

# Cryptocurrency and the Howey Test

Over a decade ago, cryptocurrency was seen as an academic concept. Today, the current market is worth more than $3 trillion. There is a debate, however, about whether these assets are securities or currencies. One way to understand whether the government can regulate crypto is by using the Howey Test. Knowing how the Howey Test applies to cryptocurrency can help determine whether it will allow government regulation for these investments.

## What Is the Howey Test?

The United States Securities and Exchange Commission (SEC) can step in to regulate assets that are too risky for the average investor. For that reason, many investors wonder whether cryptocurrency is an investment that needs to be controlled by the SEC. If cryptocurrencies are securities, they will be open to regulation. The method to determine whether an investment is a security is known as the Howey Test. According to the United States Securities and Exchange Commission, when a person invests with a reasonable expectation of profits, an investment contract is created. The Howey Test can apply to any transaction, contract, or scheme. If an asset meets specific criteria, it is determined to be an investment contract or security.

If the investment is a security, it is a financial instrument with a type of monetary value that can be traded or sold in a financial market. Some common types of securities include exchange-traded funds, options, bonds, stocks, and mutual funds. All companies that offer securities must register with the SEC, and those that violate any regulations can face penalties from the commission.

The first question to ask is how the Howey Test determines if investments are classified as securities. The Howey Test is one of the most basic tests to determine whether an asset qualifies as an investment contract. To test an asset, the Howey Test asks the following four questions:

* Is it an investment?
* Is there an expectation of profit?
* Is it a common enterprise?
* Is profit derived from others?

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### Is It an Investment?

Many people believe that buying any cryptocurrency token is an investment. However, the website may have nuanced wording, such as “contribute” instead of “purchase.” If the word “purchasing” is used, then it could be construed as an investment. In the Howey Test, if purchasing any digital coins or tokens were deemed an investment, the assets could fall into the security category.

### Is There an Expectation of Profit?

In some cases, the cryptocurrency holder’s expectations may differ from the initial objectives. For example, a person may believe that his or her contribution will lead to a profit, but there were no promises that the token would increase in value. Sometimes, tokens are used as a reward and could, thereby, meet the standards set by the Howey Test. If companies use digital assets in place of shares or dividends, that cryptocurrency could pass this portion of the Howey Test.

### Is It a Common Enterprise?

Under most definitions, a common enterprise will hold a horizontal structure. However, there are three approaches to consider:

* A horizontal structure is when the investor pools money to invest in a specific project
* A vertical structure links the investor’s success to the party that receives the investment
* A broad vertical structure relies on the expertise of a promoter or third party

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### Is Profit Derived from Others?

If the profit from the token is outside the control of the individual holder, then it could meet this criterion. However, many digital tokens or coins are considered open source and belong to a broader community. On this basis, cryptocurrency is decentralized, meaning that any individual could impact another person’s investment return. In many cases, cryptocurrency returns are driven by a limited number of holders, such as miners and institutions. These individuals could have a significant impact on cryptocurrency.

In some cases, cryptocurrencies could be considered a security. However, if they replace sovereign currencies, like the euro or the dollar, they are not a security. One popular digital token is Bitcoin. This coin does not pass the Howey Test. While it does meet the first criteria, it does not satisfy the second or third questions. Bitcoin is not a joint enterprise, and the coin is not reliant on others to increase its value.

According to the United States Securities and Exchange Commission, an initial coin offering (ICO) could be considered a security. The first prong of the test is satisfied since it sells and offers a digital asset in exchange for something of value. Next, United States courts have determined that the “common enterprise” exists with these offerings. The preliminary determination depends on whether any investor expects profits from the ICOs and whether those profits come from the work of others. If an ICO meets those elements, it is subject to SEC regulation.

As of today, however, most ICOs do not pass the Howey Test. Instead, they are considered utility tokens. These tokens work like digital coupons to allow investors to access a future service or product for a smaller fee. However, that does not mean all digital coins or tokens are free from SEC scrutiny. The commission has begun to levy fines against those unregistered digital assets that can qualify as securities.