Crypto Skeptics' Supreme Risk: The Danger of Relying on Courts to Decide Crypto's Fate

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Introduction

The nature of most crypto assets is contested. The industry asserts that the vast majority are commodities because of their issuers' decentralized nature, whereas critics argue that most are securities. The former are subject to limited oversight by the Commodity Futures Trading Commission (CFTC), whereas the latter are heavily regulated by the Securities and Exchange Commission (SEC). There is little overlap between the perspectives, and Congress has been unable to enact legislation clarifying crypto's regulatory status.

With the divide between perspectives so large, the task of clarifying the regulatory regime has been given to the courts. Under a 1946 Supreme Court precedent, assets are considered securities if they meet a four-part test, which has become known as the *Howey* test, and courts have thus far—with one notable exception, *SEC v. Ripple Labs*—agreed that sales of most crypto assets subject to litigation are securities. Accordingly, those skeptical of crypto assets as investment opportunities appear content to let the courts proceed, without the need for legislation at all.

This course of action—relying on the Supreme Court to be the final arbiter of which regulatory regime crypto assets are subject to—is problematic. Not only does waiting for the Court to decide mean that crypto markets will continue their unregulated operations and speculators and investors may be harmed in the interim, but there is significant risk that today's Supreme Court will read its precedent in ways that diverge from prior interpretations, opening the floodgates to regulatory arbitrage away from the securities laws. The crypto industry has not-unconvincing legal arguments that are based in history and interpretations of Congressional intent that may persuade this Court—the most conservative in nearly a century—to ignore the language of prior precedent and narrow the securities laws' scope.

The stakes could not be higher. Sales of crypto assets may end up as mere commodity sales, and beyond crypto, the securities laws would be optional for all businesses raising funds from members of the public; issuers would sell securities to the extent it helps them raise capital and investors could face the decision between investing without appropriate protections and not investing at all. The federal securities laws are designed to protect investors by prohibiting fraud and market manipulation; requiring sellers of stocks, bonds, and other securities to provide investors with detailed information about the risks of investment opportunities that allows for informed decision-making; and ensures that there is a cop on the beat in the form of the SEC. Making these provisions optional would significantly undermine the progress made in ensuring the nation's capital markets are fair and would return retail investors to the days of caveat emptor—buyer beware.

There are, however, actions Congress can take to avoid such an outcome. Legislators should codify an expansive view of what is a security—and in the process socialize the idea that many crypto assets *should be* considered securities, regardless of any Supreme Court holding to the contrary. Congress should also push for a strong regulatory regime for crypto assets that are commodities to elucidate the differences between crypto securities and commodities.

Cases like *SEC v. Coinbase*, *SEC v. Binance*, and *LEJILEX v. SEC* are percolating through the legal system and are likely to come before the Supreme Court before too long. Those critical of crypto should not bet on *this* Supreme Court declaring crypto tokens to be securities. Betting on them doing so could result in American investors being left as unprotected as they were before the Great Depression. Congress must act.

Most Crypto Assets Are Securities under Supreme Court Precedent

Whether an asset is a security depends on whether it is one of several enumerated assets in the Securities Act of 1933 and the Securities Exchange Act of 1934. Congress defined the term "security" in broad terms. This original definition included specific terms like "stock" and "bond" as well as catch-all terms like "investment contract" that required judicial interpretation (Securities Act of 1933). Congress took pains to note that the statutes exclude assets for which application of the securities laws—and the protections they offer—would not benefit investors. Today, the debate over whether crypto assets are subject to the securities laws is over whether crypto assets are among the statutes' enumerated assets—specifically, whether they are investment contracts—and whether applying the securities laws helps investors.

The Supreme Court first defined the term "investment contract" in 1946 in *SEC v. W.J. Howey Co*. Based on the term's historic usage, the Court articulated a four-part test for determining whether an investment contract is a security:

> "[A]n investment contract is . . . [1] a contract, transaction or scheme [2] whereby a person invests his money in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party." (*SEC v. Howey*)

This test has since become known as the *Howey* test and is the "touchstone" of whether an asset is a security, having been applied to a wide array of assets (*United Housing Foundation, Inc. v. Forman*). If an asset sale passes the *Howey* test, it is subject to the securities laws and the disclosures, investor protections, prohibitions against insider trading, and policing by the SEC that those laws require. If a sale does not pass the test, the asset is either considered a commodity subject to limited CFTC oversight or the sale is simply a contract under state law.

Historically, judges have interpreted the *Howey* test flexibly, noting the Supreme Court's contention that the test be flexible, not fixed; the Court asserts the test must be "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" (*SEC v. Howey*). Thanks to this flexibility, courts routinely rebuff attempts to use creative structuring of investment opportunities to evade the securities laws.

Applying the Howey *Test to Crypto Assets*

Using the *Howey* test, federal courts have determined many times that sales of crypto assets constitute investment contracts. Of course, the facts around any particular token must meet the *Howey* test to be deemed a security, but it is easy to show how most crypto assets likely meet all four prongs.

Many, if not most, crypto assets are issued as part of a "scheme" for capital raising (*Howey*'s first and second prongs). The Supreme Court has made clear that "Congress' purpose in enacting the securities laws was to regulate *investments,* in whatever form they are made and by whatever name they are called," (*Reves v. Ernst & Young*) and explained that "form should be disregarded for substance and the emphasis should be on economic reality" (*Tcherepnin v. Knight*). In other words, securities law should appropriately regulate investments of all kinds, no matter their particular form. Crypto-related schemes frequently entail the selling of tokens to develop protocols that earn profit for tokenholders, which constitute investments. In this sense, crypto assets themselves may be considered evidence of investment contracts in the way that stock certificates evidence equity in firms.

Similarly, it need not be the case that investors' "expectation of profit" (*Howey*'s third prong) comes solely from promoters' reversion of profits; they can also arise when promoters act to create the conditions that allow investors to resell assets for a profit. In one case, for example, a court found an expectation of profit when the plaintiff's investment in bank certificates of deposit was conditioned on its expectation that the certificates would appreciate in value and the promoter maintained a ready market in which to sell the appreciated assets before maturity (*Gary Plastic Packaging Corp. v. Merrill Lynch*). This potential for asset appreciation is prevalent in the market for crypto and one of the primary reasons why speculators purchase crypto assets: One survey found that 86 percent of respondents who owned crypto cited a reason for holding the asset as "I want to make money" (Principato et al. 2022). Desire to make a profit is demonstrated again and again with crypto issuers' own statements about how token prices will go "to the moon."

Lastly, despite claims that crypto is decentralized and that anyone may participate, many of the largest crypto projects are directed by small groups of individuals, some of which are organized under chartered legal entities (meeting *Howey*'s final prong). Many crypto assets are the governance tokens of decentralized autonomous organizations (DAOs), which are unincorporated entities that allow tokenholders to vote on proposals to change the future of the project. Many DAOs are also associated with chartered corporations that undertake activities on behalf of the DAOs, and these corporations have boards of directors and staff (Lopatto 2022).

These corporations may actually control the DAOs through majority ownership in governance tokens, rendering claims of decentralization moot. Take, for example, ApeCoin, the token for the ApeCoin DAO, which is in some way affiliated with two projects—Bored Ape Yacht Club and Mutant Ape Yacht Club—themselves launched by the Delaware limited liability company Yuga Labs (Yuga Labs, Inc. 2022). Although holders of ApeCoins may vote on projects the DAO will undertake, actions are *actually* taken by the APE Foundation, a Cayman Islands legal entity that is "tasked with administering the decisions of the ApeCoin DAO[;] is responsible for day-to-day administration, bookkeeping, project management, and other tasks;" and is paid by the DAO for its services (ApeCoin 2024; Gottsegen 2023). Furthermore, of the initial distribution of 400 million ApeCoins, 230 million were initially distributed to Yuga Labs and its founders, meaning that it could win every vote, at least at launch (ApeCoin 2024).

It is also worth noting just how similar many crypto schemes are to traditional securities. Some were sold in initial coin offerings, akin to initial public offerings, in which issuers pledged to use raised funds to develop blockchain projects, and the coins would appreciate in value once the projects launched. Others, like ApeCoin, give tokenholders voting rights, with the ability to elect schemes' leadership or make changes to the code underlying the tokens, much the way that corporate shareholders elect directors and vote on resolutions. These votes could even be to give tokenholders pro rata shares of the protocols' profits, similar to dividends (Yuga Labs, Inc. 2022).

The Conservative 'YOLO Court'

Today's Supreme Court is the most conservative in decades and has been described as the "YOLO Court" for the speed at which it is handing down precedent- and life-changing decisions (Totenberg 2022). In case after case, the Roberts Court has either overruled prior decisions or read precedent in a novel light to move American law to the right. And although the Court's conservative-leaning decisions run the gamut in terms of policy areas—from abortion rights (*Dobbs v. Jackson Women's Health Organization*) to affirmative action in education (*Students for Fair Admissions v. Harvard College*) to religious accommodations (*Kennedy v. Bremerton School Dist.*)—its opinions on business-related matters portend a constrained view of the securities laws.

Many have described the Roberts Court as "decidedly pro-business" (Gorod 2017; Liptak 2013; Franklin 2009; Epstein 2013). It has struck down laws prohibiting corporations from engaging in political speech (*Citizens United v. FEC*), made it more difficult for workers to file claims related to sex-based pay discrimination (*Ledbetter v. Goodyear Tire & Rubber Co.*), prohibited damages for emotional distress under two federal disability discrimination statutes (*Cummings v. Premier Rehab Keller*), ruled that binding arbitration clauses in contracts of adhesion are enforceable notwithstanding state law (*Viking River Cruises, Inc. v. Moriana*), prohibited pensioners from holding their asset managers accountable (*Thole v. US Bank*), and allowed pharmaceutical companies to avoid design defect claims from patients who have been harmed (*Mut. Pharm. Co. v. Bartlett),* among other decisions.

Beyond being pro-business, the Court is also anti-regulatory; it has expressly restricted the ability of government agencies to protect the public (Metzger 2020). In a trio of cases, the Court used the newly created "major questions doctrine" to strike down regulatory actions that would have imposed new regulatory requirements on businesses (*West Virginia v. EPA; Alabama Assn. of Realtors v. Department of Health and Human Servs.; Nat'l Fed. of Ind. Bus. v. Dep't of Labor*). It also reinterpreted the Clean Water Act to remove protections from a variety of wetlands previously covered, allowing businesses to pollute more freely (*Sackett v. EPA*); allowed corporate defendants to halt litigation before agency administrative law judges (the SEC's in particular), delaying the regulatory enforcement process (*Axon v. FTC*); and permitted the president to fire independent regulators, likely resulting in weaker regulations in the future (*Seila Law v. CFPB; Collins v. Yellen*). The cases go on and on.

Furthermore, prior to the appointment of Justice Amy Coney Barrett, varying compositions of four conservative jurists signaled a willingness to reach conservative outcomes in administrative cases pending a fifth vote, which they may now have. Today, there may be five votes to revitalize the nondelegation doctrine and allow the Court to strike down statutes not drafted with the justices' preferred level of specificity, eliminate the doctrine that instructs judges to defer to agencies' reasonable interpretations of ambiguous regulations, and ignore core administrative law principles when they deem appropriate.

Although one scholar argues that the current Supreme Court is a "stare decisis court" because it overturns precedent at a rate below that of its predecessors (Adler 2018), this is cold comfort given the Court's recent history of deviating from precedents without explicitly abrogating them. With regard to the recent affirmative action case, *Students for Fair Admissions, Inc. v. Harvard College*, for example, one commentator noted that the Court "did not declare that the leading precedents . . . have been formally overruled," but instead "redefined these precedents' requirements so narrowly and stringently that they are now impossible to comply with" (Stern 2023). In evaluating whether crypto assets sales are securities sales, it is possible for the Court to do something similar.

Will the Supreme Court Modify *Howey*?

Despite the *Howey* Test's long-standing tenure, crypto advocates and some scholars have begun arguing that its four parts do not accurately describe the investment contracts that Congress intended the federal securities laws to cover. Rather, this camp argues, *Howey* requires an ongoing legal relationship between securities issuers and investors and, because ownership of crypto assets does not establish that relationship, the assets themselves are not securities subject to the securities laws. If this argument breaks through, it will result in the securities laws being optional for a wide array of investments and return retail investors to caveat emptor capital markets.

This argument presupposes that the investment contracts to which the federal securities laws should apply are only those "in which one party entrusted another with capital for the purpose of entering into, or funding, some sort of profit-seeking venture" (Cohen et al. 2022). Under this view, all securities must have a singular issuer to whom investments are made and against whom investors have legal rights. When investors purchase a company's stock, for example, they are investing capital in exchange for the right to vote for directors, receive dividends, and obtain a pro-rata share of the firm's assets when the firm is dissolved.

In a recent amicus brief, six securities law professors agree that this is what Congress intended when it enacted the Securities Act of 1933, not the broad understanding of the term "investment contract" that courts observe today (Brief of Securities Law Scholars 2023). Congress, they argue, intended to incorporate and crystallize in the securities laws a recognition that "the holder of an 'investment contract' must be promised an ongoing right to participate in the income, profits, or assets of an enterprise." Accordingly, the scholars assert that "every arrangement the Supreme Court has deemed an 'investment contract' promised the investor some ongoing, contractual interest in the enterprise's future endeavors," even if that "scheme" involved multiple contracts.

Unlike these prior investment contracts, crypto proponents argue that no legal relationships are, by necessity, created between issuers and holders of crypto assets, and certainly not when crypto assets are resold in the secondary market. Although an evaluation of the facts and circumstances is required to confirm the status of any given crypto asset, this view supposes that most crypto assets are simply sold as means by which tokenholders interact with blockchain protocols. Holders of UNI tokens may vote on proposed changes to the Uniswap protocol, for example, and BNB tokens can be used to pay transaction fees on the Binance blockchain. Some sales of crypto assets may be investment contracts, but most are mere commodity sales, proponents argue. And even if token sales are accompanied by sellers' pledges to undertake some other action to create profits, those pledges will not necessarily be binding on secondary-market purchasers, meaning that initial sales would be securities but secondary-market sales would not.

To bolster this view, crypto proponents argue that crypto assets are fundamentally unlike traditional securities and should not be categorized with them. Whereas traditional securities serve a single function (investment), crypto assets serve many functions for blockchain-based applications, such as use in paying transaction fees, voting on proposals, and serving as media of exchange, along with serving as investments (Grewal 2022). And where issuers of traditional securities are singular entities that make choices affecting ventures' success, crypto tokens may be associated with enterprises "managed by a diffuse group of individuals" (Grewal 2022). For crypto assets that have these differences from traditional securities, the securities laws' disclosures and protections may be inappropriately tailored or unwarranted all together.

These arguments are not unconvincing, and without Congressional action, skeptics of crypto assets are naively hoping that this Supreme Court—the most conservative in nearly a century—will ignore the arguments about history and Congressional intent to hold that crypto assets should nevertheless be considered securities. They are betting that the Court will adhere to the plain language of prior precedent, rather than reinterpreting or narrowing the *Howey* test the way it did with its affirmative action jurisprudence.

Perhaps the Court will leave *Howey* intact; it has not been as aggressive in pursuing conservative changes to the securities law as it has in other areas, and has largely taken cases only to resolving circuit splits (*Slack Technologies v. Pirani*; Pritchard 2016). But taking the *Howey* test to this Court is nevertheless a high-risk strategy given that severe consequences may follow. Because the *Howey* test would require an ongoing contractual relationship, contracts that disclaim issuers' or promoters' ongoing responsibilities related to the investments—even when an ongoing responsibility is implied—would be considered commodity sales.

Such a result would leave a hole right in the heart of the securities laws. The absurdity can be seen in the SEC's lawsuit against the company Ripple Labs, in which the judge bought these arguments (*SEC v. Ripple Labs*). Ripple sold XRP tokens directly to institutional purchasers (e.g., venture capitalists, brokers) and to the general public through exchanges, all the while promoting its tokens as investment opportunities and explaining how it worked to increase their value. The court held that the sales to institutional purchasers *were* securities while those to the general public *were not* on the grounds that institutional purchasers invested directly in Ripple Labs, with the understanding that the firm would use their capital to increase the value of XRP tokens, whereas investors who purchased tokens through exchanges could not have known whether they were purchasing tokens from Ripple, which would use the money for investment purposes, or from someone else, who would not. The result is that the most sophisticated investors received the securities laws' protection while those who needed it the most were left to fend for themselves.

The consequences of such a decision on investor protection and capital formation could be significant if the securities laws, ultimately, become optional for asset sales to the vast majority of people. The securities laws' registration requirements—which mandate all issuers of publicly traded securities disclose the identities of firms' directors and chief executives, firms' plans for using the capital raised, and investment risks, among other information—and the SEC's regulation of securities brokers, exchanges, and other market actors enable informed decision-making and foster market integrity, which together allows capital to flow to its most efficient uses. If issuing crypto assets becomes a way for issuers (at least, those that are in control of endeavors while claiming to be decentralized) to raise capital without providing appropriate disclosures, the securities laws' benefits for companies, investors, and capital markets could disappear—not just for entities that run applications on blockchains, but for other, traditional issuers as well.

For example, companies could transition themselves into DAOs, thereby retaining an organizational structure while avoiding the securities laws (and perhaps the corporate laws as well). Although there is evidence that the securities laws provide benefits to some companies (Cross and Prentice 2006; Ferrell 2007; Greenstone et al. 2006; Guiso et al. 2008), those benefits do not necessarily transfer to all issuers, such as the penny stock issuers most likely to be replaced by DAOs (Beatty and Kadiyala 2003). Furthermore, existing incentives may be completely upended if the securities laws effectively become optional. As a result, all investors could face a world where conflicts of interest and insider trading run rampant—as has been shown to be the case in private securities markets (Pollman 2012).

What Congress Can Do

All is not lost, and Congress can avert this outcome by enacting legislation to accomplish two complementary goals.

First, Congress should enact legislation to codify an expansive view of what is considered a security in secondary-market trading. Just as institutional investors are served by the application of the securities laws to Ripple's primary sales, retail investors should be protected with disclosures, registration requirements, prohibitions against insider trading, and other provisions of the securities laws when those same assets are sold in the secondary markets. The *Howey* test works effectively when interpreted broadly, so Congress should codify a directive that courts should do just that: Interpret the *Howey* test broadly such that a contract is not necessary for an asset to be considered a security and that courts should evaluate the economic reality of whether there is an investment in a common enterprise—including instances in which centralized promoters act to increase the value of the assets they've issued. Further, Congress should make clear that issued assets may serve as the "representation" of investments (think of the XRP tokens that Ripple sold to institutional buyers) for purposes of allowing these investments to trade on exchanges or in secondary markets.

In addition, Congress should enact a strong regulatory regime for crypto assets that are not securities. Not only is such a regulatory push necessary even if the Supreme Court upholds the current *Howey* test, as some crypto assets will nevertheless be commodities (e.g., Bitcoin), but such a framework could elucidate the differences between ownership of securities and commodities for profit-making purposes—that is, the differences between assets that are (at least sometimes) used for investment and assets that are only ever used for speculation. For purposes of such legislation, "investment" may be defined as the allocation of capital for financial gain into an asset distributed by an issuer who uses that capital to increase the value of that asset. "Speculation," on the other hand, may be defined as the allocation of capital for financial gain into an asset where there is no issuer.

As applied to crypto assets, the difference between investment and speculation revolves around the existence of an issuer or promoter. Crypto securities have issuers, and the securities laws require them to provide disclosures. Crypto commodities, on the other hand, lack such issuers, and legislation governing the trading of these assets could require brokers and exchanges to provide disclosures instead. This legislation should also provide for trading protections, such as through prohibiting abusive trading practices, conflicts of interest, and misappropriation of customer assets.

Conclusion

The Supreme Court has not yet ruled on whether crypto assets can be securities, and there is no guarantee that it will rewrite the *Howey* test. However, not only does waiting for the Supreme Court to be the final arbiter of crypto's regulatory regime mean that crypto markets will continue unregulated and speculators and investors will be harmed, but there is a significant probability that the Court will overwrite decades of precedent, causing additional harms to befall markets and market participants. Congress should, accordingly, enact legislation to codify an expansive vision of what constitutes a security as well as legislation to regulate crypto commodities.

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