When Should Crypto Assets Be Considered Securities?

By **Lewis Cohen, Greg Strong and Sarah Chen** (December 14, 2022)

Anyone who follows news around the use of blockchain technology and crypto assets likely is familiar with the frequently expressed concern that most fungible crypto assets, frequently referred to as tokens, should be considered securities in the U.S.

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In particular, U.S. Securities and Exchange Commission Chair Gary Gensler has repeatedly stated that he believes that almost all tokens are securities.[1]

Last month, the U.S. District Court for the District of New Hampshire granted the SEC's motion for summary judgment in SEC v. LBRY Inc.,[2] a case involving sales of LBC, a crypto asset issued by the blockchain-based decentralized media distribution platform LBRY.

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The trial court judge concluded that "LBRY offered LBC as a security."[3] However, a critical question remains: Is LBC token itself a security, or were the offers and sales of LBC tokens by the defendant securities transactions?

This question may well be soon revisited in an even higher-profile ongoing litigation in the U.S. District Court for the Southern District of New York, SEC v. Ripple Labs Inc. Counsel advising in this area need to look carefully at this question on any project or matter they handle involving tokens.

Sarah Chen

Although the positions on this issue currently taken by the SEC should guide counsel in advising clients, we believe that a better understanding of these issues will benefit all stakeholders in the crypto asset space and will help guide the policy discussion going forward.[4]

Developing Our Analysis of Crypto Assets

To understand how tokens themselves should be treated under the federal securities laws, we reviewed all relevant appellate cases over the last 75-plus years that apply the federal securities laws' catch-all term, investment contract, starting with the case that provides the court-made definition of the term "investment contract," SEC v. W.J. Howey & Co. in 1946.[5]

In Howey, the U.S. Supreme Court sought to encapsulate what it believed Congress was seeking to accomplish through the use of the undefined term "investment contract" in the statutory definition of "security," concluding that an investment contract was a contract, transaction or scheme that involves: (1) an investment of money (2) in a common enterprise (3) with an expectation of profits to come (4) from the efforts of the promoter or a third party.

This quickly became known as the Howey test.[6] Such a principles-based test is needed to provide a remedy for deliberate or inadvertent investment schemes that may circumvent the rigors of the securities registration process and the related anti-fraud provisions by obfuscating the economic realities of a commercial arrangement.

In the 75 years since Howey, courts saw cases involving an almost limitless diversity of purported investment schemes. The common theme was almost always an arrangement that involved a sale of some object that the purchaser was not interested in using, marketed by a promoter with an explicit, or occasionally implicit, undertaking to increase the value of that object through the promoter's managerial efforts.

Examples of objects of investment schemes given by the SEC in a recent filing in connection with LBRY include orange groves, payphone leases, investment packages to secure EB-5 visas, online ad services, licenses to sell dental products, films, multi-level marketing programs, chinchillas and virtual shares.[7]

Rather self-evidently, none of these items are themselves securities. Yet each of these assets or interests, and many more we found, were present in fundraising schemes identified by courts as investment contract transactions.

However, unlike as was the case with the myriad failed investment schemes that led to the prior litigation, with crypto assets a fair number of projects have been successful and robust secondary markets have developed for the assets — the objects of the original scheme.

Yet the fact that a secondary market for an asset has emerged does not itself transform an otherwise nonsecurity asset into a security — just check out the secondary markets for high-end handbags or limited edition sneakers.[8]

The SEC has a near 100% track record of establishing that fundraising sales of crypto assets are securities transactions. However, these cases do not address our question: Are crypto assets themselves securities?

Why is this so important? Crypto assets are technology tools that facilitate the use of decentralized systems. To be useable, like commodities, they need to be readily available to users at a transparent market price achieved through trading in an open market.

Also like commodities, crypto assets are investable in the same way that lithium or other components of technologies like mobile batteries are investable — an expectation of increased demand in the future for the technology might lead one to conclude that the costs of storage, etc., of the asset will be offset by the ability to sell the asset at a higher price in the future, when demand is greater.

Our Findings

The vast majority of the Howey cases we reviewed relate to a scheme of some sort, generally involving a sale of a nonsecurity asset and some accompanying formal or informal undertaking on the part of the fundraising entity to increase that asset's value over time or to produce income from the asset.

While there are limited cases applying the Howey test in which a particular asset was found to constitute an investment contract, these were cases in which there was a financial instrument that provided specific legal rights against an identifiable party.

What becomes clear in looking at the complete case record is that regulators and market participants looking at tokens frequently conflate the transactions in which the tokens were sold with the status of the tokens themselves.

The vast bulk of crypto assets do not create or purport to create legally enforceable rights against another person or entity — the ineluctable essence of a security. In fact, this very concept is generally anathema to the underlying thesis of blockchain based projects — that the network or protocol, once deployed through the use of smart contract code, will continue indefinitely, regardless of the participation of any particular individual or entity.

Crypto assets provide their owners with an ability to use a network or protocol but not a right to do so. If the related protocol does not work as expected, the crypto asset does not create or provide rights of recourse against any third party. Most crypto assets have a seller but, once sold, that entity can dissolve and the asset will continue to exist. With a security, if the issuer is dissolved, the security no longer exists.

The Great Morphing Debate

Nevertheless, even if crypto assets are not themselves securities, some have argued that the presence of the more general undertakings that frequently accompany the early sales of the asset — which in many cases would be fundraising securities transactions — effectively financialize the asset, causing it to embody the original investment scheme for an indefinite period of time, even when the asset is exchanged among persons who are wholly unrelated to the original scheme.

We refer to this as the embodiment theory. This idea appears to underlie the decision in SEC v. LBRY.[9]

However, adopting the embodiment theory necessitates also embracing a concept that has come to be known as morphing — the idea that a crypto asset may embody the initial investment scheme pursuant to which it was sold for a time and then cease to do so at a later time. i.e., the crypto asset would morph into a nonsecurity.

While this theory is expedient to address the current status of some tokens, it largely fails if it were to be used as a general principle or extension of the tried-and-true Howey test.

Although there are plenty of unknowns when it comes to how and when a commercial transaction bleeds over into a securities transaction under Howey, the test is applied in hindsight to parties that have already raised funds, or who have taken steps to make offers to raise funds. Those parties have all the law and the facts at their disposal needed to evaluate whether a fundraising scheme would be considered a securities transaction.

However, third parties dealing with crypto assets in secondary transactions do not have this luxury. Our existing securities laws are based on the premise that any market participant can examine a given instrument and determine whether it is, or is not, a security.

Many of our securities laws are strict liability statutes, meaning that ignorance of whether a given instrument is a security is no excuse for a violation of law. This would apply not only to operators of marketplaces for crypto assets, but also to companies acting as dealers in these assets, funds investing in the assets, brokers coordinating customer sales of these assets, and custodians holding the assets.

The embodiment theory, if adopted by a court, would create not just a difficult or cumbersome burden for all of these good-faith actors — simply put, it would be impossible to implement over time.

If a crypto asset can morph into a nonsecurity, market participants would need to be able to

determine and agree upon the exact moment at which this morphing occurred. A minute too soon in making this determination may result in a violation of law; a minute too late may cause the participant to miss a valid business opportunity.

Worse yet, after a crypto asset has morphed into a nonsecurity, nothing suggests that it could not subsequently morph back.

For example, let's say that participants in a project in good faith conclude that all original informal promises previously made have been fulfilled and that the relevant token has indeed morphed — what if a project participant subsequently published new promises and expressly linked those promises to the value of the token; would this cause the token to remorph back into a security?

It is unclear how market participants seeking to comply with the law would be expected to determine the security status of a crypto asset they are dealing in at any given moment in time. Adoption of the embodiment theory would ultimately lead to many more disputes and uncertainties than it solves.

A Better Way Forward

There are legitimate concerns about gaps in our legal framework relating to tokens.

For those tokens that are not properly characterized as securities, there is no requirement that any disclosures to the market be provided by the project teams that raised money through the sales of these assets.

A legislative framework[10] that imposes ongoing disclosure obligations on those who fundraise with nonsecurity crypto assets, combined with federal oversight of secondary markets in these nonsecurity assets, could point the way toward responsible leadership of the U.S. in this rapidly emerging space.

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Disclosure: DLx Law filed an amicus brief in the SEC's lawsuit against Ripple Labs, an ongoing case that is mentioned in the article.

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[1] See, e.g., SEC Chair Gary Gensler, Speech: "Kennedy and Crypto", September 8, 2022, available at https://www.sec.gov/news/speech/gensler-sec-speaks-090822 ("Of the nearly 10,000 tokens in the crypto market, I believe the vast majority are securities" (footnote omitted)).

[2] See SEC v. LBRY, Inc., No. 21-CV-260-PB, 2022 WL 16744741 (D.N.H. Nov. 7, 2022).

[3] Id.

[4] We recently published a discussion draft of a paper entitled "The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets Are Not Securities," exploring this question in the context of the long history of securities case law. See Lewis Rinaudo Cohen, Gregory Strong, Freeman Lewin & Sarah Chen, "The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets are Not Securities" (discussion draft), available athttps://papers.ssrn.com/sol3/papers.cfm?abstract_id=4282385.

[5] S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946).

[6] Id.

[7] See Memorandum of Law in Support of Motion for Summary Judgment, S.E.C. v. LBRY, Inc., No. 21-cv-00260 (D.N.H.) (May 4, 2022) at p. 22.

[8] See Future Market Insights, "Second Hand Bag Market Outlook (2022-2032)", available athttps://www.futuremarketinsights.com/reports/second-hand-bag-market; see also Felix Richter, "Outside the Box: The Booming Secondary Sneaker Market", Mar. 2, 2021, available athttps://www.statista.com/chart/24313/stockx-gross-merchandise-volume/.

[9] See SEC v. LBRY, Inc., at note 2 supra.

[10] See Title III of the Lummis-Gillibrand Responsible Financial Innovation Act, available at https://www.congress.gov/bill/117th-congress/senate-bill/4356?s=1&r=8.