pool loses their investments and vice versa. Thus, a coin purchaser in an ICO investment shares the risk of loss or profit with *all* other investors of the business.¹²⁷

¹²³

¹²⁴ See Lauren Harrington, *Security, Currency or Utility, How Do You Classify Your Cryptocurrency?*, INTELLIGENT (Mar. 26, 2018) available at <https://www.intellichq.com/resources/security-currency-utility-classify-cryptocurrency/>

¹²⁵ *Id.*; 1 Federal Securities Act of 1933 § 2.01 (2018)

¹²⁶ *Id.*

The *Howey test* is an "objective inquiry into the character of the instrument or transaction offered based on what the purchasers were 'led to expect.'" *Warfield v. Alaniz*, 569 F.3d 1015, 1021 (9th Cir. 2009).

¹²⁷ "This is not to say that all ICOs must be deemed securities offerings... so evaluate the facts and circumstances of each offering because increased access to the new functionality may arise so these things may not be securities once

B. From a policy perspective, classifying ICOs as ‘securities’ is appropriate

According to the *Wall Street Journal*, ICOs raised more money during 2017 alone than many standard options combined.¹²⁸ A look at the history¹²⁹ of cryptocurrency tells a story of constant growth, but it also demonstrates a sensitive area in need of protection. Therefore, the SEC’s measures in classifying cryptocurrencies offered in ICOs as a ‘securities’ is warranted due to the magnitude of impact it has on the investing public and private companies. Also, classifying coins offered in ICOs will determine “which U.S. federal agency has jurisdiction over bitcoin-related activities in regulatory criminal matters.”¹³⁰

An SEC’s Commissioner’s role is to protect investors and preserve the market’s integrity.¹³¹ Regulation by the SEC can internally begin by employing the necessary support: staff to guide formation of rule of law and understanding of cryptocurrency; and think-tanks or as they are often referred to as ‘Sandboxes’¹³² to generate sensible results and feedback.¹³³ Think tanks will allow the SEC to formulate better understanding of cryptocurrency and allow for one governing body of law.

The textual construction of the definition of a security accounts for functions of cryptocurrency to fall under the Securities Act. While it is unlikely that the drafters of the Act anticipated that anything like virtual currency would ever exist, let alone influence our daily lives,

the environment is completed”¹²⁷ Recent case law suggest that classification of an ICO is a fact-intensive analysis that yields differing outcomes based on the circumstances of each case.¹²⁷

¹²⁸ Footnote needed.

¹²⁹ Supra...

¹³⁰ See *Kaplanov*, at 26 (noting that the Securities and Exchange Commission will have jurisdiction over bitcoin if it is classified as a security).

¹³¹ *Id.*

¹³² *Id.*

¹³³ “we must be careful not to let our lack of familiarity with new technology breed anxiety and therefore bad regulation. There is a risk, when something truly innovative comes along, that regulators will focus only on the harms the innovation may bring and miss entirely the opportunity it presents to improve people’s lives. New technology does often bring with it risks; it can take time and experience for developers to build in the proper safeguards.”

the drafters did intend for legislation in the financial field to evolve with time.¹³⁴ Section 2(a)(1) of the Securities Act describes “specific and non-specific” instruments in which all create “a need for special protection in the circumstances of an ‘offer’ or ‘sale.’”¹³⁵ “Non-specific categories, such as ‘investment contracts,’ are included in order to extend the reach of the Securities Act to circumstances evidencing the characteristics of a security and the consequent need for protection, regardless of form A security is a bundle of characteristics that evidence *investment risk*.”¹³⁶

The central goal of the Securities Act is “to eliminate serious abuses in a largely unregulated securities market.”¹³⁷ Congress in enacting the Act “painted with a broad brush” recognizing the “limitless scope of human ingenuity” specially around the profit-making schemes.¹³⁸ Congress’s purpose in enacting the Act was to protect investors by regulating investments, regardless of their form or name.¹³⁹ Thus, the Act applies to many forms or methods of doing business as long as the same function is present.¹⁴⁰ A ‘thing’ can have many forms but “still represent the same function, and therefore be subject to the same regulation.”¹⁴¹ Cryptocurrency creates a new form of conducting the business of holding and trading assets, yet the guideline of who governs it is not alerted, for the essential functions and risks associated with cryptocurrency “is the creative heart of the financial world.”¹⁴²

¹³⁴ 1 Federal Securities Act of 1933 § 2.01 (2018)

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.*; “Courts should look not to the form but to the ‘economic realities of the transaction.’” See *SEC v. Blockvest, LLC*, No. 18CV2287-GPB(BLM), 2019 U.S. Dist. LEXIS 24446 (S.D. Cal. Feb. 14, 2019) (quoting *United Hous. Fdn. v. Forman*, 421 U.S. 837, 838 (1975)).

¹³⁸ See 1 Federal Securities Act of 1933 § 2.01 (2018).

¹³⁹ See *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990).

¹⁴⁰ *Id.*

¹⁴¹ See *Beaches and Bitcoin: Remarks before the Medici Conference*, SECURITIES AND EXCHANGE COMMISSION PRESS RELEASE, (May 21, 2018) available at <https://www.sec.gov/news/speech/speech-peirce-050218>.

¹⁴² *Id.* (Where the purpose of a transaction, or the use of proceeds of a loan evidenced by a note, is to raise money for a business enterprise, and the lender (“purchaser”) of the note is interested primarily in a return expected to be generated from the enterprise, the purpose or motivation for the transaction is decidedly investment-oriented.’ See, e.g., *SEC v. Tee to Green Golf Parks, Inc.*, 2011 U.S. Dist. LEXIS 4388 (W.D.N.Y. Jan. 18, 2011) (Money was

PART IV: An Alternative Approach to Regulating ICOs

At the outset of ICOs' release in 2017, the new method of crowd funding witnessed wild success in the financial market and generated high demand over time. The new method of fundraising also increased the level of scrutiny applied by regulators, like the SEC, in response to the fraud and deception associated with the technology.¹⁴³ Nonetheless, material problems remain overlooked: the lack of consumer knowledge when investing into ICOs sold to the public for investment, making some ICOs wild successes the product of nothing more than blind demand; and, start-up businesses interested in raising funds through ICOs are without a guideline on what procedures to follow in order to avoid violating security laws. This Note proposes an alternative approach to dealing with ICOs, which begins with law-makers examining and enhancing the *Howey test*, essentially, building upon the seminal test to account for the loopholes created by ICOs.

Adding to *Howey's* basic framework is two-folds. First, the SEC should publish informational guidelines for investors with various conducted studies as the source of its content, and the SEC should require certain criteria to be met before an ICO can be offered to the general public for crowdfunding. Second, Congress needs to pass new legislation accounting for ICOs in securities laws and formalizing the SEC's authority in regulating. Both points are explained below. The aim of this approach is to provide lawmakers and scholars in the field with insights to the impact of niche regulation on our financial sphere while offering legal clarity to the regulation of such technology.

A. The SEC's Need to Enhance Current Regulatory Measures

sought for general business use, and purchasers undoubtedly viewed their purchase of the notes as investments, enticed by the prospect of a 10% return.).”

¹⁴³ *Id.*

Federal securities law says relatively little about cryptocurrencies, particularly ICOs.¹⁴⁴ “So far, there have been very few benchmarks for moving regulation forward: the *Howey test*, a metric to measure whether or not an asset is a security as defined by the Securities Act of 1933; the DAO Report, a report released by the SEC on the DAO hack in 2016; prior enforcement actions; and, most recently, the SEC’s Statement on Digital Asset Securities Issuance and Trading”¹⁴⁵ Enhancement of the current benchmarks begin with increasing efforts from the SEC internally. Thus, an initial step toward reform involves simply increasing the amount of legal guidance available to investors and offerors regarding the regulatory treatment of ICOs.

i. Informational guidelines for investors

The SEC needs to first enhance the investor’s experience by publishing informational guidelines for investors with sufficient detail and particularity. Currently, the SEC has provided the public with speeches, guidelines, and warnings via its site about investing in ICOs. However, none of the information published is enough to communicate the *level* of risk associated with ICOs because it does not educate¹⁴⁶ the investor on ICO’s legal implications; it simply warns of their risks. Meaning, an investor relies on agencies as the SEC to ensure ideas in the market place are safe enough for the consumer to invest in, after all that is a main task taken up by the SEC. An average investor understands that there is a certain level of inherit risk to every investment made and the level of heightened risk needs to properly explained by the SEC. By the SEC’s

¹⁴⁴ See *CFTC v. McDonnell, et al.*, No. 18-cv-361, ECF No. 29 (E.D.N.Y. March 6, 2018) (federal government official quoted saying the government is not sure how to deal with regulating such new technology and it “think[s] it is not fully equipped to dealing with cryptocurrency.”)

¹⁴⁵ “Guidance by Enforcement”: How the SEC Is Slowly Shaping ICO Regulation
<https://bitcoinmagazine.com/articles/guidance-enforcement-how-sec-slowly-shaping-ico-regulation/>

¹⁴⁶ ADD HERE where the void is (find where it is NOT enough to educate investors)

enhancement of its efforts to regulate and speak on ICOs, it will provide grounds for congressional support to adopting legislation.

The SEC has already taken important steps in this direction. SEC Commissioner Hester Peirce welcomed cryptocurrency technology eagerly during the Medici Conference in May 2018.¹⁴⁷ Peirce commented on the difficulties innovation poses on regulators, he said, “[w]e are used to the way things have been done.... Figuring out whether and how [our rules] apply to new ideas is difficult.”¹⁴⁸ Peirce further urged innovators and business owners interested in the cryptocurrency market to “help [the Commission] learn more about the technology so that we are able to think about the regulatory obstacles that may stand in the way of crypto-technology’s ability to improve our lives.”¹⁴⁹

ii. Creation of an S-1 form for ICOs by the SEC

When a company wants to register its security with the SEC before offering it for sale, the process is well understood because the SEC has specific guidelines and clear rules to be followed in order not to be in violation of security laws.¹⁵⁰ A start-up wanting to raise funds via ICOs however is without any procedural guidelines from the SEC and is unaware of its violation of security laws until the SEC pursues action against the company. This problem would be eliminated with the creation of an S-I form unique to ICO registration.¹⁵¹ The additional measure can further be enhanced if the procedural guidelines are made specifically for startups.

iii. Providing required terms within contracts for sale of ICOs

¹⁴⁷ See *Beaches and Bitcoin: Remarks before the Medici Conference*, SECURITIES AND EXCHANGE COMMISSION PRESS RELEASE, (May 21, 2018) available at <https://www.sec.gov/news/speech/speech-peirce-050218>.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ <https://www.investopedia.com/terms/s/sec-form-s-1.asp>

¹⁵¹ More to come later.

The SEC must require certain terms to be included in each contract of sale of an ICO. The required terms aim to foster transparency between all parties involved: an investor, the seller of the ICO, and the SEC. Since most ICO sale contracts are now offered online,¹⁵² an online form of the contract should be required to include links directing an investor to the SEC site. The SEC website should explain which would contain useful information. The investor holds certain expectations regarding monitoring duties of the SEC, thus when investing, the general public is not unreasonable in expecting the SEC to only approve legitimate business dealings regardless of the form. An investor with more information is more likely to grasp a fuller picture of the true risks associated with the currency and recognize that many agencies, not just the SEC, are struggling to grapple the SEC's in a way. The site also serves as a disclaimer from the SEC regarding the unknowns of cryptocurrency.

B. Congress' Need to Pass Legislation Accounting for ICOs in Securities Laws

Cryptocurrencies are touching major financial systems and institutions in modes requiring consumer protection. The desired appeal of ICOs and the blockchain technology in general has increased calls for legal clarity regarding the limits and obligations that apply to issuers of and investors in cryptocurrencies. At a congressional “crypto roundtable” in September of 2018, over 45 representatives of cryptocurrency companies and investors “told lawmakers that there is a pronounced lack of regulatory clarity for” ICOs, and that “current regulations were not only vague, but outdated.”¹⁵³ “The crypto industry won’t have a firm standard for what conduct is allowed and what’s illegal until Congress passes new legislation or the SEC’s theories are tested in court.”¹⁵⁴

¹⁵²

¹⁵³ <https://cointelegraph.com/news/us-new-legislation-proposes-to-exclude-crypto-from-securities-laws>

¹⁵⁴ “Guidance by Enforcement”: How the SEC Is Slowly Shaping ICO Regulation
<https://bitcoinmagazine.com/articles/guidance-enforcement-how-sec-slowly-shaping-ico-regulation/>

The SEC's theories *have* been tested in court without ample success resulting. As discussed in Part II of this Note, the SEC holds the apparent authority to regulate ICOs as securities offerings under the *Howey test*. While the *Howey test* serves as an excellent starting point to regulating ICOs as securities, the test is only the floor and not the ceiling in proper regulation of ICOs. In late 2018, the SEC's request for an injunction against BlockVest, a company offering unregistered security offerings, was denied by a California judge.¹⁵⁵ The judge held that the tokens offered by BlockVest did not constitute an investment contract under the *Howey test* because of the company's argument that there was no expectation for returns.¹⁵⁶ BlockVest and other startups like it have been able to evade the SEC's bite by self-labeling their products as utility tokens rather than securities.¹⁵⁷ If a company can prove that its token is "built to serve a function" rather than operate an "investment vehicle," then it could sell without having to register with the SEC.¹⁵⁸ The BlockVest case demonstrates one failure of the *Howey test*: not accounting for ICOs offered to raise funds simply by evading the "investment contract" definition within the test.

Riding this cryptocurrency roller-coaster has not been without ups and downs; as seen with BlockVest, there are loopholes that clever financiers remain able to exploit. But, essentially there are three phases best describing the evolution of cryptocurrencies, particularly, ICOs. Phase one of dealing with cryptocurrencies is done, consumers and lawmakers now have at least a basic understanding of the many uses of the blockchain technology and the need for its regulation. Phase two is to translate an understanding of ICOs (which are cryptocurrencies) into authoritative action. Phase two is partly complete, as the SEC has asserted its jurisdiction over cryptocurrencies and initiated enforcement actions against egregious abuses. Now, phase three is to unite all of the

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* What function does BlockVest purport to serve?

understandings and research into legislation, thus this phase must be addressed by Congress to actualize the SEC’s authority as sole regulator of ICOs.

i. The proposed Token Taxonomy Act should fail.

In December of 2018, Congressmen Warren Davidson and Darren Soto introduced the Token Taxonomy Act bill.¹⁵⁹ The act proposes several amendments to federal securities and tax laws. One proposed change is to amend Section 2(a)(1) of the Securities Act to explicitly exclude “digital tokens” from the definition of a “security.” While this current proposal remains a mere bill, members of Congress should not vote to enact it due to its failure to account for basic feature of ICOs. The proposed act offends the inherent nature of ICOs because it does not recognize it as investment tools to be regulated under the Securities Act of 1933 and 1934. Further, the proposed act does not address initial reasons for inventing the distributed ledger technology within cryptocurrency—namely, mounting market failures and a distrust for the centralized financial systems. Thus when linking our current understanding of why ICO even came about to the need to regulate, the act is offending the safeguards created if such legislation is passed. By failing to address the core reason why people are repelling the use of ICOs and the distributed ledger technology, the proposed act only creates room for more loopholes by taking digital tokens out of the definition of a security. What is missing from this legislation is accounting for the parallels between the 1929 Depression which led to the creation of the Securities Acts and the 2008 crash. The proposed legislation is not adding to our understanding of ICOs, it is simply providing a way out for digital token users from regulation and tax, two major areas of concern.

¹⁵⁹ Token Taxonomy Act, H.R. 7356, 115th Cong. (2018).

<https://davidson.house.gov/media-center/press-releases/congressmen-warren-davidson-darren-soto-introduce-ico-fix-businesses>

Another amendment proposed by the bill deals with tax treatments of cryptocurrency transaction. The proposed bill suggests that such transactions should be excluded from an individual's gross income, thereby offering a tax deduction. Again this argument misrepresents some essential characteristics of cryptocurrency. If cryptocurrency is to be treated as a currency, there is no imaginable way in which the use of it in transactions does not affect one's value does not implicate tax assessments accounting for capital gains and losses. Tax effects attach regardless when a company offers currency as a crowdfunding tool thus the bill should fail. The legislation is not adding to our understanding of ICOs, it is simply providing a way out for digital token users from regulation and tax, two major areas of concern. The motivations behind the legislation are questionable for those reasons.

ii. A practical consideration for dealing with ICOs as an investment tool via a proposed legislation

A look at the record behind the 1933 and 1934 Act reveals the fear of a centralized system—and for good reason—coupled with a repeat market crash in 2008 post high frequency trading (“HFT”) explains the market's reaction with the invention of a decentralized system with the cryptocurrency technology. However, new proposed legislation will not offend this underlying rationale because it will simply monitor one form of the many uses of the blockchain technology in order to protect investors. Meaning, this approach dismantles the negative aspects of the ICOs uses while maintaining the decentralized attractiveness of the technology in other uses. The need for regulation of ICOs outweighs the fears associated with regulation because it actually takes steps toward preventing a third major market crash. “When new or as-of-yet undeveloped tokens with an uncertain future value are offered by developers in exchange for money, users are at the greatest risk of loss, and unscrupulous developers have the best chance of finding short-term

gains.”¹⁶⁰ Currently in regulating cryptocurrencies offered in ICOs, the SEC operates under unsaid expectations that any business with unregistered securities will be in violation of the 1933 Act and that companies offering these coins will voluntarily work with the SEC to ensure compliance. However, while courts under *Howey* disregard form and emphasize the economic realities of a transactions with the expectation of future returns by the investor, enhancing upon the *Howey test* in forthcoming legislation enables the SEC to enforce with a legal authority backing their actions.¹⁶¹ As of now, the SEC has to litigate and defend its title in court in order to enforce its regulation upon companies offering cryptocurrency in ICOs. New legislation that amends the security laws to include cryptographic coins used in ICOs as a security will eliminate the confusion and save time and resources.¹⁶²

Congress may push back on the idea of amending security laws to include ICOs due to the various non-security use of ICOs. A Congressional Research Services’ Report, done by Legislative Attorney Jay Sykes, prepared for members and Committees of Congress acknowledged the diverse uses of ICOs and the impossibility of drawing broad conclusions about their status under the securities laws.¹⁶³ A simple response to Congress’ concern is that only ICOs passing

¹⁶⁰ See Peter Van Valkenburgh, *Framework for Securities Regulation of Cryptocurrencies v2.0*, COIN CENTER REPORT, Aug. 2018, available at <https://coincenter.org/entry/securities-framework/>

¹⁶¹ See Peter Van Valkenburgh, *Framework for Securities Regulation of Cryptocurrencies v2.0*, COIN CENTER REPORT, Aug. 2018, available at <https://coincenter.org/entry/securities-framework/>

¹⁶² “Guidance by Enforcement”: How the SEC Is Slowly Shaping ICO Regulation <https://bitcoinmagazine.com/articles/guidance-enforcement-how-sec-slowly-shaping-ico-regulation/>

“The foundation of the securities laws dates back to the 1930s, long before anyone could have imagined the concept of a digital asset issued via the internet through the use of blockchain technology. This old legal framework simply wasn’t designed for the digital age, and as a result, it doesn’t provide the regulatory clarity that the crypto industry needs to move forward Much like the outdated Securities Act, Chervinsky finds that these various references for guidance are not robust enough to substantiate actual regulation and satisfy the industry’s need for clarity.”

Id.

¹⁶³ See Jay B. Sykes, *Securities Regulation and Initial Coin Offerings: A Legal Primer*, CRS Report (Aug. 31, 2018).

the *Howey test* would be incorporate under security laws; the aim of legislation is not to classify every ICO as a security and blindly couch it under security laws, but to give the SEC the necessary backbone to properly regulating ICOs without having to run to the courts for support each time a violator attempt to bypass registering its ICO which it plans to use as an investment contract.

Assuming security laws apply, a new law enhancing the *Howey test* enables enforcement mechanisms that are reliable and constant for both sides of the cryptocurrency industry: investors and regulators. Legislation is necessary because it will give the SEC actual authority to regulate the industry of instead of relying on its current apparent authority which only leads to constant litigation surrounding a complex area of the law. Further, enactment of legislation will boost consumers' confidence and provide needed stability to the market and practitioners. Lastly, understanding the grassroots of how ICOs work will enable investors to make educated investing decisions... Such regulation enables diversifying investors' portfolios while offering appropriate means of assessing risk.¹⁶⁴ The existence of preventive measures for business owners to obey and proper knowledge for U.S. consumers to make educated investing decisions will facilitate proper growth in this technological area. Further, such regulation will eliminate confusion¹⁶⁵ and classification discrepancies,¹⁶⁶ while providing a unified system of monitoring this new form of money to serve as base.¹⁶⁷

PART V: CONCLUSION

¹⁶⁴ Blockchain technology is more than just Bitcoin, it provides a more accurate, efficient and secure way of record keeping that can be provided to many industries. https://www.youtube.com/channel/UCToe3dspZyw2L_JY-JmP3Mw?v=9DCGEPZPxFM

¹⁶⁵Disagreements regarding which law ought to apply.

¹⁶⁶ See I.R.S. Notice 2014-21 (2014), available at <http://www.irs.gov/pub/irs-drop/n-14-21.pdf> (describing how existing tax principles apply to virtual currency transactions based on whether or not bitcoin is a currency, security, or commodity which determines the amount of taxed by the IRS).

¹⁶⁷ *Id.*

Whether accepted, rejected or regulated, it is clear to see from the world's acknowledgment of cryptocurrency that it is no longer viewed as the nerdy money or just online money. Rather, it has earned its place and respect in major financial markets further signifying the vitality of properly assessing and regulating these currencies.¹⁶⁸ Many regulators (i.e. the IRS, CFTC, and most notably the SEC) are attempting to grapple with regulating certain aspects of the currency's use in order to prevent fraud and deception seen. For instance the SEC has decided to classify cryptocurrency coins offered in a crowdfunding mean a 'security.' Yet, while the existing frameworks are functional, they give rise to classification issues in determining whether a cryptocurrency coin is a security, commodity or property leading to ineffective regulation by overall. In order to address the loopholes in regulation and enforcement, this Note supports the rising demand to regulate cryptocurrencies offered in ICOs as securities solely under the SEC's umbrella but calls for a recall in the manner the SEC is regulating ICOs.

The alternative approach proposed argues for enhancement to the famous *Howey test* in regulation rather than relying on existing, inadequate mechanisms for regulating this unorthodox rim of technological innovation. Enhancement comes from educating the investing public on the levels of inherent risk associated with ICOs and a push on Congress to enact laws accounting for ICOs within the Securities Acts of 1933 and 1934. This Note does not purport to give ultimate rule of law, it merely provides a starting point for the SEC to tackle current financial concerns

¹⁶⁸ See Stephanie Avakian, *The SEC Enforcement Division's Initiatives Regarding Retail Investor Protection and Cybersecurity*, U.S. SECURITIES AND EXCHANGE COMMISSION (Oct. 26, 2017), <https://perma.cc/5H7U-65AX>. Problems regulation would not solve but would manage: environmental, privacy and criminal. Cryptocurrency "can be an attractive vehicle for fraudulent conduct. We think that creating a permanent structure for the consideration of these issues within the Cyber Unit will ensure continued focus on protecting both investors and market integrity in this space" US: New Legislation Proposes to Exclude Crypto From Securities Laws. Spotlight on Initial Coin Offerings I <https://www.sec.gov/ICO>; <https://cointelegraph.com/news/us-new-legislation-proposes-to-exclude-crypto-from-securities-laws>.

associated with ICOs without perplexing the legalities or hindering the marketplace of ideas for such technology.