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Will the FTX Collapse Finally Force U.S. Policymakers to Wake Up?: Regulatory Solutions for Cryptocurrency Tokens Not Classified As Securities Under the Supreme Court's *Howey* Analysis

Paul Andersen

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PAUL ANDERSEN*

INTRODUCTION

Since the launch of cryptocurrency on online exchanges in 2010, United States citizens have been purchasing cryptocurrency tokens directly from the token developers and from holders through secondary markets.[1] While purchasers are often buying these tokens for individual use, the tokens can be, and often are, purchased with the expectation that they can be resold at a higher value on secondary markets when demand increases.[2] This dual purpose has led government agencies like the Securities and Exchange Commission ("SEC") to question if these tokens are securities that should be regulated under existing federal securities law.[3] Through enforcement actions, the SEC has determined they can regulate many cryptocurrency tokens as securities under the Supreme Court's *Howey* analysis.[4] However, because a majority of non-fungible tokens ("NFTs") and in-ecosystem tokens are likely not securities under the *Howey* analysis, they SEC cannot regulate them.[5] Despite this, there are proactive steps that federal regulatory agencies, the Supreme Court, and Congress should take to limit the negative consequences of non-regulation to American consumers.[6] Part I of this comment explores the stock

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1. Wayne Duggan, *The History of Bitcoin, The First Cryptocurrency*, U.S. NEWS & WORLD REPORT (Feb. 27, 2023, 4:29P), https://money.usnews.com/investing/articles/the-history-of-bitcoin.

2. *See infra* notes 82, 87, and accompanying text.

3. *See infra* Section III.

4. *See infra* Section II.

5. *See infra* Section III.

6. *See infra* Section IV.

market creation, development of securities, implementation of securities regulations to protect investors and maintain market stabilization, introduction of crypto-assets, and the United States' inadequate regulatory response.[7] Part II examines how many cryptocurrency tokens have been, and likely can continue to be, regulated under *Howey*.[8] Part III outlines the issue that many NFTs and in-ecosystem tokens likely cannot be regulated as securities under *Howey*.[9] Finally, Part IV outlines why NFT and in-ecosystem token regulation is necessary[10] and discusses potential regulatory solutions.[11]

At the outset, it must be stated that there is significant scholarship on the rise of blockchain technology, crypto-assets, and initial coin offerings;[12] how these technologies will impact traditional centralized financial institutions;[13] how to classify and regulate digital-assets;[14] how under the Supreme Court's *Howey* analysis crypto-assets are or are not securities;[15] and when an NFT becomes a security.[16] This comment seeks to add to this discussion by detailing: (1) how NFT and in-ecosystem token use and demand will increase; (2) how continuing the trend of non-regulation for NFTs and in-ecosystem tokens will harm American consumers and destabilize financial markets; (3) why under the current *Howey* analysis and case precedent these tokens likely cannot be regulated as securities; and, most importantly, (4) what steps federal agencies, Congress, and the Supreme Court can take to mitigate the negative impacts on American consumers and financial markets.

7. *See infra* Section I.

8. *See infra* Section II.

9. *See infra* Section III.

10. *See infra* Section IV.A.

11. *See infra* Section IV.B.

12. *See* Randolph A. Robinson II, *The New Digital Wild West: Regulating the Explosion of Initial Coin Offerings*, 85 Tenn. L. Rev. 897 (2018); Trevor I. Kiviat, *Beyond Bitcoin: Issues in Regulating Blockchain Transactions,* 65 Duke L. J. 569 (2015); *see also* THOMAS LEE HAZEN, 1 TREATISE ON THE LAW OF SECURITIES REGULATION § 1:79.50 (2022).

13. *See* Kartik Hosanagar & Kevin Werbach, *How the Blockchain Will Impact the Financial Sector,* WHARTON SCHOOL OF THE UNIVERSITY OF PENNSYLVANIA (Nov. 16, 2018), https://knowledge.wharton.upenn.edu/article/blockchain-will-impact-financial-sector/.

14. *See generally* Lindsay Sain Jones, *Beyond the Hype: A Practical Approach to Cryptoreg*, 25 V. J.L. & TECH. 175 (2022); *see supra* note 12; *see also* Michael Sherlock, Note, *Bitcoin: The Case Against Strict Regulation*, 36 BOS. UNIV. REV. OF BANKING & FIN. L. 975 (2017).

15. *See generally* Jones, *supra* note 14; *see* M. Todd Henderson & Max Raskin, *A Regulatory Classification of Digital Assets: Toward an Operational Howey Test for Cryptocurrencies, ICOs, and Other Digital Assets*, 2 COLUM. BUS. L. REV. 443 (2019).

16. *See generally* Brian Elzeig & Lawrence J. Trautman, *When Does a Nonfungible Token (NFT) Become a Security*, GEORGIA STATE UNIV. L. REV., Forthcoming (March 11, 2022) (explaining when NTFs become a security under the *Howey* analysis).

I. BACKGROUND

Section I examines securities development and the need for regulation,[17] the United States' implementation of Investment and Securities Laws,[18] blockchain and cryptocurrency development,[19] and the United States' existing regulatory response.[20]

A. United States' Stock Market Crash, 1930 Great Depression, and the Need for Regulation

American stock traders founded the United States' Stock Exchange ("Stock Market") in 1790 to facilitate the buying and selling of publicly held companies.[21] The Stock Market has two market types: (1) primary markets, in which companies (issuers) offer and sell securities[22] to investors through initial public offerings ("IPOs"), and investors exchange their capital for these shares with the expectation that the share value will rise and/or that they will receive dividend payments;[23] and (2) secondary markets, in which investors who purchased from primary market issuers resell securities to other investors.[24] These two markets both occur in the same exchanges,[25] which allows individual investors to sell or purchase shares beyond the IPO.[26]

17. *See infra* Section I.A.

18. *See infra* Section I.B.

19. *See infra* Section I.C.

20. *See infra* Section I.D.

21. *Wall Street and the Stock Exchanges: Historical Resources*, LIBRARY OF CONGRESS, https://guides.loc.gov/wall-street-history/exchanges; James Chen, *What Is the Stock Market, What Does it Do, and How Does it Work?*, INVESTOPEDIA (Jul. 07, 2022), https://www.investopedia.com/terms/s/stockmarket.asp.

22. Will Kenton, *What are Financial Securities? Examples, Types, Regulation, and Importance*, INVESTOPEDIA (Jun. 11, 2022) https://www.investopedia.com/terms/s/security.asp ("The term 'security' refers to a fungible, negotiable financial instrument that holds some type of monetary value. A security can represent ownership in a corporation in the form of stock, a creditor relationship with a governmental body or a corporation represented by owning that entity's bond; or rights to ownership as represented by an option.").

23. Chen, *supra* note 21.

24. *Id.*

25. *Id.*

26. *Id.*

The Stock Market Crash of 1929,[27] the Federal Reserve's incorrect response to financial speculation,[28] and the passage of the Smoot-Hawley Act[29] led to the 1930 Great Depression.[30] The Great Depression lasted until 1939, during which time investors stopped investing, banks stopped lending, and companies laid off workers.[31] This led to the highest records of United States unemployment and an extreme recession for the rest of the world's economies.[32]

In response to the Stock Market Crash and the Great Depression, President Franklin D. Roosevelt passed the New Deal.[33] The New Deal created a series of programs, government agencies, and regulations focused on stabilizing the economy, providing jobs, and proactively addressing Great Depression's causes.[34] Two prominent New Deal regulations—the Securities Act of 1933 and the Securities Exchange Act of 1934—concerned securities, Stock Market operation, lending generally, enforcement requirements, and federal regulatory agencies.[35]

B. The United States' Investment and Securities Regulation

The Securities Act of 1933 ("Securities Act") requires public securities issuers to disclose material information to potential investors and to ensure any securities transactions are not based on fraudulent information or practices.[36] These disclosures take the form of annual registration forms that provide information about the company's management details, financial statements, and a description of the security for sale.[37] While this information is not guaranteed to be accurate, investors can pursue remedies from companies providing inaccurate or fraudulent

27. Gary Richardson et al., *Stock Market Crash of 1929*, FEDERAL RESERVE HISTORY (Nov. 22, 2013), https://www.federalreservehistory.org/essays/stock-market-crash-of-1929 (In 1929, the Stock Market crashed after the introduction of margin houses allowing average investors to purchase stocks with borrowed funds, rampant bank loans that were not liquid, and years of speculation resulted in stocks valued at more than they were worth).

28. Patrick J. Kiger, *5 Causes of the Great Depression*, HISTORY (Mar. 10, 2022), https://www.history.com/news/great-depression-causes.

29. *Id.* (discussing how the Smoot-Hawley Act increased U.S. tariffs by an average of 16 percent points).

30. *Id.*

31. *See generally Great Depression History*, HISTORY (Nov. 3, 2022), https://www.history.com/topics/great-depression/great-depression-history (discussing the factors leading to the Great Depression).

32. *Id.*

33. *See generally New Deal*, HISTORY (Oct. 5, 2021), https://www.history.com/topics/great-depression/new-deal (discussing the factors leading to the New Deal).

34. *Id.*

35. *Id.*

36. U.S. Sec. & Exch. Comm'n, *The Laws that Govern the Securities Industry*, INVESTOR, https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities industry.

37. *Id.*

information.[38] The Securities Exchange Act of 1934 ("Exchange Act") governs securities transactions on secondary markets.[39] It requires that companies register publicly traded stocks, disclose all material information to investors, ensure stocks based on fraudulent or misleading information are not sold, and makes insider trading illegal.[40] It also established the SEC as the federal securities regulatory body.[41] The Exchange Act provides the SEC with broad authority to regulate the securities industry; lead investigations into alleged violations including insider trading, selling unregistered securities, and providing false financial information of the Exchange Act; and pursue remedies for impacted investors.[42]

Under 15 U.S.C § 77(b)(a)(1), a security is defined as:

> *[A]ny note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, . . . investment contract, voting-trust certificate, . . . any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, . . . or right to subscribe to or purchase, any of the foregoing.*[43]

Similarly, in section 2(a) of the Securities Act the definition of "security" includes an "investment contract."[44] In determining what constitutes an investment contract, courts rely on the test outlined in *SEC v. W.J. Howey Co.*[45] In *Howey,* the Supreme Court determined that a company selling sections of large citrus groves, and a service contract for the purchased area, fell under the classification of "an investment contract" and were thus securities regulated by the SEC.[46] They determined these sales were investment contracts because the company was not simply selling land.[47] Instead, they offered an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise to persons outside of the local district who lacked the equipment and experience to cultivate, harvest, and market the citrus products.[48] The Court indicated four main reasons for the classification of an investment contract. First, these persons had no "desire to occupy the land or to develop it themselves," and purchased the grove interests solely based on the

38. *Id.*
39. *Id.*
40. *Id.*
41. *Id.*
42. U.S. Sec. & Exch. Comm'n, *supra* note 36.
43. Securities Act of 1933, 15 U.S.C. § 77(b)(a)(1).
44. *Id.*
45. SEC v. W.J. Howey Co., 328 U.S. 293, 297-301 (1946).
46. *Id.* at 299-300.
47. *Id.*
48. *Id.*

"prospect of a return on their investment."[49] Second, a common enterprise managed the entire grove, its marketing, and the sale of the citrus products.[50] Third, there was an expectation of a return on their investment from the entire grove's citrus product sales.[51] Fourth, those expectations of profit were a direct result of the efforts of the common enterprise.[52]

Following this decision, lower courts latched on to the Court's statement that: "[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[53] Over time, these elements have been refined in to a four prong test: (1) an investment of money, (2) in a common enterprise, (3) with an expectation of profits, (4) that are derived from the efforts of others.[54] The Court in *Howey* further stated that the securities laws were designed "to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[55] Additionally, in *Techerepnin v. Knight*, the Court outlined that "in searching for the meaning and scope of the word 'security' in the [Securities] Act, form should be disregarded for substance and the emphasis should be on the economic reality."[56]

The Court also clearly defined what does not constitute a security in *United Housing Foundation, Inc. v. Forman*, where it held that shares of stock to lease an apartment in a state subsidized nonprofit housing cooperative were not securities under *Howey* because "when a purchaser is motivated by a desire to use or consume the item purchased—'to occupy the land or to develop it themselves,' as the *Howey* Court put it—the securities laws do not apply."[57] Since the decisions of these cases, federal and state courts have attempted to interpret the policies behind this precedent by asking if "the particular investment or instrument involved is one that needs or demands the investor protection of the federal (or state) securities laws."[58]

It is also important to recognize that generally the United States' laws and regulatory approach are not extraterritorial. This means they apply only within the

49. *Id.* at 300.

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.* at 298-99.

54. THOMAS LEE HAZEN, 1 TREATISE ON THE LAW OF SECURITIES REGULATION § 1:50 (2022) (citing *Howey*, 328 U.S. at 298-99).

55. *Howey*, 328 U.S. at 299.

56. Techerepnin v. Knight, 389 U.S. 332, 336 (1967) (citing *Howey*, 328 U.S. at 298).

57. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852-53 (1975).

58. HAZEN, *supra* note 54, § 1:50.

United States' territorial jurisdiction, unless the statute gives a clear, affirmative indication that it applies extraterritorially.[59] Federal statues generally lack these clear, affirmative instructions.[60] While no definitive determination exists that the Securities Act or Exchange Acts always lack affirmative instructions, the Supreme Court applied this principle to the Securities Act in *Morrison v. National Australia Bank Ltd.*[61] The Court determined that if any future application of the Securities Acts are to be extraterritorial, they must pass the Court's newly articulated two-factor test: (1) Does the statute give a clear, affirmative indication that it applies extraterritorially?; (2) If not, did the conduct at issue occur in the United States?[62] This principle speaks to the limited scope of United States' financial regulations, while cryptocurrency offerings occur in a global market.[63]

C. Blockchains and Cryptocurrencies

While the *Howey* test outlined above is generally effective for determining whether most offerings are securities, in 2008, cryptocurrency became prominent with the deployment of Bitcoin and the blockchain ledger.[64] This new blockchain ledger and cryptocurrency token technology perplexed regulators, and continues to do so, as even today federal regulators debate crypto-asset classification and regulation under existing laws.[65]

Cryptocurrency is "any form of currency that only exists digitally, that usually has no central issuing system[66] or regulating authority but instead uses a decentralized

59. *See* Morrison v. National Australia Bank Ltd., 561 U.S. 247, 255-56 (2010); *see also* William J. Moon, *Regulating Offshore Finance*, VANDERBILT L. REV., Jan. 1, 2019, at 1, 21.

60. Moon, *supra* note 59, at 22-23.

61. *Id.* at 21 ("Employing this test, the *Morrison* Court concluded the Exchange Act did not apply to the facts at hand because it applies only to 'transactions in securities listed on domestic exchanges, and domestic transactions in other securities.'").

62. *Id.*

63. *Id.* at 22-23; *see also* Brian D. Feinstein & Kevin Werbach, *The Impact of Cryptocurrency Regulation on Trading Markets*, 7 J. OF FIN. REGUL. 48, 49 (2021) ("[Cryptocurrencies] are inherently global, because they exist digitally and their value is not based on any fiat currency or physical asset.").

64. Usman W. Chohan, *A History of Bitcoin*, CRITICAL BLOCKCHAIN RSCH. INITIATIVE, Feb. 5, 2022, at 8-14.

65. *See generally* Cheryl L. Isaac et al., *CFTC and SEC Perspectives on Cryptocurrency and Digital Assets – Volume I: A Jurisdictional Overview*, K&L GATES (May 6, 2022), https://www.klgates.com/CFTC-and-SEC-Perspectives-on-Cryptocurrency-and-Digital-Assets-Volume-I-A-Jurisdictional-Overview-5-6-2022 ("The rise of cryptocurrencies and digital assets in the financial markets, including the investment management industry, has given rise to a crucial question: which federal regulator - the Securities and Exchange Commission (SEC) or the Commodities and Futures Trading Commission (CFTC) will be primarily responsible to regulate the use of crypto and crypto-related activities?").

66. Ted Bililies, *Centralization Versus Decentralization: What's Right for You?* ALIXPARTNERS (Apr. 2016), at 2, https://www.alixpartners.com/media/14446/ap_centralization_versus_decentralization_apr_2016.pdf ("Centralization refers to the concentration of management and decision-making power at the top of the organizational hierarchy for the purpose of coordinating financial, human, and other business resources. In

system[67] to record transactions and manage the issuance of new units, and that relies on cryptography to prevent counterfeiting and fraudulent transactions."[68] A blockchain is "a digital database containing information (such as records of financial transactions) that can be simultaneously used and shared within a large decentralized, publicly accessible network."[69] A cryptocurrency coin is a coin built on its native blockchain—e.g., Bitcoin is native to the Bitcoin blockchain.[70] Comparatively, the term "cryptocurrency tokens" is a way to describe all cryptocurrencies other than Bitcoin and Ethereum that represent a unit of value on a given blockchain—e.g., tokens created and deployed on a blockchain like Ethereum.[71]

Cryptocurrency tokens are created or developed by "founders" who are the individuals who established a new cryptocurrency on an existing blockchain or to build a new blockchain and native cryptocurrency.[72] Tokens can be fungible, meaning each token is the same and carries the same value,[73] or non-fungible, meaning each token is unique and carries a different value.[74] Currently, Ethereum serves as the largest blockchain platform for the development of new cryptocurrencies.[75] Tokens created on blockchains are often referred to as utility tokens, digital assets that enable the exchange of utility, which can take many forms: paying transactions fees on a platform, conveying voting or governance rights, or entitling the holder to rewards.[76] Utility tokens are classified in four major categories: (1) DeFi tokens, cryptocurrency-based protocols that aim to reproduce

centralized organizations, strategic planning, goal setting, budgeting, and talent deployment are typically conducted by a single, senior leader or leadership team.").

67. *Id.* ("[I]n decentralized organizations, formal decision-making power is distributed across multiple individuals or teams.").

68. *Cryptocurrency*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/cryptocurrency (last visited Nov. 1, 2022).

69. *Blockchain*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/blockchain (last visited Nov. 1, 2022).

70. *What is a token?*, COINBASE, https://www.coinbase.com/learn/crypto-basics/what-is-a-token (last visited Nov. 1, 2022).

71. *Id.*

72. Allie Grace Garnett, *How to Make a Cryptocurrency*, INVESTOPEDIA, https://www.investopedia.com/how-to-make-a-cryptocurrency-5215343 (last updated Mar. 24, 2023).

73. Christian Pinto-Gutiérrez et al., *The NFT Hype: What Draws Attention to Non-Fungible Tokens?*, MATHEMATICS, Jan. 2022, at 1.

74. *Id.*

75. Satis Group, *Cryptoasset Market Coverage Initiation: Network Creation*, BLOOMBERG (July 11, 2018) at 6, https://research.bloomberg.com/pub/res/d28giW28tf6G7T_Wr77aU0gDgFQ; *see also* DApps, *DApps Statistics*, STATE OF THE DAPPS (Nov. 1, 2022), https://www.stateofthedapps.com/stats/platform/ethereum#new (reporting that Eth has 2,970 total decentralized applications compared to 332 on the next platform, of which cryptocurrency tokens are one application.).

76. Cristiano Bellavitis et al., *A Comprehensive Review of the Global Development of Initial coin Offers (ICOs) and Their Regulation*, J. BUS. VENTURING INSIGHTS, 2021, at 2 (2021).

traditional financial-system functions like lending and saving, insurance, and trading;[77] (2) governance tokens, specialized DeFi tokens that give holders a say in the future of a platform, product, or token;[78] (3) non-fungible tokens ("NFTs"), ownership rights to a unique digital or real-world asset (e.g., digital artwork, rare video game items, or a house in a virtual community);[79] and (4) security tokens, tokens that act as traditional securities by selling shares in a company without requiring a broker.[80] These categories are not exhaustive, but they do encompass a vast majority of the tokens currently on the market.[81] After creation and deployment, these tokens are often sold to individuals to raise capital through an Initial Coin Offering ("ICO") and can then be traded on secondary markets.[82]

In 2013, the cryptocurrency market was made up of 14 crypto-assets.[83] That quickly exploded to 1,500 crypto-assets in 2018—half of which were tokens created on top of other networks.[84] By the end of 2019, the number grew to 2,800.[85] As of early 2022, that number now sits at approximately 10,400.[86] Since 2010, individuals have been purchasing cryptocurrency tokens directly from the token founders through ICOs and from holders on secondary markets with almost no regulation.[87] The lack of token regulation has resulted in widespread ICO scams that have cost investors billions.[88]

D. The United States' Inadequate Regulatory Response

The United States' inadequate, reactive, and "patchwork" regulatory response to the introduction of cryptocurrencies has occurred at both the federal and state level, which includes market regulators, banking regulators, agencies tasked with

77. *What is a token?*, *supra* note 70.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. Cristiano Bellavitis et al., *supra* note 76, at 1; *Crypto-assets: Implications for Consumers, Investors, and Businesses*, U.S. DEP'T OF TREASURY (Sept. 2022) at 18, https://home.treasury.gov/system/files/136/CryptoAsset_EO5.pdf.

83. Satis Group, *supra* note 75, at 1.

84. *Id.*

85. *Crypto-Assets*, *supra* note 82, at 14.

86. *Id.*

87. Cristiano Bellavitis et al., *supra* note 76, at 3-4.

88. *See* Kenny Phua et al., *Don't Trust, Verify: The Economics of Scams in Initial Coin Offerings*, Apr. 2022, at 4 (finding 40% of 5,935 ICOs studied—valued at $12 billion U.S.—were scams); Satis Group, *supra* note 75, at 1 (finding 80% of projects by share number were scams); David Segal, *Going for Broke in Cryptoland*, NEW YORK TIMES (Nov. 2, 2021), https://www.nytimes.com/2021/08/05/business/hype-coins-cryptocurrency.html (discussing the fact that fake "hype coins" can be made in minutes, "Cryptoland is swarming with scammers," and that it took less than $1,000 to create and market a fake hype coin).

protecting the financial system, and agencies with the authority to enforce consumer protection laws.[89]

At the federal level, the Commodity Futures Trading Commission ("CFTC") oversees commodity derivatives, associated markets and intermediaries, and maintains anti-fraud and anti-manipulation enforcement over commodities that are not securities.[90] The SEC oversees securities and securities derivatives,[91] while the Federal Reserve, Options Clearing Corporation ("OCC"), and Federal Deposit Insurance Corporation ("FDIC") oversee federal and state banking activities.[92] Finally, the Consumer Financial Protection Bureau ("CFPB") regulates the offerings of consumer financial products and services.[93] Notably, there is no federal agency with exclusive authority to regulate crypto-assets,[94] which results in different agency action causing significant confusion about the appropriate regulatory classifications for crypto-assets.[95] At the state level, crypto-asset definitions, laws, and regulatory agencies vary significantly, if they exist at all.[96] While thirty-seven states passed legislation regarding cryptocurrency, digital or virtual currencies, and other digital assets in 2022, these disjointed laws continue the concerning trend of avoiding a comprehensive and consistent crypto-asset regulatory approach.[97]

While countless federal and state agencies are attempting to regulate crypto-assets, the response has been splintered, as some view tokens as a security, some as commodities, and some as currency.[98] Further, the response has often been exclusively reactive and has not encompassed all crypto-assets being sold to consumers.[99] In 2013, the Department of Treasury's Financial Crimes Enforcement Network ("FinCen") issued a guidance memo interpreting "an administrator or exchanger" of virtual currency as a Money Services Business required to follow their financial regulations.[100] Later in 2015, the CFTC classified cryptocurrencies as commodities falling under the Commodity Exchange Act.[101] Then in 2017, the SEC

89. *Crypto-Assets*, *supra* note 82, at 39.

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.*

95. *See infra* notes 89-104 and accompanying text.

96. Heather Morton, *Cryptocurrency 2022 Legislation*, NAT'L CONF. OF STATE LEGISLATURES (Jun. 7, 2022), https://www.ncsl.org/research/financial-services-and-commerce/cryptocurrency-2022-legislation.aspx.

97. *Id.*

98. *Id.*

99. *See infra* notes 100-05 and accompanying text.

100. Fin. Crimes Enf't Network, U.S. Dep't of Treasury, FIN-2013-G001, Guidance on Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies (Mar. 18, 2013), at 3.

101. Order Instituting Proceedings Pursuant to Sections 6(c) & 6(d) of the Commodity Exchange Act, Making Findings & Imposing Remedial Sanctions at 3, *In re* Coinflip, Inc., CFTC No. 15-29 (Sept. 17, 2015).

issued an investigation report finding that Decentralized Autonomous Organization ("DAO") tokens issued to raise capital to fund company "projects" were securities under the Securities Act of 1933 and Securities Exchange Act of 1934.[102] Despite this finding, enforcement action using the report was limited to "advise those who would use a . . . [DAO entity], or other distributed ledger or blockchain-enabled means for capital raising, to take the appropriate steps to ensure compliance with the U.S. federal securities laws."[103] In 2019, the SEC published its framework for the *Howey* "investment contract" analysis of digital assets.[104] While it provided guidance on the SEC's approach to a cryptocurrency *Howey* analysis, many felt it was overly broad and lacked clarity around what mattered most to determine if a digital asset was a security because it listed thirty-eight unweighted considerations.[105]

II. CRYPTOCURRENCY TOKENS EFFECTIVELY REGULATED UNDER *HOWEY*

Even with the fractured regulatory response, the SEC is leading the regulatory efforts by classifying certain cryptocurrency tokens as securities.[106] Its Crypto Assets and Cyber Unit pursues enforcement actions against cryptocurrency tokens developed on blockchains that clearly meet the four-factor *Howey* test.[107] Based on the SEC's articulated approach to regulating tokens, any token that is created and issued by founders or a company, that investors purchase with physical or digital currency, that have an expectation of profits from marketing, expected development plans, or future partnerships, and that are derived from the efforts of the founders or a common enterprise can likely be regulated by the SEC as securities under the *Howey* test.[108] In several instances, the SEC through enforcement actions[109] and courts through *Howey* have done just that.[110]

102. Report of Investigation, Securities Exchange Act Release No. 34-81207, SEC Docket Volume 117 Number 5 (July 25, 2017), at 1.

103. *Id.* at 1-2.

104. *Framework for "Investment Contract" Analysis of Digital Assets*, SEC. & EXCH. COMM'N, https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets (Apr. 3, 2019).

105. Hester M. Peirce, *How We Howey*, SEC. AND EXCH. COMM'N (May 9, 2019), https://www.sec.gov/news/speech/peirce-how-we-howey-050919.

106. *SEC Nearly Doubles Size of Enforcement's Crypto Assets and Cyber Unit*, SEC. & EXCH. COMM'N (May 3, 2022), https://www.sec.gov/news/press-release/2022-78.

107. *See generally* U.S. SEC v. Kik Interactive Inc., 492 F. Supp. 3d 169 (2020); U.S. SEC v. Telegram Group Inc., 448 F. Supp. 3d 352 (2020).

108. *See infra* notes 111-14 and accompanying text.

109. *See Crypto Assets and Cyber Enforcement Actions,* SEC. & EXCH. COMM'N, https://www.sec.gov/spotlight/cybersecurity-enforcement-actions (Mar. 2, 2023) (providing a comprehensive list of SEC crypto-asset enforcement actions since 2013, many of which include tokens that courts have not considered under *Howey* because they were settled prior to litigation).

110. *See infra* notes 111-13 and accompanying text.

In *U.S. SEC v. Kik Interactive Inc.*, the court determined a token issued by Kik for use as currency to buy and sell digital products across different applications was a security because: (1) purchasers invested money; (2) a common enterprise existed when the sale proceeds went to a single bank account used by the founders for future token and ecosystem development; (3) purchasers had an expectation of profit because Kik promised to develop more applications that would drive demand for the token as a currency; and (4) those expectations of profits were derived from the efforts of others because Kik's founders led the development and implementation of new applications and the creation of new company partnerships that would drive future Kik token demand.[111]

Similarly, in *U.S. SEC v. Telegram Group Inc.*, the court determined that initial offerings in future tokens were securities because: (1) investors provided dollars in exchange for the future delivery of the Gram token; (2) Telegram operated as a common enterprise when it pooled assets and used those assets for development efforts; (3) investors had an expectation of profit because the token supply was capped and there were clear plans to develop products to drive future token demand; and (4) these expectations were derived from the efforts of others because creation of the Gram token and new token functionality were the direct result of Telegram's entrepreneurial and managerial team.[112]

Finally, while the case has yet to be fully litigated, the SEC's enforcement approach is apparent in a recently filed complaint, *SEC v. Wahi, et al.*, where the SEC asserts first that nine different ICO tokens are securities, and second that they were illegally traded on by a former Coinbase employee using insider information.[113] This is the largest single enforcement action, encompassing nine tokens that are alleged securities under *Howey*, and also one of the first to include an insider trading claim in the digital-asset space.[114]

While these steps highlight the SEC's priority of identifying and litigating good "use cases" to develop court precedent where crypto-assets are considered securities under *Howey*, they are underinclusive—not encompassing NFTs and certain utility tokens that function similarly to tokens considered securities under *Howey*[115]—and leave consumers purchasing non-regulated tokens almost completely unprotected.[116]

111. *Kik Interactive Inc.*, 492 F. Supp. 3d at 177-180.

112. *Telegram Group Inc.*, 448 F. Supp. 3d at 367-74 (2020).

113. Complaint, U.S. SEC v. Wahi, et al., No. 2:22-cv-01009 (W. D. Wash. Jun. 21, 2022).

114. *Id.*

115. *See infra* Section III; *see also* Jillian Grennan, *FinTech Regulation in the United States: Past, Present, and Future*, SSRN.com (Aug. 31, 2022) at 22, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4045057.

116. Grennan, *supra* note 115, at 22.

III. THE ISSUE: TOKENS NOT EFFECTIVELY REGULATED UNDER *HOWEY*

With a foundational knowledge of the application of securities regulation, the introduction and growth of cryptocurrency assets, the United States' inadequate regulatory response, and the SEC's recent attempts to regulate cryptocurrency tokens under *Howey*, this section examines the issue that most NFTs and in-ecosystem currency tokens are likely not able to be regulated under *Howey.*[117]

A. NFTs and In-Ecosystem Tokens

NFTs provide purchasers with ownership rights to unique digital or real-world assets (e.g., digital artwork, rare video game items, a house in a virtual community, or access to exclusive in-person events).[118] Comparatively, in-ecosystem or gaming currency tokens are used to purchase items, services, or goods in ecosystems or games built on top of a blockchain.[119] Both NFTs and gaming tokens often function within the same platform, world, or ecosystem.[120] A few of the most popular NFTs are Bored Ape Yacht Club and Decentraland.[121] In many instances, gaming tokens are either directly or indirectly tied to the NFTs associated with those games or ecosystems.[122] For example, Bored Ape Yacht Club NFT holders are direct recipients of the APE ecosystem currency ApeCoin, and Decentraland LAND NFTs and in-ecosystem goods and services are purchased with MANA ERC-20 tokens.[123]

B. Why Most NFTs and In-Ecosystem Tokens Likely Fail the Howey Test

This section examines why NFTs and in-ecosystem tokens are likely difficult to regulate as securities under the *Howey* test. These challenges are explored through the lens of the four *Howey* considerations, whether there is: (1) an investment of money; (2) in a common enterprise; (3) with the expectation of profits; (4) based

117. *See infra* Section III.B; *see also* Grennan, *supra* note 115, at 22 (SEC Commissioners have stated there are existing tokens and NFTs that on their face may not look like securities, but likely should be regulated as securities under *Howey,* even though a new approach is necessary).

118. *See supra* note 79 and accompanying text.

119. Wayne Duggan & Farran Powell, *What Is Crypto Gaming?*, FORBES ADVISOR, https://www.forbes.com/advisor/investing/cryptocurrency/what-is-crypto-gaming/ (Aug. 8, 2022, 3:28 PM).

120. *Id*.

121. *Top NFTs*, OpenSea, https://opensea.io/rankings?sortBy=one_day_volume (last visited Nov. 1, 2022) (reporting that as of November 1, 2022, the top charts ranked Bored Ape second and Decentraland tenth).

122. *See infra* note 123 and accompanying text.

123. Hannah Miller, *Bored Ape's New ApeCoin Puts NFTs' Power Problem on Display*, FORTUNE (Mar. 20, 2022), https://fortune.com/2022/03/20/bored-apes-new-apecoin-puts-nfts-power-problem-on-display-andreessen-horowitz-animoca-brands/; *Decentraland Glossary*, DECENTRALAND, https://docs.decentraland.org/player/general/glossary/ (last visited Apr. 12, 2023) ("MANA's purpose is to allow users of Decentraland to purchase LAND and goods and services from other users.").

on the efforts of others.[124] Additionally, this section utilizes two example NFTs and in-ecosystem tokens, (1) Bored Ape NFTs and ApeCoin, and (2) LAND NFTs and MANA tokens to provide practical examples of how these token types present challenges under each *Howey* prong.[125]

i. Investment of Money

The first consideration in the *Howey* analysis is whether there was an investment of money.[126] The Supreme Court has broadly defined an investment of money as the purchase or acquisition of something in exchange for an item of value.[127] While this prong is usually straightforward, NFTs and in-ecosystem tokens have unique functionality and features that make this a more complex consideration.[128]

a. NFTs

Even though purchasers generally pay either physical or digital assets for NFTs, these purchases will likely not be considered an investment of money under the first *Howey* prong.[129] In *Kik* and *Telegram*, crypto-currency tokens were purchased under the assumption that future development would increase token demand and value.[130] Comparatively, most individuals purchase NFTs to own a unique digital or real-world asset, even if the development of future products will increase demand and value.[131] Further, motivation to buy an asset simply because its value may appreciate does not automatically make it a security—e.g., purchasing a piece of artwork because it may appreciate in value does not make it a security.[132] An argument can be made that NFT purchase funds are also utilized to further develop the ecosystem and create new owner benefits, but this argument is likely outweighed by the purchaser's primary purpose of using the NFT or the benefits associated with it.[133] For example, when a Bored Ape NFT purchaser paid 0.08 Eth, they received a unique graphical representation of a cartoon-like ape living on the blockchain, which served as a membership card and provided exclusive

124. *See supra* note 54 and accompanying text.

125. *See infra* note 134-36 and accompanying text.

126. *See supra* notes 54-55 and accompanying text.

127. *See supra* notes 49, 55 and accompanying text.

128. *See infra* Section III.B.i.a, III.B.i.b.

129. *See infra* notes 130-36 and accompanying text.

130. *See supra* notes 111-12 and accompanying text.

131. *See supra* note 74-75, 118 and accompanying text.

132. Dahl v. English, 578 F. Supp. 17, 20 (N.D. Ill. 1983) (finding art was not a security because it did not meet the definition of an investment contract under *Howey*).

133. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852-53 (1975) ("[W]hen a purchaser is motivated by a desire to use or consume the item purchased' those items are not securities under *Howey*.").

membership benefits.[134] While these funds were utilized to develop future benefits,[135] the purchaser's primary purpose was to own and use the unique cartoon-like ape online and to access the member benefits.[136]

b. In-Ecosystem Tokens

In-ecosystem tokens present an even more complex analysis because they have different distribution methods. They can be: (1) airdropped to current NFT holders at no charge; (2) given freely to founders or developers; (3) stored in a DAO blockchain treasury; (4) provided to initial investors at no charge; or (5) sold in an ICO.[137] Many of these methods do not involve an exchange of physical or digital assets for the tokens.[138] The variety of distribution, and lack of investment of any physical or digital assets in exchange for the token in many cases, distinguish these substantially from the investments in tokens considered to be securities in *Kik* and *Telegram*.[139]

Because the primary reason to purchase an NFT is often owning and using a unique digital asset, and many in-ecosystem token distribution methods do not involve the exchange of physical or digital-assets, a majority of these tokens likely fail *Howey's* investment of money prong.

ii. In a Common Enterprise

The second *Howey* analysis consideration is whether there is a common enterprise.[140] The Court's precedent has found a common enterprise exists in two structures: (1) horizontal, or (2) strict vertical commonality.[141] Horizontal commonality is two or more investors who pool their investments together and split

134. *Welcome to the Bored Ape Yacht Club*, BORED APE YACHT CLUB, https://boredapeyachtclub.com/#/home (last visited Nov. 1, 2022).

135. *Id.*

136. *Id.*

137. *See ApeCoin for the Web3 Economy,* APECOIN, https://apecoin.com/about (last visited Nov. 1, 2022) (The one billion ApeCoin launched were distributed as follows: 15% to existing NFT holders, 47% to the DAO treasury, 15% to the Yuga Labs company, 1% to charity, 14% to launch contributors, and 8% to the founders of Yuga Labs); Ari Meilich, *The Decentraland Token Sale Terms*, MEDIUM (July 3, 2017), https://medium.com/decentraland/the-decentraland-token-sale-terms ("40/20/20/20 distribution: 40 percent of the token supply will be sold to the crowdsale buyers, 20 percent is reserved to incentivize the community, 20 percent will go to the development team, early contributors and advisors, and the remaining 20 percent will be held by Decentraland.").

138. *Id.*

139. *See supra* notes 107, 137 and accompanying text.

140. *See supra* notes 54-55 and accompanying text.

141. *See* U.S. S.E.C. v. SG Ltd., 265 F.3d 42, 49 (1st Cir. 2001); *see also* Teed v. Chen, No. 22-cv-02862-CRB, Slip op. at 12 (N.D. Cal. Nov. 9, 2022) (applying the common enterprise horizontal or strict vertical commonality standard in the Bitcoin context).

the net profits and losses in accordance with their pro rata investments.[142] By contrast, vertical commonality is established when the fortunes of the investors are linked with those of the founders, managerial team, or promoters.[143]

A cursory review of many NFTs and in-ecosystem tokens' Decentralized Autonomous Organization ("DAO") governance structures may lead one to believe there is no common enterprise.[144] While DAOs are theoretically structured as fully democratized organizations that allow all token holders governance rights through the ability to submit proposals and vote on future development and expenditures, in practice many DAOs do not function that way.[145] Many DAOs have appointed Boards who hold significant percentages of tokens in circulation that serve as votes on proposals, and they also may oversee the DAO's treasury that holds these large token positions.[146] Moreover, because the ability to make community vote proposals is often restricted to board members, board members hold more tokens that act as votes, and that same group manages the implementation of approved proposals, a small core group exercises control.[147]

A perfect example of this lack of decentralization is the ApeCoin DOA governance structure, where 15% of tokens were provided directly to Yuga Labs, the company in charge of ApeCoins development, 8% were provided to Yuga labs founders, 15% of tokens were provided to existing NFT holders (many of which are likely the core

142. *Id.*

143. *Id.*

144. *Decentralized Autonomous Organizations (DAOs)*, ETHEREUM, https://ethereum.org/en/dao/ (last visited on Oct. 27, 2022) ("DAOs allow us to work with like-minded folks around the globe without trusting a benevolent leader to manage the funds or operations. There is no CEO who can spend funds on a whim or CFO who can manipulate the books. Instead, blockchain-based rules baked into the code define how the organization works and how funds are spent. They have built-in treasuries that no one has the authority to access without the approval of the group. Decisions are governed by proposals and voting to ensure everyone in the organization has a voice, and everything happens transparently on-chain.").

145. *See* Gail Weinstein et al., *A Primer on DAOs*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (September 27, 2022), https://corpgov.law.harvard.edu/2022/09/17/a-primer-on-daos/ ("First, a DAO's decentralized governance model does not always work as advertised, as a small group of founders, holders of significant amounts of tokens, and/or others interested in being actively involved may become a *de facto* control group (either because the size of their holdings is sufficient to control the vote or, as often occurs, other members lose interest in participating). Second, decision-making through smart contracts on the blockchain can stifle change and needed adaptation, as it requires consideration and voting by the members and re-coding of the software every time a change is to be made. To address these two issues, some DAOs have instituted subgroups, dubbed "sub-DAOs," which are effectively committees comprised of groups of the DAO's members, to consider and accomplish specific tasks and thus avoid the necessity of votes by the full membership on every small decision. …Fourth, there is the potential for "governance attacks," in which a single actor or a group, whose objectives are not aligned with the DAO's stated mission, might take control of the DAO (pursuant to the DAO's own governance procedures) and drain the DAO's treasury or otherwise deploy it to their own ends.").

146. *Id.*

147. *Id.*

founders and developers), 14% to launch contributors, 1% to charity, and 47% were placed in the DAO treasury.[148] Because 48% are not in use (47% in treasury and 1% donated to charity), this functionally means that Yuga labs, Yuga labs founders, and founders holding NFTs have a controlling interest over proposals made, votes on proposals, and on how those approved proposals are executed.[149] A more recent example is discussed in the *SEC v. Eisenberg* complaint.[150] In that complaint, the SEC details how the MNGO governance token rights were illusory because: (1) not all token holders were eligible to submit every type of governance proposal; (2) "governance proposals are executable code … [and] not all MNGO token holders may have the … requisite technical skills to submit … proposals"; (3) a 2% of token holders voting requirement, and a three-day voting period, allowed proposals to pass with only a small percentage of token holders voting; (4) 50% of MNGO token ownership was in the hands of Mango's creators; (5) in practice only "five-to-ten MNGO token wallet address voted" on proposals, and Mango creator wallets "dominated the votes"; and (5) after the initial token sale a seven-member council inclusive of Mango Market creators was created and had "authority to unilaterally (i.e., without a governance proposal) control upgrades of the Mango Markets."[151]

Because the practical realities of DAO governance structures likely make them centralized, many NFTs and in-ecosystem tokens are likely operating under a common enterprise, so this prong likely weighs in favor of the SEC's ability to regulate under *Howey*.[152]

iii. Reasonable Expectation of Profits

The third *Howey* analysis consideration is whether the investment in a common enterprise occurs with *a reasonable expectation of profits*.[153] The Court's precedent, and the SEC's guidance, recognize purchasers have a reasonable expectation of profits when the digital assets are expected to realize appreciation ("such as selling at a gain in a secondary market"); an active participant (promoter, sponsor, or third party) provides "essential managerial efforts that affect the success of the enterprise" resulting in expected or realized future profits; the asset is offered broadly to potential purchasers instead of simply to those who use its functionality; the asset price is not correlated to the good or service price that it can be exchanged for; and the digital asset is marketed as an investment, a way to build

148. *See supra* note 137 and accompanying text.

149. *Id.*

150. *See generally United States Securities and Exchange Commission v. Avraham Eisenberg Complaint*, SEC. & EXCH. COMM'N (Jan. 20, 2023), https://www.sec.gov/litigation/complaints/2023/comp-pr2023-13.pdf.

151. *Id.* at 1-3.

152. *See supra* Section III.B.ii.

153. *See supra* notes 53-54 and accompanying text.

capital, and potentially profitable based on future network or asset development.[154] The SEC and courts also use an objective analysis to asses "the 'economic reality' of the transaction and the instruments use in commerce, the distribution plan, and the 'the economic inducements held out to the prospect.'"[155]

In the NFT and in-ecosystem token context, the considerations in this prong mirror many of those presented in the "investment of money" section above.[156] NFTs are specifically defined as the purchase of ownership rights to a unique digital or real-world asset,[157] while in-ecosystem tokens are defined as the currency used to purchase services and goods within the ecosystem.[158] One way to think about the potential expectation of profits associated with NFT and in-ecosystem token purchases is by comparing them to the expectations of profits when purchasing a physical asset, such as a house or piece of artwork that is not considered a security under *Howey*.[159] The SEC has clearly stated that "[p]rice appreciation resulting solely from external market forces (such as general inflationary trends or the economy) impacting the supply and demand for an underlying asset generally is not considered 'profit'" under *Howey*.[160] For example, while a home value may increase over time, purchasers generally buy houses to live in, and any future value increase is likely a result of external market forces, not from the efforts of the owner.[161] Similarly, NFTs are primarily purchased for individual use or use of the NFT's benefits, and in-ecosystem tokens are purchased to buy goods or services within the ecosystem.[162] However, NFTs and in-ecosystem tokens are distinct in that many of them are a part of a common enterprise, unlike the single owner of a house.[163] Further, their marketing and promotional materials establishes some expectation

154. *Framework*, *supra* note 104 (emphasis added).

155. *Id.*

156. *See supra* Section III.B.i.

157. *See supra* note 118 and accompanying text.

158. *See supra* note 119 and accompanying text.

159. Hart v. Pulte Homes of Michigan Corp., 735 F. 2d 1001 (6th Cir. 1984) (holding that a mobile home sale was not a security under *Howey*).

160. *Framework*, *supra* note 104.

161. *See supra* note 159 and accompanying text.

162. *See supra* notes 157-58 and accompanying text.

163. *See supra* Section III.B.ii.

that the scarcity from a limited supply,[164] future ecosystem development,[165] and the addition of new exclusive membership benefits,[166] will increase NFT and in-ecosystem demand and value when sold on secondary markets.[167]

Because of this, it is unclear how a court would rule on the expectation of profit prong. The variety of scenarios and factual complexities presented above likely foreshadow significant variance among district and appellate courts. Within this variance, some courts may determine that individuals purchase NFTs and in-ecosystem tokens for its functional use, and that price fluctuations are simply a result of external market forces. Therefore, NFTs would fail the reasonable expectation of profit prong.

iv. Derived From the Efforts of Others

The fourth and final *Howey* analysis consideration is whether the expectations of profits are derived from the efforts of others.[168] Under this prong, the SEC and courts consider "others" to be an asset's founders, managerial team, or promoters.[169] They consider "efforts" to be both the marketing of potential future actions and expertise, as well as the actual actions taken by founders, managerial team, or promoters to develop and promote the enterprise.[170]

In most cases, this prong is likely to weigh in favor of NFTs and in-ecosystems tokens being securities under *Howey*. As discussed above, the ongoing development of NFT and in-ecosystem token benefits, infrastructure, and uses are often a direct result of a common enterprise of founders or core developers.[171] This is the exact situation as the tokens considered securities in *Kik* and *Telegram*, where a core group of founders were developing and implementing ecosystem improvements.[172] Because of these founders and developers' material efforts, this

164. *Welcome to the Bored Ape Yacht Club*, BOREDAPEYACHTCLUB (2021), https://boredapeyachtclub.com/#/home ("Bored Ape NFTs were capped at 10,000."); *Decentraland*, COINMARKETCAP, https://coinmarketcap.com/currencies/decentraland/ ("LAND NFTs were capped at 90,601."); *ApeCoin Allocation*, APECOIN (2022), https://apecoin.com/about ("ApeCoins were capped at 1,000,000,000."); and *FAQs*, DECENTRALAND, https://docs.decentraland.org/player/general/glossary/ ("MANA tokens were capped at 2,805,886,393.").

165. *Welcome to the Bored Ape Yacht Club*, *supra* note 164; *Proposal Process*, APECOIN (2022), https://apecoin.com/governance; Eseban Ordano et al., *Decentraland, A Blockchain-Based Virtual World*, DECENTRALAND WHITEPAPER, at 5-10, 13-15.

166. *Welcome to the Board Ape Yacht Club*, *supra* note 164.

167. *See supra* notes 82, 87 and accompanying text.

168. *See supra* notes 54-55 and accompanying text.

169. *Framework*, *supra* note 104.

170. *Id.*

171. *See supra* Section III.B.ii.

172. *See supra* notes 111-12 and accompanying text.

prong likely weighs in favor of NFTs and in-ecosystem tokens being considered securities under *Howey*.

Under the four prong *Howey* analysis, most NFTs and in-ecosystem tokens likely do not meet the investment of money and expectation of profits prongs, so they are not "investment contracts" and likely cannot be regulated as securities.[173]

IV. THE NEED FOR NFT AND IN-ECOSYSTEM TOKEN REGULATION AND POTENTIAL SOLUTIONS

Due to the significant consumer demand, expected future integration into personal and business functions, billions of dollars spent each year, and rampant scams and mismanagement in the NFT and in-ecosystem token market, identifying and implementing regulatory solutions is essential for consumer protection, token issuer compliance, and market stability.[174] While NFTs and in-ecosystem tokens likely cannot be regulated as securities under *Howey*,[175] there are potential regulatory solutions that federal agencies, the Supreme Court, and Congress can take to limit the negative consequences of unregulated NFTs and in-ecosystem tokens.[176] Subsection A examines why NFT and in-ecosystem regulation is necessary,[177] while subsection B outlines potential regulatory solutions.[178]

A. NFT and In-Ecosystem Token Regulation Is Necessary For Consumer Protection, Token Issuer Compliance, and Market Stability

While the crypto-asset marketplace is currently experiencing significant strife,[179] the popularity, use, and integration of crypto-assets and their underlying technology into consumers lives is expected to increase exponentially.[180] The industry's expected growth, rampant fraud and mismanagement, and lack of information asymmetry, material information transparency, and governance structures that protect purchasers, necessitate the implementation of comprehensive regulatory solutions to protect consumers, ensure token issuer compliance, and maintain market stabilization.[181]

173. *See supra* Section III.B.i and Section III.B.iii.
174. *See infra* Section IV.A.
175. *See supra* Section III.
176. *See supra* Section IV.B.
177. *See infra* Section IV.A.
178. *See infra* Section IV.B.
179. *See infra* notes 186, 197–202 and accompanying text.
180. *See infra* notes 191-96 and accompanying text.
181. *See supra* Section IV.A.

In 2021, over $40 billion worth of NFTs were sent to market,[182] and $25 billion were sold.[183] As of May 1, 2022, $37 billion worth of NFTs were sent to market,[184] and as of September 2022, $23.5 billion in NFTs have been sold.[185] Further, even during the current "crypto winter,"[186] all-time NFTs sales on the top five marketplaces surpassed $40 billion on October 29, 2022.[187] NFT market growth is the byproduct of increases in Bitcoin and Ether's valuation,[188] media coverage,[189] and celebrities and social media influencer endorsements.[190] Even with current market volatility, this growth is expected to continue as NFTs are integrated into video games[191] and new promising future applications materialize, such as the Metaverse.[192] Additionally, the global gaming token market—an in-ecosystem currency token—is currently worth more than $12.8 billion,[193] and while some of

182. *Crypto-Assets: Implications for Consumers, Investors, and Businesses*, U.S. DEP'T OF TREASURY, Sept. 2022, at 24.

183. Elizabeth Howcroft, *NFT Sales Hit $25 Billion in 2021, but Growth Shows Signs of Slowing*, REUTERS (Jan. 11, 2022), https://www.reuters.com/markets/europe/nft-sales-hit-25-billion-2021-growth-shows-signs-slowing-2022-01-10/.

184. *Crypto-Assets*, *supra* note 182 at 24.

185. *Id.*; *see also* Sara Gherghelas, *Q3 DappRadar Blockchain Industry Report*, DAPPRADAR (October 6, 2022) at 15, https://dappradar.com/blog/dappradar-q3-industry-report-on-chain-indicators-signal-a-recovering-crypto-market.

186. *See* Farren Powell, *Crypto Winter is Here: What You Need to Know,* FORBES, (September 2, 2022), https://www.forbes.com/advisor/investing/cryptocurrency/what-is-crypto-winter/.

187. Jamie Redman, *The Top 5 NFT Marketplaces Surpass $40 Billion in All-Time Sales*, BITCOIN, https://news.bitcoin.com/the-top-5-nft-marketplaces-surpass-40-billion-in-all-time-sales/.

188. Christian Pinto-Gutiérrez et al., *supra* note 73 at 2 ("[F]inding that investors were more attracted to NFTs after increases in both Bitcoin and Ether returns.").

189. Joshua T. White et al., *The Role of the Media in Speculative Markets: Evidence from Non-Fungible Tokens (NFTs)*, SOCIAL SCIENCE RESEARCH NETWORK, May 2022, at 1–5 (finding that increase in traditional media coverage mirrored growth in NFT transactions, that these productions often highlighted celebrity ownership or participation in NFT projects and appeared to prioritize educating viewers/readers on what NFTs were).

190. *Id.*; *see also* Amanda Mull, *Celebrities and NFTs Are a Match Made in Hell*, THE ATLANTIC (February 4, 2022), https://www.theatlantic.com/technology/archive/2022/02/nft-jimmy-fallon-paris-hilton-millionaire/621486/; *see infra* note 197 and accompanying text.

191. *Crypto-Assets, supra* note 182 at 24-25 ("The integration of NFTs into popular games, as well as the development of blockchain-native games, means that players can purchase tokenized game features and attributes which they own and are able to transfer. With an estimated 215 million, or 66% of, Americans playing video games at least once per week, the potential market for such so-called "play-to-earn" games is substantial.").

192. *Id.* at 25 ("NFTs have a number of potential future applications, including: (i) enabling the recording and verification of transfers of real estate ownership; (ii) facilitating automatic royalty payments for music and film; (iii) preventing duplication and counterfeits in the titling of other property and consumer goods; (iv) enabling more digital credentials, including identification, licensing, certification; and (v) facilitating financial industry legal compliance."); *see also* Oleg Fonarov, *What is the Role of NFTs in the Metaverse?*, FORBES (Mar. 11, 2022), https://www.forbes.com/sites/forbestechcouncil/2022/03/11/what-is-the-role-of-nfts-in-the-metaverse/?sh=e8355b36bb87.

193. Duggan, *supra* note 119.

these gaming tokens only have value within a particular game or gaming ecosystem, the top tokens also have significant real-world value on secondary markets.[194] With the introduction of Web3, a new decentralized version of the internet using blockchains, cryptocurrencies, and NFTs,[195] NFTs and in-ecosystem tokens demand is expected to rise.[196]

While the total number of NFTs on the marketplace, consumer demand, and NFT primary and secondary sales are expected to increase significantly, scams, "rampant fakes," and plagiarism plague the NFT marketplace.[197] Further, the broader crypto-asset industry is laden with fraud, theft, and mismanagement.[198] Moreover, the crypto-asset industry lacks information asymmetry, transparency of material information for purchasers, and governance structures that protect purchasers.[199] This was most recently seen in the collapse of FTX—the world's third-largest crypto-asset marketplace, due to widespread mismanagement of investor funds and fraudulent representations to investors, marketplace users, and regulators.[200] Tied to the FTX collapse are civil lawsuits against celebrities, such as Tom Brady, Stephen Curry, Gisele Bündchen, and Kevin O'Leary, for their alleged involvement in promoting the fraudulent and mismanaged crypto-asset marketplace.[201] These celebrity and influencer endorsements are commonplace and are a driving force

194. *Id*.

195. *Id.*

196. Matthew Blumenfeld et al., *Demystifying Web3*, PWC, https://www.pwc.com/us/en/tech-effect/emerging-tech/what-is-web3.html.

197. Elizabeth Howcroft, *Marketplace Suspends Most NFT Sales, Citing 'Rampant' Fakes and Plagiarism*, REUTERS (February 12, 2022), https://www.reuters.com/business/finance/nft-marketplace-shuts-citing-rampant-fakes-plagiarism-problem-2022-02-11/ ("The biggest NFT marketplace, OpenSea, valued at $13.3 billion after its latest round of venture funding, said last month more than 80% of the NFTs minted for free on its platform were 'plagiarized works, fake collections and spam.'"); Joe Tiday, *YouTube Star Logan Paul Apologises for CryptoZoo Project Failure*, BBC (Jan. 9, 2023), https://www.bbc.com/news/technology-64210289 (discussing how millions of dollars were spent on NFT and in-ecosystem tokens promoted by YouTube star Logan Paul, after which the promised game in which NFT holders could make future profit never materialized).

198. *Crypto-Assets*, *supra* note 182 at 26 ("As the crypto-asset market has grown, so has the volume of fraud, scams, and theft in the ecosystem; indeed, unlawful transaction activity globally reached an all-time high in value in 2021.").

199. *Id.* at 29 ("[D]isclosures in the crypto-asset ecosystem that are provided may lack standardization and may not disclose material information integral to assessing risk. Currently, investors may lack material information necessary to assess the risk of crypto-asset investments, including with respect to the probability and severity of the loss on the investment; instead, promoters of crypto-asset investments may at best be providing investors with only broad details or superficial disclosures.").

200. David Yaffe-Bellany, *How Sam Bankman-Fried's Crypto Empire Collapsed*, NEW YORK TIMES (Nov. 14, 2022), https://www.nytimes.com/2022/11/14/technology/ftx-sam-bankman-fried-crypto-bankruptcy.html.

201. Minyvonne Burke, *Tom Brady, Larry David and Other Celebrities Named in FTX Lawsuit*, NBC NEWS (Nov. 16, 2022, 7:04 AM), https://www.nbcnews.com/business/business-news/ftx-crypto-investors-sue-founder-sam-bankman-fried-celebrity-promoters-rcna57453.

behind a token's speculated value, even though many of the endorsed tokens and/or marketplaces are fraudulent.[202]

The increase in NFT and in-ecosystem token listings and sales over the last two years,[203] expected future listing, demand, and purchase growth, and the rampant fraud and lack of material information transparency in the marketplace[204] highlight the need for regulation of new and existing NFTs and in-ecosystem tokens to protect consumers, ensure token issuer compliance, and maintain market stability.[205]

B. Potential Pathways to Close the Regulatory Gap

While under the *Howey* analysis most NFTs and in-ecosystem tokens are likely unable to be regulated as securities by the SEC,[206] there are steps that federal agencies, the Supreme Court, and Congress can take to improve regulation of these tokens.[207] Specifically, federal agencies could clarify if and how, NFTs and in-ecosystem tokens fall under existing law; identify regulatory gaps and conduct notice and comment rulemaking procedures to implement new rules; transparently share these with crypto-asset consumers, issuers, and exchanges; and then confidently pursue enforcement actions to establish agency and court regulatory precedent for these crypto-assets.[208] Further, the Supreme Court could broaden its interpretation of what constitutes the "investment of money" and "with an expectation of profits" prongs under its *Howey* analysis.[209] Finally, Congress could amend existing securities laws or pass new crypto-asset focused legislation.[210]

i. Existing Regulatory Agencies can Clarify how NFTs and In-Ecosystem Tokens Fall Under Existing Law, Pass New Rules to Fill Gaps Through Rulemaking, Increase Transparency, and Prioritize Regulatory Enforcement Actions

Federal agency regulatory solutions are likely the least controversial, and most easily implemented, because they do not require the passage of new legislation, do

202. *See* David Yaffe-Bellany, *How Influencers Hype Crypto, Without Disclosing Their Financial Ties*, NEW YORK TIMES (May 27, 2022), https://www.nytimes.com/2022/05/27/technology/crypto-influencers.html; Eamon Javers et al., *Some Social Media Influencers are Being Paid Thousands to Endorse Cryptocurrency Projects*, CNBC (Aug. 11, 2022), https://www.cnbc.com/2022/08/11/some-influencers-paid-thousands-to-endorse-cryptocurrency-projects.html.

203. *See supra* notes 191-96 and accompanying text.

204. *See supra* notes 197-202 and accompanying text.

205. *See supra* Section IV.A.

206. *See supra* Section III.

207. *See infra* Section IV.B.

208. *See infra* Section IV.B.i.

209. *See infra* Section IV.B.ii.

210. *See infra* Sections IV.B.III and Sections IV.B.IV.

not require a consistently divided Congress to agree on amendments, and do not ask the Supreme Court to issue guidance on ongoing policy matters.[211] These also mirror crypto-asset regulatory improvement recommendations from the Department of Treasury[212] and the White House.[213] This section discusses the regulatory benefit of federal agencies clarifying if, and how, crypto-assets fall under existing law;[214] how identified regulatory gaps could be filled by rulemaking;[215] and the importance of increasing federal enforcement actions.[216]

a. Clarify How NFTs and In-Ecosystem Tokens Fall Under Existing Laws

As indicated by the Department of Treasury and White House reports, most federal agencies have struggled to articulate what crypto-assets fall under existing laws and what they are considering when taking enforcement actions.[217] However, there is one federal agency, the Internal Revenue Service ("IRS"), that can serve as a model for clarity and transparency with crypto-asset consumers.[218] In 2014, the IRS published The IRS VIRTUAL CURRENCY GUIDANCE to explain how existing general tax principles apply to the transactions using virtual currency through a question and answer document.[219] Through this Q&A format, the IRS answered questions such as, "how is virtual currency treated for federal tax purposes?"; "how is the fair market value of cryptocurrency determined?"; and "does a taxpayer who "mines" virtual currency realize gross income upon receipt of the virtual currency resulting from those activities?"[220] While individuals may disagree with the IRS classification

211. *See infra* Sections IV.II, IV.III, and IV.IV.

212. *Crypto-Assets*, *supra* note 182 at 50-51 ("U.S. regulatory and law enforcement authorities should, as appropriate, pursue vigilant monitoring of the crypto-asset sector for unlawful activity, aggressively pursue investigations, and bring civil and criminal actions to enforce applicable laws with a particular focus on consumer, investor, and market protection.").

213. *Fact Sheet: White House Releases First-Ever Comprehensive Framework for Responsible Development of Digital Assets*, WHITE HOUSE (Sept. 16, 2022) at 2-3, https://www.whitehouse.gov/briefing-room/statements-releases/2022/09/16/fact-sheet-white-house-releases-first-ever-comprehensive-framework-for-responsible-development-of-digital-assets/ (The report encourages "regulators like the SEC and CFTC … to aggressively pursue investigations and enforcement actions against unlawful practices in the digital assets space; CFPB and FTC … to redouble their efforts to monitor consumer complaints and to enforce against unfair, deceptive, or abusive practices; agencies to issue guidance and rules to address current and emergent risks in the digital asset ecosystem; regulatory and law enforcement agencies … to collaborate to address acute digital assets risks facing consumers, investors, and businesses; agencies are encouraged to share data on consumer complaints regarding digital assets—ensuring each agency's activities are maximally effective.").

214. *See infra* Section IV.B.i.a.

215. *See infra* Section IV.B.i.b.

216. *See infra* Section IV.B.i.c.

217. *See supra* notes 212-13 and accompanying text.

218. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938.

219. *Id.* at 2-5.

220. *Id.* at 2-3.

of crypto-assets and what tax requirements apply to them, those tax requirements are clear to crypto-asset consumers.[221]

All federal agencies could benefit from going through a similar exercise by issuing new guidance, or refining existing guidance about how each crypto-asset aligns under existing laws.[222] For example, the SEC could update its guidance[223] to address if and how each type of crypto-asset falls under their *Howey* analysis, thus informing issuers, exchanges, and consumers about applicable security law requirements.[224] To specifically address the NFT and in-ecosystem regulatory challenges, the SEC could publicly detail if and why NFTs and in-ecosystem tokens qualify or do not qualify as securities under *Howey*.[225] While it is likely that most of them do not qualify as securities, and publicly sharing this does not itself resolve the regulatory issue, it may lead to further rulemaking to fill this regulatory gap.[226] It also clearly tells consumers that they are unprotected if they buy these tokens and that they should advocate for new regulations if they are concerned about potential consequences.[227] Finally, this determination puts Congress on notice that they must act by updating existing laws or passing new crypto-asset legislation in order to empower federal regulatory agencies to take action.[228]

b. Conduct Rulemaking to Fill Regulatory Gaps

After federal agencies have clarified which crypto-assets do, and do not, fall under existing laws, they should identify the regulatory gaps, determine if they have the statutory authority to regulate crypto-assets that fall into those gaps, and then conduct a formal rulemaking process to further interpret relevant statutes, outline procedural requirements for those crypto-assets issuers, explain how they will exercise their regulatory discretion, and describe policies for implementing these newly established rules.[229]

Federal agencies are authorized to issue new and interpretative regulations by Congress through statutes, and in some cases, the President may delegate existing presidential authority to the agency to address an issue.[230] Under the

221. *Id.* at 1-5.

222. *See infra* Section IV.B.i.b.

223. While the SEC has provided a crypto-asset *Howey* framework, it could be updated based on what they have learned from enforcement actions since 2017 and to address how all tokens fall under their analysis; *see Framework*, *supra* note 104.

224. *Framework*, *supra* note 104.

225. *Id.*

226. *Id.*

227. *See supra* Section IV.A.

228. *See infra* Section IV.B.iii and IV.B.iiii.

229. *See infra* notes 233-34 and accompanying text.

230. Office Fed. Reg., A Guide to the Rulemaking Process (2011), at 1-3.

Administrative Procedure Act ("APA"), agencies must follow a formal Notice-and-Comment ("N&C") rulemaking procedure when proposing and adopting new rules, amending existing rules, and repealing outdated rules.[231] Under the N&C procedural requirements, agencies must publish the proposed rule in the *Federal Register*, summarize the issue the rule is meant to address, detail their legal authority to address this issue through rulemaking, provide relevant considerations and data informing the rule, conduct a cost-benefit analysis of the proposed rule, and outline the opportunities for interested parties to comment on the proposed rule.[232] For example, in 2022, the SEC proposed thirty-eight rules to address deficiencies with insider trading rules, reporting requirements, and environmental, social, and governance disclosures.[233]

In the crypto-asset context, these new rules can fill regulatory gaps for certain crypto-asset types by creating registration and reporting requirements, providing consumers and issuers guidance on what tokens fall under a given agency's purview, identifying tokens they are not statutorily authorized to regulate, and updating existing procedures to reflect the evolving crypto-asset technology.[234] While these new and amended rules will likely not address all of the regulatory gaps, taking steps to further clarify what crypto-assets are able to be regulated and outlining requirements for those assets will provide enforcement agencies enumerated regulations to utilize in future investigations and enforcement actions.[235]

c. Increase Federal Agency Enforcement Actions

Once federal agencies have clearly stated how crypto-assets align under existing law, and they pass new rules to regulate crypto-assets that do not align under existing law, they can begin to confidently take additional enforcement actions.[236]

231. *Id.*

232. *Id.*

233. *Rulemaking Index*, SEC. & EXCH. COMM'N (Dec. 14, 2022), https://www.sec.gov/rules/rulemaking-index.shtml.

234. *See generally Letter from Paul Grewal, Chief Legal Officer, Coinbase, to Comm'r Vanessa A. Countryman*, U.S. SEC. & EXCH. COMM'N. (Jul. 21, 2022) (on file with the U.S. Sec. & Exch. Comm.) (In re Petition for Rulemaking – Digital Asset Securities Regulation).

235. *Id.*

236. Comm'r Luis A. Aguilar, *Statement on the Importance of Clarity in Commission Orders*, SEC. & EXCH. COMM'N, Aug. 10, 2015, at 1 ("One of the Commission's most effective deterrents against future misconduct is what it says about the enforcement actions it takes. As a result, the Commission must use its position as a regulatory authority to carefully and effectively send clear messages to securities industry participants regarding what is, and what is not, acceptable behavior.").

While some respected commentators disagree with the SEC's enforcement action over rulemaking approach,[237] their enforcement response highlights the benefits of clarifying crypto-asset classifications and how clear guidance empowers enforcement staff to pursue novel technologies.[238] For example, once the SEC took internal steps to define what cryptocurrencies were investment contracts,[239] and thus able to be regulated under *Howey*,[240] there were two cryptocurrency enforcement actions upheld by courts in 2020, and a major enforcement action inclusive of nine cryptocurrency tokens in 2022.[241] However, as aforementioned, the SEC could build on this by specifically articulating how NFTs and in-ecosystem tokens align under *Howey*.[242] This would give enforcement staff more legal certainty as to what constitutes a crypto-asset that is a security, resulting in more investigations and enforcement actions.[243] This would also provide needed guidance to the crypto-asset industry as to what unregistered activities are permissible under the federal securities laws.[244]

To be clear, this is not simply a necessity for the SEC. The September 16, 2022, White House report plainly states, "agencies like the CFTC … [are encouraged] to aggressively pursue investigations and enforcement actions against unlawful practices in the digital assets space; CFPB and FTC … [are encouraged] to redouble their efforts to monitor consumer complaints and to enforce against unfair, deceptive, or abusive practices." While not solving all issues, federal agencies clearly defining if and how crypto-assets fall under existing law, and confidently investigating and litigating enforcement actions based on those determinations, will guide NFT and in-ecosystem issuer conduct. It will also provide those tokens' consumers with confidence as to what they can expect when purchasing tokens in ICOs or on secondary markets.[245]

237. Rohan Goswami, *SEC Commissioner Peirce Publicly Rebukes her Agency, Gensler on Crypto Regulation*, CNBC (Feb. 9, 2023, 6:06pm), https://www.cnbc.com/2023/02/09/sec-commissioner-breaks-with-sec-gensler-on-crypto-regulation.html.

238. *See supra* Section II.

239. *See supra* note 223.

240. *Id.*

241. *See supra* Section II.

242. *See supra* Section IV.B.i.a.

243. Comm'r Luis A. Aguilar, *supra* note 236.

244. Leo Schwartz, *'Our Rules Have to Evolve': The Crypto Industry is Trapped in Regulatory Purgatory*, FORTUNE (Sept. 19, 2022), https://fortune.com/crypto/2022/09/19/crypto-industry-trapped-regulatory-purgatory/ (explaining the SEC needs to provide further clarity on why some tokens are not considered securities … because it would "give some more specific, concrete notions of what is and isn't a security").

245. *See supra* Section IV.B.i.

ii. The Supreme Court Could Broaden its Interpretation of What Constitutes "An Investment of Money" and "With an Expectation of Profits" under Howey

Clarifying how crypto-assets align under existing law, and passing new agency rules, will likely not solve all regulatory issues; therefore, the Supreme Court should also step in.[246] While the Supreme Court is limited from issuing advisory opinions on issues not presently before the Court,[247] it can address all cases and controversies involving a constitutional question.[248] While there is currently no pending Supreme Court case or controversy involving NFTs or in-ecosystem tokens,[249] there are two cases—one involving an in-ecosystem token and the other an NFT—that could be appealed.[250]

First, the SEC is in litigation over a December 2020 enforcement action against an in-ecosystem token under *Howey* in *SEC v. Ripple Labs*.[251] In this case, Ripple Labs is alleged to have issued an in-ecosystem token that functions as an investment contract under the *Howey* analysis, and if the SECs arguments are adopted by the court, it could change the regulatory landscape for in-ecosystem tokens.[252] There is speculation that this case could be appealed to the Supreme Court, where the Court could further define how in-ecosystem tokens with functionality similar to those previously deemed investment contracts align under their current *Howey* analysis.[253]

Second, is the litigation between NFT purchasers, the company whose blockchain hosts the NFT, and that company's CEO in *Friel v. Dapper Labs, Inc*.[254] In this case, the United States District Court for the Southern District of New York adopted the "function over form" approach, conducted the *Howey* analysis, and

246. *See infra* notes 251-66 and accompanying text.

247. Marbury v. Madison, 5 U.S. 137 (1803) (holding the Court can only exercise judicial review in the context of resolving a dispute. There must be a case that presents a constitutional question for the Court to express its opinion on the matter. The judicial power of federal courts is constitutionally restricted to "cases" and "controversies").

248. *Id.*

249. *Supreme Court of the United States Granted & Noted List*, U.S. SUP. CT., Oct. 18, 2022.

250. *See infra* notes 251-59 and accompanying text.

251. Sec. & Exch. Comm'n v. Ripple Labs, Inc., No. 20CIV10832ATSN, 2022 WL 748150 (S.D.N.Y. Mar. 11, 2022).

252. *Crypto Showdown: SEC's Lawsuit Against Ripple Labs Reaches Critical Juncture*, GREENBERGTRAURIG, LLP (Nov. 2, 2022), https://www.gtlaw.com/en/insights/2022/11/crypto-showdown-secs-lawsuit-against-ripple-labs-reaches-critical-juncture; *see also* Andrew L. Lee et al., *2022 NFT Litigation Roundup*, FOLEY & LARDNER LLP (Oct. 28, 2022), https://www.foley.com/en/insights/publications/2022/10/2022-nft-litigation-roundup.

253. *Id.*

254. Friel v. Dapper Labs, Inc., No. 21 CIV. 5837, 2023 WL 2162747(VM) at *8 (S.D.N.Y. Feb. 22, 2023) ("To the Court's knowledge, no other courts have addressed either the exact substance or posture of the dispute here: whether allegations that an unregistered offer for purchase or sale of, specifically, an NFT constitutes an investment contract under Howey and thus survive a motion to dismiss under Rule 12(b)(6).").

explained that the alleged facts supported their determination that the NFT was an investment contract.[255] The Court found the investment of money prong was satisfied because purchasers "spent considerable money" on the NFTs.[256] Further, the common enterprise prong was satisfied under horizontal commonality because the company pooled and used sale and fee proceeds to "support and grow the blockchain" and the "fortunes of each investor is tied to the success of the overall venture."[257] Additionally, the expectations of profits prong was met because the company promoted record high NFT sales and resale prices above the original sale price that created a reasonable objective expectation of profits, and the purchasers subjectively believed that the NFTs were an investment that would increase in value.[258] Finally, the derived from the efforts of others prong was satisfied because the NFTs value was "derived almost entirely from the continued operation [of the private blockchain]."[259]

If appealed and selected for consideration, the Court could expand its interpretation of what constitutes "an investment of money" and "with an expectation of profits" to include purchases of unique NFT or in-ecosystem tokens that have a purpose and value for both their functionality and for the potential profit when resold on secondary markets.[260] They could do so because the *Forman* Court specifically left the legal question of whether securities laws apply to offerings that have both a consumptive and expectation of profits purpose and use.[261] Moreover, NFTs and in-ecosystem tokens dual purpose and value distinguish them from the type of offerings considered not to be securities under the Court's *Forman* precedent, as items that are primarily purchased for a desire to use or consume are not securities.[262] Further, adopting a broader interpretation aligns with the Court's precedent of establishing an offerings primary purpose through a factual

255. *Id.* at 7.

256. *Id.* at 9.

257. *Id.* at 10-13.

258. *Id.* at 16-17.

259. *Id.* at 19.

260. *See infra* notes 266 and accompanying text.

261. *Friel*, *supra* note 254, at *18 (quoting United Hous. Found., Inc. v. Forman, 421 U.S. 837, 853 n. 17 (1975)) ("Forman left open the possibility that '[i]n some transactions the investor is offered both a commodity . . . for use and an expectation of profits' and noted 'the application of the federal securities laws to these transactions may raise difficult questions that are not present in this case.'").

262. *See Forman*, 421 U.S. at 852-53 ("when a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply."); *see also Dapper Labs, Inc.*, 2023 WL 2162747 at *18 (quoting *Forman*, 421 U.S. at 853) ("Factually, Forman is irrelevant [here]. The Supreme Court found that the record established that there was 'no doubt that investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments.' Legally, Forman left open the possibility that '[i]n some transactions the investor is offered both a commodity . . . for use and an expectation of profits' and noted 'the application of the federal securities laws to these transactions may raise difficult questions that are not present in this case.'").

determination inclusive of: (1) the seller's objective purpose represented and promoted to purchasers; (2) purchasers' subjective belief about the offerings purpose and use; and (3) what the functionality of the asset was at the time of the sale—e.g. was the proposed consumptive use available at the time of purchase.[263]

Finally, in considering what satisfies the "with an expectation of profits" prong, the Court could consider if: (1) the NFT or token has an intentionally capped supply; (2) the issuer promotes the potential increase in value of those tokens from future demand; (3) the issuer promotes increased secondary market sale prices; and (4) where promises of future ecosystem or token development could reasonably convince consumers that the tokens value will increase on secondary markets.[264] If these considerations exist, NFTs or in-ecosystem tokens are distinguishable from the assets described in *Forman* and *Hart v. Pulte Homes of Michigan Corp*.,[265] because they could lead consumers to have a reasonable objective expectation of profits.[266]

While broadening these interpretations would provide the SEC with clear authority to regulate many NFTs and in-ecosystem tokens, the Court is unlikely to do so based on recent case holdings considering the role of federal regulatory agencies, the Court's articulated disdain for unyielding Congressional deference to agencies interpreting ambiguous statutes, and the Court's belief that they should not make determinations about political questions.[267] This was recently seen in the Court's holding in *West Virginia v. EPA*, where the Court ignored its thirty-eight years of precedent deferring to a federal agency's reasonable interpretations of ambiguous statutes.[268] Based on this case, it appears the current Court believes that when a statute does not explicitly authorize regulation of a certain item, thing, or action, Congress is required to amend existing laws or pass new legislation if they want an agency to do so.[269]

iii. Congress Can Pass Amendments to Existing Securities Laws to Specifically Include Crypto-Assets

While there is a plethora of precedent defining what constitutes an investment contract under the *Howey* analysis, Congress could amend the "security" and "issuer" definitions in the Securities and Exchange Acts to include crypto-asset

263. *Id.*

264. *See supra* notes 111-12, 251-63 and accompanying text.

265. 735 F. 2d 1001 (6th Cir. 1984) (holding that a mobile home sale was not a security under *Howey*).

266. *See supra* Section III.B.i.

267. *See generally* W. Va. v. Env't Prot. Agency, 142 S. Ct. 2587, 2607-16 (2022).

268. *Id.*

269. *Id.*

issuers, crypto-assets generally, NFTs, in-ecosystem tokens, and crypto-asset exchanges.[270]

First, in both the 1933 and 1934 Acts, the term "security" is defined as:

> *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.*[271]

Congress could amend this definition to include any digital crypto-assets with both a functional use, and/or where consumers can reasonably objectively expect the asset to increase in value and be resold on secondary markets for a profit based on future functionality or demand.[272] This addition recognizes that while crypto-assets are often purchased for their functional use, many of them are either also primarily, or even exclusively, purchased with a reasonable expectation that the token value will likely increase based on future token or ecosystem functionality, thus acting as an investment.[273] It would also place issuers whose tokens meet this definition, and the exchanges where they are purchased, under both the Securities Act and Exchange Act requirements when issuing and selling tokens that function as securities.[274]

While it is unclear how each senator or representative would vote on this specific amendment, it appears that there is a broad willingness to amend each Act's definition to reflect the current securities landscape[275] as a result of growing

270. *See infra* notes 271-74 and accompanying text.

271. Securities Act of 1933, 15 U.S.C. § 77b(a)(1); Securities Exchange Act of 1934, 15 U.S.C § 78c(a)(10).

272. *See generally The Amending Process in the Senate*, CONG. RSCH. SERV. (Sep. 16, 2015), https://crsreports.congress.gov/product/pdf/RL/98-853.

273. *See supra* Section III.B.i.

274. Securities Act of 1933, *supra* note 271 and accompanying text.

275. *See infra* notes 277-78 and accompanying text.

interest in federal crypto-asset regulation through legislation.[276] For example, the Securities Act's definition section has been amended six times, with the most recent proposed amendment in 2021,[277] while the Exchange Act's definition section has been amended sixteen times, with the most recent proposed amendment in 2021.[278] Further, a Congressional Blockchain Caucus formed in 2016, and proposed legislation increased from approximately two bills in 2014, 2015, and 2016, respectively, to twenty-two in 2021.[279] While not solving all crypto-asset regulatory issues, amending each Act's security definition would provide the SEC with an objective standard which it can use in further rulemaking to distinguish NFTs and in-ecosystem tokens as securities subject to its regulation.[280]

iv. Congress can Pass New Cryptocurrency Regulation Legislation

Finally, Congress could draft and pass comprehensive cryptocurrency regulation legislation like the European Union ("EU") did in October of 2022.[281] This section discusses the EU's crypto-asset regulatory rationale and framework, the United States' current regulatory legislation efforts, and articulates additional steps the United States could implement based on EU's approach to crypto-asset regulation.[282]

a. The EU's Crypto-Asset and Exchange Regulatory Approach

In an unprecedented move, the European Commission ("Commission"), the executive of the EU, the European Parliament ("Parliament"), and the Council of European Union ("Council") developed and approved the Market in Crypto-Assets

276. *See generally Lummis, Gillibrand Introduce Landmark Legislation To Create Regulatory Framework For Digital Assets*, KIRSTEN GILLIBRAND PRESS RELEASE (June 7, 2022), https://www.gillibrand.senate.gov/news/press/release/-lummis-gillibrand-introduce-landmark-legislation-to-create-regulatory-framework-for-digital-assets; Digital Commodities Consumer Protection Act of 2022, S. 4760, 117th Cong. (2022); *Warren, Marshall Introduce Bipartisan Legislation to Crack Down on Cryptocurrency Money Laundering, Financing of Terrorists and Rogue Nations*, WARREN SENATE STATEMENT (Dec. 14, 2022), https://www.warren.senate.gov/newsroom/press-releases/warren-marshall-introduce-bipartisan-legislation-to-crack-down-on-cryptocurrency-money-laundering-financing-of-terrorists-and-rogue-nations.

277. 15 U.S.C. § 77b.

278. 15 U.S.C. § 77c.

279. *Cryptocurrency Laws and Regulations by State*, BLOOMBERG (May 26, 2022), https://pro.bloomberglaw.com/brief/cryptocurrency-laws-and-regulations-by-state/.

280. *See supra* Section IV.B.iii.

281. *EU Close to Introducing Groundbreaking Law to Regulate Crypto*, AKIN GUMP STRAUS HAUER & FELD LLP (Oct. 27, 2022), https://www.akingump.com/en/news-insights/eu-close-to-introducing-groundbreaking-law-to-regulate-crypto.html.

282. *See infra* Sections IV.B.iii.a; IV.B.iii.b; IV.B.iii.c.

Regulation ("MiCA").[283] The MiCA bill (the "Bill") recognized the value that crypto-assets can provide for capital-raising processes, enhancing competition, innovating financing, serving as a new payment method, creating new employment opportunities, and providing overall economic growth.[284] It also recognized that while some crypto-assets fall under existing legislation, many crypto-assets do not, which means the markets they are traded on lack regulation.[285] Finally, it noted that the lack of regulation exposes token holders to risks, impacts market integrity through market manipulation and financial crimes, lowers user confidence in crypto-assets as a whole, leaves companies using and developing crypto-assets with no legal certainty, challenges financial stability, and ultimately undermines the value that crypto-assets provide individuals, companies, and society.[286]

To address these concerns, the Bill establishes that all currently regulated tokens will remain regulated under existing law,[287] adopts a broad definition for what constitutes crypto-assets,[288] creates a comprehensive regulatory framework,[289] and prioritizes implementing similar regulations with international organizations due to crypto-assets' global reach.[290] The Bill also breaks crypto-assets into three sub-categories to ensure effective regulation of each distinct type,[291] and determined that crypto-assets which are "unique and not fungible," such as digital art, collectibles, product guarantees, or real estate, are not covered. The committee outlined a narrow view of what constitutes an "NFT,"[292] and they specifically adopted a "substance over form approach" that examines the de facto features and

283. Kai Zhang et al., *MICA – Overview of the New EU Crypto-Asset Regulatory Framework (Part 1)*, K&L GATES (Nov. 15, 2022), https://www.klgates.com/MiCA-Overview-of-the-new-EU-crypto-asset-regulatory-framework-Part-1-11-15-2022 (explaining that while the bill must be officially approved by Parliament, the current version passed the Committee on Economic and Monetary Affairs on October 10th by a vote of 28-1. The final parliament vote is expected to take place early in the new year, and similarly passed based on the comprehensive drafting and revisions done by the three entities).

284. Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amended Directive (EU) 2019/1937 (MiCA) 965 final (Oct. 5, 2022).

285. *Id.*

286. *Id.* at 6.

287. *Id.* at 9.

288. *Id.* ("[A digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology or similar technology.").

289. *See infra* notes 294-99 and accompanying text.

290. Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amended Directive (EU) 2019/1937 (MiCA) 965 final (Oct. 5, 2022) 8.

291. *Id.* (Basing their categorization on how they seek to stabilize their value by reference to other assets: (1) crypto-assets that aim to stabilize their value by referencing only one official currency—essentially serving as electronic money; (2) asset referenced tokens—maintaining a stable value by referencing to any other value or right; and (3) non asset-referenced tokens—which cover a wide variety of tokens, largely utility tokens).

292. Zhang, *supra* note 283.

de facto uses of tokens when determining if NFTs are in fact "unique and not fungible" to avoid regulation.[293]

The comprehensive regulatory framework requires that most crypto-asset issuers, traders, and exchanges have a registered office or place of management in the EU to receive authorization to operate.[294] It further requires all token issuers to regularly and transparently share the characteristics, functions, underlying technology used, and known risks—those that are foreseeable or likely to materialize—of their listed tokens, as well as general background information on the issuer, offeror, or person seeking admission to trade with the appropriate regulatory authority and publicly through a crypto-asset white paper containing all mandatory disclosures.[295] Additionally, issuers must provide an overview of the organizational structure with a clear line of responsibility, outline the process to identify, report, and track the risks the issuer is or might be exposed to, and implement adequate administrative and accounting procedures.[296] All marketing and advertising communications must match the information shared with regulatory authorities and the public through white papers.[297] Moreover, issuers must provide retail token purchasers with a limited right to withdrawal or rescind the purchase and right to pursue civil remedies for alleged violations.[298] Furthermore, in order to maintain financial stability, all issuers are required to maintain liquid assets at the same or greater value of the liability attached to their risks.[299] Finally, for issuers or services found violating these regulations, it authorizes the home member state regulator to withdraw authorization or to impose limits on the amount issued when a token poses a serious threat to financial stability, payment systems, market integrity, and monetary policy.[300]

b. The Current United States' Crypto-Asset Legislation

In an attempt to catch up to the EU's proactive regulatory efforts and address crypto-asset issues, Senators Kirsten Gillibrand and Cynthia Lummis introduced the Responsible Financial Innovation Act ("RFIA") on June 7, 2022.[301] This Act would

293. Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amended Directive (EU) 2019/1937 (MiCA) 965 final (Oct. 5, 2022) 11.

294. *Id.* at 34.

295. *Id.* at 16.

296. *Id.* at 26.

297. *Id.* at 16.

298. *Id.* at 21.

299. Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amended Directive (EU) 2019/1937 (MiCA) 965 final (Oct. 5, 2022) 27.

300. *Id.* at 24, 102, and 107.

301. *Kirsten Gillibrand, Senator, Lummis, Gillibrand Introduce Landmark Legislation To Create Regulatory Framework For Digital Assets*, KIRSTEN GILLIBRAND PRESS RELEASE (June 7, 2022),

create the first substantial and comprehensive digital asset regulatory framework that "encourages responsible financial innovation, flexibility, transparency, and robust consumer protections while integrating digital assets into existing law."[302] RFIA first focuses on clarifying what digital-assets are commodities governed by the CFTC, securities governed by the SEC, and fungible digital-assets which are not securities by examining "the purpose of the assets and the rights or powers it conveys the consumer."[303] Second, RFIA establishes clear definitions for digital-assets that will be consistently used across all digital-asset regulation.[304] Third, RFIA requires all stable coin issuers to hold liquid assets to match 100% of their outstanding asset liabilities so consumers have confidence that assets exist for them to receive faster and more secure payments when they invest, sell, or use their stable coin holdings to make purchases.[305] Fourth, it creates an advisory committee to craft guiding principles for responding to "fast-developing technology" and to make recommendations on how regulations can "remain relevant and effective."[306] Fifth, it requires digital-asset service providers to disclose relevant information about the assets technology, how it operates, its legal treatment as a commodity or security, how it is treated in bankruptcy, risks of loss, applicable fees, and more.[307] Sixth, it clarifies how digital-assets are treated in bankruptcy, and ensures assets are appropriately safeguarded during an insolvency.[308] Seventh, it "creates a de minimis exemption so that people can make purchases with virtual currency without having to account for and report income," while also "clarify[ing] the tax treatments of different actors and actions in the digital asset industry."[309] Eighth, it requires federal financial regulators to provide interpretative guidance on a matter within the regulators jurisdiction within six months of a request.[310] While not the only legislation, the RFIA is more comprehensive than other such bills under consideration.[311]

https://www.gillibrand.senate.gov/news/press/release/-lummis-gillibrand-introduce-landmark-legislation-to-create-regulatory-framework-for-digital-assets.

302. *Id.*

303. *Id.*

304. *Id.*

305. *Id.*

306. *Id.*

307. *Kirsten Gillibrand*, *supra* note 301.

308. *Kirsten Gillibrand, Senator, Lummis-Gillibrand Responsible Financial Innovation Act Section-by-Section Overview*, KIRSTEN GILLIBRAND PRESS RELEASE (Jun. 07, 2022), https://www.gillibrand.senate.gov/imo/media/doc/Lummis-Gillibrand%20Section-by-Section%20%5bFinal%5d.pdf.

309. *Kirsten Gillibrand*, *supra* note *supra* note 301.

310. *Kirsten Gillibrand*, *supra* note 308.

311. See *supra* note 276.

While this legislation will drastically improve the United States' crypto-asset regulatory approach, it has some distinct differences from the EU approach that severely limits or expressly bars regulation of NFTs. More importantly, it completely ignores in-ecosystem tokens, resulting in no new enforcement authority for federal agencies, no new consumer protections, and no requirements for these token issuers.[312] Specifically, the Bill minimizes the need for NFT regulation when it simply says that the SEC shall only "exercise jurisdiction over an agreement, contract, or transaction involving a contract of sale of a digital asset that is fungible, which shall not include digital collectibles and other unique digital assets."[313] This simplistic limitation of the SEC's authority is at odds with the "substance over form" approach adopted by the EU and the Supreme Court in cases like *Techerepnin v. Knight*[314] when assessing if something is a security, and it does not address the clear issues that exist with NFTs that function in many ways like securities.[315] Additionally, the Bill does not discuss in-ecosystem tokens that function in many ways as securities.[316] Finally, while the Bill establishes digital-asset exchanges as financial institutions, and creates an optional pathway for those exchanges to register with the CFTC, this optional registration requirement leads to inconsistent expectations for crypto-asset exchanges when selling tokens.[317] Finally, because the Bill adds little to no new authority for the SEC to regulate NFTs and in-ecosystem tokens as securities, digital-asset exchanges are not required to register under the Exchange Act.[318]

c. Ideal Congressional Crypto-Asset Legislation

In order to avoid leaving a large swath of NFT and in-ecosystem tokens unregulated, Senators Gillibrand and Lummis, along with the Senate Finance Committee on Banking, Housing, and Urban Affairs, should follow the EU's lead and adopt a narrow definition of what actually constitutes an NFT—physical objects, real property, digital art that has only one functional use as art, etc.[319] Further, when assessing how to regulate NFTs beyond those, it should adopt a test examining the NFTs: (1) primary use – commercial or consumption use versus investment purpose; (2) the issuer's use of investor capital to develop new NFT benefits or infrastructure

312. *See supra* 302-10 and accompanying text.

313. Responsible Financial Innovation Act, S. 4356, 117th Cong. § 403(a)(1)(B) (2022).

314. *See supra* note 56 and accompanying text.

315. Responsible Financial Innovation Act, S. 4356, 117th Congress at 54 (2022); *see supra* Section III.

316. There is no mention of utility tokens, in-game, or in-ecosystem tokens that likely function as securities in practice. *See generally* Responsible Financial Innovation Act, S. 4356, 117th Cong. (2022).

317. Responsible Financial Innovation Act, S. 4356, 117th Cong. § 404 (2022).

318. *See generally id.*

319. Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amended Directive (EU) 2019/1937 (MiCA) 965 final (Oct. 5, 2022) 10–11.

for NFT holders; (3) the purchaser's expectation of profit based on value increase as result of a capped supply and future increase in demand from further infrastructure development; and (4) the frequency and purpose of secondary market transactions.[320] Finally, any bill adopting a crypto-asset regulatory framework should specifically address tokens that are difficult to regulate under existing standards and develop a committee to provide recommendations on how these tokens should be regulated moving forward.[321] The current Bill could accomplish this through the newly established advisory committee.[322]

While taking any or all these actions will not address many of the broader global cryptocurrency market concerns,[323] these steps will improve American consumer protections and market stability.[324] As indicated throughout this article, there is a growing consensus about the need for crypto-asset regulation,[325] and while Congress has been purely reactive so far, the FTX collapse, and other crypto-asset industry challenges now bring a sense of urgency and provide them the perfect opportunity to act.[326]

CONCLUSION

The increase in NFTs and in-ecosystem tokens sold through ICOs and on secondary markets,[327] billions of dollars annually spent or invested by purchasers on these tokens,[328] rampant fraud and mismanagement in the crypto-industry,[329] and inability to comprehensively regulate these under existing securities laws[330] necessitates federal action. Federal regulatory agencies should clarify how NFTs and in-ecosystem tokens fall under existing laws, conduct notice-and-comment

320. *See supra* notes 252–266 and accompanying text.

321. *Id.*

322. *See supra* note 306 and accompanying text.

323. *See supra* notes 63 and accompanying text.

324. *See* Adam J. Kuegler, *Cryptocurrency and the SEC: How a Piecemeal Approach to Regulating New Technology Selectively Stifles Innovation* 52 CONN. L. REV. 989, 1011-12 (2020); Michael Adams, *How Will Cryptocurrency Regulation Affect Crypto Prices?*, U.S. NEWS & WORLD REPORT (Jun. 29, 2022), https://money.usnews.com/investing/cryptocurrency/articles/will-cryptocurrency-regulation-affect-crypto-prices ("'Regulations are a positive aspect for the industry', says Adam Reeds, founder and CEO of Ledn, a crypto-backed lending firm, because 'many institutions and larger established groups are waiting on the sidelines.' In fact, he believes many of these institutions would like to invest in crypto, but a lack of regulations simply makes it infeasible for them.").

325. *See supra* notes 276-79 and accompanying text.

326. *See supra* Section IV.A.

327. *See supra* notes 191–96 and accompanying text.

328. *See supra* notes 182–87 and accompanying text.

329. *See supra* 196-201 and accompanying text.

330. *See supra* Section III.

rulemaking to fill gaps, and confidently take more enforcement actions.[331] The Supreme Court should broaden its interpretation of the "investment of money" and "with an expectation of profits" prongs to include tokens with a dual purpose and value so the SEC can regulate many NFTs and in-ecosystem tokens.[332] Finally, Congress should amend existing securities law or pass crypto-asset specific legislation to specifically address NFTs and in-ecosystem tokens.[333] These steps would recognize and protect the value that crypto-assets can provide the United States,[334] while limiting the negative impact on American consumers.[335]

331. *See supra* Section IV.B.i.

332. *See supra* Section IV.B.ii.

333. *See supra* Section IV.B.iii and IV.B.iiii.

334. *See supra* notes 302, 306 and accompanying text.

335. *See supra* Section IV.A.