Angels and Devils: The Early Crypto Entrepreneurs

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Angels and Devils: The Early Crypto Entrepreneurs

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This post is a summary of a paper that was selected for inclusion at the inaugural Digital Assets at Duke Conference at Duke University on January 20 and 21.

The past year was not a good one for crypto, with Sam Bankman-Fried’s massive fraud through FTX/Alameda, Do Kwon’s failed algorithmic stablecoin experiment (Terra Luna), and the many ancillary bad apples in the same orbit, including Celsius and Three Arrows Capital. My new paper is the first to look at the actions of individuals in the crypto space and tie them to the Howey test to determine if we can preordain the bad actors and have the Securities and Exchange Commission (SEC) regulate the tokens they issue, while allowing the good actors to operate under the lighter touch Commodity Futures Trading Commission (CFTC) rules. My paper reinterprets the way courts and the SEC should apply the Howey test to preordain angels and devils before future devils can cause harm going forward.

Why do the actions of crypto entrepreneurs matter? The earliest crypto entrepreneurs – Satoshi Nakamoto (Bitcoin) and Vitalik Buterin (Ethereum) – look like the angel investors that have long funded traditional startups. Those angel investors engage in “for-profit philanthropy,” investing financial capital in startups but also contributing value-added services that go beyond money. Nakamoto and Buterin exhibited many characteristics of traditional angel investors, even as crypto entrepreneurs. They invested substantial time and money creating something that others could build upon – blockchain networks. While their relative contributions of financial and human capital differ (angel investors more financial capital, crypto entrepreneurs more human capital), their similarities in purpose transcend those differences and allow a useful analogy. The common denominator is that it is more about the technology and advancing innovation than pure profit.

Where an angel sits on one shoulder, a devil sits on the other. For every crypto angel who adds meaningfully to advancing blockchain innovation and the crypto space, there is a devil doing the opposite. These are the scammers that graft on the system as a whole. Crypto devils may have started out as such, running traditional Ponzi schemes dressed up under the cover of blockchain from the get-go. For example, Bulgaria’s OneCoin never had a functioning blockchain and was sold using the same method (multi-level marketing) as Tupperware. FTX and Terra Luna are more complicated cases and may involve crypto creators who did not start out as devils but became them along the way (“fallen angels”). As more is revealed about Bankman-Fried and FTX, perhaps that whole operation will be revealed as devilish from the start.

The Howey test – the lynchpin for finding an investment contract and giving the SEC jurisdiction to regulate – has four prongs, and this Article contends that two of those prongs should be reinterpreted in light of the outsized importance angels and especially devils are having in this space. First, courts and the SEC now interpret the Howey test to ask if a crypto buyer “expected a return” from her purchase. Instead, the test should ask whether the buyer was led to expect a return. In
other words, did the crypto creator market their token to investors focusing on potential riches instead of marketing the technology, or not marketing at all? This is really what devils do – they promote and tout potential riches, whereas angels focus on the technological advancements the blockchain makes possible.

Second, when asking whether an investor’s expectation of returns depended on the efforts of others—the key inquiry in digital asset cases to date—we are asking about crypto’s core claim of decentralization. Was the blockchain network set up to run without a central actor like the Bitcoin blockchain, or was there a native token controlled and manipulated by a centralized entity. The native FTX token, FTT, was centralized and controlled by Bankman-Fried since the get-go and is thus a security. Binance’s BNB is more mysterious but potentially the same from a legal perspective. Also, for this all-important Howey prong, there is an open question of whether we are asking about pre- or post-launch Initial Coin Offerings as satisfying the “efforts of others” inquiry. That is, are we talking about efforts to create the blockchain and token from the outset, or ongoing efforts once the blockchain is up and running and the token is being traded? If we focus on angels and devils, we know the answer: Angels set up decentralized networks designed to run autonomously after launch—perhaps with a grace period to become truly decentralized—while devils retain control even after setup and continue being key to the network’s success. The focus on angels and devils leads us to the right answer on when the important efforts of others must occur to meet Howey: after setup and implementation.

Under the Howey test as re-interpreted – which is possible for courts and the SEC to do right now with no further changes to the law – digital assets that are not promoted as get-rich-quick schemes and serve a truly decentralized blockchain should be commodities regulated by the CFTC. A devil’s token, on the other hand, touted for its financial potential and kept under control of a centralized party, would be a security and thus subject to SEC registration procedures and enforcement actions for noncompliance. This re-interpreting of the Howey test to account for angels and devils will strike the proper balance of allowing the SEC to protect investors from scams while allowing truly decentralized digital assets to be governed by the lighter-touch CFTC.

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This post is adapted from his paper, "Angels and Devils: The Early Crypto Entrepreneurs," available on SSRN.