This Article examines the applicability of the federal securities laws to digital currencies. Although some enforcement actions have been brought by the SEC, digital currency transactions remain largely unregulated. The securities laws contain a broad definition of what constitutes a security. Finding a security to exist triggers many regulatory provisions of the securities laws. There is considerable case law interpreting the now well-developed test for what constitutes an "investment contract" leading to the finding that a security exists. However, to date, there is sparse authority applying the securities laws to virtual, digital, or crypto currencies. This article examines the investment contract analysis and concludes that initial coin offerings and many, if not most, digital currency transactions involve securities and therefore are subject to SEC jurisdiction and to the jurisdiction of state securities administrators. The article then outlines the regulatory consequences of applying the securities laws to digital currency transactions.

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I. INTRODUCTION AND BACKGROUND

Over the years, a wide variety of nontraditional investments from orange groves to earthworms and scotch whiskey have been held to be securities. But what about virtual, digital, or crypto currency (hereinafter collectively referred to as crypto currency)?

During the seventeenth century, speculation resulted in the infamous tulip bubble. The lessons for virtual, digital, or crypto currencies should not be ignored. The tulip bubble has been summarized as follows:

One of the largest speculative bubbles began in 1593 when tulips were brought to Holland, and over time, the tulips began to contract viruses that made flame-like colors appear on the bulbs. Tulips with flame-like color patterns were trading at much higher values than the unaffected bulbs, and by the 1630s, everyone in Holland began trading the bulbs; tulip-mania was born. Actual price data from the 1630s is scarce, but the Rijksmuseum (the Museum of the Netherlands) claims that traders were putting up their houses as collateral to secure tulip bulbs. The price of the tulips during this period was not an accurate representation of what

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1 See, e.g., SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (holding that an orange grove can be considered a security); SEC v. Haffenden–Rimar Int’l., Inc., 362 F. Supp. 323 (E.D. Va. 1973), aff’d, 496 F.2d 1192 (4th Cir. 1974) (holding that scotch whiskey can be considered a security); In re Worm World, Inc., 3 Blue Sky L. Rep. (CCH) ¶ 71,414 (S.D. Dep’t. of Comm. & Consumer Aff. 1978) (holding that earthworms can be considered securities). For a more complete taxonomy of investments that have been held to be securities, see 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1:49 (7th ed. 2016).

2 See, e.g., CHARLES MACKAY, MEMOIRS OF EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS (1841) (discussing the tulip bubble).
the bulbs were actually worth, and once some investors decided to sell, the price of bulbs began to fall. When this happened, other investors sold their tulips to avoid even bigger losses, and the bubble burst.\(^3\)

As compared to crypto currencies, tulips at least have some intrinsic value.\(^4\) In light of the massive investor losses that have occurred and are likely to continue to result from virtual or crypto currencies, appropriate regulation is necessary.\(^5\)

The securities laws’ definition is expansive because of its inclusion of “investment contract” in the statutory definition\(^6\) and the courts’ interpretation of that phrase.\(^7\) This article concludes that


\(^4\) Alex Hern, Bitcoin hype worse than ’tulip mania’, says Dutch central banker, GUARDIAN (Dec. 4, 2013), https://www.theguardian.com/technology/2013/dec/0 4/bitcoin-bubble-tulip-dutch-banker (quoting former Dutch Central Bank president: “This is worse than the tulip mania,’ he continued. ‘At least then you got a tulip [at the end], now you get nothing.”” (alteration in original)).


under most, if not all, circumstances, crypto currencies are likely to be securities. This article also explains the consequences under the securities laws of classifying a crypto currency as a security.

II. BACKGROUND – THE DEVELOPMENT OF CRYPTO CURRENCIES

Crypto currencies are essentially computer code that enables their use as digital currencies. Bitcoin became the first widely used decentralized digital currency. Other virtual currencies followed. Bitcoin’s purpose was to create a peer-to-peer version of electronic cash to allow for secure online payments without the need for third-party intermediaries such as banks. In order to avoid double-spending of the same crypto token, public ledgers provide a basis for authenticating the currency and to confirm that the funds being transferred existed in the amount and manner specified.

Crypto currencies consist of blockchains. A blockchain is a distributed record made of up of processed batches of transactions, and each processed batch is referred to as a block. The blocks are sequenced, and each block has data associated with it that is the result of all the blocks before it. Therefore, the blocks are in this way related, or chained, in a manner such that any one change to the history would be highly evident, because the subsequent blocks will

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9 See id. at 1.


change as a result.\footnote{For a general discussion of the technology, see Deborah Ginsberg, The Building Blocks of Blockchain, 20 N.C. J.L. & Tech. (forthcoming May 2019). See also, e.g., Lawrence J. Trautman & Mason J. Molesky, A Primer for Blockchain, UMKC L. Rev. (forthcoming 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3324660.} A new transaction is added to the existing blockchain when a computer on the crypto currency’s network verifies that the transaction is legitimate. All of the computers on the crypto currency’s network have access to the blockchain, back to the first transaction, and it is continually updated by passing the new blocks to other users in the network. A crypto coin file is given a unique serial number when a transfer is requested. The new serial number is broadcasted to all other computers in the crypto coin network who then work to decode the new serial number which verifies that the crypto coin’s transferor in fact owns the coin being transferred and has not already transferred that coin to someone else. A verified transaction becomes the latest block in the blockchain. The transactions are secured through public-key encryption. Essentially, two mathematically-related keys are generated: the private key is for the individual and the other key is made public to help encode payments. The private key is used to retrieve those payments and to approve transfers.

Blockchain technology removes the need for the third-party because the technology itself verifies the transactions by allowing for secure electronic transactions without having a centralized ledger or the concern of double-spending.\footnote{See NAKAMOTO, supra note 8, at 8; see also, e.g., How Bitcoin Works, BITCOIN, https://en.bitcoin.it/wiki/How_bitcoin_works (last visited June 4, 2018); J.P., Virtual Currency: Bits and Bob, ECONOMIST (June 13, 2011), http://www.economist.com/blogs/babbage/2011/06/virtual-currency.} The blockchain works through the parties of the transaction broadcasting that transaction to the network and then requiring the network to validate the transaction through a “proof-of-work” validation system.\footnote{See Kiviat, supra note 11, at 578.} The proof-of-work validation system is a competition between crypto coin network participants to validate the transactions and is otherwise known as “mining.”\footnote{Nikolei M. Kaplanov, Nerdy Money: Bitcoin, the Private Digital Currency, and the Case Against Its Regulation, 25 LOY. CONSUMER L. REV. 111, 119 (2012);} Mining verifies the transaction and
removes the need for the third-party intermediary. Verifying a crypto transaction involves a race between computers in the network to solve a very difficult algorithm problem with the winner receiving the crypto currency as compensation. Solving the problem verifies that a transaction is valid, and the winner records the transaction onto the blockchain. Mining is important because it is how the network deems a new block or transaction valid.

Traditionally, a true currency is backed by a sovereign state, and thus crypto currencies do not qualify under the traditional definition. Nevertheless, crypto currencies have been described as alternatives to true currency. So long as they remain volatile with wild price swings this is unlikely to happen. However, when a nation has an unusually volatile currency, crypto currencies may have some traction as a currency substitute.

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17 J.P., supra note 13 (describing crypto currency). Additionally, mining helps the network police itself. In order for a fraudster to doctor and validate blocks they would have to control more than half of the network’s mining capacity. Finally, mining increases the number of crypto coins within the total supply. Blocks in the network are created at a constant rate with a set number of crypto coins created per block which increases the number of crypto coins in circulation.

18 See, e.g., 31 C.F.R. § 1010.100(m) (2016) (FinCen’s definition); see also, e.g., What is Fiat Money?, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/economics/fiat-money-currency/ (last visited Feb. 22, 2019) (discussing the difference between commodity backed currency and fiat currencies backed by government).


The SEC is not the only federal regulator who has a role to play with respect to crypto currencies. There are a number of other potential regulators for the crypto currency markets. For example, the Commodities Futures Trading Commission (CFTC) regulates virtual currency transactions as commodities. The United States Treasury Department’s Financial Crimes Enforcement Network (“FinCEN”) also comes into play as may the banking regulators. In addition, the states have entered the crypto currency regulatory arena.


24 See, e.g., FIN-2013-G001, supra note 21.

It can of course be argued that since it is a medium of payment which can be used in commerce, investment in a crypto currency is based on its use as a currency rather than as an investment for profit. However, there are multiple examples of crypto currencies not being classified as currency. For example, FinCEN determined that crypto currency is not a currency since it is not “legal tender.”\textsuperscript{26} The IRS has concurred,\textsuperscript{27} as has the CFTC.\textsuperscript{28} At least one court has expressly indicated that notwithstanding Bitcoin’s use as a currency, it was a security.\textsuperscript{29} As discussed more fully in the sections that follow, the SEC has initiated action against other crypto currencies by characterizing them as securities.\textsuperscript{30}

\begin{footnotesize}
\begin{enumerate}
\item See FIN-2013-G001, supra note 21.
\end{enumerate}
\end{footnotesize}
III. DEFINITION OF “SECURITY;” THE HOWEY TEST AND THE RISK CAPITAL ANALYSIS

A. The Statutory Definition

The federal securities laws provide a fairly lengthy definition of “security.”31 The statutory definition includes specific items such as stock and also includes the broad term “investment contract.”32 The definition of securities under the Securities Act of 1933 (“1933 Act”) and the Securities Exchange Act of 1934 (“1934 Act”) are “virtually identical.”33 State securities laws contain a similar definition and by and large have adopted the federal courts’ interpretations of what constitutes a security.34 Section 2(a)(1) of the 1933 Act provides:

(a) When used in this subchapter, unless the context otherwise requires—
(1) The term “security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for,
guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.\textsuperscript{35}

Although the statutory definition includes the term “investment contract,” Congress chose not to define that term and therefore left its interpretation to the courts. The “investment contract” rubric thus provides the context for determining whether unconventional investments fall within the securities laws’ definition of security. As mentioned above, a number of nontraditional investments have been held to be securities. The existence of an investment contract depends not so much on what is actually being offered or sold, but as on \textit{how} it is being offered and sold and the expectations of investors based on marketing, promotion, and the realities of the markets where the investment transaction takes place.\textsuperscript{36}

In analyzing whether something is a security, the focus is on substance rather than form. Thus, whether or not a particular investment vehicle falls within the definition of security depends on the economic reality of the transaction.\textsuperscript{37} As a result, the fact that crypto currency is described as a coin or currency is beside the point.

\textsuperscript{35} 15 U.S.C. § 77b(a)(1) (2018) (emphasis added). Although not the primary focus of this article, it is worth noting that crypto currencies clearly fall within the definition of commodity under the Commodity Exchange Act, which provides:

\begin{quote}
(9) Commodity
The term “commodity” means wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions (as provided by section 13-1 of this title) and motion picture box office receipts (or any index, measure, value, or data related to such receipts), and all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in.
\end{quote}


\textsuperscript{37} See, e.g., United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975) (“Congress intended the application of these statutes to turn on
B. The Howey Test

The 1946 decision of the United States Supreme Court in SEC v. W. J. Howey & Co.,38 established the test for determining when an investment contract exists so as to classify an investment as a security. Although the Howey test has been refined in the more than seventy years since it was first announced, it remains the guiding principle. The Court’s opinion set forth that “[a]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party.”39 The investment of “money” includes the investment of anything of value such as property or services.40 It seems clear that crypto currency involves an upfront investment of money or something of value.

The common enterprise requirement focuses on the question of the extent to which the success of the investor’s interest rises and falls with others involved in the enterprise.41 Crypto currency has no inherent value beyond what others are willing to pay for it or value it as. Thus, the common enterprise element seems to be satisfied. As

the economic realities underlying a transaction, and not on the name appended thereto.”); Tcherepnin, 389 U.S. at 336 (“[I]n searching for the meaning and scope of the word ‘security’ in the Act(s), form should be disregarded for substance and the emphasis should be on economic reality.”); SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946) (holding that the profitability of the orange groves was in economic reality dependent upon using the promoter’s management contract).

38 W.J. Howey Co., 328 U.S. at 293.
39 Id. at 298–99.
41 See, e.g., SEC v. Eurobond Exchange, Ltd., 13 F.3d 1334, 1339 (9th Cir. 1994) (“A common enterprise is a venture ‘in which the “fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment . . . .’”) (quoting SEC v. Goldfield Deep Mines Co. of Nevada, 758 F.2d 459, 463 (9th Cir. 1985)); Brodt v. Bache & Co., 595 F.2d 459, 460 (9th Cir. 1978); SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 n.7 (9th Cir. 1973), cert. denied, 414 U.S. 821 (1973).
discussed below, the main points of controversy as to whether crypto currencies are securities revolves around the profit expectation and whether that profit is to be derived from the efforts of others. A substantial profit motive is sufficient to support this aspect of the Howey test, even if it is not the only factor motivating investors. Although the Supreme Court in Howey spoke in terms of the requirement that the profits be secured “solely” from the efforts of others, the interpretation in subsequent federal cases only requires that the profits be expected to be derived primarily or “substantially” from the efforts of others.

In addition to the Howey factors, courts have looked to the presence or absence of another applicable regulatory regime in order to determine whether an investment contract and, thus a security, exists. In a close case, the presence of a regulatory scheme covering the investment in question mitigates against classifying the investment as a security. Conversely, the absence of a parallel regulatory scheme to reduce risk will mitigate in favor of finding a security. Although there is some regulation of crypto currency exchanges that register as money transmitters, that regulation does

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43 See 1 HAZEN, supra note 1, § 1:54 (discussing the profit requirement of the Howey test).

44 W.J. Howey Co., 328 U.S. at 298–99.

45 See, e.g., Webster v. Omnitrition Int’l, Inc., 79 F.3d 776, 781 (9th Cir. 1996); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974); Glenn W. Turner Enter., Inc., 474 F.2d at 482.

46 See, e.g., Reves v. Ernst & Young, 494 U.S. 56, 67 (1990) (stating one of the factors as “whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary”); Marine Bank v. Weaver, 455 U.S. 551, 557 (1982) (noting existence of bank regulation as a factor in holding that a bank issued certificate of deposit is not a security).

47 See, e.g., Reves, 494 U.S. at 67; Marine Bank, 455 U.S. at 557.

48 Reves, 494 U.S. at 58 (noting short term note was a security notwithstanding the exclusion in the 1934 Act for short term commercial paper).

49 See, e.g., FIN-2013-G001, supra note 21; see also DEP’T OF TREASURY, FIN. CRIMES ENF’T NETWORK, FIN-2014-R007, APPLICATION OF MONEY SERVICES BUSINESS REGULATIONS TO THE RENTAL OF COMPUTER SYSTEMS FOR MINING VIRTUAL CURRENCY (2014), https://www.fincen.gov/sites/default/files/administ
not involve investor protection. This absence of other investor protection regulation weighs in favor of classifying crypto currencies as securities. It is worth noting, however, that Heather Peirce, one of the current SEC Commissioners, believes that the Howey test may need to be modified in its application to crypto currency but she seems to concede that Congressional action would be necessary to do so.50

C. The Risk Capital Analysis

An alternative to the Howey test developed under state securities laws containing the investment contract language has been favorably acknowledged in some federal decisions.51 This risk capital analysis is not as limiting as the Howey test since it is not bound to the four Howey factors discussed in the previous section. As explained by a California case that found country club founder interests to be securities:

It bears noting that the act extends even to transactions where capital is placed without expectation of any material benefits . . . . Since the act does not make profit to the supplier of capital the test of what is a security, it seems all the more clear that its objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another . . . . Properly so, for otherwise it could too easily be vitiated by inventive substitutes for conventional means of raising risk capital.52


52 Silver Hills Country Club, 5361 P.2d at 908–09. In Tanenbaum v. Agricapital, Inc., 885 F.2d 464 (8th Cir. 1989), the court conducted a risk capital
The risk capital approach can be defined in terms of four factors. The risk capital analysis will result in the finding of an investment contract when (1) the investor provides initial value to the enterprise; (2) the initial value is subject to the risks of the enterprise; (3) the initial value is induced by representations leading to a reasonable understanding that the investor will realize a valuable benefit beyond the initial value; and (4) the investor does not exercise practical and managerial control over the enterprise. It is possible for this risk capital analysis to classify investments as securities that might not satisfy each prong of the Howey test.

As noted above, the risk capital analysis is established under the law of many states and there is some discussion and support in the federal courts as well. For example, one federal court commented that it is unsettled whether the risk capital test applies to “only original ‘start-up’ capitalization or whether it also extends to transactions connected with subsequent capitalization.” Even with

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analysis when applying state law and examining whether cattle embryo contract was the sale of a security was a question of fact. See generally id.
54 Id. (“An investment contract is created whenever: (1) an offeree furnishes initial value to an offeror, and (2) a portion of this initial value is subjected to the risks of the enterprise, and (3) the furnishing of the initial value is induced by the offeror’s promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind over and above the initial value will accrue to the offeree as a result, of the operation of the enterprise, and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.”); Ronald J. Coffey, The Economic Realities of a “Security”: Is There a More Meaningful Formula?, 18 W. RES. L. REV. 367 (1967).
such a limitation on the risk capital test, it would clearly include an ICO since an ICO functions as a start-up investment.

Other federal cases have discussed the risk capital analysis with apparent approval. However, it is at least questionable whether the risk capital analysis has had success under federal law where the Howey test would fail to find a security. Nevertheless, the more expansive risk capital analysis can trigger state securities law consequences for transactions not satisfying the four-pronged Howey test. In the event that the federal courts and SEC do not embrace the broader risk capital analysis, it remains viable for state securities administrators pursuing cryptocurrency transactions. Thus, it is conceivable that states will assert jurisdiction over cryptocurrencies as securities in instances where the SEC does not.

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58 See, e.g., Simon Oil Co. v. Norman, 789 F.2d 780, 781–82 (9th Cir. 1986) (relying on cases using the risk capital analysis to find oil and gas drilling interests were securities); Union Planters Nat’l Bank v. Commercial Credit Bus. Loans, 651 F.2d 1174, 1181–82 (6th Cir. 1981) (applying risk capital analysis but finding that a loan participation agreement with a bank was not a security); Parvin v. Davis Oil Co., 524 F.2d 112, 114–16 (9th Cir. 1975) (using risk capital analysis to find undivided interests in oil and gas drilling were securities); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 477 n.7 (5th Cir. 1974) (discussing risk capital analysis favorably); Bitter v. Hoby’s Int’l., Inc., 498 F.2d 183, 185 (9th Cir. 1974) (applying risk capital analysis but finding franchise arrangement was not a security); Home Guar. Ins. Corp. v. Third Fin. Servs, Inc., 667 F. Supp. 577 (M.D. Tenn. 1987) (applying risk capital analysis but finding mortgage loans and guarantees not to be securities); Brockton Sav. Bank v. Peat, Marwick, Mitchell & Co., 577 F. Supp. 1281 (D. Mass. 1983) (applying risk capital analysis but finding that federally insured certificates of deposits were not securities); SEC v. Glen W. Turner Enters, Inc., 348 F. Supp. 766, 773–74 (D. Or. 1972), aff’d, 474 F.2d 476 (9th Cir. 1973) (“The spread of the risk capital theory from the state in which it was first applied to other states and the favorable comment with which it has been received make it an appropriate test to look to for determining what is ‘commonly known as a security.’”).

IV. CRYPTO CURRENCY AS A SECURITY

Although some have argued that crypto currencies are not securities,⁶⁰ the better view is that crypto currency transactions often, if not generally, are subject to the securities laws.⁶¹ In 2017, the SEC issued a report concluding that in many circumstances, offers and sales of crypto currencies will be securities transactions and thus subject to the SEC regulatory regime.⁶² The court cases on point agree that crypto currencies can be characterized as securities. In SEC v. Shavers,⁶³ the district court held that Bitcoin was a security even though the court acknowledged that it could be used as a currency as well.⁶⁴ In United States v. Zaslavskiy,⁶⁵ the district court upheld the sufficiency of an indictment charging securities fraud in connection with an ICO (Initial Coin Offering).⁶⁶ The court in Zaslavskiy found the allegations were sufficient to uphold the claim that the crypto currency in question was a security under the test established by SEC v. Howey and its progeny.⁶⁷ The court in Zaslavskiy noted, however, that ultimately the question of whether the crypto currency is a security would be a question for the jury.⁶⁸

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⁶¹ See, e.g., Yang, supra note 42, at 111 (discussing applicability of the securities laws); see also, e.g., Ethan D. Trotz, Tangled Up in Blue: Adapting Securities Laws to Initial Coin Offerings, 10 ELON L. REV. (Jan. 2019).
⁶⁴ Id. at *2 (“It can be used to purchase goods or services, and as Shavers stated, used to pay for individual living expenses. The only limitation of Bitcoin is that it is limited to those places that accept it as currency. However, it can also be exchanged for conventional currencies, such as the U.S. dollar, Euro, Yen, and Yuan. Therefore, Bitcoin is a currency or form of money . . . .”).
⁶⁶ Id. at *1. The indictment was based on alleged violations of the SEC’s general antifraud proscription found in section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder. 15 U.S.C. § 78j(b) (2018); 17 C.F.R. § 240.10b-5 (2018).
⁶⁸ Id. But cf. Pettersson, supra note 29 (federal court denied preliminary injunction against digital coin offering to 32 “test investors”).
As noted above, it has been argued by some that crypto currencies are not securities because of the requirement of a profit expectation and that the profit is to be derived from the efforts of others.\(^6^9\) It has been argued that because it is a currency which can be used in commerce, investment in a crypto currency is based on its use as a currency rather than as an investment for profit.\(^7^0\) However, the wild fluctuations in value and investor expectations undermine the claim that it is a currency rather than a security. Furthermore, there is evidence that a majority of transactions in crypto currencies are for investment or speculation rather than for barter.\(^7^1\) Also, as observed earlier, crypto currencies have no inherent value.\(^7^2\) Additionally, the value of a derivative currency is not derivative of a commodity, security, or anything else that has inherent value. Accordingly, the value of, and potential profit from, the currency is dependent upon others promoting and facilitating a market for the currency. This satisfies the Howey requirement that the profit be derived from the efforts of others.

An ICO is the crypto currency’s counterpart to an initial public offering (“IPO”) of securities.\(^7^3\) There is no doubt that ICOs have

\(^6^9\) See, e.g., Yang, supra note 42, at 111.

\(^7^0\) See, e.g., Alberts & Fry, supra note 60.


\(^7^2\) See supra text accompanying note 4.

raised a number of problems. For example, according to one study, half of ICOs are followed by the demise of the currency within a four-month period. The enhanced hazards of ICOs as compared to after-market crypto transactions are not by themselves a reason to reach different conclusions as to the applicability of the securities laws. Nevertheless, an SEC official indicated his belief that although ICOs are likely to involve securities, once the ICO is complete, the currency may cease to be a security. However, if a particular type of investment is a security when it is created, there is no precedent for treating it differently in the after-market.

Crypto currencies’ volatility and high risk is beyond question. As noted earlier, the absence of a parallel regulatory scheme to reduce risk is a significant factor in deciding to classify something as a security. Given the high risk of purchasing virtual currency through an ICO or in secondary after-market transactions, the absence of another regulatory scheme argues strongly in favor of classifying virtual and crypto currencies as securities. The SEC has


issued a number of investor alerts cautioning about virtual and crypto currencies and their investment risks.\textsuperscript{78} Consider the analogy to an old-fashioned chain letter or to a Ponzi scheme.\textsuperscript{79} In both instances, something without any inherent value has value pumped into it so long as the participants are willing to contribute and pay the cost of keeping the scheme afloat. The

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{78} Spotlight on Initial Coin Offerings and Digital Assets, SEC: INVESTOR.GOV, https://www.investor.gov/additional-resources/specialized-resources/spotlight-initial-coin-offerings-digital-assets.
\item \textsuperscript{79} As explained in Stuart R. Cohn, The Impact of Securities Laws on Developing Companies: Would the Wright Brothers Have Gotten Off the Ground?, 3 J. SMALL & EMERGING BUS. L. 315 (1999):
\begin{quote}
A Ponzi scheme is one that involves using new investor money to pay older investors a promised interest or other economic return. Investors are not aware of this circular use of invested funds and are falsely led to believe that the economic return is being generated by company operations, which are usually minimal or nonexistent. The term “Ponzi scheme” is derived from the notorious activities of Charles Ponzi in Boston, beginning in December 1919. Ponzi offered investors a 50% return on short-term notes, claiming that his company would earn huge amounts through the international trading of postal coupons. Interest payments were made on a timely basis, causing others to believe in the merits of the company. In fact, no business operations were ever undertaken. Ponzi collected over $14 million within eight months and made payments of approximately $9 million to his investors. The scheme was finally exposed in August 1920 by a Boston newspaper. Ponzi was sentenced to prison, from which he was paroled after three years. Following a second conviction several years later for a real estate fraud, he was deported to Italy and was employed by Mussolini in the Ministry of Finance. See In re Ponzi, 268 F. 997 (D.Mass.1920).
\end{quote}

The “slight” difference between a Ponzi scheme and a pyramid scheme was explained as follows by the First Circuit:
\end{itemize}
\end{footnotesize}

While the terms Ponzi and “pyramid” often are used interchangeably to describe financial arrangements which rob Peter to pay Paul, the two differ slightly. In Ponzi schemes—named after a notorious Boston swindler, Charles Ponzi, who parlayed an initial stake of $150 into a fortune by means of an elaborate scheme featuring promissory notes yielding interest at annual rates of up to 50%—money tendered by later investors is used to pay off earlier investors. In contrast, pyramid schemes incorporate a recruiting element; they are marketing arrangements in which participants are rewarded financially based upon their ability to induce others to participate.

SEC v. SG Ltd., 265 F.3d 42, 50 n.3 (1st Cir. 2001).
moment money stops flowing in from others, the Ponzi scheme collapses. Ponzi schemes clearly fall within the definition of securities.\textsuperscript{80} The same is true with respect to pyramid schemes which also fall within the definition of security.\textsuperscript{81}

ICOs should be treated as public offerings of securities. As noted above, the courts and the SEC agree that ICOs generally are subject to the securities laws.\textsuperscript{82} Among other things, this means that an ICO would be subject to the registration and prospectus delivery requirements of the Securities Act of 1933.\textsuperscript{83}

The foregoing discussion analyzes crypto currencies and ICOs under the two tests used by the courts for determining whether a security exists. ICOs satisfy both the \textit{Howey} test and the more expansive risk capital analysis. Depending on the surrounding circumstances, secondary market transactions in crypto currencies are also likely to be subject to the securities laws.


\textsuperscript{81} SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); \textit{see \textit{e.g.}}, SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973).


In contrast to digital coins that are traded for investments, coins that are strictly limited to use as a currency substitute may avoid securities law consequences. An SEC official has indicated that “[c]losed, fully-functional business ‘ecosystems’ that issue digital tokens through an initial coin offering may be able to avoid having to register their offerings as securities . . .” For example, banking giant JPMorgan is implementing a digital coin to facilitate corporate payments by relying on blockchain rather than slower decentralized public ledgers. True utility tokens having no secondary investment market would likely not qualify as securities. This makes sense to the extent that such purely use-oriented tokens do not have an investment component and are purely operating as a currency substitute.

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86 See, e.g., TurnKey Jet, Ink, SEC No Action Letter, 2019 WL 1554004 (Apr. 3, 2019), https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm (providing that the SEC staff would not treat ICO of utility tokens as securities where 1) the issuer would not use the funds from token sales for operations or product development, 2) the token will have immediate functionality for purchasing the issuer’s services, 3) transfer of the tickets will be restricted to wallets authorized by the issuer, 4) each token throughout its existence will be limited to $1 value in exchange for the issuer’s services, 5) any offer by the issuer to repurchase the tokens would be at a discount from face value (unless pursuant to a court ordered liquidation), and 5) the token will be marketed in a way that emphasizes the token’s functionality rather than the potential for an increase in the token’s market value); Troy A. Paredes & Scott Kimpel, From Orange Groves to Cryptocurrency: How Will the SEC Apply Longstanding Tests to New Technologies, 20 FEDERALIST SOC’Y REV. 56, 60–61 (2019) (discussing utility tokens and the definition of security); Nate Crosser, Comment, Initial Coin Offerings as Investment Contracts: Are Blockchain Utility Tokens Securities?, 67 U. KAN. L. REV. 379, 421–22 (2018) (suggesting that sale of true utility tokens should be viewed as sale of commodities); Max Dilendorf, Rika Khurdayan & Gleb Zaslavsky, INSIGHT: The Dual Nature of ‘Utility’ Tokens and Dual Token Structures, BLOOMBERG L. (Feb. 13, 2019), https://news.bloomberglaw.com/corporate-law/insight-the-dual-nature-of-utility-tokens-and-dual-token-structures.
V. CONSEQUENCES OF CLASSIFYING A CRYPTO CURRENCY AS A SECURITY

A. 1933 Act Registration Requirements

As noted above, as an initial offering of securities, ICOs would have to be registered with the SEC under the 1933 Act. 1933 Act registration involves detailed disclosures about the investment being offered. One of the most significant disclosures for ICOs would be the description of investors’ risk factors. The detailed 1933 Act disclosures are also embodied in statutorily required prospectus disclosures that must be delivered to the investors during the offering process before the securities may be purchased. Preparation of a registration statement is a long and expensive process, requiring detailed disclosures including those relating to investment risks. These disclosures would provide much more detail than investors would be likely to find in a white paper for an unregistered ICO. Thus, for example, full disclosure would assure that the description in the white paper and prospectus would match the actual code and the coins’ or tokens’ intended use. As noted directly above, the disclosures would also include a detailed description of the risk factors in the offering and coins or tokens.

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88 Regulation S-K item 503, 17 C.F.R. § 229.503 (2018) (covering a prospectus summary, including risk factors); see also id., item 303, 17 C.F.R. § 229.303 (2018) (covering management discussion and analysis, which elaborates on the types of risks and uncertainties that must be disclosed and discussed).
89 Securities Act of 1933 § 2(a)(10) (providing the definition of prospectus); id. § 5(b) (providing prospectus delivery requirements); id. § 10 (providing statutory prospectus requirements); 15 U.S.C. §§ 77b(a)(10), 77e(b), 77j (2018).
90 See 1 HAZEN, supra note 1, § 3:6 (discussing the preparation of the registration statement).
91 A white paper is the narrative that describes the coins or tokens being offered. See, e.g., What is a White Paper and How to Write it, COINTELEGRAPH, https://cointelegraph.com/ico-101/what-is-a-white-paper-and-how-to-write-it (last visited Feb. 22, 2019); WHITEPAPER DATABASE (last visited Feb. 22, 2019) (supplying a database of crypto currency white papers).
being offered.\textsuperscript{92} Material misstatements in the registration statement can result in liability, which is strict liability for the issuer of the securities and negligence for other participants in the registration statement.\textsuperscript{93}

The registration process is divided into three periods. Prior to the filing of the registration statement with the SEC (the prefiling period), there are strict limitations on what can be said about the upcoming public offering.\textsuperscript{94} Once the registration statement is filed, there is a statutory twenty-day waiting period,\textsuperscript{95} which generally is considerably longer for an initial offering.\textsuperscript{96} Although statutorily-qualified offers may be made during the waiting period,\textsuperscript{97} sales cannot be made until after the registration statement has become effective.\textsuperscript{98} The SEC has been vigorously pursuing unregistered ICOs.\textsuperscript{99} In addition to SEC enforcement, unregistered ICOs can result in private rights of actions by purchasers of the crypto currencies that should have been registered or that otherwise failed to comply with the 1933 Act’s registration requirements.\textsuperscript{100}

To summarize, absent an exemption from registration with the SEC,\textsuperscript{101} (1) offers to sell may not be made prior to filing the


\textsuperscript{94}1933 Act § 5(c) prohibits offers to sell prior to the filing of the registration statement. 15 U.S.C. § 77e(c) (2018). “Offer to sell” is broadly defined to include any communication reasonably calculated to generate a buying interest. See § 77b(a)(3) (providing the definition of “offer to sell”); Carl M. Loeb, Rhoades & Co., Exchange Act Release No. 5870, 38 S.E.C. 843, 844 (1959); SEC Rule 135, 17 C.F.R. § 230.135 (2018).


\textsuperscript{96}See 1 HAZEN, supra note 1, §§ 2:15, 2:29 (discussing the waiting period).


\textsuperscript{100}Section 12(a)(1) provides a right of rescission to purchasers of securities that were sold in violation of 1933 Act § 5. 15 U.S.C. § 77l(a)(1) (2018).

\textsuperscript{101}Exemptions are found in 1933 Act §§ 3, 4, 15 U.S.C. §§ 77c, 77d (2018). These exemptions are strictly construed and the burden of establishing an
registration statement, registration, offers must comply with the statutory prospectus delivery requirements, and sales cannot be made until the registration becomes effective after the expiration of the statutory waiting period.

B. State Regulation

In addition to SEC consequences, ICOs may implicate state securities laws (also known as blue sky laws). State securities law registration requirements would apply to ICOs unless registered with the SEC under the 1933 Act. State securities administrators have been quite active with respect to crypto currency transactions. For example, the North American Securities Administrators Association (“NASAA”) has flagged ICOs and crypto currency transactions in general as involving a high potential for securities fraud. NASAA also created a task force of state securities administrators to engage in “Operation Cryptosweep” that resulted in more than 200 inquiries or investigations and nearly 50 enforcement actions in more than 40 states.

exemption falls on the person claiming the exemption. See generally 1 HAZEN, supra note 1, ch. 4 (discussing 1933 Act exemptions).


\section*{C. Exemptions from 1933 Act Registration}

Aside from recognizing ICOs as public offerings of securities, there are other 1933 Act issues. For example, what about secondary transactions apart from or in the aftermarket following an ICO?\footnote{See, e.g., Alfredo B. D. Silva & F. Dario de Martino, \textit{Structuring Secondary Token Sales: How to Monetize Digital Tokens Under U.S. Securities Laws}, BLOOMBERG L. (Sept. 18, 2018), https://www.bna.com/insight-structuring-secondary-n73014482631/ (discussing the difference between ICOs and aftermarket transactions).} The 1933 Act’s registration requirements apply absent an exemption. Sections 3 and 4 of the 1933 Act provide exemptions

\cite[actions); see also, e.g., \textit{Cryptocurrencies and Initial Coin Offerings}, N.D. SEC. Dep’t, http://www.nd.gov/securities/enforcement-investment-fraud/cryptoinvestments-bulletin (last visited Nov. 6, 2018).}
that could be applicable to certain crypto currency transactions.\textsuperscript{115} Section 4(a)(1) of the 1933 Act exempts most secondary securities transactions.\textsuperscript{116} As such, even though treated as securities, transactions in crypto currencies between buyers and sellers would not be subject to 1933 Act registration even though they would be subject to the securities laws’ anti-fraud\textsuperscript{117} and anti-manipulation\textsuperscript{118} provisions.

At least in theory, there are some other exemptions from 1933 Act registration that could be used to avoid a full-fledged 1933 Act registration for an ICO. The exemptions for public offerings, which are described below, include offerings exempt under SEC Regulation A,\textsuperscript{119} qualifying crowdfunding offerings,\textsuperscript{120} and intrastate offerings.\textsuperscript{121} In addition, offerings made only to qualified investors can qualify for the exemption for offerings not involving a public offering.\textsuperscript{122} All of these, except potentially the non-public offering exemption, are not suitable for ICOs.

Section 4(a)(2) of the 1933 Act exempts transactions not involving a public offering.\textsuperscript{123} As interpreted by the Supreme Court,

\begin{footnotesize}
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\item[117] See, e.g., 1933 Act § 17(a); 1934 Act § 10(b); SEC Rule 10b-5; 15 U.S.C. §§ 77q, 78j(b) (2018); 17 C.F.R. § 240.10b-5 (2018). 1934 Act Rule 10b-5 prohibits material misstatements and omissions of fact in connection with a purchase or sale of securities and also supports an implied private right of action. See 3 Hazen, supra note 1, § 12:15. Scienter, or the intent to deceive, is an element of any Rule 10b-5 violation. See id. §§ 12:50-12:58. Section 17(a) of the 1933 Act prohibits material misstatements and omissions in connection with the offer or sale of a security. 15 U.S.C. § 77q(a) (2018). Section 17(a) thus applies to fraud by sellers of securities but not by purchasers. Although section 17(a) does not support an implied private right of action, scienter is not required and can be violated by negligent conduct. See Hazen, supra note 1, §§ 12:50, 12:97.
\item[118] See, e.g., 1934 Act §§ 9, 10(b), 15 U.S.C. §§ 78i, 78j(b) (2018).
\end{enumerate}
\end{footnotesize}
a non-public offering involves an offering to sophisticated investors who are able to fend for themselves. Accordingly an ICO offered and sold only to qualifying investors would be exempt from the 1933 Act registration requirements applicable to public offerings. This would include an offering solely to “accredited investors”—a concept that includes high wealth individuals. Therefore, private placements of ICO’s remain a viable option. However, if a public market develops in the wake of a private placement, the 1933 Act registration requirements likely would be implicated. In addition, 1933 Act section 4(a)(5) and SEC Rule 504 provide simpler exemptions for nonpublic offerings up to $5 million, provided the offering is made solely to accredited investors. The Rule 504 and section 4(a)(5) limited offering exemptions are simpler than the nonpublic offering exemption under section 4(a)(2) or Rule 506 because those latter exemptions are likely to have additional limitations on the qualification of investors necessary for an exempt transaction. On the other hand, the non-public offering exemption

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125 Accredited investor includes individuals with a net worth of at least $1 million or an annual income of $200,000 (or joint annual income of $300,000). See SEC Rule 501(a)(1), 17 C.F.R. § 230.501(a)(1) (2018).
128 See generally HAZEN, supra note 1, § 4:64–4:88 (providing an overview of the non-public offering exemption).
132 For example, the exemption for transactions not involving a public company require a showing of access to information and the investors’ ability to fend for themselves. See, e.g., SEC v. Ralston Purina Co., 346 U.S. 119 (1953) (setting forth the requirements for the § 4(a)(2) exemption). See generally HAZEN, supra note 1, §§ 4:64–4:88.
under Rule 506 results in automatic preemption of any state securities law registration requirements.  

Another exemption from 1934 Act registration is found in SEC Regulation A for offerings up to $50 million. Regulation A offerings operate much like a registered offering in that there is a required disclosure document and a waiting period after the disclosures are filed with the SEC until the effective date when sales may be made. Thus, any attempt to use Regulation A for an ICO would involve disclosures that are absent from other unregistered ICOs.

A third at least theoretical, exemption would be the use of crowdsourcing for ICOs. Section 4(a)(5) of the 1933 Act provides an exemption from registration for offerings up to $1 million. The low dollar ceiling may render the crowdfunding exemption undesirable for ICOs. Although significantly less detailed than Regulation A or registered offerings, the crowdfunding exemption is conditioned on minimal disclosures. Another requirement for any crowdfunding offering is that the website or portal for the offering must be registered with the SEC.

A final exemption worth mentioning is the intrastate offering exemption. The statutory exemption for offers made solely within the borders of a single state requires that the issue be organized in and the business be substantially confined to that state. One practical difficulty is how to conduct an intrastate offering over the internet which by its very nature crosses state lines. The intrastate exemption provided in SEC Rule 147A not only avoids the

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135 17 C.F.R. § 230.251(a) (2018). Regulation A offers two tiers—offerings up to $20 million (tier 1) and offerings up to $50 million (tier 2). The primary difference between the two tiers is the level and detail of required disclosures.
requirement that the issuer of the securities be organized in the state of the offering, but it also allows offers beyond the state’s borders so long as out of state investors are excluded from the offering.141 If an intrastate ICO is economically viable, there could thus be an exemption from 1933 Act registration. However, the laws of most states would require that such an offering be registered under the applicable state blue sky law.

The discussion above shows that the theoretically available exemptions for 1933 Act registration would likely not be feasible for an ICO. Furthermore, even if such an exemption could be used, it would only be an exemption from 1933 Act registration and would not impact the other consequences of an investment being classified as a security. Those consequences are discussed in the section that follows.

D. Other Consequences of Classifying Crypto Currency as a Security

Classifying a crypto currency as a security has a number of consequences beyond the 1933 Act’s registration requirements. The SEC has brought enforcement actions based on ICOs as unregistered securities offerings.142 The securities laws’ anti-fraud143 and anti-manipulation144 provisions would apply to all crypto transactions. Virtual and crypto currencies are particularly ripe for manipulation. For example, virtual and crypto currencies have been susceptible to classic “pump and dump” manipulation.145 The SEC has noted this

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145 See Shane Shifflett & Paul Vigna, Traders are Talking up Cryptocurrencies, Then Dumping Them, Costing Others Millions, WALL ST. J. (Aug. 5, 2018),
potential for securities manipulation in its denial of approval for exchange traded funds ("ETFs") based on crypto currencies.\textsuperscript{146} Following the SEC’s continued delay in addressing the Chicago Board Options Exchange’s ("Cboe") application for a crypto currency ETF, the exchange withdrew its listing application.\textsuperscript{147} However, following the end of the government shutdown, Cboe reapplied for listing of a bitcoin exchange traded fund.\textsuperscript{148}

The SEC also has brought enforcement actions charging manipulation and fraud in connection with crypto currency


transactions.\textsuperscript{149} The potential for manipulation, as well as the uncertainty over the risks associated with crypto currencies, were also prominent in the SEC’s suspension of trading in virtual currency tracking certificates.\textsuperscript{150} The CFTC has also voiced concerns over crypto currency manipulation. For example, the CFTC secured a federal court order against a crypto currency boiler room operation.\textsuperscript{151} In addition to SEC enforcement efforts and CFTC initiatives, the Department of Justice launched criminal investigations into suspected crypto currency price manipulation.\textsuperscript{152} The Department of Justice has also secured indictments based on securities fraud involving digital currency.\textsuperscript{153}

Anyone in the business of selling or promoting crypto currency transactions could be classified as a broker-dealer and thus subject to the 1934 Act’s broker-dealer registration requirements.\textsuperscript{154}

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\textsuperscript{153} See Dep’t of Just. News Release, Cryptocurrency CEO Indicted After Defrauding Investors of $4 Million, 2018 WL 6243047 (Nov. 28, 2018).
\end{quotation}

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\textsuperscript{154} Among other things, broker-dealers in securities, absent an exemption, must register with the SEC and with the Financial Industry Regulatory Authority (FINRA). Section 15 of the Securities Exchange Act of 1934, 15 U.S.C. § 78o
SEC has in fact brought enforcement actions for crypto currency sales by an unregistered broker-dealer.\textsuperscript{155} The Financial Industry Regulatory Authority ("FINRA") also requires registration of broker-dealers.\textsuperscript{156} Thus, for example, FINRA has pursued registered broker-dealers and associated persons\textsuperscript{157} FINRA announced an enforcement priority for supervising and monitoring digital currency transactions by FINRA member broker-dealers and associated persons.\textsuperscript{158}

To the extent that secondary or after-market transactions in crypto currencies involve securities, any web portal or exchange for


\textsuperscript{157} As defined by the 1934 Act:

The term “person associated with a broker or dealer” or “associated person of a broker or dealer” means any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term

those transactions would have to be registered as a securities exchange under the 1934 Act.\textsuperscript{159} Earlier this year, the death of a Canadian exchange’s CEO resulted in a potential loss of hundreds of millions of dollars since no one else had the encryption key to unlock the exchange’s crypto currency wallets.\textsuperscript{160} It is conceivable that regulation as an exchange might have prevented this scenario. Other potential problems with exchanges include the potential of manipulation\textsuperscript{161} which could be curtailed with exchange regulation.

State securities administrators have also pursued online platforms for crypto currencies.\textsuperscript{162} There has been some preliminary movement in Congress to preempt the states with respect to crypto currency regulation\textsuperscript{163} but there is no indication that anything is likely to happen soon.

The Investment Advisers Act of 1940 requires registration of professionals charging for securities related investment advice.\textsuperscript{164}


\textsuperscript{161} See supra text accompanying notes 144–146.


Accordingly, giving advice regarding crypto currencies can thus trigger those registration requirements.\textsuperscript{165}

In addition to federal law consequences, the states regulate securities broker-dealers. Thus, enforcement actions may be brought by state regulators against broker-dealers who violate the state securities laws broker-dealer registration provisions.\textsuperscript{166} A number of state securities regulators have been active in pursuing crypto currency transactions.\textsuperscript{167}

\section*{VI. Conclusion}

Crypto currency markets have been exceptionally volatile. Many investors have suffered massive losses. The need for regulating these high-risk markets should be evident from its performance over the years. Although there are only a handful of decisions to date, the SEC and the courts agree that initial coin offerings involve an offering of securities and thus are subject to SEC regulation. These decisions are headed in the right direction. By applying the Supreme Court’s test of what type of investment qualifies as a security, many if not all crypto currency transactions warrant scrutiny under the securities laws. Even beyond ICOs, crypto currency transactions often will implicate the securities laws. For example, the antifraud provisions as well as the broker-dealer and exchange registration requirements for those in the business of marketing crypto currencies should be applied to many crypto currency transactions. In the unlikely event that federal regulation can be avoided, state securities laws have used a broader test for classifying investments as securities. Accordingly, state laws may reach transactions not pursued by the SEC. It follows that with the exception of true utility


\textsuperscript{166} See, e.g., N.C. GEN. STAT. § 78A-39 (2017) (providing that enforcement actions can include “[d]enial, revocation, suspension, censure, cancellation and withdrawal of [broker-dealer] registration”).

tokens with no investment market, many, if not most crypto
currencies are likely to implicate the securities laws at least at some
point during their life cycle.