Identifying Investment Contracts, From Chinchillas To Crypto

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Almost all business ventures involve someone investing money for the purpose of earning a profit. In many cases, multiple investors pool their money into an entity or into the hands of a smaller group of individuals who are tasked with turning a profit. In these circumstances, it is important to ask whether the investment opportunity constitutes a "security" for purposes of state and federal securities laws. If an investment is a "security," those involved must comply with federal and state securities laws in connection with the original issuance and any subsequent transfer of the investment. For example, most securities transactions must be registered or satisfy a registration exemption. Also, anti-fraud rules apply to securities transactions, and state and federal securities regulators have jurisdiction over them. In addition, pooled investment entities that are investing in securities may be required to register as investment companies and those selecting the investments by such entities may need to register as investment advisers. The failure to comply with these requirements may have significant consequences and may trigger, among other consequences, rescission rights, damages, and civil penalties under federal and state law.

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When examining an investment opportunity, the starting point is the definition of "security" under the Securities Act of 1933.[1] Many of the instruments contained within that definition are easily identifiable, such as "stock" and a "note." However, the definition also contains a catch-all category referred to as an "investment contract." To determine whether an investment is an "investment contract," federal courts use the test laid out in U.S. Securities and Exchange Commission v. W.J. Howey Co. and its progeny: An investment contract exists when a transaction involves (1) an investment of money, (2) in a common enterprise, (3) with profits to come solely from the efforts of others, based on the facts and circumstances.[2] Usually, the analysis will focus on the third prong, as the first two prongs more often are found to be present.

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Because of the broad reach of the Howey test, investment contracts can arise in essentially any circumstance. For example, interests in a pooled investment entity such as a limited liability company or partnership often constitute investment contracts.[3] Contractual arrangements may also constitute investment contracts. As an example, the Howey case involved the sale of a citrus grove coupled with a service contract where the seller had exclusive control over the land and the growing and selling of the citrus fruit, and the seller shared any profits with the purchasers.[4] The court found that this arrangement constituted an investment contract because the purchasers had no involvement with the land or the citrus operation, and any profits were derived solely from the efforts of the seller.[5] Fast forward to 2017 when many nonsecurities lawyers may have been surprised to read in the SEC's so-called DAO report that high-tech digital assets such as cryptocurrencies should be analyzed using the Howey test and may constitute investment contracts.[6]

The following are other illustrative examples of investment opportunities analyzed by courts under the Howey test:

Condos: The sale of condominium units or other real estate coupled with other contracts such as “rental pool” arrangements where the manager rents out the property when it is unoccupied by the owner could be viewed collectively as an investment contract if offered together, but otherwise likely are not.[7]

Lottery Pools: Interests in a lottery pool where individuals combined their funds for a manager to use to purchase lottery tickets and distribute winnings were found to be investment contracts.[8] However, paying a fee to an “application processor” to enter an applicant in a lottery system used for awarding certain leases may not be an investment contract.[9]

Gold Coins: Contracts for the purchase of gold coins from gold that was yet to be mined during a time of high inflation was found not to be an investment contract due to the expectation of profits coming primarily from market forces.[10]

Payphones: The sale and leaseback of payphones that were managed and maintained by the seller/lessee was found to be an investment contract.[11]

Worm Farms/Chinchillas: Purchasers of worm farms/chinchillas with an agreement with the seller for the seller to repurchase the offspring was found to be an investment contract.[12]

Three recent SEC enforcement actions illustrate the pitfalls of failing to identify an investment opportunity or venture as involving the sale of securities.

First, in SEC v. Contrarian Investments LLC and SEC v. Nevada Sports Investment Group LLC, on Sept. 10, 2018, the SEC announced the filing of settled charges against two Nevada sports betting funds alleging that the funds had violated the registration requirements of the Securities Act.[13] The two funds operated under a 2015 Nevada law that allows entities to solicit and collect funds from individual investors, aggregate those funds, place wagers on certain sporting events, and split the wagering profits among the investors.[14] The SEC alleged that the betting funds sold securities without proper registration or exemption under the securities laws.[15] The offer and sale of a security must be registered with the SEC and state securities regulators or qualify for an available exemption under the Securities Act. In their charging documents, the SEC noted that investors provided money to the funds, the funds represented that they would use the funds to place wagers and share the profits with investors, each of the funds was controlled and operated by the fund’s managing member or general partner, respectively, and the managing member or general partner decided how funds would be wagered and the investors played no role in the profit-generating process of placing wagers.[16] These factors presumably satisfy all of the prongs of the Howey test. Each of the funds settled with the SEC, without admitting or denying the SEC’s findings, and consented to the entry of a judgment ordering a permanent injunction against future violations of the registration provisions of the Securities Act.[17]

Second, in the Matter of Crypto Asset Management LP and Timothy Enneking, the SEC announced settled charges against a hedge fund manager that operated a fund investing in cryptocurrencies.[18] The SEC alleged that the fund raised capital from investors by selling partnership interests constituting investment contracts without registration or valid exemption, and through the use of material misrepresentations.[19] In addition, this is also the SEC's first action against a cryptocurrency fund for failing to register as an investment company. Generally speaking, the Investment Company Act of 1940 requires an issuer engaged in the business of investing, reinvesting, owning, holding or trading in securities to register as an investment company subject to certain conditions and exemptions.[20] The SEC alleged that the fund's cryptocurrencies in question constituted investment contracts, thereby subjecting the fund to the Investment Company Act's registration requirement.[21] The fund had failed to register, did not meet any statutory exemption or exclusion, and did not seek an exemptive order from the SEC.[22] In addition to being ordered to cease and desist from committing future violations, the respondents were censured, and they agreed, jointly and severally, to pay a $200,000 civil penalty.[23]

Lastly, in the Matter of Tokenlot LLC, Lenny Kugel and Eli L. Lewitt, on the same day as announcing the action involving the cryptocurrency fund, the SEC also announced settled charges against a limited liability company and its founders for acting as unregistered broker-dealers in the cryptocurrency space.[24] The SEC alleged that the respondents promoted and sold digital tokens that constituted investment contracts requiring them to register as broker-dealers with the SEC.[25] The Securities Exchange Act of 1934 generally requires any broker or dealer effecting transactions in, or inducing or attempting to induce the purchase or sale of, any security to be registered with the SEC.[26] The Exchange Act generally defines a "broker" to mean any person engaged in the business of effecting transactions in securities for the account of others, and generally defines a "dealer" to mean any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise.[27] In this case, the respondents had violated the securities laws as unregistered brokers by promoting and selling digital tokens constituting securities on behalf of others for compensation, and as unregistered dealers by buying and selling digital tokens constituting securities on their own behalf.[28] The SEC also alleged that the respondents violated the registration provisions of the Securities Act.[29] In addition to being ordered to cease and desist from committing future violations, the respondents, jointly and severally, agreed to disgorge $471,000 in profits and to pay $7,929 in interest.[30] Each of the founders also agreed to pay a $45,000 civil penalty, and agreed to industry bars and to not participate in penny stock offerings for three years.[31]

As these recent cases illustrate, securities law violations and significant consequences may arise as a result of failing to identify that a business venture involves the sale of securities.[32] Accordingly, when structuring a business venture that involves any type of capital-raising transaction, it is important to ensure that the venture complies with federal and state securities laws.

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as legal advice.

[1] 15 U.S.C. § 77b(a)(1).

[2] 328 U.S. 293, 301 (1946).

[3] This article does not discuss interests in partnerships and limited liability companies as investment contracts; that topic was covered in a prior Law360 article: https://www.law360.com/articles/956212/when-are-llc-interests-securities-

[4] See supra note 2.

[5] Id. at 209-301.

[6] See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Securities Exchange Act of 1934 Release No. 81207 (July 25, 2017) (concluding that digital tokens entitling purchasers to vote and share in profits derived from "projects" the organization would fund was an investment contract because (1) purchasers of the tokens invested money in the form of ether, (2) purchasers expected profits from the "projects," and (3) such profits would be derived from the efforts of the founders of the organization and "curators" that would approve "projects"). See also Munchee Inc., Securities Act of 1933 Release No. 10445 (Dec. 11, 2017) (concluding that digital tokens sold to be used in a digital "ecosystem" and to-be-developed smartphone app to be an investment contract).

[7] See, e.g., Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development, Securities Act Release No. 33-5347 (Jan. 4, 1973); Hocking v. Dubois, 885 F.2d 1449 (9th Cir. 1989) (en banc); Intrawest Corporation, no-action letter (Nov. 8, 2002); Salameh v. Tarsadia Hotels, 885 F.2d 1449 (9th Cir. 2013).

[8] See 537721 Ontario Inc. v. Mays, 14 Kan. App. 2d 1, 780 P.2d 1126, rev. denied 245 Kan. 785 (1989).

[9] See State Dept. of Finance v. Resource Service Co. Inc., 130 Idaho 877, 950 P.2d 249 (1997), reh'g denied, (Feb. 5, 1998).

[10] See SEC. v. Belmont Reid, 764 F.2d 1388 (9th Cir. 1986).

[11] See SEC. v. ETS Payphones Inc., 123 F.Supp. 1160 (N.D. Ga. 1995).

[12] See Smith v. Gross, 604 F.2d 639 (9th Cir. 1979); Miller v. Central Chinchilla Group Inc., 494 F.2d 414 (8th Cir. 1974).

[13] SEC v. Contrarian Investments LLC, No. 02:18-CV-01725 (D. Nev.) filed Sept. 7, 2018; SEC v. Nevada Sports Investment Group LP, No. 02:18-CV-01726 (D. Nev.) filed Sept. 7, 2018.

[14] Contrarian Investments at 2, 4–5; Nevada Sports Investment Group at 2, 4–5.

[15] Contrarian Investments at 1, 3–4; Nevada Sports Investment Group at 1–3, 6–7.

[16] Contrarian Investments at 5–6; Nevada Sports Investment Group at 5-6.

[17] Contrarian Investments at 8; Nevada Sports Investment Group at 8.

[18] In the Matter of Crypto Asset Management LP and Timothy Enneking, SEC Order (Sept. 11, 2018).

[19] Id. at 3-4.

[20] 15 U.S.C. § 80a-3, 80a-7.

[21] Crypto Asset Management at 3.

[22] Id.

[23] Id. at 5.

[24] In the Matter of Tokenlot LLC, Lenny Kugel and Eli L. Lewitt, SEC Order (Sept. 11, 2018).

[25] Id. at 4-5.

[26] 15 U.S.C. § 78o.

[27] 15 U.S.C. § 78c(a)(4); 15 U.S.C. § 78o(a)(5).

[28] Tokenlot at 4-5.

[29] Id. at 3-5.

[30] Id. at 8.

[31] Id. at 8-9.

[32] It is worth noting that other securities law violations also may arise. For example, a manager, managing member or general partner of an entity found to be investing in securities who is compensated for managing the entity's investments could be an investment adviser subject to registration under the Investment Advisers Act of 1940. See 15 U.S.C. § 80b-2(a)(11); 15 U.S.C. § 80b-3(a).