

# Practical Legislation to Support Cryptocurrency Innovation

BY JACK SOLOWEY AND JENNIFER J. SCHULP

In bull and bear cycles alike, cryptocurrencies have commanded the attention of markets and policymakers. The 117th Congress has introduced dozens of bills addressing the crypto ecosystem.<sup>1</sup> In addition, multiple regulators have been outspoken about their readiness to be the “cop on the beat” when it comes to overseeing crypto markets.<sup>2</sup> Nonetheless, key questions remain about how best to regulate the crypto ecosystem and the extent to which current laws and regulations apply. This briefing paper proposes a cryptocurrency regulatory framework with the goals of dispelling uncertainty, unencumbering entrepreneurship, and providing practical consumer protections.<sup>3</sup> The framework recognizes the unique risks and benefits of cryptocurrencies, proposing a clear-cut test for whether crypto projects trigger securities laws and a common-sense registration and disclosure option for those that do.

## LEGISLATING RATIONAL SECURITIES TREATMENT

A top priority for any crypto regulatory framework is determining whether and to what extent cryptocurrencies are or ought to be subject to U.S. securities laws. At a high level, the federal securities regime seeks to ensure that public representations regarding potential investment opportunities are accurate.<sup>4</sup> Where crypto entrepreneurs sell tokens to the public to finance the development of their projects, it is reasonable to ask whether, when, and how securities laws apply. While various federal bills touching the question have been introduced, and the Securities and Exchange Commission (SEC) has engaged with the issue in enforcement actions and informal guidance, to date no law or formal rule has decisively clarified the application of securities laws to cryptocurrencies.<sup>5</sup>



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A jurisdiction that leaves the applicability of laws uncertain or prioritizes legacy regulatory formalities regardless of their practical relevance to cryptocurrencies risks becoming inhospitable to both crypto entrepreneurs and users to the detriment of technological innovation, capital formation, and consumer welfare.<sup>6</sup> Accordingly, any applicable securities rules should be tailored to the specific risks of cryptocurrencies: fraud, deception, and manipulation by developers, sellers, and promoters who remain actively involved in the management of crypto projects.

## Background on Securities Classification

Determining whether a crypto project presents risks akin to those of traditional securities goes hand in hand with the question of whether the project’s activities meet the legal standard for a security offer.<sup>7</sup> The Securities Act of 1933 defines “security” to include an “investment contract.”<sup>8</sup> Under the Supreme Court’s canonical test articulated in *SEC v. W. J. Howey Co.*, “an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money in a [2] common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party.”<sup>9</sup>

The *Howey* test’s fourth prong—whether a purchaser is relying on the efforts of a third party—is critical to determining whether a crypto project presents the risks that securities laws were designed to mitigate. Securities laws evolved in no small part to address the risks posed to investors by a managerial body’s ability to possess information that investors do not and its capacity to act at odds with investors’ best interests.<sup>10</sup> In the era of the Securities Act and the *Howey* decision, and for decades thereafter, the archetypical covered entity under securities laws was a centralized enterprise with a corporate form, headquarters, and managerial hierarchy. Crypto projects aspire to upend this model, eschewing not only the physical plant of 20th-century enterprises but also, more importantly, managerial bodies exercising ongoing control over projects.

Where a crypto project involves the expectation of third-party managerial efforts (i.e., where it is centralized), and the other *Howey* test elements are satisfied, applying securities safeguards is appropriate to mitigate associated risks. But where a project does not involve

this expectation and the associated risks (i.e., where it is decentralized), applying legacy securities laws is both legally inappropriate and practically ineffective for addressing potential harm.

## A Clear Test for Decentralization

Policymakers should provide a clear test for whether a crypto project is decentralized.<sup>11</sup> The key decentralization question in light of *Howey* and its progeny is whether the cryptocurrency purchaser is led to expect profits “solely” from the efforts of others, or in other words, whether the purchaser is relying on others’ essential managerial or entrepreneurial efforts.<sup>12</sup> The decentralization test therefore should ask if at the time of a token sale managerial efforts are required to make the cryptocurrency project achieve minimum viable functionality, including with respect to both the token’s underlying technology and the broader project’s promoted utility. More formally, the question is whether when selling a cryptocurrency, the seller, promoter, or developer explicitly or implicitly promises performance necessary to bring the project and its benefits to fruition.<sup>13</sup> If yes, the cryptocurrency project is centralized. If not, it is decentralized for the purposes of securities laws.<sup>14</sup>

Congress should clarify that securities laws do not apply to decentralized cryptocurrency projects. For example, Congress could amend 15 U.S.C. § 77b and 15 U.S.C. § 78c by providing new subdivisions (a)(20) and (a)(81), respectively, that read:

The term “investment contract” shall not include a contract, transaction, or scheme involving the sale of an intangible asset wherein –

- (A) the seller or promoter of the intangible asset, or an agent of the seller or promoter, does not at the time of the instant, primary market sale of the intangible asset explicitly or implicitly promise performance without which –
  - (i) the intangible asset would not exist; or
  - (ii) the promised benefits of the intangible asset would not materialize; and

- (B) the intangible asset does not convey a financial right or interest in the seller, promoter, or a corporate entity.

## **ESTABLISHING TAILORED DISCLOSURES FOR EMERGING DECENTRALIZED CRYPTOCURRENCY PROJECTS**

Cryptocurrency projects can take time to achieve decentralization. Some projects may seek to sell their cryptocurrencies to finance their development, including via so-called initial coin offerings (ICOs) or token presales. In the words of SEC Commissioner Hester Peirce, applying securities laws to cryptocurrencies at this stage “create[s] a regulatory Catch 22.”<sup>15</sup> In short, a nascent cryptocurrency may be insufficiently decentralized to avoid securities laws, which in turn create compliance costs that foreclose an important means of financing the cryptocurrency’s development and thereby achieving decentralization.<sup>16</sup> A targeted registration and disclosure option for crypto projects in the process of decentralizing could avert this outcome and provide more relevant information to purchasers.

A crypto project is naturally centralized during an ICO, which inherently involves a promise of future development efforts and, in many cases, future token delivery. Promised future development efforts may include building software and promoting its adoption by validators, users, or other network participants who would accept the token in exchange for goods or services. The key question is not which efforts are underway but rather whether the sale of the token involved an explicit or implicit promise to undertake efforts without which the project’s benefits would not manifest. Notably, it is possible for a crypto project’s token infrastructure to be decentralized while the broader project still involves centralization, such as where developers promise to sign up participating merchants. For that reason, the decentralization test considers not only promises regarding the functionality of the technology but also the benefits of the project as a whole. Where there are such promises during a primary market sale, this proposal would require tailored disclosures by the relevant seller for each tranche of centralized tokens sold. Token sales that do not involve a promise of performance at the time of a primary market

sale would be exempt from the definition of an investment contract and not require such disclosures.

While facilitating the development of decentralized crypto projects, this framework also seeks to protect against end runs around applicable securities laws by projects that are not on the road to decentralization. On the front end, the framework restricts eligibility to projects that intend to create bona fide cryptographically secure distributed ledgers. First, registration under this proposal is limited to projects that do not entitle token recipients to any financial rights—such as to equity, debt, interest, profits, or dividends—in the seller, promoter, developer, or any other business. Second, the registration is confined to projects that promise to develop an open-source, permissionless, publicly readable, and cryptographically secure distributed ledger capable of validating stores or transfers of tokens without intermediaries. Each of these attributes is a key element of decentralized operations that render the application of securities laws designed for centralized firms inappropriate. For example, open-source software avoids creating a walled garden controlled by initial developers through proprietary intellectual property rights and helps to ensure that a crypto project ultimately can be maintained through consensus adoption of software updates by distributed users.<sup>17</sup> Similarly, being permissionless means network participation is conditioned only on users deploying the project’s software, not an initial team rewarding insiders.

On the back end, the framework addresses the risk of a person or group maintaining ongoing control over the project beyond disclosed development efforts. First, the registrant will remain subject to the provisions of the Securities Act that create liability for fraud, untrue statements, and material omissions. Ongoing project management beyond disclosed development efforts, including those that deviate from the maturation course for an open-source, publicly readable, disintermediated, permissionless, and cryptographically secure distributed ledger, would be vulnerable to legal actions for fraud or material omissions or misstatements. In addition, where the seller, promoter, or developer makes subsequent promises regarding the project to users or prospective users who did not participate in a registered token sale or to participants in registered sales after the execution of their purchases, the cryptocurrency project would lose eligibility for the tailored disclosure framework. The reasons for revoking the

project's eligibility are that subsequent promises present risks not bargained for in the initial investment contract, cannot be mitigated by disclosures at the time of the sale, and violate the principles of decentralization for which a crypto project is afforded a tailored registration option.

For decentralizing crypto projects, Congress should legislate a tailored registration model prioritizing disclosures related to the specific risks of cryptocurrencies and providing protections against fraud and misleading statements. For example, Congress could amend 15 U.S.C. § 77c by adding a new section (a)(15) to exempt the following projects from the Securities Act, subject to the corresponding conditions:<sup>18</sup>

Any investment contract implicitly or explicitly promising the development of an open-source and permissionless blockchain or other cryptographically secure distributed ledger capable of recording, according to a consensus protocol, stores or transfers of intangible assets validated without an intermediary in a transaction history that is perpetually open to public retrieval, provided that –

- (A) the investment contract includes a promise to deliver the intangible asset to the purchaser;
- (B) neither the investment contract nor the intangible asset promises or conveys any financial right or interest in the seller, issuer, promoter, or any corporate entity;
- (C) the investment contract is registered according to the requirements of, and its sellers, issuers, and promoters, as applicable, make the specialized disclosures pursuant to section 77g(e) of this title;
- (D) the investment contract and its sellers, issuers, and promoters are not exempt from the requirements of and remain subject to sections 77g(e), 77l(a)(2), and 77q of this title; and
- (E) the sellers, issuers, and promoters of the investment contract do not make any additional explicit or implicit promises of performance in connection with the investment contract or intangible asset to investment contract counterparties after the execution of their investment contracts or prospective investment contract

counterparties outside of a sale registered in accordance with section 77g(e) of this title.

The exemption would require compliance with a tailored registration framework, which Congress could outline by amending 15 U.S.C. § 77g to add a new subsection (e):<sup>19</sup>

(e) Registration statement for intangible asset investment contracts

A registration statement filed pursuant to the exception provided under section 77c(a)(15) of this title shall be exempt from the requirements of section 77f of this title, be filed with the Commission in electronic format, be made available on a publicly accessible website on an ongoing basis, and contain –

- (1) the names of the seller, promoter, and development team members;
- (2) the professional, technical, and other relevant qualifications and experience of the development team members;
- (3) the amounts of intangible assets of the issuer held by the seller, promoter, development team members, and any other recipients prior to the first public sale for which a registration is filed, and the amounts of intangible assets to which such persons have a right or have indicated an intention to hold; the foregoing amounts' percentages of the total supply of the intangible assets in existence at the time of the registration, total supply of tokens scheduled to exist following the public sale for which the registration is filed, if knowable, and total supply of the intangible asset that ultimately will come into existence, if knowable;
- (4) any rights, privileges, or restrictions specific to the intangible assets distributed prior to the first public sale for which a registration is filed, such as options or lock-up periods;
- (5) a commitment to report on an ongoing basis whenever any holder of the intangible asset, or right to the intangible asset, received prior to the first public sale for which a registration is filed sells, exchanges, burns, or otherwise disposes

of 10 percent or more of his or her held amount or right thereto, provided that staking of the intangible asset shall not be considered a sale, exchange, burn, or disposal thereof for purposes of this disclosure obligation;

- (6) all pertinent technical documents, including archival copies of and uniform resource locators for all white papers, yellow papers, and other files produced by the seller, promoter, or development team describing the intangible asset, the intangible asset's supporting infrastructure, and the general character of the project related to the intangible asset;
- (7) all pertinent marketing materials, including archival copies of and uniform resource locators for public statements, relating to the intangible asset and its corresponding project produced by the seller, promoter, or development team;
- (8) a uniform resource locator for the public repository containing the program code for the intangible asset and its corresponding infrastructure on an ongoing basis for the duration of the public sale for which the registration is filed, as well as an archival copy of the code at the time of registration;
- (9) a commitment to report on an ongoing basis for the duration of the public sale for which the registration is filed all material changes to the program code committed by the development team and provide a description of the resulting functional changes;
- (10) a tool allowing for a real-time search of the intangible asset's transaction history recorded in its applicable blockchain or other cryptographically secure distributed ledger, and instructions for operating the tool;
- (11) a statement of the intangible asset's general character, intended design, and how the development team will produce an open-source and permissionless blockchain or other cryptographically secure distributed ledger capable of recording,

according to a consensus protocol, stores or transfers of intangible assets validated without an intermediary in a transaction history that is perpetually open to public retrieval, which shall include descriptions of the intangible asset's estimated development timeline and the purpose of the public sale for which the registration is filed, the planned supply of the intangible asset or determinants thereof, the protocols for recording and validating transactions on the intangible asset's blockchain or other cryptographically secure distributed ledger and the applicable consensus mechanism, and the governance mechanism for updating the program code for the intangible asset;

- (12) a description of any promised benefits of the intangible asset; and
- (13) a description of the risks of holding the intangible asset, including any cybersecurity or functional vulnerabilities or risks of loss of value reasonably foreseeable by or known to the seller, promoter, or development team, as well as a statement of these risks that is no more than 280 characters in length; and a commitment to affirmatively provide the foregoing risk statement, in addition to access to the public website containing the foregoing disclosures, to all public purchasers of the intangible asset in the course of a public sale prior to its execution.

## CONCLUSION

The core innovation of decentralized cryptocurrencies is their capacity to mitigate risks through technology. To incentivize the development of cryptocurrencies that realize this potential and to provide consumer protections focused on addressing actual risks, not preserving a regulatory status quo, Congress should amend securities laws to provide a simple test for decentralization and a streamlined token registration pathway for projects on the road to decentralization.

## NOTES

1. Jason Brett, “Congress Has Introduced 50 Digital Asset Bills Impacting Regulation, Blockchain and CBDC Policy,” *Forbes*, May 19, 2022.
2. Paul Kiernan, “More Crypto Market Turmoil Is Predicted by SEC Chairman Gary Gensler,” *Wall Street Journal*, May 18, 2022; and Isabelle Lee, “The CFTC Chief Said His Agency Should Oversee Crypto in a Challenge to SEC’s Gensler,” *Markets Insider*, October 27, 2021.
3. This paper addresses cryptocurrencies that do not endeavor to peg their price to another asset (e.g., a fiat currency) either by maintaining collateral reserves or using an algorithmic method. In this paper, “cryptocurrency” specifically refers to nonpegged cryptocurrencies and is used interchangeably with “token.” For recommendations for regulating reserve-backed stablecoins, see Norbert J. Michel and Jennifer J. Schulp, “A Simple Proposal for Regulating Stablecoins,” Cato Institute Briefing Paper no. 128, November 5, 2021.
4. See Elisabeth A. Keller, “Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934,” *Ohio State Law Journal* 49 (1988): 343–44.
5. See, e.g., Lummis-Gillibrand Responsible Financial Innovation Act, S. 4356, 117th Cong. (2022); Digital Commodity Exchange Act of 2022, H.R. 7614, 117th Cong. (2022); Clarity for Digital Tokens Act of 2021, H.R. 5496, 117th Cong. (2021); and Strategic Hub for Innovation and Financial Technology, “Framework for ‘Investment Contract’ Analysis of Digital Assets,” Securities and Exchange Commission, modified April 3, 2019. See also Jack Solowey, “Don’t Put the Cart before the Horse When Regulating Crypto,” *Cato at Liberty* (blog), Cato Institute, May 18, 2022.
6. See Hester M. Peirce, “On the Spot: Remarks at ‘Regulatory Transparency Project Conference on Regulating the New Crypto Ecosystem: Necessary Regulation or Crippling Future Innovation?’” (transcript of speech, Washington, DC, June 14, 2022).
7. See Peter Van Valkenburgh, “Framework for Securities Regulation of Cryptocurrencies,” Coin Center, August 2018.
8. 15 U.S.C. § 77b(a)(1).
9. *SEC v. W. J. Howey Co.*, 328 U.S. 293, 298–99 (1946).
10. These problems often are labeled an information asymmetry and agency problem. See Paul G. Mahoney, “The Economics of Securities Regulation: A Survey,” working paper, Law and Economics Research Paper Series 2021-14, University of Virginia School of Law, August 2021, pp. 8–9. See also Keller, “Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934,” pp. 338–39.
11. In 2019, the Securities and Exchange Commission’s Strategic Hub for Innovation and Financial Technology (FinHub) published a framework for assessing whether a cryptocurrency purchaser is relying on the efforts of others, but it did not provide conclusive guidance. FinHub, “Framework for ‘Investment Contract’ Analysis of Digital Assets.” See also Solowey, “Don’t Put the Cart before the Horse When Regulating Crypto.”
12. *United Housing Foundation Inc. v. Forman*, 421 U.S. 837, 852 (1975). See *SEC v. Glenn W. Turner Enters. Inc.*, 474 F.2d 476, 481–82 (9th Cir. 1973). See also FinHUB, “Framework for ‘Investment Contract’ Analysis of Digital Assets”; and Basil V. Godellas, “When It Comes to Analyzing Utility Tokens, the SEC Staff’s ‘Framework for ‘Investment Contract’ Analysis of Digital Assets’ May Be the Emperor without Clothes (Or, Sometimes an Orange Is Just an Orange) (Part IV),” *Non-Fungible Insights: Blockchain Decrypted* (blog), Winston & Strawn LLP, December 18, 2019.
13. This test is based on the “Bahamas Test” proposed by professors M. Todd Henderson and Max Raskin, which asks: “If there is a minting and selling of an instrument, as opposed to open mining of it, is there either an explicit or implicit contract to build and manage software such that if there were a breach of that contract, the project would fail? . . . Said differently: if the sellers fled to the Bahamas or ceased to show up to work—like Satoshi Nakamoto—would the project still be capable of existing?” M. Todd Henderson and Max Raskin, “A Regulatory Classification of Digital Assets: Toward an Operational Howey Test for Cryptocurrencies, ICOs, and Other Digital Assets,” *Columbia Business Law Review* 2019 no. 2 (2019): 461.
14. To the extent decentralization exists on a spectrum, Bitcoin arguably sits at one pole as the “gold standard,” as its anonymous creator, Satoshi Nakamoto, did not promise performance at the point of sale or otherwise. Nonetheless, other cryptocurrencies can pass this proposal’s test, depending on their development stage, and decentralize over time, as Ethereum arguably did. See Henderson and Raskin, “Regulatory Classification of Digital Assets,” pp. 470–73. See also “Ether Sale,” History of Ethereum, Ethereum, last updated July 14, 2022.
15. Hester M. Peirce, “Running on Empty: A Proposal to Fill the Gap between Regulation and Decentralization”

(transcript of speech, Chicago, February 6, 2020).

16. Commissioner Peirce proposed an innovative solution to this problem: a safe harbor delaying by three years the application of key securities law provisions to decentralizing projects, provided that the projects made certain disclosures and after three years either achieved decentralization or registered under the Securities Exchange Act. Hester M. Peirce, “Token Safe Harbor Proposal 2.0,” Securities and Exchange Commission, April 13, 2021. The proposed Clarity for Digital Tokens Act of 2021 sought to codify the safe harbor. Clarity for Digital Tokens Act of 2021, H.R. 5496, 117th Cong. (2021).

17. Mining tokens according only to a distributed validation protocol would not be a sale in which a third party made a promise to the recipient regarding future performance. See Henderson and Raskin, “Regulatory Classification of Digital Assets,” pp. 452–53; and Van Valkenburgh, “Framework for Securities Regulation of Cryptocurrencies.”

18. See Peirce, “Token Safe Harbor Proposal 2.0”; Securities Clarity Act, H.R. 4451, 117th Cong. (2021); and Lummis-Gillibrand Responsible Financial Innovation Act, S.

4356, 117th Cong. (2022). Congress should make conforming amendments, including for secondary market sales of qualifying intangible assets not to be subject to inapplicable securities laws, such as by amending 15 U.S.C. § 78c to exclude from the definitions of “exchange,” “broker,” “issuer,” and “dealer” persons who otherwise would be subject to those definitions but conduct their ordinary business with respect to intangible assets qualifying for the tailored registration under 15 U.S.C. § 77c(a)(15). These persons should remain subject to those definitions with respect their activities that fall within such definitions but do not involve qualifying intangible assets.

19. These disclosures are based on Commissioner Hester M. Peirce’s safe harbor proposal. Peirce, “Token Safe Harbor Proposal 2.0.” For another “fork” of the disclosures described under Peirce’s proposal, see lex-node, “SafeHarbor X,” GitHub, January 8, 2022. See also Chris Brummer, Trevor I. Kiviat, and Jai R. Massari, “What Should Be Disclosed in an Initial Coin Offering,” in Chris Brummer, *Cryptoassets: Legal and Monetary Perspectives* (Oxford, UK: Oxford University Press, 2019); and Carol R. Goforth, “Cinderella’s Slipper: A Better Approach to Regulating Cryptoassets as Securities,” *Hastings Business Law Journal* 17, no. 2 (February 2021): 329.



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