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Security Or Commodity? Cato Institute Rolls Out Dual-Tier ICO Regulation Proposal

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U.S. regulators should lay out clear rules dictating when a cryptocurrency issued in an initial coin offering is considered a security and when it is a commodity, a new Cato Institute brief urges.

The report, authored by Diego Zuluaga - a policy analyst at Cato's Center for Monetary and Financial Alternatives, recommends that classification of offerings promising future delivery of a crypto-token center on whether or not they are marketed as an investment and tradeable on a secondary exchange prior to product launch.

The first level of this two-tiered proposal would be an offering in which a cryptocurrency is marketed as an investment, delivered to the buyer and able to be traded on an exchange prior to launch. This would meet the four prongs of the Howey Test and be considered a security.

On the other hand, a token that is marketed as a non-tradeable advance purchase of a commodity - for which the buyer would be refunded if the application fails to go live - would be classified as a commodity as long as no physical delivery of a token is involved.

Zuluaga explained:

“Contracts that fit the second set of criteria would be closer to forward contracts because they would involve the physical delivery of the cryptocurrency to the contract buyer when the application became functional. They therefore would not qualify as securities.”

Additionally, the proposal suggests that functioning cryptocurrencies already in circulation should be deemed commodities and fully differentiated from offerings that involve the promise of future delivery.

Clarity Critical

Such an approach would strike the right balance between concerns over fraud and consumer protection while ensuring that the benefits of ICOs as a new vehicle for democratized capital formation are realized in the United States."

"An overzealous application of securities laws to cryptocurrencies could raise barriers to investor access and capital formation, which would have a chilling effect on the development of cryptocurrency technology and markets," Zuluaga warned, emphasizing that a "clear, reasonable and appropriate" definition of what is and is not a security would allow markets to grow and regulators to fulfill their mission of protecting consumers.

He continued:

“Regulators can achieve their objectives by designating existing cryptocurrencies, such as bitcoin and ether, as commodities and by clearly describing the circumstances under which contracts for future cryptocurrencies will meet the Howey test."

Zuluaga also emphasized that despite progressive actions taken by states such as Wyoming, which passed legislation exempting certain tokens from securities requirements earlier this year, a federal level solution is required because of cross-border trading and preemption issues.

"[E]ven if more states undertook measures similar to Wyoming’s, the prospect of a more restrictive policy from federal regulators would perpetuate policy uncertainty, as federal regulation could preempt lighter state-level regimes," he concluded.