NORTH CAROLINA BANKING INSTITUTE

Volume 27 | Issue 1 Article 18

3-1-2023

Creating a Path to Regulation -- Digital Assets, Howey and the Regulatory Dilemma

Gunjan D. Devnani

Creating a Path to Regulation – Digital Assets, *Howey*, and the Regulatory Dilemma

I. INTRODUCTION

In recent years, the number of digital asset related products has rapidly increased, bringing with it a rise in fraud within digital asset markets.[1] Though regulators and investors have not come to an agreement for a term that describes the assets that are traded on the blockchain platform, this note will use the term "digital asset" to describe such investment products.[2] Despite being home to the largest number of cryptocurrency ("crypto") investors, exchanges, trading platforms, crypto mining firms, and investment funds, the United States currently lacks a cohesive regulatory framework to protect crypto investors.[3] In November of 2021, this very issue was spotlighted in *Audet v. Fraser*, when the United States District Court for the District of Connecticut held that four digital asset-related products were not securities under the Securities Exchange Act of 1934[4] and therefore not within the reach of the SEC's regulatory authority.[5] In doing so, the jury applied the test put forth in the seminal securities law case, *SEC v. W.J. Howey Co.*,[6] and subsequently, the judge ruled on a post-trial motion that the jury reasonably could have found that the products were not securities based on the evidence before it.[7]

---

1. *See* Emma Fletcher, *Reports Show Scammers Cashing in on Crypto Craze*, FED. TRADE COMM'N (June 3, 2022), https://www.ftc.gov/news-events/data-visualizations/data-spotlight/2022/06/reports-show-scammers-cashing-crypto-craze [https://perma.cc/2WGF-HE4D] (explaining that cryptocurrency is the leading payment method for scammers to get consumers' money).

2. INNOVATIVE DIGIT. PRODS. & PROCESSES SUBCOMM. JURISDICTION WORKING GRP., AM. BAR ASS'N, DIGITAL AND DIGITIZED ASSETS: FEDERAL AND STATE JURISDICTIONAL ISSUES 1 (2020), https://www.americanbar.org/content/dam/aba/administrative/business_law/buslaw/committees/CL620000pub/digital_assets.pdf [https://perma.cc/A637-7FW2].

3. *See* THOMSON REUTERS, CRYPTOCURRENCY REGULATIONS BY COUNTRY 5 (2022), https://www.thomsonreuters.com/en-us/posts/wp-content/uploads/sites/20/2022/04/Cryptos-Report-Compendium-2022.pdf [https://perma.cc/Z22R-8A9Y] (describing the U.S.'s regulatory position with regards to crypto markets).

4. Securities Exchange Act of 1934 § 3, 15 U.S.C. § 78c(a)(10) (2018).

5. Audet v. Fraser, No. 3:16-CV-940 (MPS), 2022 WL 1912866

6. SEC v. W.J. Howey Co., 328 U.S. 293, 297–98 (1946).

7. *Audet*, 2022 WL 1912866, at *12–14.

In an effort to foster cooperation and comprehensive regulation among the Executive agencies, on March 9, 2022, the White House issued an Executive Order on Ensuring Responsible Development of Digital Assets.[8] The order calls upon the Board of Governors of the Federal Reserve System (the "Fed"), the Consumer Financial Protection Bureau ("CFPB"), the Federal Trade Commission ("FTC"), the Securities and Exchange Commission ("SEC"), the Commodity Futures Trading Commission ("CFTC"), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency ("OCC") to coordinate their regulatory efforts.[9]

The Order also outlined the various policy objectives that regulatory efforts should serve with regard to digital assets.[10] A coordinated effort by regulatory agencies should protect consumers, investors, and businesses in the U.S.; protect global financial stability; and mitigate systemic risk.[11] The Order also states that any regulatory scheme should reduce illicit finance and national security risks posed by misuse of digital assets; reinforce U.S. leadership in the global financial system and in technological and economic competitiveness; promote access to safe and affordable financial services; and support technological advances that promote responsible development and use of digital assets.[12] This note will primarily focus on analyzing solutions that further the White House's goals of protecting consumers and investors, as well as mitigating the risks posed by misuse of digital assets.

The debate over how exactly to regulate digital assets stems primarily from a lack of consensus as to whether digital assets and related products should be categorized as securities or commodities.[13] Seeking to each exert their own regulatory authority over the digital asset market, the SEC views digital assets as securities, while the CFTC views digital assets as commodities.[14] When defined as securities, digital assets are subject to the regulatory obligations imposed by state

8. Exec. Order No. 14067, 87 Fed. Reg. 14143 (Mar. 14, 2022).

9. *Id.* at 14145.

10. *Id.* at 14145–47.

11. *Id.* at 14147–49.

12. *Id.* at 14144–45.

13. *See* THOMSON REUTERS, *supra* note 3, at 3 ("Adding to the challenge is the ambiguous nature of digital assets themselves and the lack of standardized definitions, thus creating questions of overlap and jurisdiction.").

14. *Id.* at 5.

and federal securities laws.[15] Under the SEC's framework, digital assets that are securities are subject to registration and reporting requirements, the exchange on which the digital asset is traded must be registered, and the issuer must meet the exchange's listing standards.[16] The CFTC, on the other hand, currently has exclusive jurisdiction over transactions involving commodity derivatives, or financial products that derive their value from an underlying commodity, including digital asset derivatives.[17] The Commodity Exchange Act's broad definition of the term "commodity," however, leaves room for the CFTC to widen its scope of jurisdiction to include even digital asset products that are not derivatives.[18] The significance of the categorization of digital assets under one of these umbrellas is that it implicates the regulatory scheme under which digital assets and digital asset products will be analyzed and, by extension, the relief available to investors that have been defrauded by companies that sell digital asset products. In other words, the agency under which digital assets fall will have the power to carry out the policy principles outlined by the White House in its March 2022 Executive Order.

At the heart of this regulatory dispute are the obstacles posed by the *Howey* test. The *Howey* test is used by the Supreme Court to determine whether something is an "investment contract" and therefore a security under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act") (together, the "Securities Acts").[19] In *Howey*, the Court established a three-pronged test to determine whether a product is a security: there must be (1) an

15. *See* FIN. STABILITY OVERSIGHT COUNCIL, REPORT ON DIGITAL ASSET FINANCIAL STABILITY RISKS AND REGULATION 87 (2022), https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf [https://perma.cc/ZW9D-JUU2] (explaining the implications of crypto-assets being classified as securities).

16. *See id.* (explaining the regulatory requirements of digital assets that are classified as securities).

17. *See id.* at 89 (outlining the jurisdiction granted to the CFTC by the CEA).

18. *See id.* (explaining the CEA's broad definition of the term "commodity" and detailing the CFTC's 2014 position that virtual currencies, like bitcoin, are commodities under the CEA).

19. *See* Nathan Reiff, *Howey Test Definition: What It Means and Implications for Cryptocurrency*, INVESTOPEDIA (Updated Sept. 30, 2022), https://www.investopedia.com/terms/h/howey-test.asp#:~:text=The%20Howey%20Test%20attempts%20to,1933%20and%20the%20Securities%20Exchange [https://perma.cc/UBP7-6E8T] (explaining what the Howey test is and how it is used).

investment of money with regard to the product in (2) a common enterprise, with (3) profits to be derived solely from the efforts of others.[20] The second and third prongs are open to judicial interpretation, permitting courts to focus on the individual activities of investors and disregard the entirety of the transaction in order to find that there is no common enterprise and that investors contribute in some way to their own profits.[21] Such reasoning allows companies that sell digital asset products to bypass the SEC's registration and reporting requirements under the Securities Acts, as was the case in *Audet v. Fraser*.[22] Inconsistent application of the *Howey* test to digital assets by the courts, combined with a jurisdictional fight between the SEC and the CFTC as to which is authorized to regulate digital asset spot markets, has left participants in these markets unsure about their rights and protections.

In its Executive Order, the White House called for a unified approach to mitigate the risks to investors posed by an unregulated three-trillion-dollar market.[23] While a possible solution may be to modify the *Howey* test so that the second and third prongs of the test do not provide any leeway for courts to disregard the entirety of a transaction, a more comprehensive and permanent solution would be to redefine digital assets as commodities, definitively bringing them within the reach of the CFTC. Since a modified *Howey* test with tighter constraints may still leave room for judicial interpretation, allowing the CFTC (rather than the SEC) to regulate digital assets is an efficient solution that utilizes an existing regulatory agency. Without the problems posed by the flexibility, or lack thereof, of the *Howey* test to stand in its way, the CFTC may also be better equipped to protect investors and consumers from fraud and reduce the risks that stem from the misuse of digital assets, thereby aligning with

20. *See* SEC v. W.J. Howey Co., 328 U.S., 293, 298–99 (defining the three prongs of the Howey test).

21. *See* Audet v. Fraser, No. 3:16-CV-940 (MPS), 2022 WL 1912866, at *12–14 (D. Conn. June 3, 2022) (holding that the jury could have reasonably found that there was no common enterprise and that profits were not derived solely from the efforts of others based on the actions of individual investors.).

22. *See Audet*, 2022 WL 1912866, at *12–14 (holding that a jury could have reasonably found that Hashlets were not investment contracts, and therefore not within the regulatory authority of the SEC).

23. *See* Exec. Order No. 14067, 87 Fed. Reg. 14143 (Mar. 14, 2022); *What Is the Howey Test & Does Crypto Pass*, EMBROKER (Dec. 7 2022), https://www.embroker.com/blog/what-is-the-howey-test-does-crypto-pass/ [https://perma.cc/8Y4C-4QJU] (stating that the world's cryptocurrency market is worth three trillion dollars).

the White House's goal to ensure the responsible development of digital assets.

This Note will first dive into the mechanics of the *Howey* test as well as the Securities Acts of 1933 and 1934.[24] Part III of this note will assess how the *Howey* test was applied in *Audet v. Fraser* and analyze whether it served to further any of the objectives laid out by the White House's Executive Order.[25] Part IV of this note will then examine how the *Howey* test might be modified to better serve those policy objectives,[26] and Part V of this Note will examine how those objectives may be served by treating digital assets as commodities and discuss the pros and cons of pending legislation that has this goal in mind.[27]

II. REGULATION OF DIGITAL ASSETS AS SECURITIES – SECURITIES LAWS AND THE *HOWEY* TEST

A. Securities Laws

The Securities Act of 1933 governs the security registration with the SEC and national stock markets, while the Securities and Exchange Act of 1934 governs security trading on the secondary market, such as the New York Stock Exchange.[28] Following the stock market crash of 1929, the 1933 Act was passed with the objective of providing more transparency to investors through financial statements and prohibiting misrepresentations and fraud within securities markets.[29] Prior to the Great Depression, companies were able to sell stock based on fraudulent promises to investors while providing minimal truthful information

24. *See infra* Part II.
25. *See infra* Part III.
26. *See infra* Part IV.
27. *See infra* Part V.
28. *See Securities Law: A Guide to the 1933 and 1934 Acts and Their Amendments, Including Sarbanes–Oxley and Dodd–Frank – Research and Markets*, BUSINESSWIRE (Sept. 9, 2016), https://www.businesswire.com/news/home/20160909005850/en/Securities-Law-A-Guide-to-the-1933-and-1934-Acts-and-their-Amendments-including-Sarbanes-Oxley-and-Dodd-Frank---Research-and-Markets [https://perma.cc/XNL4-3NAZ] (providing a general overview of the 1933 and 1934 Acts).
29. Will Kenton, *Securities Act of 1933*, INVESTOPEDIA (Updated Oct. 20, 2020), https://www.investopedia.com/terms/s/securitiesact1933.asp [https://perma.cc/BX5C-9XX8].

about the company's financials or operations.[30] The 1933 Act's disclosure requirements ensure that investors receive financial and other significant information about securities offered for public sale and prohibit the fraudulent sale of securities.[31]

Passed at the direction of President Roosevelt, the 1934 Act created the Securities and Exchange Commission (SEC) and gave it broad authority over securities markets, including the power to register, regulate, and oversee the securities industry.[32] The SEC is tasked with ensuring that public companies comply with the 1934 Act's disclosure requirements.[33] Under § 13 of the 1934 Act, public companies of a certain size are "reporting companies" and are required to make periodic disclosures regarding their financial condition.[34] Additionally, the SEC has the authority to discipline companies who fail to comply with federal securities laws.[35]

Section 2(1) of the 1933 Act defines the term "security" to include other descriptive terms such as "certificate of interest or participation in any profit sharing agreement," "investment contract," and "in general, any interest or instrument commonly known as a security."[36] When a company violates a federal securities law, the 1934 Act allows the SEC to bring a civil enforcement action.[37] It also allows investors to initiate suits against the alleged fraudulent company.[38] Section 10(b) of the 1934 Act[39] is the anti-fraud statutory provision,

30. *See Securities Law History*, LEGAL INFO. INST., https://www.law.cornell.edu/wex/securities_law_history [https://perma.cc/W5EZ-P3L3] (last visited Feb. 2, 2023) (providing a historical background for the 1933 and 1934 Acts).

31. U.S. Sec. & Exch. Comm'n, *The Laws That Govern the Securities Industry*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry [https://perma.cc/DP8G-F8DJ] (last visited Jan. 11, 2023).

32. LEGAL INFO. INST., *supra* note 30.

33. *Id.*

34. Securities Exchange Act of 1934 § 3, 15 U.S.C. § 78(m) (2018).

35. LEGAL INFO. INST., *supra* note 30.

36. Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2018).

37. *See Securities Exchange Act of 1934*, LEGAL INFO. INST., https://www.law.cornell.edu/wex/securities_exchange_act_of_1934 [https://perma.cc/CZZ5-D4FD] (last visited Feb. 2, 2023) ("The SEC enforces statutory disclosure requirements bringing enforcement actions against companies that disseminate fraudulent or incomplete information in violation of federal securities laws.").

38. 15 U.S.C. § 78j; *see* LEGAL INFO. INST., *supra* note 37 ("Courts have held that there is a private right of action to sue under 10b-5.").

39. 15 U.S.C. § 78j(b).

enforced under Rule 10b-5 by the SEC.[40] The language of Rule 10b-5 makes it unlawful for a market participant "to employ any device, scheme, or artifice to defraud," make untrue statements or omissions that mislead investors, or "engage in any act, practice, or course of business" that would defraud investors.[41]

B. The Howey Test

The *Howey* test is the prevailing legal framework to analyze whether an asset constitutes an investment contract, and therefore a security, under the 1933 Act.[42] The term "investment contract" is included within the scope of the test articulated by the court in *SEC v. W.J. Howey Co*, and can be broken up into three parts: (1) an investment of money; (2) in a common enterprise; (3) with profits to be derived solely from the efforts of others.[43] According to the *Howey* court, this test "permits the fulfillment of the statutory purpose" of encompassing all instruments that might fall within the "concept of" a security.[44]

The first prong, an investment of money, is not typically at issue when analyzing whether digital assets are securities.[45] Since this requirement is met when an asset is acquired in exchange for value, satisfying this prong is usually achieved through offer and sale of a digital asset product.[46]

In deciding whether the purchaser of a digital asset made an investment of money "in a common enterprise," thereby satisfying the second prong of *Howey*, federal courts have made it clear that either horizontal or vertical commonality must exist within the enterprise.[47] Horizontal commonality refers to "the tying of each individual

40. 17 C.F.R. § 240.10b-5.

41. *Id.*

42. *See* Reiff, *supra* note 19 (discussing using the *Howey* Test to determine if something is a security).

43. S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

44. *Id.* at 299.

45. *Framework for "Investment Contract" Analysis of Digital Assets*, U.S. SEC. AND EXCH. COMM'N (Apr. 3, 2019), https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_edn10 [https://perma.cc/CL9J-PHGP].

46. *Id.*

47. *See* Revak v. SEC Realty Corp., 18 F.3d 81, 87 (2d Cir. 1994) (explaining that a common enterprise under the *Howey* test can be established by a showing of horizontal commonality, and that some courts have held that a common enterprise can be established by a showing of vertical commonality).

investor's fortunes to the fortunes of the other investors by pooling their assets, usually combined with the pro-rata distribution of profits."[48] To find horizontal commonality, each investor's profitability must depend on the success or failure of the enterprise as a whole.[49] Applying the horizontal commonality approach, the Seventh Circuit found that when a purchaser of a time-share received only rental profits from a single apartment, there was no horizontal commonality, because there was no pooling of profits.[50] Had the investor instead owned an undivided share of the total rentals of all the rental units in the apartment building complex and received a pro-rata share of the pooled rental profits, there would have been horizontal commonality.[51]

Vertical commonality, on the other hand, is far more forgiving than horizontal commonality, and has two variants: broad vertical commonality and narrow vertical commonality (sometimes referred to as "strict" vertical commonality). Broad vertical commonality occurs when an investor's fortunes are tied to the efforts or *expertise* of the investment promoter,[52] while narrow vertical commonality refers to tying an investor's fortunes to the *fortunes* of the investment promoter.[53] In *Revak v. SEC Realty Corp*., however, the Second Circuit held that broad vertical commonality was not enough to satisfy the common enterprise prong of *Howey*.[54] The Court reasoned that if a finding that an investor's profits were tied to the efforts of an investment promoter was enough to satisfy the common enterprise prong of *Howey*, the third prong of *Howey* (profits to be derived solely from the efforts of others) would be an unnecessary inquiry.[55] Thus, broad vertical commonality would be inconsistent with *Howey*.[56] In contrast to federal courts' finding that a "common enterprise" is a necessary element of an investment contract, the SEC has interpreted the *Howey* test differently, stating that it neither requires that there be horizontal or vertical

48. *Id.*

49. *Id.*

50. *See* Wals v. Fox Hills Dev. Corp., 24 F.3d 1016, 1019 (7th Cir. 1994) ("[T]here was not a pooling of profits, which is essential to horizontal commonality.").

51. *See id.* at 1018 (comparing ownership of a stock, where each owner receives a pro rata share in a company's profits, with ownership of a condominium, where profit is solely based on the individual unit owned).

52. SEC v. ETS Payphones, Inc., 300 F.3d 1281, 1284 (11th Cir. 2002).

53. Revak v. SEC Realty Corp., 18 F.3d 81, 87–88.

54. *Id.* at 88.

55. *Id.*

56. *Id.*

commonality to support a finding that an asset is a security nor views a "common enterprise" as an element of a security.[57]

In the SEC's view, the term "investment contract" under *Howey* is derived from state Blue Sky laws, where the term had come to mean "a contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment.'"[58] Notably absent from this definition is the idea that the investor must be tied, in any manner, to other investors or investment promoters; it simply requires that income or profit is derived from the "laying out of money."[59]

The third prong of the *Howey* analysis asks whether the profits of an investment of money in a common enterprise would be derived solely from the efforts of others.[60] When analyzing digital assets like those in *Audet*, which concerns products that leave room for some investor involvement, this prong presents the greatest hurdle to finding that the asset is a security. An asset is found to derive profits from the efforts of others when a promoter, sponsor, or other third party provides essential managerial efforts that affect the success of the enterprise and investors reasonably expect to derive profit from those efforts.[61] The court in *Howey* emphasized that the focus of this inquiry is the "economic reality" of the transaction.[62] More specifically, to determine whether profits derived from an investment of money sufficiently relied on the efforts of others, the transaction itself and the manner in which the product is offered and sold must be analyzed.[63]

---

57. *See* U.S. SEC. AND EXCH. COMM'N, *supra* note 45, at n.10 (outlining how the Howey analysis applies to digital assets).

58. *See* Barkate, Exchange Act Release No. 49542, 2004 WL 762434 n.13 (Apr. 8, 2004) (explaining why the SEC does not view the "common enterprise" prong of Howey as an element of an investment contract).

59. *Id.*

60. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298 (explaining the third prong of the *Howey* test).

61. *See, e.g.*, SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 (9th Cir.) (explaining the circumstances under which the third prong of *Howey* would be satisfied).

62. 328 U.S. at 298.

63. *See* U.S. SEC. AND EXCH. COMM'N, *supra* note 45 (outlining how the *Howey* Analysis applies to digital assets and explaining what the court in *Howey* meant when it held that the focus of the third prong of the analysis should be on the economic reality of the transaction).

III. AUDET V. FRASER

In June 2022, The United States District Court for the District of Connecticut applied the *Howey* test to a digital asset product and found that it was not an investment contract.[64] GAW Miners LLC was established in 2014 to generate profits through the mining of bitcoin and other cryptocurrencies.[65] One of its products, called a Hashlet, represented a share of profits in GAW's computing power.[66] The SEC and class action plaintiffs alleged that GAW sold more Hashlets than it had the hardware to support, the profits from its mining efforts were insufficient to cover the returns promised to the Hashlet purchasers, and to cover this up, GAW used money from the sale of additional Hashlets to pay some of the returns owed.[67]

A. How Hashlets Work

Based on conflicting trial testimony, Hashlets were either a computer used for mining cryptocurrency, or a percentage of mining power at a mining farm.[68] "Mining" is a term used to describe a method of obtaining cryptocurrency without having to buy it using money.[69] Cryptocurrency transactions occur on the blockchain, which is a public database of all crypto transactions ever made.[70] Miners "verify" these transactions using sophisticated hardware to solve a computational mathematical problem and the miner with the first computer to solve the

64. Audet v. Fraser, No. 3:16-CV-940, 2022 WL 1912866, PINCITE (D. Conn. June 3, 2022).

65. *GAW Miners News*, COINTELEGRAPH, https://cointelegraph.com/tags/gaw-miners [https://perma.cc/2V27-8B5Z] (last visited Feb. 2, 2023).

66. *Audet*, 2022 WL 1912866, at *2.

67. *See* Jesse Frenkel & James Walker, *Co-Founder of Crypto Mining Firm Prevails in Jury Verdict Based on Interpretation of Unique Securities Fraud Instruction*, PERKINS COIE: WHITE COLLAR BRIEFLY (Nov. 22, 2021). https://www.whitecollarbriefly.com/2021/11/22/co-founder-of-crypto-mining-firm-prevails-in-jury-verdict-based-on-interpretation-of-unique-securities-fraud-instruction/ [https://perma.cc/LV74-W9AP] (giving backround on *Audet*).

68. *Audet*, 2022 WL 1912866, at *1–2.

69. *See What is Mining?*, COINBASE, https://www.coinbase.com/learn/crypto-basics/what-is-mining [https://perma.cc/KQ8V-M9W7] (last visited Jan. 31, 2023) (providing an explanation of "mining" as it relates to cryptocurrency).

70. *See* Euny Hong, *How Does Bitcoin Mining Work?*, INVESTOPEDIA (updated May 5, 2022) https://www.investopedia.com/tech/how-does-bitcoin-mining-work/ [https://perma.cc/6UQA-JPDG] (explaining what the blockchain is and how it works).

problem earns cryptocurrency as a reward.[71] A mining pool is made up of a joint group of miners who combine their resources to strengthen their chance of successfully verifying a transaction.[72] Rewards earned from mining pools are usually proportionally divided between individuals who contributed to the pool.[73] Purchasers of Hashlets purchased a share of mining power, giving them a share of profits generated by mining activities.[74] Each purchaser could select a different mining pool for their Hashlet, and would receive a return based on the value of the mining power of this pool.[75]

B. Jury Verdict

Plaintiffs brought a private class action suit against Stuart Fraser (founder of GAW Miners LLC) under § 10(b) of the 1934 Act as well as Rule 10b-5 and Sections 36b-29(a)(1) and (2) of the Connecticut Uniform Securities Act.[76] Prior to this, the SEC filed a securities fraud enforcement case against Homero Joshua Garza, a business associate of Fraser.[77] Garza settled with the SEC and agreed to a judgement entered against him.[78] In applying the *Howey* test to Hashlets, the jury in *Audet* found that the second and third prongs of the analysis were not met, and therefore Hashlets did not constitute an investment contract.[79] Plaintiffs then brought a post-trial motion, arguing that the jury's finding that

71. *See* COINBASE, *supra* note 69 (explaining how miners earn cryptocurrency through the mining process).

72. *See* Jake Frenkenfield, *Mining Pool: Definition, How It Works, Methods, and Benefits*, INVESTOPEDIA (updated Jan. 15, 2022) https://www.investopedia.com/terms/m/mining-pool.asp [https://perma.cc/LJZ4-HADM] (explaining how mining pools work).

73. *Id.*

74. Audet v. Fraser, No. 3:16-CV-940, 2022 WL 1912866 at *12 (D. Conn. June 3, 2022).

75. *Id.*

76. *Federal Jury Finds Cryptocurrency Products Not Securities in Landmark Verdict*, PAUL WEISS (Nov. 18, 2021) https://www.paulweiss.com/practices/litigation/securities-litigation/publications/federal-jury-finds-cryptocurrency-products-not-securities-in-landmark-verdict?id=41746 [https://perma.cc/S8EQ-57EW].

77. *See* Andrew F. Fowler, *United States: The Case of Audet v. Fraser: Hashlets, Hashtakers, Hashpoints and PayCoin, Oh My!*, HUGHES HUBBARD & REED, https://www.hugheshubbard.com/news/the-case-of-audet-v-fraser-hashlets-hashtakers-hashpoints-and-paycoin-oh-my [https://perma.cc/JAR2-CAZ4] (last visited Jan. 31, 2023) (giving procedural background of SEC action against GAW Miners, LLC).

78. *See id.* (procedural background of SEC action against GAW Miners, LLC).

79. *Audet*, 2022 WL 1912866, at *12.

Hashlets were not investment contracts was against the weight of the evidence.[80] It should be noted that the jury verdict in *Audet* may not be the last say on how to analyze Hashlets under *Howey*; an appeals court may be able to overrule the district court's ruling and reason that *Howey* should be applied more narrowly such that Hashlets fall within the definition of an investment contract.

With respect to the common enterprise element, the court first analyzed whether horizontal commonality existed by using the Second Circuit's definition, requiring "the tying of each individual investor's fortunes to the fortunes of the other investors."[81] Plaintiffs argued that the key feature of horizontal commonality is whether the investors' profits are tied to the success of the entire enterprise, but the court ruled by applying the Second Circuit's definition and held that the evidence that Hashlet purchasers could earn different profits depending on the mining pools they chose and whether or not they "boosted" their Hashlet could reasonably support the jury's finding that the fortune of one Hashlet purchaser was not tied to those of other Hashlet purchasers.[82]

The court in *Audet* then analyzed whether a jury could have reasonably found that vertical commonality existed to satisfy the common enterprise prong of *Howey* and determined that failure of this prong would not have been against the weight of the evidence.[83] Plaintiffs presented testimony that if the Hashlet purchaser's return was less than or equal to the service fee, GAW would pay the Hashlet purchaser the smallest fraction of a bitcoin above the amount of the fee, thus depriving GAW of the full amount of the fee due to the investor's misfortune and tying, at least in some part, the performance of GAW to the performance of its investors.[84] However, drawing from *Marini v. Adamo*,[85] the court in *Audet* held that the jury could have found that there was no *proportional* relationship between GAW and Hashlet owners such that there was "an interdependence of both profits and

80. *Id.* at *1.
81. Revak v. SEC Realty Corp., 18 F.3d 81, 87 (2d Cir. 1994).
82. *Audet*, 2022 WL 1912866, at *13.
83. *Id.* at *12.
84. *Id.* at *13.
85. *See* Marini v. Adamo, 812 F. Supp. 2d 243, 256 (E.D.N.Y. 2011) (holding that to determine that a common enterprise exists, a plaintiff must prove that the fortunes of the plaintiff and defendant rise and fall together).

losses."[86] According to the court, because GAW earned the same fee regardless of the investor's profits, it was not against the weight of the evidence to find that the second prong of *Howey* was not met.[87]

In finding that the weight of the evidence would not have precluded the jury from finding that the third prong of *Howey* — profits derived solely from the efforts of others — was unsatisfied, the court pointed to the fact that an investor's money and decisions regarding the selection of mining pools were combined with GAW's mining equipment in order to generate an investor's profit.[88] Such decision-making power, in the court's eyes, allowed the jury to reasonably conclude that investors had "significant control' over their Hashlets while GAW provided only the physical computing equipment necessary for mining.[89]

The result the jury reached in this case stands contrary to the principal policy objectives laid out by the White House's Executive Order on Ensuring Responsible Development of Digital Assets. By not classifying a Hashlet as an investment contract, those investors who purchased Hashlets and did not receive their promised return were left unprotected, both exemplifying and contributing to the overall risk posed by digital asset markets. Additionally, the jury verdict directly clashes with the SEC's framework for investment contract analysis.[90] The SEC has said that "[i]n evaluating digital assets, we have found that a 'common enterprise' typically exists."[91] Moreover, instead of viewing the third prong of Howey as "profits to be derived [solely] from the efforts of others," the SEC analyzes whether there exists a "[r]easonable expectation of profits (or other financial returns) derived from the efforts of others."[92] The SEC's version of this inquiry aligns with the holding in *Howey* in that it focuses on the "economic reality" of the transaction, concerned with the "character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect" — not the strict interpretation exhibited by the court in *Audet*, which found any minimal

86. *Audet*, 2022 WL 1912866, at *14.
87. *Id.*
88. *Id.*
89. *Id.*
90. U.S. SEC. AND EXCH. COMM'N, *supra* note 45.
91. *See id.* (SEC's analysis for the "common enterprise" prong of the *Howey* test).
92. *See id.* (SEC's analysis for the third prong of the *Howey* test).

involvement by the investor sufficient for failure of this prong.[93] The jury verdict, in essence, promotes the misuse of digital assets, effectively cautioning investors against making digital asset investments in the U.S.

IV. MODIFYING THE *HOWEY* TEST

By failing to define a "common enterprise," the *Howey* court left the satisfaction of the second prong of the test open to the possibility of narrow application to an emerging technology like digital asset mining, as shown in *Audet*. The court in *Audet* looked to see if there was either horizontal or vertical commonality and held that the jury could have reasonably found that no common enterprise existed.[94] If the term "common enterprise" were more clearly defined to cast a wider net, it could encompass digital asset products and ensure that this prong of the test still furthers the overall purpose asserted by plaintiffs in *Audet*: that the success of investors is tied to the success of the enterprise as a whole.[95] Requiring that each investor's success be tied to the success of the other investors does nothing to further the idea that purchasers of digital assets are invested in a common enterprise; it only serves to cast out digital assets from the scope of securities regulations.

Moreover, the failure of *Howey* to define what constitutes the "efforts of others" allowed the court in *Audet* to reason that any minimal effort by an investor could preclude a finding that a digital asset is an investment contract. While the mining pool chosen by an investor for their Hashlet had the ability to generate the investor's profit or loss, the investor needed to only click on their Hashlet and drag it to a mining pool to generate their misfortune or success; no knowledge of digital asset products was required to put forth this "effort." GAW, on the other hand, provided the complex and sophisticated equipment (typical of a mining farm) that used significant amounts of power[96] and from

93. *Id.*

94. *Audet*, 2022 WL 1912866, at *14.

95. *Id.* at *12.

96. *See* Eric Rosenberg, *How Much Energy It Takes to Power Bitcoin*, THE BALANCE (updated Sept. 15, 2022) https://www.thebalancemoney.com/how-much-power-does-the-bitcoin-network-use-391280 [https://perma.cc/WJ4U-F9ZK] (explaining the specifics of how much power it takes to mine bitcoin).

which investors reaped the benefits.[97] A finding of "effort," should be rooted in the knowledge or expertise that one party exhibits in an investment venture, not the ability of an investor to do well or poorly based on a decision requiring no understanding of the asset in which an individual is investing.

Supplementing the *Howey* test with digital-asset focused legislation would allow both the SEC to take action that would help prevent the reoccurrence of the fraud exhibited in *Audet* and thereby serve the principles related to protecting investors, mitigating risk, and promoting access to safe financial services. However, having any "test" used to classify digital assets leaves at least some room for judicial interpretation and therefore some probability of risk that a company dealing in digital assets may be able to skirt around regulation and misuse those assets.

V. REGULATION OF DIGITAL ASSETS AS COMMODITIES

In December of 2020, the CFTC released a Digital Assets Primer, discussing the classification of digital assets.[98] In its assessment, the CFTC points out that The Commodity Exchange Act defines the term commodity to include "goods and articles . . . and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in,"[99] noting that this definition does not limit commodities to tangible goods.[100] The Commodity Exchange Act further gives the CFTC jurisdiction over transactions involving commodity derivatives, which are financial instruments that derive their value from some underlying commodity, meaning the CFTC already has jurisdiction over digital asset derivatives.[101] The crux of the problem lies in the regulatory gap in the spot market for digital assets that are not classified as securities.[102] In contrast to derivatives markets, in a digital

97. *See Audet*, 2022 WL 1912866, at *2 ("Audet testified that the Company was responsible for hosting, running, and maintaining the mining machines.").

98. COMMODITY FUTURES TRADING COMM'N, DIGITAL ASSETS PRIMER (2020), https://www.cftc.gov/media/5476/DigitalAssetsPrimer121520/download [https://perma.cc/9UQN-DQ6X].

99. Commodity Exchange Act § 1a, 7 U.S.C. § 1a(9) (2018).

100. COMMODITY FUTURES TRADING COMM'N, *supra* note 98, at 5.

101. *See* FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 15, at 89 (outlining the CFTC's jurisdiction over commodity derivative markets, as dictated by the Commodity Exchange Act).

102. *Id.*

asset spot market, a market participant buys or sells the actual asset, and the purchaser receives the digital asset immediately after buying it.[103] A gap like this means that when a digital asset both fails the *Howey* test and falls outside the CFTC's jurisdictional power, it becomes an unregulated digital asset beyond the reach of protective measures put in place by either the SEC or CFTC.

In response to the call for some form of regulation of digital asset spot markets, in June of 2022, Senators Lummis (R-WY) and Gillibrand (D-NY) took legislative initiative by introducing a bipartisan bill that would classify many digital assets as commodities, giving the CFTC the power to regulate them.[104] The Responsible Financial Innovation Act (RFIA) creates a "pathway for digital asset exchanges to register with the CFTC to conduct trading activities" and "establishes core principles, rulemaking, custody, consumer protection, prevention of market manipulation, information-sharing and preemption standards."[105] The proposed bill requires "providers of digital assets to clearly disclose information in customer agreements related to their product, including asset treatment in bankruptcy, risk of loss, applicable fees, redemption, and more."[106] Most notably, the bill defines the term "digital asset" as "a natively electronic asset that confers economic, proprietary, or access rights or powers and is recorded using cryptographically secured distributed ledger technology, or any similar analogue."[107]

The bill does not completely preclude digital assets from being regulated as securities; it makes a clear distinction between digital assets

---

103. *See* Tim Smith, *Spot Market: Definition, How They Work, and Example*, INVESTOPEDIA (updated Sept. 29, 2021) https://www.investopedia.com/terms/s/spotmarket.asp. [https://perma.cc/8NAN-RCWP] (differentiating a derivatives market from a spot market).

104. *See Lummis, Gillibrand Introduce Landmark Legislation to Create Regulatory Framework for Digital Assets*, KRISTEN GILLIBRAND (June 7, 2022) https://www.gillibrand.senate.gov/news/press/release/-lummis-gillibrand-introduce-landmark-legislation-to-create-regulatory-framework-for-digital-assets/ [https://perma.cc/L4HJ-98LK] (explaining the Responsible Financial Innovation Act, and how it gives authority to the CFTC to regulate digital assets).

105. LUMMIS-GILLIBRAND RESPONSIBLE FINANCIAL INNOVATION ACT: SECTION-BY-SECTION OVERVIEW 3 [hereinafter RFIA Overview], https://www.lummis.senate.gov/wp-content/uploads/Lummis-Gillibrand-Section-by-Section-Final.pdf [https://perma.cc/3LMM-R25F].

106. *Id.*

107. Lummis-Gillibrand Responsible Financial Innovation Act, S. 4356, 117th Cong. § 101(a) (2022).

that are commodities and digital assets that are securities such that a digital asset will always fall in one category or another.[108] An overview of the bill states that "[d]igital assets which are not fully decentralized, and which benefit from entrepreneurial and managerial efforts that determine the value of assets, but do not represent securities [are ancillary assets and] . . . will be required to furnish disclosures with the SEC twice a year."[109] The overview goes on to state that "[a]ncillary assets in compliance with these disclosure requirements are presumed to be a commodity."[110]

By defining digital assets that do not meet the standard to be classified as securities as ancillary assets, and then categorizing those ancillary assets as commodities subject to SEC disclosures, the bill ensures that when a digital asset fails to meet the requirements of a security under the *Howey* test, consumers will still have the information necessary to make informed decisions through the SEC's disclosure requirements.[111] In other words, this framework would help ensure investor protection and mitigate risks by providing for two regulatory pathways: either the SEC or, if *Howey* presents an obstacle, the CFTC.

Another bipartisan bill, introduced in August of 2022, seeks to achieve the same goal: implementing a uniform regulatory scheme for digital assets that are not securities by classifying them as commodities.[112] The Digital Commodities Consumer Protection Act (DCCPA) would require "digital commodity platforms" to register with the CFTC.[113] In contrast to the RFIA, however, the DCCPA would define certain cryptocurrencies as "digital commodities" rather than "digital assets."[114] While the RFIA defines a digital asset by its "economic, proprietary, or access rights or powers," under the DCCPA, a digital commodity is simply "a fungible digital form of personal

108. *See* RFIA Overview, *supra* note 105, at 2 ("For the first time, this bill makes a clear distinction between digital assets that are commodities or securities . . . .").

109. *Id.*

110. *Id.*

111. *Id.*

112. *See* Deanna R. Reitman et. al, *How the Digital Commodities Consumer Protection Act of 2022 Would Broaden the CFTC's Authority to Regulate Cryptocurrencies and Other Digital Assets*, DLA PIPER (Aug. 16, 2022), https://www.dlapiper.com/en/us/insights/publications/2022/08/how-the-digital-commodities-consumer-protection-act-of-2022/ [https://perma.cc/85WK-5VLH] (comparing the RFIA with the proposed Digital Commodities Consumer Protection Act).

113. *Id.*

114. *Id.*

property that can be possessed and transferred person-to-person without necessary reliance on an intermediary."[115] This definition of a digital commodity leaves the question of what rights a digital commodity must confer up to the CFTC, thereby granting the CFTC broader discretion in determining exactly which digital assets fall within its jurisdiction.[116] While both the RFIA and the DCCPA seek to close the existing regulatory gap in digital asset markets, by leaving open the possibility of a digital asset being classified as a security, both pieces of proposed legislation leave open the possibility of a digital asset, like a Hashlet, having to work its way through a court's application of the *Howey* analysis. Thus, legislation like the RFIA and DCCPA will only be effective at regulating digital assets when combined with a modified *Howey* test that addresses the flexibility in its second and third prongs.

In contrast to the aforementioned pieces of legislation, in which digital assets products may still be subject to *Howey*, handing regulatory power over all digital asset markets to the CFTC entirely circumvents the problem of having a fact-specific test. The broad definition of the term "commodity" in the Commodity Exchange Act,[117] combined with the CFTC's existing jurisdiction over digital asset derivative markets,[118] presents the ideal opportunity to utilize an existing regulatory agency with expertise in digital asset markets to address the dangers posed by companies like GAW. This path to regulating digital assets presents a rule by which to classify digital assets and avoids the possibility of judicial interpretation presented by the *Howey* test. Not only does this serve the policy objectives of protecting investors and mitigating systemic and illicit finance risks posed by the misuse of digital assets,[119] it also provides businesses and consumers with a level of certainty regarding the disclosure requirements for digital assets. The current jurisdictional confusion regarding whether the CFTC or the SEC can regulate digital asset markets has done nothing to promote efficiency in the regulation of cryptocurrency markets and only serves to slow down

115. *Id.*

116. *Id.*

117. *See* Commodity Exchange Act § 1a(9), 7 U.S.C. § 1a(9) (2018) (defining "commodity" in part as all "goods and articles . . . and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in.").

118. FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 15, at 89.

119. Exec. Order No. 14067, 87 Fed. Reg. 14143, 14143–44 (Mar. 9. 2022).

or completely bar the digital asset investor's opportunity to seek relief from the fraudulent activities of companies like GAW.

Though regulating digital assets under the CFTC is certainly a viable and efficient solution, it should be noted that the perception of digital asset markets, in their nature and volatility, is vastly different from that of commodity markets.[120] For many investors, it would seem more natural to regulate digital assets as securities.[121] Recognizing that cryptocurrencies are a far cry from commodities like gold, oil, or wheat, critics of regulatory schemes that hand jurisdictional power of digital assets over to the CFTC have said that cryptocurrencies more closely resemble securities because investors put money into them, hoping for a return.[122] Another noted difference between digital asset markets and traditional commodity markets is the type of investor involved.[123] In a keynote address to the Brookings Center on Regulation and Market and the Hutchins Center on Fiscal and Monetary Policy, CFTC Chairman Rostin Benham addressed the fact that crypto investors tend to be younger and more vulnerable, and that it is "incumbent [upon the CFTC] to educate, to inform, to disclose risks involved."[124]

VI. CONCLUSION

The sale of cryptocurrency-related products represents a rapidly expanding and unregulated market, and as the *Howey* test stands today, investors of digital assets are left unprotected under securities laws. The facts presented in *Audet v. Fraser* give color to this danger and exemplify how the broad language of the *Howey* test fails to hold

120. *See* Connor Donevan & Patrick Jarenwattananon, *There's a New Plan To Regulate Cryptocurrencies. Here's What You Need To Know*, NPR (June 14, 2022, 5:00 AM), https://www.npr.org/2022/06/14/1104303982/crypto-bitcoin-stablecoin-regulation-senate [https://perma.cc/RBN7-6LCE] (providing commentary on proposed legislation to regulate cryptocurrencies).

121. *See id.* (discussing criticisms of placing cryptocurrency under the jurisdiction of the CFTC rather than the SEC).

122. *Id.*

123. *See* Aaron Klein, *The Future of Crypto Regulation: Highlights from the Brookings Event*, BROOKINGS (Aug. 11, 2022), https://www.brookings.edu/2022/08/11/the-future-of-crypto-regulation-highlights-from-the-brookings-event/ [https://perma.cc/55WL-ZRAR] (listing higher participation in crypto markets than commodity markets as a challenge for regulators).

124. *Id.*

companies like GAW miners accountable for engaging in a Ponzi scheme.[125]

While preventing a repeat of Audet could be found in modifying the *Howey* test such that the second and third prongs of the test are redefined to encompass a product like Hashlets,[126] current proposed legislation like the RFIA or DCCPA could combine with a modified *Howey* test to produce a comparable result, though the existence of any fact-dependent test in the classification of a digital asset may not be as inclusive as giving the CFTC jurisdictional control over all digital asset markets.[127] A far more comprehensive, efficient, and simple solution would be to define digital assets as commodities and allow their regulatory scheme to be dictated by the CFTC, such that their classification is defined by a rule rather than a test.[128] An approach like this would serve the principal policy objectives outlined by the White House Executive Order on Ensuring the Responsible Development of Digital Assets, namely investor, consumer, and business protection; systemic and illicit finance risk mitigation; and promoting access to safe financial services.

GUNJAN D. DEVNANI[*]

125. *See supra* Part III.
126. *See supra* Part IV.
127. *See supra* Part V.
128. *See supra* Part V.

[*] Thank you to my editors, Beth Nelson and Max Veith, for their continual support and guidance, Professor Lissa Broome, for her mentorship and wisdom, and the Editorial Board of the North Carolina Banking Institute, for the chance to explore a fascinating legal landscape. I would also like to thank my friends and family, who are my unwavering pillars of support and prime source of encouragement. Finally, I would like to give special gratitude to my father, who taught me to approach all of life's endeavors with compassion, dedication, and courage.