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Why Cryptoequity May Not Be Securities

The year is 1941 and the place is Lake County, Florida, a town just outside of Orlando with a population of about 30,000. The W.J. Howey Company, then operated by Dodge Taylor, is selling plots of a citrus grove along with the right to share in any profits from crop sales. The investment-like nature of Howey's sales eventually landed the company before the United States Supreme Court and resulted in a decision that still has important ramifications for securities law practice.

Fast forward to the present. Cryptocurrency technologies of the sort underlying Bitcoin are beginning to be used to sell software services and access to decentralized ledger platforms. These types of so-called "cryptoequity" have the potential to change how businesses operate, from raising funds to using automated contracts to giving stakeholders a unique voice.

Over the summer, Ethereum reportedly pre-sold over $12 million worth of cryptoequity tokens to fund the operation of its "distributed application software platform." The Ethereum tokens are required for developers to implement software on its platform. Another platform, Swarm, is selling tokens that allow entrepreneurs to use its decentralized crowdfunding technology to raise funds with their own programmable cryptoequities. As of July 2014, Swarm had reportedly sold about $750,000 worth of tokens.

Because of their innovative and somewhat malleable nature, cryptoequities are also operating in a legal gray area.

In 1946, Howey's scheme was blocked when the Supreme Court ruled in *SEC* v. *Howey* that the interests being sold qualified as "investment contracts" and hence were subject to regulation by the Securities and Exchange Commission (SEC). The *Howey* test for qualifying as a regulated investment contract, now canon in the field of securities regulation, requires an agreement to involve an investment of money, a common enterprise, and an expectation of profits from the efforts of a promoter.

The *Howey* test is broad and captures a wide variety of interests not commonly understood to be securities. Over the years, it has led courts to find earthworm farm interests, a seat on the New York Stock Exchange, and virtual shares in a fantasy investment game as deserving securities regulation.

If cryptoequity is treated by the law as securities, the organizations that obtained funds by selling them would have to register with the SEC and comply with its disclosure requirements and broader regulatory regime. Yet despite the breadth of the *Howey* test and being labeled as a type of "equity," the tokens may not qualify as federally regulated investment contracts.

Under *Howey*, it doesn't matter whether the investment capital comes in the form of legal tender, digital currency, or some other valuable asset. Bitcoin ponzi schemer Trendon Shavers found that out the hard way. However, a contract must subject the buyer to a financial loss for it to be regulated. While cryptoequity in the form of software rights and memberships may fall in value, it would be difficult to characterize them as regulated investment contracts without also including a wide variety of other non-financial, commercial agreements and ordinary product sales. Funds obtained from selling memberships to use an existing facility do not provide "risk capital" as is the case with securities. To the extent Ethereum and Swarm sold tokens *after* they were operational, the funds they raised don't qualify as risk capital. However, Ethereum's continued platform development after its token pre-sale makes the sale at least somewhat like a regulated offering.

Cryptoequity may not meet the common enterprise requirement, either. Courts have interpreted a common enterprise to exist when an investor's gain is tied directly to the success of the promoter (or a third party), or at least generally dependent on the promoter's efforts. Applying this "vertical commonality" requirement to cryptoequities, however, indicates they are not securities due to the potentially massive gap between the success of a platform (i.e., the promoter) and an individual token holder.

Individual developers and entrepreneurs may fail using an otherwise successful platform. The converse may be true as well. Tokens may be interoperable so that holders can use them on multiple platforms, or export their underlying applications or projects to other platforms. The fact that Ethereum's platform was recreated on the Bitcoin platform suggests that very little intrinsic relationship exists between the success of a token holder and any particular platform, and certainly not something like a passive investor's relationship to a single company's management. And depending on how they develop their applications, individual token holders may find their purchase to be worthwhile or a waste of money. This potentially different payoff undermines the common enterprise in the "horizontal" sense (i.e., among token holders).

Likewise, what cryptoequity holders actually purchase with their funds may undermine the sale from being classified as a securities offering. The expectation of profits requirement does not exist when a buyer receives a good, service, or property. This is why crowdfunding platforms like Kickstarter are not subject to federal regulation. It is also why courts, including the U.S. Supreme Court, hold that shares in housing cooperatives or condos are not securities, even when they come with a reduction in rent or income from renting common areas. If cryptoequity is viewed as conferring a right to use "real estate" on a ledger, then, like housing shares, they may not qualify as regulated agreements.

The active involvement of cryptoequity holders--either as developers or entrepreneurs--may limit the applicability of federal law as well. Passive parties that rely on managers to generate a profit are the hallmark of securities investors. On the opposite extreme are partners that equally manage a business: the law presumes that partnership interests are not

securities. This is because a partner, as opposed to a mere investor, does not rely on the efforts of others and does not need to be protected by the securities laws in doing so. (The same approach applies to LLCs managed by its members.) Buyers of Ethereum's tokens may be viewed as active participants because they promised their purchase was to use and develop on its software platform (and not as an investment). According to *Howey*, a purchase motivated to actively "develop" property is not a securities investment.

Finally, based on the 1990 Supreme Court case of *Reves v. Ernst & Young*, cryptoequities may not be regulated because they closely resemble commercial contracts that are obviously not securities. The *Reves* court held that promissory notes secured by home mortgages or business assets were obviously not securities, and neither were agreements that resembled them. The commercial nature of cryptoequity tokens in providing access to software and fundraising platforms may lead a court to hold the same.

Securities regulation is not meant to guard all types of agreements against fraud and manipulative behavior. So while it remains to be seen how the SEC will approach cryptoequities, there is good reason to believe that at least some types of cryptoequity are too commercial in nature to fall under its regulatory orbit.

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