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HOWEY, *RALSTON PURINA* AND THE SEC'S DIGITAL ASSET FRAMEWORK

The SEC's digital asset Framework summarizes and extends the traditional Howey *analysis for determining when an investable asset is a security. The author suggests that the Framework foretells a shift from* Howey*'s attempt to distinguish between investable assets that are, and are not, subject to federal securities regulation, to a more expansive concept that finds a security whenever investors may need Securities Act protections.*

By Joseph A. Hall *

In 1946, the Supreme Court addressed a basic question under federal securities law: when does the Securities Act of 1933 regulate the offer and sale of an investment opportunity? In *SEC v. W.J. Howey Co.*,[1] the citrus-grove case, the Court articulated a test for determining when the sale of an investment opportunity involves an "investment contract" and thus a "security" under the Securities Act. Instead of concluding that an investment opportunity is a security when particular offerees need the protection of the Securities Act, the Court set forth an objective (if somewhat difficult to apply) analysis that later courts have generally broken down into four separate prongs: "The test is whether the scheme involves [I] an investment of money [II] in a common enterprise [III] with profits to come [IV] solely from the efforts of others." Focusing on the essential characteristics of what makes a security and a securities transaction, the *Howey* test plainly aimed to distinguish securities from myriad other forms of investments, and transactions regulated by the Securities Act from other investment and commercial transactions generally.

Nearly three-quarters of a century later, the *Howey* test remains the touchstone for determining whether a particular investment opportunity is an investment contract and thus a security. And so, in 2017, the SEC applied it to a blockchain-based digital token distributed by an unincorporated organization called The DAO.[2] Proceeding via a "report of investigation" rather than an enforcement action, the SEC explained that the DAO token was in fact a security and that the unregistered token offering was therefore an illegal unregistered securities offering. The Commission analyzed the token and the circumstances of its distribution under the *Howey* test and explained why it was satisfied.

Although experienced securities lawyers were not surprised by the Commission's handling of the DAO token, some wondered whether the federal courts would be inclined to look at digital assets through the same lens — after all, the SEC does not have an unblemished record when it comes to asserting jurisdiction over novel

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[1] 328 U.S. 293 (1946).

[2] SEC, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Rel. No. 34-81207 (2017).

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* *JOSEPH A. HALL is a partner in the corporate department of Davis Polk & Wardwell LLP. From 2003 to 2005 he served at the Securities and Exchange Commission under Chairman William H. Donaldson, ultimately as Managing Executive for Policy. His e-mail address is joseph.hall@davispolk.com.*

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or previously unregulated activities. Even when the activities in question seem squarely within the Commission's wheelhouse, the federal courts can be skeptical of regulatory overreach.[3] Digital assets — including Bitcoin and Ether — and the blockchain technology on which they are built have been around for just a decade or so, and are the subject of a great deal of interest and enthusiasm among technologists and hobbyists, as well as many in the broader commercial and financial communities. And it is easy to find influential voices arguing that SEC regulation of the technology is both inappropriate and potentially destructive of legitimate commercial value.[4] But as of this writing, while a few lower courts have considered or are considering the applicability of *Howey* to digital assets,[5] the appellate courts have yet to weigh in.

Since announcing its views on the DAO token, the SEC has brought a handful of enforcement actions against the promoters of "initial coin offerings" or "ICOs."[6] The SEC's decisions to proceed in these cases were based on its assessment under *Howey* that the conduct at issue bore hallmarks of a traditional securities offering — the marketing of an asset on the basis of its anticipated future value, with at least some of the proceeds expected to be used to drive the asset's valuation. Some of the cases also featured more than a tinge of allegedly fraudulent activity.

THE FRAMEWORK

Rather than continue to elaborate and refine the *Howey* analysis for blockchain technology and digital assets through settled or litigated cases, on April 3, 2019, the Strategic Hub for Innovation and Financial Technology (FinHub), a cross-divisional SEC staff working group, published a "Framework for 'Investment Contract' Analysis of Digital Assets."[7] While much of the Framework reiterates concepts that the Commission previously articulated in *The DAO* and settled enforcement cases, it also contains a few hints that the staff, if not the Commission itself, may be preparing to move beyond an orthodox *Howey* analysis, and find a security when it believes offerees need the protection of the Securities Act.

The *Howey* test has four prongs, but the Framework only focuses on the third and fourth. As to prong I (investment of money) and prong II (common enterprise), the Framework simply notes that these prongs are "typically" satisfied when evaluating digital assets. The footnotes illuminate why this is so.

In note 9, the Framework makes the (seemingly) internally contradictory assertion that "the lack of monetary consideration for digital assets . . . does not mean that the investment of money prong is not satisfied." In other words, according to the Framework, no investment of money is needed to satisfy the investment-of-money prong. If no investment of money is needed to establish an investment of money, then prong I of the *Howey* analysis obviously loses much of its definitional force.

In note 10, while the Framework observes that "[i]n order to satisfy the 'common enterprise' aspect of the *Howey* test, federal courts require that there be either 'horizontal commonality' or 'vertical commonality,'" the footnote goes on to say that "[t]he Commission, on the other hand, does not require vertical or horizontal

[3] E.g., *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (SEC lacked power to regulate most hedge funds); *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996) (viatical settlement contracts are not securities because profits from their purchase do not derive predominantly from efforts of others); *The Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (SEC lacked authority to require national securities exchanges to ban listing companies with disparate common-stockholder voting rights).

[4] E.g., Token Taxonomy Act, H.R. 7356, 115th Cong. (2018).

[5] E.g., *Balestra v. ATBCoin LLC, et al.*, Civ. Act. No. 17-CV-10001 (VSB), 2019 WL 1437160 (S.D.N.Y. Mar. 31, 2019); *SEC v. Blockvest, LLC, et al.*, Civ. Act. No. 18-CV-2287-GPB(BLM), 2019 WL 625163 (S.D. Cal. Feb. 14, 2019).

[6] E.g., SEC Press Release 2017-227, *Company Halts ICO After SEC Raises Registration Concerns* (Dec. 11, 2017), https://www.sec.gov/news/press-release/2017-227; SEC Press Release 2018-8, *SEC Halts Alleged Initial Coin Offering Scam* (Jan. 30, 2018), https://www.sec.gov/news/press-release/2018-8.

[7] https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

commonality per se, nor does it view a 'common enterprise' as a distinct element of the term 'investment contract.'" Despite the words chosen by the *Howey* Court to articulate and limit its holding, the Framework seems to be saying that it is unnecessary to establish a common enterprise in order to find an investment contract, suggesting that prong II of the *Howey* analysis is irrelevant. With prongs I and II effectively excised from the *Howey* test, it is unsurprising that the Framework implies that these prongs can be ignored in digital-asset *Howey* analyses.

It may not be safe to assume that the federal courts will dispatch prongs I and II with the alacrity of the Framework. In appearing to water down the investment-of-money prong, FinHub may have drawn on long-standing interpretations of the Securities Act term "sale" indicating that for the sale of a security to take place, virtually any form of consideration, whether or not monetary, is sufficient.[8] These cases however did not face the question of whether the subject of the sale was in fact a security — in cases interpreting the meaning of "sale," an asset's status as a security (usually common stock) was a given. *Howey*, on the other hand, asks for more than just common-law consideration in order to distinguish securities transactions from transactions not subject to Securities Act regulation, as later courts have recognized. The Ninth Circuit explained it thusly: "an investment of money" means that "the investor must commit his assets to the enterprise in such a manner as to subject himself to financial loss."[9] While securities undoubtedly *may* be sold for non-monetary consideration, the *Howey* Court identified the receipt of monetary consideration — capital formation — as a key factor typifying how Congress conceptualized a securities transaction. If monetary consideration means *any* form of consideration, then prong I of the *Howey* analysis would be of minimal help in distinguishing transactions regulated by the Securities Act from other investment and commercial transactions generally.

Admittedly, prong II has confounded the federal courts since *Howey* was announced, with judges divided over whether commonality of the "horizontal,"[10] "broad vertical"[11] or "strict vertical"[12] variety is required to satisfy the *Howey* test. But this divergence of interpretations would not justify ignoring prong II. Indeed, one of the strongest arguments that Bitcoin is not a security (a result concurred in by the SEC staff)[13] is its failure to exhibit commonality, however one defines the term. Bitcoin "miners" compete with one another and so cannot be said to be in horizontal commonality with one another, since one miner's gain is another's foregone opportunity. And given the decentralization of the Bitcoin network, there is no upstream manager, promoter, or other entity for miners to be in vertical commonality with, whether broad or strict. It is precisely these characteristics that make Bitcoin easier to analogize to a commodity like gold than to a security like common stock, a circumstance that should underscore the importance and utility of prong II if the *Howey* test is meant to be a tool for differentiating between those valuable assets that are regulated by the federal securities laws and those that are not.

HOWEY PRONGS III AND IV

As noted above, the Framework focuses nearly exclusively on prong III (expectation of profits) and prong IV (managerial or entrepreneurial efforts of others). While much of the analysis of these two prongs is consistent with previous Commission statements, there are a few indications that the staff may be seeking to expand the range of activities and circumstances that satisfy these two prongs.

First, the Framework introduces the concept of an "Active Participant" or "AP," and defines it as "a promoter, sponsor, or other third party (or affiliated group of third parties)" that may provide "essential managerial efforts that affect the success of the enterprise." When "investors reasonably expect to derive profits from those efforts," the Framework states that both prongs III and IV of *Howey* are met. Since prongs I and II are essentially irrelevant under the

[8] E.g., SEC Press Release 99-83, *SEC Brings First Actions to Halt Unregistered Online Offerings of So-Called "Free Stock"* (Jul. 22, 1999), https://www.sec.gov/news/headlines/webstock.htm; SEC Division of Corporation Finance, *Staff Legal Bulletin No. 4 (CF)* (Sep. 16, 1997), https://www.sec.gov/interps/legal/slbcf4.txt.

[9] *Hector v. Wiens*, 533 F.2d 429, 432 (9th Cir. 1976); *see also Gary Plastic Packaging v. Merrill Lynch et al.*, 756 F.2d 230, 239 (2d Cir. 1985).

[10] E.g., *SEC v. Infinity Grp. Co.*, 212 F.3d 180, 188 (3d Cir. 2000).

[11] E.g., *Long v. Shultz Cattle Co., Inc.*, 881 F.2d 129, 140 (5th Cir. 1989).

[12] E.g., *SEC v. SG Ltd.*, 265 F.3d 42, 49 (1st Cir. 2001).

[13] William Hinman, Director, SEC Division of Corporation Finance, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto (Jun. 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418.

Framework, this alone is enough to yield a regulated securities transaction under the Framework. The Framework then pushes the AP concept further by referring to the possible emergence of a "successor AP" at some point in the future. By including third parties, groups, and their successors under the AP rubric, the Framework introduces the possibility that the staff will locate a security even when, after the initial distribution of a non-security digital asset, a previously uninvolved individual, entity, or group begins to influence the development of the asset or its network in a manner the regulator can characterize as managerial or entrepreneurial. The Framework cites no authority for this expansion of the *Howey* test, and it is difficult to conceive of how it would work in practice. How, for example, will these third parties realize when they incur registration and reporting obligations? At what point do purchasers of digital assets from these third parties acquire Section 12(a)(1) rescission rights? How do other players in the blockchain ecosystem, like digital-asset trading platforms, figure out that they are suddenly engaged in activities requiring SEC licensing?

Second, in its discussion of investors' reasonable expectations surrounding an AP's efforts, the Framework places emphasis on the amount of the digital asset retained by the AP, reasoning that if the AP "has the ability to realize capital appreciation from the value of the digital asset," then purchasers would reasonably expect the AP to expend efforts to enhance the value of the asset or its associated network. Coupled with the breadth of the AP concept, there seems to be a chance that the staff would find a security simply because a third party, who becomes active in the development of the network, amasses a substantial holding in the digital asset. A development like this certainly cannot be ruled out, given the democratic, enthusiastic, and at times passionate and raucous communities that naturally coalesce around promising new blockchain technologies.

Third, the Framework evinces a marked suspicion of any digital asset that does not depreciate or does nothing more than hold its value, or indeed of any asset that might have investment appeal. While it is undoubtedly true that investors buy securities with the hope that they will increase in value or, at the very least, not lose value, this characteristic of a security does not distinguish it from many other kinds of assets, least of all other investable assets. Under the Framework, the increase in value of a digital asset merely because its native network becomes more robust could point to the finding of a security.[14] Although the Framework acknowledges that capital appreciation arising "solely" from external market forces is not "generally" considered profit under *Howey*,[15] it nevertheless seems to recast *Howey* as a means to distinguish between non-investable assets and investable assets, rather than between investable assets that are securities, and assets (investable and otherwise) that are not securities.

SLOUCHING TOWARDS *RALSTON PURINA*

The Supreme Court decided in 1953 that the meaning of "public offering," left undefined in the Securities Act, "should turn on whether the particular class of persons affected needs the protection of the Act."[16] According to the Court in *SEC v. Ralston Purina Co.*, "[a]n offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'" In other words, it doesn't matter how many people one contacts or how they are contacted: a securities placement is a "public offering," and subject to registration under the Securities Act, if the people appealed to need the informational and other benefits of Securities Act registration. Applying this reasoning, the Court held that the feed manufacturer should have registered a common-stock offering that it made available only to its employees. While a more straightforward exercise in motivated reasoning would be hard to find, this was probably appropriate in context, and the U.S. securities markets are likely a fairer place because of this expansive holding.

The Framework's dismissal of *Howey* prongs I and II, and expansion of prongs III and IV suggest that the staff

[14] "The more the following characteristics are present, the more likely it is that there is a reasonable expectation of profit:

footnote continued from previous column…

- "The digital asset gives the holder rights to share in the enterprise's income or profits, or to realize gain from capital appreciation of the digital asset.
- "*The opportunity may result from appreciation in the value of the digital asset that comes, at least in part, from* the operation, promotion, improvement, or *other positive developments in the network*, particularly if there is a secondary trading market that enables digital asset holders to resell their digital assets and realize gains."

Framework, *supra* n.7, text following n.18 (emphasis supplied).

[15] E.g., *SEC v. Belmont Reid & Co., Inc.*, 794 F.2d 1388, 1391 (9th Cir. 1986); *Noa v. Key Futures, Inc.*, 638 F.2d 77, 79 (9th Cir. 1980).

[16] *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953).

is moving away from the circumscribed definition of "investment contract" articulated in *Howey* towards a more expansive concept, reminiscent of the *Ralston Purina* approach, that labels an asset a security when it has investment appeal and is made publicly available on an undifferentiated basis.

It is unlikely that the *Howey* Court intended to compose a definition of "investment contract" that would encompass most investable assets that were not already enumerated in the Securities Act definition of "security," even those that may share some characteristics with what one normally thinks of as a security. It would have been obvious to the Court that not all securities are exchanged for "money," as required by prong I, and one can posit examples of securities that probably do not entail any "common enterprise," however defined, contemplated by prong II — an issue sold to one purchaser would not exhibit horizontal commonality, and a security issued by an unmanaged trust or other special purpose vehicle arguably would not exhibit vertical commonality. On the other hand, the Court could have tightened the definition further by including other typical features of securities — transferability, for example — but it evidently decided not to, and instead struck a balance that fairly captured what it determined Congress must have had in mind. So rather than take a maximalist *Ralston Purina* approach and simply hold that a security exists whenever investors who cannot fend for themselves need information and protection, the *Howey* Court designed a more nuanced test that delineates which sorts of non-enumerated investable assets and transactions are subject to the registration requirements of the Securities Act and which are not.

Prong I of the test narrows the potential universe of investment-contract securities transactions to those that are used for a classic purpose: raising investment capital. Prong II of the test further narrows the universe to those that exhibit another classic, if not ubiquitous, characteristic of securities transactions: the pooling together of investor funds (horizontal commonality) or the establishment of a strong link between the fortunes of passive investors and the fortunes of active promoters (vertical commonality). Simply reading these requirements out of the *Howey* test risks expanding the definition of "investment contract" to encompass a wide variety of investable assets that the *Howey* Court apparently did not think Congress intended to sweep under the aegis of the federal securities laws — even if an investor arguably might benefit from the securities regulatory scheme. Precious metals and gems, furniture and antiques, fine art, real estate, racehorses, stamps, coins and other collectibles, jewelry and timepieces, foreign currencies and other commodities — all of these assets offer the investor an expectation of profits and the value of any such asset may well be affected by the activities of third parties — think of the role of gallerists and auction houses in the art world, jockeys and trainers at the racetrack, and architects and developers in the world of real estate. Focusing only on prongs III and IV — and indeed *expanding their compass* — thus opens the door to finding a wide array of investable assets to be securities.

One might ask: And what is wrong with that? Wouldn't it be better if purchasers received full and fair disclosure of the risks whenever they acquire an asset that they might not fully understand? This is certainly an appropriate legislative policy choice, but according to the *Howey* Court, it is not the policy choice Congress made in 1933. A more specific concern when dealing with digital assets is that labeling a digital asset a security for purposes of the federal securities laws is, today, effectively a death knell for the asset and its commercial utility. Today there are no U.S. trading venues or clearing agencies for digital-asset securities, and several other activities touching digital-asset securities would be subject to licensing and regulation. Even if sales of a digital asset were registered under the Securities Act (something that has not yet happened), there would be no secondary-market trading exemption from state blue sky laws. So, at least as matters currently stand, a determination by the SEC staff that a particular digital asset is a security would likely deal a severe blow to the commercial prospects for the digital asset along with its native network and technology.

The Commission and its staff are facing significant stakes, and they are appropriately biased towards the protection of investors in a risky asset class that today lacks a statutorily designated regulator. And when Main Street investors lose large sums of money in a scam involving crypto (or pseudo-crypto) assets, the House Financial Services and Senate Banking Committees will have no qualms calling SEC commissioners and officials up to Capitol Hill to grill them in front of the camera, despite Congress having done virtually nothing to clarify regulatory responsibility for this new asset class, and despite *Howey* placing substantive limits on the Commission's ability to regulate sales of investable assets that do not meet its test. What appears to be the Framework's reshaping and expansion of the *Howey* test is therefore understandable, whether or not at the end of the day it is fully subscribed to by the federal courts. ■