

High Noon For Cryptocurrency Offerings In Texas?

By **Philip Bezanson and David Springer** (March 20, 2019, 2:29 PM EDT)

On Feb. 21, 2019, Texas state securities regulators entered a first-of-its-kind consent order against several out-of-state companies that offered cryptocurrency mining-based investments. The order determined that the investments were “securities” under Texas law, and that neither the offerors nor the securities had been registered with the state.

The U.S. Securities and Exchange Commission has been taking aggressive steps in the crypto-investment space over the past two years, but Texas is believed to be the first state to levy a monetary fine against the offerors of cryptocurrency-based investments. Taking a cue from recent SEC actions, Texas also became the first state to require the offerors to contact investors with a rescission offer for the full amount of their investments, less any profits.

Background

Countless articles have been published about the basics of cryptocurrency mining, but in essence, transactions of cryptocurrency like bitcoin and Ethereum are recorded in a public cryptographic ledger, or blockchain. The use and integrity of the ledger requires computers to continually solve complex math problems.

To incentivize people to devote computing power to this task, units of cryptocurrency are awarded to those who allocate computing power to solve the math problems. This process of devoting computer power in exchange for cryptocurrency is called mining.

Texas Enforcement Action

Mintage Mining described itself as a “collaborative crypto mining platform” that “mine[s] the most current coins on the most state-of-the-art hardware.” According to the Texas State Securities Board, or SSB, Mintage Mining and apparently related entities in Utah and Nevis^[1] offered “Hash Rate Units” and “open-ended hardware rental” units that were tied to cryptocurrency mining.

The units were described by the SSB as contracts that entitled purchasers to a share of net mining revenue. For example, individuals could purchase units that entitled them to a share of weekly mining revenue, minus hosting and management fees, that resulted from the mining efforts of a single piece of



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hardware. The minimum initial investment was just \$25.

Advertisements for Mintage Mining claimed that the company's cryptocurrency mining efforts could generate annual returns up to 250 percent. Advertising efforts also included the use of multi-level marketing; affiliates could earn commissions by recruiting new investors to buy units. Further, the SSB found that Mintage Mining told investors that Mintage was "in compliance" with securities laws and "works to always stay ahead of cryptocurrency regulation."

Yet the SSB concluded that the units were "securities" as defined by the Texas Securities Act and that neither the units (alleged to be securities) nor the offerors were registered with the state. The Texas Securities Act's list of items that are defined as "securities" is lengthy and includes "any certificate or instrument representing or secured by an interest in any or all of the capital, property, assets, profits or earnings of any company, investment contract, or any other instrument commonly known as a security."

The SSB asserted that Mintage Mining violated Sections 7 and 12 of the act, which respectively prohibit the offering of nonexempt securities for sale in Texas that have not been registered with the Securities Commissioner and the offering of securities for sale in Texas by an offeror who has not registered with the Securities Commissioner.

Partially superseding an emergency cease and desist order that the SSB entered last summer, the consent order required the parties involved to collectively pay a \$25,000 fine to the state, and to contact Texas investors with a rescission offer for the full amount invested minus any profits that were paid. The consent order "is the first cryptocurrency enforcement action by a state regulator resulting in payment of a fine and a full rescission offer," according to the SSB.

The Mintage Mining case is one of 18 cryptocurrency-related enforcement actions taken by the SSB in recent years.

Relationship to Federal Efforts

The spate of Texas enforcement actions parallels the work of the SEC, which has been increasingly assertive in the cryptocurrency space. The SEC has taken action in approximately 30 digital asset cases since 2012.

Those cases involved a broad range of alleged fraud and nonregistered offerings, and at least one shares several factual similarities to Mintage Mining. In 2015, the SEC took action against bitcoin mining companies that attempted to sell "\$20 million worth of purported shares in a digital mining contract they called a Hashlet" in what the SEC deemed to be an unregistered offering.

A common thread between state and federal efforts has been the assertion that digital assets can and will be deemed "securities" and will therefore be subject to various securities laws. In 2017, SEC Chairman Jay Clayton issued a forceful warning to would-be investors in, and offerors of, cryptocurrency and other digital assets. Clayton observed that some market professions had attempted to recast offerings as something other than securities, but those "assertions appear to elevate form over substance. Merely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security."

He said that the SEC concluded such offerings "represented an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or

managerial efforts of others,” and were therefore securities subject to applicable law.

Mintage Mining may have attempted to position its offerings as opportunities that were separate from “securities” by casting the investment as an “open-ended hardware rental” — the implication possibly being that purchasers were merely buying rental time on mining hardware, and would simply retain the proceeds that they earned from using the rented equipment. That issue was noted in an expert report by the SSB’s Director of Enforcement.

He concluded: “When disregarding the technical labels and terminology used by Respondent Mintage Mining, the investments in the Open-Ended Unit Investment Program were substantively similar to these securities insofar as investors tendered the same amount of money to receive the same stake in the underlying venture and to share in the same profits from the underlying venture.” While not discussed in the consent order, the SSB seems to be taking a clear position that it believes attempts to “elevate form over substance” will not evade Texas securities laws.

Texas law defining what constitutes a security is quite similar to federal law. Notably, the U.S. Supreme Court’s *Howey*[2] test, which is the foundational test for what constitutes an investment contract for purposes of the Securities Act of 1933, has been adopted by Texas courts.[3]

Drawing heavily on federal precedents, the Texas Supreme Court recently derived three key principles to guide its application of the *Howey* test to a transaction:

- “First, we must broadly construe the term 'investment contract' to maximize the protection the Act is intended to provide to the investing public.”[4]
- “Second, we must focus on the 'economic realities' of the transaction to determine whether it meets the test’s requirements.”[5]
- “And third, if the 'economic realities' satisfy the requirements, we must conclude that the transaction is an 'investment contract' regardless of the labels or terminology the parties used to describe it.”[6]

The Texas Supreme Court’s recent consideration of what constitutes a security had nothing to do with cryptocurrency, but it is almost inevitable that at some point, a Texas state court will have to apply those principles to a crypto case.[7]

Long Arm of the Law

It is not novel or controversial for Texas securities regulators to take action against an out-of-state company that offered unregistered securities to Texans. And the question presented by Mintage Mining — namely, what is a security — is analyzed similarly under Texas and federal law. But that might not always be the case.

As the SSB continues its enforcement campaign in the highly dynamic cryptocurrency space, Texas courts and regulators might soon be forced to address novel issues that may not so closely track federal law. Texas’ apparent eagerness to police crypto offerings — even where, as in Mintage Mining, “few Texas residents” participated — will, along with similar efforts by other states, continue to complicate the regulatory environment for crypto.

Perverse Incentive?

State and federal regulators will likely continue to identify and pursue outright frauds; however, in a market where innovation and technology move fast, policing the more esoteric and technical aspects of securities laws could prove more difficult. Absent clear guidelines — like those published by the SEC[8] — and continued dialog about innovation, future offerors who are trying to comply with black letter law, avoid the missteps of early crypto offerings and generally do right by their investors may take a less-is-more approach to disclosure.

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[1] The SSB’s conclusions distinguish between the actions of the several entities, but for reader convenience, this article uses Mintage Mining to refer generally to Respondents Mintage Mining LLC, BC Holdings and Investments, Social Membership Networks Holding, NUI Social and an individual person.

[2] SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

[3] Searsy v. Commercial Trading Corp., 560 S.W.2d 637, 640 (Tex. 1977) (adopting the Howey test as restated in United Housing Foundation Inc. v. Forman, 421 U.S. 837 (1975).

[4] Life Partners Inc. v. Arnold, 464 S.W.3d 660, 670 (Tex. 2015) (internal quotations and citations omitted).

[5] Id.

[6] Id.

[7] At least one federal court has done so. See SEC v. Shavers, No. 13-CV-416, 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013) (finding that particular bitcoin-related investments met the definition of investment contracts and, as such, were securities).

[8] The SSB is making progress, too. It has posted the Director of Enforcement’s expert report mentioned above as “guidance to the industry on the applicability of securities laws to cryptocurrency-related investment offerings.” <https://www.ssb.texas.gov/news-publications/commissioner-fines-crypto-investing-firms-obtains-repayment-investors>; https://www.ssb.texas.gov/sites/default/files/SOAH_Symatri_Rotunda.PDF.