

# SEC Regulation of Cryptocurrency

## What are cryptocurrencies?

In January 2009, the first block of Bitcoin was officially mined. Now known as the Genesis Block, this initial ledger is the cornerstone of Bitcoin. *History of Bitcoin*, <http://historyofbitcoin.org>. The Genesis Block launched the trading of bitcoin (lower case “b” denotes the digital currency) on the Bitcoin (upper case “B” denotes the entire network) network. <https://bitcoin.org/en/vocabulary#bitcoin>.

Bitcoin is the first and most recognized model of cryptocurrency, and it is also considered the launch of the so-called “crypto revolution.” Bitcoin and other cryptocurrencies launched since 2009 are built on three fundamental characteristics. Cryptocurrencies were intended to be (1) trustless; (2) immutable; and (3) decentralized. *See The Age of Cryptocurrency*, Paul Vigna (Jan. 2015); *see also Cryptocurrency basics – 3 key characteristics and why they matter*, <https://medium.com/datadriveninvestor/cryptocurrency-basics-3-key-characteristics-and-why-they-matter-7348242abe18>.

These three characteristics led to the creation of the blockchain system. The current system of traditional currency requires trust and reliance on middle-men like banks and other controlling agencies. Unlike most currencies, cryptocurrencies rely on decentralized ledgers called blockchains that are designed to be managed by and accessible to the public. The goal of this system is to increase the accessibility of currency and decrease the transaction costs associated with transferring money. *The Age of Cryptocurrency*.

At Bitcoin’s launch 1,309.03 bitcoin equaled \$1.00. However, in December 2017, bitcoin reached its highest value of \$19,783.21 per 1 bitcoin. *History of Bitcoin; From \$900 to \$20,000: Bitcoin’s Historic 2017 Price Run Revisited*, <https://www.coindesk.com/900-20000-bitcoins-historic-2017-price-run-revisited>.

Although Bitcoin and some other cryptocurrencies have since been deemed commodities instead of securities, the extreme increase in value of the previously-unheard-of cryptocurrency has led to the popularity of Initial Coin Offerings (“ICOs”) along with increased scrutiny from government agencies like the SEC. The SEC has made clear that just calling a digital asset “cryptocurrency” will not exempt the asset from security laws. *SEC announces cryptocurrency ether is not a security*, <https://finance.yahoo.com/news/sec-announces-ether-not-security-162658147.html>. Instead, the SEC will apply the Howey test to determine if the substance of the ICO meets the definition of a security.

## The SEC will apply Howey

Up until the last few years, the SEC had been largely silent on how – and if – it planned to regulate cryptocurrencies. The recent release of a no action letter regarding the planned offering of digital tokens (the “TurnKey Jet No Action Letter”) and the “Framework of ‘Investment Contract’ Analysis of Digital Assets” by the SEC has indicated that the SEC plans to apply the Howey test in the digital asset context.

The “Framework of ‘Investment Contract’ Analysis of Digital Assets” (the “Framework”) provides a “framework for analyzing whether a digital asset is an investment contract and whether offers and sales of a digital asset are securities transactions. *Framework of ‘Investment Contract’ Analysis of Digital Assets*, [https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#\\_edn1](https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_edn1). Under the Howey test, a digital asset is an “investment contract” when there is (1) an investment of money in (2) a common enterprise with (3) a reasonable expectation of profits to be derived from the efforts of others. *Framework*.

Because the first two elements of the Howey test are typically met when evaluating digital assets, the Framework focuses on characteristics that should be considered when analyzing whether the third prong of Howey has been satisfied. *Framework*.

When evaluating the third prong, the Framework suggests looking at the “economic reality” of the transaction and whether a purchaser “may expect to realize a return through participating in distributions or through other methods of realizing appreciation on the asset, such as selling at a gain on a secondary market.” *Framework*.

The Turnkey Jet No Action Letter also relies on the Howey test. *Re: Turnkey Jet, Inc.*, April 10, 2019, <https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm>. TurnKey proposed a plan to sell blockchain-based digital assets in the form of online “tokens.” *Re: TurnKey*. Customers were to purchase the tokens, with each token to be valued at US\$1.00 and then use the tokens to purchase air charter services. *Re: Turnkey*.

Because the purpose of the tokens is to “pre-pay for and consume” air charter services and the tokens would not be marketed as a way to trade and transfer on a secondary market for profit, the SEC determined that the TurnKey tokens were unlikely to meet the Howey test. Therefore, the Division of Corporation Finance did not recommend action to the SEC. *Re: TurnKey*.

While this recent guidance from the SEC is helpful to issuers trying to determine if their ICO falls under security regulations, the SEC has yet to clarify how third parties like brokers can legally trade and hold digital securities after the Howey test has been applied.