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## The Commodification of Cryptocurrency

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## NOTE

### THE COMMODIFICATION OF CRYPTOCURRENCY

Neil Tiwari\*

*Cryptocurrencies are digital tokens built on blockchain technology. This allows for a product that is fully decentralized, with no need for a third-party intermediary like a government or financial institution. Cryptocurrency creators use initial coin offerings (ICOs) to raise capital to build their tokens. Cryptocurrency ICOs are problematic because they do not fit neatly within either of two traditional categories—securities or commodities. Each of these categories has their own regulatory agency: the SEC for securities and the CFTC for commodities. At first blush, ICOs seem to be a sale of securities subject to regulation by the SEC, but this is far from clear and creates regulatory difficulties. This is because the Howey test, which determines whether an asset is a security or not, does not cleanly apply to nontraditional assets, like tokens. This Note argues for a revised standard that reconciles Howey with cryptocurrencies. This standard would require cryptocurrency creators to show how essential blockchain technology is to their token if they want to fall beyond the scope of the Howey test, and consequently SEC regulation. This standard would still preserve regulatory protections from fraud, which the CFTC provides for investors, while loosening regulatory restrictions on the cryptocurrencies that leverage blockchain technology most usefully.*

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## INTRODUCTION

Cryptocurrencies expose a rift between the financial market regulatory schemes administered by the Securities Exchange Commission (SEC) and by the Commodity Futures Trading Commission (CFTC). Traditionally, the authority of each of these two regulators has been delineated by a clearly defined boundary separating securities and commodities. Bitcoin and other cryptocurrencies disrupt the securities/commodities dichotomy as they do not cleanly fit in either category. This Note examines the disruption through the lens of cryptocurrency initial coin offerings (ICOs). ICOs, a relatively recent phenomenon, allow entrepreneurs to raise substantial amounts of capital outside the existing framework of securities laws.<sup>1</sup> Although the SEC recently announced enforcement actions against these offerings,<sup>2</sup> reasoning that some cryptocurrencies are securities under the Securities Act of 1933,<sup>3</sup> the CFTC holds that cryptocurrencies<sup>4</sup> are commodities under the Commodity Exchange Act.<sup>5</sup>

The distinction between classifying cryptocurrencies as securities or commodities is critical. First adopted in *SEC v. W.J. Howey Co.*, the investment contract test (*Howey* test) establishes four requirements that determine

1. See Jay Clayton, *Statement on Cryptocurrencies and Initial Coin Offerings*, U.S. SEC (Dec. 11, 2017), <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11> [<https://perma.cc/EF9S-ATGL>] (“I believe that initial coin offerings—whether they represent offerings of securities or not—can be effective ways for entrepreneurs and others to raise funding, including for innovative projects.”).

2. *Cyber Enforcement Actions*, U.S. SEC, <https://www.sec.gov/spotlight/cybersecurity-enforcement-actions> [<https://perma.cc/322T-NDEH>].

3. SEC, RELEASE NO. 81207, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934: THE DAO (2017), <https://www.sec.gov/litigation/investreport/34-81207.pdf> [<https://perma.cc/RB2T-HC6B>] [hereinafter DAO REPORT] (“Based on the investigation, and under the facts presented, the Commission has determined that DAO Tokens are securities under the Securities Act of 1933 . . .”); *Company Halts ICO After SEC Raises Registration Concerns*, U.S. SEC (Dec. 11, 2017), <https://www.sec.gov/news/press-release/2017-227> [<https://perma.cc/YGN9-CFNA>] [hereinafter *Company Halts ICO*]; *SEC Emergency Action Halts ICO Scam*, U.S. SEC (Dec. 4, 2017), <https://www.sec.gov/news/press-release/2017-219> [<https://perma.cc/NK66-CKJE>].

4. When referring to cryptocurrencies generally, I will use the terms “digital token,” “digital coin,” “coin,” and “token” interchangeably. When referring to specific cryptocurrencies, like bitcoin, I will identify them by name.

5. *In re Coinflip, Inc.*, CFTC No. 15-29, [2015–2016 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 33,583 (Sept. 17, 2015).

whether an agreement is an investment contract and therefore a security.<sup>6</sup> But cryptocurrencies do not neatly fit within the investment contract test.<sup>7</sup> The test distinguishes between commodities and securities, but the novelty of cryptocurrency strains that distinction.<sup>8</sup> If firms selling digital tokens to raise capital are found to be selling securities, they must comply with the registration requirement enforced by the SEC.<sup>9</sup> The registration requirement entails disclosing an exhaustive list of items to investors that is both costly and time-consuming to compile and, perhaps most critically, exposes the issuer to fraud liability under Rule 10b-5.<sup>10</sup> Additionally, “[t]he presence of a security also brings with it the monitoring and enforcement of the SEC and possible criminal sanctions for violations of the securities laws.”<sup>11</sup>

Traditionally, commodities were distinct from securities because they were tangible and held inherent value.<sup>12</sup> Typical commodities include gold, livestock, and wheat.<sup>13</sup> These are nonfungible, are relatively nonmarketable, and require substantial care or attention.<sup>14</sup> In contrast, securities are intangible and have no inherent value; instead, they derive their value from the efforts of an enterprise.<sup>15</sup> Put simply, compared to securities, commodities indicate a higher dependence on the efforts of the seller to return a profit to the buyer.<sup>16</sup>

Contemporary finance has morphed these traditional commodities into financial instruments that can be used like securities. Commodities transactions now serve “essential functions of speculation, hedging, and price dis-

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6. 328 U.S. 293, 301 (1946).

7. See *Investor Bulletin: Initial Coin Offerings*, U.S. SEC (July 25, 2017), [https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib\\_coinofferings](https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings) [https://perma.cc/JEC5-372V] (“Depending on the facts and circumstances of each individual ICO, the virtual coins or tokens that are offered or sold may be securities.”).

8. See *infra* Part II.

9. See Securities Act of 1933, 15 U.S.C. § 77e(c) (2012) (prohibiting actions unless a security is registered with the SEC).

10. See STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION* 95 (4th ed. 2015); see also 17 C.F.R. § 229 (2017). This section, Regulation S-K, details all of the information that firms must disclose about securities they hope to sell to the public. It’s a long and detailed list that is costly and time-consuming to compile.

11. CHOI & PRITCHARD, *supra* note 10, at 95–96.

12. Alan R. Bromberg, *Commodities Law and Securities Law—Overlaps and Preemptions*, 1 J. CORP. L. 217, 222 (1976).

13. See Andrew Verstein, *Insider Trading in Commodities Markets*, 102 VA. L. REV. 447, 447, 454 (2016) (describing how gold, copper, zinc, grain, and livestock are all commodities).

14. Differences between securities and commodities can be understood through these factors. Securities are fungible—Apple common stock is identical to all other Apple common stock. Relative marketability refers to the ability for investors to access the market because “the market does not deal in quantities as small as the sales in question.” Bromberg, *supra* note 12, at 224. Finally, and most obviously, commodities often require care or attention, as is the case in agricultural commodities like wheat. *Id.*

15. *Id.* at 222.

16. *Id.* at 225.

covery.”<sup>17</sup> The principal participants in commodities markets are sophisticated traders who use commodities in much the same way they use securities.<sup>18</sup> Furthermore, the modern legal definition of a commodity is much more expansive than the traditional view of tangible assets with inherent value.<sup>19</sup> Section 1(a)(9) of the Commodities Exchange Act defines “commodity” to include “all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.”<sup>20</sup> This regime governs the largest financial markets in the world, including bets on interest rates, futures, swaps, and the currency exchange markets.<sup>21</sup> Where the capacious definition of commodity ends and where the definition of a security begins is not obvious.

Cryptocurrencies occupy an unclear place in this regulatory scheme. According to an SEC investor bulletin, some ICO transactions are securities while others are not.<sup>22</sup> But according to the CFTC, “[b]itcoin and other virtual currencies are . . . properly defined as commodities.”<sup>23</sup> As a result of this administrative split, an unclear rule has been established: cryptocurrencies that are structured like bitcoin are more likely to be commodities subject to regulation by the CFTC, while cryptocurrencies that are differently structured are more likely to be securities regulated by the SEC. This confounds regulated entities and provides little guidance on how firms should structure their offerings or tokens. Lawyers, too, are unsure of how to advise clients.<sup>24</sup> SEC Chairman Jay Clayton noted that the “most disturbing” feature of ICOs is lawyers providing “equivocal advice.”<sup>25</sup> This uncertainty must be addressed for the benefit of all stakeholders: cryptocurrency firms, regulatory entities, and even the lawyers involved.

This Note provides a standard for evaluating cryptocurrency ICOs that is consistent with the *Howey* test but still provides room for the cryptocurrency market to grow.<sup>26</sup> Part I discusses the rise of cryptocurrencies, beginning with bitcoin. It examines the deeply factual problem that regulation of bitcoin and other cryptocurrencies gives rise to: whether or not a cryptocur-

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17. Verstein, *supra* note 13, at 456.

18. *See id.*

19. *Id.* at 455.

20. Commodities Exchange Act, 7 U.S.C. § 1a(9) (2012).

21. Verstein, *supra* note 13, at 455–56.

22. *Investor Bulletin: Initial Coin Offerings*, *supra* note 7.

23. *See In re Coinflip, Inc.*, CFTC No. 15-29, at 3, [2015–2016 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 33.583 (Sept. 17, 2015) (holding that bitcoin and other virtual currencies are commodities).

24. Jon Hill, *Clayton Warns Lawyers Over Their Advice on ICOs*, LAW360 (Jan. 23, 2018, 10:17 PM), <https://www.law360.com/articles/1004863/clayton-warns-lawyers-over-their-advice-on-icos> [<https://perma.cc/RXJ5-YUQ9>].

25. *Id.*

26. *See infra* Section III.B.

rency is a security. Part II describes how cryptocurrencies present difficulties for the *Howey* test and raise the specter of regulatory arbitrage. Part III endorses a standard that a cryptocurrency is only a commodity if it is built on blockchain technology that provides sufficient utility.

## I. THE HISTORY OF BITCOIN AND ITS REGULATION

### A. *The Basics of Blockchain Technology*

Cryptocurrencies are made possible by a technological innovation: the blockchain.<sup>27</sup> Put simply, the blockchain, a decentralized ledger, is a connected list of encrypted transactions—like a database.<sup>28</sup> The blockchain is an improvement on conventional databases because it solves the problem of trusting intermediaries.<sup>29</sup> In typical transactions, “you have to believe the intermediary will store the data accurately.”<sup>30</sup> In a cryptocurrency blockchain, transactions are funneled through coin “miners,” who solve complicated cryptographic problems to securely verify them.<sup>31</sup> The ability for independent individuals to verify digital transactions through cryptography, without involving centralized institutions like a bank or government, is an innovation with huge potential.<sup>32</sup> The technology, though still new, enticed investors and drove up the valuation of cryptocurrencies like bitcoin, turning it into one of the most volatile assets traded today.<sup>33</sup> The law historically strug-

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27. JERRY BRITO & ANDREA CASTILLO, *BITCOIN: A PRIMER FOR POLICYMAKERS* 5–10 (2d ed. 2016).

28. Dov Greenbaum, Opinion, *What Bitcoin Needs Is a Few Good Regulations*, WALL STREET J. (Dec. 14, 2017, 6:27 PM), <https://www.wsj.com/articles/what-bitcoin-needs-is-a-few-good-regulations-1513294030> (on file with the *Michigan Law Review*) (“A blockchain is effectively an interconnected, distributed ledger.”).

29. Irving Wladawsky-Berger, *The Evolution of Trust in the Era of Platforms and Blockchain*, WALL STREET J.: CIO J. (Sept. 8, 2017, 1:51 PM), <https://blogs.wsj.com/cio/2017/09/08/the-evolution-of-trust-in-the-era-of-platforms-and-blockchains/> (on file with the *Michigan Law Review*) (“Trust is one of the key attributes associated with blockchain technologies. A 2015 Economist issue called blockchain ‘The Trust Machine,’ and noted in one of its articles that blockchain ‘offers a way for people who do not know or trust each other to create a record of who owns what that will compel the assent of everyone concerned. It is a way of making and preserving truths.’” (quoting *The Great Chain of Being Sure About Things*, ECONOMIST (Oct. 31, 2015), <http://www.economist.com/news/briefing/21677228-technology-behind-bitcoin-lets-people-who-do-not-know-or-trust-each-other-build-dependable> [<https://perma.cc/27L3-YA9U>])).

30. *The Great Chain of Being Sure About Things*, ECONOMIST (Oct. 31, 2015), <http://www.economist.com/news/briefing/21677228-technology-behind-bitcoin-lets-people-who-do-not-know-or-trust-each-other-build-dependable> [<https://perma.cc/27L3-YA9U>].

31. *Id.*

32. *See id.*

33. For reference, bitcoin traded at \$5,518.85 on October 24, 2017. *Bitcoin (USD) Price*, COINDESK, <https://www.coindesk.com/price/> (on file with the *Michigan Law Review*). Within three months bitcoin leapt up to \$19,783 then plunged back to \$10,370. Mike Bird & Gregor Stuart Hunter, *Just Another Day for Bitcoin—A 25% Plunge*, WALL STREET J. (Jan. 16, 2018,

gles with technological innovations because it relies on precedent and, therefore, does not reliably envision future developments. Grappling with technological changes is a continuing challenge for the legal community, and cryptocurrencies put that challenge into stark relief.<sup>34</sup>

### B. *The Rise of Bitcoin*

Bitcoin is the most popular of available cryptocurrencies.<sup>35</sup> Bitcoin miners verify transactions on the blockchain by solving complicated cryptography problems and are rewarded with bitcoins.<sup>36</sup> Bitcoins can be used by whoever accepts bitcoin for payment, and their price depends on the market.<sup>37</sup> But, it remains unresolved “[w]hether bitcoin will ultimately be a store of value, akin to digital gold, or a means of payment.”<sup>38</sup> Equally puzzling for lawyers, regulated entities, and regulatory agencies is the question of how the law should apply to bitcoin.

Viewing bitcoin as a commodity, as the CFTC suggests,<sup>39</sup> makes sense because its primary function is storing value.<sup>40</sup> This characterization places it

9:21 PM), <https://www.wsj.com/articles/just-another-day-for-bitcoin-20-plunge-1516103459> (on file with the *Michigan Law Review*).

34. See Jeffrey Neuburger, *Reflections on Technology-Related Legal Issues: Looking Back at 2017; Will 2018 Be a Quantum Leap Forward?*, PROSKAUER: NEW MEDIA & TECH. L. BLOG (Dec. 20, 2017), <https://newmedialaw.proskauer.com/2017/12/20/reflections-on-technology-related-legal-issues-looking-back-at-2017-will-2018-be-a-quantum-leap-forward/> [<https://perma.cc/4JKX-4NP2>].

35. See Paul Vigna et al., *Why Bitcoin? Why Now?*, WALL STREET J. (Dec. 9, 2017, 7:00 AM), <https://www.wsj.com/articles/why-bitcoin-why-now-1512820800> (on file with the *Michigan Law Review*) (“Growing interest in bitcoin attracted wider attention from the investment community . . . More than 100 funds dedicated to bitcoin and its ilk have popped up.”).

36. BRITO & CASTILLO, *supra* note 27, at 8–9. The mining feature is one of the fundamental features of bitcoin. Miners get bitcoin in return for verifying transactions. There are outstanding questions about what will happen to bitcoin and how it may be self-regulating when mining loses that incentive, but those are far off in the future. See generally Vigna et al., *supra* note 35 (“Bitcoin is created, or ‘mined,’ at a preset, steady pace. There are currently about 16.7 million bitcoin outstanding; mining will stop when the total reaches 21 million, expected to occur around the year 2140.”).

37. See BRITO & CASTILLO, *supra* note 27, at 6–7, 13–14. SEC Chairman Jay Clayton noted that “market participants should treat payments and other transactions made in cryptocurrency as if cash were being handed from one party to another.” Clayton, *supra* note 1. In his view, cryptocurrencies are the equivalent of cash—they are akin to fiat currency. *Id.* But he states that calling something a “currency” does not mean it avoids the securities laws. *Id.*

38. Vigna et al., *supra* note 35.

39. *In re Coinflip, Inc.*, CFTC No. 15-29, [2015–2016 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 33,583 (Sept. 17, 2015).

40. “Cryptocurrencies aren’t commodities because they don’t have an alternate use. People own them as a store for value.” Akshay Singh, Letter to the Editor, *Bitcoin Can Be a Competitive Store of Value*, WALL STREET J. (Sept. 12, 2017, 11:47 AM), <https://www.wsj.com/articles/bitcoin-can-be-a-competitive-store-of-value-1505231277> (on file with the *Michigan Law Review*). Singh suggests that stores of value aren’t commodities, but that contradicts our

in the same category as conventional commodities—most notably, gold.<sup>41</sup> Although there are clear distinctions between bitcoin and gold, such as gold's utility in creating other goods like jewelry and electronics,<sup>42</sup> any legal distinction disappears once they are both declared commodities.<sup>43</sup>

But if bitcoin is a commodity, what are other cryptocurrencies? Doves of cryptocurrencies have been created in the years since bitcoin's invention, but not all of them share bitcoin's "commodity" characteristics, such as non-fungibility, nonmarketability, and actual utility.<sup>44</sup> In the absence of these features, other cryptocurrencies would be considered securities, subject to the demanding (and expensive) disclosure requirements of the securities laws.

### C. Initial Coin Offerings and Regulatory Concerns

Staying on the commodity side of the line has become increasingly complicated with the advent of initial coin offerings, or ICOs.<sup>45</sup> Instead of going to the conventional sources of funding—venture capital, angel investors, or banks—entrepreneurs with clever cryptocurrency ideas pre-sell their cryptocurrency and use the proceeds to fund their projects.<sup>46</sup> This looks quite similar to a sale of securities.<sup>47</sup>

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understanding of gold as a commodity. Regardless, the primary use of bitcoin seems to be as a volatile store of value. Like other currencies, and indeed like gold itself, "[m]arket forces determine the price of currency which can be measured relative to other currencies." *Id.*

41. See generally Pradeep Dubey et al., *Is Gold an Efficient Store of Value?*, 21 *ECON. THEORY* 767, 767–68 (2003) (introducing the idea of commodities, such as gold and tobacco, as mediums of exchange and stores of value).

42. See *id.* at 768 ("[G]old yields utility.").

43. The CFTC recently allowed bitcoin futures to be traded on commodities exchanges, just like gold. Alexander Osipovich, *Bitcoin Futures Set to Start Trading as Regulator Gives Thumbs Up*, *WALL STREET J.* (Dec. 1, 2017, 3:43 PM), <https://www.wsj.com/articles/regulator-opens-way-to-bitcoin-futures-1512133201> (on file with the *Michigan Law Review*).

44. See, e.g., Matt Levine, *Opinion SEC Halts a Silly Initial Coin Offering*, *BLOOMBERG* (Dec. 5, 2017, 5:00 AM), <https://www.bloomberg.com/view/articles/2017-12-05/sec-halts-a-silly-initial-coin-offering> [<https://perma.cc/AGZ5-32CF>] (PlexCoin is an example of a fraudulent token that expresses these characteristics—it's not fungible nor marketable nor provides any utility.).

45. See Steven Russolillo, *Initial Coin Offerings Surge Past \$4 Billion—And Regulators Are Worried*, *WALL STREET J.* (Dec. 14, 2017, 4:54 PM), <https://www.wsj.com/articles/initial-coin-offerings-surge-past-4-billionand-regulators-are-worried-1513235196> (on file with the *Michigan Law Review*).

46. *Id.* ("[An ICO] is a method of corporate fundraising that circumvents traditional capital markets. Typically tech startups, many involved in the digital-currency sector, raise money from investors in exchange for newly created digital coins or tokens, which they can trade.").

47. *Id.* ("[S]ome regulators say ICOs should be regulated like securities.").

Concerned with potentially unregulated securities sales, the SEC has recently begun enforcement actions on cryptocurrency ICOs.<sup>48</sup> Its principal argument is that the cryptocurrency at issue is an investment contract, and therefore a security subject to the SEC's regulatory jurisdiction.<sup>49</sup> Initially, the SEC only pursued fraudulent cryptocurrency offerings, but more recently, it has also targeted seemingly legitimate tokens.<sup>50</sup> As a cryptocurrency shares more of the bitcoin "commodity" features, when does the SEC lose the authority to regulate? Quite unhelpfully, SEC Chairman Jay Clayton commented that "[a]s securities law practitioners know well, the answer depends on the facts."<sup>51</sup>

Nevertheless, the SEC is considering imposing gatekeeper liability on lawyers who assist with ICOs.<sup>52</sup> In a recent speech, Chairman Clayton castigated ICO lawyers for "tak[ing] a step back from the key issues—including whether the 'coin' is a security and whether the offering qualifies for an exemption from registration—even in circumstances where registration would likely be warranted."<sup>53</sup> He instructed SEC staff "to be on high alert" for ICOs that may be "contrary to . . . the professional obligations of the U.S. securities bar."<sup>54</sup>

But the SEC's position is still ambiguous. Early releases warn investors against cryptocurrencies but do not make a definite finding on whether they are securities.<sup>55</sup> Although the SEC's position on cryptocurrencies remains unclear, enforcement actions have strictly applied the *Howey* test.<sup>56</sup> Chairman Clayton recently attempted to clarify the issue, noting that "[b]efore launching a cryptocurrency or a product with its value tied to one or more cryptocurrencies, its promoters must either (1) be able to demonstrate that the currency or product is not a security or (2) comply with applicable registration and other requirements under our securities laws."<sup>57</sup> This rule is still

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48. See, e.g., Paul Vigna, *SEC Targets Initial Coin Offering 'Scam,'* WALL STREET J. (Dec. 4, 2017, 11:51 AM), <https://www.wsj.com/articles/secs-cyber-unit-charges-canadian-firm-with-coin-offering-fraud-1512400168> (on file with the *Michigan Law Review*).

49. DAO REPORT, *supra* note 3 (applying the *Howey* test to argue that DAO Tokens are securities).

50. Compare Levine, *supra* note 44, with Matt Levine, *SEC Halts a Real Initial Coin Offering,* BLOOMBERG (Dec. 12, 2017, 3:20 PM), <https://www.bloomberg.com/view/articles/2017-12-12/sec-halts-a-real-initial-coin-offering> [<https://perma.cc/MXX9-WWDN>].

51. Clayton, *supra* note 1.

52. John Reed Stark, *Beware ICO Lawyers, You're the Next Target,* LAW360 (Jan. 31, 2018, 12:55 PM), <https://www.law360.com/articles/1006847/beware-ico-lawyers-you-re-the-next-target> (on file with the *Michigan Law Review*).

53. *Id.*

54. *Id.*

55. *Investor Bulletin: Initial Coin Offerings,* *supra* note 7.

56. The SEC goes through each prong of the *Howey* test in their argument. See, e.g., DAO REPORT, *supra* note 3.

57. Clayton, *supra* note 1.

problematic because “demonstrat[ing] that the currency or product is not a security” is precisely the issue on which regulated entities need guidance.<sup>58</sup>

The different classifications between bitcoin—as a commodity—and most other cryptocurrencies—as securities—blurs a previously clear separation.<sup>59</sup> Whether a cryptocurrency is a commodity depends on a factual judgment made by the SEC, CFTC, or a federal judge.<sup>60</sup> This creates expensive uncertainty for both cryptocurrency firms and regulatory authorities. Each individual cryptocurrency must be analyzed to determine whether it crosses the line between commodity and security. This may stifle innovation in the blockchain space because creators cannot be certain of their regulatory obligations or cost. For the regulator, it signals suboptimal enforcement in the area because none of the agencies are certain where the line lies.

## II. CRYPTOCURRENCIES PRESENT CHALLENGES FOR *HOWEY*

Part II discusses the test for an investment contract, the *Howey* test, and how cryptocurrencies and their underlying technology have trouble meeting the test’s requirements. These difficulties create regulatory uncertainty regarding whether a new cryptocurrency does or does not satisfy the test.

### A. *The SEC and the Howey Test*

For the SEC to bring cryptocurrencies within its jurisdiction, it must show that a particular cryptocurrency is a security as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act). The Securities Act defines a security as “any note, stock . . . [or] investment contract.”<sup>61</sup> Although the Exchange Act has a slightly different definition,<sup>62</sup> courts use similar interpretations.<sup>63</sup> Because cryptocurrencies are not enumerated in either Act (they certainly were not contemplated in the 1930s),

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58. *Id.*

59. The CFTC claims that “There is no inconsistency between the SEC’s analysis and the CFTC’s determination . . . that virtual tokens may be commodities . . . depending on the particular facts and circumstances.” COMMODITY FUTURES TRADING COMM’N, A CFTC PRIMER ON VIRTUAL CURRENCIES 14 (2017), [http://www.cftc.gov/idc/groups/public/documents/file/labcftrc\\_primercurrencies100417.pdf](http://www.cftc.gov/idc/groups/public/documents/file/labcftrc_primercurrencies100417.pdf) [<https://perma.cc/DN62-RGLF>]. Although that may be true, it is far less clear for regulated entities on where their regulatory obligations lie. See generally Bromberg, *supra* note 12.

60. COMMODITY FUTURES TRADING COMM’N, at 14 *supra* note 59 (explaining that classification as a security or commodity varies “depending on the particular facts and circumstances”).

61. Securities Act of 1933, Pub. L. No. 73-22, § 2(1), 48 Stat. 74, 74 (codified as amended at 15 U.S.C. § 77b(a)(1) (2012)).

62. Securities Exchange Act of 1934, Pub. L. No. 73-291 § 3(a)(10), 48 Stat. 881, 883–84 (codified as amended at 15 U.S.C. § 78c(a)(10)).

63. See, e.g., *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.1 (1985).

the SEC must fit them into the catchall term: “investment contract.”<sup>64</sup> Congress included the term to cover any novel financial instruments that people may conjure up in the future, but has left it up to courts to define the term on a case-by-case basis.<sup>65</sup>

The Supreme Court adopted the test for an investment contract in the seminal case *SEC v. Howey*.<sup>66</sup> The case holds that an instrument is an investment contract, and therefore a security, if it satisfies every element of a four-prong test: (1) an investment of money (2) in a common enterprise (3) with the expectation of profits (4) solely from the efforts of others.<sup>67</sup> Cryptocurrencies present new challenges for this test because they may not be investments of money, and novel blockchain technology underlying the tokens may eliminate any efforts of others. Indeed, cryptocurrencies may even allow entrepreneurs to evade securities laws through careful token construction.

Prong one, the investment of money element of the test,<sup>68</sup> immediately presents a challenge for classifying cryptocurrencies as securities. This prong can be distilled into two parts: (1) whether there is an investment and (2) whether that investment is money.<sup>69</sup> Cryptocurrencies with ICOs clearly satisfy the second part because investors pay for the tokens.<sup>70</sup> But here, money does not strictly mean cash.<sup>71</sup> Consumers can participate in the ICO using other cryptocurrencies such as bitcoin, or even capital assets.<sup>72</sup>

The more confounding question is whether there is an investment. In *United Housing Foundation, Inc. v. Forman*, the Supreme Court found that a scheme to sell apartment units was not a security because it was not an investment.<sup>73</sup> Instead, the purchase of housing was found to be primarily for consumption.<sup>74</sup> Likewise, digital tokens that are created primarily for consumption, a service granted by the originating firm, should not be treated as

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64. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946) (“It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”).

65. *Id.* at 298–99.

66. *Id.* at 301.

67. *Id.*; see also *SEC v. Edwards*, 540 U.S. 389, 393 (2004).

68. *Howey*, 328 U.S. at 301.

69. *Id.*

70. DAO REPORT, *supra* note 3, at 5 (“In exchange for ETH, The DAO created DAO Tokens . . .”).

71. See, e.g., *Int’l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 560 n.12 (1979) (“This is not to say that a person’s ‘investment,’ in order to meet the definition of an investment contract, must take the form of cash only, rather than of goods and services.”); *Hector v. Wiens*, 533 F.2d 429, 432–33 (9th Cir. 1976).

72. See, e.g., DAO REPORT, *supra* note 3.

73. 421 U.S. 837, 859–60 (1975) (“[A]cquiring housing rather than making an investment for profit[] is not within the scope of the federal securities laws.”).

74. *United Hous.*, 421 U.S. at 858.

an investment. That is, if consumers can exchange their tokens for a service or product, it would cease to be an investment under *Forman*.<sup>75</sup>

Cryptocurrency creators seeking to escape SEC oversight can leverage this distinction between consumption and investment to engage in regulatory arbitrage. They can ensure that their token provides nominal utility—not just a means of raising money or a method of tracking the value of the company itself.<sup>76</sup> Moreover, cryptocurrencies can be designed to have utility because creators typically make them as a currency for their particular enterprise.<sup>77</sup> Because failing to satisfy even one prong of the *Howey* test allows an asset to escape securities regulation,<sup>78</sup> the utility function of a token is a critical measure of how it will fare under regulatory scrutiny.

Prong two, the common enterprise prong,<sup>79</sup> will likely be met by most if not all cryptocurrencies selling tokens. Circuits are split in their interpretation of this prong, with some favoring horizontal commonality and some favoring either broad or narrow vertical commonality.<sup>80</sup> In horizontal commonality, investors pool funds into an investment, and the profits of each investor correlate with those of other investors.<sup>81</sup> Cryptocurrencies sold in ICOs have this trait as the return from the purchase of a digital token will be distributed pro rata to each investor.<sup>82</sup> The appreciation of token value is much like that of stock, in that the corresponding gain for each investor depends on how much of the token they own.

Vertical commonality introduces a promoter<sup>83</sup> to the scheme.<sup>84</sup> Narrow vertical commonality considers whether the profits of an investor are tied to

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75. *See id.*

76. Though, SEC Chairman Clayton noted that this isn't a formalistic view: "Merely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security." Clayton, *supra* note 1.

77. *See* David Goodboy, *3 Types of Cryptocurrencies You Need to Know*, NASDAQ (Jan. 15, 2018, 3:00 PM), <https://www.nasdaq.com/article/3-types-of-cryptocurrencies-you-need-to-know-cm905488> (on file with the *Michigan Law Review*) (discussing that "utility cryptocurrency is designed for a particular task" as opposed to transactional or platform cryptocurrencies).

78. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

79. *Id.* at 301.

80. *See, e.g.,* SEC v. Eurobond Exch. Ltd., 13 F.3d 1334, 1339 (9th Cir. 1994); Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 222 (6th Cir. 1980), *aff'd* 456 U.S. 353 (1982); SEC v. Cont'l Commodities Corp., 497 F.2d 516, 521–22 (5th Cir. 1974).

81. *See, e.g.,* Curran, 622 F.2d at 221.

82. *See* Crypto Dan, *Equi Capital ICO—Transforming Venture Capital*, MEDIUM (Feb. 28, 2018), [https://medium.com/@info\\_19130/equi-capital-ico-transforming-venture-capital-3c49b4aee082](https://medium.com/@info_19130/equi-capital-ico-transforming-venture-capital-3c49b4aee082) [<https://perma.cc/A7DU-YX7S>]. Investors in ICOs track the value of the investment based on how much the market values the cryptocurrency. *See id.* If a coin increases in value, the investors return depends on how much they own—a pro rata share. *See id.*

83. A promoter provides expertise to the enterprise to increase its value. The *Howey* test refers to promoters as someone who generates an expectation of profit. *Howey*, 328 U.S. at 298 ("[In this type of enterprise, investors] profit solely through the efforts of the promoter or of some one other than themselves.").

84. *See, e.g.,* Cont'l Commodities, 497 F.2d at 516.

a promoter,<sup>85</sup> while broad vertical commonality considers whether the success of the investor depends on the promoter's expertise.<sup>86</sup> This analysis is trickier than that of horizontal commonality and overlaps substantially with the fourth prong of the *Howey* test, from the efforts of others. The difficulties introduced by vertical commonality are best addressed in prong four.<sup>87</sup>

Prong three, the expectation of profits,<sup>88</sup> refers to the return an investor seeks on their investment, rather than the profits that the system or issuer of a cryptocurrency might earn.<sup>89</sup> This ultimately depends on the degree to which the token provides utility. Tokens released through ICOs will likely meet this prong of the test because investors are not paying for the utility of the tokens for enterprises that have not yet launched. They are merely investing in the token for its volatility and potential to appreciate in value. Likewise, tokens purchased for their utility that happen to appreciate in value due to market forces would also satisfy this prong.<sup>90</sup>

Prong four, solely from the efforts of others,<sup>91</sup> is the most problematic for cryptocurrencies seeking to be regulated as commodities. Courts have interpreted the "efforts from others" test to mean managerial or entrepreneurial efforts,<sup>92</sup> making the key question whether the cryptocurrency originators are contributing these efforts. Cryptocurrency creators can persuasively argue that they do not contribute any effort beyond initially creating the token because there is no ongoing managerial or entrepreneurial task.<sup>93</sup> At minimum, the decentralized nature of the new technology means that

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85. See, e.g., *Eurobond Exch.*, 13 F.3d at 1339.

86. See *Cont'l Commodities*, 497 F.2d at 522.

87. Resolving the circuit split may be a potential step toward clarifying the regulation of cryptocurrencies, but it is moot here. In circuits that use horizontal commonality, the fourth prong will be the lynchpin of the discussion. In circuits that use vertical commonality, the main cryptocurrency argument against *Howey* will apply to both the second and fourth prongs. Therefore, this Note focuses on the fourth prong.

88. *Howey*, 328 U.S. at 301.

89. See, e.g., *SEC v. Edwards*, 540 U.S. 389, 394 (2004).

90. The outcome of this prong, in particular, depends on how the facts are characterized. If there isn't an investment of money, then there is unlikely to be an expectation of profit. In that case, this prong is moot because the asset would have already failed to meet the requirements of prong one.

91. *Howey*, 328 U.S. at 301.

92. See, e.g., *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479–84 (5th Cir. 1974); *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482–83 (9th Cir. 1973).

93. See *Frequently Asked Questions*, BITCOIN, <https://bitcoin.org/en/faq> [<https://perma.cc/ET88-9LUW>] ("Nobody owns the Bitcoin network much like no one owns the technology behind email. Bitcoin is controlled by all Bitcoin users around the world. While developers are improving the software, *they can't force a change in the Bitcoin protocol* because all users are free to choose what software and version they use." (emphasis added)).

cryptocurrencies do not fit this prong as readily as conventional investment contracts do.<sup>94</sup>

Fortunately for the SEC, truly fraudulent ICOs will likely satisfy this prong because firms engaging in the scheme will want to cash in on the offering.<sup>95</sup> The money raised by an ICO is often managed by a person or entity that would satisfy this final prong.<sup>96</sup> In contrast, tokens like bitcoin, which do not have a managerial or entrepreneurial effort behind them,<sup>97</sup> would not satisfy this test. The origination of bitcoin had no such initial offering—instead, the network was created and the first “block” of bitcoins was mined and put into circulation.<sup>98</sup>

Even if bitcoin had originated with a sale of tokens, the SEC would still have had to show how all four prongs of the *Howey* test were satisfied. As a useful comparison, a company that sells gold is not selling a security every time it transacts in gold.<sup>99</sup> The value of that gold, even as an investment, is not tied to anything that the gold company does.<sup>100</sup> Likewise, the value of bitcoin is not affected by managerial or entrepreneurial efforts—it depends on how valuable the market thinks the technology is.<sup>101</sup>

### B. *The Vanishing Line Between Commodity and Security*

Viewing cryptocurrencies as commodities helps explain a hole in *Howey*. Tokens that provide utility are more like commodities, such as gold or wheat, than securities.<sup>102</sup> When analyzing commodities like gold or silver, courts hold that those minerals are not securities because their value de-

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94. See Nathaniel Popper, *Understanding Ethereum, Bitcoin's Virtual Cousin*, N.Y. TIMES (Oct. 1, 2017), <https://www.nytimes.com/2017/10/01/technology/what-is-ethereum.html> (on file with the *Michigan Law Review*) (“As with Bitcoin, Ethereum mining serves a dual process of getting new Ether into the world while providing an incentive for people to join the network and help maintain the Ethereum blockchain.” (emphasis added)).

95. See, e.g., Vigna, *supra* note 48 (“The SEC alleged that PlexCorps violated securities laws by marketing and selling up to \$15 million worth of cryptocurrencies . . . .” The SEC then froze the assets of PlexCorps.).

96. *Id.*

97. See Marco Iansiti & Karim R. Lakhani, *The Truth About Blockchain*, HARV. BUS. REV., Jan.–Feb. 2017, at 118.

98. Benjamin Wallace, *The Rise and Fall of Bitcoin*, WIRED (Nov. 23, 2011, 2:52 PM), [https://www.wired.com/2011/11/mf\\_bitcoin/](https://www.wired.com/2011/11/mf_bitcoin/) (on file with the *Michigan Law Review*) (“Nakamoto himself mined the first 50 bitcoins—which came to be called the genesis block—on January 3, 2009.”).

99. See *Noa v. Key Futures, Inc.*, 638 F.2d 77, 79 (9th Cir. 1980) (“Applying these standards to the facts here, we hold that no investment contract was created. Once the purchase of silver bars was made, the profits to the investor depended upon the fluctuations of the silver market, not the managerial efforts of Key Futures. The decision to buy or sell was made by the owner of the silver.”); see also *SEC v. R.G. Reynolds Enters.*, 952 F.2d 1125 (9th Cir. 1991); *SEC v. Belmont Reid & Co.*, 794 F.2d 1388, 1391 (9th Cir. 1986).

100. See *Noa*, 638 F.2d at 79.

101. See *Frequently Asked Questions*, *supra* note 93.

102. See *supra* Section II.A.

pends on market forces, not the efforts of others.<sup>103</sup> Similarly, the value of a token like bitcoin hinges only on the market's perception of how valuable the token and its underlying technology will be in the future.

The CFTC reinforced this argument in *In re Coinflip*, in which the Commission asserted that virtual currencies, including bitcoin, are commodities under the Commodities Exchange Act.<sup>104</sup> The CFTC reasoned that "Section 1a(9) of the Act defines 'commodity' to include, among other things, 'all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.'"<sup>105</sup> If virtual currencies are commodities, subject to CFTC regulation by the CFTC, then they cannot also be securities regulated by the SEC.

The line between securities and commodities, or security-tokens and nonsecurity-tokens, is now an intensely fact-specific inquiry.<sup>106</sup> The SEC must explore the details of the token, from whether the entity originating the token is providing significant managerial efforts to whether the tokens have utility beyond that of an investment vehicle.<sup>107</sup> The framework this regulatory scheme creates is needlessly complicated. Some cryptocurrencies are commodities, while some are securities, and determining where that line is drawn is burdensome.<sup>108</sup> Regulatory stakeholders will have to pay the cost of that uncertainty. Fraudulent coin schemes will intermingle with legitimate coins, causing the SEC to both over- and underenforce the securities laws: legitimate tokens may be attacked while fraudulent tokens may be missed.

More troubling, however, is that tokens initially appearing to be securities may eventually not satisfy all prongs of the *Howey* test as their creators allow the blockchain technology to take over. Historically, instruments declared to be securities always remained securities thereafter.<sup>109</sup> Securities laws, and *Howey*, certainly did not contemplate an instrument that changes over time.<sup>110</sup> In light of this, the line-drawing problem between commodity and security takes a new edge—the line is not only troublesome to draw but also dynamic.

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103. *E.g.*, *R.G. Reynolds*, 952 F.2d at 1135; *Belmont Reid*, 794 F.2d at 1391; *Noa*, 638 F.2d at 79.

104. *In re Coinflip, Inc.*, CFTC No. 15-29, at 3, [2015–2016 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 33,583 (Sept. 17, 2015).

105. *Id.* (quoting 7 U.S.C. § 1(a)(9) (2012)).

106. *See supra* Section II.A. The SEC will have to do a *Howey* analysis on each token it chooses to pursue. *See also* sources cited *supra* note 3.

107. *See* DAO REPORT, *supra* note 3.

108. *See supra* Section II.A.

109. For example, the enumerated categories in §2(a)(1) of the Securities Act of 1933 suggest this: stocks remain stocks; notes remain notes. Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2012).

110. Alternatively, they could be viewed as separate instruments across subsequent sales. That is, token A sold during an ICO is distinct from token A sold well after it has utility.

Solutions to this problem lie in developing clear metrics as to whether a cryptocurrency should be treated as a security, enabling the SEC to more efficiently tackle the question. A more nuanced cryptocurrency analysis will separate the scams from viable tokens: cryptocurrencies released for the intrinsic benefits of their technology, rather than as a method to evade the securities laws, will fall outside the definition of a security. This is the best-case scenario for the digital token industry and the SEC because fraudulent schemes ultimately discourage investment. Enabling the SEC to sniff out fraud while preserving the well-functioning cryptocurrency firms will propel this new industry onward.

As the market for cryptocurrencies and their ICOs explodes, we can expect to see more creative formulations to evade securities regulation. Because bitcoin is already considered a commodity,<sup>111</sup> similar financial instruments will contend that they too do not meet the four prongs of the *Howey* test.<sup>112</sup> Solutions to this problem must address the realities above: that tokens that satisfy the *Howey* test are securities, tokens that are not securities are commodities, and a clear, static regulatory categorization of securities and commodities is preserved.

### III. CRAFTING A STANDARD: HOW CRYPTOCURRENCY CREATORS CAN REBUFF *HOWEY*

Classifying a security at its outset is important to serve the goals of the securities laws.<sup>113</sup> The SEC notes that the “two basic objectives” of the Securities Act of 1933 are to “require that investors receive financial and other significant information concerning securities being offered for public sale; and prohibit deceit, misrepresentations, and other fraud in the sale of securities.”<sup>114</sup> Justice Powell noted that “the parties’ inability to determine at the time of the transaction whether the Acts apply neither serves the Acts’ protective purpose nor permits the purchaser to compensate for the added risk of no protection when negotiating the transaction.”<sup>115</sup> Similarly, crafting a coherent standard for cryptocurrencies within the confines of existing securities law is critical for both buyers and sellers of these tokens.<sup>116</sup>

This Part offers a solution to the problem of cryptocurrencies evading the *Howey* test and creates a dynamic line between securities and commodi-

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111. *In re Coinflip, Inc.*, CFTC No. 15-29, at 3, [2015–2016 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 33,583 (Sept. 17, 2015) (holding that bitcoin and other virtual currencies are commodities).

112. *See, e.g.*, DAO REPORT, *supra* note 3.

113. *See What We Do*, U.S. SEC, <https://www.sec.gov/Article/whatwedo.html> [<https://perma.cc/G68D-SH2M>] (explaining that classification is one way the SEC “protect[s] investors, maintain[s] fair, orderly, and efficient markets, and facilitate[s] capital formation”).

114. *Id.* (cleaned up).

115. *Gould v. Rufenacht*, 471 U.S. 701, 705–06 (1985).

116. *See id.*

ties.<sup>117</sup> It first introduces the necessary characteristics of a sound policy: bringing tokens that meet all four prongs of *Howey* into the SEC's regulatory grasp, excluding those that do not, and reducing the regulatory burden that arises out of a deeply factual question. Then, it offers a recommendation that satisfies those requirements and is both legally plausible and administratively workable. The recommendation introduces a standard that allows the SEC to more efficiently analyze tokens and tighten or loosen the regulatory constraints on cryptocurrency ICOs depending on the agency's own policy preferences.

#### A. *The Components of a Solution*

A solution must bring fraudulent ICOs clearly within the regulatory reach of the SEC or the CFTC.<sup>118</sup> If a token does not meet all four prongs of the *Howey* test, it must be a commodity, and if it satisfies all four prongs, it must be a security.<sup>119</sup> Although Congress did not contemplate cryptocurrencies, the *Howey* test was intended to cover novel instruments that may arise in the future.<sup>120</sup> A proposed solution to the *Howey* test must ensure that a token that does not meet its four prongs is beyond the purview of securities law, rather than simply defeating the test's capacity.<sup>121</sup> Under the framework illustrated in Part II, cryptocurrencies that do not meet the four prongs of the *Howey* test fall within the definition of commodities. If the SEC does not have the power to regulate, the CFTC does.<sup>122</sup> Indeed, the CFTC has filed enforcement actions for "fraudulent activity involving virtual currencies," indicating that circumventing the SEC will not leave fraud unchecked.<sup>123</sup>

Finally, the solution must, at least in part, relieve the regulatory burden cryptocurrencies introduce. In the absence of any modifications, the SEC must apply the *Howey* test.<sup>124</sup> As illustrated above, this is a deeply factual inquiry.<sup>125</sup> And because the stage of development of a cryptocurrency affects

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117. SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

118. Examples of such coins include Bananacoin. BANANACOIN, <https://www.bananacoin.io/> (on file with the *Michigan Law Review*).

119. See *Howey*, 328 U.S. at 301.

120. See *id.* at 299 ("It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.").

121. The implication here is that if a token does meet the four prongs of *Howey*, then it is safely categorized as a commodity—an asset that does not need the searching disclosures of the securities laws.

122. See *supra* Section II.B.

123. Christopher Conniff et al., *CFTC Reasserts Its Role in Virtual Currency Regulation*, LAW360 (Jan. 25, 2018, 3:40 PM), <https://www.law360.com/articles/1005846/cftc-reasserts-its-role-in-virtual-currency-regulation> (on file with the *Michigan Law Review*).

124. See *Howey*, 328 U.S. at 301.

125. See *supra* Section II.A.

the *Howey* analysis, the factual burden is even greater.<sup>126</sup> Alleviating that burden is a central concern, along with providing certainty in application.

The most straightforward way for this drifting line between security and commodity to be resolved is through agency action, either by the SEC or the CFTC or both.<sup>127</sup> More specifically, a solution must reconcile the *Howey* test with cryptocurrencies like bitcoin, which is widely regarded as a commodity. The SEC or the CFTC should release guidance that creates an articulable standard within the *Howey* framework. An interpretation of the *Howey* test for an investment contract that cryptocurrency creators and the agencies themselves can use to filter through the thousands of coin offerings makes these fact-specific questions significantly less burdensome.

### B. *Is Blockchain Technology Essential to the Enterprise?*

Regulators perceive cryptocurrency ICOs as means for avoiding enforcement actions while raising substantial amounts of capital.<sup>128</sup> This is a justifiable impression given that only one in ten tokens is actually in use following ICOs.<sup>129</sup> If a token cannot be used, it will not pass the *Howey* test. Because a token is not functional, it must be an investment and it must be built with managerial efforts.<sup>130</sup> Those 90% of tokens not in use will be defined as securities under the *Howey* test.<sup>131</sup> But the remaining 10% should be treated as commodities.<sup>132</sup>

To tackle the 10% treated as commodities, regulators should impose a standard that analyzes how essential the blockchain is to the enterprise. This standard should be based on the most problematic prong of the *Howey* test: “from the efforts of others.”<sup>133</sup> Courts have read this prong to mean managerial and entrepreneurial efforts, but implicitly it has always been efforts *that advance a manager’s interests*.<sup>134</sup> In *SEC v. Glenn W. Turner Enterprises*, the Ninth Circuit concluded that the “managerial efforts” were efforts that “produce[d] the money which [made] him rich.”<sup>135</sup> The Fifth Circuit reiterated

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126. See *supra* Section II.A.

127. Legislation and judicial actions being the other two methods, agency actions are by far the most expedient.

128. See Russolillo, *supra* note 45.

129. See Olga Kharif, *Only One in 10 Tokens Is in Use Following Initial Coin Offerings*, BLOOMBERG (Oct. 23, 2017, 5:00 AM), <https://www.bloomberg.com/news/articles/2017-10-23/only-one-in-10-tokens-is-in-use-following-initial-coin-offerings> [https://perma.cc/78TA-TPQ7].

130. See *supra* Section II.A.

131. See Kharif, *supra* note 129.

132. See *id.*

133. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

134. See, e.g., *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 485 (5th Cir. 1974); *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482–83 (9th Cir. 1973).

135. 474 F.2d at 482.

this theme in *SEC v. Koscot Interplanetary*.<sup>136</sup> In both cases, managers enriched themselves through their efforts. But that is not the case for cryptocurrencies. If the cryptocurrency is functioning properly, the managers will work to remove themselves from the picture because the whole point of the blockchain is self-governance.<sup>137</sup> Bitcoin is illustrative here—there is no entity or organization that controls bitcoin;<sup>138</sup> the technology governs itself.<sup>139</sup>

When analyzing the final prong, the SEC should evaluate managerial efforts and find that an increasing level of sophistication with blockchain cuts *against* a finding of managerial efforts. The more that an enterprise depends on blockchain technology, the more likely a manager will ultimately eliminate his or her own duties in the future. Likewise, a token that does not use a blockchain in a manner like bitcoin will not get deferential treatment because it requires the promoter's continuing intervention. This is a sliding scale: the closer a token is to achieving a fully self-governing platform, the more likely it will not have "the efforts of the others" to the degree contemplated by *Howey*.<sup>140</sup>

The test is a predictive tool to separate tokens that are more likely to eliminate management versus those that are less likely to do so. If a token does not need a blockchain to function, then there is no reason to presume that the managers will automate themselves out of a job. Management that seeks to perpetuate its job will always meet the final prong of the *Howey* test, and the eventual disappearance of that prong may never occur. These tokens are typically the ones that society is interested in regulating as securities because their creators use the craze over cryptocurrencies to raise funds outside the reach of securities laws.<sup>141</sup> These schemes use tokens as a gimmick to avoid regulation at the expense of investor protection.

As a matter of policy, this makes sense; the proposed standard incentivizes the right type of tokens that society wants to develop—tokens that use the blockchain for the purpose for which it was developed.<sup>142</sup> Innovative uses of technology, like bitcoin, are such examples.<sup>143</sup> Developing a self-governing system like bitcoin will increase the likelihood that all four prongs of *Howey* are not satisfied, putting the scheme outside of the SEC's regulatory reach

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136. 497 F.2d at 483.

137. See Iansiti & Lakhani, *supra* note 97.

138. *Frequently Asked Questions*, *supra* note 93.

139. See *id.*

140. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

141. See *Investor Bulletin: Initial Coin Offerings*, *supra* note 7.

142. This has been done before with emerging growth companies—a class of companies that receives less regulatory scrutiny because the SEC wants to encourage growth. See *Emerging Growth Companies*, U.S. SEC (last modified Nov. 30, 2017), <https://www.sec.gov/smallbusiness/goingpublic/EGC> [<https://perma.cc/AYL7-S5XS>]. See generally *The Great Chain of Being Sure About Things*, *supra* note 30.

143. See Wladawsky-Berger, *supra* note 29.

and into the hands of the CFTC. This gives an excellent incentive structure for currency creators: keep the crypto in cryptocurrency or face the SEC. This structure ensures that the core innovation of this technology serves to create efficiency, fairness, and growth, rather than merely serving as a platform for under-the-radar fundraising.

This is not to say that blockchain should only be used in self-governing tokens. Rather, if entrepreneurs use the blockchain without creating a self-governing system, then they should register it as a security or otherwise comply with the securities laws.<sup>144</sup> Creating a token that does not rely on the blockchain while seeking exemption from the securities laws reeks of regulatory arbitrage.<sup>145</sup> If managerial oversight will always be needed, then it becomes increasingly unlikely that the token would not satisfy the fourth prong of *Howey*.

The more a cryptocurrency creator can show that a token legitimately uses the blockchain, making it similar to bitcoin,<sup>146</sup> the greater the presumption against the cryptocurrency satisfying the fourth prong of *Howey*. Consequently, that sort of token is more likely to be a commodity. Those that want to abuse the investor craze over “cryptocurrency” as a buzzword will still meet all of the *Howey* prongs, and the instruments they are promoting will fall within the definition of a security. This standard alleviates the factual burden on the SEC by distilling the fourth prong into a simple principle: are you automating yourself away or not? In other words, the standard measures the ability of the cryptocurrency to eliminate management.

Perhaps what is most attractive for the SEC about this test is that it can be adjusted to be as inclusive or exclusive as the SEC would like. For example, claiming that the blockchain foundation behind a coin must be so essential as to eventually eliminate the need for managers would restrict the to-

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144. See, e.g., *KODAK and WENN Digital Partner to Launch Major Blockchain Initiative and Cryptocurrency*, KODAK (Jan. 9, 2018), [https://www.kodak.com/corp/press\\_center/kodak\\_and\\_wenn\\_digital\\_partner\\_to\\_launch\\_major\\_blockchain\\_initiative\\_and\\_cryptocurrency/default.htm](https://www.kodak.com/corp/press_center/kodak_and_wenn_digital_partner_to_launch_major_blockchain_initiative_and_cryptocurrency/default.htm) (on file with the *Michigan Law Review*). (“This initial Coin Offering is issued under SEC guidelines as a security token under Regulation 506 (c) as an exempt offering.”).

145. *Regulatory Arbitrage*, INVESTOPEDIA, <https://www.investopedia.com/terms/r/regulatory-arbitrage.asp> [<https://perma.cc/N38D-8SYR>] (“Regulatory arbitrage is a practice whereby firms capitalize on loopholes in regulatory systems in order to circumvent unfavorable regulation.”).

146. Firms can explain how and why blockchain technology is essential to tackling the problem; i.e., why cloud storage has a classic intermediary problem (because everyone has to store their data on a third party’s server), and the blockchain naturally remedies that by decentralizing storage space. More granularly, firms can follow the recommended steps in the Coinbase white paper *A Securities Law Framework for Blockchain Tokens*, such as controlling the timing of sale to be after the project is live, to show that their coins are not securities. COINBASE ET AL., *A SECURITIES LAW FRAMEWORK FOR BLOCKCHAIN TOKENS* (2016), <https://www.coinbase.com/legal/securities-law-framework.pdf> (on file with the *Michigan Law Review*).

kens to less than a handful that have reached that stage, like bitcoin.<sup>147</sup> If every other token is a security, and that may be the SEC's wish, then this test can accomplish that. But at the same time, if a coin has the reach and the decentralization of bitcoin, the SEC may see the value in reducing the regulatory burden and allowing the token to continue development with the profits accrued from an ICO.<sup>148</sup> This standard allows for that judgment at the time of an initial sale, a critical feature in administering the standard.<sup>149</sup>

Further, the SEC can ensure that a security will always be a security.<sup>150</sup> Cryptocurrencies change over the course of their development. At conception, sales of the token are securities because they give no utility and need managerial efforts.<sup>151</sup> But when a cryptocurrency reaches a critical level of self-governance, it would almost certainly not satisfy the *Howey* test if new tokens were sold. This is because the tokens either give substantial consumption value or are fully self-governing.<sup>152</sup> The alternative would be to test each sale against *Howey*, but that is a demanding factual analysis that would particularize the facts to such a degree that adjudications would be unpredictable. If one cryptocurrency was found to not be a security, other cryptocurrency creators would not have a clear understanding of whether or not they would be responsible for the securities laws.

The biggest challenge to applying this standard is developing administrative expertise on the blockchain. Expecting the SEC to learn about blockchains in order to decide cryptocurrency cases is a significant burden. But that burden is the product of technological innovation and will likely persist

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147. If one in ten tokens are in use following coin offerings, it is likely that only a small percentage are far enough in development to successfully argue that they can be fully automated in the future. See Kharif, *supra* note 129.

148. Cryptocurrencies and blockchain are socially valuable inventions, and allowing them to flourish by reducing the regulatory burden is a reasonable position for the SEC. See *Emerging Growth Companies*, *supra* note 142; *The Great Chain of Being Sure About Things*, *supra* note 30.

149. There may be concerns that this standard would introduce a line-drawing problem of when something has enough blockchain functionality or enough evidence that it will be self-governing, but because it is being administered by the SEC, the agency can install any arbitrary line that they deem appropriate.

150. This problem arises if the SEC were to review cryptocurrencies at the point of each sale. There is some support for this. The securities laws are transaction based, not security based. Every sale of a security must be registered, *CHOI & PRITCHARD*, *supra* note 10, at 96–97, so cryptocurrency originators could argue that subsequent sales of the same token are not securities anymore because the factual circumstances have changed. Such a view would create an incredible factual burden on the SEC and provide many more questions than answers.

151. See Clayton, *supra* note 1. (“By 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.”).

152. See *supra* Section II.A.

as blockchain technologies develop. In time, developing blockchain expertise at the SEC will become even more necessary.

Fortunately, there is an upside. If regulated entities know that the SEC will evaluate their tokens based on how well they articulate their blockchain-based goals, they will have incentives to produce clear white papers and disclosures that can explain how their blockchain works and why they do not satisfy *Howey*. Typically, the SEC must show that an instrument is a security.<sup>153</sup> Instead, if the burden shifts to the token creator, the learning curve for the SEC is alleviated.

Society has an important interest in the development of novel technologies without burdening those technologies with unnecessary regulation. The standard articulated here offers a compromise. It would allow some cryptocurrencies that society deems useful or essential to develop while still protecting investors from fraudulent offerings.

### C. *Blockchain Examples: From Bitcoin to Bananacoin*

Examples help illustrate how this test would work. First, consider both extremes. These are the easy cases. Fully decentralized cryptocurrencies like bitcoin are widely regarded as commodities, not securities.<sup>154</sup> In these cases, the blockchain has achieved its purposes and becomes a fully decentralized web.<sup>155</sup> There are no managers and no entrepreneurs behind the service.<sup>156</sup> Applying the standard to bitcoin, we would ask how essential to the enterprise is the blockchain.<sup>157</sup> For bitcoin, the enterprise is based entirely on the blockchain. The goal of bitcoin, to be an alternative medium of exchange, necessitated a fully decentralized system that is the blockchain and nothing more.<sup>158</sup>

The other extreme is also simple. Consider a fraudulent token like Bananacoin, which is pegged to the export price of 1 kilogram of Laotian bana-

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153. The SEC brings actions against firms if it believes they are unregistered securities involved in the transaction. See *CHOI & PRITCHARD, supra* note 10, at 96–97; see, e.g., *SEC v. Edwards*, 540 U.S. 389 (2004); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 294 (1946) (“The Securities and Exchange Commission instituted this action to restrain the respondents from using the mails and instrumentalities of interstate commerce in the offer and sale of unregistered and non-exempt securities in violation of § 5(a) of the Act.”); *SEC v. SG Ltd.*, 265 F.3d 42 (1st Cir. 2001).

154. *In re Coinflip, Inc.*, CFTC No. 15-29, at 3, [2015–2016 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 33,583 (Sept. 17, 2015).

155. See generally *SATOSHI NAKAMOTO, BITCOIN: A PEER-TO-PEER ELECTRONIC CASH SYSTEM*, <https://bitcoin.org/bitcoin.pdf> [<https://perma.cc/6SJZ-NUAY>] (using bitcoin as an example of the need for a blockchain to be fully decentralized).

156. See *id.*

157. See *supra* Section III.B.

158. See *NAKAMOTO, supra* note 155, at 1 (“What is needed is an electronic payment system based on cryptographic proof instead of trust . . .”).

nas.<sup>159</sup> The blockchain is not essential here. The export price of bananas can be tracked, and has always been tracked, without a blockchain. There is no reason for this to be a decentralized web.<sup>160</sup> Even if Bananacoin owners, or like-minded entrepreneurs, argue that the blockchain offers a fresh new tool, they would still fall within the definition of a security under *Howey*.<sup>161</sup> Here, blockchain is merely a mechanism to raise money—not to create a decentralized platform.<sup>162</sup>

The hard case is for those tokens that fall in between. Consider two tokens: Cloudtoken and Tezos.<sup>163</sup> Cloudtoken uses tokens to help a decentralized cloud storage platform.<sup>164</sup> Tezos is “a decentralized blockchain” that governs itself “to facilitate formal verification” in smart contracts.<sup>165</sup> At the initial coin offering stage, before the project is built, these will both undoubtedly be securities. But later in development, the analysis shifts. How essential is the blockchain for this operation? For Cloudtoken, decentralizing cloud storage may be an interesting and innovative use of the blockchain, and there are strong arguments that this is more like bitcoin and less like Bananacoin.<sup>166</sup> Cloudtoken attempts to accomplish something that is already

159. BANANACOIN, EXPANSION OF BANANA PRODUCTION IN LAOS WITH THE HELP OF CROWDFUNDING 4, [https://bananacoin.io/files/White\\_Paper\\_Bananacoin\\_en.pdf](https://bananacoin.io/files/White_Paper_Bananacoin_en.pdf) (on file with the *Michigan Law Review*) (“Bananacoin tokens will be exchangeable for a certain amount of Lady Finger bananas or equivalent monetary compensation. Because the token is backed by the market value of 1 kilogram of bananas . . . .”); see also Clint Rainey, *Yes, You Can Now Buy Bananacoins, a Cryptocurrency Linked to Banana Prices*, GRUB STREET (Jan. 22, 2018, 1:22 PM), <http://www.grubstreet.com/2018/01/bananacoins-are-a-cryptocurrency-linked-to-banana-prices.html> [<https://perma.cc/N7B6-Q6Z5>].

160. This is abundantly clear from vague gestures toward blockchain in the white paper. “Blockchain” appears eleven times in a twenty-three page white paper and never sees more than a hand-wavy treatment. See BANANACOIN, *supra* note 159.

161. The creators aim to “take advantage of blockchain technology in addressing real business objectives,” but absent is any justification for why they need a blockchain. See *id.* at 3. A relevant question an SEC investigation could ask under my theory is: does the Laotian banana market have an intermediary problem that the blockchain is trying to remedy? Or, would the creators of the blockchain be able to step away once this system is self-governing?

162. Although the Bananacoin white paper purports that the token is to stave of the endangered cultivar of the common banana, it does not explain why cryptocurrency is necessary. See Rainey, *supra* note 159 (“As many people know by now, the common banana (a cultivar known as the Cavendish) is endangered . . . . [but this] hasn’t stopped people from ridiculing the reach into cryptocurrency . . . .”); BANANACOIN, *supra* note 159.

163. CLOUD, CLOUD ICO WHITE PAPER, [https://buy-token.cloudwith.me/uploads/themepdf/en/cloud\\_ico\\_whitepaper.pdf](https://buy-token.cloudwith.me/uploads/themepdf/en/cloud_ico_whitepaper.pdf) [<https://perma.cc/46GK-NLQS>]; L.M. GOODMAN, TEZOS—A SELF-AMENDING CRYPTO-LEDGER (2014) [https://tezos.com/static/papers/white\\_paper.pdf](https://tezos.com/static/papers/white_paper.pdf) [<https://perma.cc/ST7H-XTGK>].

164. CLOUD, *supra* note 163.

165. TEZOS, TEZOS: THE SELF-AMENDING CRYPTOGRAPHIC LEDGER, [https://coindexter.s3.amazonaws.com/uploads/whitepaper/whitepaper/27/Tezos\\_Overview.pdf](https://coindexter.s3.amazonaws.com/uploads/whitepaper/whitepaper/27/Tezos_Overview.pdf) [<https://perma.cc/KCZ5-UYAC>].

166. “If people mostly use your token to buy cloud storage, then it is prepaid cloud storage; if they mostly use it to speculate, then it is a security.” Matt Levine, *What Is an ICO Any-*

widely available—cloud storage—but uses a novel technology to improve it. The utility it provides is clear: cloud storage. Whether or not the decentralized blockchain technology is critical to its development such that it will eliminate management is less clear. Tezos, on the contrary, is unquestionably something that mirrors bitcoin. In its white paper, the creators write that Tezos is “a self-amending crypto-ledger,” and they show numerous lines of code that describe how the token functions.<sup>167</sup> Because of this language, investors can reasonably expect that the “efforts of others” prong will eventually be unnecessary.<sup>168</sup> Tezos is legitimately furthering technological innovation. And in that view, the token would not satisfy prong four of the *Howey* test at a certain point of development. Cloudtoken, likewise, may also not satisfy the fourth prong at some point, but that would occur later on in development than in Tezos. The conclusion is that Tezos would be able to sell tokens without registering them with the SEC earlier in its lifetime than Cloudtokens could.

Each of these tokens, from Bananacoin to Tezos, would have the burden of showing in their white paper or other releases that they either provide enough utility or that they will become self-governing. Under this standard, Bananacoin would be preempted from using an ICO to sell a security outside the reach of SEC regulation. Tezos, by contrast, would not be overly burdened by the SEC regulatory requirements because CFTC regulations would be more appropriate. The rationale is that if the tokens provide utility, they are products (a commodity); if they are self-governing, there are no managerial efforts. Comparing these white papers is indicative: Bananacoin hardly mentions why it needs a blockchain or how its blockchain works, while Tezos is technologically savvy and explains how and why their blockchain is useful.<sup>169</sup> There are strong benefits to all stakeholders: technological innovators can create with reduced regulatory hurdles; regulators can more narrowly differentiate between cryptocurrency ventures; and financial market

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*way? A Few Theories*, Opinion, BLOOMBERG (Oct. 17, 2017, 11:35 AM), <https://www.bloomberg.com/view/articles/2017-10-17/what-is-an-ico-anyway-a-few-theories> [<https://perma.cc/B5RH-N337>]. This tracks the argument above: once cloud tokens are actually functional, they may provide enough utility to escape prong one of *Howey*. To escape prong four, the SEC might ask whether the managers of the Cloudtoken will ever be eliminated: can it be fully self-governing?

167. GOODMAN, *supra* note 163. The creators also write, “Most importantly, Tezos supports meta upgrades: the protocols can evolve by amending their own code. To achieve this, Tezos begins with a seed protocol defining a procedure for stakeholders to approve amendments to the protocol,” *id.* at 1, which suggests that users can interact with the platform without involvement from Tezos creators, bolstering the argument that it intends to be free of management at some time.

168. See, e.g., SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

169. Compare BANANACOIN, *supra* note 159, with CLOUD, *supra* note 163 (“1. The basic building block of the decentralized cloud platform is a GridNode component, providing the basic cloud platform service blocks. 2. The GridNodes are interconnected to form a mesh network for service management and request routing. Each GridNode is connected to the blockchain.”).

participants can have continued faith in the integrity of the financial markets at large.

#### CONCLUSION

The reasoning behind *Howey* opens the door for more lenient regulations on cryptocurrencies by treating them as commodities instead of securities. The fourth prong of *Howey*, “from the efforts of others,” implicitly means the self-serving efforts of managers based on prevailing case law.<sup>170</sup> This allows some cryptocurrencies to escape securities regulation and instead be classified as commodities. The cryptocurrencies that should be developed will inevitably be fully decentralized to realize the full potential of the blockchain. Managers working to automate themselves out of the picture are thus not the entrepreneurs that *Howey* is intending to bring within the definition of a security. Framing the “from the efforts of others” inquiry to include managers that automate themselves out effectively asks the question, “How essential is the blockchain to your enterprise?” Thus, tokens that are more like bitcoin should be less likely to be considered securities, but instead, commodities subject to regulation by the CFTC; tokens that do not rely in a substantial way on the blockchain will be securities subject to regulation by the SEC.

This solution mitigates the uncertainty created by a blurred line between commodity and security introduced by cryptocurrency by clarifying when a token would become a commodity (i.e., when it becomes self-governing). Cryptocurrencies introduce even more questions about consistency between the two separate regulatory agencies and the fundamental question of whether something can switch between the two. The proposed solution offers a consistent principle that the SEC and CFTC can use in the absence of judicially created tests or legislation to minimize the burden of fact-specific inquiries and slightly clarify that dynamic line between commodity and security. Critically, this solution does not require legislative intervention or even notice-and-comment rulemaking by the SEC and the CFTC. Instead, it is a plausible and practical application of existing Supreme Court precedent to a technological innovation beyond anything imaginable by Congress in the 1930s.

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170. See *Howey*, 328 U.S. at 299; *SEC v. R.G. Reynolds Enters.*, 952 F.2d 1125 (9th Cir. 1991); *SEC v. Belmont Reid & Co.*, 794 F.2d 1388 (9th Cir. 1986); *Noa v. Key Futures, Inc.*, 638 F.2d 77 (9th Cir. 1980).