

# REGULATED UNDER EXISTING LAWS, DIGITAL ASSETS OFFER NEW INVESTMENT OPPORTUNITIES

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*A common misconception about digital assets is that they exist in a lawless virtual Wild West. While there are not any federal regulations specifically drafted for digital assets, our existing laws were intended to be broad enough to encompass new financial instruments, and a wide variety of laws have been adapted to digital assets. Determining what rules apply, however, turns on whether digital assets are treated as securities, commodities, or currencies.*

*On Feb. 6, the chairman of the Securities and Exchange Commission (SEC), Jay Clayton, and the chairman of the Commodity Futures Trading Commission (CFTC), J. Christopher Giancarlo, testified before the U.S. Senate Committee on Banking, Housing, & Urban Affairs and addressed some of the confusion regarding the application of our current laws to digital assets.*

*Clayton told the committee, "I am very optimistic that developments in will help facilitate capital formation, providing promising investment opportunities for institutional and Main*

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*Street investors alike."*

*This followed a previous investor bulletin issued by the SEC in July 2017 that stated initial coin offerings (ICOs) are "fair and lawful investment opportunities" but can be used improperly. ICOs, depending upon the features of the blockchain token, can be subject to United States security laws. Clayton also told the committee: "I believe every ICO I've seen is a security."*

*The key to determining whether an ICO is a security turns on the application of SEC v. W. J. Howey Co., 328 U.S. 293 (1946). In the 1940s, the W. J. Howey Company (Howey), a Florida corporation, decided to raise capital to finance a new business venture by selling tracts of its citrus groves. Howey, not wanting to lose out on the profits from the citrus groves, gave the potential buyers the option to lease the land back to Howey's service company.*

*Pursuant to the lease agreement, Howey's service company would retain the complete right of possession of citrus groves and would market and sell the citrus under its name. Once harvested, the nominal landowners would receive an account of the citrus harvested from its tract and a portion of the profits. Most buyers were not farmers and lacked any expertise in cultivating citrus trees, but were attracted to the opportunity by the expectation of profits. Howey's plan worked and investors from around the country "bought" its citrus groves.*

*While likely not the first enterprising farmer to offer an investment opportunity in its land, Howey was the first to catch the eye of the SEC. The SEC alleged that, by failing to register the transactions between Howey and its buyers, Howey violated the 1933 Securities Act. The Supreme Court agreed. Under the test articulated in Howey, a transaction is a security if there is: (1) an investment of money, (2) an expectation of profits, (3) a common enterprise, and (4) the profits come solely from the work of others.*

*Applying that test, the Court concluded that Howey's real estate contracts were securities subject to regulation by the SEC. Like Howey's real estate contracts, cryptocurrencies and digital assets are challenging the traditional notion of a security. To date, the SEC has issued enforcement actions against ICO sponsors and relied on the Howey test in designating ICOs as securities.*

*Bitcoin, the most well-known cryptocurrency, is fundamentally different than blockchain tokens designed as investment mechanisms and offered through ICOs. Unlike blockchain tokens, Bitcoin was designed as a digital currency that could be used by two parties to transact business without having to trust a third party. While not a security, the CFTC designated Bitcoin as a commodity subject to its oversight. Last fall, the CFTC allowed two companies to trade Bitcoin futures contracts. Like the SEC, the CFTC has also pursued regulatory action related to cryptocurrencies, like Bitcoin. Recently, the CFTC issued subpoenas to Bitfinex, a popular cryptocurrency exchange, related to its capital reserves and its relationship to Tether, a cryptocurrency allegedly backed by one U.S. Dollar for each token issued.*

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*Digital assets and cryptocurrencies may seem like apples to Howey's oranges, but they are, in one sense, exactly the same – they are new investment opportunities and financial instruments that will help grow new capital and are regulated by existing law. This does not mean new regulations and better oversight are not needed – they are – but the notion that digital assets are not regulated is inaccurate. Overall, Clayton's and Giancarlo's testimony struck an optimistic, but cautious, tone about the future of digital assets. Giancarlo told the committee: "We owe it to this generation to respect their enthusiasm about virtual currencies with a thoughtful and balanced response, not a dismissive one."*

*Cryptocurrencies may seem like a brave new frontier, but in many cases they are no different than buying a plot of land in Howey's citrus grove.*

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