

## Are Stablecoins Securities?

Stablecoins—cryptocurrencies that aim to maintain stable value relative to a benchmark such as a commodity, a fiat currency, or a basket of assets like real estate—have recently exploded in prominence. The stablecoin market cap doubled in just four months in 2020, with total dollar-pegged stablecoin supply reaching \$100 billion as of May 2021. This increased prominence raises the question of whether stablecoins satisfy the U.S. Supreme Court’s test in *SEC v. W.J. Howey Co.* 328 U.S. 293, 298-99 (1946), which the SEC and lower courts have applied to evaluate whether cryptocurrencies constitute an “investment contract,” and hence securities subject to the securities laws and SEC oversight. What is now well-known in crypto circles as the “*Howey* test” finds there to be an investment contract if: “a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party.” SEC Chairman Gary Gensler has emphasized that the SEC will focus on this exact question in the years to come, and particularly on stablecoins the SEC views as derivatives of securities. *See* Prepared Remarks of Gary Gensler at the American Bar Association, July 21, 2021.

Two important federal district court decisions applied the *Howey* test to “non-stable” cryptocurrencies in 2020: *Sec. & Exch. Comm’n v. Telegram Grp. Inc.*, 448 F. Supp. 3d 352 (S.D.N.Y. 2020) (“*Telegram*”), and *Sec. & Exch. Comm’n v. Kik Interactive Inc.*, 492 F. Supp. 3d 169 (S.D.N.Y. 2020) (“*Kik*”). In *Telegram*, the Southern District of New York granted the SEC’s request for an injunction preventing the distribution of “Gram” tokens by Telegram Group Inc., finding that Telegram’s initial private sale, coupled with the potential for public resale, constituted a scheme to distribute unregistered securities. *Telegram*, 448 F. Supp. 3d at 352. Then, in September 2020, the Southern District of New York again ruled in favor of the SEC at summary judgment in *SEC v. Kik Interactive Inc.*, finding that the “Kin” tokens that Kik had offered and sold through a pre-sale and initial coin offering also constituted securities. *Kik*, 492 F. Supp. 3d at 169.

Of note, the biggest current non-stablecoin case being litigated under *Howey* – whether the cryptocurrency XRP is a security – is in midstream, with Ripple Labs vigorously contesting the SEC’s case, and winning various pretrial discovery battles along the way. *Securities & Exch. Comm’n v. Ripple Labs Inc.*, No. 1:20-cv-10832 (S.D.N.Y. Dec. 22, 2020). Yet no court has analyzed *Howey* as applied to stablecoins (XRP is not a stablecoin), meaning that stablecoin projects need to try to predict how a court would apply the *Howey* test without direct precedent.

Many stablecoin projects share similarities with other cryptocurrency projects with respect to the first, second, and fourth prongs of the *Howey* test as applied in *Telegram* and *Kik*. Regarding prongs one and two, for example, both *Telegram* and *Kik* noted there was no dispute that an investment of money had occurred. They both also held that defendants had established a common enterprise given they had pooled money earned from initial offerings and used it to fund their operations and develop their blockchain systems. Numerous stablecoin projects are arguably similar in this respect, given they offer stablecoins for other currencies, then use those to fund the operations and development of a blockchain ecosystem. Stablecoin projects are also potentially implicated by *Howey*’s fourth prong. This prong states that the expectation of profits should stem “solely from the efforts of the promoter or a third party,” but lower courts have adopted a more relaxed test, and will ask whether the “reasonable expectation of profits [were] derived from the entrepreneurial or managerial efforts of another.” *Telegram*, 448 F. Supp. 3d at 375. Many centralized stablecoin projects—which are algorithmic, crypto-collateralized, and fiat-collateralized—would arguably meet this version of the “efforts of another” prong, given stabilization

mechanisms generally rely on the minting entity's efforts in initial development and ongoing management and verification. However, not all stablecoin projects may be treated equally, and may not be treated equally at different points in their life cycles. An argument could be made that a purely algorithmic stablecoin project would not meet this prong, at least after the algorithm was operating successfully, thereby eliminating the ongoing management and verification that was at play in *Telegram*. This dividing line was reflected in the no action letters issued by the SEC to TurnKey Jet, Inc. and Pocketful of Quarters, Inc. See TurnKey Jet, Inc., SEC No-Action Letter (Apr. 3, 2019); Pocketful of Quarters, Inc., SEC No-Action Letter (July 25, 2019). In reaching its recommendation for nonenforcement, the SEC noted that Turnkey and Pocketful would not use any funds derived from the sale of the tokens to develop the associated token networks, which were to be fully operational upon any sale of the tokens, and the tokens would be immediately usable for their intended purpose at the time they are sold.

The third prong in the *Howey* Test—whether an individual is led to expect profits—is one of the most discussed and is where stablecoins are more likely to diverge from other cryptocurrencies. *Telegram* held that an investor possesses an expectation of profit when her motivation to partake in the relevant scheme is the prospect of a return on investment, even where that motivation is secondary to a motive unrelated to profit. *Id.* at 371. In evaluating the expectation of profit, *Telegram* discounted the initial purchasers' legal disclaimers of an intent to resell, finding sufficient evidence of such intent in the "economic realities" of the sale, including the initial sale of Grams at a discount relative to the expected market price in a post-launch public market. *Id.* at 372. *Kik* likewise analyzed the economic realities underpinning the Kin offering, finding a reasonable expectation of profit where purchasers depended on a centralized entity, there Kik, to ensure that the coin's "consumptive use," and hence value, would materialize. 492 F. Supp. 3d at 178. Stablecoins are certainly distinguishable from the "non-stable" cryptos at issue in *Telegram* and *Kik*—where cryptocurrencies have become vehicles for high-growth, high-risk investment, stablecoins aim for constancy. Nevertheless, the *Telegram* and *Kik* courts' flexible reasoning and focus on economic realities might allow the SEC or private counsel the latitude necessary to argue that *Howey* is applicable to stablecoins. Algorithmic stablecoins that must ramp up to a stable value sometimes offer discounted sales prior to successful stabilization. These sales may support an argument that initial purchasers, despite formal disclaimers by issuers and purchasers alike, buy with the intent for resale following stabilization at the higher price. Likewise, stablecoins pegged to assets other than fiat (such as gold, a consumer price index, or diamonds, for example) may be analyzed to assess whether potential growth in the value of the underlying asset is sufficient evidence of an expectation of profit under *Telegram*'s realities-driven analysis. Stablecoins also present possible opportunities for profit through arbitrage. For example, the March 12<sup>th</sup>, 2020 collapse in bitcoin prices drove investors to the safe-harbor of stablecoins, increasing demand and causing the price of most dollar-pegged stablecoins to jump up to between \$1.03 and \$1.06, opening profit opportunities for holders willing to sell. If "investors" in fiat-pegged stablecoins can expect to sell their holdings in excess of the peg during downturns in the crypto market, this, arguably, may be a sufficient expectation of profit under *Telegram* and *Kik*. Finally, as Chairman Gensler has recently emphasized, stablecoins whose value is backed directly or synthetically by an instrument deemed to be a security, whether equities or other cryptocurrencies, may face enforcement action or civil litigation under the theory that, in economic reality, the stablecoin is simply a derivative of a security.

Successive extensions of the *Howey* test have raised as many questions as they have answered for cryptocurrencies, including stablecoins. The complexity of the findings of the *Telegram* and *Kik* opinions continue to demonstrate the opacity of the regulatory landscape. It continues to be difficult to draw broader conclusions or extrapolate rules or principles from enforcement actions that, as the *Telegram* court notes, are specific to the facts of a particular project and digital asset. However, as discussed above, the SEC, plaintiffs' counsel, and stablecoin issuers must all take notice of the trends signaled in *Telegram* and *Kik* as they adapt to the shifting lines and rationales that separate securities from non-securities.