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BLOG

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

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In our January 17 blog, "When Is a Crypto Asset a "Security," and Why Does That Matter? (Part I)," the Crypto Law Corner explained that SEC-registered investment advisers must apply the so-called "*Howey* test," **on a case–by-case basis**, to determine whether a particular crypto asset is a security, and suggested that 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."

Why is the *Howey* test daunting?

Although the three-part "*Howey* test" may sound simple and straightforward, it is anything but.

Applying it on a case-by-case basis involves an intensive and complicated "facts and circumstances" analysis—an analysis that can produce a conclusion on which reasonable minds can differ.

To get a feel for how complicated a "*Howey* test" analysis can be in the context of crypto assets, *see* the Remarks of William Hinman, Director, SEC Division of Corporation Finance, before the "Yahoo Finance All Markets Summit: Crypto" (June 14, 2018) (Hinman Crypto Remarks), which can be found here. Although Director Hinman clearly was trying to be helpful to market participants by demonstrating how to conduct a "*Howey* test" analysis, his remarks, in the context of this overall speech, only enforced the complexities of applying the *Howey* test to crypto assets.

As a result, applying the Howey test to a particular crypto asset could consume considerable time and resources, with no assurance that the SEC would not "second guess" an investment adviser's *Howey* analysis with respect to such asset.

That said, at least in the case of so-called "initial coin offerings," the SEC's position is that such offerings, and the "coins" or "tokens" issued in connection with such offerings, are in many if not most (but not necessarily all) cases likely to be "securities."

For example, according to SEC Chairman Jay Clayton, "[b]y and large, the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws."[1]

Further, because of enforcement actions taken, and regulatory pronouncements made, by the SEC beginning in the latter half of 2017,[2] many issuers of "coins" or "tokens" are now actively assessing whether such "coins" or "tokens" are securities, and are taking steps to comply with federal securities laws if they conclude that such coins or tokens are securities.

While no coin or token issuers appear to have filed registration statements with the SEC, and although the SEC appears to be dragging its feet on approving coin or token offerings conducted pursuant to Regulation A+, many issuers are now offering their coins or tokens in transactions that are designed to qualify for the exemption from the registration provisions of the Securities Act provided by Rules 506(b) or 506(c) of Regulation D thereunder (and, to a lesser extent, Regulation Crowdfunding).

To a certain extent, this relieves advisers of the need to determine whether particular crypto assets are "securities," because if the issuer of such crypto assets effectively takes the position that such assets are securities by virtue of structuring its offering of such assets in a manner designed to qualify for an exemption from Securities Act registration requirements, it would seem that an adviser could reasonably conclude that such assets are securities for purposes of the adviser's regulatory obligations pertaining to securities under the Investment Advisers Act.

After all, if an issuer concludes that particular crypto assets are securities, an adviser should be in a good position to argue that it is not required to conduct its own independent "*Howey* test" analysis of such assets to determine whether they are securities.

On the other hand, if an adviser determines that an issuer of coins or tokens has not offered those coins or tokens pursuant to an effective registration statement, pursuant to an SEC-approved Regulation A+ offering or pursuant to an exemption from Securities Act registration requirements, it would appear that it is incumbent on the adviser to conduct its own "*Howey* test" analysis.

For example, prior to the SEC's recent crackdown on unregistered coin/token offerings, hundreds if (if not thousands) of coin/token offerings were not structured in a manner designed to qualify for an exemption from Securities Act registration requirements. So there are many digital assets in "circulation" that may well be securities under the *Howey* test but whose issuers did not treat them as such.

Further, if an adviser concludes—after applying the *Howey* test to a particular coin or token—that such coin or token is a security but that such coin or token was not offered pursuant to an effective registration statement, pursuant to an SEC-approved Regulation A+ offering or pursuant to an exemption from Securities Act registration requirements (such as that provided by Rule 506(b) or Rule 506(c) of Regulation D), the adviser would be well advised to steer clear of investing in such coin or token because of potential legal and regulatory restraints that might prohibit the adviser from ultimately disposing of such coin or token at a time the adviser would otherwise believe to be opportune.

Finally, just when you thought you might be able to tell the difference between a crypto asset that is a security and one that is not, a new consideration springs up—namely, whether a crypto asset initially offered as a security can, over time, become something other than a security, *e.g.*, a commodity.

In the Hinman Crypto Remarks (which can be found here), William Hinman, Director of the SEC's Division of Corporation Finance, stated:

> To start, we should frame the question differently and focus not on the digital asset itself, but on the circumstances surrounding the digital asset and the manner in which it is sold. To that end, a better line of inquiry is: "Can a digital asset that was originally offered in a securities offering ever be later sold in a manner that does not constitute an offering of a security?" In cases where the digital asset represents a set of rights that gives the holder a financial interest in an enterprise, the answer is likely "no." In these cases, calling the transaction an initial coin offering, or "ICO," or a sale of a "token," will not take it out of the purview of the U.S. securities laws.
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> But what about cases where there is no longer any central enterprise being invested in or where the digital asset is sold only to be used to purchase a good or service available through the network on which it was

> created? I believe in these cases the answer is a qualified "yes."
>
> If the network on which the token or coin is to function is sufficiently decentralized—where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts—the assets may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful.

So, a crypto asset that started its life as a security can potentially morph over time into a type of financial instrument that is not a security (usually, a commodity).

As a result, investment advisers may have a duty not only to determine whether a particular crypto asset is a security at the time the adviser acquires it on behalf of a client, but also to monitor the status of such asset from time to time to determine whether it has ceased to be a security!

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[1]SEC Chairman Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings* (Dec. 11, 2017), which can be found here.

[2]*See* Statement on Digital Asset Securities Issuance and Trading, SEC Divisions of Corporation Finance, Investment Management and Trading Markets (November 16, 2018), which can be found here.

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