

ARTICLE

IS BITCOIN A SECURITY?

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INTRODUCTION

Investor interest in the cryptocurrency¹ Bitcoin has exploded over the past two years.² The market capitalization of Bitcoin rose from less than \$150 million at the beginning of 2013 to over \$5 billion today,³ and a Bitcoin exchange-traded fund may soon be listed on the NASDAQ Stock Market.⁴ Yet, as the value of Bitcoin has increased, so has concern over how the U.S. Securities and Exchange Commission (“SEC”) will treat Bitcoin.⁵ The SEC

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¹ The term “cryptocurrency” refers to a digital currency that relies on the principles of cryptography to process and validate transfers.

² See, e.g., Michael J. Casey & Paul Vigna, *Bitcoin and the Digital-Currency Revolution*, WALL ST. J. (Jan. 23, 2015, 12:44 PM), <http://www.wsj.com/articles/the-revolutionary-power-of-digital-currency-1422035061> (archived at <http://perma.cc/QN75-CF64>).

³ *Bitcoin - Market Capitalization*, COINDESK, <http://www.coindesk.com/data/Bitcoin-market-capitalization/> (archived at <http://perma.cc/LKP7-G9E5>) (last visited Nov. 28, 2014).

⁴ Rachel Abrams, *Winklevoss Twins to List Bitcoin Fund on Nasdaq*, N.Y. TIMES (May 8, 2014, 5:45 PM), <http://dealbook.nytimes.com/2014/05/08/winklevoss-twins-to-list-bitcoin-fund-on-nasdaq/> (archived at <http://perma.cc/8CUT-6NXW>). See also Winklevoss Bitcoin Trust, Registration Statement (Form S-1) (July 1, 2013).

⁵ See, e.g., Todd Zerega and Tom Watterson, *Regulating Bitcoins: CFTC vs. SEC?*, SWAP REPORT (Dec. 31, 2013), <http://www.theswapreport.com/2013/12/articles/general/regulating-bitcoins-cftc-vs-sec/> (archived at <http://perma.cc/536B-ULPB>) (“[C]ould or would the SEC attempt to classify a speculative investment in Bitcoins as a security?”); Dan Stroh, *Secure Currency or Security? The SEC and Bitcoin Regulation*, UNIV. OF CINCINNATI L. REV. BLOG (Nov. 18, 2014), <http://uclawreview.org/2014/11/18/secure-currency-or-security-the-sec-and-bitcoin->

has issued an investor alert concerning “Bitcoin and Other Virtual Currency-Related Investments,”⁶ and has brought enforcement actions against virtual currency-related investments, asserting that these investments were securities.⁷

However, the SEC has not yet publicly taken a position on whether Bitcoin is itself a security. The answer to the question of whether Bitcoin is a security is critical for participants in the Bitcoin market. If Bitcoin were found to be a security, then sellers of Bitcoin, exchanges for the transfer of Bitcoins, and special purpose vehicles formed to hold Bitcoin, among others, would be subject to onerous regulatory requirements and potential penalties for failing to meet these requirements.⁸ This article attempts to answer this fundamental question of whether Bitcoin is a security by applying existing case law to the sale and mining of Bitcoin.

I. THE NATURE OF BITCOIN

Bitcoin is a “decentralized peer-to-peer [digital] payment network.”⁹ It is decentralized because it is powered by its users rather than any central authority.¹⁰ It is peer-to-peer because payment transactions do not require a third-party intermediary such as a bank or credit card company to validate the transaction. Instead, the Bitcoin network relies on the principles of cryptography to process and validate transfers of Bitcoins.¹¹ Each transaction on the Bitcoin network is recorded on a decentralized public ledger, called a “blockchain.”¹² The blockchain is visible to all computers on the Bitcoin network.¹³ The blockchain does not reveal the identity of the parties involved in the transaction because each user’s identity is encrypted.¹⁴ The public ledger verifies that a user transferring Bitcoin has in fact transferred the specified amount of Bitcoin to the user receiving that amount of Bitcoin.¹⁵

regulation/ (archived at <http://perma.cc/2MZM-SPCG>) (“Because bitcoins are securities, the SEC should continue, and possibly increase, its monitoring of those using bitcoins.”).

⁶ *Investor Alert: Bitcoin and Other Virtual Currency-Related Investments*, SEC (May 7, 2014), http://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia_bitcoin.html (archived at <http://perma.cc/NFB3-QTUN>).

⁷ See *SEC v. Shavers*, No. 4:13-CV-416, 2013 U.S. Dist. LEXIS 110018, at *3-4 (E.D. Tex. Aug. 6, 2013); *In re Voorhees*, Securities Act Release No. 9592, 2014 SEC LEXIS 1922 (June 3, 2013).

⁸ See *infra* Part II.

⁹ *Frequently Asked Questions*, BITCOIN.ORG, <https://bitcoin.org/en/faq#what-is-bitcoin> (archived at <http://perma.cc/AV97-YZJY>) (last visited Nov. 9, 2014).

¹⁰ *Id.*

¹¹ See CRAIG K. EWELL ET AL., CONG. RESEARCH SERV., R43339, BITCOIN: QUESTIONS, ANSWERS, AND ANALYSIS OF LEGAL ISSUES 1 (2015).

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.* at 3.

¹⁵ *Id.* at 2.

The power of Bitcoin's public ledger is that it solves, through the use of cryptography, the so-called "double spending" problem.¹⁶ The double spending problem occurs when a participant in a currency market can simultaneously transfer a single unit of currency to two different recipients.¹⁷ Double-spending problems are greatest when a transferor can easily misrepresent information about the recipients of a particular currency unit, and can thus transfer the same unit of currency twice.¹⁸ Due to the easy reproducibility of digital information, the double spending problem is acute for a digital currency.¹⁹

Individual Bitcoins are generated through a process called "mining."²⁰ Users of the Bitcoin network can mine new Bitcoins by using computing power to perform complex calculations that process transactions on the Bitcoin network, secure the network, and keep network users synchronized.²¹ Once a miner has proven that it was the first to perform such a calculation, that miner is compensated with newly generated Bitcoins.²² The process of mining is not merely a way for participants in the Bitcoin ecosystem to potentially reap personal rewards. Mining is also critical to the functionality of the Bitcoin network because it is through the mining process that the blockchain is continued and verified.²³

II. THE IMPLICATIONS OF BITCOIN BEING A SECURITY

The issuance and transfer of securities are highly regulated by both federal and state law. Consequently, if Bitcoins were determined to be a "security" for purposes of federal law and/or state "blue sky" laws, the environment for mining, exchanging, and publicly providing information about Bitcoin would be deeply altered, and, depending on how the relevant rules were seen to apply,

¹⁶ *Id.*

¹⁷ *See generally* David Chaum, *Achieving Electronic Privacy*, SCI. AM., Aug. 1992, at 96.

¹⁸ Clifton B. Parker, *Stanford scholars say Bitcoin offers promise, peril*, STAN. REP. (Feb. 18, 2014), <http://news.stanford.edu/news/2014/february/bitcoin-athey-srinivasan-021814.html> (archived at <http://perma.cc/AQ6M-2S42>).

¹⁹ With traditional physical currency, the double-spending problem is less significant because the transferee can see the currency. This is because everyone involved in an exchange has immediate visual access to the original physical currency involved and it is not trivially easy to reproduce the currency (this is why the Federal Reserve is constantly modifying U.S. currency to make it difficult to reproduce). Where the transferor and transferee of physical currency are not both physically present at the time of transfer, the risk of double-spending is much greater. Accordingly, third-party financial intermediaries such as banks and credit card companies are typically used to validate that the currency is not being double-spent. *Id.*

²⁰ *See Frequently Asked Questions*, *supra* note 9.

²¹ *Id.*

²² EWELL, *supra* note 11, at 2 n.3.

²³ *See Frequently Asked Questions*, *supra* note 9.

could make the use of the Bitcoin blockchain impossible.²⁴ While this article does not attempt to canvass all of the laws and regulations that would be implicated by a determination that Bitcoin is a security, it is worth noting the more significant laws that would apply.

A. The Securities Act of 1933

The Securities Act of 1933 (the “Securities Act”) was enacted by the U.S. Congress in the wake of widely reported fraud and weak disclosures in the securities markets leading up to the market crash of 1929.²⁵ Consequently, an essential purpose of the Securities Act is to create a framework of regulations with the aim of ensuring that issuers and sellers of securities provide investors with adequate and accurate information upon which to base their investment decisions.²⁶ The Securities Act prohibits the sale or offer of a security to the public unless the security is registered with the SEC or an exemption from registration under Section 4(a) is available.²⁷ An issuer that seeks to register a security in compliance with the Securities Act is required to file with the SEC a registration statement (which includes a prospectus to be used in the sale of such securities) that conforms to the specific requirements of the SEC’s rules and is made publicly available.²⁸ Registration of securities under the Securities Act is time-consuming, expensive, and typically necessitates the involvement of attorneys, accountants, and other professionals.²⁹ Moreover, in the case of Bitcoin, which was established anonymously by a yet-unidentified person or persons, it is unclear on whom the registration obligation would fall.³⁰ Indeed,

²⁴ For example, as discussed in Part II.A. below, if Bitcoin miners were found, in carrying out the function of running the complex calculations required to create new Bitcoins, to be issuers of Bitcoins, or acting as agents of the issuer of Bitcoin engaged in a public offering of securities required to be registered under Section 5 of the Securities Act, they would be unable to provide the most basic information required in the registration statement to be filed with the SEC on Form S-1, including the issuer’s name and address.

²⁵ See 1 LOUIS LOSS, JOEL SELIGMAN, & TROY PAREDES, *SECURITIES REGULATION* 281 (5th ed. 2014) (“[T]he public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities” (quoting President Franklin Roosevelt)). With reference to the Securities Act’s sister legislation, which followed a year later, see *Tcherepnin v. Knight*, 389 U.S. 332, 336 n.10 (1967) (“The Securities Exchange Act was a product of a lengthy and highly publicized investigation by the Senate Committee on Banking and Currency into stock market practices and the reasons for the stock market crash of October 1929.”).

²⁶ Henry T.C. Hu, *Too Complex to Depict? Innovation, “Pure Information,” and the SEC Disclosure Paradigm*, 90 *Tex. L. Rev.* 1601, 1601 (2012).

²⁷ Securities Act of 1933, 15 U.S.C. §§ 77d(a), 77e(a) (2012).

²⁸ 1 HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *SECURITIES LAW HANDBOOK* 10 (2014 Ed.).

²⁹ *Id.* at 263-64.

³⁰ In the case of other cryptocurrencies, the SEC may more easily be able to identify the persons or entities that sponsored the creation of the blockchain on which the relevant

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the continuous production (through mining) of new Bitcoins is an essential feature of the architecture of the Bitcoin blockchain, and yet it presents the possibility that miners themselves are “issuers,” or acting as agents of the issuer, of Bitcoins.³¹

Although Section 4(a)(1) of the Securities Act provides for certain transactions in securities without a registration statement’s being in effect, these permitted transactions fall into narrow categories and their requirements must be strictly adhered to in order for them to apply.³² For example, transactions in securities by any person other than an issuer, underwriter, or dealer do not require registration under Section 5 of the Securities Act.³³ If, however, a person purchases securities from an issuer, or from any person who controls the issuer, with a view to making a public resale (rather than for investment purposes), then the person falls within the definition of “underwriter” and cannot avail himself of this exemption from the registration requirement.³⁴ The typical Bitcoin transaction is not structured so as to permit compliance with these requirements: depending on who the issuer of Bitcoin is

cryptocurrency is used. For example, the identity of persons and entities that created the cryptocurrencies Dogecoin and Litecoin are public. *See* Danny Bradbury, *Litecoin founder Charles Lee on the origins and potential of the world’s second largest cryptocurrency*, COINDESK (July 23, 2013, 1:05 PM), <http://www.coindesk.com/litecoin-founder-charles-lee-on-the-origins-and-potential-of-the-worlds-second-largest-cryptocurrency/> (archived at <http://perma.cc/FG3B-YVL5>); Asa Bennett, *Dogecoin Creator Jackson Palmer on Doge, Currency And Bitcoin*, HUFFINGTON POST (Apr. 25, 2014, 9:59 AM), http://www.huffingtonpost.co.uk/2014/04/24/dogecoin-creator-doge-jackson-palmer_n_5199347.html (archived at <http://perma.cc/GTM5-TE3C>).

³¹ The Exchange Act defines an “issuer” as “any person who issues or proposes to issue any security; except that with respect to certificates of deposit for securities, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or of the fixed, restricted management, or unit type, the term ‘issuer’ means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; and except that with respect to equipment-trust certificates or like securities, the term ‘issuer’ means the person by whom the equipment or property is, or is to be, used.” 15 U.S.C. § 78c(a)(8).

³² *Id.* § 77e.

³³ *Id.*

³⁴ “The term ‘underwriter’ means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors’ or sellers’ commission. As used in this paragraph the term “issuer” shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.” *Id.* § 77b(e)(11).

found to be, Bitcoin miners are either acquiring securities directly from the issuer, or those who purchase Bitcoins from them are acquiring securities directly from the issuer; transactions on the blockchain are publicly disclosed, even if the transacting parties are identified only anonymously; and, because Bitcoins offer no potential for dividends, many purchasers can be expected to be acquiring Bitcoins for the purpose of reselling them, rather than holding them indefinitely as an investment. In any event, the Bitcoin blockchain is not currently configured to permit potential purchasers of Bitcoins to make representations regarding their investment intent and that they are not purchasing for resale.

Similarly, if a Bitcoin miner is regarded as the issuer of the Bitcoins she mines, then Section 4(a)(2) of the Securities Act would exempt from registration her transactions in Bitcoin so long as they do not involve a public offering. Under Regulation D, the widely used safe harbor for private placements, an issuer must, among other things, either offer its securities without the use of any form of public advertisement or other general solicitation and limit its investors largely to persons that it reasonably believes are “accredited investors”³⁵ or, if it does employ a general solicitation to market its securities, it must verify that each person that acquires the securities in the offering is an accredited investor.³⁶ As with determining investment intent, the Bitcoin blockchain does not offer an opportunity, or facility through which, to require potential purchasers to make representations as to their status as accredited investors. Because the transactions are conducted on a public blockchain, it may not be possible for a miner to claim that she has not offered the Bitcoin through a form of public advertisement. A failure by an issuer to comply with the applicable requirements imposed on its offering of securities can result in the purchaser’s having a rescission right.³⁷

B. The Securities Exchange Act of 1934

Generally speaking, any person who is in the business of effecting transactions in securities for the accounts of others or for itself is a broker or a dealer, and thus subject to the requirement to register in such capacity under the Securities Exchange Act of 1934 (the “Exchange Act”).³⁸ Consequently, if Bitcoins were found to be securities for purposes of the Exchange Act, then market participants who facilitate the buying and selling of Bitcoins, both for

³⁵ 17 C.F.R. § 230.506(b) (2014).

³⁶ *Id.* § 230.506(c).

³⁷ 17 U.S.C. § 771(a) (2012).

³⁸ The Exchange Act defines a “broker” as “any person engaged in the business of effecting transactions in securities for the account of others”. 15 U.S.C. § 78c(a)(4)(A) (2012). A “dealer” is defined as “any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person’s own account through a broker or otherwise”. *Id.* § 78c(a)(5)(A).

their own account and for the accounts of others, would potentially have to register with the SEC as broker-dealers, or find an exemption from registration upon which they could rely.

In addition, the Exchange Act imposes an anti-fraud obligation on any purchase or sale of a security whether it is registered or not.³⁹ The well-known Rule 10b-5 under the Exchange Act makes it “unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce . . . to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, . . . in connection with the purchase or sale of any security.”⁴⁰ Were Bitcoins determined to be securities for purposes of these anti-fraud obligations, statements that sellers of Bitcoins make in connection with their sales could subject them to liability under Rule 10b-5.

C. The Investment Company Act of 1940

The Investment Company Act of 1940 (the “Investment Company Act”) governs entities, such as mutual funds and private investment funds, that hold securities in a pooled portfolio for their investors.⁴¹ If Bitcoin is a security, then any entity that is established to hold Bitcoins may be subject to the numerous, specific, and burdensome requirements of the Investment Company Act. Such requirements would include registering the entity with the SEC as an “investment company,” conforming the entity’s governance to the narrow set of permitted structures, and registering the person that has discretion over the investment decisions of the entity as an investment adviser under the Investment Advisers Act of 1940.⁴² Although the Investment Company Act provides exclusions from the definition of investment company for certain pooled investment vehicles (and thus its registration requirements), the exclusions most commonly relied upon limit the number of investors in the entity and/or require the investors generally to be ultra-high net worth “qualified purchasers.”⁴³ If Bitcoin is a security, then entities that are formed to hold Bitcoins that seek to avoid registration as investment companies would

³⁹ *Id.* § 78j.

⁴⁰ 17 C.F.R. § 240.10b-5.

⁴¹ *See* 15 U.S.C. § 80a-3(a)(1) (defining an “investment company” as, among other things, “any issuer which . . . is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities . . .”).

⁴² *See id.* § 80a-8(a) (requiring registration); *id.* §§ 80a-10(a), 80a-10(c) (setting parameters on the board of registered investment companies); *id.* §§ 80b-3(a), 80b-3a(a)(1)(B) (requiring the registration of investment advisers and expressly carving out investment advisers to registered investment companies from the investment adviser registration exemption available to state-regulated investment advisers).

⁴³ *See id.* §§ 80a-3(c)(1) (limiting investors to 100 or less), 80a-3(c)(7)(A) (limiting investors to qualified purchasers).

have to rigorously comply with the requirements of these exclusions, ensuring that all of the relevant entity's owners satisfy the applicable criteria and that the entity does not make or propose to make a public offering of its own equity interests.⁴⁴

III. THE DEFINITION OF "SECURITY"

Evaluating whether Bitcoin is a security requires an interpretation of the Securities Act, a statute enacted over a decade before the construction of the first fully-functional digital computer.⁴⁵ The Securities Act was created with the dual objectives of "requir[ing] that investors receive financial and other significant information concerning securities being offered for public sale" and "prohibit[ing] deceit, misrepresentations, and other fraud in the sale of securities."⁴⁶ The legislative intent behind the Securities Act was to create a legal construct that would not be outpaced by financial innovations.⁴⁷

In defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."⁴⁸

The term "security" is intended to be defined in "sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."⁴⁹ Nonetheless, as the Supreme Court has observed, in passing the Securities Act "Congress did not . . . intend to provide a broad federal remedy for all fraud. Accordingly, the task has fallen to the [SEC] . . . and ultimately to the federal courts to decide which of the myriad financial transactions in our society come within the coverage of these statutes."⁵⁰

"Security" is defined broadly in Section 2(a)(1) of the Securities Act,⁵¹

⁴⁴ *Id.*

⁴⁵ Construction of ENIAC, the first Turing-complete digital computer, was completed in 1946. See *Milestones: Electronic Numerical Integrator and Computer, 1946*, ENGINEERING & TECH. HIST. WIKI (Feb. 25, 2015), http://www.ieeeahn.org/wiki/index.php/Milestones:Electronic_Numerical_Integrator_and_Computer,_1946 (archived at <http://perma.cc/K79R-PL47>).

⁴⁶ *The Laws That Govern the Securities Industry*, SEC, <http://www.sec.gov/about/laws.shtml> (archived at <http://perma.cc/9P4N-C6ZV>) (last visited Nov. 22, 2014).

⁴⁷ See *Reves v. Ernst & Young*, 494 U.S. 56, 60-61 (1990).

⁴⁸ *Id.* at 60-61 (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946)).

⁴⁹ *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847-48 (1975) (quoting H.R. REP. NO. 85-73, at 11 (1933)).

⁵⁰ *Reves*, 494 U.S. at 61 (internal quotation marks and citation omitted).

⁵¹ The Exchange Act also defines "security." The Exchange Act definition is largely identical to the definition in the Securities Act, except that any instrument that is a "currency or any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time

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which provides:

The term “security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.⁵²

IV. COMMON TYPES OF SECURITIES

The Supreme Court has observed that the Securities Act’s lengthy litany of instruments in the definition of “security” includes both “commonly known documents traded for speculation or investment”⁵³ “whose names alone carry well-settled meaning”⁵⁴ – for example, “stock”, “bond”, and “note” – as well as instruments of “a more variable character, designated by such descriptive terms 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.’”⁵⁵ When an instrument falls within one of the categories of commonly known instruments, the Supreme Court has relieved courts from engaging in a “case-by-case analysis of every instrument,” as “[s]ome instruments are obviously within the class Congress intended to regulate because they are by their nature investments.”⁵⁶

Even a passing familiarity with the items listed in the definition allows one to see that Bitcoin is not among the instruments “commonly known” as securities. Taking each type in turn, one can easily establish that Bitcoin does not fall into any of these types of instruments.

In the case of “stock,” the Supreme Court has looked for where “an

of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited” is expressly carved out from the definition. Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (2012). Because this carve-out does not bear on the analysis at hand, this article refers to the Securities Act’s definition throughout.

⁵² *Id.* § 77b(a)(1).

⁵³ *Howey*, 328 U.S. at 297.

⁵⁴ *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985).

⁵⁵ *Howey*, 328 U.S. at 297.

⁵⁶ *Reves v. Ernst & Young*, 494 U.S. 56, 62 (1990).

instrument is both called ‘stock’ and bears stock’s usual characteristics,” and has identified stock’s usual characteristics as “(i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value.”⁵⁷ Bitcoin does not bear critical indicia of the “stock,” because, although transferable and able to appreciate (and depreciate) in exchange value, Bitcoins do not carry a right to a dividend declared by an issuer, a right to vote on an issuer’s affairs or conduct, or, in fact, any kind of right to participate in the economic success of a juridical entity.⁵⁸ Because Bitcoins are not stock, they cannot be treasury stock, which is simply stock that an issuer has reacquired from its stockholders.⁵⁹ For similar reasons, a Bitcoin is not a “transferable share,” which would require it to represent a fractional “share” of an enterprise⁶⁰ or a “preorganization certificate or subscription,” which would require it to represent an interest in a business entity that was issued prior to, but in anticipation of, the legal formation of such entity.⁶¹

Certain of the instruments listed in the Securities Act’s definition of “security” have technical meanings and relate to very particular types of instruments. A “security future” is a “contract of sale for future delivery of a single security or of a narrow-based security index, including any interest

⁵⁷ *Landreth*, 471 U.S. at 686 (quoting *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851 (1975)).

⁵⁸ See BLACK’S LAW DICTIONARY 1551 (9th ed., 2009) (defining the term “stock,” in relevant part, as “[t]he capital or principal fund raised by a corporation through subscribers’ contributions or the sale of shares” and “[a] proportional part of a corporation’s capital represented by the number of equal units (or shares) owned, and granting the holder the right to participate in the company’s general management and to share in its net profits or earnings.”

⁵⁹ See *id.* (defining the term “treasury stock” as “[s]tock issued by a company but then reacquired and either canceled or held”).

⁶⁰ See *id.* (defining the term “share,” in relevant part, to mean “[o]ne of the definite number of equal parts into which the capital stock of a corporation or joint-stock company is divided”).

⁶¹ Pre-organization subscriptions and the certificates representing them are rarely used in sophisticated business transactions, but they are contemplated in the corporations law statutes of various states. See, e.g., 8 DEL. CODE ANN. tit. 8, § 165 (West 2015) (providing that subscriptions for stock of a corporation to be formed shall be irrevocable for six months after being made, except as provided in the subscription itself or as consented to by all other subscribers or the corporation); *Collins v. Morgan Grain Co.*, 16 F. 2d 253 (9th Cir. 1926). By including pre-organization certificates and subscriptions in the litany of instruments included in the definition of “security,” the Securities Act expressly brings into the ambit of the statute interests that have been purchased but for which the relevant issuer hasn’t been formed as a juridical entity, thus eliminating the possibility for persons to avoid the statute’s prohibitions, prescriptions, and penalties simply by taking investors’ money on the promise of creating an entity that they in fact never form.

therein or based on the value thereof” other than certain excluded securities.⁶² A “security-based swap” is any agreement, contract, or transaction, that is a put, call, floor, collar, or similar option of any kind (other than certain specified types of agreements, contracts, and transactions that are expressly excluded) that is based on (a) an index that is a narrow-based security index (generally a securities index with nine or fewer component securities and meeting certain other criteria), including any interest in such index or in the value of such index; (b) a single security or loan, including any interest in such security or loan, or in the value of such security or loan; or (c) the occurrence, non-occurrence, or extent of the occurrence of an event (so long as it meets a specified materiality threshold) relating to a single issuer of a security or the issuers of securities in a narrow-based security index.⁶³ Critically for these definitions, Bitcoin does not entitle its holder to require a contract counterparty to sell such holder any other security or other asset, to buy a security or any other asset from such holder, or to pay any amount to the holder, or require the holder to pay any amount to its counterparty, in each case upon the payment of an amount or the occurrence of any economic or other event. The presence of these features is not only key to security-based swaps, but also to puts, calls, straddles, options, and privileges on securities, securities indices, non-U.S. currencies,⁶⁴ and other assets.⁶⁵ Lacking these features means that Bitcoin does

⁶² 15 U.S.C. § 78c(a)(55)(A) (2012). The Securities Act adopts the Exchange Act’s definition of “security future” by cross-reference. *Id.* § 77b(a)(16).

⁶³ An understanding of the term “security-based swap” requires reference to three separate statutes and tracking through nested cross-references. The Securities Act, *id.* § 77b(a)(17), defines “security-based swap” by referring to the Commodity Exchange Act of 1974. 7 U.S.C. § 1a(42) (2012). The Commodity Exchange Act, in turn, defines “security-based swap” by reference to the Exchange Act’s definition of the term. *Id.* The Exchange Act’s definition, however, refers, in significant part, back to the Commodity Exchange Act’s definition of “swap.” 15 U.S.C. § 78c(68). The Commodity Exchange Act’s definition of “swap” is a lengthy definition that, along with tying the definition to the functional characteristics typical of “swaps,” sets out a list of twenty-two specifically named types of swaps, and ten categories of transactions excluded from the definition. The term “narrow-based security index” is defined in the Exchange Act and in the Commodity Exchange Act. *Id.* § 78c(a)(55)(B); 7 U.S.C. § 1a(35). Unsurprisingly, neither Bitcoin nor any other cryptocurrency is named in any of these explicit and technical definitions.

⁶⁴ It is worth noting in this context that, although the definition of “security” includes “any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency,” 15 U.S.C. § 77b(a)(1), there is no need to determine whether Bitcoins are a “currency” for this purpose, because the Securities Act covers only these specified rights to acquire or sell non-U.S. currencies, not the sale and purchase of such currencies themselves. Retail transactions in currencies are governed by the Commodity Exchange Act and are subject to the jurisdiction of the Commodity Futures Trading Commission. 7 U.S.C. § 2(c)(2)(B). An analysis of the treatment of Bitcoin under the Commodity Exchange Act is outside the scope of this article.

⁶⁵ See BLACK’S LAW DICTIONARY 1203-04 (9th ed. 2009) (defining “option,” in relevant part, as “[t]he right (but not the obligation) to buy or sell a given quantity of securities,

not fall into any of the enumerated types of instruments that relate to options, swaps, futures, or warrants or rights to subscribe or purchase.

The Securities Act's definition of "security" also lists several types of certificates. A "collateral-trust certificate" is a certificate representing a debt secured by the deposit of another security with a trustee.⁶⁶ A "voting-trust certificate" is a certificate that the trustee of a trust, itself organized to hold shares of voting stock in a closely held corporation and to empower such trustee to exercise the stock's rights to vote, issues to the beneficial holders of such stock.⁶⁷ A "certificate of deposit for a security" is a bank-issued certificate evidencing the bank's receipt of a security and agreeing to provide such security to the depositor.⁶⁸ A "certificate of interest or participation in any profit-sharing agreement," on the other hand, has a less established definition, and (as noted above) is one of the "more variable"⁶⁹ categories of security that the courts have been called upon to examine. To the extent courts have evaluated this term in the definition of "security," they have applied it only if the relevant instrument was also "commonly known as a security."⁷⁰ Where courts have focused on sharing in profits, it has instead been in the context of interpreting the term "investment contract," as discussed below.⁷¹ Most importantly, however, in terms of the characterization of Bitcoin under these elements of the definition of "security," each of them requires the existence of a certificate.⁷² Bitcoins are not evidenced by certificates or instantiated in

commodities, or other assets at a fixed price within a specified time"; "call option" as [a]n option to buy something (esp. securities) at a fixed price even if the market rises; the right to require another to sell. Often shortened to 'call'; and "put option" as "[a]n option to sell something (esp. securities) at a fixed price even if the market declines; the right to require another to buy. Often shortened to 'put'"). A "privilege" in this context is a right similar to that afforded by a call option, but which inures to a current holder of a security. *See, e.g., id.* at 1297-98 (noting, in the definition of "preemptive right" that it is a "shareholder's privilege to purchase newly issued stock – before the shares are offered to the public – in an amount proportionate to the shareholder's current holdings in order to prevent dilution of the shareholder's ownership interest. . . . Also termed 'subscription privilege'").

⁶⁶ *See id.* at 203 (noting, in the definition of "bond," that a "collateral trust bond" is also termed a "collateral trust certificate").

⁶⁷ *See id.* at 1655, 1714 (9th ed. 2009) (defining "voting trust certificate," and, under the definition of "trust," defining "voting trust").

⁶⁸ *See id.* at 256 (9th ed. 2009) (defining a "certificate of deposit" with respect to cash deposits).

⁶⁹ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 297 (1946).

⁷⁰ *See, e.g., Goodwin v. Elkins & Co.*, 730 F.2d 99, 102 n.4 (3d Cir. 1984) (noting that the "certificate of interest or participation in any profit-sharing agreement" term was "colorably relevant" to a partnership interest, but concluding that "[a profit-sharing] provision alone is not sufficient to make that agreement a security") (quoting *Marine Bank v. Weaver*, 455 U.S. 551, 560 (1982)).

⁷¹ *See infra* Part V.

⁷² *See, e.g., Tcherepnin v. Knight*, 389 U.S. 332, 339 (1967) (noting that the

certificated form, and thus cannot be “securities” under these elements.

Similarly, Bitcoin clearly conveys no right to a fractional undivided interest in oil, gas, or other mineral rights. Admittedly, the Supreme Court has noted that oil and gas rights “were notorious subjects of speculation and fraud,”⁷³ and so a court may be warranted in taking as broad an interpretation as possible when evaluating instruments that might constitute interests in such rights, and, thus, securities subject to the Securities Act and Exchange Act.⁷⁴ Even a broad construction of these terms, however, cannot convert a wholly virtual resource like Bitcoin into an interest in any of those most tangible of terrestrial resources: oil, gas, and minerals.

Purchasers may borrow money to acquire Bitcoins, but transactions for or in Bitcoins do not themselves result in any continuing obligation of one party to pay another. Consequently Bitcoins do not represent evidences of indebtedness, debentures, or bonds.⁷⁵ The term “note” similarly conveys a sense of an obligation of the maker of the note to the holder.⁷⁶ The Supreme Court and the U.S. courts of appeals, however, have given particular attention to “notes” when conducting analyses under the Securities Act’s definition of “security”, because this category of instruments has proven to be relatively broad.⁷⁷ The Supreme Court has adopted a “family resemblance” test to determine when an instrument that is called a note also constitutes a “note” that is a “security” for purposes of the Securities Act.⁷⁸ This test, however, applies only to instruments that are called or referred to by the term “notes.”⁷⁹ Besides

“withdrawable capital shares” being analyzed are “investment contracts,” but could also be ‘viewed as ‘certificate[s] of interest or participation in any profit-sharing agreement’” because they “must be evidenced by a certificate” as required by the relevant Illinois law under which they were issued).

⁷³ SEC v. Joiner, 320 U.S. 344, 352 (1943).

⁷⁴ See *id.* (conceding that leasehold subdivisions of parcels of land on the basis of promises to drill for oil on the land are not fractional undivided interests in oil, but finding that the interests were nonetheless securities because they were “investment contracts”).

⁷⁵ BLACK’S LAW DICTIONARY 200, 460 (9th ed. 2009) (defining “bond,” in its broadest and simplest meaning, as “[a]n obligation; a promise”; defining “debenture” as “[a] debt secured only by the debtor’s earning power, not by a lien on a particular asset” and as “[a]n instrument acknowledging such a debt”).

⁷⁶ *Id.* (defining “note,” in the relevant respect, as “[a] written promise by one party (the maker) to pay money to another party (the payee) or to bearer.”).

⁷⁷ *Reves v. Ernst & Young*, 494 U.S. 56, 62-63 (1990).

⁷⁸ See *id.* at 64-65.

⁷⁹ *Id.* at 62-63 (Explaining that the term “note” may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context A majority of the Courts of Appeals that have considered the issue have adopted, in varying forms, ‘investment versus commercial’ approaches that distinguish, on the basis of all of the circumstances surrounding the transactions, notes issued in an investment context (which are ‘securities’) from notes issued in a commercial or consumer

not representing a payment obligation of any kind, Bitcoin is not identified as a “note,” and consequently a court would not be expected to apply this test. Consequently, Bitcoins are not bonds, debentures, evidences of indebtedness, or notes for purposes of the Securities Act’s definition of “security.”

V. INVESTMENT CONTRACTS

A financial investment that does not fall within any other category of “security” may nonetheless fall within the very broad category of “investment contract.” Indeed, in *SEC v. Shavers*, the defendant argued that the Bitcoin investments that he sold were not “securities,” but the court rejected that argument, finding that shares of digital hedge fund Bitcoin Savings and Trust were “investment contracts” and therefore securities.⁸⁰ This decision has been interpreted by some commentators as holding that Bitcoin itself is a security subject to regulation by the SEC.⁸¹ This is incorrect. The court limited its holding to whether shares of the hedge fund were investment contracts and did not consider whether Bitcoin itself is an investment contract.⁸² However, the fact remains that analyzing whether Bitcoin is an investment contract is the key to determining whether it is a security.

“[A]n investment contract for purposes of the Securities Act means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”⁸³ This definition, which the Supreme Court articulated in *SEC v. Howey*, has been interpreted as creating a three-prong test, requiring proof of (a) an investment of money, (b) a common enterprise, and (c) the expectation of profits to be derived from the efforts of others.⁸⁴ While it might seem intuitively appealing to shortcut this analysis for transactions that do not involve speculation on future investment returns or purchases of goods with a value independent of any potential investment return, the Supreme Court has rejected the notion that “an investment contract is necessarily missing where the enterprise is not speculative or promotional in character and where the tangible interest which is sold has intrinsic value

context (which are not”).

⁸⁰ *SEC v. Shavers*, No. 4:13-CV-416, 2013 U.S. Dist. LEXIS 110018, at *4-6 (E.D. Tex. Aug. 6, 2013).

⁸¹ See, e.g., Michael Bobelian, *Serious Money*, CAL. LAW. (May 2014), http://www.callawyer.com/clstory.cfm?eid=934788&wteid=934788_Serious_Money (archived at <http://perma.cc/8KRL-32MJ>) (“[A]s of 2014, a federal court had found that Bitcoin is a security.”); Stroh, *supra* note 5 (“As the court determined in *Shavers*, bitcoins are a security”).

⁸² *Shavers*, 2013 U.S. Dist. LEXIS 110018, at *14 (noting that “the Court determined that the BCTCST [Bitcoin Savings and Trust] investments Defendants sold meet the definition of investment contract and, as such, are securities”).

⁸³ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

⁸⁴ *SEC v. SG Ltd.*, 265 F.3d 42, 46 (1st Cir. 2001) (citing *Howey*, 328 U.S. at 298-99).

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independent of the success of the enterprise as a whole.”⁸⁵

A. Investment of Money

“The first component of the *Howey* test focuses on the investment of money. The determining factor is whether an investor ‘chose to give up a specific consideration in return for a separable financial interest with the characteristics of a security.’”⁸⁶ Under this broad definition, most purchases of Bitcoin will qualify as an investment of money, because the specific consideration given up in exchange for Bitcoin is either fiat currency backed by a government, such as U.S. dollars, or another virtual currency that constitutes a specific consideration. In fact, at least one federal court has already explicitly concluded that payment of Bitcoin constitutes an investment of money under this prong of the *Howey* test.⁸⁷

B. Common Enterprise

In determining whether or not a scheme satisfies the common enterprise requirement of the *Howey* test, federal courts have applied one or more of the following criteria: (i) horizontal commonality; (ii) broad vertical commonality; and (iii) strict vertical commonality.⁸⁸ The law concerning the application of these criteria is inconsistent between different Courts of Appeals, and is still developing within certain circuits.⁸⁹ It therefore is important to consider all three of these criteria for whether a common enterprise exists.

1. Horizontal Commonality

The horizontal commonality approach to evaluating the existence of a common enterprise provides that a common enterprise exists if there is a

⁸⁵ *Howey*, 328 U.S. at 301.

⁸⁶ *SG Ltd.*, 265 F.3d at 48 (quoting *Int’l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 559 (1979)).

⁸⁷ *Shavers*, 2013 U.S. Dist. LEXIS 110018, at *6. *See also In re Voorhees*, Securities Act Release No. 9592, 2014 SEC LEXIS 1922 (June 3, 2013) (SEC cease-and-desist order asserting that sales of hedge fund shares in exchange for Bitcoin were unregistered offerings).

⁸⁸ *SG Ltd.*, 265 F.3d at 49 (“Courts are in some disarray as to the legal rules associated with the ascertainment of a common enterprise Many courts require a showing of horizontal commonality Other courts have modeled the concept of a common enterprise around fact patterns in which an investor’s fortunes are tied to the promoter’s success rather than to the fortunes of his or her fellow investors. This doctrine, known as vertical commonality, has two variants[:] . . . [b]road vertical commonality . . . [and] . . . narrow vertical commonality.”) (internal citations omitted).

⁸⁹ *Id.* (“Courts also differ in their steadfastness of their allegiance to a single standard of commonality. . . . To complicate matters further, four courts of appeals have accepted horizontal commonality, but have not yet ruled on whether they will also accept some form of vertical commonality.”).

“pooling of assets from multiple investors so that all share in the profits and risks of the enterprise.”⁹⁰ Thus, the horizontal commonality approach focuses on the relationship among investors in an economic venture. The Courts of Appeals taking this approach place great weight on whether the scheme involves a “pooling” of assets.⁹¹ For the common enterprise prong to be satisfied, horizontal commonality requires that an investor’s assets be joined with another investor’s assets into a joint enterprise in which each investor shares the risk of profit and loss according to his or her individual investment.⁹²

There is certainly a sense in which purchasers of Bitcoin can be seen as participating in a broadly defined joint endeavor. There is a strong feeling of community among proponents and longtime users of Bitcoin. Many, if not most, holders of Bitcoin own or work for enterprises that somehow make use of cryptocurrencies. The value of Bitcoin is likely related to the collective success of those enterprises. If the holders and miners of Bitcoin are successful in convincing others to purchase Bitcoins and in increasing the use of Bitcoin, the value of Bitcoin will generally increase.⁹³

However, purchasers of Bitcoin will not be pooling their assets in a single, common enterprise to which they are making payments. Due to the decentralized nature of Bitcoin, there is no common entity that generates, sells, or controls Bitcoins.⁹⁴ Purchasers’ payments for Bitcoin will go to the miner who generates the Bitcoin or to someone who obtains Bitcoin from a previous holder of the Bitcoin through a market exchange.⁹⁵ Both mining and subsequent market transactions are decentralized processes.⁹⁶ While a single miner or holder of Bitcoin may sell different Bitcoins to different purchasers, the resulting aggregation of payments with the seller is an unintended byproduct of the decentralized purchases, not an intentional “pooling” of the purchasers’ assets with the seller to further a common enterprise in which the purchasers all are investing.

In addition, purchasers of Bitcoin are not investing in the profits and risks of

⁹⁰ *Id.* (citing *SEC v. Infinity Grp. Co.*, 212 F.3d 180, 187-88 (3d Cir. 2000)).

⁹¹ *See generally* *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016 (7th Cir. 1994).

⁹² *Id.* at 1018 (finding no investment contract where a condominium’s sharing program creating “a pooling of weeks, in a sense . . . [b]ut . . . not a pooling of profits, which is essential to horizontal commonality”).

⁹³ While it is intuitive that increasing the use of Bitcoin will cause an increase in its value, in some cases increasing transactions in Bitcoin may have a contrary effect. For example, many retail businesses that accept payment in Bitcoin immediately sell the Bitcoin that they receive for fiat currency. To the extent that they are selling goods to individuals who previously were holders of Bitcoin and these individuals do not acquire new Bitcoin to replace the Bitcoin that they used to make their purchase, these transactions may have the effect of decreasing the value of Bitcoin by increasing the available supply.

⁹⁴ *See supra* Part I.

⁹⁵ *See supra* Part I.

⁹⁶ *See supra* Part I.

the person or entity selling the Bitcoin. While these sellers of Bitcoin *may* use the payments that they receive to take actions that would increase the value of Bitcoin, they have absolutely no obligation to do so, and purchasers generally have no reason to expect the sellers to do so. The future value of Bitcoin is based primarily on factors other than how the sellers use the payments that they receive. These factors include, for example, retailers' willingness to accept payment in Bitcoin, actions taken by various regulators both in the United States and internationally, the willingness of banks and other financial institutions to open accounts for Bitcoin businesses, the quality of competing decentralized virtual currencies, and the rate at which miners create new Bitcoins by performing the work of processing transactions.⁹⁷ Accordingly, to the extent that certain purchasers of Bitcoin view their purchase as an investment, it is an investment based on these market factors, not an investment based on anticipated actions by the seller from whom they are purchasing the Bitcoin.

Several federal courts have held that when a seller has no ongoing obligation to act for the benefit of a common group of purchasers, the instrument sold does not satisfy the horizontal commonality test.⁹⁸ For example, purchasers of plots of land in a common development have attempted to assert that these purchases constitute an investment contract because the value of their interests was tied to the common development of the land and community in which the plots were located.⁹⁹ However, courts evaluating such assertions "have held that the developer must make a commitment to manage, develop or otherwise service the plaintiff's property in a common enterprise."¹⁰⁰ In the absence of such an ongoing commitment, the venture to which the purchasers pay the purchase price is not a venture in which the purchasers share with each other a common risk of profit and loss.¹⁰¹ Rather, they are paying a seller that is engaged in its own distinct venture and that will not directly generate profits and losses for the group of purchasers.¹⁰² The same logic applies to sellers of Bitcoin, who have no obligation to act for purchasers of Bitcoin after the sale of that Bitcoin.

⁹⁷ See *supra* Part I.

⁹⁸ See, e.g., *Rolo v. City Investing Co. Liquidating Trust*, 845 F. Supp. 182, 236 (D.N.J. 1993).

⁹⁹ *Id.* at 236.

¹⁰⁰ *Id.* at 236. See also *Davis v. Rio Rancho Estates, Inc.*, 401 F. Supp. 1045, 1050 (S.D.N.Y. 1975) (holding that the expectations of land purchasers that land would rise in value if seller "built roads and other improvements" did not make purchase an investment in a common venture because "this is not the type of managerial service contemplated in *Howey*," and noting that there was no management contract or management obligation and "defendants did not promise to run the development and distribute profits" to the purchasers "as did the operators of orange groves in *Howey*").

¹⁰¹ *Rolo*, 845 F. Supp. at 236.

¹⁰² *Brodv. v. Bache & Co., Inc.*, 595 F.2d 459, 462 (9th Cir. 1978).

2. Broad Vertical Commonality

The broad vertical commonality approach to evaluating the existence of a common enterprise focuses on the expertise of the promoter of the alleged security.¹⁰³ “Broad vertical commonality requires that the well-being of all investors be dependent upon the promoter’s expertise.”¹⁰⁴

In the case of sales of Bitcoin, the only potential “promoter” would be the seller of the Bitcoin. As noted in the discussion of horizontal commonality, there is no common seller of Bitcoin, because the creation and transfer of Bitcoin is decentralized. In addition, the future value of Bitcoin is not dependent on the expertise of the decentralized sellers of Bitcoin.¹⁰⁵ The absence of any obligation on the part of the sellers to use their expertise to further the value of the sold Bitcoins again ensures that Bitcoin is not a security under the broad vertical commonality criteria for “common enterprise.”

Courts have repeatedly adopted similar logic in instances where a developer sells plots of land based on representations that the developer will finish a land development, but will not continue to manage it after initial development is complete.¹⁰⁶ Where a seller is “attempting to transfer its entire interest and upon sale [removes itself] from the enterprise, this is not a situation where the seller and buyer [enter] into a common venture dependent for success upon the providing of capital by the buyer and management by the seller.”¹⁰⁷ Thus, when Bitcoin sellers do not undertake to act to increase the value of Bitcoin

¹⁰³ SEC v. SG Ltd., 265 F.3d 42, 49 (1st Cir. 2001)

¹⁰⁴ *Id.* See also SEC v. ETS Payphones, Inc., 300 F.3d 1281, 1284 (11th Cir. 2002) (“Broad vertical commonality . . . only requires a movant to show that the investors are dependent upon the expertise or efforts of the investment promoter for their returns.”).

¹⁰⁵ See *supra* Part V.B.1.

¹⁰⁶ See, e.g., Rodriguez v. Banco Cent. Corp., 990 F.2d 7, 11-12 (1st Cir. 1993) (holding that purchasers of lots of undeveloped real estate were not part of common venture with the promoter who sold the land, despite “strong and repeated suggestions that the surrounding area would develop into a thriving residential community,” because “apart from the promise of an existing lodge or a new country club, the evidence did not show that the promoter or any other obligated person or entity was promising the buyers to build or provide anything”); Woodward v. Terracor, 574 F.2d 1023, 1025 (10th Cir. 1978) (holding that purchasers of lots from a developer were not part of “any common venture or common enterprise” with the developer because the developer “was under no contractual obligation to the plaintiffs other than deliver title once the purchase terms were met” and had no “collateral management contract with the purchasers”).

¹⁰⁷ Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd., 544 F.2d 1059, 1065 (10th Cir. 1976) (holding that purchaser of partial interest in oil and gas lease is not part of common venture with the seller). See also Davis v. Rio Rancho Estates, Inc., 401 F. Supp. 1045, 1050 (S.D.N.Y. 1975) (holding that developer that had no ongoing management obligation after the transfer of title and whose “interest was in recouping their investment, making a profit and moving on” was not part of a common enterprise with the purchaser, regardless of the purchasers’ expectation of profit).

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after the sale, they are not participating in a common vertical enterprise with the purchasers.

3. Strict Vertical Commonality

This strict vertical commonality approach to evaluating the existence of a common enterprise requires that the investors' fortunes be "interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."¹⁰⁸ "It is not necessary that the funds of investors are pooled; what must be shown is that the fortunes of the investors are linked with those of the promoters, thereby establishing the requisite element of vertical commonality."¹⁰⁹ "Thus, a common enterprise exists if a direct correlation has been established between success or failure of [the promoter's] efforts and success or failure of the investment."¹¹⁰

While eliminating the pooling requirement might initially appear to address the primary reason decentralized transfers of Bitcoin cannot be an investment contract, it remains clear that sales of Bitcoin fail the test for strict vertical commonality. Sellers of Bitcoin receive their only compensation at the moment that the Bitcoin is sold; they do not receive additional compensation based on future increases in the value of Bitcoin. Accordingly, the connection between the financial interests of buyers and sellers does not create a vertical commonality of interest.

The importance of the connection between the fortunes of the promoter and the investor was evident in *Brodt v. Bache & Co.*, where the United States Court of Appeals for the Ninth Circuit held that a discretionary commodities brokerage account was not an investment contract "because the success or failure of . . . [the brokerage house did] not correlate with the individual investor's profit or loss."¹¹¹ Rather, the brokerage house was compensated through commissions and "could reap large commissions for itself and be characterized as successful, while the individual accounts could be wiped out."¹¹² There was no direct correlation between the success or failure of the brokerage house, on the one hand, and the individual brokerage account holder, on the other hand; therefore, the court held that the investor's account with the brokerage house did not satisfy the "vertical commonality" test for determining whether such an arrangement constitutes a common enterprise so as to constitute an investment contract.¹¹³ By analogy, because there is no correlation between the future value of Bitcoin and the payment that a seller receives in the sale of Bitcoin, this sale does not satisfy the "vertical

¹⁰⁸ *SG Ltd.*, 265 F.3d at 49 (quoting *SEC v. Glenn W. Turner Enters.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973)).

¹⁰⁹ *SEC v. Eurobond Exch. Ltd.*, 13 F.3d 1334, 1339 (9th Cir. 1994).

¹¹⁰ *Id.*

¹¹¹ *Brodt v. Bache & Co., Inc.*, 595 F.2d 459, 461 (9th Cir. 1978).

¹¹² *Id.*

¹¹³ *Id.*

commonality” test.

C. *Expectation of Profits Solely From Efforts of the Promoter*

The final prong of the *Howey* test requires that a person “is led to expect profits solely from the efforts of the promoter or a third party.”¹¹⁴ In *Forman*, the Supreme Court explained that “[t]he touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”¹¹⁵ “The courts of appeals have been unanimous in declining to give literal meaning to the word “solely” in this context, instead holding the requirement satisfied as long as ‘the efforts made by those other than the investor are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.’”¹¹⁶

Bitcoin fails this test because even purchasers of Bitcoin who make their purchase in anticipation of profits do not expect these profits to result from the action of the promoter. If the expectation of economic return from an instrument is based solely on market forces, and not on the efforts of the sponsor, then the instrument does not satisfy this prong of the *Howey* test.¹¹⁷ Thus, in *Noa v. Key Futures, Inc.*, the Ninth Circuit held that a contract to purchase silver bars was not an investment contract because, “once the purchase of silver bars was made, the profits to the investor depended upon the fluctuations of the silver market” and not on the managerial efforts of a third person, and “the decision to buy or sell was made by the owner of the silver.”¹¹⁸ Purchasers of Bitcoin acquire a commodity like silver, the value of which may fluctuate, but based solely on market forces and not on the efforts of a sponsor or promoter.

VI. CONCLUSION

While no court or government agency has yet opined on whether Bitcoin is a security, based on an analysis of case law applying the definition of “security” under the Securities Act, it appears that Bitcoin is not a security. Bitcoin does not fall within the definition of any common type of security. In addition, Bitcoin does not appear to fall within the broad definition of “investment

¹¹⁴ SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

¹¹⁵ United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (2d Cir. 1975).

¹¹⁶ *SG Ltd.*, 265 F.3d at 55 (quoting SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir. 1973). See also *Lino v. City Investing Co.*, 487 F.2d. 689, 692 (3d Cir. 1973) (holding that “an investment contract can exist where the investor is required to perform some duties, as long as they are nominal or limited and would have little direct effect upon receipt by the participants of the benefits promised by the promoters” (internal quotation marks and citation omitted)).

¹¹⁷ *Noa v. Key Futures, Inc.*, 638 F.2d. 77 (9th Cir. 1980).

¹¹⁸ *Id.* at 79.

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contract” that the Supreme Court articulated in *Howey*.¹¹⁹ A sale of Bitcoin is not an investment contract because a purchase of Bitcoin is not an investment in a common enterprise and because purchasers should not expect to receive profits from their purchase based on the efforts of the seller. As the SEC has made clear, however, securities law is not irrelevant to virtual currency investments.¹²⁰ The SEC has already successfully applied securities law to private investment funds that invest in Bitcoin companies.¹²¹ In addition, the rapidly developing virtual currency ecosystem involves a wide variety of transactions that could involve the sale of securities depending on how these transactions are structured, including fundraising for Bitcoin businesses and for alternative virtual currencies. As a result, we can expect the virtual currency industry to continue to generate novel securities law questions for years to come.

¹¹⁹ *Howey*, 328 U.S. at 298-99.

¹²⁰ SEC v. Shavers, No. 4:13-CV-416, 2013 U.S. Dist. LEXIS 110018, at *3-4 (E.D. Tex. Aug. 6, 2013)

¹²¹ *Id.*