

Is Cryptocurrency a Security (like an orange grove)?

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In the first episode of the CryptoCounsel at Wiley, hosts Josh Simmons and Frank Scaduto discuss the evolving landscape of cryptocurrency regulation, focusing on recent disputes and the challenges posed by the SEC's regulatory actions. Using the Howey Test from a 1946 Supreme Court case involving orange groves, they explain how the SEC determines if an asset is a security and how the SEC needs a better regulatory framework for the rapidly growing crypto industry.

Transcript

Josh Simmons

Welcome to the initial episode of the CryptoCounsel at Wiley, where we decode the most important crypto issues in litigation and regulation. My name is Josh Simmons. I'm an international lawyer who does crypto disputes.

Frank Scaduto

And I'm Frank, a securities litigator who also does crypto disputes.

Josh Simmons

I think it's incumbent upon us, Frank, for our initial episode to say: Why are we doing this? Why are we here?

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Frank Scaduto

Who doesn't have a podcast now, Josh?

Josh Simmons

Ah, but our podcast is going to be special, Frank.

Frank Scaduto

Okay. Well, we are special because we are at a firm that does this stuff day in, day out, at the intersection of technology, finance, law, you've got the international piece, and crypto is this wild west of legal issues that really excites a lot of the people like us that work in this space.

Josh Simmons

That's exactly right. It is fascinating that it transcends borders, as we're going to get into today. It transcends regulations and existing legal frameworks. We're a law firm based in Washington, DC, we have about 250 lawyers. We specialize in regulations, disputes, a whole host of issues, and crypto touches on all of it.

Just in the past year, I've been working on a dispute involving the largest Bitcoin mine in North America. Now guess, Frank: How deep is the largest Bitcoin mine?

Frank Scaduto

How deep is the basement of your client's house, Josh?

Josh Simmons

I think it's actually a ground level, but it's quite a big warehouse.

Frank Scaduto

Nice. Yeah, no, I mean, this space is just, it's incredibly wild. I mean, for me, I think you, you know well that I used to be a large bank lawyer, a lot of old school finance companies. And, I also love technology and apparently crypto [00:02:00] was the answer to how could I combine being a large financial litigator with my technology love, and that's how we wound up here.

Josh Simmons

That makes perfect sense, and we're going to talk more today about how the securities laws, like orange groves, apply to crypto.

For me, I came at this from an international angle. I've had clients in Germany and Cyprus, and they have operations related to crypto and it turns out, crypto seems to be causing a lot of disputes in the world. Why?

Frank Scaduto

It's just one of those things, Josh.

Josh Simmons

It's the Wild West, right?

Frank Scaduto

It is.

Josh Simmons

And that's why we're here. We want to help you understand this intersection of cryptocurrency, litigation, regulation, we are the CryptoCounsel at Wiley, and we're going to unpack these issues.

We're going to start today with something near and dear to the heart of Washington, DC lawyers, which is regulation. We're going to start this episode as we hope to start every episode with some quick bits. These are some hot news items from recent weeks that captured our attention, particularly when it comes to crypto disputes. And lately there have been a lot of them. One of those disputes is a complaint filed by ConsenSys, the company responsible for Ethereum against the SEC commissioners by name.

And a quote in that complaint is that the SEC is on a campaign to seize control over the future of cryptocurrency, one of the fastest growing and most innovative technologies in the world. Frank, is that an overstatement or an understatement?

Frank Scaduto

I think it is an overstatement, and an understatement, and a fact, all at once.

The SEC is doing way, way too much, too fast with respect to crypto. I think something probably should be done with respect to crypto. I'm not sure it's the SEC, but the SEC is moving very fast, and these complaints like the one by ConsenSys, we're going to see a lot more of them, and it's a healthy reaction to the SEC overreach that's happening.

Josh Simmons

Perhaps then we should give applause to the ConsenSys team for accomplishing what every complaint should, which is overstatement, understatement, and fact, all at the same time.

Frank Scaduto

Indeed, they did a marvelous job. It's a very good complaint. And I hope we see it go where it needs to go, which is pushing back against the SEC for the way they are regulating, which is by enforcement in this space.

Josh Simmons

Bit number two, probably the most famous, now infamous, developments in the crypto space in recent years has been the collapse of FTX, the sentencing of Sam Bankman-Fried, and yet some strange silver lining came out that the creditors of FTX in the bankruptcy will recover all of their money plus interest.

Frank, does this mean that we want more companies in the crypto space to go bankrupt or is this just a fortunate timing?

Frank Scaduto

I'm definitely in favor of companies in the crypto space not going bankrupt. I hope they expand and grow and thrive. I will say that news was that they recovered every penny plus interest for the investors who were affected by the collapse of FTX.

The only other situation like that I can remember would be the Madoff situation where the folks who worked on that recovered incredible sums and just a remarkable job by lawyers and doing what they do best, so.

Josh Simmons

It may be ironic that it's consistent with an argument Bankman-Fried made in the course of his trial, which is that FTX was not insolvent, it just had a liquidity problem.

Frank Scaduto

Yeah, I think that to the extent people were wondering about the truthfulness of Mr. Bankman-Fried the recent revelation of where the money was and that it was attainable, was - it certainly suggested that, that was a large enterprise to ferret away money that succeeded wildly and then was ultimately brought to justice.

Josh Simmons

This is probably not the last we'll hear of it and Bankman-Fried will have a lot to think about while he's in prison for a while.

Frank Scaduto

Quite some time.

Josh Simmons

Bit number three, and this is harkening to our topic of today. If the Ethereum complaint managed overstatement, understatement and fact, I'm curious about your thoughts on our own amicus brief where we argued that, in support of Coinbase's litigation against the SEC, the Securities and Exchange Commission, that the SEC should engage in rulemaking of crypto. Is this an overstatement or an understatement?

Frank Scaduto

It depends who you ask. So our clients in that amicus brief, the Satoshi Action Fund and the Texas Blockchain Council, would say that the SEC should not regulate at all, because the states should be driving that conversation. They should be doing something to put some guardrails around an industry that is growing. In Coinbase's case, for Coinbase, they desperately want the SEC to regulate in some way, shape, or form to tell them what the heck is going on. What are the rules of the road for an exchange, a platform like Coinbase? It's really unusual. It is probably the only instance, I could think, where a company is asking to be regulated.

And, it really is just a reflection of the fact that the SEC, by doing its enforcement-based regulation, which is incredibly unpredictable, it's so much harder for companies to grow, to build, to launch in this space, without a clear understanding of what the rules are. So it is, it is unusual. And depending on who you ask, you might get a different answer, but there should certainly be some regulation. By whom, I think is a really open question.

Josh Simmons

And that is why we are here. We want to be the CryptoCounsel who help companies understand what's happening in Washington with these regulations, it's incredibly complex. There's more and more litigation and we're going to help you get to the bottom of it. And we're going to start with basics today.

And the key question, Frank, the question that everyone is asking, everyone is debating in the crypto space. Is cryptocurrency a security?

Frank Scaduto

Yeah, this is the conversation, and it is incredibly complicated.

Josh Simmons

Wait, wait, wait. The way it works is I'm cross-examining you, I need a yes or no answer. Is cryptocurrency a security?

Yes or no, Frank?

Frank Scaduto

What is a security, Josh? These are weighty, weighty questions. Yes, no, maybe, depends. This one has gone in so many odd directions. But let me let's start with: Why does this matter? What does crypto, in its various forms as a technology as a currency, being a security mean for anyone?

And what it means is, if it's a security, it means the Securities and Exchange Commission can regulate it, under the SEC's current regulatory regime. And how that works with crypto is almost impossible because crypto, you typically have a decentralized network with no single promoter or what securities lawyers called an issuer.

So it's very hard to understand how crypto and crypto companies and the currencies and the tokens and the other products that are associated with this space can operate within the SEC securities regulation regime when they don't have a central issuer or promoter or group of people who can comply with the regulations they're being asked to comply with, such as issuing quarterly and annual reports, audited financial statements, all sorts of other disclosures that companies that are listed on a public stock exchange and are truly the issuer of securities, you know, Apple, General Motors publicly traded companies.

They do, under the current SEC regime because it is suited to those more traditional businesses. Crypto is a whole other animal. So, if it is a security, which is the reason everyone wants to know, is it a security, it potentially could gut the entire industry, and at the very minimum, cause it to go outside the United States, which I think is a very bad thing for the country and the industry and its future here.

Josh Simmons

This is the specialty of Washington, DC is creating existential threats. So let's, break it down to a smaller question first, because you've been talking about cryptocurrency generally. What about Bitcoin? I think Bitcoin's the most understood, most robust cryptocurrency, people have some idea of what it is and how it works.

Is bitcoin a security?

Frank Scaduto

It is not. And I can confidently tell you that right now, because the SEC and chairman Gensler of the SEC has said, and continues to say, Bitcoin is not a security. The reasons why it is not a security, I think we'll get to in a second.

Let's layout for sort of the framework for how the SEC and others are attempting to think about whether crypto is a security or not. But Bitcoin as it presently stands is the one and only, it used to be Ethereum was also in this category, and Ether, but now it's just Bitcoin is the one that has been specially plucked out as not a security, and, and we'll talk about why in a moment.

Josh Simmons

Well, before we do, I have to share my favorite conspiracy theory on this, because we'll come back to the SEC Commissioner more I'm sure of Gary Gensler, but in researching the progeny of Bitcoin, where does it come from, who invented it, my favorite idea, well, it must be Gary Gensler, because there's no other way to justify why it's not a security, but all the other cryptocurrencies are.

Yes or no?

Frank Scaduto

Yeah.

Josh Simmons

Did Gary Gensler invent Bitcoin?

Frank Scaduto

It is true that Satoshi's Bitcoin wallet must be, I mean, I'm not even sure what the present value is, but if it is Gensler, as you suggest, and I'm interested to hear more about this, maybe on another episode he would be a very rich man. So perhaps, yeah, but I mean, this whole, is it a security thing, it's wild to me because, I don't know if you're a fan of the Godfather movies. But in the Godfather movies, whenever oranges appear, something bad happens to a character. Right? So, there are many famous scenes involving oranges and then the death of the godfather himself, the character famously finds a horse head in his bed, and the night before he's got a bowl of oranges on his dinner table, and there are other examples.

Josh Simmons

I know where you're going with this oranges example, but I hope you're not saying that something bad's gonna happen because we're talking about cryptocurrency.

Frank Scaduto

No, definitely not. But I do feel like every time oranges, enter the conversation of is crypto a security, bad things happen. And that's because the whole test around which this conversation is revolving is from a Supreme Court case 1946 called *Howey* and it involves oranges and the sale of orange groves specifically.

Josh Simmons

What did it say?

Frank Scaduto

They said, well, first of all, why were they saying and talking about it in the first place? Security is actually, is a defined term in congressional legislation that the SEC has to follow.

And it has a bunch of specific things like stocks, bonds, things that people are pretty comfortable are securities. But then it has this thing called investment contracts. That's an example of the things that are securities in the definition. So the Supreme Court in 1946 was called upon to address an issue that arose from an investment opportunity, involving the sale of orange groves. This company, the *Howey Company*, sold orange grove land to investors, most of whom were tourists at a hotel that *Howey* also owned nearby. And then they were separately offered, the investors were offered an opportunity to enter into an agreement with the *Howey Company* for *Howey* to manage the orange groves, to grow the oranges and other produce, and sell it on the market. And then the investors would receive a portion of the profits. They would essentially pool together those profits and then give people a percentage based on the level of their investment. So the investors profit was dependent on how well *Howey* did at growing oranges and selling them.

Josh Simmons

And, kudos to the American entrepreneurial spirit. Before there was crypto, there were oranges.

Frank Scaduto

Indeed. Yes. So this is taking place in Florida and they're growing oranges like gangbusters. People are making a lot of money. And then the Securities and Exchange Commission says, wait a minute, that is an investment contract. You, Howey, were required under securities regulations to register this investment opportunity that you provided to these investors.

And, of course, Howey disagreed, it went through the lower courts, lower courts agreed with Howey and said, no, this is not an investment contract. This is not something we intended in this legislation for the Securities and Exchange Commission to regulate. It went up to the Supreme Court and the Supreme Court said, actually, we disagree.

This is a security. This is an investment contract. And they announced a test. They said, basically, and I will pull it up.

So, the Supreme Court said an investment contract means a contract where someone invests his money, that's the first thing - in a common enterprise, second thing - and is led to expect profits, that's the third piece of it - from the efforts of the promoter or third party. That's the fourth piece of the test.

So you have to have investment, in a common enterprise, expectation of profit. Then that profit is going to come from the efforts of someone who is not you, a third party who you're placing your trust in. And they said by that standard, by that test, this orange grove opportunity is an investment contract that is a security. And so you have to go ahead and register with the SEC, and meet whatever applicable requirements apply to you. And since then, this has become the cornerstone of every conversation, every court analysis of whether something's a security. So from 1946 to present day, you and I sitting here now, it's all funneled through this test.

And there's been not a whole lot of development by the Supreme Court on the various pieces of that. So the lower courts, the district courts, the courts of appeals, are left to sort through it on a case by case basis and attempt to analogize between selling an investment opportunity in orange groves, to things as sophisticated as these new technologies underlying various crypto networks, currencies, tokens, different sorts of new things that we've just never seen before.

Josh Simmons

So let's start with the easy example we found, where apparently, everyone now agrees that Bitcoin is not a security. Therefore, it is not an investment contract. How does the analogy work with the orange grove? Why is Bitcoin not an orange grove?

Frank Scaduto

So this is the funny thing is the SEC has said it's not. They have not supplied a ton of analysis. But what people are assuming, and I think this generally tracks, is Bitcoin was created by someone who no one has been able to locate, or maybe a group of people who did it in conjunction. But it is as decentralized as decentralized can be. There is no promoter or central person, or in the case of securities, an issuer who's sort of driving things.

It is a truly decentralized network of computers, people, mostly anonymous to one another. And then, because of that, it doesn't meet some of these various tests - the efforts of a promoter or third party, the common enterprise - it's very hard, to map that concept onto the Bitcoin network, the "Big B", and little "b" Bitcoin, the currency that's native to it.

Josh Simmons

We'll get into this decentralization because I think it's one of the key premises and promises of cryptocurrency that the proponents of crypto are championing. Because, historically, finance is centered in the banks, it's centered in certain institutions, and crypto offers a promise of decentralization. Anyone in the world can buy, sell crypto, if they have computer access. And that's caused some positive stories, which we'll cover in later episodes, but it's also caused a lot of negative stories, potential scams and claims about those, which we'll get into as well.

But that's the tension here. Right? The SEC is trying to regulate crypto on the one hand, and on the other hand, there's a promise from decentralization. There are potential benefits here. Now, setting aside Bitcoin, which is not an orange grove. What about the other cryptocurrencies? This is what's been in litigation in recent months about the definition of a security as applied to cryptocurrencies. Coinbase has been at the center of it. What's the analysis looking like? Where's this heading?

Frank Scaduto

So, since you raised Coinbase, those cases, the one against Coinbase being the most prominent, and now potentially one involving Robinhood, another trading platform, are strange because they don't even go at the underlying asset, digital asset that is or is not a security.

They're one step removed saying, well, you're a trading platform, a broker dealer again to use more traditional securities law terminology, who's facilitating the sale or the purchase of these digital assets. And so you have to register in order to allow the purchase or sale of these unregistered securities. So, so that, I mean, is a, it's a whole nother layer of complexity.

But looking at sort of the assets themselves, now we have something like Ethereum, which was, you know, after Bitcoin, the biggest and I think most widely adopted cryptocurrency. And for a long time, the SEC was saying, no, it's not a security. And, I think they were largely persuaded that it was similar to Bitcoin.

At some point, Ethereum had a fork, it went off in a different direction for reasons we don't have to address here. And it switched its validation model to a proof of stake model, but moved away from proof of work, which is the one that Bitcoin still uses. And there is a sense among many that it's the proof of staking that feels a lot like pooling together money in a common enterprise with the expectation of profit, by the efforts of a third party. And I think that is what dragged the SEC in the other direction in saying, okay, well now this looks and feels a lot more like a security.

Josh Simmons

What's their theory? Because you said that there hasn't been a clear explanation of why Bitcoin is not a security. What's the theory, the argument that the SEC is putting forward against Ethereum and the other cryptocurrencies?

Frank Scaduto

Well, I mean, in a lot of these cases, they're not even putting forward a theory directly in a rulemaking or in a sort of public document that is subject to some scrutiny, a lot of these things are starting as Wells notices by the SEC, which is an investigation outside the public view, where they're poking around to try to understand the contours of the business that is attached to the technology and whether or not it fits into the test. But I think generally speaking, the SEC is trying to understand and characterize, increasingly in enforcement actions that are happening in court, these companies that are crypto businesses as common enterprises where people are putting their money and someone has to run those businesses to return a certain level of profit to the investors to try to make them feel like any other business. I think at some level, the SEC wants to regulate the cryptocurrency businesses that are out there now as like any other business, regardless of the technology. And what I think the crypto industry and the true believers and the people that know this better than the SEC, because they're the ones who built it, the technology and the business is inseparable. And so it is a fundamentally flawed idea that you can regulate something like Ethereum or, you know, its underlying native asset, Ether, and separate the business piece of that. They're one in the same.

Josh Simmons

And I think the challenge, and I come at this from an international perspective, is that, yes, there could be an appropriate way to regulate this new digital asset. It's an interesting space. It's a new frontier. The government always is catching up to the entrepreneurial spirit, trying to figure out how to safely control new assets, new developments. But the challenge here is that with the SEC's, what's been called in a lot of the briefs, a regulation by enforcement approach, it's creating a huge amount of uncertainty for companies in the crypto space. For example, if a company is deciding we want to build a Bitcoin mining facility, we want to invest millions of dollars. They might look at the United States right now, see this cloud of uncertainty and decide: Is there another country? Is there another jurisdiction where we should go? Why do we not want that to happen, Frank? Why should we have this investment happening in the United States? And what should the government be doing about it?

Frank Scaduto

Yeah, I mean, it's a huge industry. It is a huge driver of innovation and growth in whatever economy it's going to take residence in.

Right now, the United States is a leader and should continue to be, hopefully. And we should want to grow that cryptocurrency business and let the innovation flourish the same way we've let any number of other companies and technologies over the years, whether it's Ford or a Facebook or whatever sort of stage we are in American history.

So to do what the United States Securities Exchange Commission is doing right now is inconsistent with that happening. And you see it in the ConsenSys lawsuit that you mentioned in the quick bits. I mean, they say point blank. We built this business on the words of the SEC and Gary Gensler, the Chairman, that Ether and Ethereum was not a security.

We built an entire, you know, multi-billion dollar company around it. And now the SEC is saying the opposite. If that's going to continue without any certainty as to whether, the business, the technology, the product, the service that you're building in the crypto space. Whether you know for sure that you're going to be subject to regulation or not, and what that regulation is and how you comply with it, it's almost impossible for a company to want to set up shop in the United States when it could do so elsewhere without that threat.

It's existential. I mean, these companies may not exist, if the current SEC trajectory continues.

Josh Simmons

So these are the stakes. The stakes are high. We have digital innovation, but we also have regulation, and there's a lot of uncertainty about that. We've covered this threshold question of: Is cryptocurrency a security?

And as you've explained, Frank, there's going to be a lot more dispute about this, a lot more litigation. So let's wrap up this first episode with a final word before we tackle in the next episode: How that litigation is playing out and what the consequences are? What's the final word, Frank?

Frank Scaduto

Final word is: Does it matter what I say or you say, or anyone says on this? Unless and until the SEC is forced by Congress or by someone to stop doing what it's doing, the courts are going to decide these issues. And it's really chaotic. It's sort of a no-win proposition. So we need a better way here in the US. There has to be. . . It could evolve the SEC, it could not evolve the SEC, but it can't be what we're doing right now.

Josh Simmons

When you're starting from an orange grove and going to Ethereum, you're going to have some trouble with the analogy. But that's why we're here to help. CryptoCounsel at Wiley, we are wired into Washington. Thanks for listening.

