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BLOG

When Is a Crypto Asset a "Security," and Why Does That Matter? (Part I)

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There is a very broad range of crypto assets, including:

- "digital," "crypto" and "virtual" currencies;
- "virtual" coins or tokens; and
- "traditional" equity or debt securities that have been "digitized" or "tokenized."

You can find descriptions of the various sorts of crypto assets here. These descriptions have been taken not from technical textbooks, but from opinions and advisories issued by courts and regulators that have had occasion to discuss certain legal and regulatory issues surrounding crypto assets, as well as risks associated with investing in such assets.

Drawing distinctions between different types of crypto assets is important *because the regulatory treatment of a particular crypto asset depends in large part on whether or not it is a security*.

For example, as will be discussed in detail in subsequent posts on this blog:

- An investment adviser's calculation of its regulatory assets under management may depend on whether crypto assets managed by the adviser are "securities" (or "cash or cash equivalents").
- Crypto assets that are securities are subject to the pre-clearance and reporting (both holdings and transactional) requirements of Rule 204A-1 under the IAA, whereas crypto assets that are not securities are not subject to those requirements.
- To the extent that crypto assets are considered "securities or funds" of a client, an investment adviser must comply with Rule 206(4)-2 under the IAA—the so-called Custody Rule—if the investment adviser is considered to have custody over such assets pursuant to that rule.

So, when is a crypto asset a "security" for purposes of the federal securities laws? The answer:

- Traditional equity or debt securities that have simply been "digitized" are clearly securities. The fact that they are represented by records on a distributed ledger or blockchain clearly does not alter their status as securities.

- At the present time, certain high-ranking officials of the Securities and Exchange Commission (SEC)—but not the SEC itself—have concluded that two well-known "cryptocurrencies" or "virtual currencies"—namely, Bitcoin and Ether—are not securities for purposes of the federal securities laws.[1] Unfortunately, that does not give us a lot of guidance on the status of "virtual currencies" in general, because Bitcoin and Ether are only two virtual currencies out of literally hundreds if not thousands currently in "circulation."

So where does that leave us with respect to "virtual currencies" other than Bitcoin and Ether, and with respect to other crypto assets such as coins and tokens? Are they securities?

Although, as noted above, certain high-ranking SEC officials have conceded that two types of **cryptocurrencies**—namely, Bitcoin and Ether—are not securities, the SEC's general attitude with respect to other crypto assets (including other cryptocurrencies) is that it is up to market participants to decide whether a particular crypto asset is a "security."

Now that we are on our own, how do we determine whether a particular crypto asset is a security?

At the outset, the regulators have made it clear that simply calling something a "virtual currency," "cryptocurrency," "crypto asset," "digital asset," "coin," "token," etc. is not determinative of its status as a **security** for purposes of the federal securities laws. For certain statements made by courts and regulators on this point, see here.

What matters is **substance**, not **form**.

If, in substance, a crypto asset is a security, the fact that it consists of, or is represented by, records in a blockchain or distributed ledger clearly does not alter its status as a security. Again, for certain statements made by courts and regulators on this point, see here.

How do we determine whether a crypto asset is, in **substance**, a security? The answer:

Generally, we must apply the so-called "*Howey* test," **on a case by case basis**, to determine whether a particular crypto asset is a security.

Under the three-part "*Howey* test"—which is named after a U.S. Supreme Court case, *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946))—a financial instrument such as a crypto asset will be considered an "**investment contract**," and therefore a "**security**,"[2] where there is:

1. an investment of money (which could include, for example, an investment of fiat currency or cryptocurrency)
2. in a common enterprise
3. with an expectation of profit derived from the managerial or entrepreneurial efforts of others.[3]

In our next post, we will discuss why applying the *Howey* test can prove daunting to SEC-registered investment advisers in the event they are required to determine whether particular crypto assets are "securities."

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[1]*See, e.g.*, Remarks of William Hinman, Director, SEC Division of Corporation Finance, before the "Yahoo Finance All Markets Summit: Crypto" (June 14, 2018), which can be found here.

[2]Section 2(a)(1) of the Securities Act of 1933 and Section 3(a)(10) of the Securities Exchange Act of 1934 generally define the term "security" 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, 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." [Emphasis added]

Clearly, many crypto assets do not appear, on their face, to be “securities” because often they do not take the form of stocks, bonds, *etc*. But the definition of “security” contains a “catch-all” term—namely, “investment contract—that picks up esoteric instruments that, in substance if not form—have the same basic attributes of the types of financial instruments expressly named as securities in the definition.

[3]As a matter of fact, in *Howey, the Supreme Court* held that an “investment contract” means “a 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, 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 enterprise.” 328 U.S. at 299-300. [Emphasis added.] Subsequent case law, however, has tended to ignore the word “solely,” with courts differing on the scope or degree to which investors must rely on the efforts of others in order for there to be a finding that a particular “contract, transaction or scheme” constitutes an “investment contract” and therefore a “security.” The resulting elasticity of the *Howey* test has proven to be a powerful tool in the hands of regulators and plaintiffs.

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