What High Court Vaccine Ruling Could Mean For Crypto Regs

By **William Walsh** (March 21, 2022)

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The U.S. Supreme Court's recent decision to block a federal vaccine mandate was the latest example of the court's willingness to strike down regulations it views as overreaching, even where its ruling has significant practical consequences.

If the current court majority is willing to block regulations designed to protect the life and health of millions of Americans from the threat of a pandemic, will they hesitate to question the reach of the federal securities laws — written almost a hundred years ago — in the context of virtual assets, a rapidly evolving area of technology and finance? The answer is far from clear.

As the market for virtual assets continues to broaden in diversity and complexity, the U.S. Securities and Exchange Commission continues to depend largely on a single precedent supporting its jurisdiction to regulate these assets: the Howey test, based on the 1946 decision in SEC v W.J. Howey Co.[1] In Howey, the Supreme Court established the framework courts have used to determine what constitutes a security under federal law for more than 75 years.

But the framework of Howey — and the statutory basis on which it was built — is of questionable relevance to the diverse world of virtual assets, and Howey's application in this area depends almost entirely on defining such assets as investment contracts.

The Supreme Court, as presently constituted, appears likely to be willing to question this proposition, as signaled by the court's recent parsing of the Occupational Safety and Health Act to deny the Occupational Safety and Health Administration's authority to impose a workplace vaccine requirement.

While this recent decision did not concern securities regulation, the court's constrictive reading of the term "occupational" could just as easily be applied to interpreting the term "investment contract," which was codified in 1933.

Many have argued that the market needs greater clarity from regulators as to what constitutes a security in the context of virtual assets — and the SEC has provided some such guidance. But new regulations may not be enough: If the Supreme Court determines that virtual assets — or some subset of them — are not investment contracts under the Securities Act, then by extension, the SEC's authority to enact such regulations would be limited, much as the court held OSHA's authority to be limited.

When the issue of cryptocurrency-as-a-security comes before the court, the justices may be willing to consider whether an updated analytical approach is necessary — or, even more dramatically, whether the Securities Act is applicable to many forms of cryptocurrency at all.

In light of the costs and uncertainty associated with the case-by-case approach necessitated by the current Howey jurisprudence, this might be a welcome development — or it could just create more uncertainty. But such a decision is likely, and Congress needs to be prepared to respond — or to act before the court does.

Defining an Investment Contract

Under Howey, whenever a question arises as to whether a particular financial arrangement qualifies as a security, the question typically becomes whether it is an investment contract — a catch-all term in the Securities Act — because the remaining securities defined in the statute are more specific and are largely irrelevant to cryptocurrency.

In turn, courts apply the Howey test, which considers whether the instrument involves (1) an investment of money (2) in a common enterprise (3) with an expectation of profit (4) from the efforts of others.

Obviously, the Securities Act was enacted without cryptocurrency in mind, as the act and the Howey decision both predate the era of modern computing. And it is questionable whether many of the virtual assets in circulation or development today — including tokens associated with decentralized autonomous organizations and distributed through diverse means such as airdrops and staking rewards — really fit a reasonable definition of "investment contract." While certainly some fit that definition, where the line is or should be drawn is unclear.

This definitional problem is demonstrated through the challenges token issuers, exchanges, lawyers and courts face when they attempt to analyze modern cryptocurrency under the Howey elements. The SEC has tried to guide the market by issuing its framework for investment contract analysis of digital assets.[2]

But the SEC's framework contains dozens of criteria, none of which are determinative, and it is unclear what weight any factor should be given. Ultimately the market is left with the uncertainty of a case-by-case determination of each token, subject to selective regulation by enforcement by the SEC.

The current regime is burdensome on litigants and regulators alike, requiring a detailed factual analysis for every subject token. As professor Miriam Albert of Hofstra University has observed, "[t]he intentional breadth and adaptability of the definition of investment contract necessarily leads to complex and fact-intensive judicial inquiries in the application thereof, and allows for the possibility of inconsistent results between and among the various courts engaging in such inquiries."[3]

The lower federal courts have been grappling with these issues for years, but the Supreme Court has yet to weigh in — having last considered Howey in depth in 2004, in SEC v. Edwards,[4] well before the launch of the bitcoin network and the development of the modern cryptocurrency market.

In the absence of any other authority, regulators, litigants and courts have generally accepted that the Howey analysis applies to to evaluating whether a cryptocurrency is a security. But the Supreme Court has yet to weigh in.

The Supreme Court Stays Enforcement of OSHA's Vaccine Requirement

On Jan. 13, the Supreme Court stayed a workplace mask mandate imposed by OSHA in National Federation of Independent Business v. U.S. Department of Labor.[5] The court held that OSHA had likely exceeded its powers in imposing a COVID-19 vaccine requirement, stating that "OSHA is tasked with ensuring occupational safety — that is, 'safe and healthful working conditions.'"[6]

The court questioned whether OSHA's statutory power to regulate occupational hazards and to set workplace safety standards applied to a broad vaccine mandate — ultimately deciding that the agency lacked this authority.[7]

In reaching this conclusion, the court observed that it "expect[s] Congress to speak clearly when authorizing an agency to exercise powers of vast economic and political significance."[8] The court further stated that "imposing a vaccine mandate on 84 million Americans in response to a worldwide pandemic is simply 'not part of what the agency was built for.'"[9]

Justice Neil Gorsuch, joined by Justices Clarence Thomas and Samuel Alito, issued a concurrence that went further, advocating application of the nondelegation doctrine — a theory that appears to be gaining traction in the court[10] — and which, according to the concurrence, "ensures democratic accountability by preventing Congress from intentionally delegating its legislative powers to unelected officials."[11]

The concurrence expressed concern that an agency "may seek to exploit some gap, ambiguity, or doubtful expression in Congress's statutes to assume responsibilities far beyond its initial assignment."[12] This question of an agency's assignment is particularly germane to the regulation of virtual assets, as numerous agencies have sought to stake out their territory in this area, with significant ongoing conflict over where the regulatory boundaries lie.[13]

The reasoning of the majority, as elaborated upon by Justice Gorsuch's concurrence — and its demand for clear statutory authority for a federal agency to regulate a significant field of economic activity — could equally apply to regulation of the burgeoning industry of diverse virtual assets through the blunt instrument of traditional securities regulation, which requires shoehorning such assets into the definition of "investment contract."

While there are some sales of virtual assets that may fit this definition — not to mention purely fraudulent coin sales — some market participants have persuasively contested the characterization of certain assets as investment contracts.[14]

In 2019 in Lorenzo v. SEC, the court cited Howey for the premise 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.'"[15]

The current justices may not disagree with this stated objective of the securities laws, but they may question whether the various incarnations of tokens currently available or in development broadly qualify as schemes envisioned by Howey. Indeed, the court has previously shown willingness to question the applicability of the securities laws to instruments that do not fit the ordinary concept of a security.[16]

Even if the court recognizes the importance of some form of regulation in the virtual currency world, it may decide that the Securities Act as written does not cover many or most of these assets.

And it probably will not bend over backward to interpret the act broadly — as the court's willingness to block a vaccine mandate designed in urgent response to the COVID-19 pandemic demonstrates it might be equally willing limit the scope of the securities laws — particularly where the court will recognize that Congress has the power to enact new laws more suitable to these developing technologies.

There are various approaches the court could take if presented this question. For instance, it could choose to adapt the considerations of the SEC Framework, ideally into a more concise test that market participants can use to better predict whether their activities fall under the ambit of the securities laws.

And the court might look to current scholarship to further refine the application of the Howey elements to cryptocurrency.[17] The court's approach and the extent of its reach will also depend, among other things, on the facts of whatever case it ultimately decides to hear.

The court may simply decide to allow the current regulatory regime to continue as it stands — leaving market participants and litigants to continue parsing the SEC framework and lower-court precedent in determining what qualifies as an investment contract. But the court's readiness to stand in the way of major regulatory action it sees as not established by legislation — as it did in NFIB — suggests it could be willing to act here too, and potentially exclude a significant segment of virtual assets from the current securities regulatory regime.

However the court deals with a challenge to the application the "investment contract" definition to virtual assets, some change is likely to come, and it is needed.

As professor Carol Goforth of the University of Arkansas aptly described the process of applying Howey to cryptocurrency: "[t]he Howey test is much like forcing Cinderella's slipper onto the feet of her stepsisters; it does not fit well, and it is painful. The solution is not to try and lop off toes and heels, but to find a different choice of footwear."[18]

Congress Should Act

A decision by the Supreme Court to exclude some subset of virtual assets from the definition of a security would likely not be the end of the line for regulation of these assets. Indeed, members of Congress have already recognized the desirability of enacting legislation to clarify the applicability of the securities laws to virtual assets.

For instance, the Digital Asset Market Structure and Investor Protection Act, H.R. 4741,[19] recently introduced by Rep. Don Beyer, D-Va., contains various provisions related to regulation of virtual currency, including defining "digital asset security" as a token that grants the holder equity, profits, interest, dividend payments or voting rights, or is sold for the purpose of raising capital to develop a network — i.e., an ICO.

The bill also provides a path for tokens initially defined as securities to evolve into nonsecurity cryptocurrencies — a process that is contemplated by the current SEC Framework but not well-defined, either by the SEC or by courts.

Another bill, the Token Taxonomy Act, H.R. 1628[20], originally introduced in December 2018, and reintroduced to the 117th Congress, goes further. It broadly defines "digital tokens" and excludes them from the definition of a security under the Securities Act while still including as securities those tokens that represent a "financial interest in a company or partnership, including an ownership interest or revenue share."

These bills are still in the early stages of the legislative process, and it is unclear the extent to which they will gain traction in the absence of a major regulatory disruption — such as a recalibration of the Howey test by the Supreme Court.

Markets and Investors Will Benefit From Greater Regulatory Certainty

In light of the astounding growth in recent years of virtual assets as a component of the global economy with a market capitalization exceeding $3 trillion in November 2021, and the growing interest among retail investors in cryptocurrency, it is essential that regulation become more predictable, effective and economical.

The Supreme Court has yet to weigh in on this debate, but when it does, the court is likely to pare back the scope of regulation of virtual assets based on current law. Congress has the opportunity to avoid this uncertainty, and should act before the court does.

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[1] S.E.C. v. W.J. Howey Co. , 328 U.S. 293.

[2] https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

[3] Miriam R. Albert, The Howey Test Turns 64: Are the Courts Grading This Test on A Curve?, 2 Wm. & Mary Bus. L. Rev. 1, 8 (2011).

[4] S.E.C. v. Edwards , 540 U.S. 389.

[5] National Federation of Independent Business, et al. v. U.S. Dept. of Labor, et al. , Case Nos. 21A244 and 21A247, 595 U.S. __ (2022).

[6] Slip Op. at 3.

[7] Id. at 6.

[8] Id.

[9] Id. at 7.

[10] See, e.g., Julian Davis Mortenson, Nicholas Bagley, Delegation at the Founding, 121 Colum. L. Rev. 277, 279 (2021).

[11] Id., Concurrence at 5.

[12] Id.

[13] In addition to the SEC, regulators that have claimed or explored jurisdiction over virtual assets include the CFTC, OCC, Federal Reserve, FDIC, Treasury, FinCEN, and various state agencies.

[14] See, for example, the Wells Submission submitted by Ripple Labs in its ongoing litigation with the SEC regarding the XRP token: https://ripple.com/wp-content/uploads/2020/12/Ripple-Wells-Submission-Summary.pdf.

[15] Lorenzo v. Sec. & Exch. Comm'n , 139 S. Ct. 1094, 1103, (2019); see also Reves v. Ernst & Young , 494 U.S. 56, 61 (1990) ("Congress therefore did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment.").

[16] Marine Bank v. Weaver , 455 U.S. 551, 559 (1982).

[17] See, e.g., M. Todd Henderson, Max Raskin, A Regulatory Classification of Digital Assets: Toward an Operational Howey Test for Cryptocurrencies, ICOs, and Other Digital Assets, 2019 Colum. Bus. L. Rev. 443, 491 (2019).

[18] Carol R. Goforth, Cinderella's Slipper: A Better Approach to Regulating Cryptoassets As Securities, 17 Hastings Bus. L.J. 271, 274 (2021).

[19] https://www.congress.gov/117/bills/hr4741/BILLS-117hr4741ih.pdf.

[20] https://www.congress.gov/bill/117th-congress/house-bill/1628?r=1&s=4.