

What The Howey Test Misses About Crypto Assets

By **Boris Richard** (June 28, 2019, 2:03 PM EDT)

The March 2019 report by Timothy Massad, the former chairman of the Commodity Futures Trading Commission, titled “It’s Time to Strengthen the Regulation of Crypto-Assets,” highlighted the inadequacy of the current regulatory framework with respect to cryptocurrencies and ICOs — including the current bifurcated regulatory framework for digital tokens, the blurred lines of division of regulatory and enforcement authority between the CFTC and the U.S. Securities and Exchange Commission, conflicting regulations at the state and federal level, and the lack of regulation and unified compliance standards with respect to crypto exchanges.



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In addressing the crypto regulatory quagmire, the Massad report justifiably called for a Congress-led enactment of a coherent framework that would establish core principles for the regulatory treatment of cryptocurrencies. Such a framework would include guidance on which digital assets are subject to regulation, including potential registration carveouts for tokens with consumptive focus (i.e. those used by, and distributed to, consumers to buy digital services and goods through decentralized blockchain applications, or dApps) and for exchanges, broker-dealers and other electronic trading platforms trading such “medium-of-exchange” altcoins or nonsecurity cryptocurrencies.

A critical factor in building a coherent framework for digital tokens is the assessment of whether the current regulatory approach adequately captures the economics of digital tokens when determining if they qualify as a security. In this respect, the recent SEC “Framework for ‘Investment Contract’ Analysis of Digital Assets,” while nonbinding and presented by SEC staff as an analytical framework only, clearly signals that the SEC will continue to pursue its regulatory and enforcement stance in the cryptospace using existing federal securities laws.

The framework also reinforces long-held market suspicion that nearly all digital tokens would be deemed by the regulator as an “investment contract” under the Howey test, except under very restrictive and rare circumstances (e.g., the SEC’s first no-action letter with respect to TurnKey Jet Inc.’s TKJ tokens) and, perhaps, for some stablecoins. Furthermore, the SEC’s framework, recently likened by commissioner Hester Pierce to the Jackson Pollock approach of splashing a lot of factors on the canvas without a clear message, is difficult to navigate, and creates more uncertainty going forward, as it raises the possibility of future reclassifications of security tokens into nonsecurity tokens once the Howey test no longer applies.

The four-prong Howey test — specifically its “efforts of others” and “profit expectations” prongs — remains the core of the new token framework. The SEC goes into great detail in demonstrating that these two prongs are highly likely to be met, unless a blockchain is fully functional with a fully decentralized ecosystem of developers and users, and tokens are nonresellable, nontransferable, may not appreciate in value and have well-defined and limited consumptive uses only on a particular blockchain.

In practical terms, any token with an economic substance as a network asset will be deemed as an “investment contract.” And the few exemptions would be reserved for those tokens used solely as a means of facilitating entries in an accounting ledger. It is difficult to imagine realistic conditions under which a token could satisfy all of the hypothetical conditions listed in the framework in order to be exempted from security registration.

For example, I am not aware of any blockchain currently in existence that is “fully functional” from the SEC’s perspective. The reason is simple: Blockchain ecosystems, including the established ones, are constantly evolving and implementing new technological solutions to introduce new consensus algorithms, achieve scalability, reduce transaction costs, increase transactions per second and allow wider deployment of smart contracts and dApps.

Ironically, this constant evolution is necessary to achieve the decentralization that the SEC requires of a token not to be a security (e.g., second-layer dApps sidechains, P2P payment channels, ZK-SNARK blockchains, blockchain interoperability solutions and migration from PoW to DPoS, to name just a few). And it is hard, if not impossible, to imagine conditions under which decentralization of a blockchain with viable consumptive uses of a token does not lead to the long-term appreciation in that token’s value.

In essence, the “profit” and “efforts of others” prongs of the Howey test substantively fail to consider both the economic purpose and the decentralized architecture of many blockchains hosting tokens at issue.

On the one hand, many native tokens are designed to serve almost exclusively as a medium of exchange and a means of payment for digital goods (such as, for example, contributed social media content) and services between blockchain users transacting through “smart contract”-enabled decentralized applications, with very limited (if any) liquidity of conversion into fiat currencies. Payment infrastructure tokens and privacy coins are also examples of transactional instruments that are a far cry from being investment contracts.

The fact that “managerial efforts of others” are initially required to kickstart a blockchain should be irrelevant, if (and this is often the case) the blockchain ecosystem’s future success and path to achieving decentralization hinges on the deployment of many dApps developed by multiple independent code developers, peer-to-peer payment channels and the individual customer transactions fueled by those dApps. The SEC’s “investment contract” token framework takes a different view, requiring immediate and full functionality and decentralization for a token not to be classified as a security.

On the other hand, there is nothing inherently wrong with purchasers’ expectations of a token’s future price appreciation, or their ability to realize capital gains through a resale of the token at a higher price in the secondary market (see the SEC’s justification of its November 2018 cease-and-desist order against Ether Delta). In fact, such future appreciation is to be expected for any blockchain offering economic value to its users, and it does not make a token an investment contract by itself.

By focusing on token purchasers' expectations of profit, or ways in which ICO promotional materials might explain how increasing usage of the token boosts adoption, expands the user base and increases token's intrinsic value, the Howey test does not adequately capture the crucial nature of many tokens as dynamic network assets. As the growing academic literature on blockchain token valuation argues, the long-term intrinsic value of a token reflects a dynamic, multistage interplay of users' beliefs about the utility and quality of the blockchain, heterogeneity of their transactional needs, rate of token adoption and the endogenously determined size of the user base.

Through such an interplay, users' expectations influence token usage needs and size of the user base. These expectations, in turn, provide a (hopefully) positive feedback loop to the token value, which causes more users to join the blockchain ecosystem by signaling its quality, etc.

An economically justified regulatory alternative to the Howey test must reflect the nature of a token's economic uses on the issuing blockchain, and take into account the economic nature of many tokens as dynamic network assets. Such an alternative should actually strengthen the regulation of crypto assets by allowing the SEC to better focus on investor protection, required token issuer disclosures and registration of crypto market participants when appropriate.

It would also help curtail private litigations against ICO issuers, which often claim violations under the Securities Act and seek the recovery of damages that were, in fact, caused by the burst of the crypto-market-wide bubble in 2018, and not by the alleged failure to register with the SEC. This becomes more important as Bitcoin's dominance is likely to decline in the longer term, reflecting the increased adoption and usage of altcoins not currently deemed to be commodities.

Developing an alternative to the Howey test to determine the scope of regulatory reach and enforcement with respect to cryptocurrencies is by no means an easy task. It will require a concerted effort by regulators, crypto market actors, academics and legislators (the Token Taxonomy Act and the Digital Taxonomy Act bills introduced by Reps Warren Davidson and Darren Soto are notable steps in the right direction).

Such an effort should also be informed by the regulatory approaches being considered elsewhere in the world, such as the framework established by FINMA in Switzerland. In particular, when it comes to the determination of whether a token is subject to registration as a security, consider the recent U.K. Financial Conduct Authority consultative guidance that only digital tokens with clear contractual rights to cash flows or claims on assets should be subject to the regulation and registration. Notably, the FCA effectively rejected the "decentralization" and "functionality" tests, thereby parting ways with the Howey test.

The recent SEC guidance on digital assets does have one positive to it, namely that it provides ultimate clarity as to the approach the regulator will pursue going forward. In this regard, it is at least consistent with the SEC's enforcement actions and previous public statements over the past year and a half. But continued reliance on regulations that are rooted in a 1946 U.S. Supreme Court case (*SEC v. Howey*) in the world of crypto assets will inevitably stifle innovation in the crypto space and push the economic benefits of public blockchains and cryptocurrencies outside of the U.S.

Congress, in consultation with crypto market actors, investors and regulators, should take the lead on establishing a coherent regulatory framework that recognizes the economic nature of most

cryptocurrencies as network assets and allows for growth of decentralized public blockchain ecosystems, while providing adequate protections for token users and investors.

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